Don't Get Crushed by Your Home

The Motley Fool

By Seth Jayson

As a math teacher, my wife runs into teenagers who are, to put it mildly, completely clueless when it comes to matters of money and personal finance. But while recently instructing a class for fellow teachers, she came across some sad evidence that perfectly intelligent adults have a lot to learn about money, especially when it comes to the emotional process of buying a house in an overheated market.

Last week, after showing her colleagues how to use their fancy **Texas Instruments** (NYSE: TXN) calculators to do time-value of money calculations, a few of the enterprising batch started to enter the terms of their mortgages. One woman in particular looked mortified, eyes like saucers, jaw dropping onto the desk, that kind of thing.

Turns out, she and her new husband had recently taken out an adjustable-rate mortgage, and she was shocked to see what a change in the interest rate might do. But it was worse than that. It was an ARM that actually amortizes negatively. Don't know what I mean? Here's a refresher.

The way not to pay

With most home mortgages, the payment you make each month goes toward two distinct destinations. One bit pays the interest you owe, and the other pays off a bit of the original principal on the loan. As you continue to make your payments, the outstanding principal on the loan shrinks bit by bit—and the amount of principal you pay off each month grows. That's how you can pay off your home by the end of the loan's term.

These days, a huge percentage of home buyers—up to 50% in some areas, according to various reports—are taking advantage of interest-only loans. My colleagues have already discussed the risks of these, both for the consumer and for financial institutions such as **Countrywide Financial** (NYSE: CFC), **Wells Fargo** (NYSE: WFC), **J.P. Morgan Chase** (NYSE: JPM), **Washington Mutual** (NYSE: WM), and **Provident Bankshares** (Nasdaq: PBKS).

But these negatively amortizing loans are even scarier. Like a credit card, the minimum payment every month isn't enough to cover the interest accrued. The difference is tacked onto the amount you owe, and as a result, the principal on the loan continues to rise. In other words, despite the fact that you're making the required payments, the real amount you paid for that house continues to swell. At least until it reaches 110-125% of the original purchase price, at which point the loan converts and you're expected to pay the whole amount of the new principal and interest every month.

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The hard truth
A few figures I gleaned from one bank's online calculator ought to help illustrate just how quickly you can get yourself into trouble with a loan like this. Imagine you buy a run-of-the-mill home in the Washington D.C. area, borrowing $500,000. Assume that you make your minimum payments at the teaser rate, until the principal reaches $550,000. (That will happen in less than 3 years.) At that point, the loan is amortized over 30 years at a new, higher interest rate (let's say 7.25%). Suddenly, your tasty-looking $1,608 per month jumps to $3,752.

Now you probably understand why this young woman looked so shocked. If you're thinking, "How could you not know the payment terms of the largest purchase you'll ever make?" consider how such "products" are marketed.

These loans typically come with 1% teaser rates and are sold with happy-sounding names like "option ARM," "Cash Flow Mortgage, or "Pick-a-Payment" plans. As you might guess, they're marketed under the guise of "affordability." But that's a pretty slippery word to use when the buyers may end up starting their homeowner experience by beginning their loan paybacks at a price 10% to 25% higher than what they thought they were paying for the house.

Worse yet, as interest rates go up (I know, it hasn't happened yet, but it will), the people holding these loans, making minimum contributions, will see their payments suddenly jump by huge amounts — perhaps even double. For people who are already stretched thin by their mortgage payments— my realtor tells me that paying 40% of gross monthly income is not unusual out here — this could mean disaster.

The Foolish bottom line There easiest way to avoid this kind of financial deathtrap is to buy no more home than you can afford, and perhaps even be willing to admit that you can't afford a home. Despite what the commercials with the soft focus and the puppy dogs and the picket fences want you to think, there's no shame in renting, especially if you're stuck in a bubbly market. But if you're determined to get out there and pay any price to get your dream house, at least stick with a more traditional ARM, or even an old-fashioned fixed-rate mortgage. Fortune — even ill fortune — favors the prepared.