NEWS FROM SCDCA

South Carolina Department of Consumer Affairs

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FOR IMMEDIATE RELEASE

PART TWO: SCDCA CAUTIONS CONSUMERS ABOUT ADJUSTABLE RATE MORTGAGES

Columbia, SC… … …Because mortgage plans today have many options and variations, consumers must be careful about contract terms. Adjustable rate mortgages (ARM) may be particularly deceiving. Lenders may offer a plan with initial low rates and payments that is very costly in the long run. To avoid these financial risks, consider the following features of ARMs.

Discounts Some lenders offer initial ARM rates lower than "standard" ARM rates (the sum of the index and the margin). These rates, called discounted rates, are often combined with large initial loan fees ("points") and much higher rates after the discount expires. The seller pays an amount to the lender, allowing the lender to offer you an initial low rate and initial low payments. This arrangement is referred to as a "seller buydown." The seller may increase the sales price of the home to cover the cost of the buydown. A lender may use a low initial rate to decide whether to approve your loan, based on your ability to afford it. You should consider whether you would be able to afford later payments if the discount expires, and the rate is adjusted

Payment Shock Payment shock may occur if your mortgage payment rises sharply at the first adjustment. For example, if your initial discounted ARM is 8% and your monthly payment is $476.95, a rise to the 10% "standard" ARM rate in the second year would result in monthly payments of $568.82. If the index rate also increases 2%, the total ARM rate of 12% would result in a monthly payment increase of almost $200. By looking for a mortgage with features such as interest-rate caps and payment caps you may reduce the risk of such large increases in your payments.

Interest-Rate Caps An interest-rate cap limits the amount your interest rate can increase. Interest caps may be overall or periodic caps. By law, virtually all ARMs must have an overall cap. Many have a periodic cap. An overall cap limits the amount interest rates can increase over the life of the loan. A periodic cap limits the amount your interest rate can increase from one adjustment period to the next. A drop in interest rates, however, does not always lead to a drop in monthly payments. In fact, with some ARMs that have interest-rate caps, your payment amount may increase even though the index rate has not. If a rate cap holds down your interest rate, increases to the index that were not imposed because of the cap may carry over to future rate adjustments.

Payment Caps Some ARMs include payment caps, which limit your monthly payment increase at the time of each adjustment, usually to a percentage of the previous payment. In other words, with a 7.5% payment cap, a payment of $100 could increase to no more than $107.50 in the first adjustment period, and to no more than $115.56 in the second. If your ARM includes a payment cap, however, find out about “negative amortization.”

Negative Amortization Negative amortization occurs when your monthly mortgage payments are not large enough to pay all of the interest due on your mortgage. Because payment caps only limit payment increases, and not interest-rate increases, payments sometimes do not cover all the interest due on your loan. The interest shortage in your payment is added to your debt, and interest may be charged on this larger debt amount. Consequently, you might owe the lender more later in the loan than you did at the start. In some cases, an increase in the value of your home may cover the interest you owe. Discuss negative amortization with the lender to understand how it will apply to your loan.

Prepayment Some agreements may require you to pay special fees or penalties if you pay off the ARM early. Many ARMs allow you to pay the loan in full or in part without penalty whenever the rate is adjusted. Prepayment details are sometimes negotiable. In South Carolina, prepayment penalties only apply to loans under $180,000.

Conversion Your agreement with the lender may include a clause that lets you convert the ARM to a fixed-rate mortgage at designated times. When you convert, the new rate is generally set at the current market rate for fixed-rate mortgages. The interest rate or up-front fees may be somewhat higher for a convertible ARM. Also, a convertible ARM may require a special fee at the time of conversion.

For more information, contact the SCDCA Public Information & Education Division at 803.734.4190, toll-free at 1.800.922.1594 or online at www.scconsumer.gov.