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Alternative Mortgages

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Families and individuals face many difficult decisions about housing today. Many communities in Oklahoma have limited rental options. For many families, purchasing a home at inflated market values and increasing interest rates makes it impossible to meet the costs on current income.

There is a need for mortgage financing which can be adjusted as family income increases. The conventional or regular mortgage with a fixed payment during the life of the loan has a higher interest cost to the buyer when income is lowest. If payments could be adjusted to more nearly reflect ones ability to pay, as income increases, more housing could be available. The demand for housing is great. Many people 25-35 years old would like to own a home but find it impossible on today's market.

The conventional mortgage which allows the buyer to pay the same rate of interest and monthly payment over the life of the loan is almost a thing of the past. Most lenders are reluctant to lend money for a twenty or thirty year period. In an inflationary money market where interest rates are like a roller coaster, the lender, as well as the buyer, wish to get a fair return on their investment.

In order for individuals and families to obtain money to purchase housing, new policies regarding lending had to be made. The Federal Home Loan Bank Board through the Federal Reserve System must approve lending plans used by federally chartered lenders as banks and savings institutions. State banking agencies approve and regulate state chartered lending agencies. A number of alternative mortgage instruments (AMI's) have been introduced into the market.

What are "alternative" mortgages? Simply stated, they are mortgages which provide another choice to the regular mortgage. A choice that might blend better with the family's present financial resources and situation. A choice that could cost more. A choice that requires careful study prior to signing a contract.

How do "alternative" mortgages differ from a conventional mortgage? Is there more than one kind of "alternative" mortgage? What are the uses? These and other similar questions are answered in this publication. The information that follows defines five "generic" types of "alternative" mortgages. A few advantages and disadvantages are given for each. And, a few ideas about when and why you might use one of these new mortgages.

Graduated Payment Mortgage (GPM)

The Graduated Payment Mortgage (GPM) has three characteristics:

1. The rate of interest is fixed for the life of the mortgage.
2. The number of payments are fixed for the life of the mortgage.
3. The monthly payment increases over the life of the mortgage.

As you can see, the GPM has a fixed rate of interest and a fixed life just like a regular or conventional mortgage. But, it has payments which start at low dollar amounts and gradually increase. An established time and rate scale determine the increase on payments. The longer you make payments, the higher they go, as well as the over all cost.

Obviously, this type of mortgage is attractive for young or first time home buyers who expect their earnings to go up. For example, payments the first year may be as much as 20 percent lower than payments on a regular mortgage. But, watch out—payments toward the end of the mortgage will be much higher to more than make up the difference.

This plan may make it seem possible for you to be able to buy more house in the beginning, and pay for it as your income grows. Remember though, the house costs more than the GPM than with a conventional mortgage, since the payments start low but continue to rise over life of the loan! The interest is not paid as quickly with lower payments at first, as with a conventional mortgage that has a fixed payment for the life of the loan. Payments maybe set so low, they do not cover the interest. When this happens, the portion of interest not paid each month is added to the remaining principal. This means you could sell the house during the second year, for example, and owe more than the amount of the original loan. So, careful thought should be given to the use of the GPM. It should complement the total financial plan of the individual or family. If not used correctly, it can create more problems than it solves.

The buyer is also risking loss if economic condition change, causing changes in income. If income drops instead of rising, a family might be forced to give up their home. One way this risk can be minimized is through the use of an insured loan. This insurance, whether through a government agency such as the Federal Housing Authority or a private agency, requires that the amount owed on the home not exceed the fair market value of the house. Lenders may require an insured loan with a graduated payment mortgage.

The GPM might be used by the young professional family that is concerned with inflation. For example, as inflation causes increases in income, this additional income can be used toward making payments as they also increase with the GPM. Remember—the value of the house can increase with inflation too. This increase in value helps the owner partially recover some of the costs created by the increasing GPM monthly payment. The family is able to make payments with inflated dollars which have less purchasing power. The GPM can be made to work for the home buyer who programs all parts of the financial plan carefully. On the other hand, if early payments are set too low, the GPM can be very costly.

Another important point for the buyer to consider is attitude toward the house. If the GPM is viewed as simply paying rent, it may be tempting for the owner not to care for the property as well. And, less attention to maintenance may lead to more rapid depreciation of property. An "unkept" home usually does not have the market value it should. When sold, the price may be much lower than expected, which places a double jeopardy on the family. The house sells for less and the mortgage costs more. This emphasizes the need to protect your mortgage dollar through careful family financial planning and maintenance of your home.

You may be asking whether there can be variations in the GPM. And the answer is "yes"! For example, some lenders may have what is called a "Flexible Level Graduated Payment Mortgage" (FLGPM). It has all the features of the GPM, however, payments cover only the interest on the loan the first few years. There is no payment on the principal during this period. Payments then level off at a higher amount as the loan gets older.

Another variation is the "Purchase Assistance Mortgage (PAM)." It requires a large down payment which allows lower payments during the first year or two. Those who have saved to purchase a home may have sufficient money to make the down payment but not enough income to meet higher monthly payments as might be for a regular mortgage.

The "Flexible Loan Insurance Plan (FLIP)" variation places the down payment in a savings account to earn interest. The money plus interest earned helps make payments during the early years. Many of the GPM plans do not build equity. This type plan serves best in time of inflation when income and property values are increasing. Other variations may be found but they are built around the basic plan of the Graduated Payment Mortgage.

Think before you borrow! There may be other reasons the Graduated Payment Mortgage either fits or does not fit you. If income can be anticipated to rise as quickly as increases in mortgage payments, and property values increase beyond the amount owed at any one time, then one should be able to meet and use the graduated mortgage payment plan without difficulty. Consider all the benefits and costs before you sign the mortgage. What appears best today may not be best later. As you know, "a good deal today, should be a good deal tomorrow!"

Variable Rate Mortgage (VRM)

The Variable Rate Mortgage (VRM) also has three characteristics:

1. The interest rate may vary over the life of the loan.
2. The number of payments may vary over the life of the loan.
3. The amount of the monthly payment may vary over the life of the loan.

The VRM is used by lenders so adjustments can be made which reflect changing money market conditions. Since there are so many things which can change, it is wise to know exactly what the lender can or cannot do before you enter this agreement. For example, the interest rate usually does not vary more than 2½ percent during the life of the loan. Generally, the lender cannot increase the rate more than one-half percent per year. These limits for change are stated in the mortgage agreement. Increases in the rate are optional and are the lender's choice, but, decreases are required of the lender. It should also be clear that any change in the interest rate will change the monthly payment or extend the life of the loan. Any adjustment will add to the costs for the total mortgage loan. Careful thought should be given to the overall costs of this type of mortgage.

The option to extend the life of the loan rather than increase monthly payments can be a very costly choice. Payments may not cover the interest portion of the payment. This increases the interest costs, delays time for any build-up of equity. The time to pay off the loan could extend beyond the 100 years.

The Renegotiable Rate Mortgage, or Roll Over Mortgage (ROM) is a variation of the VRM. It is used by some lenders in Oklahoma. The overall rate increase allowed is higher than for standard VRM. Federally chartered savings institutions, a prime mortgage lender, have been recently approved by Federal Mortgage Loan Bank Board to offer the renegotiable rate loan plan.

The VRM may be attractive to the home buyer who does not have a larger downpayment or who cannot get a conventional loan. Lenders are sometimes slow to make loans if they think interest rates are going up sharply. On the other hand, borrowers are hesitant to pay a high interest rate if it looks like the cost of money is coming down. The VRM may make it possible for lender and borrower to both be served. However, the home buyer should study all provisions of the agreement thoroughly before entering the contract.

Another attraction for the borrower could occur if mortgage rates are steadily increasing. Through the VRM a family could be assured their interest rate would not increase more than approximately 1/2 percent per year and that it would increase gradually over 2 or 3 percent in total. It is even down more advantageous when rates are going down, since the rate can also be adjusted downward. It is very important for both parties to understand the limits or amounts of change which can be made in the interest rate, payments and length of the mortgage. A satisfied borrower is one who thoroughly understands all parts of the mortgage contract.

Variations also exist in the Variable Rate Mortgage. To illustrate, the "Roll Over Mortgage" is a renegotiable form of the VRM. The interest rate and mortgage plan are "rolled over" or renegotiated every three to five years. Another variation would set the monthly payment and vary the length of the plan with the changes in interest rate. Or, the length of the loan could remain constant and the amount of the monthly payment change with changes in the interest rate. An illustration of the effects of changing interest rates in the VRM may be observed in Table 1.

Reversible Annunity Mortgage (RAM)

The Reversible Annuity Mortgage (RAM) is entirely different from the other two and has three characteristics:

1. A loan on a debt-free or almost debt-free house, secured by the house.
2. The loan is used to purchase an annuity.
3. The annuity provides income for the homeowner.

This mortgage arrangement, the RAM, is really the opposite or reverse of the GPM, and the VRM. When a home is fully paid for, it represents a sizeable amount of money. It is an asset which does not provide interest income for the owner. Of course, it does tend to increase in value through inflation. But, these increases cannot be used by the family unless they are changed into some other form of interest bearing asset. The RAM provides a way to change or convert the house into an income producing asset. The income produced can then be used for any number of things.

Not everyone should run out and place a RAM on their home. There are a number of older couples on fixed incomes, however, who have been affected by inflation. These may be individuals who have their homes paid for, yet do not have enough to live on because of rising prices. The RAM could provide one way for a person to regain some of the value from the home without selling it—without moving to a smaller, less expensive house.

One other use could be made of the RAM. A young professional family may need resources for a business. If the home has little or no debt against it, the RAM could be used to generate income for the business. This plan should be used with care since it can use up a part or all the value in the home.

No doubt there are other uses for the RAM. But its use should be treated with much care. For example, the rate of interest paid on the annuity should be similar to current money market rates. There should be a clause in the contract guaranteeing a "certain sum" or specified amount. This prevents the premature death of the homeowner from terminating the income. And, it protects the value of the home.

There are two variations in the basic RAM agreement. One allows the owner to live in the home until death. At death, all rights are given up to the remaining proceeds. In this agreement, the lender actually buys the house and pays the owner a monthly income. The second type is a nonrepayable RAM. The owner purchases an annuity. The lender uses the home as collateral or security for the annuity. A monthly amount is then paid the owner from the interest.

As with any mortgage agreement, the homeowner should thoroughly understand the agreement. It may be necessary to have a lawyer or someone look over contract terms to insure protection of the homeowner's rights.

Shared Appreciation Mortgage (SAM)

The Shared Appreciation Mortgage is similar to an Equity Rate Appreciation (ERA) partnership mortgage. This type is the most complicated and controversial of the alternative mortgage instruments.

It has three characteristics:

1. Lender offers lower than market rate of interest (reduced monthly payments) for the first ten years of the loan.
2. Lender shares in profit from sale of house; or, if not sold in 10 years, homeowner must pay the lender his share of the profits from appreciation of the house.
3. Lender refinances house at end of profit share term (10 years) with a new mortgage.

This type of mortgage may seem to give the prospective buyer a break, especially with interest rates continuing to rise. The lender offers a lower rate of interest than currently being asked in the market for housing loans.

The homeowner is interested in the lower monthly payment offered by the lender. Although mortgage loans may be written for 30 years, the actual life of a loan for a given owner is less than 7 years. In return for lowered rates and monthly payments, lenders share on the appreciation of the property over a given period of time, usually eight or ten years. At that time the lender requires payment for his share of the appreciation on the house. If the homeowner does not have sufficient funds to make the payment he may be forced to sell the property and move. At the end of the designated loan period, 8 to 10 years, the lender will require that a new loan be made on the new appraised value of the property. The current rate of interest and higher monthly payment may force the homeowner to move if his financial resources have not kept up with inflation.

Lenders are looking for ways to keep their money in circulation at current money market rates. The amount of appreciation shared by the lender may depend upon market conditions, risks to lender as well as potential earning capabilities of the prospective homeowner. There is controversy over how much the prospective homeowner stands to gain in the Shared Appreciation Plan.

Before choosing this instrument, take a careful look at present and future financial resources and earning potential.

The family that does not plan to live in a house more than three years may want to consider deferred interest mortgage (DIM). This type allows a lower initial rate of interest and monthly payments. When the house is sold, the lender receives the deferred interest and a fee, usually expressed in points on value of the house. Each point represents 1 percent of the mortgage loan. The fee is usually paid from the owners equity.

Adjustable Mortgage Loan (AML)

A new creative type mortgage called either the Adjustable Mortgage Loan (AML) or Adjustable Rate Mortgage (ARM) has three primary characteristics:

1. The interest rate and monthly payment can change every month.
2. There is no limit on the rate or payment increases.
3. Changes in the rate of interest are tied to changes in an index.

This type mortgage is presently offered by lenders in an attempt to tailor mortgage plans for potential home buyers. Before selecting this type of loan, the buyer should carefully read and understand all parts of the plan.

The AML may be less attractive to the borrower since it places major controls in the hands of the lender. The borrower has little choice in how frequent or how much the loan changes.

The AML rate is tied to an economic index beyond either the lender or borrower's control. Lenders must lower the mortgage rate if index goes down, but increases are at the lender's option. Wages may not keep up with many of the indexes lenders may select. Financial planning for the borrower using the AML will be very difficult since adjustments may be made as frequently as once each month. This makes it less attractive to those on fixed incomes or those on incomes less likely to keep pace with inflation. While a family's income may increase during times of inflation, it usually will not increase as rapidly as mortgage payments.

A variation of the deferred interest mortgage (DIM) is the Contingent Appreciation Participation (CAP) mortgage. This plan allows you to a lower interest rate. The lender shares in the appreciated value of your house based upon some stated formula.

Table 1 shows how shifting interest rates affect monthly payments. The following assumptions must be made in order to interpret these figures correctly:

1. 10 percent of the House Price is needed for a cash down payment.
2. The mortgage term is thirty years.
3. 25 percent of the gross monthly salary is necessary for the mortgage payment, which includes principal and interest only.
4. Insurance and taxes are not included in these figures.

Summary

Keep these points in mind as you make decisions about home loans of any type:

- Any loan is a promise of income not yet earned.
- Understand every part of the mortgage agreement—before signing.
- Shop for the mortgage agreement which complements your financial plan.
- Borrow from a reputable lender who is concerned about more than making the loan.
- Remember, a "good deal" today is a "good deal" tomorrow.

Since mortgage conditions are changing so rapidly you may wish to consult lenders in your area or your county extension home economist for other information, and housing publications.

References: Alternative Mortgage Instruments, Conference Proceedings, Cornell University 1978.

Table 1. How Shifting Rates Affect Monthly Payments

House Price	12% Interest Monthly Payment	12% Interest Needed Annual Salary	14% Interest Monthly Payment	14% Interest Needed Annual Salary	18% Interest Monthly Payment	18% Interest Needed Annual Salary	20% Interest Monthly Payment	20% Interest Needed Annual Salary
$45,000	$417	$20,016	$480	$23,040	$610	$29,297	$677	$32,484
55,000	509	24,432	587	28,176	746	35,808	827	39,703
65,000	602	28,896	693	33,264	882	42,319	978	46,922
75,000	695	33,360	800	38,400	1,017	48,829	1,128	54,141
85,000	787	37,776	907	43,536	1,153	55,340	1,278	61,359

Source: Wall Street Journal August 18, 1980

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