

Valuable Mortgage Questions

AS INTEREST RATES HOVER NEAR historic lows, this is an excellent time to revisit your current mortgage plan and explore financially astute options for the future. Begin your preparation by exploring the following key questions with a trusted adviser:

- What is my tolerance for risk?
- How long will I remain in the home?
- Is a fixed rate truly the right choice for me?
- How do I evaluate the pros and cons of different plans?

Risk tolerance

The over-riding goal of effective mortgage management centers is balancing risk with reward. Begin by estimating your level of risk on a scale of one to five with one being ultraconservative and five demonstrating a high threshold for risk. Levels change as time passes, so use a five- to seven-year window as the measuring stick. Your individual ranking will be based on personal instincts and past experiences, outside opinions, world events, and your stage in the life cycle. A couple nearing retirement may view their risk level much different than a high-achieving 40-year-old. Likewise, an employee on a highly volatile career path may view risk different than one in a historically stable job.

Asset time frame

Consider how long you will retain the property as an asset. First, think about how many years you'll actually reside in the home. Then, compare that to the prospect of relocating while holding onto the house as rental property. Depending on a number of variables, including property type, current equity in the home, and market conditions, you may benefit by adding real estate assets to your portfolio over the next few years.

Fixed vs. ARM

A mortgage plan should be tailored to your unique DNA, not your neighbor's or relative's.

Every type of program has pros and cons. With your mortgage adviser, understand the differences and analyze actual bottom-line numbers when making the best choice. Many homeowners fail to recognize the hidden opportunities that can exist.

ARMs (adjustable rate mortgages) are not taboo. Evaluate the risk from an after-tax basis. Planning to move in three to five years? By selecting a seven-year ARM, you are guaranteed the rate will not increase for 84 months. You also created a two- to four-year buffer or protection zone against future rate increase if your original time line holds true to course.

Assume the difference between a 30-year fixed rate and seven-year ARM is 1 percent. On a \$300,000 mortgage, that is a \$3,000 annual savings. Calculated over seven years, the gross savings is \$21,000, or \$250 per month. This monthly savings is all interest and subject to IRS deductibility rules. If you fall within the 30 percent tax bracket, the \$250 payment differential results in an after-tax cost (or savings) of \$175. Had you selected a fixed rate, you would pay \$250 gross more each month (\$175 net) for the added security of a fixed rate.

On the other hand, let's assume you'll relocate in the same time frame but keep the house as rental property. In this case, it may be more advantageous to select a fixed rate plan. Interest rates are higher and underwriting guidelines more restrictive for investment property if you refinance out of an ARM that adjusts up.

Interest only or full payment

Of all the mortgage types, the interest only option is by far the most misunderstood when it comes to the level of risk and reward. The critical success factor is how you manage the monthly savings. The very word "only" in the title drives many to make just the interest payment and literally forget about contributing to principal. Astute homeowners, on the other hand, continually evaluate opportunities to invest the monthly savings. Two common methods are to make principal payments as cash flow opportunities such as salary bonuses and



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income tax refunds appear. Or, if the opportunity presents itself, consider investing the savings in another type of financial instrument (e.g., mutual funds, 401(k)) to generate a higher rate of return.

Many homeowners are not aware of a mortgage management option called "recasting" or "re-amortization." Normally, when you make additional principal payments, the loan balance drops but your monthly payment remains the same. Under this concept, handled through your current mortgage holder, you make a lump sum payment to reduce principal and the payment is recalculated based on the remaining balance. Lenders normally require a minimum one-time reduction of at least \$5,000 and usually charge \$250 to \$500 to modify the loan.

Scores of opportunities exist in today's market. Seek input from a trusted adviser, ask yourself key questions, and adopt an analytical approach to balancing risk with reward. U