

A Reprint from *Tierra Grande*

Buy Now, Pay Later

Risks of Aggressive Financing

By Jennifer Evans-Cowley



Homebuyers of all income levels are able to purchase a more expensive house with an ARM than with a conventional mortgage. Some builders suggest that a homeowner's pay raises will cover house payment increases if interest rates rise in the future, but in fact many homeowners are unprepared for increases when they occur.

One of the more unique ARMs offered by Fannie Mae is the two-step mortgage, which adjusts only once at either a five- or seven-year term. For the remainder of the 30-year loan, the interest rate is stable. The result is a lower interest rate than on a 30-year conventional mortgage because homebuyers have a lower interest rate in the initial years of the mortgage.

Fannie Mae also offers a seven-year balloon mortgage. Over the seven years, the homeowner makes payments based on a 30-year fixed term. At the end of the

seventh year, the mortgage must be paid in full. Again, the interest rate is usually lower than a comparable 30-year fixed-rate mortgage. This type of mortgage can be beneficial to those homebuyers who plan to sell or refinance within seven years.

M/I Homes offers an interest-only mortgage program in which homebuyers pay only the interest on their home for the first ten years of the mortgage. The company now offers an interest-only loan with zero percent down, which can be combined with a 2-1 buydown. A buydown reduces the interest rate by a predetermined amount for a set period.

For example, a 2-1 buydown reduces the interest rate by 2 percentage points during the first year and 1 percentage point during the second year. The third year the homebuyer makes payments based on a permanent interest rate. When payments rise at the end of the buydown, some families find that they can no longer afford the home.

Using the interest-only loan with a 2-1 buydown program, a homebuyer pays as little as \$807 per month on a \$250,000 home for the first year and \$1,016 per month for the second year. In the third year, the payment increases to approximately \$1,224, still less than the \$1,478 payment under a conventional 30-year loan with a 5.875 percent interest rate. At the end of the ten-year interest-only period, homeowners begin paying interest and principal, which results in a larger monthly payment.

Special Programs

Fannie Mae's energy efficient mortgage factors in the savings on energy in determining the amount of money a homebuyer

Demand for new homes has stayed healthy throughout the lengthy course of the current national economic slump. In part, this strong demand can be attributed to record-breaking low interest rates. Aggressive financing had a role in pumping up homeownership as well.

Many of the largest homebuilders in the United States have their own financing companies that handle mortgage loans for new home purchases. These and other lenders, including Fannie Mae, often offer aggressive financing programs that make it easier for buyers to purchase a home.

ARMs, Balloon, Interest-Only Loans

With interest rates at record lows, homebuyers are increasingly choosing adjustable rate mortgages (ARMs). An ARM has an interest rate that changes periodically. A one-year ARM, for example, allows the lender to change (increase or decrease) the interest at the end of each year of the loan.

This type of mortgage may be less expensive for a homebuyer over a long period if interest rates remain steady or decrease. ARMs also may be beneficial for those who do not plan to own a house for a long time. According to the Mortgage Bankers Association, 17 percent of mortgages originated in 2002 were adjustable rate, up from 12 percent in 2001.

Lenders typically charge a lower starting interest rate for an ARM than a fixed-rate mortgage, making house payments lower initially. Some lenders base the loan amount on current income and the first year's payments. As a result, lower-income homebuyers may qualify more easily for an ARM than for a fixed-rate mortgage.

can borrow, thus allowing buyers to qualify for a larger loan. Fannie Mae is testing another program — the location efficient mortgage — in several cities across the United States. This program takes into account reduced transportation costs when homebuyers purchase homes near bus or light rail lines. The mortgage allows a maximum housing-to-income ratio of 39 percent and a debt-to-income ratio of 50 percent. Under a conventional loan program, the limits are 35 percent and 45 percent, respectively.

A number of homebuilders participate in the Nehemiah Program. This program, started in 1998, allows homebuilders to provide a “downpayment gift” to the non-profit Nehemiah Corporation. The corporation then gives up to a 6 percent downpayment to a qualifying homebuyer, allowing the homebuyer to purchase the home with little or no money down. The program has no income limits as long as applicants obtain a qualified mortgage — typically an FHA mortgage. Since the program began, Nehemiah has provided more than 142,000 downpayment gifts.

The benefit of all these financing programs is that they enable more people to afford a home. They also allow current homeowners to move up to larger, more expensive homes. On the down side, these programs sometimes allow homebuyers to purchase homes they cannot afford over the long term.

Foreclosures on the Rise

Texas home foreclosure rates have been rising according to the Mortgage Bankers Association (see chart). In 2002, the home foreclosure rate for FHA mortgages was 1.6 percent, up from 1 percent in 2001. VA mortgage foreclosure rates went from 0.96 percent in 2001 to 1.26 percent in 2002. The association reported a 4.5 percent delinquency rate nationwide for mortgage loans for one- to four-unit residential properties at the end of 2002.

Conventional mortgage foreclosures are also up — 0.69 in 2002 compared with 0.57 in 2001. This is the highest foreclosure rate for conventional mortgages since 1994. It should be noted that while foreclosure rates have risen in the past year, they are still lower than after the 1991 recession.

In first quarter 2003, more than 6,700 homes in the Dallas-Fort Worth Metropolitan area were foreclosed on, up 35 percent from the same quarter in 2002. Denton County experienced an 88 percent increase in foreclosure rates, while Collin County was up 63 percent, according to the Foreclosure Listing Service.

While the loss of a job, illness or change in family status are the most common causes of delinquency and foreclosure, the type of financing and amount of equity in the home also affects a family's ability to avoid foreclosure. ARMs and buydowns tempt buyers with low initial rates, but interest rate adjustments or larger payments at the end of the buydown period can prove financially devastating.

Additionally, homeowners who purchased homes with little or nothing down and subsequently encountered financial problems find that they have little equity in the house. When they try to sell, they may find that the home has not increased in value as quickly as expected. This makes it more difficult to sell the home they can no longer afford. To make matters worse, buyers often prefer to take advantage of homebuilder incentives and purchase a new home rather than a home that is a few years old.

On the down side, aggressive financing programs sometimes allow homebuyers to purchase homes they cannot afford over the long term.

The Department of Housing and Urban Development (HUD) has a program to help homeowners who fall behind on their mortgage payments (see www.hud.gov/foreclosure/index.cfm). HUD pays the lender the delinquent amount. In return, the homeowner signs a note promising to repay HUD without interest. During 2002, more than 72,000 families participated in this program, up threefold from 1999.

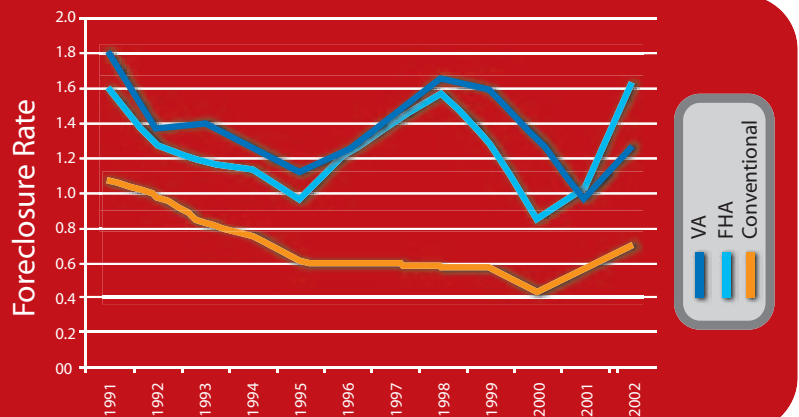
The Mortgage Bankers Association forecasts that interest rates will increase in the second half of 2003, with 30-year conventional mortgage interest rates expected to rise to 6.3 percent. If this happens, many homeowners with adjustable rate mortgages may face suddenly unaffordable house payments.

While aggressive financing programs allow more people to purchase a home, they carry an increased foreclosure risk. Homebuyers need to understand these risks when selecting home financing. Real estate professionals can help their clients by informing them about financing options available. ➔

Dr. Cowley (cowley.11@osu.edu) is an assistant professor with the Austin E. Knowlton School of Architecture at Ohio State University.

TEXAS MORTGAGE FORECLOSURES

Source: Mortgage Bankers Association





MAYS BUSINESS SCHOOL

Texas A&M University
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