

Saving Your Home from Foreclosure

The first of a series

It is no secret that housing markets around the country are generally down. It's also no secret that many consumers took out risky home mortgages during the recent housing boom, and the monthly payments on many of those loans are going up at the worst possible time. If you are one of those unlucky people in this position, you may be panicked. But panic is the worst possible reaction you could have. You need to come up with a strategy to determine the best course of action for you, and that requires a rational decision making process.

If your home mortgage is an interest only loan, or what is called an Option ARM (more about this later), you may already know that your payments will eventually go up. Many people who purchased a new home or refinanced an existing home in the recent housing boom signed up for one of these two types of loan. What many consumers didn't realize is that both of these types of loans will eventually be converted to a conventional loan. And when that happens, these loans become a lot less affordable.

In this article, we're going to cover the differences between the two types of loans. We'll look at the differences between them, their individual downsides, and at some of the fine print included in many loans.

Interest Only Mortgages

These loans are just what they say they are. Consumers making the monthly minimum payment are only covering the interest on their loan. They are making no payments towards their principle balance.

To give you an example of how a loan like this works, let's look at a \$250,000 mortgage at 7% interest. If you wanted to pay the house off in 30 years, you would have to make a monthly payment of \$1,663. But if you have an interest only loan, the minimum monthly payment you would have to make would be \$1,458.

Most consumers view the interest only payment option as being quite attractive. That's because it looks like they are saving more than \$200 per month. Unfortunately, they are not actually saving anything. The \$200 per month difference is just deferred for a time. Eventually, it will be added back into the monthly payment. More about this later.

Option ARM Mortgages

Option ARMs provide consumers with even more payment options. With this type of mortgage, consumers can often make much smaller monthly payments at the beginning of their loan.

Using the same example as above, a \$250,000 mortgage with a 7% interest rate, let's look at the payment options of an Option ARM loan. In this case, the payment amount if you want to pay off your home in 30 years doesn't change. Neither does the interest only payment. But Option ARM customers will be given another choice; a much smaller minimum payment. Through one bank that we looked at, the monthly payment would be \$915. A lot of people will simply ask, "Where do I sign?"

But just as with the interest only loans, Option ARMs are simply deferring your payments. The money still needs to be paid back. The biggest difference between Option ARMs and Interest only loans is that with an Option ARM you could actually wind up owing a lot more than you borrowed in the first place. This is called "negative amortization" or "neg-arming" for short.

Why are my payments going up?

You say to yourself that you have been making all of your mortgage payments on time. So why did you just receive a notice that your monthly payment is going to double, or even triple? Let's take a look at both Option ARM and interest only mortgages to see what actually happens to the payments you make.

In both interest only and Option ARM loans, consumers are given multiple payment choices. Take a look at one of your more recent mortgage statements and you should see both the "principle and interest" payment and an "interest only" payment options. If you have an Option ARM, you will also see a third option for a monthly minimum payment.

Unfortunately, most people will choose to pay the monthly minimum payment. That's where the trouble begins.

In an interest only loan, consumers are only allowed to make interest only payments for a fixed period of time. This can go on for anywhere from 1 to seven years. At the end of that seven year period, the loan converts to an adjustable rate

mortgage that must be paid off in the years remaining on the loan.

So using the same \$250,000 loan mentioned above, if a consumer paid the minimum amount for a period of seven years, at the beginning of year eight the monthly payment would jump from \$1,448 to \$1,883. And that's without any change in interest rates. If interest jumped by a percentage point to 8%, the monthly payment would increase to \$1,984. That's a jump of more than \$500 per month.

Consumers making the monthly minimum payment on an Option ARM would be in even worse shape. They would see their monthly payment obligation increase from \$915 to \$2,152. Again, this is without an increase in interest rates. If interest rates jumped by a percentage point to 8%, their monthly minimum payment would increase to \$2,339. Worse than this, they would owe the bank \$294,772 instead of the \$250,000 they actually borrowed. Why? Well, because their mortgage is negative amortization at a rate of more than \$500 per month for the first seven years of their loan.

It's enough to make your head spin, but the math is actually pretty simple. Here is a brief explanation that can help you determine if this is going to be a problem for you.

In the example above, remember the interest only loan? The monthly minimum payment was \$1,458. Now remember the Option ARM loan? The minimum payment was \$915.

Both of these loans were for \$250,000. Both of them had a 7% interest rate. So how could there be such a difference in the payments? That's where negative amortization comes in.

A \$1,458 monthly payment covers only the interest on the loan. After you make your monthly payment, you still owe \$250,000 to the bank. No more, but no less.

But if you pay less to the bank than \$1,458 a month, the difference between what you pay and the "interest only" payment amount is added to the balance of your loan. In this case, that is \$543 per month. This means that after you make your first monthly payment, instead of owing the bank \$250,000 (the amount you initially borrowed), you now owe them \$250,543 (the amount you initially borrowed plus the difference between the monthly interest only payment and what you actually paid).

Every month you make the minimum payment, the balance on your loan goes up by another \$543. Over the course of seven years, this will add more than \$44,000 to the amount you owe the bank.

The Downsides of These Loans

The downside to both interest only and Option ARM loans should be fairly apparent to you now. With an interest only loan, you may not be losing ground, but you're not gaining either. At least not in a "down housing market".

If you are making the monthly minimum payment and you have an Option ARM loan, then you are losing ground. The balance on your loan — what you actually owe on your house — is going up. In a down housing market this is a recipe for disaster.

The Fine Print

As bad as all of this may seem, things can be worse. Many lenders have financed homes using interest only and Option ARM loans with steep pre-payment penalties. These penalties are often more than \$10,000 should the homeowner decide to sell or refinance.

Why did they do this? Well the answer is simple. They wanted to lock consumers into these loans for a long period of time. These risky loans are very profitable to the lenders that offer them.

You should also know that lenders are willing to pay mortgage brokers high fees if they include pre-payment penalties in their loans. This means that unscrupulous brokers may be pushing loans that make them a lot of money but that will hurt you as a consumer.

It is important to note here that there may be some good reasons for agreeing to short prepayment penalties. You should also know that we are not suggesting that most loan brokers are unscrupulous. But it is up to you as a consumer to do your homework and know what you are signing when you take out a home mortgage.

I already have a bad mortgage. Now what?

If you already have an interest only or Option ARM loan, don't panic. In our next article, we'll talk about coming up with a strategy to help you get through a bad situation.

by Jim Malmberg

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