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Understanding Option ARMs: Risks and Benefits

This is the second article in a series about option ARM loans. The first segment described the ins and outs of an option ARM home mortgage. This article seeks to lay out the pros and cons of the program.

As stated in the first part of this article option ARMs are home loans with adjustable interest rates that allow the borrower to choose between four different payment amounts every month for a certain number of years. Because of the risks these loans have come under heavy criticism from the Federal Reserve and other loan regulators. Yet there must be some great benefits if the loan has become popular, right?

The Benefits

There are indeed some enticing advantages to getting an option ARM loan. One of the most attractive benefits is the incredibly low interest rate and payments available at the beginning of the loan. This rate can be as low as 1% for the first month, and generally the rate cannot rise by more than 7.5% each year after that for several years. Getting a low rate and having low payments means some people can buy more expensive homes than they could have qualified for with other programs.

Another nice feature of the loan is the flexibility it affords. Borrowers can make a choice each month for several years about how much they want to pay. When finances get tight, they can make the minimum payment; when they get their yearly bonus, they can make the 15-year payment. Others who are financially savvy can make minimum payments in order to invest the saved money.

The Risks

One of the worst risks is the problem of negative amortization. This is when the borrower pays less than even the amount of interest due each month. The remaining interest is added to the total principal due and the loan balance actually grows as you make payments, instead of shrinking. The scary part of this is that if you have to sell your home, the amount you still owe on your mortgage will likely be much higher than the amount of money your home is actually worth. You run the risk of selling at a loss and having to come up with the difference to cover your original mortgage. In a worst case scenario, you might end up bankrupt.

Option ARM borrowers are also in danger of “payment shock.” With this loan, the payment from month-to-month might jump to more than double. Those who bought homes that were too expensive for them to afford with a traditional loan will probably be in trouble as the payment rises.

Those who are poor at managing their finances may also run the risk of defaulting or going to into foreclosure with an option ARM, as it takes careful watching and planning to stay on top of the balance.

While option ARM loans can offer some immediate benefits to homebuyers, consumers are warned to be cautious when jumping into such a mortgage. They should carefully weigh the benefits and risks and affordability of the adjustable loan in order to make the best decision for their home mortgage plans.