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What are Specialty Mortgages?

In times past, the only loan option for home buyers was the traditional 30-year fixed rate mortgage. Over the past few decades however, mortgage lenders have developed several different kinds of loans to fit the various needs of consumers. The problem is that many of the new ‘specialty’ or ‘exotic’ loans were designed for sophisticated home buyers but are routinely issued to less informed borrowers. These loans can be helpful in many situations, but before you jump into one, make sure you fully understand the terms and consequences of a specialty mortgage.

Most specialty loans are versions of adjustable rate mortgages (ARMs). Two of the most common are Interest-Only mortgages and Option Payment ARMs. An Interest-Only loan is designed to allow for very low monthly payments for the first five to ten years. A traditional mortgage payment is made up of two parts: the principal and the interest. With Interest-Only loans, borrowers only have to pay the interest portion of the payment each month for the introductory period. This means the payment is lower than a traditional 30-year fixed loan. The risk however, is that you are not making any contribution to the principal of your loan and your payments will increase dramatically after the initial period. The problem is that most people who get into Interest-Only loans cannot afford to make the higher payments and they face the risk of defaulting on their mortgage if they do not refinance out of the loan. These loans may be good for those who either plan to refinance before the payments reset or who plan to move out of their home within the five to ten years.

The other popular exotic ARM loan is the Option Payment ARM. This loan gives you the choice of four different payment amounts every month for the first several years of the loan. The first payment option is equal to what a payment would be on a 15-year fixed loan (which would pay off the loan in 15 years if made consistently). The second option is the same amount that you would pay if you had a 30-year fixed loan. The third option is an interest-only payment. The fourth is a payment amount that is even less than just the interest due for the month. The benefit of this plan is obviously that you could make really low payments for the initial period. The hazard though, is that every time you make the minimum payment the interest that wasn’t covered by the payment is tacked on to the balance of your loan, meaning your loan balance will actually increase over time even though you are making payments. This means you could end up with a mortgage loan for more than your house is worth. If you have to sell your home that could be bad news. This loan may be good however, for those who plan to only use the minimum payment option as a last resort if they have a hard financial month.

Before you commit yourself to one of these unconventional loans, make sure that you can truly afford to make the larger payments. If you can only afford the loans at the lowest payments and rates, and you do not foresee your income increasing in the next few years, you should steer clear of specialty loans or perhaps consider a less expensive home!

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