

Today's Mortgage Menu

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Congratulations! You've decided it is time to move and you want to purchase a home. Now comes the hard part — arranging a mortgage to help finance the purchase. If you haven't purchased a home with a mortgage since the 1970s, you are in for a shock. The standard fixed-rate, 25- to 30-year mortgage, while still available, has been joined by a host of new mortgages. In fact, experts estimate that there are 300 to 400 mortgage variations currently on the market (*Changing Times*). While the number offered in your local market is certainly less, there is no doubt that shopping for the "right mortgage" has become increasingly complex. This guide will increase your understanding of the alternatives in order to reduce the complexity of the mortgage financing decision.

Standard fixed rate mortgages (SFRMs)

Fixed-rate mortgages are contracts in which the rate of interest charged never changes over the life of the loan (15 to 40 years). That is, when you sign the contract you know what the monthly principal plus interest (P + I) payment is and that it will be the same during every month in the life of the contract.

Unfortunately, as with all financial contracts, the certainty of mortgage interest rates has a price and that price is a higher interest rate. Lenders have to charge you more for a fixed rate mortgage than for a mortgage with an interest rate that is allowed to change (see next section), because they don't know what the future will bring. If the future brings inflation, lenders cannot purchase as much with your money. Recently, the difference between the interest rate on a SFRM and the initial rate on a one-year adjustable rate mortgage has been in the range of two percentage points. Generally, the longer the life of the fixed rate mortgage, the greater will be the difference.

Besides charging a higher initial interest rate, lenders seldom allow new buyers to assume SFRMs (with the exception of loans guaranteed by the Federal Housing Administration and the Veterans Administration). This lack of transferability may make it harder for you to sell the home in a period of high inflation, because the buyer will have to refinance the home with a new loan at the higher interest rates.

The certainty of mortgage payments, however, may outweigh the disadvantages of a SFRM for some buyers. Borrowers in occupations sensitive to inflation may be better off buying less expensive housing with a SFRM than to risk the uncertain payments of an adjustable rate mortgage.

Adjustable rate mortgages (ARMs)

An ARM, as the name implies, allows the interest rate to change at specified times. Lenders use an interest rate index to determine the amount of change. Usually the index is either the short-term Treasury securities rate of interest or the national average mortgage contract rate of interest published by the Federal Home Loan Bank Board. Treasury rates change more rapidly than average mortgage contract rates. Most housing economists suggest choosing a less volatile, longer term index such as the Bank Board's average mortgage contract rate.

Every ARM will state how frequently the periodic adjustments in your mortgage payments may occur. These may range from every six months to every five years. As with the SFRM, the longer the term-till-renegotiation (the effective life of the contract), the greater the initial mortgage rate of interest.

The lower initial rate of mortgage interest (as compared with the initial rate on SFRMs) results from your acceptance of the risk of inflation. Inflation would increase your mortgage interest rate which, in turn, would increase your monthly payment. To protect yourself from large increases in monthly payments, insist on a limit (or cap) on the allowable increase in payments.

Caps vary in what they limit, however. Some caps restrict the increase in interest rates while others restrict the increase in monthly payments. If the cap is on interest rates, you know your monthly payments will never exceed the amount calculated from the maximum rate permitted by your contract. Commonly, interest rate caps limit the interest rate to increases of 2 percentage points annually and 5 percentage points over the life of the loan contract.

Example: A \$50,000 one-year ARM, 30-year life, 12 percent interest rate = initial P+ I of \$514.31/month.

After one year: A \$49,818.52 one-year ARM, 29-year life, 14 percent interest rate = P+ I payments of \$591.66/month.

This is the maximum P + I payment you could face in the second year.

If the index rises as in the example, your payments have increased 15 percent and, if your monthly income has not risen similarly, a greater percentage of your income will have to be devoted to mortgage payments.

If rapid inflation occurs, the maximum increase in mortgage interest rates may follow for each year thereafter. By year three, the interest rate will be 17 percent (the maximum) resulting in mortgage payments equal to \$709.88 on a remaining principal of \$49,583.72. In three years, your mortgage payments have increased by 38 percent and, as in the earlier example, your monthly income must have risen similarly or you would be required to spend a larger percentage of your income on your home mortgage payments.

The above is in comparison to, for example, a standard fixed rate mortgage for \$50,000 for 30 years at a lifetime interest rate of 14.5 percent (2.5 percent above the one-year rate), which would require payments of \$612.28 every month for the life of the loan.

An additional caution is that a contract that limits the increase in interest rates may also protect the lender by limiting the allowable decrease in interest rates. As with anything, read the contract carefully.

This example may lead you to think that a payment cap is preferred. This is not necessarily true. Use the above example and assume a payment cap of \$650. Even if interest rates go from 12 percent to 16 percent in two years your payments could not increase beyond \$650. Without the cap your payment would be \$670.29. The catch often is that the difference between the interest you are paying and that you **would be paying**, without the payment cap, is automatically added to your loan balance. In the above example, your mortgage balance at the end of two years would be \$49,928.30, \$243.48 greater than at the start of the year. An increase in the loan balance when contractual terms are fulfilled is known as negative amortization.

Fortunately, if house prices have increased dramatically, you still may have positive equity in your home. However, if your house does not appreciate as rapidly as the rate of negative amortization, or actually depreciates, you may find yourself with reduced equity in your home. In extreme cases, you may end up owing the bank more than your home is worth. Typically, lenders limit negative amortization to 25 percent of the original loan balance. That is, you will never owe more than 125 percent of what you owed initially. Additionally, some contracts require the balance due in full if the loan balance reaches 125 percent of the original balance. This would require refinancing (and would mean additional closing costs) or sale of your home. Other options might be to recontract with a fixed-rate mortgage (with its higher interest rate) on the 125 percent balance, or to extend the term of your mortgage to keep payments low. Again, read the contract carefully.

Balloon mortgages

A balloon mortgage may appear to be a standard fixed-rate mortgage amortized over 25 to 40 years. However, a balloon mortgage will have a due date, usually three to five years from initiation, at which time the remaining principal is due in full. This is known as a balloon payment, hence the name balloon mortgage.

Balloon mortgages may provide for amortization of some principal during their life, but some are designed with payments that cover interest only. The latter would result in no gain in equity (except possibly through appreciation in property value). This may not be a serious drawback since equity growth through mortgage payments is minimal in the early years of the mortgage's life anyway. In any case, when the balloon payment is due, you must refinance the loan (additional closing costs) or repay the lender from sale proceeds or other assets. Therefore, if you are considering a balloon mortgage, a comparison of expected closing costs and the length of time until the balloon payment is due are important considerations.

Graduated payment mortgages (GPMs)

The graduated payment mortgage was designed to allow young and low-income households to qualify for home ownership. Borrower qualification occurs simply by reducing the initial mortgage payments, with a schedule for mortgage payment increases being stated in the contract. The objective is to match, more closely, the growth in the cost of the mortgage with the income growth of the borrower.

The lower initial payments do not result from lower initial interest rates. Rather, the payments are reduced below what would be required by current market rates and negative amortization often occurs. This mortgage may also have an adjustable interest rate provision built into the contract. If this is the case, the increase in future payments is also, in part, determined by interest rate movements. Such a variable rate clause increases the possibility of negative amortization.

The primary shortcoming of the GPM occurs when earnings increase less rapidly than anticipated at the time the GPM's contractual rate of payment increase is determined. If earnings growth is retarded, then mortgage payments will demand a higher percentage of the borrower's income as the graduation in mortgage payments occurs. This possibility implies that GPMs are most suitable for younger households with income growth expectations greater than the stated increases in mortgage payments.

Shared equity mortgages (SEMs)

Shared equity mortgages grant lenders title to a portion of the housing equity. For example, you could purchase a home costing \$100,000 for only \$80,000 if a lender "buys" 20 percent of the home (\$20,000). The total purchase price remains \$100,000; however, your equity, in this example, would never exceed 80 percent of the market value of the home unless you purchase the lender's share.

The lender's return on the \$20,000, in the above example, is limited to 20 percent of the appreciation in the market price of the house.

The table below illustrates the example.

Increase in house price	Appreciation	Borrower's	Lender's
10 percent (\$110,000)	\$10,000	\$8,000 (80 percent)	\$2,000 (20 percent)

This would be a 10 percent return on the lender's money ($2,000/20,000= 10$ percent). If the lender believed, at contract initiation, that the rate of appreciation would be 10 percent and knew her money was costing 14 percent, she would have required a higher rate of interest on the amount loaned to the borrower. This is necessary to maintain lender profitability.

The percentage of equity held by the lender is usually less than 30 percent to encourage the borrower to maintain the property.

An SEM contract is similar to a standard fixed-rate mortgage on the percentage of the purchase price on which the borrower holds title. If the borrower paid 10 percent down on the \$80,000 portion to which he has title (i.e., \$8,000), he would be required to mortgage the remaining \$72,000. The principal and interest payments on a balance of \$72,000 would be 80 percent of the P+ I payments on a \$90,000 mortgage had the borrower obtained a SFRM on 90 percent of the purchase price. However, since borrowers are required to pay all homeowner insurance premiums and property taxes, the proportionate reduction in the cost of home ownership is less than the percentage in the home purchased by the lender.

In times of depressed housing appreciation, the availability of SEMs will be more limited. Since the homeowner experiences reduced equity growth the probability of her deciding to default the mortgage is greater. The greater risk of default and the lower return on the lender's money will retard the offering of SEMs by lenders.

When you shop for a mortgage

The above briefly describes several mortgage designs that are present in the U.S. market today. Many variations are possible by combining features of two or more of the mortgage "types." The new mortgages require more informed consumers who are able to decide which items from the mortgage menu are best for them.

Many lending institutions provide examples of how your loan payments may change. You should insist on such illustrations, but be careful to understand fully the assumptions each institution is using in its illustrations. What appears to be a good deal may simply result from sophisticated number management rather than an offer of an exceptional mortgage contract by a particular lender.

If you are unable to qualify for a standard fixed rate mortgage because your income is too low, the salesperson at the institution may direct you to an adjustable rate mortgage or graduated payment mortgage, with lower initial payments. Always remember the lower payments are only in effect for the term until adjustment. Ask yourself several, "What if?" questions to help you decide whether you could meet the maximum payment if, in fact, various developments occurred. If not, then possibly a less expensive home and a standard fixed-rate mortgage are right for you.

Your projections about the future will affect your decisions and the results. For example, if you think interest rates are going up and you choose a fixed rate mortgage only to find that interest rates decrease, or if you think interest rates are going down and you choose an adjustable rate mortgage only to find that interest rates increase, your choice could be costly. The risk of being wrong is unavoidable, but if you intelligently shop for your mortgage, are realistic about your future income expectations, and are able to adjust your plans as the future becomes the present, the probability of making the correct choice will be much higher.

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