Mortgages: Consult with Us, Too

Are you in the market for a home? Perhaps you need a larger space with room for a dedicated home office, or maybe you've decided to downsize as retirement looms. Perhaps you've decided you'd like a vacation home. Whatever the reason, when considering a mortgage, we recommend a consultation with your financial advisor. Mortgage brokers provide valuable information about interest rates, types of mortgages, down payments, and how credit scores affect options. But they are not in the best position to advise consumers on how the mortgage can best be structured to support long term financial goals.

The Economist recently ran an article titled "Poor Financial Decisions, Regulators are Keen to Stop People from Making Mistakes." Topping their list of poor financial decisions are those that people make when taking out mortgages. "Most American home loans last for 30 years, the interest rate fixed. When rates fall dramatically, most borrowers might be better off if they refinanced. Yet too few do. In 2013, 42% of American borrowers paid rates exceeding 5%, when the average rate paid on new mortgages was less than 4%."

In a recent survey, one in five Americans said the pandemic caused them or someone they know to relocate (Source: Pew Research Center, 2020).

The recession is putting many baby boomers in a predicament: a layoff has derailed their plans to work full time to build up their retirement benefits. From March 2020 to June 2020, the unemployment rate for Americans who are at least 55 years old has more than tripled, to 9.7% (Source: Center for Retirement Research, September 2020).

Unemployment caused by COVID-19 has pushed up the share of working age households who cannot afford their current standard of living in retirement from 50% to 55% (Source: Center for Retirement Research, July 2021).

Mortgage debt remains the most significant and common source of debt amount older households, representing 69% of total debt in 2016. Older adults with a mortgage are 4.8% less likely to be retired and 3.1% less likely to receive Social Security benefits. Households between the ages of 62 and 70 with a higher level of debt are more likely to claim Social Security benefits early (Source: *AAII Journal*, June 2020) introduced, popularity soared, with 68% of loan originations in 1984 being ARMs. But as interest rates declined in ensuing years, ARMs have become less popular. Perhaps that is because they are still relatively misunderstood by consumers.

The Hybrid ARM is the most common form of adjustable- rate mortgage today. The initial rate is locked for a fixed peri- od (usually five or seven years) and then adjusts either yearly (most common) or at another set interval. The interest rate for the ARM is typically based on an index tied to federal rates of interest. Since the consumer is assuming some interest rate risk, the rate during the fixed period of the ARM is typically lower than 15 or 30-year fixed interest rates. If interest rates in the market move up, the rate on the mortgage will increase after the fixed period. If interest rates decrease, then the mort- gage rate (and payment) will decrease.

The question that will almost certainly be asked by home- owners is, what if I take an adjustable-rate or hybrid adjustable-rate mortgage and rates go up? No one can predict the movement of interest rates, but the homeowner needs to consider how long they may have the mortgage. According to the National Association of Realtors, since 1985 the median seller tenure in a home has ranged between six and ten years.

Consider this: The Mortgage Bankers Association reports that the median size of a mortgage in the United States is $325,000. Given that the average rate difference between a 30- year mortgage and a 15-year mortgage has been about 0.75%, and that the rate for a 5-year hybrid ARM is another 0.25% less, the difference between the 30-year and 5-year hybrid ARM is about 1%. That is $3,250 per year starting out for the average American. Multiply that by the term of the loan, and the total difference can be close to $50,000 (the amount of interest declines over the 30-year term).

Surveys by the Federal Housing Finance Agency (FHFA) indicate that borrowers are selecting the wrong type of mortgage, leading to overpayment of interest right from the beginning.

One common way to save is to monitor when interest rates drop. Refinancing is the process by which one loan is replaced by another loan with more favorable terms. This is done to reduce monthly payments, consolidate or free up cash. All loans have fees and closing costs, and some have pre- payment penalties. Therefore, a holder needs to decide whether a lower interest rate outweighs the various additional costs involved with refinancing. When there is a significant rate drop, it is worth the time to examine whether to refinance and save on interest charges.

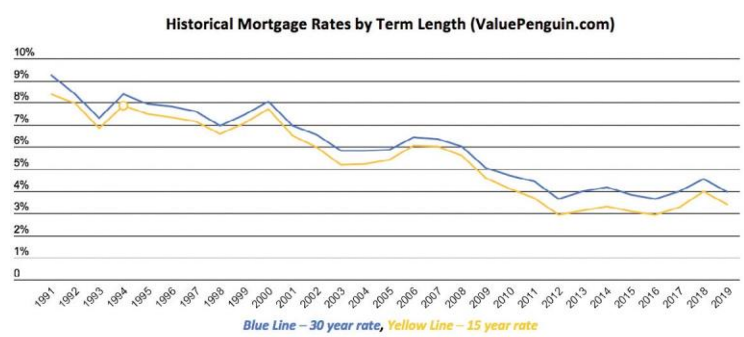
Financial advisors ought to be there to help. The role of a financial advisor is to help make financial decisions. Yet, in one of the most important financial decisions that families and individuals make, over 70% relied "a lot" on lenders or mortgage bankers to get information on mortgages, with only 13.5% relying "a lot" on financial advisors.

Perhaps individuals have been underserved in the mort- gage process in the past and this has led to an overreliance on behavioral biases such as familiarity, overconfidence, endowment effects, and status quo. These biases, when paired with an overall preference for certainty and with the fear of higher rates, has led to a preference for fixed-rate mortgages.

There is a wealth of information available about consumer decision making in choosing a mortgage. Both the FHFA and the Consumer Financial Protection Bureau conduct surveys and make the data available through Fannie Mae's website. Their monthly National Housing Survey polls 1,000 consumers about owning or renting a home, the economy, and household finances, including mortgage decision making. There are more than 100 questions.

Sorting through the data, there are a number of startling conclusions:

1. Consumers are at least four times more likely to think that mortgage rates will go up instead of go down. This despite the fact that rates were declining the vast majority of the time that the data was compiled.



2. Consumers therefore lock in their mortgage interest rate almost 90% of the time. Almost 80% of those lock the rate for 30 years.
3. During the application process, consumers were told about a fixed-rate loan 94% of the time, but were not told about a variable-rate loan 51% of the time.
4. Only 23% of consumers listed a lower interest rate as an important part of the decision-making process.

5. Despite the fact that over 70% of consumers take out a 30-year fixed rate mortgage, which typically carries the highest mortgage rate, the average tenure in a home ranges from six and ten years. The average tenure in a mortgage is less, considering that some of the consumers who stayed longer than six to ten years would have refinanced.

Ideally, financial advisors would partner with clients and mortgage brokers during this decision-making process. For homeowners, their primary residence is typically their biggest asset, and their mortgage is usually their greatest liability. A great deal of time and effort should be spent to understand all aspects of the available choices.

At Burke Financial Strategies, we are here to provide our clients with a personalized review of this important financial decision.

Sincerely,

Melissa Montalvo

Melissa Montalvo, CFP® Financial Advisor

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