Option ARM

a.k.a. Negative Amortization Loan

This Chapter presents:

- How Option ARM loans work -- There are 2 interest rates, and you need to know about both of them.
- The most important aspects of the Option ARM loan.
- How to determine whether or not this loan is right for you.

The Option ARM loan is the most misunderstood, misused, and maligned loan in our industry. It can be compared to a kitchen knife. Some people cut themselves when they use a knife while cooking. **Should we, then, outlaw kitchen knives?** Or should we simply learn to use them properly so that we avoid injury?

As of the date of this writing, the Option ARM loan has been discontinued from most lenders' available loan options. I think this is an overreaction, and discontinuing it will do more harm than good to homeowners. Again, the fact that it can be used poorly doesn't mean it shouldn't be used at all. My hope is that the storm will subside, cooler heads will prevail, and Option ARMs will become available again. The knowledge in this book will help consumers choose more wisely than they were able to in the past, because they will have a more comprehensive understanding of this loan type. No one should be able to take advantage of you after reading this.

An Option ARM is a good loan for the right person, used the right way. I have one on my home and it is ideal for my career and lifestyle. However, it can be a horrible loan if used incor-

rectly. You could have serious financial problems if you misuse it, or if you accept a loan with a high margin. Later in this chapter, I will describe why the margin is so important.

Before my clients accept an Option ARM loan, it is important to me that they thoroughly understand it. I explain the pros and cons verbally, but I have found that some people appear to be listening, but do not *really* listen. So I have always provided a written explanation for them, and then demonstrated their payment choices on an *Excel* spreadsheet. This chapter will give you a thorough understanding of how this loan really works, and of the pros and cons of selecting an Option ARM, and give you an example of your payment choices using the same *Excel* sheet I use for my clients.

Most people do not keep an Option ARM loan for more than 5 years. However, my discussion will cover what happens if you choose to keep it longer. There are two categories of Option ARM loans. We will discuss them both.

There are 2 Interest Rates associated with your loan

The most important thing to understand about *any* Option ARM loan is that **there are 2 INTEREST RATES** for this loan: the **minimum payment rate** and the **actual accrual rate.** Some less-than-honorable salesmen try to obscure this fact, and lead their clients to believe that the minimum payment rate is their *actual rate*. **It is not!**

- ✓ The minimum payment rate is based on a low rate, typically 1% to 4% (some lenders offer lower or higher minimum payment rates).
- ✓ **The accrual rate is the actual interest rate you are paying the lender.** The actual interest due the lender is usually higher than your minimum payment, although not always.
- ✓ For *fully adjustable Option ARM's*, the actual interest rate changes monthly and is calculated by adding the margin plus the index. Your margin is determined by the lender's guidelines and is typically around 2% to 4%. I shop all the lenders who offer this program to find the lowest possible margin for my clients. It is important that your loan officer do the same for you. The index is usually either the MTA or LIBOR. We will define those in a bit.
- ✓ For Hybrid Option ARMs the rate is fixed for several years. When the fixed rate period is over, your interest rate is calculated by adding the index plus the margin. In that regard, it works just like a regular Hybrid ARM. The difference between the two is that a Hybrid *Option* ARM allows you to make a minimum payment, which is less than the interest only payment, for the entire term of the fixed period. A regular Hybrid ARM does not offer this lower payment option. As I have said, as of the date of this writing, this product is no longer on the market. I include it here because I believe it is a good product and that it will come back when the storm subsides.

- ✓ Many Option ARMs have **a pre-payment penalty** period. This means that if you pay off the loan within the pre-payment timeframe, you will have to pay a penalty to the lender. Penalties can be small, but usually are large. You want to be confident that you will not sell or refinance within the 1- to 3-year timeframe if you accept those terms.

Warning

It is critical that you be aware of the margin and the pre-payment period before you agree to an Option ARM loan. It is rarely wise to choose a 3-year prepayment period if you get an Option ARM loan. A lot can happen in three years. One- or two-year pre-payment periods are usually wiser choices.

Payment Options for Fully Adjustable Option ARMs

Now let's discuss the reason for the name of the loan, and more about how it works. It is called an "Option ARM" because for the first 5 or 10 years of the loan term you will have payment options on every statement. Your options are as follows:

Option 1: You can pay the **minimum payment.**

The minimum payment is based on the fully amortized (principal and interest) payment. It is calculated using the low rate that is usually advertised. As previously noted, this rate is usually 1% to 4%.

The minimum payment will **increase each year by 7.5%.** To calculate your payment for the second year, multiply the first year's payment by 1.075. Do that each year to calculate the next year's minimum payment. For example, if your minimum payment is $1,000 the 1st year, it will be $1,075 the 2nd year. This increase continues annually until the "recast point."

Most lenders recalculate your payment after 5 or 10 years. This is called a "recast." **It may dramatically change your payment**. After the 5- or 10-year point, the loan is designed to be paid in full by the end of the term. Option ARM loan terms are either 30 or 40 years.

Your payment could go up or down at recast because the rate and principal balance change. If you have added to your principal, your payment could go up. If you have paid down principal, your payment could go down.

Lenders' guidelines vary greatly after the first recast. If you plan to keep the loan longer than the 5- or 10-year period that the lender allows you to make minimum payments, please learn the lender's recast guidelines for your particular loan, so that you will be prepared.

Option 2: You can pay the **interest only payment.**

This is only an option if the interest amount is *greater than* the minimum payment. The interest only payment is based on the ACTUAL ACCRUAL RATE. **That is the rate that determines the interest you really owe the lender.**

This rate and payment may adjust regularly (usually every month, but some are every 3 months).

- The actual rate is calculated by adding the Margin + the Index.
- The monthly payment is calculated by this formula:
  (Principal × Interest Rate) ÷ 12 = Monthly Interest Payment

Option 3: You can make a payment that includes **principal and interest** (at your actual accrual rate).

On your monthly bill, the lender will calculate the payment for you based on the actual accrual rate. Most lenders will indicate on your monthly statement the amount to pay if you want to completely pay off your home in 30 years. Some will calculate the payment for a 15-year pay-off. You can make any size principal payment you like (unless you are in a prepayment period), as long as you pay at least the minimum payment amount. The options given are for convenience of calculation for the borrower.

To recap, here are your payment options:

✓ The minimum payment;
✓ The interest only payment at your actual accrual rate (if it is greater than the minimum payment);
✓ A payment that includes interest and principal at your actual accrual rate.

Here is an example of an Excel calculator I use to give my clients a visual understanding of the options they will have and how the payment would compare to a 30-year fixed loan:

	Option ARM Compared to 30-Year Fixed Loan				
	Loan Amount	$400,000			
	Margin	2.500%			
	Index	2.000%			
	Fully Indexed Rate	4.500%			
	Min. Payment Rate	2.000%			
	Term	30.00		**30 Year Fixed**	6.00%
				Monthly Pmt.	$2,398.20
Cash Flow	**Rate**	**2.000%**	**4.500%**	**4.500%**	**4.500%**
	Year of Loan	**Minimum Payment**	**Interest Only Payment**	**P & I @ 30 yr Payment**	**P & I @ 15 yr Payment**
$11,036.69	1	$1,478.48	$1,500.00	$2,026.74	$3,059.97
$9,706.06	2	$1,589.36			
$8,275.63	3	$1,708.57			
$6,737.92	4	$1,836.71			
$5,084.89	5	$1,974.46			
$40,841.19					

Hybrid Option ARMs

The Hybrid Option ARM is a mix of a Hybrid Adjustable loan and an Option ARM. The actual rate for these loans is fixed for 3, 5, or 7 years. The minimum payment rate is also fixed for the same period of time. For some people, this loan provides for the best of both worlds. You have the flexibility of making a lower payment if you need to, but your actual rate is fixed for a number of years.

The downside to this loan type is that your actual rate will not go down when the indexes go down. There have been times when the index values were so low that people with adjustable loans were almost dancing in the streets because they had very low rates, and therefore low payments. As previously discussed, there are risks and rewards to every choice in life.

"Going Negative"

Now, let's discuss why Option ARM loans are called "Neg-am" or "Negative Amortization" loans. **Negative amortization occurs when you pay the minimum payment, and the interest**

only amount is greater than the minimum payment. You will owe the lender more money than you owed before you made the payment that is less than the interest due.

For example, if your minimum payment is $1,000, your interest only payment is $1,150, and you pay only the $1,000 minimum payment, you will owe the lender $150 more on the next month's statement. The negative $150 is added to your existing principal balance. You are effectively borrowing money from the equity in your home that month. You will have to pay it back eventually, but not today.

There is a maximum limit that the lender will allow you to borrow from your equity. The maximum limit ranges from 110% to 125% of the original loan amount.

For example, if your original loan was $500,000 a 110% lender will allow your loan balance to go as high as $550,000 ($500,000 + 10%, or $50,000). A 125% lender will allow your loan balance to go as high as $625,000 ($500,000 + 25%, or another $125,000).

Recast

What happens if you reach your maximum loan limit? The lender will "recast" your loan. Your new monthly payment will be based on the new loan balance at the actual accrual rate.

This is the most critical aspect of the Option ARM loan! Unless you are prepared for a drastic increase in your monthly payment, do not allow your loan balance to reach its recast limit prematurely! **Lenders' recast guidelines vary. If there is any chance that you will get to that limit by borrowing too much money from your equity, read the lender's guidelines and be prepared. If you already have the loan, the rules should be outlined in the "Note" you received in escrow. However, I read the Note for an Option ARM loan I used to have, and the lender did not outline how they recalculated payment at recast. If your loan's Note is unclear, call the lender or loan officer and get the recast guidelines in writing. If you are considering getting an Option ARM Loan, and think you may hit the limit, you should review the guidelines up front before deciding whether or not to go with that lender, or this loan type.**

The chapter entitled "Truth or Consequences" will help you calculate what your payment could become if you recast at the maximum principal amount allowed by the lender.

Indexes

Earlier I mentioned that your actual interest rate is calculated by adding the Index plus the Margin and that the Index value changes monthly. The most popular Indexes for Option ARM loans are the MTA and LIBOR. Some lenders use the COFI.

When index values are increasing, I recommend indexes that move slowly, the MTA, COFI, COSI and CODI[1]. The MTA moves slowly because it is a 12-month average of the CMT (Treasury). The COFI, COSI and CODI move slowly because they track the rates banks offer their deposit customers. The LIBOR is not an average and it can move rapidly. It is a good Index to choose when Index values are declining; and usually a poor choice when values are increasing.

Pros and Cons of the Option ARM

The following discussion addresses the circumstances under which the Option ARM loan is a good choice, and when it is a poor choice. While the Option ARM is maligned by those who do not fully understand it, it is an excellent loan for the right person and the right circumstances.

Pros - Who is a good candidate for an Option ARM?

Self-employed people may choose it if their income is unpredictable or cyclical. When cash flow is tight, it can be very comforting to be able to pay only the minimum monthly payment. Anyone whose income is unpredictable may prefer an Option ARM. The beauty of the Option ARM is that you can remain current with your mortgage payment requirements through the ups and downs of your financial life.

While it is best that you do not add to your principal (or "go negative"), this option is better than making late payments or defaulting altogether on your loan. If you make late payments or default, you can damage your credit rating for years to come, or worse, lose your home.

The Option ARM may be the only loan you, as a borrower, can afford if your circumstances change and you need to refinance. It is far better to have the payment options offered by the Option ARM and keep your home, than to have to sell or go into foreclosure because you cannot make the higher monthly payments associated with another type of loan. Some people bad-mouth Option ARMs because you can lose some of the equity in your home. However, if you hit hard times and cannot afford the full interest and principal payment, the lender will foreclose and you will most likely lose all of your equity. Which is better, losing **some** of your equity or **all** of your equity?

If you are buying an investment property short-term, (i.e. to fix it up and sell quickly) you may need the lowest monthly payments possible for cashflow purposes. The Option ARM loan allows you to free up your funds so that you can use the money saved to rehabilitate the property.

1 These are the commonly used abbreviations for the names of the Indexes. Please see the Glossary for complete definitions.

Cons - Who should avoid the Option ARM loan?

People who lack self-discipline are poor candidates for the Option ARM loan. These people use the lower monthly payments as an excuse to spend more money unnecessarily. Rather than investing the money they save by virtue of lower monthly payments, these folks inevitably spend themselves into the "poorhouse."

Another consideration is that some people are more comfortable with the security of knowing their rate for the life of their loan. If you can comfortably afford a 30-year fixed mortgage payment, and plan to keep the property for a very long time, you may want a 30-year fixed loan. This argument is most valid at times in the market when 30-year fixed loan rates are reasonably low as compared to other options.

Discussion

I advise my clients to make interest only payments to the lender whenever possible, and then "pay" the amounts that would normally go to the lender as principal to themselves by saving it in an interest bearing account. In my opinion, it is better to earn compound interest on your principal, than to give it to the lender and receive 0% interest on it.

Some will argue that it is wise to pay down the principal on your loan because you save money on interest when you owe less principal. They also have a point. It is really just a matter of preference. Personally, I would rather have my money where I can get to it in case of emergency. If I give it to the lender, the only way to get it back is to refinance. Refinancing is not always an option in an emergency. This is especially true if the emergency constitutes the loss of your job or other cataclysmic events that hurt your credit rating, employment, or income.

Chapter Summary:

My hope is that I have helped you understand the Option ARM Loan well enough to decide whether or not it is right for you. In this chapter we covered:

How the interest rates and payments are calculated

- ✓ There are 2 interest rates: the minimum rate and the actual accrual rate.
- ✓ The actual accrual rate is the index plus the margin, and it changes monthly.

Warnings

- ✓ How some loan officers mislead you into thinking the minimum payment rate is your actual interest rate.
- ✓ The same types give you a large margin and 3-year prepayment period in order to make more money at your expense.

- ✓ What "going negative" means and the need to avoid a premature recast.

The pros and cons

- ✓ Personality characteristics and circumstances that make you either a good candidate for an Option ARM, or a poor candidate.
- ✓ The concept that investing your money, rather than paying principal to the lender, may benefit you by giving you access to your assets when needed without having to refinance your loan.