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Beyond the Rate – Chapter 4

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 4 and we'll be looking at the various loan programs that are available these days and the advantages and disadvantages of each.

My name is Patrick and ... I am recovering from a cold ... so please excuse my raspy voice. I thought about postponing this recording but wanted to stay on a consistent schedule, so here goes ...

I'm your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

Okay. So, if you were to rate every possible loan program on a scale from the most conservative to the least conservative, you would have the 30-year and 40-year fixed amortizing loans on the conservative end and the negative amortization variable rate loans on the opposite side. Those are the two extremes. On the first side, you're paying off the loan at a fixed interest rate. Nothing changes. Your payment is exactly the same, each and every month, for 30 or 40 years. That means you make the exact same payment today as you will in the year 2036, or even 2046. On the opposite side, you've got a loan where your payment isn't even enough to pay the INTEREST on the loan – so the size of the loan is actually getting bigger each month – AND the underlying interest rate is variable as well. That means you can't even plan the extent to which your loan balance is expected to grow – not exactly "conservative". In this Chapter, we'll start at the conservative end of the spectrum and work our way to the other side. Believe it or not, there are advantages to every loan product and we'll be pointing those out as we go along.

Before we get started, we need to explore how interest rates change between these various programs. We all know that the 30-year fixed mortgage is one of the most conservative options available. It has the least amount of risk. Well, for the bank, the opposite is true. By reducing risk for the borrower, all the risk – that is, the

market risk of changing interest rates – is transferred to the bank or “the investor” as discussed in Chapter 1. If interest rates sky-rocket during that 30-year period, the bank CANNOT change the rate on your mortgage. It’s fixed. They also can’t “call” the loan because you’ve got a full 30 years to pay it off. So the bank could be making a lot more money but they’re stuck with you and your low fixed-rate mortgage.

That’s a RISK the bank takes when it gives you a fixed rate mortgage. And as a result of that risk, the bank charges a premium for a 30-year or a 40-year fixed mortgage. In fact, all other things being equal, interest rates get higher when you fix them for a longer period of time. So, an interest rate that’s fixed for 5 years will be slightly higher than an interest rate that’s fixed for only 3 years. A 7-year fixed is higher than a 5-year fixed. A 10-year is higher than the 7. A 15-year is yet higher and a 30-year fixed interest rate has traditionally been the highest. Of course, recently, the lending community has come out with the new 40-year mortgages. When those are fixed for the full 40 years, the interest rate is slightly higher than the 30-year. You get the idea. You PAY for the luxury of a fixed interest rate; the longer it’s fixed, the higher the rate is.

Now, again, let’s clarify. “All other things being equal.” That’s what we’re talking about here. Given the EXACT same credit, income and assets; given the exact same closing cost structure; given the same down payment or equity; the interest rate will be higher as you fix it for a longer period of time. There’s no question that rates could be higher or lower if other things in the file were different. For example, if you were comparing a 2-year fixed Subprime loan to a 5-year fixed A-paper loan, I guarantee the 5-year fixed would have a LOWER rate than the 2-year Subprime but there’s a lot of BIG differences between A-paper loans and Subprime loans.

It should also be mentioned that there can sometimes be a phenomena in the finance world called an “inverted yield curve”. That means that the lending community may temporarily offer lower interest rates on fixed rate products like the 30-year fixed than they would on a shorter-term product. This can happen when short-term rates (like the Prime Rate) rise quickly while the long-term rates remain relatively stable. That’s been the case during the past 18 months. And on occasion during the past year or so, that situation has existed but it’s rare and doesn’t usually last long.

So the 30-year fixed is, historically, the most conservative choice. You pay for that security with a slightly higher interest rate but the risk is extremely low. As mentioned earlier, the new 40-year mortgage is now quite common. And by amortizing the loan balance over 40 years instead of 30, it allows for slightly lower payments. Keep in mind that both of these loans have traditionally required “amortizing” payments; that is, they include both principle AND interest. Well, as the industry continues to get creative and compete for the business, the option of a 10-year Interest Only period has been added to the mix. So the interest rate would remain fixed for a full 30 years but you only have to pay interest for the first 10 years. If you think about it, there’s no reason to have a 40-year loan if you also

select the Interest Only option. If you're only paying interest, the amortization period become irrelevant. Either way, 30 years or 40, you're still only paying the interest. The difference would show up after the Interest Only period expires. With a 30-year loan, the remaining amortization period would be squeezed into the last 20 years. With a 40-year loan, the Interest Only period would expire and you'd STILL have a full 30 years to pay the principle down.

Now, how many of us actually plan to spend the next 30 or 40 years in the same house? Well, perhaps some of us are. But the majority plan to move into a different place sometime before 2036 – 30 years from now. So if you generally pay a higher interest rate for fixing it for a longer period of time, the trick REALLY is to balance the fixed period with the length of time you intend to stay in the property OR the length of time you intend to keep the mortgage. In either case, there's no sense fixing the interest rate for a period of time when you'll no longer have the mortgage. There's no sense paying for a luxury you'll never benefit from.

In today's marketplace, you can fix an interest rate for 6 months, 1 year, 2 years, 3, 5, 7, 10 years, 15, 20, 30 or even 40 years. So take a minute and think about how long you intend to stay in your current property. 5 years? Maybe 7? If that's the case, you should only fix your interest rate for 5 or 7 years; maybe 10, just to be safe. That way, you'll get the lowest interest rate possible while still getting the security you need; the security of a fixed interest rate for the period of time you expect to keep the mortgage. That way, you're getting the most for your money.

Most of these loans – the ones that are only fixed for 3, 5, 7 or 10 years – still have a full 30-year term. In other words, the payment is still calculated as if it was a 30-year amortizing loan. Again, if you select an Interest Only option as well, the amortization schedule becomes irrelevant – it really doesn't matter – you're only paying interest anyway. But for an amortizing loan – that's principle AND interest – the payment is based on a 30-year amortization period and is completely fixed during the initial fixed period. But after that, the interest rate changes to an INDEX plus a MARGIN and the loan becomes VARIABLE at that point. The margin never changes but the index can move up or down, depending trading activity on the bond markets. We discussed indexes in Chapter 2 and some variable rate loans in Chapter 3.

So, in what circumstances should you select an Interest Only mortgage? Well, there's no question that many homeowners today are really stretching to make their monthly mortgage payments. Fact is; the prices of homes have risen much faster than average wages and salaries, so it's a much bigger strain on homebuyers than it was years ago. Here's my opinion. If you select an amortizing mortgage – that's principle AND interest – you are basically putting yourself into a forced savings program. Any money you put towards your principle balance is increasing your equity. You get all that money back when you sell the house because your loan balance will be lower than it would otherwise, leaving you with the difference. An amortizing mortgage is definitely the 'conservative' choice.

On the other hand, you can look at an amortization schedule and see how much of the principle you actually pay down during the first 5 years of a 30-year mortgage. It ain't much. Depending on your interest rate, maybe 5, 6 or 7 percent. So if you're only planning to stay in the property for 5 years, the difference in your equity is fairly minimal. Meanwhile, paying only the interest would certainly reduce your monthly mortgage payment. Here in California, Interest Only mortgages are extremely common these days and they definitely serve a purpose for those homeowners who are planning to get into a new, perhaps bigger, property within a few years.

The important thing to remember, obviously, is that your original principle balance NEVER gets any smaller. In that sense, you're basically RENTING the house, and banking on the appreciation of your house's value to build your equity. During the past 10 years or so, with house prices rising between 10 and 20% each year, this strategy has paid-off handsomely. But what happens when the market starts going sideways? What happens if prices remain the same or even go down a bit? Also, consider the fact that you'll have to pay 5 or 6% real estate sales commissions when you sell the property. If you put 20% down on a house and ONLY pay interest for 5 years, and if house prices remain stable, you'll actually lose money on the deal. You'll start with 20% equity. If you end up paying 5% real estate commissions, you'll sell the place with only 15% equity (20%-5%) so you'll have LESS money after you sell the place than when you bought it 5 years earlier.

If the place actually drops in value, the situation gets even worse. I recently spoke with a client who finds himself in this situation. He bought a place 10 months ago and can't keep up with the mortgage payments. His situation is even worse because he's got a hefty prepayment penalty in his loan. Meanwhile, his home hasn't appreciated a cent. So between the real estate sales commissions and the prepayment penalty, he'll be out over \$35K if he sold today (he did 100% financing when he bought it originally). And if he rented it out, he'll still be under water about \$900 per month. Either way, he's in a bad situation. So you have to be careful. Profit is NOT guaranteed.

That brings me to the last major loan program; one that is gaining in popularity every year. It's a bit scary, actually, because this last type of mortgage is the least conservative of the bunch. It's called an Option ARM and it gives the borrower a choice of 4 different payment options each month. They can pay a minimum payment which is based on an artificial starting interest rate of just 1%. Or they can pay the Interest Only payment. They can also pay the 30-year amortized payment and, finally, they could pay the 15-year amortized payment – the highest of the 4.

We've all heard about these 1% mortgages. They're heavily marketed and most of the promotional material is highly deceptive. I personally believe that less than 10% of the people who get into these types of loans truly understand what they're getting into. There's no research to support that – it's only my opinion. So let's take a closer look and unravel all the hype surrounding these loan products. Believe me; they're not as great as they may appear.

First off, mortgage interest rates have NEVER been 1% and they never will be. 1% is a marketing label that helps them sell the loans. They calculate the payment assuming a 1% start rate, but the important thing is NOT the attractive interest rate. The important thing is that this minimum payment is BELOW the Interest Only payment – it's LESS than Interest Only. Essentially, these loans allow people to make a payment that is NOT even enough to pay the interest on the balance. So you're under water right from the start. And the difference between this minimum payment and the Interest Only payment is referred to as "deferred interest" and it gets added to your mortgage balance each month. So your loan balance is getting bigger each month. It's called Negative Amortization and it slowly erases your equity every time you make that low minimum payment.

The next thing is that these loan programs are NOT fixed. They are variable rate products, right from the very first month. The minimum payment structure is indeed fixed for the first 7 years (in most cases), but that's an artificial payment – a Negative Amortization payment. So those minimum payments don't reflect the TRUE interest rate at all. Fact is; the underlying interest rate on these loans is variable and can change every month. These loans are NOT fixed.

And third, the 30-year amortized payment is NOT fixed either. When people hear "30-year", they automatically assume "fixed"; 30-year fixed. That's not the case with these loans. They are not fixed. There's a big difference between "amortized" and "fixed". With a variable interest rate, the 30-year amortized payment changes each and every month. And these days, it's probably getting higher, not lower.

So be careful. It's pretty clear that I'm not a big fan of these loan programs but I truly think it's important for us all to understand the true implications of such a low payment. There's no free lunch out there. If it seems too good to be true, it probably is.

Anyway, yet again, we have to admit that there is value in these programs for people who fully understand them. In an appreciating real estate market, it can make it easier to maintain an investment property or provide flexibility for someone with an uneven income stream. There are benefits, yes. But if the real estate is NOT appreciating, these loan programs erase your equity and destroy potential profits. So be careful.

Okay, so if you like what you hear on this podcast, please tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I am deserving of yours, please accept my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I

can. My office phone number is 925-465-1223. Again, that's 925-465-1223. You can also reach me by email at patrick@beyondtherate.com.

See you next time for Chapter 5. We'll be looking at different closing cost structures and how they measure up in the long-run. Should you pay points? Should you buy the rate down? We'll calculate the break-even point for these decisions and give you an idea what your total closing costs should add up to in different situations. It's fascinating stuff. Stay tuned.

Bye for now.