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Don't Get Tricked by Teaser Rates

A recent news article in the San Jose, Ca. Mercury News featured a couple who had been taken in by a mortgage company offering a super low rate on an option-ARM (adjustable rate mortgage) loan. The deal featured an incredible interest rate of 1.75 percent and a fixed rate period of five years. The couple decided to take advantage of that low interest rate and save up money to pay down the principal later. What they were shocked to realize is that the 1.75 percent rate was only a ‘teaser’ rate – it only lasted for the first month of their mortgage. Thereafter is jumped up to over 8 percent. The couple had believed that the initial rate would last for the entire five year fixed rate period. As they kept making the minimum payment, their loan balance continued to grow with added interest charges. When the pair realized the financially-crushing weight of their new loan, they wanted to get out of it by refinancing. Then came the next shocker – they would have to pay $18,000 in prepayment penalties to refinance at that point. The couple decided to refinance anyway, opting instead for a fixed rate loan, but in all the loan and the refinance ended up costing them $83,000 in one year!

Don’t fool yourself that only the poor and uneducated get sucked into these types of loans. The two people in the article were successful business people with plenty of education behind them. The problem was that the wording and marketing of their option-ARM was so confusing and misleading that it made the loan seem like a good idea.

Here’s the skinny on option-ARM loans: They were designed for sophisticated borrowers with variable incomes, like sales people who rely on commissions or year-end bonuses. The loan offers four different payment options for an initial period. The first payment option is large enough that if it was made consistently the loan would be paid off in 15 years. The second payment option is equivalent to the size of a 30-year fixed rate mortgage payment. The third is an interest-only payment, with the unpaid principal being added on to the loan balance, and the fourth is an amount even smaller than the full amount of interest due that month. Making either the third or fourth payment options regularly will actually increase your loan balance as you make payments. The loan was not really designed for people to only make the minimum payment each month. It was designed to offer a little flexibility and break for those who might have one bad month of income once in a while. Many people who got into these option-ARM loans in the past several years did not make that connection. Hence the current floods of foreclosures, as rates and payments have started resetting.

So the loan itself is dangerous, but the real killer is the way the ‘teaser’ rates are marketed. People are attracted to option-ARMs because of the incredibly low interest rates. What many do not realize (and what some brokers do not tell them) is that the low rate will only last a month or two. It really is just a gimmick to get people into home loans. People looking into these loans should find out what the interest rate will be after the first few months. They may be surprised to find that it is higher than rates they could get on more conventional loans. And if you are ever in doubt about the terms of a loan, don’t be afraid to bring in your lawyer to review it with you. You may have to pay some legal fees, but you might save yourself from a shady loan that would cost you much more to maintain or get out of!