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Avoid the Shock of Negative Amortization

Mortgage lenders have been extremely resourceful in creating all sorts of home loans to accommodate the needs of borrowers. Among the more popular loan choices for low-income or poor-credit buyers are the various forms of adjustable rate mortgages (ARMs) available today. Unfortunately during the past several years of boom conditions in the sub-prime market, with money freely available for funding, borrowers did not always take the time to research the full risks attached to these “exotic” loans. Neither did lenders, eager to close more loans, always fully disclose the risks involved. The result is that many borrowers are now facing higher payments and possible foreclosure.

One type of ARM loan that seems to continue to surprise borrowers by its consequences is the kind that leaves homebuyers with larger loan balances than they started with, also known as negative amortization loans. This can happen with pay option ARMs or with loans that simply provide for extremely low interest rates for the introductory loan period. No matter how it happens many borrowers are often shocked to find out that their loan balance is actually increasing even though they are making monthly payments.

If you are currently in negative amortizing loan or if you are considering possible loan options, you should understand how it is that your balance can increase. In a fully amortizing loan, or one where the interest payments are spread out fully over the course of the loan, the monthly payments include both a portion that goes toward the principal and a portion that goes toward paying off the interest. If you have a 30-year fixed mortgage for $200,000 at 6% for example, your monthly payment would be about $1200, with about $1000 for interest and $200 for principal. Over the course of the mortgage the interest portion will shrink and the principal part will increase, so that eventually you pay off the entire loan balance in 30 years.

Some ARM loans allow you to make very small payments for the first several years. The problem with this arrangement is that the monthly payment is not even large enough to cover the amount of interest due. For example, if your ARM loan lets you pay only $850 per month, not only are you not putting any money toward the principal $200,000, but you are not even contributing the full $1000 in interest. You are short $150 of paying all the monthly interest. This amount is tacked on to the $200,000 balance. After a year of making that minimum payment, your loan balance would be close to $202,000!

This realization is obviously very shocking to borrowers as they come to understand that their payments are going to jump dramatically in order for them to pay off the loan. There are caps on how much negative amortization you can accrue, but if you reach that cap you will immediately have to start making the highest payments possible. If you are in a pay option ARM, you can avoid this by choosing to make more than the minimum payment each month. If you are looking for a new home loan, although the low payments may be very enticing, if you cannot afford to make higher payments, you should definitely avoid any loan with negative amortization!

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