

There is a bank near my office in whose lobby is a sign displaying their current mortgage rates. It shows two options; their 30-year, fixed rate mortgage and their adjustable rate mortgage. A couple of weeks ago the sign had a remarkable set of numbers. The 30-year, fixed rate was 6% and the adjustable-rate was 6.125%. Effectively, the world had turned upside down.

For decades, beginning just after WWII, the 30-year, fixed rate mortgage was the way people financed their homes. This worked fine up until the early '80s when interest rates soared to the highest levels since the Civil War. And a dramatic thing happened. Mortgage lenders were willing to make loans at 14% or higher, but they could find almost no one who could qualify for such a mortgage. As a result, just about the only way a house could be sold was if the owner agreed to take monthly payments from the buyer.

The mortgage industry responded by creating ways of lowering monthly payments so that more people could qualify for a mortgage. This is how adjustable rate mortgages were born. The initial rate was set well below the going 30-year rate, with the provision that it would adjust, probably upward, every year until it reached the market rate. And the possibility was held out that, should market rates fall, the mortgage rate could also drop.

These days interest rates are relatively low, but something else has stymied the housing market. That is the soaring prices of homes. Just like high interest rates in the '80s, these high house prices have made it difficult for many people to qualify for a 30-year mortgage to purchase a home. That's because the high price pushes up the monthly payment just as high rates did in the early '80s. Once again, the adjustable rate mortgage has been rolled out because by starting off at a rate well under market, many more people can qualify for loans. But now, even if interest rates remain stable, the increase in the mortgage rate in just a few years, which translate to higher monthly payments, will put great financial strain on many homebuyers. We are seeing this right now.

There is one other mortgage loan that makes little sense. This is the 15-year mortgage. These loans are pushed on the premise that their interest rate is lower than a 30-year mortgage. A little math will illustrate how foolish this idea is.

Suppose you wish to take out a \$250,000 mortgage and you have a choice of a 30-year loan at 6% or a 15-year loan at 5.5%. The monthly payment on the 30-year, 6% loan is \$1,491 while the monthly payment on the 15-year, 5.5% loan is \$2,033. Right away we're talking about an extra \$542 per month. However, if you took the 30-year loan and in the first year increased your payment by 4%, or \$59 a month, you would begin to accelerate the maturity of the loan. If you continued to increase your payment by 4% each year, in about 12 years you would pay off the loan. And, any month you needed extra cash you could pay your lender only the \$1,491.

The only mortgage loan a homebuyer should consider is the standard 30-year fixed rate mortgage. If you cannot qualify, save money until you can. The alternatives make no sense. An adjustable rate puts you at huge risk and a 15-year is just dumb.