Shopping for a Mortgage? DO YOUR HOMEWORK FIRST

Specialty Mortgages: What are the Risks and Advantages?

UNDERSTANDING SPECIALTY MORTGAGES

In many housing markets, home prices have risen to very high levels, making it harder to afford a home—especially for first-time homebuyers. The traditional fixed-rate mortgage and standard adjustable-rate mortgage may not be the best options for everyone. A growing number of homebuyers are deciding to use one of several new types of specialty mortgages that let them "stretch" their income so they can qualify for a larger loan. But before you choose one of these mortgages, make sure you understand their risks and how they work.

Specialty mortgages often begin with a low introductory interest rate or payment plan—a "teaser"—but the monthly mortgage payments are likely to increase a lot in the future. Some are "low documentation" mortgages that come with easier standards for qualifying, but also higher interest rates or higher fees. Some lenders will lend you 100% or more of the home's value, but these mortgages also present a big financial risk if the value of the house goes down.

It's in your best interest to learn the "ins and outs" of these packages before deciding if the loan you're considering is right for you.

Specialty Mortgages Can—

- Pose a greater risk that you won't be able to afford the mortgage payment in the future, compared to fixed rate mortgages and traditional adjustable rate mortgages.
- Have monthly payments that can increase by as much **as 50% or more** when the introductory period ends.
- Cause your loan balance (the amount you still owe) to get larger each month instead of smaller.

COMMON TYPES OF SPECIALTY MORTGAGES

Today, when you apply for a loan, you have more choices than ever before. Here are a few examples:

Interest-Only Mortgages: Your monthly mortgage payment only covers the interest you owe on the loan for the first 5 to 10 years of the loan, and you pay nothing to reduce the total amount you borrowed (this is called the "principal"). After the interest-only period, you start paying higher monthly payments that cover both the interest and principal that must be repaid over the remaining term of the loan.

Negative Amortization Mortgages: Your monthly payment is less than the amount of interest you owe on the loan. The unpaid interest gets added to the loan's principal amount, causing the total amount you owe to increase each month instead of getting smaller.

Option Payment ARM Mortgages: You have the option to make different types of monthly payments with this mortgage. For example, you may make—

- A minimum payment that is less than the amount needed to cover the interest and increases the total amount of your loan,
- An interest-only payment, or
- Payments calculated to pay off the loan over either 30 years or 15 years.

40-Year Mortgages: You pay off your loan over 40 years, instead of the usual 30 years. While this reduces your monthly payment and helps you qualify to buy a home, you pay off the balance of your loan much more slowly and pay much more interest.

This is only a short list of specialty mortgages. Today's marketplace includes many variations on these types.

WHAT ARE THE MAJOR RISKS OF SPECIALTY MORTGAGES?

1. Payment Shock. One major risk is that **your monthly payment may increase by a large amount**, resulting in "payment shock." Even a change of 1% or 2% in interest rates can result in a very big jump in your monthly mortgage payment. For example, if the interest rate on your mortgage changes from 4% to 6%, your monthly payment could rise by as much as 50% (from $1,000 to $1,500). If your income has not increased enough, you may not be able to afford the new larger monthly mortgage payment. And if that happens, you could lose your home.

Example: How Payment Shock Can Occur

Assume you buy a home for $300,000, put 10% down, and choose a 5.75% interest-only adjustable rate mortgage. The mortgage requires interest-only payments for 5 years. After that, the interest adjusts every year based on rates in effect at that point.

• Initial monthly payment: **$1,294**.

• Monthly payment after 5 years with **no** increase in mortgage interest rates (amount increases because payments begin to include principal in addition to interest): **$1,699**.

• Monthly payment after 5 years with a 3% increase in interest rate to 8.75%: **$2,220**.

2. Higher Debt Over Time. Another risk that comes with specialty mortgages involves your "equity"—the amount your house is worth after you subtract the amount you still owe to the lender. Consumers who choose some types of specialty mortgages will build equity in their home much more slowly than with traditional loans. In fact, with some specialty mortgages, **the amount you owe on your home could increase rather than decrease over time**.

WHO IS BEST SUITED FOR A SPECIALTY MORTGAGE?

Specialty mortgages are designed for homebuyers in special circumstances. The lower initial monthly payments may make sense for buyers who intend to own a home for a short time or who can handle high payments in the future. If you are a homebuyer who plans to be in your home for years, or who does not expect a significant increase in income by the time the monthly payments go up, you should very carefully consider the risks and advantages of a specialty mortgage.

QUESTIONS TO CONSIDER BEFORE CHOOSING A SPECIALTY MORTGAGE

• How much can my monthly payments increase and how soon can these increases happen?
• Do I expect my income to increase or do I expect to move before my payments go up?
• Will I be able to afford the mortgage when the payments increase?
• Am I paying down my loan balance each month, or is it staying the same or even increasing?
• Will I have to pay a penalty if I refinance my mortgage or sell my house?
• What is my goal in buying this property? Am I considering a riskier mortgage to buy a more expensive house than I can realistically afford?

Be sure you work with a REALTOR® and lender who are willing to discuss different options and address your questions and concerns!

HELPFUL STEPS TO TAKE BEFORE FINANCING A HOME

• **Check your credit status.** As of September 2005 (or earlier, depending on where you live), you have the right to receive a free credit report once a year from each of the 3 major credit bureaus—Equifax, Experian and TransUnion. For completeness, it is best to review reports from each one of them. Contact information is included under "Additional Resources."

• **Work with your REALTOR® and lender to determine how much you can afford to pay for a home.**

• **Ask your lender for your credit score**. This score, which is calculated based on your credit history and other factors, determines how lenders view your creditworthiness and determine the loan terms to offer. Scoring rules vary widely, but generally a score of 650 or higher means that you qualify for the most favorable loan terms.

• **Shop around.** Different lenders charge different rates and fees and have different options. Be sure to compare to get the best deal. Your REALTOR® can recommend reliable lenders.

• **Be sure you understand the risks of your mortgage and know whether you can handle possible payment increases.**

ADDITIONAL RESOURCES

The National Association of REALTORS®:
For information on NAR's Housing Opportunity Program, go to **www.REALTORS.org/housingopportunity**.

The Center for Responsible Lending:
For information about predatory mortgage lending practices, including "The Seven Signs of Predatory Lending," go to **www.responsiblelending.org**.

Fannie Mae:
Look for the section "For Home Buyers & Homeowners" at **www.FannieMae.com**.

Freddie Mac:
Look for the section on "Buying and Owning a Home" at **www.FreddieMac.com**.

Ginnie Mae:
For a simple calculator to help homebuyers estimate how much they can afford to spend, read "How Much Home Can You Afford?" at **www.GinnieMae.gov**.

HUD Housing Counselors:
For a list of counseling agencies, by state, approved by the Department of Housing and Urban Development (HUD), go to **www.hud.gov/offices/hsg/sfh/hcc/hccprof14.cfm**.

"Looking for the Best Mortgage" is a brochure on how to shop, compare, and negotiate the best deal on a home loan. The brochure is a joint effort of 11 federal agencies, including the Federal Trade Commission (FTC), the Federal Reserve Board, HUD, and the Department of Justice.
www.federalreserve.gov/pubs/mortgage/mortb_1.htm

National Credit-Reporting Agencies:
• Equifax 800.685.1111 **www.equifax.com**.
• Experian 888.397.3742 **www.experian.com**.
• TransUnion 800.916.8800 **www.transunion.com**.

Go to **www.annualcreditreport.com** to ask for a free copy of your credit report, once a year, or call 877.322.8228. See, also, **www.FTC.gov**.

• **INTEREST-ONLY MORTGAGES**

• **NEGATIVE AMORTIZATION MORTGAGES**

• **PAYMENT OPTION ARM MORTGAGES**

• **40-YEAR MORTGAGES**

The National Association of REALTORS®, *"The Voice for Real Estate," is America's largest trade association, representing more than 1 million members involved in all aspects of the residential and commercial real estate industries. For more information, please visit* ***www.REALTORS.org****.*

The Center for Responsible Lending *is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions. Please visit our website at* ***www.ResponsibleLending.org****.*

National Association of REALTORS®
500 New Jersey Avenue, NW
Washington, DC 20001

Center for Responsible Lending
910 17th Street NW, Suite 500
Washington, DC 20006

www.ColoradoRAM.com