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Many Buyers Opt for Risky Mortgages

High Rate of Interest-Only Loans a Concern in Virginia

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More than a third of the mortgages written in the Washington area this year are a risky new kind of loan that lets borrowers pay back only the interest, delaying for years repayment of any loan principal. Economists warn that the new loans are essentially a gamble that home prices will continue to rise at a brisk pace, allowing the borrower to either sell the home at a profit or refinance before the principal payments come due.

The loans are attractive because their initial monthly payments are tantalizingly low -- about $1,367 a month for a $320,000 mortgage, compared with about $1,842 a month for a traditional 30-year, fixed-rate loan. If home prices fall, though, borrowers could lose big.

"It's a game of musical chairs," said Allen J. Fishbein, director of housing and credit policy at the Consumer Federation of America. "Somebody is going to have the chair pulled out from under them when they find prices have leveled out and they try to sell, only to find they can't sell for what they paid for it."

About 54 percent of home buyers in the District purchased their homes using interest-only loans so far this year, according to LoanPerformance, a San Francisco-based company that tracks loan originations nationwide. About one-third of buyers in Maryland and Virginia are buying with interest-only loans.

Just five years ago, only about 2 percent of home-purchase loans in the Washington area involved interest-only terms.

Mark Zandi, chief economist of Economy.com, said buyers are turning to interest-only loans because real estate has become so expensive -- but that real estate is becoming so expensive partially because of the use of these new products.

"It largely reflects the inability of families to afford a home with a plain-vanilla mortgage," Zandi said. "This is a way for people to get into what are extremely expensive homes."

He said it also reflects "increasing speculation" that is occurring in the real estate market, as investors pursue interest-only loans "because they need to devote less resources to servicing this debt."

House prices in the Washington region have risen an average of 10 percent a year for the past four years. The interest-only loans were not available the last time the housing market sagged, in the early 1990s, so the implications of the trend are not known.

Many economists are beginning to worry that the loans could hurt consumers, lenders and the economy itself. Buyers could be exposing themselves to increased risk if home values should fall and interest rates rise, and lenders could be liable if borrowers walk away from such loans. Even the neighbors of people who have bought homes at inflated prices could face financial injury if they take home-equity loans that assume the new purchases reflect true and higher values for properties in their neighborhoods.

Interest-only loans have exploded in popularity in places like the Washington area where home prices are appreciating fastest, including California, Arizona and Florida. Nationwide, about 23 percent of home buyers are using the new kind of mortgage, according to LoanPerformance, which tracks data from more than 80 percent of U.S. lending institutions.

"There's an overwhelming trend toward the use of interest-only loans," said Mark Carrington, director of information products at LoanPerformance.

Many homeowners and mortgage bankers defend the interest-only loans, saying that savvy buyers bear little risk, particularly if they have the discipline to make payments toward the principal, even though it's not required. They get the benefits of home-price appreciation at a lower cost, they say -- and some are making big profits doing it.

Will Betts, a grocery coordinator at Whole Foods Market Inc., was 26 and earning $35,000 a year when he bought a two-bedroom apartment at 11th and U streets in the District in 2001. He bought it for $160,000 and refinanced his loan with an interest-only version in 2002, reducing his monthly payment from $1,400 to $900. Now 30, Betts sold the condo in December for $460,000, reaping a tidy profit without the need to repay any of the principal.

"It's a great thing for first-time buyers or people who don't intend to be in their place forever," said Betts, who has moved to Chicago, now earns $70,000 and has bought a $420,000 home there.

Interest-only loans come in many forms. Usually they are adjustable-rate mortgages, with the interest-only period ranging from three to 10 years, and the payment amount changing as often as monthly. After several years, they can convert to fixed-rate mortgages or remain variable. After the initial interest-only period, the buyer must begin repaying the principal at a higher rate that reflects the delay in principal payment.

"People are buying houses like they used to buy cars," said Alan E. Hummel, past president of the Appraisal Institute, who likened the process to buyers leasing a car. "They are renting the property from the bank, in this case," he said.

In the example of a typical $320,000 mortgage in this market, an interest-only home buyer could save about $40,000 over the first seven years by not paying down the principal. A buyer who took out a standard $320,000 mortgage would have paid down about $36,000 of the loan principal in the first seven years.

If the home appreciates, both could profit. But if prices fall, the purchaser with the standard loan continues making the same fixed payments. If the interest-only buyer can't come up with the cash to cover the much-bigger payment that includes principal, he might have to sell at a loss or face foreclosure.

Banking regulators are watching the home-finance market with increasing attention. Last week, federal regulators issued a warning that directed lenders to be more selective about who can get home equity loans and lines of credit. The regulators told lenders that rising interest rates could make it harder for people to repay their loans, raising the possibility of increased foreclosures.

"Regulators are growing nervous," Zandi said. "They issued more strict guidelines with regard to home equity loans, and I would suspect they will issue tighter guidelines for interest-only loans, too."

The upward spiral of real estate prices, partly fueled by increasing use of interest-only loans by some buyers, is making life even more complicated for other buyers. Blair Gormley, 32, and his wife Beth, 31, both teachers, have been trying to find a townhouse they can afford in Woodbridge for almost a year. Twice they have made offers on properties but backed out after the prices were bid so high that the monthly mortgage would have been too expensive. They could stretch their income further if they considered an interest-only loan, but Blair believes it is too risky to try.

"That's really dangerous," he said. "You don't know what interest rates will do." And if home prices fell, he said, that "would put us in a pickle."

"It would be great, yes, to get a property, but bad to be destitute," he said.