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FAMILY FINANCES

OPTION ADJUSTABLE-RATE MORTGAGE MAY BE A COSTLY CHOICE

KATHY KRISTOF

Option adjustable-rate mortgages are not suitable for most borrowers.

For Los Angeles newlyweds Joseph and Junie Horton, the deal looked too good to pass up: a mortgage with an initial 1.75 percent interest rate and payments that wouldn’t adjust for five years. The Hortons figured that with all the money they would save on interest payments, they would be able to pay down a significant chunk of the principal on their loan. So they signed on the dotted line. But after a month, the actual interest rate on their “option” ARM shot above 8 percent.

They blithely made the minimum payment each month, not realizing, they say, that the low rate they had secured was so fleeting. Within months, thousands of dollars in unpaid interest were added to their loan balance. Ready to bail out, they discovered a second catch: a prepayment penalty that would cost them $18,000 if they refinanced.

An option adjustable-rate mortgage is a complex hybrid mortgage originally designed for a narrow segment of people: sophisticated borrowers with inconsistent incomes. But because an option ARM has such a low initial payment, it became popular during the housing boom, with about $250 billion in option ARMs issued over the last three years. If you are thinking about taking out an option ARM, here are some important tips:

Know your options

An option ARM gives you a choice of four payment amounts each month:

The highest amount, if paid every month, would be enough to pay your loan off in 15 years.

The next-highest amount is calculated to pay off the loan in 30 years.

A third option allows you to pay only the interest accruing that month — and none of the principal.

The fourth option — the minimum payment — is the most tempting and usually the one that’s advertised. It is calculated based on a “teaser” interest rate that can be as low as 1 percent or 2 percent a year. But after the first month, if you make the minimum payment, not only are you not paying down the loan, you’re not even paying all the interest that’s accruing. As a result, your total debt is actually increasing.

Understand the teaser

The artificially low initial interest rate on an option ARM is known as the teaser rate because it’s the number that lures you into taking the loan. But although the payment may be fixed for several years, the teaser rate expires after the first month. The additional interest is added to the mortgage balance. Jeffrey Bemns, a Woodland Hills, Calif., attorney representing the Hortons, says borrowers are often tricked into believing that the teaser rate will last for as long as the fixed minimum payment does.

Examine your income

Jay Brinkmann of the Mortgage Bankers Association says option ARM can be good for borrowers whose take-home pay varies widely A good candidate might be a salesperson who earns large commissions in some months and not much in other months. If you have a fairly stable income, an option ARM is probably not for you.

Don’t plan to refinance

If you’re thinking about getting an option ARM and refinancing if the payments get too high, don’t count on it. Three things could keep you from refinancing, particularly in today’s market:

You may no longer have sufficient equity. If you borrowed $100,000 on a $120,000 property for example, making only minimum payments could put your loan balance upside down — above the value of your home.

If you struggle to make payments before trying to refinance, that could lower your credit score, making it more difficult — and costly — to refinance.

Your option ARM will probably have a prepayment penalty which would boost the cost of refinancing the loan.

Read the documents

The only way to really know how your mortgage works is to read the loan papers. That can mean making your way through a 2-inch stack of documents. Even then, you may run into trouble. Berns, the Hortons’ lawyer, is preparing a lawsuit alleging that the disclosures offered by mortgage lenders are insufficient.

“I challenge anyone to pick up a set of these loan documents and tell me what is going on,” he said. In Wisconsin, a judge cleared a similar suit for trial, saying, “An ordinary consumer reading the defendant’s disclosures would be confused about the cost of the loan.”

Adversarial relationship

The bigger your loan, the more your broker makes — and high fees end up fattening the broker’s wallet. Jeff Lazerson, president of a Web-based shopping service called Mortgage Grader, said high commissions for high-cost loans were one of the biggest conflicts in the real estate industry. Consumers go to a loan broker to help them find the best deal among competing mortgage lenders, but the broker is paid by the lender based on the profitability of the loan, he said.

“The broker’s incentive is not aligned to the interest of the consumer,” Larzerson said. “It is truly an adversarial relationship.” “They held a carrot in front of us and told us that this was a great deal,” said Joseph, 32, a vascular specialist who has since refinanced into a fixed- rate loan. “In one year, it cost us $83,000. It was just excruciating.”

KATHY KRISTOF WRITES FOR THE LOS ANGELES TIMES.