How a Mortgage is Calculated

Oak Tree Capital

Providing Financial Solutions

Oak Tree Capital

Providing Financial Solutions

How is a Mortgage Calculated?

First of all, let's begin this discussion by explaining how a mortgage is calculated. The monthly payment that you're responsible for paying is your loan amount times the interest rate each month. In total, monthly payments consist of principal, interest, real estate taxes, and mortgage insurance (if the down payment is less than 20% of the purchase price of the home).

The higher the interest rate attached to your mortgage, the more you'll be paying towards the interest portion of your mortgage payments. The opposite is also true. Each month that a mortgage payment is made, the portion dedicated your principal increases, and the portion dedicated to interest decreases. Each month, the interest rate is calculated based on the current outstanding loan amount.

What Are the Advantages to Overpaying Your Mortgage?

If paying off your mortgage sooner rather than later is on your agenda, then overpaying it can reap plenty of benefits for you (Find out exactly how much using our mortgage early payoff calculator).

Lower the amount of interest paid. If you overpay your mortgage and direct all of your extra payments towards the principal, not only will the principal amount be reduced, so will the amount of interest you'll have to pay over the term of the mortgage. Paying down your mortgage provides the biggest return on investment for those who are planning on staying in their current homes for the long haul.

To illustrate, let's say you currently have a 30-year fixed-rate mortgage of $300,000 at a 4% rate. By the end of the life of the mortgage, you'll have paid $215,608.52 towards interest!

Now let's say you decided to make extra payments of $300 each month. At the end of the mortgage life, you will have contributed $148,215.00 towards interest instead. That's a savings of $67,393.52!

Keep in mind that this extra money is going strictly towards the principal portion, and not the interest. That means you'll be able to cut down on your principal portion without having even one single cent of it go towards interest.

Shorten the time needed to end up mortgage-free. Using the above example, not only would your interest payments be significantly reduced, you'd also be mortgage-free 8 years and 5 months earlier compared to not overpaying your mortgage.

Build equity.

Any amount of money that you put towards the principal amount of your loan automatically builds up equity in your home. When you save interest on a mortgage by making extra payments, the equity savings in your home accrue each month. Extra payments allow you to build equity the moment the extra payment is made. You can then use the equity in your home through a refinance or upon the sale of your property.

What Are the Disadvantages of Overpaying Your Mortgage?

Opponents to overpaying a mortgage argue that the money that would otherwise be stuck in a home loan could be working to make more money over the short- and long-term through investments that yield a higher return.

Missing out on investments.

With interest rates hovering around historical lows over the past few years, many homeowners have been choosing to put their hard-earned money into investments rather than paying their mortgage off early. In fact, may homeowners are choosing to extend the life of their home loans in order to free up additional capital to invest.

This, of course, can only work if the interest rate you're currently paying on your home is less than the interest you'd be making in your investment vehicle of choice.

To illustrate, let's use the same numbers as above: say you currently have a 30-year fixed-rate mortgage of $300,000 at a 4% rate. If you had saved that extra $300 per month and used it towards an investment that has historically brought 8% returns, you could potentially end up with $425,000 if the returns remain steady. In addition to the $108,000 that would have been invested over the 30-year period through regular monthly $300 payments, over $316,000 would be made in interest.

Of course, there's always the risk that this promised rate of 8% won't necessarily pan out over the course of the investment. Market conditions can always fluctuate, as we see from time to time.

Lack of diversification. For the majority people, a home is a major component of their overall assets. By making additional payments and paying off your mortgage early, you're not increasing your assets' worth. While you are becoming debt-free sooner, you're missing out on the chance to diversify your investments and value of your assets.

Minimizing tax breaks. The sooner your mortgage is paid off, the less money you've got in your hands to take advantage of tax deductions. As time passes, tax money that is saved through deductions from your mortgage can be huge. Overpaying your mortgage reduces this effect, and may even cause you to lose a little bit of money over the long haul.

It should be noted that extending your mortgage in order to invest your money elsewhere should only be done if you have a higher tolerance for risk, and have substantial emergency funds on the back burner just in case your investments fall through.

The last thing you'd want to do is lose your home as a result of failed investments. Outstanding debt, such as a mortgage, is always a significant risk, especially with no funds on the side for a rainy day. In many cases, the extra risk simply isn't worth it. Putting your home up for collateral just so you can take a chance on an investment is often not a wise decision.

Oak Tree Capital

Providing Financial Solutions

23046 Avenida De La Carlota Carlota Plaza, # 600,
Laguna Hills, CA 92653
Toll Free 833.464.6864

homeatoaktree.com