12/30/2006

Understanding Option ARMs: The Basics

In mortgage news lately, there has been lots of controversy over the high volume of option ARM loans issued this year. The loans have contributed to enough delinquent payments and foreclosures that even the federal government has started to worry. Several months ago, the Federal Reserve held meetings in which they decided to place restrictions on these risky home loans. In their latest edition of the “Consumer Handbook to Adjustable Rate Mortgages,” the government agency warned consumers about the hazards of getting into a loan that would be too expensive for them in the future.

If you are in the process of searching for the right home loan, you may be offered an option ARM. Before you jump into this enticing loan, you should understand just what it is and what it will mean in the long term. This article will describe the details of the loan; the follow-up article will discuss the pros and cons.

What is an Option ARM?

An ARM is an adjustable rate mortgage. With a traditional ARM, like the 1-year or 5-year ARM, the interest rate on the home loan will be a low, fixed rate for the first one or five years, respectively. Thereafter the interest rate will be subject to change based on the movement of key market indicators. That means that monthly mortgage payments are likely to jump up after the initial period and fluctuate from then on to the end of the loan.

With an option ARM, also called a “pay option ARM” or a “Pick a Payment Loan,” the interest rate on the loan adjusts monthly and the payment adjusts yearly. The real kicker is that this type of loan gives you, the borrower, a choice in terms of how much you want to pay every month for a certain amount of time.

For up to three years, each month you will be given the choice of paying one of four payment amounts. These are the minimum payment option, the interest-only payment, the 30-year payment and the 15-year payment.

The minimum payment is obviously the lowest payment you could make each month. It is a sum that is even less than the amount of interest that is due each month. If you make the minimum payment consistently, your loan will experience negative amortization. That means that the unpaid portion of monthly interest will be added on to the principal of your loan, actually increasing your balance every month. If you make only the minimum payment for the first three years, your loan will be recast. That means that the balance of your loan will be re-amortized over the remaining years of your loan (27 years with a 30 year loan.)

The interest-only payment means contributing only the amount of interest that is required for the month. This is the second lowest option. At the end of the option period, though, your payments will jump up dramatically because you will have to start paying a portion of the principal.

Your third choice is to make a 30-year payment, which includes both the interest and a portion of principal. If you are capable of making this size payment every month, you might as well get a 30-year fixed loan, because making this payment consistently will get your loan paid off in 30 years.

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Finally you could choose the most expensive payment, the 15-year loan. If you made this payment every month, you would pay off your loan in 15-years. You have this option, so that you can balance out smaller payments that you have made.

Check out the next part of this article that examines the risks and benefits of this exotic loan program.

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