Q. When is a “risky” mortgage not a risk?

A. There are differing opinions, but most lenders will tell you that if a homeowner is educated about what they are getting, and disciplined enough, that homeowner can reap the benefits without getting stung.

A risky mortgage is inviting when it enables:

- Prospective homebuyers to buy a larger, more expensive home than what they can actually afford at the time.
- Prospective homebuyers to own a home when they would not be able to at all.
- An investor to extend the use of cash.

Although there are many options, following are three types of loans that fall into this category: Interest-only, 40 year, and Adjustable Rate Mortgages, or, ARMs.

Interest-only loans enable a homeowner to pay only the interest each month. The downside is the principal is not reduced. Often used when purchasing a new home, the thought behind this type of loan is, a new home will appreciate 12% to 22% in the first year or two. When the homeowner sells the home, which is generally within the first 3 to 5 years, he is able to pay off the principal part of the loan, reap the reward of the cash savings from not paying the principal, and the appraised value may be higher. Interest-only loans should be short-term, (approx 3 yr) and entered into with a strong effort to pay each month toward principal.

Forty-year loans figure principal and interest over 40 years. Each payment reduces the principal, but there is interest calculated for 10 years over the conventional 30-year loan. The loan is called due at 30 years with a balloon payment. Amortizing the loan for a greater number of years brings the monthly payment down to almost as low as an interest-only loan payment. The down side here is paying 10 years of interest for a 30-year loan.

Adjustable Rate Mortgages (ARMs) and ARM-options are probably the highest risk loans, with the “ARM-option being the riskiest of the ARM category.” ARMs start at a low introductory rate which may last from one month to five years. After the introductory period, the rate goes up incrementally until it hits the cap rate. The monthly payment reduces the principal so this is not typically a risky mortgage, unless the introductory rate is under a year. Depending on the margin and other terms, it gets risky when the introductory rate is good for one month, then raises a point monthly. By year’s end, a homeowner may have a 12% interest mortgage. Investors who fix and flip are usually consumers of the 1 and 6 month ARMs.

ARM-options allow a homeowner to choose each month to pay one of the following:

1. Minimum payment (the least amount)
2. Interest only
3. 30 Year Conventional
4. 15 Year Conventional

This is convenient for a homeowner that has a changing pay scale. In a lean month, he can pay the minimum and not be penalized on his credit report, in the lucrative months, he can make the largest payment as if his loan were a 15-year conventional mortgage. The risk enters when the minimum payment does not cover the cost of monthly interest. The previous month's shortage is added to the following month's minimum and now the homeowner has gone negative-he owes more than he did before he made last month's payment!

All of these loans can be risky; however, it is a calculated risk. They work best for the investor, the wealthy, or people whose financial situation is improving and they want a certain house NOW. If used short-term, even a "risky mortgage" can be a vital tool for home ownership.

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