

# Understanding Your Mortgage



A Home Buyer's Guide to  
Becoming a Home Owner

Updated and Revised

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# Understanding Your Mortgage

by Patty Crowe  
Edited by Laura Wertz

Richer Resources Publications  
Arlington, VA

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## Introduction

This book is intended to bring you, the home buyer, closer to an understanding of the facts of the Mortgage Game, so that you can be more in control of your own home mortgage.

Although the U.S. Truth in Lending Law requires that a lender disclose to a borrower the truth about their loan - what their interest rate will be, how much they will pay in interest on the loan they are getting over the term of the loan, and the total amount they will repay on that loan, many people, when getting their loan, yet do not fully understand certain things about their loans. Such as, why is that the amount they are required to repay, how can they, within the terms of their loan and their knowledge of loan workings, repay this loan faster and less expensively. Yet, not understanding the basics of the loan they are taking out can have devastating effects. This book is intended to provide a basic understanding of mortgages so that the homebuyer walks into a mortgage with his or her eyes opened enough to avoid some of the potential pitfalls.

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The fixed rate compounded interest loan, amortized over 30 or 40 years is a banking innovation pretty much limited to the confines of this country and it has been the mainstay of U.S. mortgages for decades. Yet in recent years, with home prices rising and the desire for home ownership increasing, new and innovative techniques have hit the market place. While these new loans have enabled people to buy homes they otherwise would not have been to afford, they have also, in many cases, left those same home buyers facing high monthly payment and, in many cases, foreclosure and loss of their homes.

The theory behind how the mortgage banking system works is a body of data which can seem complex to the average home buyer, and yet its principles are simple. The lack of understanding on the part of homeowners as to how mortgages work has led to myriad of difficulties in recent months for home buyers who entered the market without fully understanding the terms of their loans. With home mortgages becoming a messy business for some mortgages holders and foreclosures topping the list of current American crises, America's only defense is to get informed. The banking system is undergoing changes as a result of these occurrences. Congress can legislate and investigate all it wants to ensure the home buying process will result in home buyers being able to afford and keep their homes. But the truth is that lenders are not the ones who are going to create responsible lending. Only an informed public will

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ever create responsible lending practices, as it is the consumer who ultimately makes the final decision and who signs on the dotted line.

This goal of this book is to help home buyers become home owner, whether they already hold a mortgage or will be newly entering the mortgage market. The book is set up with lots of examples, so that the information given is not just a lot of meaningless words that are difficult to relate to anything real. The figures given in these examples are very real, and are designed to give a visual and graphic reality on the theory and facts behind the workings of a loan. In reading this book, should you find that you “know it all already,” then I can assume that your own loan or loans are being paid down at rates with which you are pleased and you are more than likely satisfied with their progress and your personal achievements for your loans. In that case, I urge you to give this book to someone you know who could profit from the information in the book, and themselves get as causative over their loan as you undoubtedly already are over yours. It may seem like a small thing to do for someone, but, I assure you, for those who haven’t the vaguest idea of how to be in control of their mortgage loan so that they can achieve greater equity, increase their net worth, and achieve home ownership faster and much less expensively, it will be a gift they can use.

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Although interest rates change over time and the rates used as examples in this book may not be the rate you are facing with your current mortgage, the principles of how loans work, how to pay them off faster and less expensively and how to control the payoff of any loan are the same regardless of the interest rate. Once you get the theory and see examples of it in practical application, as I have given you here, that same data can be applied to any loan amount, any interest rate, any term, and any situation.

I have found that the thing folks most want in life is to achieve an understanding of whatever it is they are dealing with because with that understanding they can do so many things, not to mention that it just plain feels good to understand something. Within the pages of this book, it is my hope that you are brought to an understanding of the Truth in Lending, and that with that understanding you can achieve with your loans what you want to achieve, and that you, the individual, are all the wiser for having an understanding of it.

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# ***PART 1***

# ***UNDERSTANDING MORTGAGES***

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## Chapter 1-1

# General Information

You may or may not know this, but on an average, a home buyer will spend approximately three to four times the amount they borrow to repay a home loan under the current system of banking. For example, on a loan of \$100,000 at 10% over 30 years, a home buyer will actually repay \$315,925.20. On a loan of, say, \$300,000 at 10%, a 30 year loan will cost the home buyer very close to \$1,000,000 for that home.

This is an expensive way to buy a home, and, in fact, this amount of expense in home buying is a relatively new idea. “New and improved” loan ideas which actually put the reality of HOME OWNERSHIP into a far away category are unnecessary, and, in fact, oppressive to the home buyer. That is my opinion, and a banker may have a very different opinion of it, but I, for one, am more in the ‘home buyer’ category than the lender category.

This book, therefore, is not so much about HOME BUYING as it is about

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HOME OWNERSHIP, a thing of which I am a great proponent. But, in this day and age, and under the present popular forms of mortgage loans, one has to know something about home buying in order to achieve home ownership.

Although millions of people buy homes every year in this country, few know enough about the subject to make the necessary financial judgments that will make that home purchase a viable activity for themselves and their family. In actual fact, the basics of this subject are very simple to learn and understand, and some of those basic facts are what this book is all about. I am personally an advocate of people being able to own their own homes, lock, stock and barrel, and not having to stretch that home buying procedure over 20, 30 or 40 years. And I know that the easiest and best way to do that is to educate people on some of the various, simple ways they can bring this about. I don't believe that people should be left in the dark, but that they should be brought to a new awareness and understanding, so that they can determine their own future. That is the goal of this book, and if it brings you closer to it, then I will have achieved my purpose.

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## Chapter 1-2

# 30 Year Fixed Rate Loan

Let's begin at the beginning. Let's look at what is a mortgage and how your mortgage payment is figured out at the lender's end.

The most common, and one of the most expensive types of loans in this country, is the thirty year fixed rate loan. Under this type of loan, one gets a certain loan amount (the principal), and to that amount is added a certain amount of interest. Let's say that the loan amount is \$100,000, and the fixed interest rate is 10%, using these figures for ease in demonstration. Calculating the total amount you would pay for that loan, and your monthly or yearly decreasing principal, is an arduous process when doing it by hand but we'll go through it here briefly so you understand how it is that your loan payments and decreasing principal balance are figured at the lender's end. Those of you to whom this basic data is already well understood, bear with me here. You may yet find some items of information that are of interest to you and can be of assistance in becoming more 'savvy' in terms of just what the best way to pay off your own loan is.

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To calculate the first month's information, take \$100,000 and multiply it by .10 (10%):

$$\$100,000 \times .10 = \$10,000$$

This gives you the amount of interest you'd pay on that loan in one year IF your principal balance remained at \$100,000 for the entire year, which of course, it doesn't. This calculation will, however, give you the amount of your first month's interest. Take that \$10,000 and divide it by 12 months. That is:

$$\$10,000 \div 12 = \$833.33$$

The answer is the amount in interest you will pay on your \$100,000 loan in the first month of your payments. Payments on a \$100,000 loan over 30 years at 10% are \$877.57 per month (excluding any additional payments you send your lender for tax and insurance escrows), so, of the \$877.57 monthly payment on your loan, for the first month, \$833.33 of this goes to the lender towards your interest on the loan, and the remaining \$44.24 goes towards principal. So, after one month of payments, your principal loan balance is now \$99,955.76.

Let's take the second month. Your loan balance is now \$99,955.76. Again, multiply this figure by 10%, which will give you the total interest remaining to be paid for the year with this new loan balance, and then, again, divide that number by 12 months:

$$\$99,955.76 \times .10 = \$9,995.57$$

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$$\$9,995.57 \div 12 = \$832.96$$

This is the amount of your second month's payment that will go towards owed interest on your loan. The balance of your payment will reduce your principal. Let's calculate it out.

$$\$877.57 - \$832.96 = \$44.61$$

In the second month of payments, your principal loan amount has been reduced by \$44.61, so your loan balance now would be \$99,911.15.

Here is a table to give you an overview of the first two years of payments on this loan:

Pmt	Payment	Interest	Principal	Balance
1	\$877.57	\$833.33	\$44.24	\$99,955.76
2	\$877.57	\$832.96	\$44.61	\$99,911.15
3	\$877.57	\$832.59	\$44.98	\$99,866.17
4	\$877.57	\$832.32	\$45.35	\$99,820.82
5	\$877.57	\$831.84	\$45.73	\$99,775.09
6	\$877.57	\$831.46	\$46.11	\$99,728.98
7	\$877.57	\$831.07	\$46.50	\$99,682.48
8	\$877.57	\$830.69	\$46.88	\$99,635.60
9	\$877.57	\$830.30	\$47.27	\$99,588.33
10	\$877.57	\$829.90	\$47.67	\$99,540.66
11	\$877.57	\$829.51	\$48.06	\$99,492.14
12	\$877.57	\$829.11	\$48.46	\$99,444.14
Totals	\$10,530.84	\$9,974.97	\$555.87	\$99,444.14

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Pmt	Payment	Interest	Principal	Balance
13	\$877.57	\$828.70	\$48.87	\$99,395.27
14	\$877.57	\$828.29	\$49.28	\$99,345.99
15	\$877.57	\$827.88	\$49.69	\$99,296.30
16	\$877.57	\$827.47	\$50.10	\$99,246.20
17	\$877.57	\$827.05	\$50.52	\$99,195.68
18	\$877.57	\$826.63	\$50.94	\$99,144.74
19	\$877.57	\$826.21	\$51.36	\$99,093.38
20	\$877.57	\$825.78	\$51.79	\$99,041.59
21	\$877.57	\$825.35	\$52.22	\$98,989.37
22	\$877.57	\$824.91	\$52.66	\$98,936.71
23	\$877.57	\$824.47	\$53.10	\$98,883.61
24	\$877.57	\$824.03	\$53.54	\$98,830.07
Totals	\$10,530.84	\$9,916.77	\$614.07	\$98,830.07

By this table, you can see that after two years of payments totaling \$21,061.68, the equity you have put into your home by way of your payments, (that is, excluding any appreciation value, home improvement value, etc.) is \$1,169.94. The balance of those payments, or \$19,891.74, went toward interest on your loan.

Now, let's look at the middle of this loan. This is year 15:

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Pmt	Payment	Interest	Principal	Balance
169	\$877.57	\$699.22	\$178.35	\$83,728.03
170	\$877.57	\$697.73	\$179.84	\$83,548.19
171	\$877.57	\$696.23	\$181.34	\$83,366.85
172	\$877.57	\$694.72	\$182.85	\$83,184.00
173	\$877.57	\$693.20	\$184.37	\$82,999.63
174	\$877.57	\$691.66	\$185.91	\$82,813.72
175	\$877.57	\$690.11	\$187.46	\$82,626.26
176	\$877.57	\$688.55	\$189.02	\$82,437.24
177	\$877.57	\$686.98	\$190.59	\$82,246.65
178	\$877.57	\$685.39	\$192.18	\$82,054.47
179	\$877.57	\$683.79	\$193.78	\$81,860.69
180	\$877.57	\$682.17	\$195.40	\$81,665.29
Totals	\$10,530.84	\$8,289.75	\$2,241.09	\$81,665.29

Totals to Date:

Payments	Interest Paid	Principal Paid	Balance
\$157,962.60	\$139,627.74	\$18,334.86	\$81,665.29

The 'paid in' equity in your home is now \$18,334.86. You have paid \$157,962.60 so far on your loan and of that, \$139,627.74 has been paid towards interest. As you can see from the charts, as time goes on and the principal decreases even slightly, the amount of your payment that is put towards interest decreases slightly, and the amount going to pay off your

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principal increases slightly, so that by year 15, about \$185 each month is going towards your principal loan payment, as compared with about \$46 in your first year of payments. There is an end to this, but, as you can see, by and large, the interest is paid first.

Look at year 30, the last year of your loan:

Pmt	Payment	Interest	Principal	Balance
349	\$877.57	\$83.21	\$794.36	\$9,191.16
350	\$877.57	\$76.59	\$800.98	\$8,390.18
351	\$877.57	\$69.92	\$807.65	\$7,582.53
352	\$877.57	\$63.19	\$814.38	\$6,768.15
353	\$877.57	\$56.40	\$821.17	\$5,946.98
354	\$877.57	\$49.56	\$828.01	\$5,118.97
355	\$877.57	\$42.66	\$834.91	\$4,284.06
356	\$877.57	\$35.70	\$841.87	\$3,442.19
357	\$877.57	\$28.68	\$848.89	\$2,593.30
358	\$877.57	\$21.61	\$855.96	\$1,737.34
359	\$877.57	\$14.48	\$863.09	\$874.25
360	\$877.57	3.32	\$874.25	\$0.00
Totals	\$10,530.84	\$545.32	\$9,985.22	\$0.00

30 Year Totals:			
Payments	Interest Paid	Principal Paid	Balance
\$315,925.20	\$215,925.20	\$100,000	\$0.00

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When I've first shown people how this actually works, they find their hair standing on end. It's not that the information is hidden. When one goes to settlement on a loan, it is required by law that the lender disclose to the purchaser or borrower exactly how much they will be paying on their loan in total payments and in total interest payments. So the information is made known to the home buyer, whether he or she cares to digest the information at that point or not. What often is not made clear is exactly how the loan amortization works. And it is for that reason that people often don't know exactly what, if anything, they can do about the situation. However, it is my experience that with understanding comes the knowledge necessary to get one out of a situation they find unfavorable and the ability to change what they want changed about a situation. It is for this reason that I have spent time on this basic demonstration of how a normal loan is amortized. I will show you some ways to save tens, even hundreds of thousands of dollars, on your total interest payments in succeeding chapters of this book which you can use and implement yourself. But the best guarantee of actually saving those tens or hundreds of thousands of dollars is by increasing your own understanding of loans, loan payments, interest, and principal reductions, and how these work.

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## Chapter 1-3

### Interest Rates

Many people don't realize just how much difference a few percentage points in the interest rate can mean to both their monthly payment and the overall amount they will be paying for their loan. The best way for this difference to become clear is by graphic example, so I'll give you some simple comparisons here to demonstrate the point.

Let's say that you have a 30 year fixed rate loan of \$275,000 at 6%. Your monthly payment on this loan would be \$2,012.71 and your total payments would be \$593,557. Of that, \$318,557 would be interest payments on your loan. What are the differences in, say, a point lower or a point or two higher? Let's look at it. We'll compare the monthly payment, the monthly interest and the total payments (principal and interest combined) over the life of the loan on a \$275,000 loan at 5%, 6%, 7% and 8% in the chart which follows.

Loan Amount	Interest Rate	Monthly Payment	Total Interest	Total Payments
\$275,000	5%	\$1476.26	\$256,453	\$531,453

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\$275,000	6%	\$1648.76	\$318,557	\$593,557
\$275,000	7%	\$1829.58	\$383,651	\$658,651
\$275,000	8%	\$2017.85	\$451,430	\$726,430

As you can see, both the monthly payments and the overall payments are quite different with these percentage point changes. That is to be expected. But look at this:

Loan Amount: \$275,000

Pmt #	Interest Rate	Monthly Payment	Amount of Payment Put Towards Principal
1	5%	\$1476.26	\$330.43
1	6%	\$1,648.76	\$273.76
1	7%	\$1,829.58	\$225.41
1	8%	\$2,017.85	\$184.52
12	5%	\$1,476.26	\$345.89
12	6%	\$1,648.76	\$289.20
12	7%	\$1,829.58	\$240.31
12	8%	\$2,017.85	\$198.51
24	5%	\$1,476.26	\$363.59
24	6%	\$1,648.76	\$307.04
24	7%	\$1,829.58	\$257.68
24	8%	\$2,017.85	\$214.98

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As you can see, the higher your interest rate, and thus the higher your monthly payment as shown above, the less of that payment is actually going towards reducing your principal balance for the first many years of your loan. Comparing a 5% interest rate with a 6% interest rate as above, even though your monthly payment is higher with a 6% loan, the amount going towards actually reducing your principal loan balance is lower. It isn't until the 20th year of payments at 6% that the amount of your payment that is applied towards your loan balance becomes higher than the amount taken from a 5% monthly payment amount. That extra amount you have been paying is interest. Here's another example using a higher loan amount of \$525,000.

Pmt #	Interest Rate	Monthly Payment	Amount of Payment Put Towards Principal
1	5%	\$2,818.31	\$630.81
1	6%	\$3,147.64	\$522.64
1	7%	\$3,492.84	\$430.34
1	8%	\$3,852.26	\$352.26
12	5%	\$2,818.31	\$660.33
12	6%	\$3147.64	\$552.11
12	7%	\$3,492.84	\$458.77
12	8%	\$3,852.26	\$378.97

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24	5%	\$2,818.31	\$694.12
24	6%	\$3,147.64	\$586.17
24	7%	\$3,492.84	\$491.94
24	8%	\$3,852.26	\$410.43

Comparing payments on this loan amount at 5% versus payments at 6%, again, although the monthly payment is higher at 6% than it is at 5%, the amount of that payment going towards reducing the principal loan amount is less in the 6% payment than it is in the 5% payment. This holds true until the last month of the 14<sup>th</sup> year of payments. Let's look at total payments on this loan:

Interest Rate	Monthly Payment	Total Interest	Total Payments
5%	\$2,818.31	\$489,594	\$1,014,594
6%	\$3,147.64	\$608,150	\$1,133,150
7%	\$3,492.84	\$732,422	\$1,257,422
8%	\$3,852.26	\$861,819	\$1,386,819

As you can see, for a \$525,000 loan, the total payments are almost \$300,000 higher on a 7% loan than they are on a 5% loan. The payments are more than \$90,000 more on a 6% loan than they are with a 5% loan. However, the difference in the amount of the monthly payments can

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often make a difference in whether a person can even qualify for a loan at a given rate and comfortably make the payments for that rate. We'll go further into the subject of interest rates in subsequent sections of the book.

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## Chapter 1-4

# Adjustable Rate Loans

Flexible Payments, Option ARMs,  
and Negative Amortization

An Adjustable Rate Loan is just that. - a loan on which the interest adjusts periodically. This adjustment can occur daily, monthly, yearly, or in just about any interval decreed by the loan. The adjustment can be based on an agreed upon rate of adjustment at the time the loan is made, it can be based on the changing market, it can be based on a certain fixed percentage above prime rate. (Prime Rate has traditionally been defined as the interest rate banks charge their most credit worthy customers.) In short, it can mean many things, but the most important thing about an adjustable rate loan is that you understand how and when it adjusts so you can track your current interest rate, your current payment, and your declining loan balance yourself, because, while this type of loan has its merits, it also has its pitfalls. They are simple to understand, but you must watch for them.

Let's take a simple 30 year loan that is adjusting yearly. Let's say the

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initial interest rate is a below prime introductory rate of 4.5%, to adjust up one interest point yearly to a maximum of 8.5%. The loan amount is \$350,000. This will give you low monthly payments in the early years of the loan, but as time goes on, your payments should be increasing along with your interest rate increases. Let's take a look at how this loan would look. Your monthly payments on this loan would look like this:

Year	Monthly Payments
1 (4.5%)	\$1,773.40
2 (5.5%)	\$1,981.90
3 (6.5%)	\$2,195.88
4 (7.5%)	\$2,414.21
5 (8.5%)	\$2,635.88

The \$2,635.88 monthly payment would then continue for the remainder of the loan.

Your yearly interest and principle payment totals would look like this during the adjustable period:

Year	Int. Rate	Yearly Payments	Yearly Interest	Yearly Principal
1	4.5%	\$21,280.80	\$15,634.49	\$5,646.31
2	5.5%	\$23,782.80	\$18,805.48	\$4,967.32
3	6.5%	\$26,350.56	\$21,929.94	\$4,420.62

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4	7.5%	\$28,970.52	\$24,987.37	\$3,983.15
5	8.5%	\$31,630.56	\$27,994.02	\$3,636.54

In the case of this particular loan the rate has adjusted such that your total yearly principal payments are decreasing over the first 5 years of the loan. Out of a total of \$112,915.24 paid during the first five years of this loan, the amount of principal paid down of the initial \$350,000 borrowed is only \$22,653.94. In the ensuing years, of course, equity will start increasing with each passing year by a little at first, and eventually by quite a lot, until the term of your loan is up and your loan is paid in full. But, for now, the amount you are spending yearly on your mortgage payments increases as the interest rate increases, while the amount of your payment going towards decreasing your loan balance is less with each passing year. This can be rather depressing as you work harder and harder each year to keep up with your increasing monthly payment amount.

Let's look at another possible pitfall on an adjustable rate mortgage. Let's say our loan is for \$455,000 at an initial interest rate of 4%, the rate to adjust annually at 1% above prime, with a maximum monthly payment of \$2,512.53. Your monthly payments in the beginning would be \$2,172.24, which is the standard payment on a \$455,000 loan over 30 years at 4%, and your payments adjust upwards as your interest rate

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increases to the maximum of \$2,512.53. Your payments can never go higher than this amount, and this monthly payment fits into your budget, so everything is fine, right? Well, not necessarily. That \$2,512.53 per month is the usual payment for a \$455,000 loan over 30 years at 5.25%. What happens if your interest rate hits 7%? You get off easy, right? Wrong. Let's look at one way this loan could go.

Let's say that the loan started out at 4%. After one year the rate increased to 5% for 12 months, and then to 6% for one year, at which point it hit 7%. At a monthly maximum payment of \$2,512.53, your payment each month will not even cover the interest on your remaining balance at 7%. What happens then? The answer is simple, though severe. Whatever is not paid to cover interest each month is simply added to your outstanding principal balance. In this case, then, we have what is called a NEGATIVE AMORTIZATION. This is where, due to the above situation, your principal balance is not decreasing with each monthly payment you make, it is increasing.

Remember, at the end of the 3<sup>rd</sup> year, your interest rate was 6%, which put your balance at that point at \$433,703.46. Then the 7% rate kicked in. Payments at 7% on a remaining balance of \$433,703.46 should be

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\$2,983.08 to pay both the interest and give some over to the principal.

But you're paying only \$2,512.53.

Look at what happens in the first year of payments on this schedule.

Pmt	Payment	Interest	Principal	Balance
37	\$2,512.53	\$2,529.94	-\$17.41	\$433,720.87
38	\$2,512.53	\$2,583.09	-\$34.92	\$433,738.38
39	\$2,512.53	\$2,583.15	-\$52.53	\$433,755.99
40	\$2,512.53	\$2,583.22	-\$70.24	\$433,773.70
41	\$2,512.53	\$2,583.29	-\$88.06	\$433,791.52
42	\$2,512.53	\$2,583.37	-\$105.98	\$433,809.44
43	\$2,512.53	\$2,583.44	-\$124.01	\$433,827.47
44	\$2,512.53	\$2,583.51	-\$142.14	\$433,845.60
45	\$2,512.53	\$2,583.58	-\$160.38	\$433,863.84
46	\$2,512.53	\$2,583.66	-\$178.72	\$433,882.18
47	\$2,512.53	\$2,583.74	-\$197.17	\$433,900.63
48	\$2,512.53	\$2,583.81	-\$215.73	\$433,919.19

As you can see, your principal balance has increased by \$215.17 in this year. What happens then by the end of the term?

Pmt	Payment	Interest	Principal	Balance
349	\$2,512.53	\$2,619.39	-\$15,442.53	\$449,145.99
350	\$2,512.53	\$2,620.02	-\$15,550.02	\$449,253.48

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351	\$2,512.53	\$2,620.65	-\$15,658.14	\$449,361.60
352	\$2,512.53	\$2,621.28	-\$15,766.89	\$449,470.35
353	\$2,512.53	\$2,621.91	-\$15,876.27	\$449,579.73
354	\$2,512.53	\$2,622.55	-\$15,986.29	\$449,689.75
355	\$2,512.53	\$2,623.19	-\$16,096.95	\$449,800.41
356	\$2,512.53	\$2,623.84	-\$16,208.26	\$449,911.72
357	\$2,512.53	\$2,624.49	-\$16,320.22	\$450,023.68
358	\$2,512.53	\$2,625.14	-\$16,432.83	\$450,136.29
359	\$2,512.53	\$2,625.80	-\$16,546.10	\$450,249.56
360	\$452,872.20	\$2,626.46	-\$450,249.56	\$452,872.20

Because your term is 360 months, anything still due at the end of that term would come due and payable at that time, in this case, \$452,876.20, a balance very close to that of your original loan amount, despite that you just spent the last 30 years paying very nearly one million dollars in loan (mostly interest) payments. The one million dollars paid does not count the balloon payment of \$452,876.20 due at the end of the term.

In years past, it would have been very unlikely that an adjustable interest rate would climb to 7% and stay there for the duration of the loan. However, with the advent of the sub-prime mortgage loan offerings to home buyers, parameters such as the one profiled above, are becoming more and more commonplace. Or worse, if interest rates kept

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rising the above situation, one's indebtedness would continue to increase as well.

One can now get a loan known as an Option ARM, or a Flexible Payment ARM. This type of loan states that a homebuyer can decide on a monthly basis how much they want to pay on their loan. It is important that anyone opting for such a loan fully understands the potential ramifications of the various scenarios and be prepared to deal with the ones which do arise. If you have this type of loan, make sure that you understand the principles of negative amortization given above so you don't find yourself in a similar situation.

On some adjustable rate mortgages, you will have a fixed monthly payment, and the thing that changes each month or year along with the interest rate, is the amount of that payment that will go towards interest vs. the amount that will be applied to your principal. For instance, if an adjustable rate loan of \$200,000 starts at 5%, adjusts monthly, and has a fixed monthly payment of \$1342.05, watch what would happen with your monthly principal payments as this fixed payment loan adjusted:

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Pmt #	Monthly Payment	Interest Rate	Interest	Principal
1	\$1342.05	5%	\$1041.67	\$300.38
2	\$1342.05	5.125	\$1066.43	\$275.62
3	\$1342.05	5.25%	\$1091.23	\$250.82
4	\$1342.05	5.5%	\$1142.04	\$200.01
5	\$1342.05	5.75%	\$1193.00	\$149.05
6	\$1342.05	6%	\$1244.12	\$97.93
7	\$1342.05	6%	\$1243.63	\$98.42
8	\$1342.05	6.25%	\$1294.94	\$47.11
9	\$1342.05	6.25%	\$1294.69	\$47.36
10	\$1342.05	6.5%	\$1346.22	-\$4.17
11	\$1342.05	6.25%	\$1294.47	\$47.58
12	\$1342.05	6.5%	\$1345.99	-\$3.94
13	\$1342.05	6.5%	\$1346.01	-\$3.96
14	\$1342.05	6.75%	\$1397.80	-\$55.75
15	\$1342.05	6.5%	\$1346.33	-\$4.28

This example covers the first 15 months on a loan adjusting monthly with a fixed monthly payment. As you can see, the amounts being applied towards your interest, and therefore your principal is what adjusts along with your interest rate, as opposed to your monthly payment adjusting. As \$1,342.05 is the monthly payment for a \$250,000, 30-year loan at 5%, then, here again, if your interest rate rises above

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about 6.5% with this monthly payment, you would again be in a negative amortization mode. Option ARM's fall into this category where the home buyer is the one who actually decides how much he wants to pay each month. Where the payment amount falls short of owned interest for the month, that home buyer is increasing, not decreasing, the amount he will ultimately owe on his loan.

This type of loan can have advantages, as you can see, but the advantages definitely depend upon the fluctuating market. Once again, you can see that a difference of a few interest points makes a lot of difference on how quickly your loan is being paid down.

There are as many things to say about adjustable rate mortgages as there are different types of these loans. It would be impossible to detail every type of adjustable rate mortgage available and just as needless. If you know what the terms of your loan are, and have a pretty good idea of the estimated or projected rate of change of the interest rate, the details of your loan can be figured out for you using any amortization calculator. These exist on-line and in small hand-held calculator form and can be invaluable in tracking the progress of your loan and in making decisions relating to paying it down, refinancing, etc. You can

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also buy software that will allow you to track your progress completely.

The news gets better in Part 2 of this book, and after a short time of applying some of the solutions contained in that section, you will be able to track your progress on your own, with or without calculators. So, for now, just read and digest the general information on loan workings. The examples above are designed to show you the basics of how negative amortizations works and how they can come about. If you have an adjustable rate mortgage, be sure you understand the terms and what interest rate you're paying so you don't get into this situation. And, please don't think it doesn't or hasn't happened. It does, and, unfortunately, has. In fact, with home prices increasing as they have been, creative financing options such as the ones mentioned here have become more and more popular.

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## Chapter 1-5

# Creative Financing

### Sub-Prime Loans, Interest Only Loans

With the rapid rise in home prices, new and first time home buyers are increasingly in the market to find financing they can afford. This has sometimes been called “creative financing.” Creative financing now comes in many more forms than ever before. In the main, these loans were created to help enable a home buyer who otherwise wouldn’t qualify for a loan to be able to obtain one anyway. The loans known as “Sub-Prime” Mortgages refer, not to mortgages at an interest rate below the prime rate, but rather to loans given to those with less than ideal credit. These loans can come in many forms. One of the techniques used in rent times is the Option ARM covered in the previous chapter. In this chapter, we are going to look at another recently popular loan option known as Interest Only Financing.

Interest Only Financing is a form of loan in which a mortgage is structured such that the home buyer pays only interest on his loan each month for a certain, specified period of time. After this specified period

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of time, he either begins making standard payments on the loan or pays the entire balance of interest plus principal in one lump sum. This lump payment is called a balloon payment. As an example, the home buyer may pay interest only on his loan for the first 5 years of the loan. During this time the interest rate may be fixed or may vary, depending on the terms of his agreement. After five years, the loan usually either converts to a standard loan now amortizing over 25 years with a variable rate or one is required to pay off the loan in one large payment. Another option at this point would be to obtain new financing.

The interest only loan has been around for years and was a popular loan in the 20's until the Great Depression hit, at which time many could no longer pay their loans and bank foreclosures forced people to lose their homes entirely. Up until the wave of sub-prime mortgages in the early part of this century, interest only loans were used largely by a person needing a temporary loan for construction purposes or for the financing of investment properties. Now, however, these loans have made a comeback because they enable folks to purchase a home they otherwise would not be able to afford. These loans are designed to reduce the monthly outlay in the early years of the loan and they do, in fact, save the homebuyer a degree of financial outlay as he is paying only interest

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in the first months or years of his loan and is not paying down the principal at all. The following chart will show you three different loan amounts, each at 6% interest. You can see what the interest only monthly payment of each would be and the amount one would not be paying in principal each month in order to try and keep the monthly payment in an affordable range.

Loan Amount	Initial Interest Rate	Monthly Payment (Interest Only)	Principal Payment Not Made (Deferred)	Equity Accumulated During Interest Only Payments
\$250,000	6%	\$1250.00	\$248.88	\$0
\$375,000	6%	\$1875.00	\$373.31	\$0
\$500,000	6%	\$2500.00	\$497.75	\$0

In each case above, the Principal Payment Not Made column shows the amount of owed principal being deferred until the Interest Only loan obligation expires. The loss of accumulated equity, or ownership, in the home shows up in the consistently \$0 total in the last column until such time as the loan structure reverts to a standard interest plus principal payment or until the balloon payment is made at the end of the interest only period. Some new home buyers find that by paying Interest Only for the first months or years of their loan, they can more easily afford

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the payments on their home loan. In the \$250,000 example above, the home buyer is paying \$248.88 less each month by deferring the amount which would ordinarily be his principal payment for the month. In the \$375,000 example, the amount being deferred is \$373.31, so his payment is \$1,875.00 rather than \$2,248.31. Although the loans are advertised as enabling the home buyer to save the difference in payments, this is actually a misnomer, as he is only deferring payment to a later date, not actually saving this money.

Despite the fact that there is no equity buildup being accumulated with this loan structure, there are instances where this loan makes sense and which distinguishes it from continuing to simply pay rent to someone else. During periods of rapidly rising home prices, one's equity in their home is increasing without ever making a principal reducing payment. If, during the initial 5 year interest only payment period, one's home value increases, let us say, from a purchase price of \$350,000 to a market value of \$500,000, the home purchaser has achieved a \$150,000 increase in equity value while making interest only payments. If the home buyer could only qualify for the \$350,000 loan based on monthly payments of interest only, this would not be a bad investment and would place the homebuyer in a position of being able to buy a home in a rapidly rising

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market before housing prices got so out of hand he or she never would be able to catch up to the accelerating cost of a mortgage. In other words, if the home buyer, knowing he couldn't really afford the payments on a standard \$350,000 mortgage, were to decide to wait a few years while working to increase his income, in a few years that same home may well be selling for \$500,000 and he would still be trying to get in a position to buy a home. By opting for the interest only loan in the first place, he has gotten into a position of being able to buy a home he could not otherwise afford, while working to increase his ability to pay for it, all the while gaining market driven equity in the home.

This is a bit speculative and somewhat risky but there is and always has been money to be made in speculation by those willing to take a chance on real estate. What is new about this is not the fact of real estate speculation, but the fact that Harry Home Buyer is taking part in speculation for a chance to become Harry Home Owner, whereas this degree of risk has traditionally been undertaken in the main by investors. Housing prices can suddenly fall and income expectations can fall short making an investment via an Interest Only Loan somewhat risky when you're talking about one's primary residence.. On the other hand, no one gets anywhere without taking at least some risk and, let's

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face it, any mortgage has built into it some degree of risk, as no one knows for certain how their lives or the markets will unfold over the length of any loan. However, it might be a wise personal policy to learn from the errors of the past. A similar scenario in the 1920's played a part in the miseries of the Great Depression. Most recently, history repeated itself when the real estate market, first leveled off, then declined, and now we are again seeing a period of higher than usual foreclosure rates and more credit problems than has been the norm. This can all be summated and statistized and reduced to economic theory and numbers crunching but the fact is that real people with real lives are involved in these foreclosures and every instance of an inability to pay bills means real agony for some family somewhere. Again, laws can be passed and legislators can take action which minimizes such risks, but the real answer lies with the individual being informed enough to make responsible borrowing decisions. There is really no shortcut to that fact.

Avoiding all risk is not possible in life or home ownership. Life has risks, that is a fact that is not going to go away. Understanding the risks of an undertaking and having a plan in any eventuality is more the object here and that is why it is important when obtaining a mortgage to completely understand that mortgage inside and out. And don't forget that even

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during the interest only payment years of the loan one can make a principal payment. Every dollar you pay in principal is a dollar you won't be paying interest on for the remainder of the loan's term. And once the interest only loan option expires and you are making regularly amortized loan payments, all of the information in the second part of this book applies. So, the message soon to come is that even with an Interest Only loan, there is still a way you can own your home sooner and for less money. Read on.

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## Chapter 1-6

### Points

Just what are “points,” and how did they come into being? It is important to spend a little time covering this subject, as you will be charged points of some kind on almost any mortgage you get whether they are advertised as “points” or whether they are hidden in amongst the closing costs you pay when you go to settle on your loan.

Points are simply this: a point is an amount of money equal to 1% of the amount of your loan. Points are additional fees you pay the lender. There are two primary types of fees charged in terms of points. One is the ‘Loan Origination Fee,’ and the other is called a ‘Loan Discount Fee.’

The loan origination fee, usually one or two points, or 1% or 2% of your loan amount, is a fee charged by the bank for giving you the loan. It is an administrative charge. This is one way the bank makes money on your loan. Sometimes you can find a loan with no points, or fees, charged, and these loans generally carry a higher interest rate than loans

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with fees.

Loan discount fees vary depending on the market and the type of loan obtained, but are fees charged by the lender when he is giving you a particularly low interest rate, or a “discounted” interest rate. It is how the lender makes money on your loan up-front. It’s a trade-off - you pay a higher interest rate and no discount points, or you get a lower rate but you pay “points” or a lump sum of money to the lender instead, quite in addition to the principal loan amount you are borrowing from him. So, again, points are simply added fees of one type or another charged by the lender in giving you your loan.

What, you might ask, about all the money being made in interest on my loan? Look here, I’m borrowing \$100,000 and this lender is making \$215,000 profit in interest payments. What about that? Why am I being charged other fees in lending me this money?

Well, you’re right, in a sense. Someone is making \$215,000 on your loan, but it isn’t the bank. It used to be that that was the business the bank was in. You’d go to a bank and borrow some money and they’d charge you X percent interest and you’d pay it and you’d get your house and

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they'd make their money and as long as you paid it through to the end, that was the end of it.

Well, that was the old days. It is true, some independent banks still operate this way. But that is not how loans typically unfold in this day and age. What happens today is that you apply for a loan, the bank charges you a loan origination fee and, sometimes, loan discount points for this loan. They give you the money, and then the bank sells your loan on the secondary market. Loans are usually sold to one of two corporations, Fannie Mae or Freddie Mac, which, in their turn, sell the loan to investors.

The bank you borrowed from no longer holds the note but, nonetheless, continues to collect your payments from you and keeps track of your loan for you. The bank you originally borrowed the money from, having resold it on the secondary market, now has that money back right away. They've made some profit on it as they've collected your loan origination fee from you. They may also have collected from you a loan discount fee.

If you were charged loan discount fees, then it can be assumed you

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obtained a relatively low interest rate. As you were given a discounted rate, and your lender now has to re-sell this loan on the secondary market, he will get less for your loan when he resells it than he would get for a higher interest rate loan. As your lender wants to resell the loan so as to recapture cold cash for it right away rather than having to wait 20, 30 or 40 years for the money at \$877.57 per month, he is willing to sell it at such a discount. The money he has recouped can now be lent to other borrowers.

So, the loan discount points are designed to offset the difference in the interest rate charged on your loan vs. the amount your lender will be able to get for the loan when he resells it. With a low interest rate, he has lost much of the profit he will make on the sale of your loan and so makes up for this by charging you fees in exchange for the lower interest rate.

The number of points varies with the lending institution and the particular loan you get. They can be as high as 3 or 4 points for a loan origination fee, and as high as 14 points for loan discount fees, which, in the case of \$100,000 loan would be \$3,000-\$4,000 up front from you at the time of settlement in loan origination fees, and more for loan

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discount fees. On a \$300,000 loan, 3 or 4 points would be \$9,000-\$12,000.

Generally, the lower your interest rate, the higher your loan discount points. Sometimes a bank offers no points and a higher interest rate or a longer term. Which loan would be best at any given time depends on the purchaser's current financial picture, his plans for the loan, how far into this loan payments he is, his intentions to resell or not resell the property after a certain amount of time, his knowledge of how to take that loan and pay it down faster (this topic will be covered later in the book), and various other factors. The thing to do would be to look at your financial picture and plans, and, if desired, get a comparative analysis done on the types of loans offered to help clarify these various options for you.

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## Chapter 1-7

# The 40 Year Mortgage

During the 1990's, some banks came out with the 40-year mortgage. This was designed, presumably, to make it easier for the home buyer to qualify for a loan, reducing their monthly payments by increasing their term. Of course, if you borrow a sum of money with a term of 30 years, your monthly payments would be lower than if you had borrowed that same sum of money for 10 years because the loan amount would be stretched out over a longer period of time. So, too, a 40-year term will require a lower monthly payment than a 30-year term. But, just what real advantage this 40-year mortgage is to the home buyer who wants to own his home needs a close inspection.

Let's look at the differences between a 30-year \$100,000 loan at 10% vs. the same loan over 40 years.

Loan Amount: \$100,000

Interest Rate: 10%

Terms: 30 years and 40 years

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Term	Monthly Payment	Total Interest	Total Payments
30 years	\$877. 57	\$215,925.20	\$315,925.20
40 years	\$848.15	\$307,592.00	\$407,592.00

The 40-year mortgage was promoted as a new solution to the expense of a 30-year loan by extending the term of the loan and thus lowering its monthly payment. But, as you can see in the above example, the monthly payment on a 40-year loan is only \$28.42 less than on a 30 year loan. By and large, the rest of the money one is paying is interest, for 10 additional years.

There can be some advantages on the loan origination fee side of the loan, as some 40-year loans offer no points. This can save a homeowner a good deal of money up front, especially if his loan is a rather large one. Points of 1% of the loan amount on a \$400,000 loan, with the bank charging 3 or 4 points, is \$12,000-\$16,000 down, quite in addition to the down payment for the property. So that could be an advantage. In that instance, let's look at the borrower's overall payments both ways.

Loan Amount: \$400,000 (0 Points)

Interest Rate: 10%

Term: 40 years

Monthly Payment	Total Paid	Total Interest Paid
\$3,396.58	\$1,630,358.40	\$1,230,358.40

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Let's compare that with a 30-year loan with points.

Loan Amount: \$400,000 (3 Points)      Interest Rate: 10%

Term: 30 years

Monthly Payment	Total Paid	Total Interest Paid
\$3,510.29	\$1,263,704.40	\$863,704.40

In this example, if you look at the difference in the monthly payments between a 30-year loan and a 40-year loan, you will see that the difference is only \$113.71 a month. Yet, because payments of \$3,396.58 are being made for ten additional years, the payments made total \$366,654 more on a 40-year loan than on a 30-year loan. That's \$366,654 more in interest payments to save \$113.71 a month in one's monthly payment, or to save \$12,000 in points. Well, the truth is that in some situations, all one can do is go with the longer term and 0 points. However, it is easy to see that this is a highly expensive loan and not necessarily one's best first choice.

Fortunately, there is something that can be done even about this. One alternative, of course, is to finance the points in with the loan, which can often be done in a refinancing situation. A \$12,000 loan over 30 years would be a total loan repayment of around \$37,000. That's a lot less than the \$366,654 put out in ten additional years of interest. Most people could

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find something to do with that \$329,654 they saved in interest payments.

This is just one possible alternative. There are actually many alternatives, and that's what we're just about to get to here.

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***PART II***  
***SOME SOLUTIONS***

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## Chapter 2-1

# General Information

If the information contained in the first section of this book was new to you and hasn't knocked you over yet, then you will find the information in the second section of this book greatly relieving. This section of the book covers some solutions to the way most loans are structured in this country and should help to put you at ease over your own loan payments and give you a feeling of accomplishment every time you pay down a part of your loan faster.

Paying down a loan faster than the way it was set up to be paid is not a difficult thing to do, and it can be done in such a way that you know what you are doing with your loan and have prediction on how much progress you are making in doing so.

Paying off your loan faster and less expensively can be done even if you don't generally have a lot of money left at the end of your month, and, if

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you want to badly enough, even if you usually have more month left at the end of your money.

In this section of the book, I will give you some ways in which this can be done without a lot of sophisticated computers or software, but with just what information you have so far discovered for yourself by gaining an understanding of the way most loans are structured. Or, you can figure the best way to pay off your loan within your own budget or financial means with the assistance of computer analysis supplied to you for a small fee by companies that specialize in this line of work.

Either way, we are over the hurdle of astonishment at how loans work, and are about to enter the body of knowledge which will get you in complete control of your own home mortgage.

This is the fun part of the book.

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Thank you for reading Part One of our popular mortgage book, *Understanding Your Mortgage*. We hope this has given you some useful information on how mortgages work and cleared up some misconceptions you may have had about your own home mortgage. To read Part Two of this informative book and discover some solutions to any mortgage, we suggest you buy and read the entire book. This book can be purchased from the publisher at [www.RicherResourcesPublications.com](http://www.RicherResourcesPublications.com) or from Amazon.com, B&N.com, Target.com and wherever fine books are sold.

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*Aristophanes' Birds*  
*Aristophanes' Lysistrata*

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Real Estate Associate

