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The Truth Behind Mortgage Insurance

September 18, 2012 by Diane

When you buy a home and secure your mortgage, one of the first questions out of your broker or lender's mouth is: "Shall I sign you up for mortgage insurance?"

At this point, the form is usually already out on the table, complete with a guilt -infused pitch on just how badly you need this coverage. Not only that, but the process is made incredibly easy for you: simply sign the paper, and your premiums will be deducted from your mortgage payments each month. You're asked a few basic questions on the spot, but otherwise the entire experience is non-invasive.

However, there are concerns about mortgage insurance and many experts suggest getting life insurance instead. But why?

Let's outline how it works

What's The Difference?

Mortgage insurance is tied to your mortgage. It will pay out the entire mortgage in the event of your death (or disability in some cases) to the bank. Sounds great: something happens to you, the mortgage goes away and your family can move on with their other concerns without the giant looming expense of their home. The insurance must also be renewed along with your mortgage renewals.

Life insurance, meanwhile, is purchased in a set term (often 20 years or more) to cover you for a set amount of money. If you die and your insurance is for $500,000, your beneficiary gets that amount upon your death. You choose the term based on your age and when you feel your expenses will go down (your house is paid off, kids are grown, etc.). You buy this insurance once and make your payments each month and it never changes or goes away for the length of the term. You often have to do a physical and fill out a comprehensive questionnaire when you apply and your rates are impacted by your state of health when you apply.

Who Needs Insurance?

If you live alone, say in a condo, you probably don't need any life insurance. "At death, the condo would be sold and the mortgage paid off and any residual equity would form part of their estate and pass on to beneficiaries," says Dylan Reece, financial advisor with Nicola Wealth Management in Vancouver. "Why pay for life insurance in the meantime?"

Those with spouses or children who would very much require financial resources in the event of death are those most in need of life insurance. The insurance should cover both your debt and your income for a period of time.

Top Reasons NOT To Buy Mortgage Insurance

By now, you're probably wondering – why wouldn't coverage on your mortgage be a good idea? Here are a number of reasons why this kind of coverage isn't always in the best interest for the policy holder:

Lack of Flexbility

Mortgage insurance expires when your mortgage does, and you must reapply. Should an unexpected occurrance strike in the meantime – like a heart attack – your rates will skyrocket.

Life insurance, on the other hand, travels with you no matter what's going on in your life, and should your health deteriorate (which it very well could over a few decades), your premium stays the same. Another factor to consider is equity; when you pay off your mortgage, your insurance coverage goes with it. With term insurance, you can get enough coverage (and you can extend your term or add to your mortgage as you go) to both pay off your home and provide money for your family.

Who’s Getting The Money?

With mortgage insurance, the bank is the beneficiary. After all, they’re the ones absorbing the loss should you default on your mortgage payments. With term, you can choose the beneficiary, including a spouse or even a parent. That person can do with the money whatever he or she sees fit: pay off the mortgage, finance your funeral, invest or live off it.

Assessing The Costs of Coverage

While the price of mortgage vs. term can be comparable, the benefits from those costs are not. While you pay out a set amount for your mortgage, you’re also paying it off. By the end of your mortgage, you could be shelling out a nice premium each month for almost no insurance coverage. (If you die a week before your mortgage is paid off, the insurance could end up paying out just a few hundred dollars.). With term, your coverage amount stays stable as the years pass. (And let’s face it you’re more likely to use life insurance in the far future; not in the new few years.) “Ultimately your beneficiaries will receive more life insurance proceeds than with bank mortgage insurance,” says Reece.

The True Price of Convenience

The joy of mortgage insurance is it’s so easy to apply. Here’s why: it’s underwritten at the time of claim. This means the insurance company only looks at your records and decides whether to approve you at the time of your death. “There can be too much room for omission / error with bank life insurance applications and thus one might be surprised to have their death benefit claim denied upon death,” says Reece. Many have been rejected at this late stage and families have been left with no coverage at all because a form was filled out wrong or it was discovered the person that died had high blood pressure when they applied.

Term insurance is underwritten at the time of application. So yes, you need a physical, but the insurance company makes a bigger commitment to you at that time because they have more information. Your claim can be rejected if you commit fraud; but that’s very rare.

Can You Trust The Pros?

When your mortgage broker or banker hands you a mortgage insurance form, that person is interested in getting their commission, but perhaps knows nothing about insurance. When you apply for term insurance, however, you’ve usually gone through an intense process with a broker or advisor to discuss your long term financial needs and you’ve found the product that’s truly right for you and your family, and at the best rate to boot.

“With bank insurance you may not get the necessary advice and generally it is not truly independent as the bank can only offer you their own “in-house” insurance product versus surveying the entire marketplace,” says Reece.

When Is Mortgage Insurance The Right Option?

If you have zero life insurance, and expect you'll be signing up for it any time soon, having mortgage insurance for a few months or years can't hurt. – in fact, it can provide you with quick and easy coverage until you have your affairs in order. This insurance is quite easy to cancel, with no penalties, so there's no harm in using it as a stop-gap.

Applying for real life insurance takes time; it can be stressful to talk about death, crunch the numbers, and no one really wants a physical. But getting the right professional advice through an advisor or broker to establish an insurance program that truly works for your needs will, over the long term, be worth it.

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About Diane

I'm a Toronto based writer, editor and teacher. I've got two little kids and just got a bigger house with a bigger mortgage! I was raised in a family that wasn't afraid to talk about money, and I'm still not. I think being open about financial issues helps us be more honest with ourselves about what we can afford, what we need to wait for and what's just unreasonable. I like to learn about how to scrimp on the boring stuff and splurge on the fun stuff.

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