Fact Sheet HE 3226

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Mortgage Alternatives: The Risks and Opportunities[1]

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Buying a home involves a difficult decision process. Today's mortgages are complex, and homeownership is no longer a nearly risk-free investment. Compare mortgage alternatives to find the best balance of risk and opportunity. Figure out which loan is the most advantageous combination of interest rate, up-front costs, total cost, tax advantages, monthly payment and terms for your particular situation. This fact sheet will help you select the right mortgage.

LONG-TERM, FIXED RATE MORTGAGES (FRM)

Description. The interest rate and monthly principal and interest payments of the FRM stay the same until the debt is paid in full. The loan is usually amortized over 30 years.

Current Prevalence. The FRM is the most common type of mortgage. As interest rates drop, FRMs become affordable and attractive to more borrowers. They are available from many types of financial institutions.

Advantages. The FRM provides protection from any increase in the interest rate and monthly payment. It creates long-term tax advantages and provides for a stable housing expense.

Disadvantages. FRM lenders charge a higher interest rate for this type of mortgage. The total interest costs over the life of the loan are substantial. There is a slow equity build-up, especially in the early years. The newer FRMs are rarely assumable. You must refinance to take advantage of a decline in interest rates. Refinancing costs total about 3 to 4 percent of loan amount, so it does not pay to refinance often.

Other Characteristics. The FRM usually requires a 20 percent down payment unless you pay for mortgage insurance to protect the lender. Private mortgage insurance may not be obtainable in depressed housing markets. Lenders usually offer a range of interest and discount point combinations to choose from.

Most Suitable Borrowers. The most suitable borrowers for FRMs include those who have fixed incomes, do not plan to sell in the future, cannot risk future increases in monthly payments, seek a long-term tax deduction, and believe that interest rates will rise.

Opportunity vs. Risk. You pay extra for the security of predictability combined with minimal monthly payments.

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15-YEAR MORTGAGES

Description. A mortgage which is amortized for 15 years is a 15-year mortgage. It is usually a fixed rate mortgage.

Current Prevalence. Once a rarity, the 15-year mortgage is now the second most common loan for refinancing.

Advantages. This type of mortgage saves roughly half of the interest that would be paid over the life of a 30-year loan. It rapidly builds equity. Lenders usually charge a slightly lower interest rate or fewer discount points than for a 30-year loan.

Disadvantages. The monthly payment is higher than longer-term mortgages (though not nearly double), thus reducing affordability. The higher payments to reduce interest costs can sometimes be false economy; some consumers could realize greater benefits by investing the extra money rather than using it to reduce the loan term and interest payments. This type of loan is usually not assumable. Consumers will also lose the tax deduction in 15 years.

Other Characteristics. See Long-Term, Fixed Rate Mortgage.

Most Suitable Borrowers. The most suitable borrowers refinance from a higher-rate mortgage to a lower-rate mortgage. They can afford higher payments now, but expect to retire or have other major expenses (children's college tuition, etc.) after 15 years are most suitable for this type of mortgage.

Opportunity vs. Risk. Consumers may increase their housing budget now to save over the long run. They will still pay extra for predictability but incur no risk of rising payments.

ADJUSTABLE RATE MORTGAGES (ARM)

Description. The interest rate on an ARM can change upward or downward, usually causing changes in the monthly payment. In some cases, the loan term and/or principal may change.

The interest rate is based upon a recognized financial "index," now most often the one-year U.S. Treasury securities yield. The loan's interest rate is set at a certain "margin" or spread above the index rate (i.e., a 2 percent higher rate than the index rate).

Most of today's ARMs are adjusted once a year and have "rate caps" which limit how much the interest rate can change upward or downward. Two-percent annual caps and a 5 to 6 percent cap increase in the life of the loan have become standard.

"Payment caps" (limits on how much the monthly payment can rise) can lead to "negative amortization" (when the principal balance or debt grows because monthly payments are not large enough to cover all the interest due). Payment caps are rarely used today and are very risky.

Versions of adjustable mortgages are also known as Adjustable Mortgage Loans (AML), Variable Rate Mortgages (VRM), or flexible rate mortgages.

Advantages. The initial interest rate is lower than a fixed rate loan — usually by 1 to 2 percent, but when interest rates are high the difference may be 3 to 4 percent. As a result, monthly payments start out much smaller and qualifying for an ARM is much easier.

If interest rates fall, the ARM rate also falls, meaning greater savings without having to incur the high costs of refinancing.

Disadvantages. If interest rates rise, then the loan rate and monthly payments will rise accordingly on the adjustment dates. If your income does not keep pace with the rise in payments, you could be forced to incur the costs of refinancing to obtain an FRM at the current higher rate for protection against further increases.

ARMs with deeply discounted initial ("teaser") rates may become much more costly at the first adjustment period, even if market interest rates have not changed. ARMs which allow negative amortization and ARMs without rate caps are very risky, but are generally avoided by lenders today, because of the high default rates associated with them.

ARMs with more safeguards have higher interest rates than ARMs with fewer safeguards. Long-term (30-year) ARMs have slow equity build-up, similar to an FRM.

Other Characteristics. Some ARMs are "convertible" to an FRM at the prevailing rate for a much smaller fee than the cost of refinancing (sometimes as little as $100). Conversion is generally allowed only during certain years of the loan.

Lenders may offer a range of interest rate-discount point combinations from which to choose.

Many lenders now have higher borrower qualification standards than in the past. Typically, the monthly mortgage payment (plus taxes and insurance) should not exceed 29 percent of your gross income, and your total debt (including housing) should not exceed 41 percent. This payment amount is often based upon the highest of either (a) the initial mortgage rate, (b) 10 percent, or (c) the current index rate plus 3 percent.

Most Suitable Borrowers. This borrower expects to own the home for less than five years, accepts the risk of future higher rates (in return for immediate use of extra cash that would have gone into higher FRM payments), believes interest rates are declining, and doesn't want a higher-rate FRM.

Opportunity vs. Risk. Consumers must live with the risk of higher future payments for certain short-term savings and potential longer-term savings.

FEDERAL HOUSING ADMINISTRATION (FHA) INSURED LOANS

Description. Housing and Urban Development (HUD) insures loans made by private financial institutions for up to 97 percent of the property value for up to 30 years. The loans finance homes in both urban and rural areas. HUD insures various types of mortgage loans, adjustable rate mortgage loans, and graduated payment mortgage loans. The interest rate is established by the market, not the government.

Current Prevalence. The typical HUD-insured loan is a fixed rate/fixed term mortgage loan. HUD-insured loans are readily available, but some of the different types of HUD-insured loans may not be available locally.

Advantages. There is a low down-payment — if the value is less than $50,000, the down-payment is 3 percent of the value; if the value is greater than $50,000, the down-payment is 3 percent of the first $25,000 and 5 percent of the value in excess of $25,000. HUD-insured loans are assumable by qualified borrowers. Some closing costs may be financed in the loan. No prepayment penalties may be collected. Interest rates and points may be slightly lower than conventional loans.

Disadvantages. There is a mortgage insurance premium that is typically financed in the loan. The premium varies from 2.3 to 3.8 percent of the loan amount, depending on the loan term and type of loan.

Other Characteristics. Maximum loan amount may be capped, except for certain high-cost areas which allow for larger loan amounts. There are no limits on family income and no subsidies on the monthly payments.

Most Suitable Borrowers. First-time home buyers and individuals purchasing moderately priced homes are the typical HUD borrowers.

Opportunity vs. Risk. HUD-insured loans provide the buyer with the opportunity to purchase with a minimal down payment as opposed to the 20-percent down-payment required on a conventional loan.

VETERANS ADMINISTRATION (VA) GUARANTEED LOANS

Description. Veterans Administration guaranteed loans provide mortgage insurance for low- and no-down-payment loans to eligible veterans. Local lenders (not the government) supply the loans. The VA sets the maximum interest rate. VA loans include FRM, 15-year fixed-rate mortgages, and others.

Current Prevalence. VA FRMs are widely available to eligible consumers.

Advantages. Eligible veterans pay no mortgage insurance premiums and may obtain a 100 percent loan-to-value mortgage (no down payment), up to a fairly high loan limit. Such 100 percent financing takes greatest advantage of tax reform provisions. VA loans offer low (below market) interest rates. Disabled vets do not pay the VA funding fee (1.875 percent of loan amount). The seller pays any discount points. The VA sets limits on closing costs in most areas. There is no maximum land value to the loan amount and no pre-payment penalty.

Disadvantages. Non-veterans are ineligible. Discount points are usually charged and if a seller pays them, the price of the house may be higher. The little or no down-payment required results in both larger debt and larger monthly payments. If the home depreciates, the housing debt may exceed the value of the house and the sale of the home would not cover the loan. Any down payment, closing costs, or points cannot be borrowed. Processing time is 30 days.

Other Characteristics. VA loans have a funding fee of 1.875 percent of the loan amount. A down payment is required for any loan amount above the amount specified by the lender.

Most Suitable Borrowers. The most suitable borrower is a veteran (especially a first-time buyer) and those wishing to refinance to tap home equity (get cash back).

FARMERS HOME ADMINISTRATION (FMHA) RURAL HOUSING LOANS

Description. FmHA provides housing loans to applicants who are without adequate housing, lack sufficient resources to obtain housing, and are unable to obtain credit from other sources. Loans are available to those who have the capacity to repay the loan, can personally occupy the home, and have a good credit history. Applicants must purchase or build in an eligible rural area as defined by FmHA. Loans may be made to an eligible applicant to buy, build, rehabilitate, improve, or relocate a dwelling to be used as a permanent residence. Income limits are set by state formulas.

Current Prevalence. FmHA loans are available to home buyers who qualify because of their income and the location of the residence. FmHA offices are located throughout the state.

Advantages. These loans make home ownership (and home improvement) possible to those who perhaps could not otherwise obtain adequate housing. The interest rate and down payment vary with household income. Closing costs are low. Borrowers who suffer a reduction in income may receive government assistance. Loan terms may be arranged for longer terms than for conventional mortgages.

Disadvantages. This type of home financing is available only to those who meet the criteria outlined by FmHA.

Other Characteristics. FmHA arranges all aspects of the loan origination, including appraisal and inspection. The applicant pays for the legal services necessary to guarantee a satisfactory title to the site, credit reports, and other incidental loan-closing costs. Except for credit reports, these expenses may be included in the loan.

Most Suitable Borrower. The most suitable borrowers are low-income, rural, first-time home buyers.

OTHER MORTGAGE VARIATIONS

Accelerated Amortization. These mortgages are a do-it-yourself or structured shortening of the loan term by making advance principal payments on loans that have no pre-payment penalty. They can result in much lower total interest cost and are similar to bi-weekly mortgages. Discuss this variation with your lender.

Home Equity Conversions. With home equity conversions, retired homeowners may tap the equity in their homes to supplement their income while remaining in the home. They may be structured in several ways. Some are loan plans where the homeowner accumulates a debt to be paid off at some future time (usually by sale of the house after death). Loan plans are unlikely to appeal to lenders in depressed housing markets.

Other versions are split-equity plans where the elder homeowner sells the house (to a relative or investor) and the equity is split into ownership rights belonging to the buyer and occupancy rights maintained by the elder for life. In other words, the buyer leases the home back to the former owner for less than the monthly annuity created from the home sale.

Home equity conversions are not widely offered. Such loans require complex legal precautions and should be carefully studied by the homeowner.

COMMON MORTGAGE FEATURES

Other mortgage features are Assumable Loans and Seller Financing. Assumable mortgages, such as VA and FHA loans, allow a buyer to take over a seller's original mortgage. The buyer must then obtain the balance of the purchase price. If lenders agree to an assumption, they may review the new buyer's credit history and adjust the interest rate of the loan to current market conditions. Many fixed-rate mortgages written since the late 1970s contain a "due-on-sale" clause, however, which prohibits an assumption. This protects the lenders when buyers want to assume sellers' existing low-rate mortgages.

With seller financing, a seller provides all or part of a buyer's first or second mortgage. While sellers may offer a slightly below-market interest rate, they may also require a balloon payment of the entire loan balance within a few years of refinancing at market rates. To eliminate possible pitfalls, seller-financed loans should be prepared and reviewed by an attorney.

Other Options include balloon, reverse annuity, shared appreciation, and renting with an option to buy.

Selecting the "right" mortgage is not an easy task. Among the factors to consider are your current and projected income, your marginal tax bracket, current market conditions, the size of your investment portfolio, and how long you plan to live in the house.

ADDITIONAL FINANCING TIPS

If you have savings or expect to receive a substantial profit from the sale of your current home, you can reduce your mortgage substantially by making a 20- to 30-percent down payment. The difference between 8-percent, 30-year $40,000 and $50,000 loans, for example, is $73 a month or $876 a year.

Do not ignore the impact of points when comparing mortgage loans. The lowest interest rate is not always the best choice. The length of time you remain in a house will determine whether to choose a lower mortgage rate with more points (recommended if you stay more than 5 years), or a higher mortgage rate with fewer or no points (recommended if you expect to move within 5 years). The annual percentage rate (APR) of a mortgage measured in total interest cost, including points and fees, can help in making comparisons among fixed-rate loans.

Remember that Private Mortgage Insurance (PMI) is almost always required with down payments of less than 20 percent of the purchase price. PMI will add about 1/4 percent to your mortgage interest rate. The cost is usually added to each monthly payment. Under government mortgage guidelines adopted in early 1989, homeowners can drop their PMI in as little as 2 years. If home equity increases to 20 percent or more due to home improvements or reductions in loan principal or 25 percent or more due to market appreciation, PMI coverage can be dropped. Contact your lender for details. If you are "stretching" to qualify for a mortgage, a 1-year low-interest ARM will usually buy the most house for the lowest initial rate and monthly payment. The trade-off, of course, is that the interest rate could increase in the future.

When shopping for an ARM, ask about the maximum annual and lifetime interest rate. Then consult a "mortgage payment table book" to find the corresponding monthly payment and consider if you could still afford the loan when the payment is at its highest.

If you can afford the higher monthly payment, bi-weekly and 15-year loans build up equity much faster than other types of mortgages. They also offset the effects of tax reform, which reduced the value of the mortgage interest deduction by lowering marginal tax brackets.

Anticipate problems that could affect your loan before you apply. Try to reduce your debt load, for example. Review a copy of your credit record. (See Fact Sheet HE 3217, *Home Buying and Your Credit Report*, for how to get your credit report.) Bring every needed document to your first meeting with a lender including the contract to buy your house, a net worth statement, loan records, statements from banks and brokerage firms, W-2s, and one or two years' previous tax returns.

Above all else, do your homework! Ask questions and compare loan features and closing costs, as well as monthly payments. One advantage of having a multitude of choices is that you are likely to find a mortgage that fits your lifestyle.