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Be cautious with ARM home loans

By John K. Ryan - November 9, 2006

It's been a fabulous run for the housing market. Historically low short-term interest rates and a move toward investing in real estate rather than the stock market led to one of the great housing booms the United States has ever experienced.

But as headlines have told us, that growth trend has slowed down some in the past year. Nationally, September sales of existing homes totaled 6.16 million, down from 6.3 million in August, and down from 7.2 million in September 2005. The National Association of Realtors reported the biggest drop in home prices since it began tracking the data in 1968. The median sale price slipped 2.2 percent to $220,000 in September following a 2.2 percent decline in August. These two declines are the first time median home prices have fallen since 1995.

The best the NAR can offer right now is that home sales are expected to stay steady the next few months, according to its Pending Home Sales Index. Some of this slowdown is because interest rates have caused potential buyers to hesitate in purchasing a mortgage.

So, should consumers hold off buying a home until the market begins to rebound? Not necessarily, as far as financial planner Cindy Menker of Contour Financial Inc. in Orland Park is concerned. The falloff has actually created a buyers market, causing sellers to be more flexible when negotiating selling prices, Menker contends. "Buyers may pay more in interest, but they can make up for it with lower housing prices," she said.

One of the reasons for housing becoming a buyers market has to do with an increase in housing inventory. Part of that stems from the growing number of foreclosures. Menker says this stems, in part, because of the popularity of adjustable rate mortgages and interest-only mortgage loans in the past few years. "People could pay their mortgages at the extraordinary low interest rates they started at (with ARMs,) but now that rates are adjusting to the market, these homeowners are having a much tougher time," Menker explained.

"Plus, they are seeing property taxes going up and they can no longer afford their homes."
According to the Mortgage Bankers Association, about 18 percent of homeowners have ARMs, but more than 25 percent of new mortgages in the first quarter of 2006 were ARMs. The upward adjustment on ARMs taken out just a few years ago can be significant with rising interest rates. A $200,000 ARM taken out a few years ago at 4.5 percent, when adjusting to 6.5 percent, will mean an increase in the monthly mortgage payment from $1,013 to $1,254 — almost 24 percent.

Interest-only payment options began to be offered to the masses as a way to borrow more money while not increasing the monthly payment. A mortgage is interest-only if the scheduled monthly mortgage payment goes strictly toward the interest rather than the principal. The option to pay interest-only lasts for a specified period, usually five to 10 years. Borrowers have the right to pay more than interest if they desire. If the borrower exercises the interest-only option during the specified period, the result is that the loan balance will remain unchanged.

Menker said those taking out interest-only loans in the last few years gambled that the housing bubble would never burst. "They figured that if cost got too large up the road, they'd sell at a profit," she said. "With selling prices down, that may not be feasible now."

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