UNIT 6 – Overview

Understanding Home Mortgages

One thing that almost every homeowner will have in common is a **mortgage** – a legal document that pledges *property* to the lender as security for payment of a *debt*. In the case of a home mortgage, the *debt* is the amount of money that is borrowed to purchase a home. The *property* is the home itself. So, when homeowner goes to a bank or other lender to get a mortgage, the lender will hold the mortgage until the homeowner pays off the debt, a process that can take up to 40 years.

The mortgage is actually at the heart of today's home ownership industry because it represents the willingness of a lender to commit a relatively large amount of funds to a borrower for an exceptionally long period of time. Without this commitment, homeowners would simply have to come up with a much larger down payment, if not the entire purchase price of the home. In many cases the borrower is a young couple or a family with a relatively modest credit history, so the lender is taking a risk when it makes such a large loan.

To protect itself, the lender – the one who actually "owns" the mortgage – can take possession of the home if the borrower fails to make the regular monthly payments as agreed upon in the mortgage. While this happens only in extreme circumstances, the homeowner must take exceptional care to make sure that the payments are made on time. In fact, because owing a home is one of the best investments anyone will ever make, a borrower must go out of his or her way to make sure that the terms of the contract –expressed in terms of the size and frequency of the payment – are honored.

Finally, the mortgage itself can take a variety of formats. One of the simplest is the fixed rate mortgage which involves a fixed payment over the life of the mortgage. Another popular mortgage is the variable rate that allows the size of the payment to fluctuate with changes in interest rate. There are variants of each, and there are even more complicated mortgages that are not explored here, but the principles are the same.

Unit Objectives:

- Explain the concept and structure of a home mortgage.
- Construct, interpret, and use the mortgage amortization schedule.
- Disclose the key differences between the fixed rate, variable rate, and other hybrid mortgages.
- Show how to find the right mortgage for you.

Key Concepts:

- **Adjustable rate mortgage (ARM):** Mortgage whose monthly payment increases or decreases with changes in the interest rate. Also called a variable rate mortgage.

- **Adjustment period cap:** The maximum adjustment that can be applied to the mortgage during any one adjustment period.

- **Amortized payment:** Payment that is just large enough to pay off both the principal and interest over the life of the mortgage.

- **Duration:** The *length* of the mortgage; normally 30 years but can also be in 5-year increments from 10 to 40 years.

- **Fixed rate mortgage**: Mortgage whose monthly payment stays fixed regardless of changes in interest rates.

- **Graduated payment mortgage (GPM)**: Mortgage with low initial payments during the early years of the mortgage; payments then rise gradually after that and then level off for the remainder of the loan.

- **Growing equity mortgage (GEM):** Mortgage whose monthly payments are designed to pay of the loan off early by having the equity in the loan grow faster than normal.

- **Index:** A published interest rate series – usually based on U.S. Treasury bond yields or the London LIBOR rate (the rate at which banks in London borrow from other banks) – that is used to adjust the ARM rate.

- **Interest Only Mortgage**: Mortgage with early monthly payments just large enough to cover the interest on the loan. After the initial period, the monthly payment increases so that the principal can eventually be paid off.

- **Lifetime cap:** The ceiling on an ARM (if the rate goes up), or floor (if the rate goes down) that limits the maximum adjustment that can be applied to the initial interest rate. For example, the interest rate on a 5% ARM with a

2% margin and a 5% lifetime cap can never become larger than 12%, or smaller than 2%.

- **Margin:** An initial markup (expressed as a percent) that is *added* to the stated interest rate. So, a 5% ARM with a 2% margin will actually cost 7% at the beginning of the mortgage.

- **Mortgage amortization schedule**: A simple listing showing the monthly mortgage payment, interest on principal, principal reduction, and remaining principal.

- **Mortgage:** A legal document that pledges property to the lender as security for payment of a debt.

- **Number system:** A mortgage description such as 2/1, 5/3, etc., where the first number refers to the number of years in the initial period during which the interest rate cannot change. The second number refers to the length of time between subsequent readjustment periods. So, a 5/3 mortgage will have a fixed rate for the first 5 years that can be subsequently adjusted every 3 years after that.

- **Principal**: The original amount borrowed.

- **Progressive tax:** Tax system that taxes higher incomes at higher marginal tax rates than lower ones.

- **Reset:** An adjustable rate mortgage that adjust the interest rate and the monthly payment just once during the life of a mortgage.

- **Simple interest**: Interest that is not compounded; for example, the interest on a 12%, $100 simple interest loan would be: $100(.12) = $12.00.

- **Teaser Rate**: An unrealistically low introductory mortgage rate, sometimes approaching 0%, that applies to the first five or six months of a mortgage.