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Mortgage Types Available To You

In today's times, whether you are buying a house, or considering refinancing an existing mortgage, deciding which type of a mortgage is best for you can be confusing. That's because it involves more than just numbers crunching. You must also make certain decisions and assumptions about which way interest rates will go, how long you will be in the house, and what your tax bracket will be over the life of the mortgage, as well as the present and future tax deductibility of the interest you will pay.

To make matters even more confusing, these quantitative aspects are also linked with certain qualitative issues that need addressing. How do you feel about having a debt on your head? Are you a good saver? Are you a bit of a gambler or are you a serious conservative?

Basically, mortgages can be divided into two main types: Fixed, and Adjustable Rate. Within these two categories further division occurs as we shall see.

Fixed Mortgages

By definition, fixed mortgages refer to the fact that the interest rate you will pay is fixed (locked in) over the entire life of the loan. Thus, no matter how long of a mortgage you have selected, and no matter what happens to interest rates over the years, your mortgage rate will not change–nor will your contracted payment for the mortgage itself. This is the most prevalent type of mortgage out there. In 1998, it accounted for 76% of all residential-type mortgages.

The main choice in this category centers around the length of the mortgage you want. Do you select the 30 year? Or the growingly prevalent 15 year? These represent the two most common fixed mortgage choices, so we will focus on them.

Obviously, a 15 year mortgage is shorter. Also, interest rates you will pay on a 15 year are usually a bit lower(1/4 to ½ point lower). This is because the bank's risk period is halved compared to a 30 year, so some of this risk-saving is passed on to you, the borrower. However, your monthly payment will be higher since you are paying it off over a much shorter time period. Thus, a 15 year mortgage is more of a "forced savings" vehicle than a 30 year, and you build up house equity faster by paying more each month.

Add to this the fact that all mortgages are "front-loaded"(meaning more of your early payments go toward interest instead of principal), and you can conclude that a 15 year mortgage will save a considerable amount of total interest over the life of the loan. In fact, you have probably seen the bank advertisements comparing the difference in total interest saved, and it appears staggering. So this is definitely the way to go by a large margin, right?

Not necessarily. This is where two of the variables we suggested earlier come into play. The first variable is your income tax bracket. Since the current 2000 federal tax codes allow you to deduct mortgage interest paid on a residence (up to a $1 million acquisition mortgage), the rate of your tax bracket can narrow the gap between the total payments of a 15 and 30 year mortgage.

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Why? This is because the higher your projected tax bracket, the more interest you may be able to deduct. That means the 30 year mortgage creates larger tax deductions, which is a form of savings to you. Thus, while you are paying a larger absolute amount of interest on a 30 year mortgage, you may not always be paying a great deal more in after tax dollars.

Second, what will you do with the difference in monthly mortgage payment amounts between a 15 and a 30 year mortgage? Will you invest it? And if you do, will you do it successfully? If you can answer Yes to both of these questions, you can narrow the gap even further between the two choices. In fact, if you were successful enough as an investor, you may even make enough on the invested differential to offset ALL the savings on a 15 year fixed mortgage. So while the 15 year mortgage creates a quicker equity build-up than a 30 year, the two issues of your tax bracket, and what you will do with the monthly mortgage payment differential are the critical factors.

Note: We will not address the other two important issues of liquidity value, and portfolio diversification in comparing the two types of mortgages, although these factors have real value to many people, both in quantitative terms, and psychological comfort as well. However, entire books can be written on these two issues alone.

As a point of interest, most 30 year mortgages allow you to make extra payments periodically. This can create almost the same result as having a 15 year fixed without legally committing you to the higher monthly payment. This may be a good compromise when deciding which type to get. The "Reverse Laws Of Compounding" show that, by making an extra monthly payment each year on your new 30 year mortgage, you can shave 7-9 years off its payout period, with the current 2000 mortgage rate averages. So, if you are considering this with a 30 year mortgage, make sure there are no extra charges if you make any pre-payments on principal.

As you can surmise, there is no simple answer in deciding between a 15 year and a 30 year mortgage. You must know a bit about yourself as a saver, and an income earner projected over the life of the loan. On the other hand, there is one general rule of thumb to consider following, which goes like this: The lower your tax bracket, and the less disciplined/less successful you are as a saver, the more you may wish to lean towards a 15 year mortgage if you can handle the extra current amount you would be paying on the monthly mortgage. Everything else being equal, forced savings is better than none at all!

Adjustable Rate Mortgages

These are exactly what they say. They are mortgages in which the interest rate you will pay is variable, not fixed; it adjusts according to a certain index the lending institution is using. Issues such as when the rate changes, by how much it will change, and the maximum amount it can rise are all variables that can differ from one lending authority to another. These mortgages are nicknamed "ARMS."

However, most have similar features you should check out. First, the bulk of the adjustables will change their rates according to one of two main indexes or variations thereof: A formula based on the change in US Treasuries is a very common index; and, the use of the so-called 11th District cost of funds which is coordinated by the Federal Home Loan Bank Board is the other main index.

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Second, many ARMS have a maximum lifetime "CAP" which means they limit the total amount the interest rate can change. A commonly used figure here is 6 points over the contracted rate, meaning that if you contracted at 5%, it couldn't go higher than 11%.

However, be careful here because the contract rate for this is usually higher than the initial "Come-on" rate that is frequently advertised. Again, a common technique lending institutions use to promote these adjustable rate mortgages is to give you a first year's discount on the actual contracted rate. So, you may be paying only 3% in year-one when in fact you have actually contracted for a 5% ARM. After the first year, your mortgage automatically adjusts upward to the 5% rate, and all loan CAPS may be based on the 5% contract not the 3% starting point. This is important to know when deciding on fixed vs adjustable, or which ARM to choose from another.

Finally, many ARMS limit the amount they can raise the interest rate to no more than 2 points a year. So, if you contract at an initial 4% rate with a lifetime CAP of 6 points, and a 2 point maximum yearly rise limit, you know that your maximum exposure over the life of the loan is a 10% interest rate. You also know that it will take until the fourth year to hit the 10% no matter how much, or how fast, interest rates rise.

A variance on this type of adjustable mortgage is called a Hybrid. The rate is fixed for a certain number of years, then it changes according to what has happened in the open market after that period of time. A "5/25" for instance means your rate will stay fixed for the first 5 years, then change to a new rate for the remaining 25 years.

So, is an Adjustable Rate Mortgage better for you than a Fixed? And which type: a basic ARM, or a Hybrid? Obviously, for most people it is easier to qualify for an ARM than a Fixed, since one of the qualifying issues most lending institutions use keys off the monthly mortgage amount, and a monthly ARM payment is lower in the beginning than fixed mortgages.

However, here is where you must get out your crystal ball to really decide. Do you think interest rates(hence your mortgage rate) will stay down, go lower, or rise over the life of your proposed ARM? Or, if they do change, when will they change? Will you still own the house by then, or will you have sold it? So, the issue of how long you plan to keep the house enters into the equation as well.

Are there any guidelines here? Yes! First, if you definitely know you will be selling the house in a short time, you can do some numbers crunching to calculate your maximum exposure on an ARM mortgage vs a Fixed. Conversely, you can figure out where the breakeven year is between a lower rate, maximum Capped ARM vs a Fixed if you make some basic assumptions. Naturally, if you believe interest rates will go down over your expected liability period, an ARM makes sense.

But, if you are planning to stay in the house indefinitely, and you couldn't handle the ARM if it hit its maximum rate, be careful. There are many people taking out ARMS because they can't qualify for a regular Fixed based on their income levels. That may be fine in the current interest rate environment, but what happens if interest rates continue on an upward tear? It could create a serious cash flow problem.

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Sources To Apply For Mortgages

BANKS: The most commonly known places to apply for mortgages are commercial banks and Savings & Loan Associations. The majority of these institutions serve as initiators and collectors of these mortgages. They do not keep the mortgage they establish for you. Rather, they "sell" it off along with others they have made into blocks(or pools) of mortgages.

Because of this type of selling of mortgage blocks, they need common denominators for the pool, so they tend to follow so-called "Fannie-Mae" requirements as to loan qualifying formulas. They evaluate you in terms of your income level, any other long-term and short-term debt, the proposed new monthly mortgage payment, house taxes, and house insurance, coupled with your credit worthiness, and the amount of your downpayment to determine if you will get the loan. These are the strictest of loans for which to qualify.

MORTGAGE BROKERS: Mortgage brokers can be another source, and may be better for those who can't meet the stricter Fannie-Mae rules. Basically a loan source "middleperson," a mortgage broker may represent numerous sources of funds, including individuals, pension plan money, or other exotic sources.

In the cases where the loan sources as represented by this broker do not sell off their loans, it may prove easier to get a loan. There is more discretion in the qualifying factors. There may or may not be extra fees associated with getting loans through mortgage brokers, depending on their size and the competitiveness of the market in which you are located. Also, these mortgage contracts are not as standardized as many large banks, so they should be read with care – every line of fine print.

CREDIT UNIONS: Some of the larger credit unions offer very good deals on mortgages. So, those who have a credit union at their job should always check there first. Special allowances may also be made to members of the credit union as to qualifying formulas.

HOUSING FINANCE AUTHORITIES: Most of the states have a program along these lines. Basically these are quasi-independent agencies set up to provide mortgage rate subsidies and/or reduced downpayment requirements for the purchase of a residence. Most of these loans are given to first time home buyers or people who have not owned a home for at least 3 years.

Not everyone can use this program because funds are limited, and there are usually maximum caps on how much income you have, and the price of the home you can buy. The programs are geared toward low-income, and moderate-income applicants.

Conclusion

It's nice to have choices. A choice of places in which to apply helps you to get the least expensive mortgage within your selection category. But, oh that selection category! What type of mortgage do you choose? Fixed 30, Fixed 15, Adjustable Rate, or Hybrid?

While the answers require some careful thought, and some serious number crunching to maximize your efficiency of choice, it can be done with the right facts, figures, and assumptions.

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