

## Taking a Close Look at “Exotic” Mortgages

As interest rates begin to slowly rise, and homes increase in value in the Austin and Galveston areas, a number of new, exotic mortgages have appeared in the mortgage lending world. Each is basically a mechanism that allows a borrower to buy more home than they could ordinarily afford, and a cautious approach is warranted.

First, a few terms:

**Amortization:** the period in which your home will be paid off. 10,15, and 30 years are the norm.

**Principle and Interest:** A total mortgage payment normally consists of a payment that reduces the principle amount of the loan plus the payment of interest to the lender.

**Straight Line Amortization:** Payment of a principle and interest amount will reduce the loan to 0 at the end of the amortization period.

**Negative Amortization:** Minimum monthly payments being made are not enough to cover either the principle amount or the total interest due. Instead of the loan balance decreasing each month, it is increasing.

Now, a look at these Exotic Animals:

**The 40 Year Loan:** As the name says, this is a loan with a forty year amortization period. The interest rate is normally about 1/2% higher than on a 30 year loan, but the ten additional years of amortization does reduce the monthly payment.

**Positives?** A monthly payment that is \$30-\$40 per month lower than a 30 year loan can mean that a young couple can qualify for a home and stop renting. This type of loan can also be very good for an older person on a fixed income.

**Dangers?** Most first time home buyers live in their homes for 5 years. Normal costs for a seller are about 8% of the sales price. With a forty year loan, only about 3% of the principle will have been reduced during the first five years. Therefore, the value of the home must increase a minimum of 5% to simply break even. If any improvements have been made, the sales value must reach even higher to recoup the costs.

**The Interest Only Loan:** for the first 5, 10 or 15 years of the loan, only the interest payments are made. The loan balance remains unchanged during the interest-only period.

Positives: The payment is significantly lower. One can qualify for and buy a more expensive home. Someone who receives a large year-end bonus, or who works in a commission only field, might find this attractive. Payments to the principle can be made as sums of money arrive, but the monthly payment remains at a lower, manageable level.

Dangers?: If the borrowers make only the interest payments during a five year period, then sell, they will need significant value appreciation to avoid owing more than their home is worth.

**The Option ARM: In my professional opinion, this is the most risky loan in the marketplace.** The borrower is subject to a changing interest rate and has the option whether or not to make a payment. The initial teaser rate may be very attractive, but close examination of the “what ifs” at the end of the initial rate can paint a scary picture. Rates could increase dramatically, up to 5-6% over the initial rate in a year. On a \$100,000 loan, the monthly principle and interest could move from \$536 to \$877 if the rate moves from 5% to 10%. That increase could create real economic hardship for many borrowers. Increase the loan amount; increase the exposure.

Given the option to skip payments, a borrower could move quickly into an area of negative amortization as well as unmanageable monthly payments. Such a financial situation often leads to foreclosure.

In the Real Estate Department at UFCU, our mission is to educate and guide our borrowers into making wise decisions when they finance a home. No single loan product is all bad or all good, and the “right loan” depends so much on you. Talk to us and discover a mortgage lending approach that really does focus on your financial well-being.