



## Finding a Mortgage: Alternative vs. the Old Standards, What's Right for You? By Ken Harney

Almost anyone buying a home in 2006 will need to grapple with important questions like these:

- What type of mortgage makes sense for me?
- Do I sign up for one of those new loans that offer minimal monthly payments in the early years and higher payments later? Or should I stick with a traditional fixed-rate 30-year mortgage?
- Would an “interest-only” plan be a smart move for me?

And what about loans that involve “negative amortization” to keep payments low?

Here's a quick guide to the pros and cons of some of the most popular new alternatives to traditional mortgages.

Each of the new loan types can be an excellent solution for home buyers with specific needs, resources, and timetables. But each also carries potential risks for the unwary.

**'Interest-Only' Mortgages.** Monthly payments on traditional 30-year or 15-year mortgages consist of interest charges plus reductions of the underlying debt. Each month you reduce the amount of debt you owe to the lender. At the end of a few years, your loan balance will be hundreds or even thousands of dollars less than when you started.

Interest-only mortgages are different. They require no reduction in your loan balance as part of the monthly payment. If your original loan was for \$250,000, you will still owe that same \$250,000 at the end of five years.

The attraction of interest-only plans is their **lower monthly payments**, generally around 20% initially. An interest-only mortgage for \$200,000 at 6%, for example, carries a monthly payment (exclusive of taxes and insurance) of about \$1,000. A \$200,000 fixed-rate 30-year loan at 6% would cost you about \$1,200 (again exclusive of taxes and insurance).

The new “alternative” mortgages add to the menu you have of loan choices when you buy a home. The “old standards” on that menu include:

**30-Year Fixed Rate Mortgages.** These come with payments that never change during the full term of the loan. They are set up to steadily reduce your principal debt to zero over time. Their big attraction in a market like today's — they lock you into interest rates that are among the lowest available in four decades.

**15-Year Fixed Rate Mortgages.** These generally come with interest rates set about one half of a percentage point below 30-year fixed rate loans. They have the advantage of making your home debt-free in 15 years. However, they also require somewhat higher monthly payments than a 30-year fixed-rate loan of comparable size.

**“Adjustables.”** These are loans whose rates vary — up or down — based on interest-rate movements in the overall economy. Most adjustables offer lower initial rates than 15- and 30-year fixed rate mortgages. But they also come with the potential of moving higher over time. So-called “hybrid” adjustables fix your payments for a pre-set initial period — say three, five or seven years — then convert into regular adjustables.

The \$200 lower monthly cost reflects the fact that you are not paying off any of the “principal” debt you owe the lender. Those savings, in turn, may be precisely what you need to afford the payments on the new house you want to buy.

But here’s the downside: Interest-only loans usually limit the period of lower payments to the first five or 10 years. Once that time is up, they require you to either **switch to sharply higher monthly payments** — to begin paying off the underlying loan balance — or to **refinance into what may be a higher interest-rate environment**.

You need to think through these scenarios carefully before choosing an interest-only mortgage. Generally these loans work best for:

- **Buyers who know they’re likely to sell their house within the interest-only period.** If the local market has appreciated significantly during the five or 10 years, your sales proceeds should be enough to pay off the loan balance.
- **Buyers who know they are likely to have higher household income before the interest-only period expires.** They should then be able to handle the higher monthly costs of the loan.

But keep this in mind: House price inflation, while commonplace in recent years, is not guaranteed for the future. Nor are today’s low interest rates.

Interest-only loans magnify the risks of these scenarios. You need to feel comfortable that you can handle them.

**'Payment Option' and 'Negative Amortization' Mortgages.** These are among the most popular new plans, and they come with their own distinct benefits and risks. Payment option loans allow you to choose among several types of payment plans:

- Interest-only
- Traditional interest-plus-debt-reduction
- Minimum payments much lower than interest-only for pre-set periods

Many buyers choose the minimum payment option because it cuts their monthly costs by hundreds of dollars and helps them afford their purchase. But the minimum payment plan also involves what is known as “negative amortization” — increasing the amount you owe the lender. Say you began with a \$200,000 mortgage balance. After several years of minimum payments and negative amortization, you might owe \$210,000 or more.

You might be willing to take on that higher debt burden if you are confident your property will appreciate in value. But what if it doesn’t? And since payments on all option loans increase sharply after pre-set initial periods, you also need to ask yourself: How will I handle these extra costs?

Any of these new loan concepts might work for you, if have a good grasp of their mechanics, timing, and risks. Your loan officer or home builder can be great resources to help walk you through the details.

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