03/28/2007

Hybrid ARMs for Bad Credit Borrowers

Is your credit score at the low end of the spectrum? Are you interested in becoming a homeowner, but worried that your credit will prevent you from qualifying? One way you may be able to break into the market is with a hybrid loan from a sub-prime lender.

Sub-prime lenders specialize in lending mortgage money to those with poor credit scores, usually about 620 or lower. They have created special loan programs to help bad credit borrowers get into homes. One such program is the hybrid ARM or adjustable rate mortgage. This loan is basically a combination of a fixed and adjustable rate mortgage. Borrowers get a low fixed rate for a period at the beginning of the loan, generally 2 to 3 years in this case. After the first few years, the interest rate is allowed to adjust up or down based on the movements of a specific market index.

These loans were designed to allow bad credit borrowers to get into a loan and rebuild their credit by making timely mortgage payments during the fixed rate period when the payments are low. Theoretically at the end of the fixed term, the borrower’s credit should have improved enough to qualify them for a good interest rate on a refinance loan. These loans are really not designed to be permanent loans.

There are usually prepayment penalties attached to these hybrids. Lenders require borrowers to pay an extra fee if they refinance or sell before the first few years are up. Since the borrowers are supposed to be using the time to rebuild their credit, this is not typically a problem.

Obviously these hybrid ARMs are helpful for those bad credit borrowers who are serious about rebuilding their credit. In the past, these loans could also qualify those with poor credit for bigger mortgages than they could get elsewhere because the initial payments were so low.

There are several risks involved with hybrid ARMs though. As the mortgage industry is finding out today, sometimes bad credit borrowers are not fully informed about when they need to refinance or how much the adjustable rate period can affect their monthly payments. Plus many probably got into bugger loans than they could truly afford, even though they could qualify for them. Now that the housing market has slowed and equity is less abundant, many sub-prime borrowers are facing foreclosure as their interest rates adjust and their payments skyrocket by as much as 50%.

Another risk is that the borrowers might not keep current on their mortgage payments during the initial fixed period. This will not improve their credit score and they may not be able to qualify for a good refinance loan by the time they really need it.

Recently the Federal Reserve has issued guidelines asking mortgage lenders to qualify sub-prime borrowers at the highest payment level possible in order to keep people from getting into loans they cannot afford. If you are interested in improving your credit with the help of a sub-prime hybrid ARM, make sure you do extensive research and grill your lender about the terms and conditions before you sign!