Traditional Mortgages Worth the Price?

WHITE PAPER

TABLE OF CONTENTS

Introduction.....2-3
A Short History of Fixed-Rate, Fixed-Payment Loans.....4
How Does an Amortized-Payment Loan Work?.....5
Total Interest Cost vs Interest Rate and Payment.....6-7
The All In One Loan™ and Total Interest Cost.....7

Introduction

The fixed-rate mortgage has been the dominant choice of financing for American homeowners since its creation in the 1930s. It was designed in response to the financial instability of the Great Depression, which had locked up credit markets and brought the housing industry to a halt. The fixed-rate mortgage, along with other innovations, unlocked both consumer power and access to home financing. Before the fixed-rate mortgage, home buyers relied on the adjustable-rate, 5-year, interest-only loan with a balloon payment at the end and a down payment of 50%.

The benefits of fixed-rate loans are obvious:

1. The borrower gets a reliable, fixed payment amount for the entire term of the loan.
2. The loan balance declines steadily to hit zero with the last payment, leaving no final balloon payment to worry about.
3. Homeowners and other property owners can easily manage their monthly finances around this predictable mortgage payment, due on the same day each month.

The main drawback is less obvious. Historically, borrowers who opt for a fixed rate mortgage are given a higher interest rate than if they chose an adjustable-rate loan. This is because the lender assumes all possible changes to interest rates over the life of the loan. To reduce the risk of changes, lenders charge the borrower a premium.

> What history has proven beyond a shadow of a doubt is that predicting rate direction is a waste of time. The very futility of such exercise is exactly why lenders charge more for fixed rates. Financial markets charge a premium for predictability. Fixed-rate mortgages must therefore be funded from more expensive (higher yielding) sources.*

Borrowers generally don't know how to figure out what that premium is, nor can they calculate how much more in interest they will pay over the life of the loan.

But a person who has good income, positive cash flow, and good finance management skills may benefit from choosing an adjustable-rate loan. By choosing an adjustable-rate loan, they could pay thousands less in interest.

> The fixed rate loan has been an economic boon to the American housing industry and homeowners. But this doesn't mean that individual citizens need to work for the benefit of society instead of themselves by sticking with fixed-rate loans! If an adjustable-rate loan like a hybrid 5/1 ARM or the All In One Loan™ – a home equity line of credit with integrated sweep-banking – makes more sense for an individual borrower, the borrower should make detailed comparisons of the advantages and risks of each option and choose the loan that best fits their financial goals and abilities.
>
> **DAVE HERBST, VP OF CMG FINANCIAL**

> Perhaps it is finally time to confront our fixation on the 30-year fixed-rate mortgage and see it for what it is: an outdated product that we've relied on as a safety blanket after a period of crisis. Or, alternatively, an overutilized mortgage product that government securitization has lured us into believing is more beneficial to borrowers and lenders than it actually is.**
>
> **CHELSEA MIZE OF MAXWELL**

A Short History of Fixed-Rate, Fixed-Payment Loans

By the early 1930s, the American economy was in deep financial crisis. Banks had overextended themselves during the economic boom of the Roaring '20s. When the boom abruptly stopped in 1929, too many borrowers – including mortgage borrowers – could not repay their debts.

Mortgages prior to this Great Depression were quite different from the mortgages we see today. Before the Great Depression, mortgage loans had:

- Short terms of five years
- Variable rates
- Interest-only monthly payments
- A balloon payment of the full amount due (the loan balance) at the end of the term

Continual refinancing of the loan was common for homeowners who could not meet the balloon payment. The loans were held in portfolio by the banks that lent the money, so the risk of default was not shared by other investors.

As a result, the homeownership level was low. Only about 20% of Americans owned their own home.

In response to the wave of bank failures and the contraction of credit in the 1930s, the federal government began to innovate:

The Federal National Mortgage Association (Fannie Mae) opened for business in 1938 as part of the New Deal. Its mission was (and still is) to inject liquidity into the home financing market by buying loans from banks, packaging them into batches and selling them on a secondary market to investors. This secondary market of mortgage-backed securities allowed investors to pool mortgages together to share the risk of default.

Plus, by buying the loans from banks, Fannie Mae gave the banks back the money they had originally lent to the borrower. They could turn around and lend that money out again. This cycle could repeat itself endlessly, allowing a lot more loans to be made, unblocking the purchase of homes, and expanding homeownership.

The next innovation was **the creation of the amortizing fixed-rate loan**, with a longer loan term of up to 30 years. This offered lower-income people a manageable monthly payment that still ensured full loan payoff at the end of the term.

Plus, with the **advent of the secondary market, higher loan-to-value loans** of up to 80% could be made because the risk of default was dispersed among many investors.

Over time, these innovations spurred rapid increases in homeownership, rising from 20% around the 1930s to over 65% today.

Mortgage market innovation drove homeownership rates up from 20% in the 1930s to over 65% today.

How Does an Amortized-Payment Loan Work?

A **fixed-rate mortgage** is a 'fully amortizing' mortgage loan where the interest rate remains the same through the term of the loan, as opposed to loans where the interest rate may adjust. As a result, monthly payment amounts, and the duration of the loan are fixed.

Amortization (literally meaning 'to death') spreads the payment of the loan amount over the life of the loan. Starting with the very first payment, a portion of every payment goes to reducing the loan balance.

To do that, each payment is split between the monthly interest due and the amount that pays down principal (the loan balance).

In the beginning, almost the entire monthly payment goes to paying the interest due. Just a small portion is applied to reducing the balance.

Over time, as the balance comes down, the interest due decreases, leaving more of the fixed monthly payment for principal reduction. In the end, almost all of the payment goes to principal reduction because the loan balance has shrunk to the point where the interest due monthly is just a few dollars.

Amortized Mortgage Payment Split Between Interest and Principal

Loan Amount	$560,000
Interest Rate	3.000%
Monthly Payment	$2,360.98

	Interest	Principal	Percent Interest
Payment #1	$1,400.00	$960.98	59.30%
Payment #120 (Year 10)	$1,067.51	$1,293.47	45.21%
Payment #240 (Year 20)	$615.63	$1,745.35	26.08%
Payment #360 (Year 30)	$5.89	$2,349.22	0.25%
Total Payments	$289,953.73	$560,000.00	34.11%

Total Interest Cost vs Interest Rate and Payment

While the invention of the fixed-rate mortgage was instrumental in rapidly expanding homeownership access in America, its benefits of a predictable monthly payment and amortization schedule are not the best solution for every borrower.

The real measure of what a loan will cost you is 'total interest cost.' How much interest will you pay on the amount you borrow before you pay the debt off? In the example above, the total interest paid will total about $289,953.73.

The calculation of what you will ultimately pay for your real estate purchase is driven by three factors:

1. Interest Rate
2. Loan Term
3. Amount Borrowed

While today's homeowners tend to believe their loan's interest rate plays the largest role in their monthly and total mortgage expense, they are wrong. The amount you owe over time is far more important.

As an example, if you changed the loan term to 15 years at a rate of 5%, the total interest cost drops by $83,272.27 to $237,119.20 despite having a higher rate. This is because the 15-year loan is designed to pay off the loan balance much more rapidly.

Going even further, if you borrow $560,000 at an interest rate of 10% for 5 years, your total interest cost would add up to $153,901.00, exactly $136,052.73 less despite having a significantly higher rate.

Here is the rate of payoff and total interest paid on the 3% 30-year fixed rate loan:

Interest Paid By	Total Payments Made	Total Interest Paid	Total Balance Paid
Year 5	60	$79,534.59	62,124.37
Year 10	120	$149,028.84	134,289.07
Year 15	180	$206,860.06	$218,116.80
Year 20	240	$251,143.32	$315,492.50
Year 25	300	$279,689.02	$428,605.75
Year 30	360	$289,953.73	$560,000.00

About 50% of the total interest is paid in the first third of the loan's term alone.

Interest costs can be influenced in three ways:

- Change the interest rate, by refinancing or taking out an adjustable-rate loan
- Change the loan term, by accelerating loan balance repayment or refinancing
- Change how much you owe, by aggressively paying down the balance

The All In One Loan™ and Total Interest Cost

Every household's financial situation is unique, which is why borrowers should invest a good amount of their time in analyzing which loan is best to meet their goals. One loan product that stands out on the basis that it delivers results according to how it is used, is the All In One Loan. If you run scenarios using the online comparison calculator, you will see that it is designed to rely less on a fixed interest rate to provide a financial benefit. Instead, it offers greater control of its daily principal balance and payoff timing.

Sources:
The Federal Reserve
Fannie Mae
Amortization-calc.com
Calculatedrisk.com
*Ratespy.com - https://www.ratespy.com/the-most-misconstrued-study-in-mortgage-history-03105681
**Himaxwell.com - https://himaxwell.com/blog/30-year-fix-part-2-mortgage-products-around-world/
https://himaxwell.com/blog/30-year-fix-3-gse-reform-fate-30-year-mortgage/
https://medium.com/@byrnehobart/the-30-year-mortgage-is-an-intrinsically-toxic-product-200c901746a