

Home Stretch

Is it worth the risk and cost to go with an unconventional mortgage?

BY KERRY HANNON

With the recent housing boom, nontraditional home mortgages surged onto the lending scene. Labeled "exotic" by industry experts, these options helped footloose home buyers find low monthly payments and others buy a house that cost more than they ever imagined they could afford.

Adjustable rate mortgages, or ARMs, with various options for paying them off soared in popularity, along with interest-only loans that have low monthly payments and mortgages that have 40-year terms. In tight

housing markets today, such unconventional loans are still in vogue.

Tempted to consider some of these alternatives to the traditional 30-year fixed? Be wary. "Many borrowers may not fully understand the changing payment schedules, especially the sharp monthly payment increases common in these mortgages," says Allen Fishbein of the Consumer Federation of America. And if you put very little down and real estate prices decline, you could face a loan balance that exceeds the present value of your home. That's downright scary.

Here's a look at the pros and cons of some of the basic non-traditional options available.

MORTGAGE TYPE

40-year fixed

These loans offer fixed rates with principal and interest payments each month. In general, the interest rates are higher — about one-quarter of a percentage point more than a comparable 30-year mortgage. But the monthly payments are lower. What's the monthly savings on a 30-year, \$200,000 loan at 6½ percent versus a 6½ percent 40-year loan? About \$60. That's \$720 a year.

PROS: The loans can be easier to qualify for and the maximum amount you can borrow often is higher. The slightly lower payments can make a difference on a tight monthly budget. You avoid anxiety about interest-rate fluctuations.

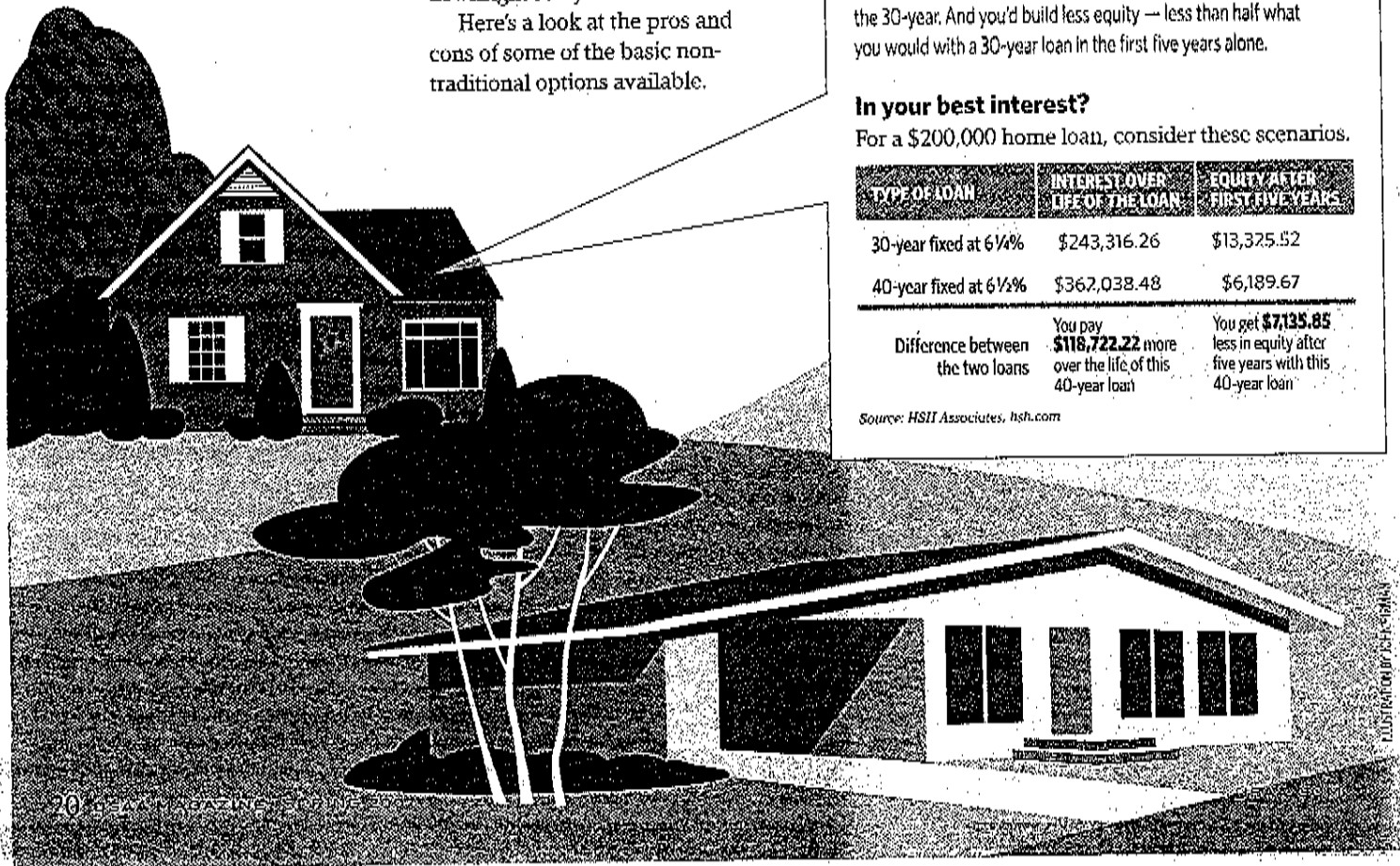
CONS: You pay far more in interest. In the \$200,000 loan example above, you'd pay about \$119,000 more in total interest over the life of the loan for the 40-year mortgage than you would for the 30-year. And you'd build less equity — less than half what you would with a 30-year loan in the first five years alone.

In your best interest?

For a \$200,000 home loan, consider these scenarios.

TYPE OF LOAN	INTEREST OVER LIFE OF THE LOAN	EQUITY AFTER FIRST FIVE YEARS
30-year fixed at 6¼%	\$243,316.26	\$13,325.52
40-year fixed at 6½%	\$362,038.48	\$6,189.67
Difference between the two loans	You pay \$118,722.22 more over the life of this 40-year loan	You get \$7,135.85 less in equity after five years with this 40-year loan

Source: HSII Associates, hsi.com



MORTGAGE TYPE**Interest-only**

An interest-only payment plan allows you to pay only the interest for a fixed term, usually five to seven years. After that, you must repay the balance, refinance, or begin paying the principal and the interest. In most cases, you can choose to make a larger payment toward the principal whenever you want.

In the housing market's heyday a few years back, interest-only mortgages attracted buyers who were more interested in the home's short-term appreciation value than in building equity over 30 years with a traditional fixed mortgage. They paid a couple of years' worth of the interest, never touching the principal, then flipped the house for a big profit anyway with a big listing price. The market's not so rosy today, but this kind of mortgage still attracts buyers with initially low monthly payments.

PROS: If you're likely to move again in a few years, this might make sense. And if you're self-employed with an unpredictable income stream, get paid in the form of commissions or bonuses, or are likely to earn a lot more in a few years, this might be a good option.

CONS: Increased payments when the loan adjusts can be a shock, and you might need to sell, or refinance, because you can't afford the monthly bill. If the house has dropped in value, you'll be in trouble because you haven't reduced the principal balance on the loan or built any equity. You could have to pony up thousands of dollars in sales costs, which would need to be paid out of whatever equity you started out with (in the form of the down payment). You also might have trouble refinancing for the amount owed.

MORTGAGE TYPE**Payment-option adjustable rate**

The interest rates with ARM mortgages change as time goes by, and the plans for paying off the loans vary — meaning more flexibility and more risk. The initial rate on a payment-option ARM is low, say 2 percent for the first few months, then rises to a rate closer to that of other mortgage loans. Payment options include:

- a traditional payment of principal and interest based on a set loan term, such as a 15-, 30-, or 40-year payment schedule.
- an interest-only payment, typically for five years.
- a minimum payment, which may be less than the amount of interest due that month and may not pay down any principal, generally for five years.

PROS: The lower initial monthly payment, compared with traditional fixed-rate loans and standard adjustable-rate loans, makes buying a home possible on a tight budget. These loans give you more ways to control your finances, particularly if you are only going to be in the home for a short time, have irregular income, or want to invest money that would otherwise be tied up in a mortgage.

CONS: You'll have higher monthly payments in the future. The worst-case scenario: the minimum-payment option, where you pay low monthly payments for up to five years because of deferral of principal and interest. The result? Negative amortization, when monthly payments don't cover interest owed. The unpaid amount is added to the loan balance.



MORTGAGE TYPE**80-20 and 80-10-10**

Don't have money for a down payment? No problem. You can apply for 100 percent financing. Private mortgage insurance, or PMI, is commonly required when the first mortgage is for more than 80 percent of the home's price. A piggyback loan preserves an 80 percent first mortgage, but combines up to a 20 percent second mortgage at the same time, eliminating the need to pay for a PMI policy. A similar option combines an 80 percent loan for the purchase price, a 10 percent home equity loan, and a 10 percent down payment.

For both options, you're still expected to come up with closing costs.

The interest rate on the piggyback loan or line of credit often is higher than the rate on the first mortgage. But the combined monthly payments for both loans usually cost less than a single payment for a loan greater than 80 percent of the home's value once the cost of

the PMI policy is factored in. This is especially true if you itemize deductions on federal income tax, because mortgage interest is deductible, but premiums for a mortgage insurance policy are not. In other words, when you pay PMI you don't get tax deduction benefits, but the interest paid on the primary loan and secondary loan throughout the year both can count toward your tax burden.

PROS: If you have a good credit rating, but haven't accumulated a lot of savings, you can buy a home without a down payment. Or, if you have ample savings for down-payment money, but the money is invested and you don't want to liquidate it, you can still land a mortgage without disturbing your investments.

CONS: If the house loses value, you leave yourself at some risk because you might owe more than the house is worth.

**What's a reverse mortgage?**

Reverse mortgages are loans for older homeowners that allow them to convert home equity into cash.

If you are age 62 or older, a reverse mortgage lets you hold the title and keep living in your home, while collecting payments generated by a loan secured by the home's equity. Opt for a lump sum payment, or take monthly cash advances during the life of the loan. Because the money is paid as a loan, it's not considered taxable income and won't affect Social Security

or Medicare benefits. "If you're living on a limited income and feeling cash poor,

but house rich, these loans can improve your quality of life," says Keith Gumbinger of mortgage information provider HSH Associates.

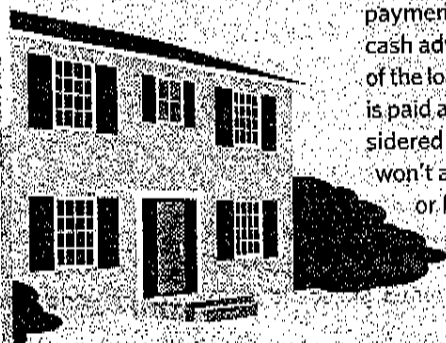
To qualify, your mortgage must be fully or nearly paid off. Available proceeds and payments are determined by your age, length of the loan, and the value of the home and its expected appreciation, combined with the mortgage interest rate. There are loan limits, which typically vary by geographic area.

Borrowers are responsible for taxes, insurance, and upkeep. The loan does not have to be repaid until you sell and move, or you die. Either

way it is paid by the proceeds from the home sale.

Not all lenders offer these loans. Nor are they permitted in every state. This type of loan can be costly to set up, may be subject to periodic fees, and is not for everyone. Some companies allow you to access only a percentage of the equity you've built, so available funds can be much less than the actual equity. Other traditional ways to convert home equity into cash include a home equity loan or equity line of credit.

For more, visit the Federal Trade Commission Web site at ftc.gov/bcp/online/pubs/homes/rms.htm.



HOME BUYER'S CHECKLIST

- What monthly mortgage payment can I realistically afford?
- How long do I plan to stay in the home?
- Do I expect my income to rise during that period?
- How much do I have saved for a down payment?
- What other sources do I have for a down payment — family loan, savings account, etc.?
- How much money can I commit to points and fees?

ASK A LENDER

- What's your best rate at the fees I can afford to pay?
- What are my payment options?
- What is the full term of the mortgage?
- How long is the option period?
- What is the initial interest rate?
- If an ARM, how often can the interest rate adjust?
- What is the overall interest rate cap?
- Can this loan have negative amortization?
- Is there a limit to how much the balance can grow before it is recalculated?
- Is there a prepayment penalty if I end this mortgage early by refinancing or selling my home? How much is the penalty?
- How much is the monthly payment?
- What is the most my minimum payment could be after 12 months?
- What would my minimum monthly payment be after five years?
- What are the fees and charges due at the closing on this loan?
- Do I qualify for lower interest rates or reduced fees for first-time home buyers?

Which way to finance?

If you were to buy a \$200,000 home with a 10 percent down payment and a \$180,000 mortgage, here's what your home equity might look like after five years (with no changes in property value) with different kinds of loans.

LOAN TYPE	LOAN BALANCE AFTER 5 YEARS	EQUITY AFTER 5 YEARS
Traditional fixed-rate mortgage 30-year term; 6.7% interest rate	\$168,882	\$31,118 (\$20,000 down payment plus \$11,118 paid on mortgage)
Traditional 5/1 ARM 30-year term; 6.4% for first 5 years	\$168,298	\$31,702 (\$20,000 down payment plus \$11,702 paid on mortgage)
5/1 interest-only ARM 30-year term; 5 years of interest-only payments, then 25 years of principal and interest payments; 6.4% interest rate for first 5 years	\$180,000	\$20,000 (\$20,000 down payment)
Payment-option ARM 30-year term; 5 years of minimum payments, then recast for remaining term; starting interest rate of 1.6% for 1 month, then 6.4%; assume no rate increases	\$195,562	\$4,438 (\$20,000 down payment minus \$15,562 negative equity)
Payment-option ARM 30-year term; 5 years of minimum payments allowed, then recast for remaining term; starting interest rate of 1.6%, then 6.4%; 7.5% annual payment cap; assume rate increases 2% per year up to 12.4%. This loan will reach the 125% balance limit in month 49 and will be recast as an amortizing loan at the beginning of year 5.	\$223,432	-\$22,432 (\$20,000 down payment minus \$42,432 in negative equity)

Source: The Federal Reserve Board

These numbers are only examples; your balance will depend on the type of loan, the interest rate, and how often the interest rate changes.

