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Borrowers advised against high-risk loans

By: PATRICK WRIGHT - Staff Writer

Carlsbad financial planner Judy Stewart said she advises clients not to buy a home that costs more than three or four times their household income.

"I don't let clients reach for real estate," said Stewart, a certified financial planner and owner of Stewart Financial Services in Carlsbad. "If they can't afford it, they can't afford it."

Unfortunately, many homeowners now believe that they stretched too far during the real estate boom of the last six years. As prices rose dramatically in that period, many borrowers chose risky loans to buy homes that they couldn't afford with conventional loans.

A growing number of borrowers want to replace those loans, according to experts. However, because home prices have stabilized, or even fallen, some homeowners now owe more on their mortgages than their homes are worth.

In addition, mortgage interest rates have risen in the last three years, making it more difficult to refinance.

Mortgage interest rates have increased from a 40-year low of 5.43 percent for a standard, 30-year, fixed-rate mortgage in 2003 to a high of 6.88 percent last year. The current average is 6.33 percent, according to HSH Associates Financial Publishers in New Jersey, which tracks the mortgage industry.

Two of the most dangerous loans have become popular. The California Association of Realtors said earlier this month that 43 percent of home buyers statewide chose to take second mortgages, typically 20 percent of the purchase price, in addition to a first mortgage covering 80 percent.

This combination is known as "100 percent financing" and involves a "piggyback" mortgage, because the second mortgage rides atop the first. The percentage of homeowners carrying a first and second mortgage is the highest since 1982 and the second highest in the last 30 years, the association said.

Also, First American Real Estate Solutions, a research firm in Santa Ana, said 60 percent of all loans taken out for home purchases statewide in 2005 were adjustable-rate mortgages. These mortgages, or ARMs, have monthly payments that rise and fall with interest rates. If rates rise, borrowers can be hit with monthly payments double or even triple their initial payments.

Victoria Johnson, president of the San Diego chapter of the California Association of Mortgage Brokers, said that she has been flooded with people trying to understand their adjustable-rate mortgages.

She said people don't understand which loan would be best for them, and lenders, some unlicensed, aren't educating them. Her association produces a checklist of questions to help borrowers get the right loan.

"There aren't bad loans," she said. "The problem is how they are being used."

Look before you sign

To avoid financial peril in the mortgage market, do your homework before signing the paperwork. The North County Times spoke recently to 10 financial advisers and mortgage brokers about loan choices.

The experts agreed that a fixed-rate mortgage is the most secure one. A fixed-rate mortgage charges the same fixed interest rate for the term of a loan.

Borrowers make the same monthly mortgage payment in the first month as they do in the last. Although these loans usually come in terms of 15 or 30 years, borrowers can shorten the term to 10 years or extend it to 40, or even 50 years.

Interest rates for fixed-rate mortgages are currently a little more than 6 percent, and borrowers with good credit might get a rate below that. Those with poor credit usually pay more than the average interest rate.

Some borrowers who gamble that interest rates will drop after they take out their loans choose an adjustable-rate mortgage. As it sounds, the ARM starts out with one interest rate and a set monthly payment that rises or falls with national interest rates.

If interest rates drop, the interest rates on ARMs can fall below the rate borrowers might otherwise have gotten with a fixed-rate loan. However, the borrowers risk that interest rates go up and monthly mortgage payments increase as soon as a year or two later.

The most popular ARM has a five-year term. It has a fixed rate for the first 5 years and then adjusts with interest rates after that. However, the initial, fixed-rate term can range from three years to 10 years. The borrowers can select from among many ARM variations.

How an ARM works

For example, a borrower named John buys a home with a fixed-rate mortgage of 6 percent. But John believes that interest rates could go down, so he gets an adjustable-rate mortgage that starts at 5.5 percent for five years and then adjusts every year after that.

If national interest rates go down after five years, the interest rate on the loan could drop even lower, saving him money, compared with a 6 percent, fixed-rate mortgage. However, rates could go up and push the loan rate to 7 percent, costing John more each month.

Whether a borrower chooses a fixed-rate mortgage or an ARM, each requires the borrower to pay down the loan principal every month.

Loans with high risk

Another choice, but a risky one, is the interest-only mortgage. Some people refer to it by this mouthful ---- fixed-rate, adjustable-payment loan.

The monthly mortgage payment is calculated to charge only interest, with nothing paid toward the loan principal. This loan is risky because the interest-only payment term lasts only for a designated period. Then the loan is recalculated, and the borrower starts making monthly payments on the principal as well.

For example, Mary buys a home, using a \$500,000, 30-year mortgage at 6.25 percent. She makes interest-only payments for the first 10 years. Her monthly mortgage payment is \$2,604.

But once the 10 years are over, Mary must begin paying down the \$500,000 principal, along with interest, for the remaining 20 years. Although the interest rate stays the same, her monthly payment jumps from \$2,604 to \$3,654.

Mortgages with even greater risk

Then there is the negative-option, adjustable-rate mortgage, sometimes referred to as an "option ARM." No other loan is more controversial. Most financial advisers and mortgage brokers interviewed for this article warned against them.

"I think the people who got into option ARMs a few years ago are in a world of hurt," said Stewart, the Carlsbad financial planner.

This ARM offers a dangerous trade-off: a low monthly mortgage payment in exchange for loan principal that increases over time.

The low-interest "teaser" rate is lower than that of a typical, fixed-rate mortgage. The smaller payments at the start often appeal to lower-income buyers or those struggling to buy.

Teaser rates can be as low as 2 percent for the first year or two, but come with a readjustment shock that can send borrowers scurrying to refinance.

Still other loans, called "payment-option ARMs," let borrowers choose whether to make a monthly payment that reduces some of the principal.

For example, Mark buys his "dream" home with a \$500,000 negative-option ARM. He gets an initial teaser rate of 2 percent for the first year. His monthly mortgage payment is about \$1,800, or \$21,600 per year. This requires financial discipline because Mark earns \$50,000 per year.

After the first year, his monthly mortgage payment readjusts, or resets, at 7.5 percent for the next four years. Mark struggles to make payments, now up to about \$2,600 per month. At the end of five years, it adjusts again so that Mark starts paying off the principal. What started as a \$1,800 monthly payment is now about \$3,600, or \$43,200 per year.

Mark thinks about refinancing after the first readjustment. However, the loan carries a prepayment penalty of \$10,000 for the first five years. If he tries to pay off the loan or refinance before the five years are over, he must pay the penalty. Eventually, Mark falls behind on his payments, defaults and loses his house.

Jon Beyrer, a certified financial planner with the Del Mar firm Blankinship & Foster, considers prepayment penalties unnecessary.

"You have lenders (making) a few extra bucks by nailing borrowers with it," he said.

No free lunch

Rick Mayes, a fee-only financial planner in Carlsbad, said that borrowers should be extremely wary of deals that sound too good to be true, because lenders will make money from the deal.

"There is no free lunch," he said. "One way or another, they are getting their money back."

Once the borrower decides on a mortgage, there is a list of other payments to monitor. Don't be concerned if the lender wants to charge fees for closing costs, such as title policy, zoning disclosures, easements, mineral-rights zoning, mold-and-termite inspection and paperwork filing for the deposit and escrow account information. But these fees shouldn't be more than 2 percent

of the final sales price.

Borrowers routinely pay title insurance when they get a mortgage. It protects both the borrower and the lender from unforeseen problems with the title, such as a third party claiming that the title isn't accurate.

Also, they shouldn't be surprised if a lender requires private mortgage insurance. Private mortgage insurance, also known as PMI, is usually charged monthly to borrowers who make a down payment of less than 20 percent of a home's value.

Borrowers should be suspicious, though, if the final paperwork includes an administration fee or an application fee. These can be excessive fees charged to boost profits. Charging application fees is like charging customers for walking into a store, experts say.

Christopher Cagan, director of research and analytics for First American Real Estate Solutions, said the difference between getting a good loan and getting a bad one is doing your homework.

"People don't understand what they sign," he said.

For a mortgage worksheet or to find a local member of California Association of Mortgage Brokers, call Victoria Johnson at (858) 523-9990, Ext. 202.

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Two of the more dangerous loan options are 100 percent financing and payment option adjustable rate mortgages. Most home loans only cover 80 percent of a home's value, with the remaining 20 percent financed through a downpayment. But many lenders permit borrowers to take out a second mortgage for the remaining 20 percent at a higher rate than the first mortgage.

If the loans are fixed, meaning they stay the same throughout the loan, borrowers might be fine. But if the loans are tied to interest rates, they could rise in as little as six months. Without a downpayment or a house with an increasing value, borrowers don't have a "safety net" to refinance if payments become unaffordable and they are more likely to default on the loan.

These loan descriptions deal with rates for a home's first mortgage, usually up to 80 percent of the home's value.

The remaining 20 percent is usually paid through a down payment or a second mortgage, which carries a higher rate than the first mortgage.