Price-Level Adjusted Mortgage

A price-level adjusted mortgage (PLAM) is a lending instrument in which an overall price index (such as the gross national product deflator or Consumer Price Index) is used periodically to adjust subsequent mortgage payments for the effect of inflation during the period. It is one among several alternatives to a conventional fixed-rate mortgage (FRM); others include the adjustable-rate mortgage (ARM), graduated-payment mortgage (GPM), and the shared-appreciation mortgage (SAM). When inflation is persistently high (as it was in the late 1970s and early 1980s), such alternatives become attractive to lenders or borrowers. In a conventional FRM, lender and borrower each gamble on the rate of inflation. If consumer prices rise faster than expected, lenders risk a loss in the purchasing power of their capital over the life of an FRM. Lenders, on the other hand, count on inflation to make FRM payments more affordable with the passing of time. In other words, a proportion of the mortgage interest rate can be thought of as an inflation premium. For lenders, the attraction of ARMs or PLAMs is that they offer protection against changes in mortgage rates; the borrower assumes the risk of increased inflation. In this, a PLAM is a special version of an ARM: one that protects lenders only against interest rate changes that arise because of unanticipated inflation. For borrowers, the attraction of these mortgage alternatives is that they reduce either the cost of the mortgage in its earlier years (the so-called tilt problem) or the cost of borrowing. (SEE ALSO: Alternative Mortgage Instruments)

—John R. Miron

Further Reading


Principal

Using the standard fixed-rate mortgage (FRM), each debt service payment is divided into two portions: the interest payment (or the payment on the mortgage balance) and the principal payment (or the payment of the mortgage balance). The principal payment is the portion of the debt service used to repay the mortgage note.

Many consumers and housing analysts have often misunderstood the payment of principal. Many novice borrowers think that interest and principal payments are made in equal proportions when a mortgage is being repaid. However, it should be emphasized that each mortgage payment (called debt service) can be divided into an interest payment and a sinking-fund payment. The sinking fund is calculated so that the accumulation of all payments over the life of the mortgage will sum to the amount of the mortgage owed. Thus, the standard FRM is said to be a "self-amortizing loan" because the sum of the sinking-fund payments will completely repay the amount borrowed.

Another misunderstanding is the accumulation of principal payments under the amortization procedure. Because all interest must be paid first out of the debt service payment and because the outstanding balance owed at the beginning of the loan is large, a high percentage of the payment goes to paying interest. Any remaining debt service payment greater than the amount of interest owed each period goes to the principal payment (this is the sinking fund). As time goes on, the percentage allocated to interest of the debt service falls and the percentage allocated to principal rises. But for 25- or 30-year mortgages, at most interest rates, the so-called equity buildup proceeds very slowly.

Perhaps the greatest misunderstanding is the mistaken value placed on the equity buildup when making the "rent versus buy" decision. It is frequently argued that if a household rents, it ends up only with "rent receipts." However, if it purchases and finances with debt, the household acquires an equity (i.e., ownership) interest by systematic repayment of the mortgage through principal repayments. At the time of sale, it is argued, that instead of rent receipts, the household will acquire wealth through equity buildup. The problem with this strategy is that equity buildup consists of a series of payments to repay the mortgage, dollar-for-dollar right out of the household's checking account. In other words, the principal repayments are extra payments (over and above interest) specifically set aside (in a sinking fund) to repay the mortgage note. Therefore, principal payments are required under the FRM and have nothing to do with the decision to rent or buy.

Principal payments are also important because as equity buildup occurs, the owner acquires a larger and larger ownership interest in the property. With such a large interest, the owner is likely to maintain the property better, try harder than ever not to default on the mortgage, and consider the equity in the property as an increasingly important part of the household's portfolio. Therefore, as a form of household savings, principal plays an essential role in the accumulation of wealth for households. (SEE ALSO: Mortgage Finance)

—Austin J. Jaffe

Further Reading