**Variety in mortgage offerings may ultimately be a boon to borrowers, but, at least at the start of the mortgage-shopping process, variety holds the potential for plenty of confusion. Here's a guide to some of the basics.**

Always be aware that some lenders, in their desire to offer something the competition doesn't have, may offer loans that mix features in new -- and potentially confusing -- ways.

**5 types of mortgages**

1. 30-year fixed rate.
2. One-year adjustable-rate, or ARM.
3. Hybrid.
4. Interest-only.
5. Payment-option loans.

**30-year fixed rate mortgage**

The traditional mortgage remains a favorite of borrowers. Although the interest rate is generally higher than the starting rates on other loan types, your interest rate and payment will remain fixed for 30 years with this type of loan, and that's a boon to planning your long-term finances.

A variety on this is a fixed-rate loan with a term of 15 or 20 years. Required monthly payments on these loans will be significantly higher than on a 30-year fixed, but you will build equity faster and, in the long term, pay much less in interest. Most lenders allow you to prepay principal on a 30-year loan, so you can retire the debt earlier. Some lenders also offer 40-year terms, which lowers the monthly payment, but stretches out your indebtedness significantly and boosts the total amount you will have spent on interest.

**One-year adjustable-rate mortgage, or ARM**

This is the original variety of an adjustable rate mortgage, commonly referred to as an ARM.

**Important ARM factors**

|  |  |  |  |
| --- | --- | --- | --- |
| • | Index | • | Frequency of rate adjustment |
| • | Margin | • | Annual and life-of-loan caps |
| • | Caps | • | Payment caps |

A one-year ARM has a 30-year term, but your interest rate will adjust every year. The interest rate will be determined by the index that your loan is pegged to, typically one-year Treasury rates or the LIBOR index (an acronym for the London Interbank Offered Rate) or the COFI index (Federal Reserve Cost of Funds Index). LIBOR and COFI indexes also are used frequently for mortgages that adjust their interest rates more frequently than once a year.

To determine your new interest rate each year, the lender will add a specific**margin**, say 2.75 percentage points, to that index. However, borrowers are protected from wild run-ups in interest rates by two important**caps**that are called for in most loan documents. Typically, your rate can rise (or fall -- it does happen) by no more than 2 percentage points each year, and over the life of the loan it can rise by no more than 6 percentage points. Most ARMs start with below-market "teaser" rates, so you should expect your interest rate will rise at its first and possibly second anniversary.

With any ARM, it is important to note**how frequently the interest rate can adjust**(it can be as frequently as every month with some varieties), plus the index and the margin used to set the new interest rate. Always check for**annual and life-of-loan caps**on the interest rate. If the loan documents talk about**payment caps**-- that means your interest rate changes are unlimited. If you pay only the capped payment, you might not be paying enough to cover the interest that is actually being charged on the loan. That unpaid interest gets added to your loan balance, a practice called negative amortization. Your loan balance grows even as you're making the required monthly payment, and that's a risky financial practice.

**Hybrid mortgages**

Sometimes called a "three-year fixed" or a "five-year fixed," these loans incorporate some of the features of fixed- and adjustable-rate loans. For example, a basic "3/27 hybrid" loan will offer you a rate that is fixed for the first three years and then converts to a one-year ARM for the remaining 27 years of the full 30-year term.

Similarly, a "5/25 hybrid" offers a fixed rate for the first five years and then converts to a one-year ARM for the remaining 25 years. These loans can be a money-saver for borrowers who are all but certain that they will move within three or five years and thus don't need to pay extra for an interest rate that is fixed for a longer period.

**Watch the adjustments and caps**

Some varieties of these loans, however, will adjust the interest rate every six months -- or even more frequently -- once the fixed-rate period ends. Pay close attention to those details -- and to whatever interest-rate caps will protect you from rapid changes -- before agreeing to apply for the loan, and again when reviewing your loan documents. Once again, look for interest-rate caps instead of payment caps, because the latter could cause your indebtedness to grow over time.

**Interest-only mortgages**

As the name implies, these loans, usually an ARM or a hybrid, allow a borrower to make interest-only payments during the first five years or so. After that, borrowers are expected to repay principal and interest in order to pay off the loan within the remaining 25 years of its term.

Borrowers can be in for a big payment shock once the interest-only period ends because they have to pay off the entire amount borrowed in only 25 years, compared to the typical 30. Rising interest rates will exaggerate that shock. Typically this type of loan works best for a borrower who is certain he or she will be selling the home or refinancing within the interest-only period and is simply seeking to keep his or her house payment temporarily at its rock-bottom low. If combined with a low down payment, these can be very risky loans for borrowers because they may not find it as easy to refinance out of this loan as they had anticipated, especially if the value of their home has not grown enough to give them a good equity stake.

**Payment-option loans**

They come by different names, usually incorporating the words option or choice. These loans offer borrowers a choice of two or three payments each month, but their complexity grows right along with those choices.

**4 ways to make mortgage payment with option loans**

1. Make full payment of principal and interest.
2. Pay more than a full payment.
3. Pay only the interest due for the month.
4. Pay only a portion of the interest.

The first two choices are fairly straightforward: You can pay the full amount of principal and interest owed that month, just as you would with a traditional mortgage, or you can choose to pay even more and pay off a 30-year-loan on a 15-year schedule. However the other two choices can get borrowers in over their heads if they aren't careful. In any given month, a borrower can opt to pay only the interest that is due that month, or the borrower can choose an even smaller minimum payment, an amount that covers none of the principal and only part of the interest that is owed. To make things even more complicated, these loans often have interest rates that adjust as frequently as every month. And payment caps could allow your minimum payment to rise by as much as 7.5 percent in a given year.

**Risk factors**

If borrowers choose to make the minimum payment frequently, these loans can set the borrower up for a huge payment shock after just a few years. At the end of five years, or whenever the borrower's outstanding loan balance has grown to 10 percent or 15 percent above their original loan amount, the loan will be recast. That means the lender will draw up a new payment schedule designed to get the loan paid off on time, and the minimum payments can grow dramatically. There are no caps on how high the payment can go at these recast periods. Only the most financially sophisticated borrowers (perhaps those few who already understand from personal experience how hedge funds and arbitrage work) should consider these very complicated mortgages.

**Sticking points on any type of mortgage**

There are two other options that can be added on to almost any loan, and it's worth your time to look for them in the fine print.

Prepayment penalties, which can amount to six months of interest, restrict borrowers from refinancing out of a mortgage within the first few years. Some even apply if you were to sell the home. Avoid them unless the lender is giving you a very deep discount on the interest rate as compensation.

Also check for balloon payments. These can be called for in some ARMs that have easy terms in the early years. If your loan calls for a balloon payment, that is payment of all the money outstanding, at year 10, you'd better have good plans lined up for refinancing that loan -- or a lot of cash on hand.