BUSINESS FOCUS:

With rates at historic lows, do I want a 30-year mortgage?

By Mike Urnezis, Ledyard National Bank

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Everywhere you turn today, there's commentary on low mortgage rates, high refinance volume and increasing home buying power due to our current COVID-19 economy. The "go-to" loan is 30-year fixed, fully amortized, because it's the most affordable and provides stability in a monthly principal and interest payment that will not change over the life of the loan (unlike an adjustable rate mortgage that comes with interest rate risk). Additionally, it's an important path to ownership for first-time homebuyers and low- to moderate- income borrowers that might otherwise remain renters. According to Freddie Mac, 90% of homebuyers chose a 30-year loan in 2019.

Understand how amortization works

With homeownership being the average American's largest asset and respective debt, understanding the impact of debt/loan expense and amortization is important to financial goals. Many are surprised by the material interest savings a shorter term/amortization delivers, albeit the payment is higher. Amortization is defined in the Cambridge Dictionary as, "the process of reducing cost or total in regular small amounts." A 30-year loan stretches repayment out longer with more interest expense incurred due to the slower pace of principal reduction.

For example (round numbers): $250,000 loan amount:

- 30-year fixed @ 3.125% = $1,071 monthly principal and interest; total payments life of loan = $385,538
- 15-year fixed @ 2.625% = $1,682 monthly principal and interest; total payments life of loan = $302,710

Result: Shorter term/amortization saves over $82,000!

A 30-year loan provides a more affordable payment, creating increased cash flow for savings, maximized retirement, 529s and everyday expenses. The 15-year loan builds equity (amortizes) much quicker, reducing interest expense. Additionally, a 15-year rate is typically .375% to .625% less than that of a 30-year. Below is the allocation of the first principal and interest payment from our example above:

- 30-year fixed @ 3.125% = $1,071
First payment allocation:
principal: $419.90 / interest: $651.04
- 15-year fixed @ 2.625% = $1,682
First payment allocation:
principal: $1,134.84 / interest: $546.88

Result: In the very first payment, the 15-year loan pays down principal by an additional $714.94 and saves $104.16 interest expense.

A 15-year loan is not for everyone. A careful review of debt-to-income ratio and overall financial goals must be considered with a higher payment commitment. While a first-time home buyer may only qualify for a 30-year term, a savvy, disciplined investor who can afford a 15-year payment may choose to lock in longer term rates to invest the difference in the market with risk tolerance in mind.

Consider prepayment options

If the monthly commitment of a 15-year is too high for the budget and/or you recently closed on a 30-year, there's good news. Residential, owner-occupied mortgage loans typically allow for prepayment of principal without penalty, creating flexibility in amortization. So, you can keep the affordability of a 30-year term while making additional payments to principal as you wish. Taking our 30-year fixed example from above, what if we added $100/month to principal?

$250,000 loan amount:

- 30-year fixed @ 3.125% = $1,071 monthly principal & interest; total payments life of loan = $385,538
- 30-year fixed @ 3.125% = $1,071 plus $100 month to principal; total payments life of loan = $365,552

Result: Interest savings of almost $20,000 and loan payoff 47 months earlier

Other terms exist — ask your lender

If something in the middle of these two terms is best, most lenders offer 20- and 25-year fixed, too. With so many options to consider, your experienced, local loan originator can assist with analysis and scenarios for a loan tailored to your plan.

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