

**PROFITING**  
**FROM THE**  
**BANKING**  
**INDUSTRY'S**  
**BIGGEST**  
**SECRET**

A Consumer Guide Presented by: **The Asher Institute** FOR CONSUMERS

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## **INTRODUCTION**

The **Asher Institute** FOR CONSUMERS was formed in 2003 to educate and inform consumers about various consumer issues so they can make smarter decisions regarding finances, banking and mortgages. The Institute has identified a major consumer misnomer that needlessly costs American consumers billions of dollars a year. The misnomer is perpetuated by the banking industry in order to maximize profits and has been very successful due to the misinformed status of the public. This Guide reveals the banking industry's biggest secret and how consumers can take advantage of it.

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What does the banking industry's biggest secret concern? Mortgages. When it comes to mortgages, most consumers are knowledgeable and able to choose between various loan products and select the right home loan for their risk tolerance. The most highly promoted loan type of all, the 30-year fixed-rate mortgage, is the one most often selected. Our research revealed some shocking truths about the 30-year fixed that equally stunned both consumers and mortgage industry experts alike.

Consumers choose a 30-year fixed based on two things and only two things- a low fixed rate and a low fixed payment. But the Institute found that only ONE of those two things is actually true. The other one is false. Which one is false? The part about the interest rate being fixed. Contrary to public opinion, the interest rate on a 30-year fixed-rate mortgage is NOT fixed. That's right, NOT fixed. You will learn that a 30-year fixed-rate mortgage is actually an **ADJUSTABLE RATE MORTGAGE** and the rate consumers are really paying on them is much, much higher than they could ever imagine, completely blocking their paths to financial freedom.

Because common wisdom says that a 30-year fixed-rate mortgage must actually have a fixed rate, it's an easy sell for the lenders, who profit substantially from the misnomer. The Institute finds nothing wrong with corporations profiting as that is their sole purpose. However, since this particular profit game is the result of a misinformed public, we find the solution is to inform consumers exactly how it all works.

In order to understand the misnomer, you'll have to learn a lot more about mortgages and this Guide will serve as the medium. We'll start by just looking at the obvious, how a low-rate 30-year fixed works. On the next page, you'll see an Amortization Schedule for a low-rate 30-year fixed. This chart shows how much of each year's payment goes to Principal(to the loan balance, to the consumer) and how much goes to Interest(to the lender). For examples throughout this Guide, we'll use an average American conforming loan, a \$150,000 30-year loan at a "fixed" interest rate of just 6.0%. The Amortization Schedule shows how the loan *really* works, and keep in mind that at the same rate, it works exactly the same as any other loan amount. Whether a 30-year loan around 6.0% has a balance of \$50,000 or \$500,000, the proportion of Principal to Interest is the same.

**\$150,000 30-YEAR FIXED-RATE MORTGAGE AT 6.0%**

	<b><u>“THE LENDER”</u></b>	<b><u>“THE CONSUMER”</u></b>	<b><u>PAYMENT = \$899.33</u></b>
<b>Year</b>	<b>Interest</b>	<b>Principal</b>	<b>Balance</b>
1	\$8,949.89	\$1,842.02	\$148,157.98
2	\$8,836.28	\$1,955.63	\$146,202.35
3	\$8,715.66	\$2,076.25	\$144,126.11
4	\$8,587.60	\$2,204.31	\$141,921.80
5	\$8,451.65	\$2,340.26	\$139,581.54
6	\$8,307.30	\$2,484.61	\$137,096.93
7	\$8,154.06	\$2,637.85	\$134,459.08
8	\$7,991.36	\$2,800.55	\$131,658.53
9	\$7,818.63	\$2,973.28	\$128,685.25
10	\$7,635.24	\$3,156.66	\$125,528.59
11	\$7,440.55	\$3,351.36	\$122,177.23
12	\$7,233.84	\$3,558.07	\$118,619.16
13	\$7,014.39	\$3,777.52	\$114,841.64
14	\$6,781.40	\$4,010.51	\$110,831.13
15	\$6,534.04	\$4,257.87	\$106,573.27
16	\$6,271.43	\$4,520.48	\$102,052.78
17	\$5,992.61	\$4,799.30	\$97,253.49
18	\$5,696.60	\$5,095.31	\$92,158.18
19	\$5,382.33	\$5,409.57	\$86,748.60
20	\$5,048.68	\$5,743.23	\$81,005.38
21	\$4,694.45	\$6,097.45	\$74,907.92
22	\$4,318.38	\$6,473.53	\$68,434.39
23	\$3,919.10	\$6,872.81	\$61,561.59
24	\$3,495.20	\$7,296.71	\$54,264.88
25	\$3,045.16	\$7,746.75	\$46,518.13
26	\$2,567.36	\$8,224.55	\$38,293.58
27	\$2,060.08	\$8,731.83	\$29,561.75
28	\$1,521.52	\$9,270.39	\$20,291.37
29	\$949.75	\$9,842.16	\$10,449.21
30	\$342.70	\$10,449.21	\$0.00

Each year, the consumer pays \$10,792 but a different portion of that total gets credited to Principal and to Interest. In the first year, \$8950 of the payments go straight to the lender and the remaining \$1842 gets credited back to the consumer. Here are some other facts gleaned from this schedule:

- It takes 19 years before just *half* the monthly payment goes to Principal, the consumer (\$5482 to Principal, \$5309 to Interest).
- It takes 24 years before 2/3 of the monthly payment goes to Principal.
- After 7 years, the consumer has paid \$75,600 but only \$15,541 goes to Principal.
- After 10 years, over 84% of the starting balance is still owed.
- After 15 years, over 71% of the starting balance is still owed. At that point, the consumer has paid \$161,000 in payments, more than the original starting balance.
- After 21 years, half of the starting balance is still owed. At that point, the consumer will have paid \$226,800 with only \$75,000 of it going to Principal.

The numbers are heavily skewed in favor of the lender because they are designed to be. It's due to something many consumers are familiar with, front-end loaded interest. Even though the monthly payment is fixed, each payment has a different contribution to Principal than Interest, and the contribution to Interest in the first years is much greater than in the last years. The result of this system is that the lender collects their interest first, up front.

The Institute found that most consumers know that the interest on mortgage loans is front-end loaded, purposely stacked against them. But we also found that those same consumers, no matter how educated, as well as mortgage industry experts, do not realize that the front-end loaded interest completely throws off the fixed interest rate schedule. Look back at Year 1. The consumer pays \$10,792 but only \$1842 of it gets credited back to Principal. What if he sold his house after that first year? Would it seem like he paid a 6.0% rate? Look even after 10 years. The consumer pays the lender almost \$108,000 but less than \$25,000 of it goes back to Principal. That's not a 6.0% rate. The same holds true for even longer periods of time like 20 and 25 years. So if a 30-year fixed is kept for even 1 month less than 30 years, the rate consumers really wind up paying on it is higher. How much higher? The Effective Rate Formula reveals what the actual, real interest rate would be if a front-end loaded loan was kept for less than the entire 30-year term.

### **EFFECTIVE RATE**

The Effective Rate calculation is a measure of the actual interest rate consumers pay on their home loans by factoring in the front-end loaded interest. The formula asks, “What rate would I really pay if I only held a front-end loaded loan for X number of years?”

Using a financial calculator:

PV = equity built in a given time period.  
N = number of years being analyzed  
PMT = monthly payment(as a negative sum)

CPT, then I/Y(Compute, then Interest/Year) = Actual Interest Rate

When we applied this formula to our sample 6.0% 30-year loan, the results were as follows:

If our sample 6.0% loan is kept for 25 years, the consumer would wind up paying almost \$270k over 25 years for \$104k in loan equity. Entered into our formula, the actual rate is **9.43%**. That’s right, **9.43%, not 6.0%!** And that’s based upon giving up the loan only 5 years early.

Now how much would the real rate be if that loan was kept for 20 years? The answer is **14.82%**. What about for 15-years? The answer keeps rising. It’s a **24.16%** interest rate. Paying \$161,879 and with less than \$44,000 of it going back to Principal shouldn’t seem like a 6.0% rate because it *isn’t*.

And it only gets worse. Holding on to that low 6.0% fixed-rate 30-year loan for 10 years results in paying an actual **43.48%** interest rate. Keeping it for 7 years results in paying a staggering **68%** interest rate to the lender. Keeping it for only 5 years results in the equivalent of a **102%** rate. Holding it for 3 years yields an actual **182%** rate and 1 year a **580%** rate!

We informally polled hundreds of consumers as well as mortgage industry experts, some of whom have over 25 years of experience in the business, with the following question: “If you held a 6.0% 30-year fixed-rate loan for 7 years, considering that the interest is front-end loaded and you’re not waiting 30 years for it to all even out, what rate do you think you’d really wind up paying?”

The responses to this question and reaction to the correct answer spurred the development of this Guide. Every time, the consumer or expert guessed between 8% and 12% with an occasional highest answer of “triple,” which would represent 18%.

There was never a guess greater than 18% and yet the reality is that the Effective Rate is actually 68%, almost 400% greater than any guess. The guesses were logical, yet so far off that it became instantly clear that a gross and major misconception on the part of the general public existed.

It was also clear that these numbers had never been disclosed to consumers. Not one respondent had ever heard of an “Effective Rate” calculation or a similar formula. What impacted the Institute the most, however, was the reaction of the respondents after we revealed the actual answer of 68%. One respondent after another was stunned and silenced. It seemed consumers were well aware that mortgage interest is front-end loaded but no one seemed to have any idea just *how* front-end loaded it really is.

What the Effective Rate demonstrates is that the **only** way to wind up paying the low advertised Note Rate is to keep the loan for all 30 years. Due to the interest being front-end loaded, the rate becomes ADJUSTABLE based upon how long the loan is kept. On a 6.0% 30-year fixed, the low “fixed” 6.0% Note Rate is the absolute MINIMUM rate a consumer will pay. Even though the monthly payment is fixed, a consumer may wind up paying as much as a 580% interest rate. So a 30-year fixed-rate mortgage is actually an Adjustable Rate Mortgage.

### **YEAR 5**

The Effective Rate also shows that the entire concept of the 30-year loan is based upon the single principle of keeping it for the entire term. The banks have been relying upon consumers to concentrate on the fact that it all evens out 30 years later. But how many consumers keep the same mortgage for 30 years? The fact is:

**NATIONALLY, HOMEOWNER’S KEEP THEIR MORTGAGES FOR:**

### **5 YEARS ON AVERAGE**

Whether they refinance, move for a new job across town or across the country, whether they’re about to have kids or the kids are about to move onto college, Americans keep their home loans for an average of just 5 years. They keep their *homes* for longer than 5 years, but their mortgages for only 5. Previously, the long-standing national average was 7 years but with the golden era of refinancing of the early 2000’s, the average has decreased to just 5 years.

By combining the 5-year statistic with the U.S. Department of H.U.D.'s 2003 data which shows the national average mortgage interest rate is 6.16%, the Effective Rate Formula shows us that **homeowners, on average, are paying a 107% interest rate on their mortgages**, what many consider to be their biggest and best investments - most without ever realizing it. And lenders are quietly earning an average of 107% in interest on billions of dollars of home loans, significantly contributing to record profits quarter after quarter.

The Institute believes this fact can't be understated or underestimated based upon the rates consumers pay on different trade-lines. On cars, they pay between 0 and 15%, on credit cards they pay between 0 and 30% and yet on their "low 6.0% fixed-rate" mortgage, the largest debt of all, they pay an average rate of 107%. Their credit card balances may be only 15k and the auto loan may be 20k but that super high-rate mortgage has a balance of 100k or 200k or more. Consumers are paying the highest rate on their largest loan.

Now think about this scenario. An average American who earns \$50,000/year, has a wife and 2 children, a modest retirement account and a 30-year mortgage. We give him a credit card that has a \$150,000 balance with an APR of 107% and tell him that he's now responsible for it – the debt it his. What would happen to his family's life and future outlook if he had *that* credit card? What would it do to them financially?

The answer is that it would probably devastate his family and severely limit any opportunity they had to gain or build wealth. The numbers prove that the 30-year fixed-rate mortgage is equivalent to a giant credit card with an astronomical APR. Millions upon millions of American consumers have this credit card, this massive liability, which serves as nothing but a giant mountain standing in the way of their financial hopes and dreams. The mountain's bigger than Mount Everest yet remains invisible due to the deceptive nature of the game. And no matter how much more consumers earn at work and no matter how much their other investments return, it winds up being meaningless in the long run because that home loan, that 107% APR'd "credit card" is sucking all the wealth-building power out of them.



### **ILLUSIONARY PROFIT**

Now we'll look at the Illusionary Profit that occurs when consumers sell their homes. Mr. and Mrs. Miller bought their house 5 years ago for 150k. They took out a 150k 30-year fixed at 6.0%. They lived there happily for 5 years. Then they put their house up for sale and sold it quickly for 190k. Mr. Miller says to his wife, "See honey, we did well. We picked out a good house in the right area, paid the right amount for it and we made a 40 thousand dollar profit." And they congratulate each other and smile. They're happy. And so is their lender. Why? Because the game just worked successfully on yet another consumer, in fact so successfully that the Millers are about to buy a new house on a 30-year fixed and start the game all over again.

The Millers played the game, knowingly or not, and they lost. Why? Because they THINK they made a \$40,000 profit from the sale of their house. They THINK their biggest investment was a good one, a profitable one. But the problem is that they actually LOST money, not made it. Let's see how much interest they paid on their 30-year mortgage in that 5 years. They paid 60 payments of \$899.33 for a total of payments to their lender of \$54,000 and were credited back just \$10,500. So they paid \$43,500 in interest and yet their house only increased in value by \$40,000.

Compare the numbers and you'll see that the Millers might have sold their house for 40k more than they paid, but when factoring in their home loan, they actually LOST MONEY. This also doesn't factor in the additional costs associated with selling a house, which usually totals 6%, or in this case \$11,400. What was supposed to be their biggest, best and most important investment cost them money. And perhaps the worst part of all is that the Millers are under the impression that they *made* money.

### **HISTORY**

Let's look at the history of mortgages for a moment. In the early days of American home ownership, mortgages didn't exist. If someone wanted a house, they had to pay cash in full. Of course, only a few people could afford that. After the Depression, Franklin D. Roosevelt tried to stimulate the economy by offering a sweeping host of reforms with a new set of programs designed to boost the economy, collectively known as The New Deal. In it were programs that gave grants to artists just to create art and programs to build unneeded highways just to put people to work. There was also a new agency established to boost home ownership called the FHA, or Federal Housing Administration.

For the first time, it allowed Americans to finance part of their homes by allowing them to put down ‘only’ 80% instead of 100%. Americans would finance 20% of their house on only 2 available terms, 5 and 7-year balloons. They would make interest-only payments on the 20% for 5 or 7 years and when the term came due, they would owe the original remaining 20%.

Over time, the down payment requirement lessened and the 15-year term was introduced. The 15-year required both Principal and Interest to be paid, which created a higher payment but had no balloon where a large sum would be due. Down payment requirements continued to lessen and more and more Americans became homeowners.

Finally, in order to allow almost every American the opportunity to buy a house, the 30-year term was introduced. The 30-year term was designed specifically for people who couldn’t *qualify* for a 15-year term and it punished them severely for that. The 30 made home ownership available, but just not affordable due to the way the loan amortizes. And somehow, over time, this was forgotten and many consumers, who *could* qualify for a shorter term, began to take 30’s. They focused on the lower monthly payment and the free cash flow it created, never looking at how the loan really works. Eventually millions of consumers focused only on the ultra short term and took out these loans that simply weren’t necessary. Lenders collected billions in extra profit as a result, never daring to remind consumers of the benefits of the shorter term as that would severely cut into their profits.

Soon lenders began to take advantage of consumer’s complacency and constantly promoted the 30-year fixed as a quality loan by stressing the low fixed rate and low fixed payment. And so what the Institute dubs “The Culture of Acceptance” was born and reinforced as millions of Americans came to believe that the 30-year was a smart, viable home loan with many benefits. Many others knew it wasn’t a great loan but still took one anyway as it simply wasn’t stigmatic. So people everywhere forgot the importance and history of a short term and regardless of qualification, chose to finance their homes for 30 years. That quick, seemingly logical decision became the single most costly choice for American households as they unwittingly stood in line, choosing to sign up for loans equivalent to giant credit cards with APR’s over 100%!

## **SHOPPING FOR MORTGAGES**

When it comes to shopping for mortgages, the Institute found that consumers have become very adept at finding the best deal in terms of Note Rate and fees. However, the Institute has concluded that they have been misled into shopping for the wrong thing as the basis of their shopping is fundamentally flawed.

Consumers are interested in finding the lowest interest rate so they aggressively search and shop for the lowest Note Rate, which is the advertised interest rate of a loan and widely regarded as being the actual interest rate of a loan. The problem is the fact that the Note Rate has virtually NO bearing on the actual interest rate of the loan. The Note Rate is a **30-year** rate. That is, it's only a valid rate if the loan is kept for all 30 years. So consumers are solicited with low 30-year fixed rate quotes and are trained to shop for that 30-year-based rate quote yet none of them will ever get to pay that low advertised rate because none of them will ever keep the loan for all 30 years.

Consumers will literally cancel transactions with one lender in order to receive an eighth better in Note Rate with another lender. Yet the Note Rate is virtually meaningless because consumers will wind up paying 10-20 times the advertised Note Rate as demonstrated by the Effective Rate. Certainly, the Note Rate has some importance, as it helps to determine the monthly payment, but again it has virtually no bearing on the real, actual interest rate and that's what consumers are looking for – the REAL rate.

What helps perpetuate this misconception is the fact that there are no disclosures pertaining to the REAL interest rates of home loans. Consumers are told they're getting a fixed-rate loan yet at no point are they told that they have to hold it for all 30 years to actually receive that low rate. There are no forms prior to or at Close of Escrow that disclose the ACTUAL rate the borrower would pay if they kept the loan for less than 30 years. Consumers are never told or required to sign a waiver that discloses that they might actually wind up paying a 580% rate. In fact, there's not a single document, NOTHING AT ALL, that discloses the ACTUAL interest rates they might pay!

The Institute believes this omission to be a gross misrepresentation to the public at large. We further believe that at the very least, disclosures concerning the Effective Rate should be required to be signed by borrowers and find it completely negligent that no such requirements are currently in place. As a consumer advocacy organization, we intend to lobby Congressional leaders to initiate such regulation. We anticipate a strong lobbyist effort against our proposals due to the lenders benefiting so substantially from the misnomer but we invite interested consumers to support our efforts by learning more on our website at [www.AsherInstitute.org](http://www.AsherInstitute.org).

Our recommendation for consumers, with respect to shopping for mortgages, is to first consider the Effective Rate. We believe consumers should take the time to critically predict how long they anticipate keeping the mortgage or home. Then they should view or create(using the E/R formula) an Effective Rate schedule of each potential loan program so that they can accurately determine the real rate they may wind up paying.

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