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Some home buyers face risk of carrying too much debt

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In the next couple of years, a combination of rising mortgage interest rates and falling home values could plunge thousands of homeowners underwater.

Being underwater means owing more than the house is worth. It's an especially risky situation for people with interest-only mortgages and pay-option adjustable-rate mortgages because they don't build equity unless they choose to. Some might be able to refinance or get through hard times by living frugally. Others will have to sell their houses, possibly at a loss. Still others will lose their houses to foreclosure.

If you have an interest-only or pay-option ARM, assess your situation and, if you conclude that you are in jeopardy, act quickly.

"I don't think burying your head in the sand is a viable option," says Neil Garfinkel, an lawyer with Abrams Garfinkel Margolis Bergson in New York City.

Two groups of borrowers should look ahead to see if they're heading toward a reef that could sink them.

The first group consists of homeowners who are making the minimum payments on interest-only mortgages. Not all of these folks are at risk. The ones who should especially watch out are those who bought homes in the past year or two in markets where house values are falling, and who made no down payment or a minuscule one.

The other group consists of people who are making minimum payments on pay-option ARMs on homes that they bought within the past two years after making a down payment of 10 percent or less.

Pay-option ARMs are adjustable-rate mortgages that allow borrowers to decide how much to pay each month. Under some conditions, the minimum payment doesn't even cover that month's interest, so the loan balance rises. According to an analysis by Comstock Partners, a Yardley, Pa.-based asset management company, 15.2 percent of 2005 home buyers owe at least 10 percent more than their houses are worth. Those people made minimum payments on pay-option ARMs, or their homes' values dropped or both.

"The market has changed in the last three, four, five months -- dramatically -- and they're not getting from their houses what their neighbors were getting 12 or six months ago," says John Hayes, president and CEO of HomeVestors, the company with the "We Buy Ugly Houses" billboards.

As short-term interest rates have risen in the past two years, the underlying rates of interest-only and option ARMs have gone up, too. Sooner or later, the minimum monthly payments could rise abruptly, past the point of comfort. It's time to refinance, if possible. There are plenty of loans to choose -- from plain-vanilla 30-year, fixed-rate mortgages to 40-year loans to hybrid ARMs to more esoteric programs.

Michael Moskowitz, president of Equity Now, a mortgage lender in New York City, touts a relatively new product, the 30-year, fixed-rate loan in which the payments are interest-only in the first 10 years.

"For someone who is long-term in the house -- really long-term -- this is the best product," he says.

Such a loan comes with a big payment shock after the loan's 10th anniversary. By that time, Mr. Moskowitz says, the borrower's income has risen enough to handle the higher payment, or the home-owner has refinanced the loan or sold the house.

Some people won't be able to refinance, especially if they are underwater and low on cash. In that case, says Jim Svinth, vice president of capital markets for HomeLoanCenter.com, take a knife to expenses:

"Do you really need two cars? Do you have a boat? Really make tough decisions in order to stay current on the loan."

If that's not enough, talk to the loan servicer as soon as you can. Don't let the customer service rep brush you off by telling you that no help is available until your payment is a month overdue. Say, "Please escalate this call and let me speak to a supervisor." Once your payment is a month past due, your options shrink.

Depending on your situation and whether the originating lender sold the loan, the servicer might give you a break on the mortgage payments in exchange for putting the home on the market immediately.

"If someone is starting to feel they're starting to get underwater ..., now is the time to sell," Mr. Garfinkel says. "I'm not saying they're going to make a boatload, but they can get out."

There is a type of sale called a "short sale," in which the house is sold for less than the mortgage balance, and the difference is either forgiven or paid off over time. You can't do a short sale without the cooperation of the lender. If you can afford to -- and you probably can't afford not to -- hire an attorney to negotiate the details of a short sale with the lender.

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