The Negatives of Negative Amortization Loans

What are Negative Amortization Loans?

Negative amortization occurs when the monthly payments on a loan are insufficient to pay the interest accruing on the principal. The additional interest expense is added to the loan balance. The increased loan balance results in higher interest expense and an increasing loan balance. Thus, the term "negative amortization" since the payments are insufficient to amortize the loan balance. The homeowner is, in effect, borrowing more money each month to cover the interest on the loan. The monthly payment is an interest-only payment. Until the loan starts to amortize, there isn't a principal part of the monthly payment. This helps current cash flow, but doesn't help to pay off the mortgage.

What's the problem with Negative Amortization?

- If the loan term ends without sufficient amortization, the remaining mortgage owned can be larger than the original mortgage.
- The monthly payment is eventually reset to a higher payment amount allowing the loan to amortize over its remaining life.
- The increase required in the monthly payment to repay the larger loan balance over a shorter period can be substantial.
- If rates have increased substantially in the interim, refinancing may not be a good option.
- Real estate prices may not continue to increase, especially if interest rates begin trending higher.
- Being upside down, or owing more than a home is worth, because of negative amortization, puts the homeowner in a difficult position when selling the home.

Possible solutions to the issue of Negative Amortization

- Negative amortization can generally be offset by increasing monthly payments.
- ARMs typically limit the amount of negative amortization to 125 percent of the original loan. If the loan balance exceeds this amount, the borrower has to start paying the excess.
- Ultimately, the resolution may be to refinance the loan, with terms that provide for timely reduction of the debt over a reasonable period. This may require extending the maturity of the loan.

How are borrowers enticed with Negative Amortizations?

- Easier qualification standards
- The ability to borrow a larger amount than the borrower would otherwise qualify for based on their income
- Lower initial rates lure many borrowers
- Increased cash flow during the beginning of the loan. The monthly payment doesn't have to increase because the interest rate on the ARM goes up.

Whom does a Negative Amortization loan make sense for?

This type of loan makes sense for people and companies who have "dependable" seasonal or staggering incomes, for wealthier people who want more flexibility for investments, or for those who anticipate increased earnings or cash flow in the future. (Borrowers may inadvertently have negative amortization if they make payments less than the scheduled payment under the terms of the loan contract). For others, negative amortization is not recommended and can even be regarded as predatory or abusive, particularly on loans which have high interest and fees, prepayment penalties, or other abusive features.