

Mortgage Lenders Teasing You?

Once upon a simpler time, mortgage loans were based on 20% down payments, 15 or 30 year amortization schedules, and interest rates that were fixed. Today, the combination of keen mortgage lending competition, low long-term interest rates, growing demand for ever larger homes, and mortgage lenders' desire to shift risk from themselves to their borrowers has produced an array of financing options that can bewilder even the savviest shoppers.

To make an informed choice in today's complex mortgage market, borrowers need to grasp a variety of arcane financial notions such as teaser rates, interest rate indices, payment caps, reset frequencies, and index margins before taking the mortgage plunge. This space is too limited to address the many issues that can nip the heels of the unwary, but when the time comes to weigh your mortgage options, it's worth remembering that your lender is your counterparty. What's good for it may not be the best choice for you.

As an example, many of the loans being marketed today are known as "option ARMS" where "ARM" is an acronym for "adjustable rate mortgage" and "option" refers to the fact that the borrower has the flexibility to choose among a variety of payment options over the course of the loan. In short, option ARMs usually offer initial interest rates and/or monthly payments that are artificially suppressed. Known as teaser rates and payment caps, these enticements are intended to induce borrowers to bear the eventual risk of fluctuating interest rates and monthly payments – a risk that is supremely difficult to quantify. Of course, this is precisely why lenders seek to transfer this risk to their borrowers.

So what's the downside to these new fangled loans? Once that artificially low interest rate or payment begins to vanish, you might find that your monthly payment rises much faster than your income. You might also find that your loan balance has *increased*. If or when this happens, you might then become familiar with a few of the more unhappy terms from the mortgage industry's lexicon such as payment shock, negative amortization, and even deed-in-lieu of foreclosure.

Like a teenager who is not quite sure how to handle that new-found freedom, option ARMs can be creative financing strategy, or a recipe for trouble.

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