

Ask Quinlan Mortgage

Ask Quinlan Mortgage is a new monthly feature that seeks to clear up common misconceptions about the mortgage process and answer questions related to refinancing, home purchases, and real estate investments. Have a question that you would like to see answered in our monthly feature? Contact Quinlan Mortgage at 401-345-6672, by email at quinlanmortgage@verizon.net or visit our website, www.quinlanmortgage.com.

Tips on Avoiding Foreclosure

Preface: This article is not intended to make people nervous or paranoid. Instead, we hope to educate borrowers (particularly first-time homebuyers) on some important considerations when applying for a home loan.

The home buying process should be enjoyable and exciting. Unfortunately, because of the size of the purchase involved, the rapid movement of housing inventory and the overwhelming variety of financing options available, the process of buying a home has become less than enjoyable. In addition, the recent explosion in the housing market attracted a large influx of new entrants into the real estate business, increasing the potential for predatory lending practices and placing more pressure on home buyers to educate and protect themselves.

Fortunately for those currently shopping for a home, the market has recently shifted favorably toward buyers. This takes a little pressure away from buyers when home shopping. The days of “over-bidding” and tripping over other buyers during an open house are behind us for now. This means that consumers can relax a little and take a deep breath!

Regulatory officials have continued to “weed out” mortgage consultants that take part in predatory business practices, which also provides some comfort for consumers. Nevertheless, buyers still need to exercise caution when choosing the home loan that best fits their needs. The following tips provide insight into some of the factors buyers should consider to avoid problems down the road:

- Know exactly what you’re getting into - ask your mortgage consultant questions until you are satisfied, and be sure to get estimates on costs from your mortgage consultant in writing. We have mentioned this in past articles, but it is important and well worth repeating.
- Know your financial situation and do some planning for the expected and unexpected future. Do you plan to travel? Do you have expensive hobbies? Do you plan on taking on a car payment? Don’t assume that the bank knows what is affordable for you. Try to leave room in your budget for additional things aside from your house payments. It is important that you discuss your budget with your mortgage consultant so that you can work together to select the appropriate loan based on your individual needs. If you don’t have a budget, ask your mortgage consultant to assist you in creating one.
- Be careful with the following programs:
 - **Stated income Loan:** This type of loan was originally intended for self-employed borrowers or borrowers with income that is difficult to support with adequate documentation. Unfortunately, some institutions abuse these programs and inflate the

income on applications to increase the chances that the loan will be approved. These practices are not only unethical - they can also set borrowers up for financial ruin by placing them into loans that they cannot actually afford. Keep in mind that you and your mortgage consultant have an obligation to be sure that the income listed on the application is ACCURATE.

• **Negative Amortization loan:** Also known as “*option arms*” or “*pick-a-payment loans*”, these loans allow you to choose the amount of interest that you pay on a monthly basis, generally for the first few years of the loan. The biggest surprise to most people regarding these loans is the fact that the amount of interest that is not paid in one month gets added to your loan balance (hence the negative amortization). A traditional amortized loan declines over time as you make monthly payments. With a negative amortization loan, however, your loan amount could actually increase over time.

Here’s an example of how a negative amortized loan might work: Say your total interest rate is 6%. You have the option to pay as little as 3% in any given month. The 3% that you don’t pay in any given month (total rate of 6% - 3% paid) is applied to your mortgage balance. Therefore, your mortgage balance begins to *increase*, and you begin paying interest ON interest.

We should note that these loans generally come with ‘caps’ on how much the balance can increase (e.g., 125%). However, because of today’s inflated housing market and because so many borrowers are putting small down payments on homes, this type of program can limit your options (unless you have the cash to bring to closing when *selling* your house).

A dangerous feature of these programs is that the loan will eventually readjust (i.e., re-amortize) in order to maintain the full amortization period. What does this mean?

Here’s an example. You pay a portion of the interest, say 3% instead of 6%, for the first 5 years out of your 30 year loan. After these initial 5 years, your loan balance is higher than your initial loan amount, because the interest that you didn’t pay has been added to the balance. Now you have 25 years to pay off this larger balance. Therefore, your payments jump up dramatically and if your financial situation hasn’t improved enough to keep up with it, you have a problem. You can either try to keep up with the payments and “live for your home”, sell the home (assuming your loan balance hasn’t grown higher than the value of the home), or face foreclosure.

Then why do these loans exist and why are they so popular? They’re obviously very lucrative for banks and some mortgage consultants push them because the banks pay high commissions for these loans.

Who are these loans best suited for? If carefully used, these loans could be advantageous for some investors, including those looking to rehabilitate a property and quickly sell it. I would strongly argue that they are NOT for most first-time homebuyers who are trying to get into more house than they can actually afford by paying the smallest amount possible in an inflated housing market.

• **Interest only loans:** Interest only loans do not require that you pay interest on interest and they do not involve a balance increase, like the negative amortization loans discussed above. In interest only loans, the balance remains the same during the interest only period (with no principal reduction). However, similar to the negative amortization loan, the loan readjusts after the initial interest only period, in order to stay on track for the fully amortized term.

Again, these types of loans have gained popularity in recent years with inflated home values and borrowers stretching themselves thin in order to get the most house within their financial means. Be careful when making the assumption that in a few short years you will be able to afford a much higher payment. This type of aggressive thinking has contributed to the high foreclosure rates that we're experiencing today.

Although there are many factors to consider when choosing the right loan program, we hope that this article helped shed some light on some important considerations. Simply put, if doesn't make sense or sounds too good to be true, ask plenty of questions until you are satisfied or walk away.

If you are looking to buy a home or re-finance your existing home, or if you have questions or comments about this article, please contact Adam Quinlan at:

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