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financial

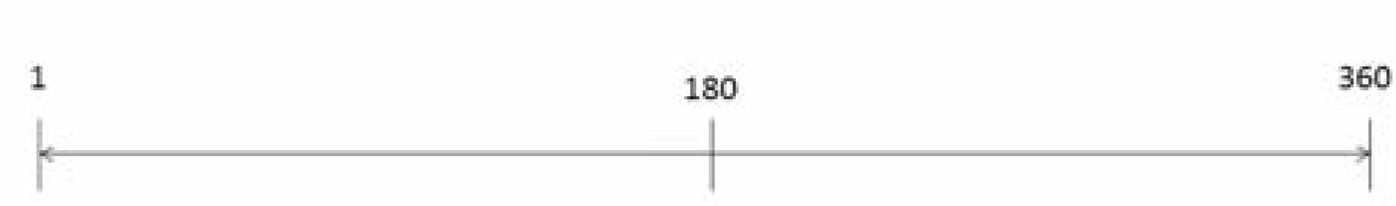
The 15-Year Mortgage
And Why You Should Hate It!

Mortgages are one of the most highly debated financial tools, right up there with life insurance. You'll find a variety of opinions about the most effective strategies regarding how you pay your mortgage loan. There is a lot of misinformation out there and what I want to make sure we discuss first is the bank's biggest concern regarding mortgage loans. If we understand the bank's motivation then we'll have a better idea of what we should do with our own money.

So, what is the number one concern for the bank regarding your mortgage? Most people say, "The risk!" or "The borrower's credit worthiness." The correct answer is inflation. Inflation is their biggest concern. Let's take a look, because once you understand this banking principle, you'll end up making a different choice with how you handle your mortgage.

Our home is one of the only assets we have, if not the only, that is a part of our "accumulated" money, our "lifestyle" money and our "transferred" money all the same time. We hope our equity continues to grow and that the house appreciates in order to create more accumulation for us as a whole. It's also a lifestyle choice because technically we could live in a one bedroom studio but we don't. The transferred money has to do with the mortgage debt: we're paying principal and interest back to a lender so we are therefore transferring money out of our wealth. This transferred money can be quite excessive because let's face it, we probably don't have many assets that have $300,000 loans against them; therefore, how we handle this is absolutely critical.

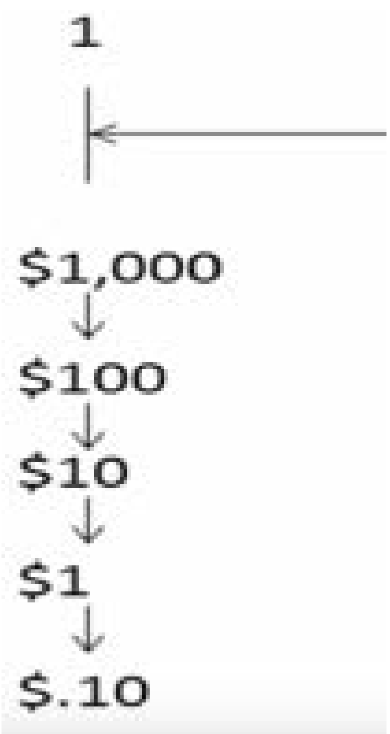
Let's take a look a timeline. The number "1" on the left represents the very first payment you make on your mortgage, so month one. Month 180 is year 15. Month 360 is year 30. We know that banks offer lower rates on a 15 Year mortgage than a 30 Year mortgage. Let's assume that we have a $1,000 payment beginning Month 1 and the interest rate on the 15 Year is 3.25% and the 30 Year is 4.00% and let's use a 3% inflation factor.



Now, today we write that first check for $1,000 and it feels like $1,000 because it has the same buying power today as its face value. It represents a current buying power of $1,000. Pretty simple. Now, just using an inflation value of 3%, at month 180 you're still writing the check, it is a fixed payment. So you're still writing a $1,000 check but it feels like $642. I'd personally love to have my first house payment back when I was 25 years old. I was freaking out then but now, that payment would feel like nothing. So at year 15, this $1,000 will not feel like $1,000 anymore...it'll feel like $642. At month 360, year 30, it'll feel like $412.

Wouldn't it be great if you could write all the checks, make all the payments, right at the very end when each one only felt like $412? You bet it would, that would be cool. So along the way we're making the $1,000 payment but every month that goes by the value of that $1,000 slowly becomes worth less to us. Now the bank is also in this mix. What does your $1,000 represent to them? If it's buying power for you, what is it for them? The answer: it's collateral power!

The bank accepts that $1,000 payment and they loan it back out to bring a new payment of $100. Then they leverage that $100 in order to bring in another payment of $10. Then the $10 to bring in $1. Then the $1 to bring in $.10. Then the $.10 to bring in $.01...and so on and so on. Traditional banking leverages every dollar that comes in seven to ten times...if not more. So your $1,000 payment represents $1,000 of collateral power to them.



At year 15, it feels like $642 to you which makes you a little bit happier but the bank isn't as happy. Why? Because your payment now only represents $642 worth of collateral power. At year 30, you're very excited because your fixed mortgage payment of $1,000 only feels like $412 and it's really easy to make that monthly payment. Again, the bank is not excited because the $1,000 payment now only represents $412 in collateral power.

Now, if you were to look at the Adjustable Rate Mortgages like a 3 Year ARM, a 5 Year ARM, or a 10 Year ARM, you'll discover that each time you get closer and closer to Month 1 (where the dollar has its highest value), the interest rates get less and less. The 3 Year ARM has a lower rate than the 5 Year. The 5 Year is lower than the 10 Year...and so on. Why is that the case? Because they know they're going to get every dollar back, all of it, over a short period of time which represents a very high collateral power for the bank.

So, we have to ask ourselves a couple questions. First, do the banks have your best interests at heart? Everybody says no to this question. It's not that they're bad (well in some cases they've proven to be) but they definitely do represent their interests first. They exist to make money. They provide services to us, which is great, but their decisions are based around their profitability. So if they don't have our best interests at heart, and we can get a lower rate on a 15 Year than the 30 Year, then why are they promoting the 15 Year?

That is an interesting question because it counters what the banks tell us. Let's look at what we're told. We're told (and I'm not using a specific loan amount at the above mentioned interest rates, I'm writing very generally here), we're told that if we get a $200,000 mortgage using a 15 Year term then we'll pay only $80,000 in interest for a total of $280,000 out of pocket to buy the home. This is what the financial entertainers of the world like to point out to us. And then they say,

"But see, if you do the 30 Year mortgage, you'll pay the $200,000 loan plus an additional $200,000 in interest for a total of $400,000 out of pocket. The 15 Year will save you $120,000!!"

This is what we're told. It's so easy to look at those two figures and say "Yeah, that's right! I'm going to do a 15 Year if I can." And this is where so many people stop doing their analysis. But, it's a smoke screen. If the bank doesn't have our best interests at heart then it must be a smoke screen…there is no other explanation adequate. If the bank makes over $120,000 more on one loan compared to another, and we're told this is the reason we should lower the term, then why in the world would they give us an incentive to go with the loan that creates a "smaller" profit for them? You see, these two don't line up.

We agree that the bank does not have our best interest at heart, their profit is their motivation, and they're giving us a big incentive (by .75 of a point in this example – today I believe the difference is 1.0% or more) to go with a lower term. Why would they possibly walk away from so much profitability if it represents $120,000 more?

It doesn't make sense. It doesn't line up. If this was truly the best decision then they'd be offering us 50 and 60 year mortgages at rates that would be lower than the 15 year. The 30 year would have a lower rate than the 15. The ARMS would have the highest interest rates in hopes we wouldn't choose those loans at all. Think of how much they could collect in interest with a 50 or 60 year loan...FAR more than the 30 year and enough to make the 15 year look silly.

The reality, it is NOT in the bank's best interest to stretch out the term. They make far more money, significantly more profit, on a shorter term loan than they do the longer term. They don't care about the $120,000 difference...they want to leverage your money when it has its highest value (collateral power). Would they rather leverage your $1,000 payment seven to ten times when its lowest value would be $642 or $412? The higher it is, the better it is for the bank. They absolutely prefer shorter notes in order to maximize their profits. Again, this is called Fractional Reserve Banking...the use of other people's money. This is how banks operate. They make 10 times more money on a 15 Year note than 30 Year because of how they leverage the dollar.

Let's look at the mortgage interest rates historically. If you look back to 1999, Bill Clinton was President, economically we were booming with little inflationary concern. We weren't in a position where inflation was considered much of a problem. The 30 Year mortgage loan rate averaged 6.89%. The 15 Year mortgage loan rate averaged 6.51%. Only a difference of .38%.

The banks then weren't that concerned about the difference between the 15 Year and the 30 Year due to a lack of inflationary pressure on the dollar. So being extended out 30 years wasn't much of a problem for them. Let's fast forward to 2012 when we had a lot of inflationary concerns really begin to take hold. The national average was 3.99% for the 30 Year. The 15 Year average was 3.23%. A difference was ¾ of a point...double what it used to be bank in 1999.

They increased the incentive 100%! They doubled it! Now why would they possibly do that? It's because of the inflationary concern. They were "scared" (or at least taking all precautions) of the negative impacts of inflation to their profitability model. They know full well that liquidity is key when inflation is ugly. As individuals, we too need to be liquid in order to maximize the incredible opportunities that exist when inflation is waving its flag. Listen to the radio ads, look at the ads you see online, they always promote the 15 Year mortgage...always. When has a company ever marketed something that is not profitable for them? Has it ever happened that a company spent millions of dollars in advertisements to market to the public a product that is the least profitable for their company? Never! Banks are no different. So listen!

The biggest mistake a homeowner can make is to believe that the math makes sense about the interest difference and therefore decides to send extra principal payments to the lender.

Whether it's one extra payment per year or a little extra each month, it's a mistake financially because we're giving them our most valuable dollars sooner and all we're doing is shortening our term. If they get our dollar over a shorter period then what do they get to do with those funds? They get to leverage it and spin it out seven to ten times. We lose buying power, they gain collateral power.

So using our example, if you sent them $500 extra per month you'd be making a payment of $1,500. They gain collateral power and you believe the interest savings is what's in your best interest but it's not. Let's take a look.

So, on the additional principal, does the bank pay us any interest? Meaning, that $500 per month would be $6,000 a year. After two years you would have sent them an additional $12,000. So at the end of that two years, you paid $12,000 more than your note agreement required. Does the bank reward you with interest on that $12,000? No. That $12,000 hasn't grown to $15,000 or even $12,001. But people will say, "Well I saved interest on the back-end." That's different. It's easy to get people focused on that as if it's the right move but it circles us right back to the difference in interest between the 30 Year and the 15 Year. It's the wrong side of the coin.

Does the bank say, "Thank you for accelerating your loan. Because you've sent us extra money we've credited you 10% on that $12,000 you sent to us?" Of course not.

If a home is free and clear and the identical house sitting next to it is mortgaged 100%, there's no difference in value. The homes are valued the same. Mortgage balances do not determine the value. We don't earn any additional equity or interest on the principal we've paid in.

What happens if you end up needing that additional $12,000 due to some circumstance? Life can happen. It can often "happen" in such a way that you quickly burn through other financial safety nets. So you're sitting on this asset, your equity, you've paid $12,000 into the house and you want some of it back. I mean, it's yours right? If the money was sitting in a tin can you could simply pull out the can and grab the money. You need the $12,000 that you've sent to the bank as extra payments but do you have access to it? No. Not without qualifying again. Not without paying fees to get to the money. Not without restructuring your loan or getting a new one. What would the rates be at that time? Could that mess things up if the rates were now higher? Of course.

So if you want the money, what do you have to do? You have to go to the bank and you have to tell the banker, *"Hey, we've been sending you extra payments, more than what you required, and we'd just like to get $6,000 of it back."* What if you lost a job? What if your credit is different than before? The bank simply says to you, *"Thank you so much for sending the extra $500 every month. We really do appreciate it. But we cannot extend you a new loan at this time."*

Why do you need or want the money? Could your needs and wants have an impact on whether or not the bank will lend it to you again? You bet they do. A simple cash-out refinance has a higher loan rate than a rate-and-term refinance as well as a lower loan-to-value ratio. The bank determines that your need for the cash is a negative and they'll hit your rate for that need. So infuriating to be asked, "Why do you need the money?" "It's my damn house, I'll use it how I want." But that's not the case when you're the lender...they determine whether you can access it or not. For that one reason, I'd rather have my money sitting in a tin can personally.

All of these aspects are "unknowns". In year two you paid the extra $12,000 and you need the money back, there's too many "what ifs", there's no planning that can be done. Can you access the funds, what are the rates going to be if you do get a loan again, what are the purposes behind why you need the money, could the bank not like why you need the funds and what happens if your home depreciates?

The house depreciating has certainly happened to a lot of people. They paid a lot of extra principal into their loan and then suddenly, due to uncontrollable economic factors, their house depreciates and wipes out all the extra principal. Now it's just gone. Vanished.

We have to understand that inflation is the bank's number one concern. It is the reason they give us an incentive. If you're a business owner and you offer a line of products and there's one particular product that you really want to move because it represents a lot of financial opportunity for you, what do you do? You provide an incentive. This is all the bank is doing here and they've increased that incentive during our current economic times because they are concerned about what 30 years represents to the fixed payment and their leveraging power of it; therefore, we need to be concerned about what that represents to our buying power and the ability to earn on our money over that time in order to help ourselves offset the effects of inflation.

This economic reality of banking holds true whether you agree with it or not. It's not subjective, it's objective. When you take it to heart regarding your personal financial situation, I know you'll come to find that the short term mortgage and the acceleration of the mortgage loan is one of the biggest financial mistakes you can make. Instead, you should be taking the longer note and paying any extra principal to yourself so that you can access the funds, use the money, invest the money, touch the damn money...whatever.

I have a second eBook that digs into the math behind this as well titled "The Most Misunderstood American Dream: A Mortgage." This uses math to prove that the 15 Year is the worst option for borrowers.

Thanks for reading,
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