# The Mortgage Professional

Volume X, No. 5 | *"Information you can use"* | May, 2005

## "1%!?! What a GREAT Rate!"

## Payment Cap and Option ARM Products Gain Popularity

**Focus on Products**

We have all seen the rate sheets and advertisements shouting about great low rate Adjustable Rate Mortgages, but when the numbers start to seem too good to be true, a closer look at the loan program is warranted. The recent rise in popularity of "interest only" and low "teaser" rate ARMs are examples of this.

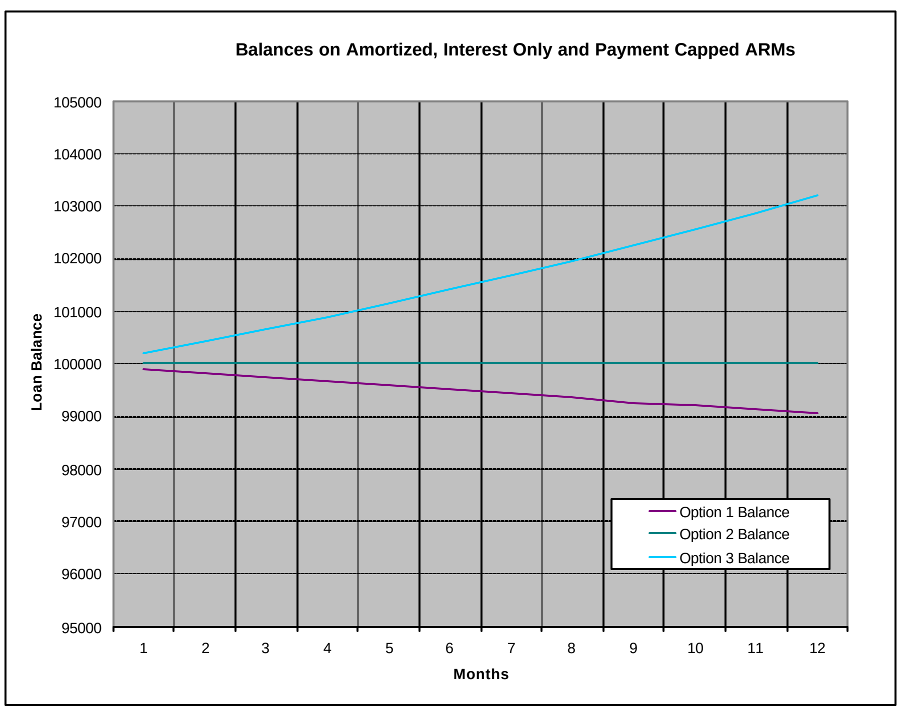
In theory there is nothing wrong with a "teaser" rate. A borrower may be able to use the low introductory rate for specific benefit. For instance, using the period when the interest rate is low to pay additional amounts towards the loan principal is a time tested strategy, particularly when the borrower also is able to identify a finite period of time that the loan will be in place. The difficulty is that many Loan Officers do not understand the basic functions of an ARM, and so are not very good at explaining loan mechanics to borrowers. As a consequence any borrowers enter into loan contracts they do not understand.

As an example, a loan officer offering a 1 Year ARM helps the borrower understand that the interest rate will change every year. The borrower then hears of an incredible 1% 1 Year ARM. Because the public has been taught that lower interest rates are better, the borrower is compelled to request the low rate product. How different could the terms be?

In this case, the terms are quite different. A 1 Year ARM offers an interest rate that is fixed for one year. The 1% 1 Year ARM offers PAYMENTS that are fixed at the 1% level, but that do not reflect that the underlying interest rate is changing. The introductory rate and subsequent payment rate changes are based on the payment rate NOT THE INTEREST RATE. The deficit between the payment rate and the actual interest rate carrying cost on the loan can result in principal being added back to the loan – a process known as negative amortization.

### Payment Caps = Negative Amortization

In the illustration shown here, the borrower's loan balance increases far more dramatically with deferred interest than it decreases with amortization. This is because negative amortization is compounded interest – interest on interest. While this isn't horrific in itself, this illustration only shows what happens when interest rates increase moderately – at the rate of 1% per year. In today's rising short term interest rate environment, rates are likely to rise much more rapidly, adding more to the loan balance.



## Is This a Bad Option for Borrowers?

There are many loan officers who advocate the use of the teaser rate ARM to bridge a particular situation:

- An investor purchasing a property to sell in a short period of time (flip)
- A borrower who is purchasing a home and who has to make two mortgage payments (old home and new home) for a defined period of time
- A borrower who believes their home will appreciate faster than the loan balance accrues and so borrows from appreciation to offset deferred interest
- A borrower who is using the option ARM as a modified version of a reverse equity loan

These are all rational justifications for accepting this type of loan. A sophisticated borrower will appreciate that he or she has multiple options – amortized, interest only, or deferred interest - for making payments. They will be aware and capable of handling the consequences of each choice. An uneducated borrower may choose this product for the visceral appeal of that very low payment. This type of loan doesn't suit that borrower, as the pace of negative amortization will soon sweep the equity away from the property, even at a high rate of appreciation.

### Comparison of Payments and Loan Balances for Option Arms

| | | |
|---|---|---|
| Rate Formula | Initial Loan | 100000 |
| | Term | 360 |
| | Intro Rate | 1.750% |

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Index | 3.97 | 4.12 | 4.24 | 4.39 | 4.48 | 4.6 | 4.72 | 4.8 | 4.91 | 5.02 | 5.13 | 5.24 |
| Margin | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 |
| New Rate | 6.72 | 6.87 | 6.99 | 7.14 | 7.23 | 7.35 | 7.47 | 7.55 | 7.66 | 7.77 | 7.88 | 7.99 |
| Option 1 Fully Amortized | $ 646.61 | $ 657.13 | $ 665.14 | $ 675.18 | $ 681.23 | $ 689.30 | $ 697.41 | $ 702.82 | $ 710.28 | $ 717.76 | $ 725.26 | $ 732.77 |
| Option 1 Balance | $ 99,913.39 | $ 99,828.26 | $ 99,744.63 | $ 99,662.93 | $ 99,582.17 | $ 99,502.81 | $ 99,424.80 | $ 99,347.53 | $ 99,271.41 | $ 99,196.43 | $ 99,122.57 | $ 99,049.79 |
| Option 2 Interest Only | $ 560.00 | $ 572.50 | $ 582.50 | $ 595.00 | $ 602.50 | $ 612.50 | $ 622.50 | $ 629.17 | $ 638.33 | $ 647.50 | $ 656.67 | $ 665.83 |
| Option 2 Balance | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 |
| Option 3 Payment Rate | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 | $ 357.24 |
| Option 3 Balance | $100,202.76 | $100,419.17 | $100,646.87 | $100,888.48 | $101,139.09 | $101,401.32 | $101,675.30 | $101,957.76 | $102,251.35 | $102,556.19 | $102,872.39 | $103,200.11 |

| | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 | 21 | 22 | 23 | 24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Index | 5.35 | 5.46 | 5.57 | 5.68 | 5.79 | 5.9 | 6.01 | 6.12 | 6.23 | 6.34 | 6.45 | 6.56 |
| Margin | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 |
| New Rate | 8.1 | 8.21 | 8.32 | 8.43 | 8.54 | 8.65 | 8.76 | 8.87 | 8.98 | 9.09 | 9.2 | 9.31 |
| Option 1 Fully Amortized | $ 740.30 | $ 747.85 | $ 755.41 | $ 762.99 | $ 770.59 | $ 778.20 | $ 785.82 | $ 793.46 | $ 801.12 | $ 808.79 | $ 816.47 | $ 824.17 |
| Option 1 Balance | $ 98,978.08 | $ 98,907.41 | $ 98,837.75 | $ 98,769.10 | $ 98,701.42 | $ 98,634.70 | $ 98,568.90 | $ 98,504.03 | $ 98,440.05 | $ 98,376.94 | $ 98,314.69 | $ 98,253.27 |
| Option 2 Interest Only | $ 675.00 | $ 684.17 | $ 693.33 | $ 702.50 | $ 711.67 | $ 720.83 | $ 730.00 | $ 739.17 | $ 748.33 | $ 757.50 | $ 766.67 | $ 775.83 |
| Option 2 Balance | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 | $100,000.00 |
| Option 3 Payment Rate | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 | $ 384.04 |
| Option 3 Balance | $103,512.67 | $103,836.84 | $104,172.73 | $104,520.51 | $104,880.31 | $105,252.29 | $105,636.59 | $106,033.39 | $106,442.83 | $106,865.10 | $107,300.36 | $107,748.80 |

For a free copy of this spreadsheet in Excel Format visit www.lendertraining.com and browse to "Loan Officer Tools"

The Option ARM – the three payment options – suit particular borrower situations.

- A borrower with variable income who receives most of his or her income at more sporadic intervals than monthly, such as an attorney receiving annual or quarterly distributions.
- A seasonal business owner or worker, such as a landscape or pool contractor, might benefit from the low cash flow requirement in the winter months.

### Drawbacks of Potential Negative Loan Balances

**Prepayment Penalties**: Option ARMs normally have a prepayment penalty to prevent the borrower from refinancing within the first 2 or 3 years. Being saddled with negative equity, and being unable to refinance to more favorable loan terms, tend to exacerbate the impact a loan that grows to be unaffordable.

**Negative Amortization Cap**: The loan balance can grow as deferred interest gets added to the principal balance. This cannot proceed unabated, and the lender normally caps the negative amortization to 110% – 125% of the original principal balance. Once this cap is reached, the monthly payments are re-cast (new monthly payments established) as a fully amortizing loan. Even if the negative equity balance is not attained, many loan documents require that the loan be re-cast every five years.

**Subordinate Liens**: Many second trust lenders are unwilling to accept 2nd lien position behind a loan that will potentially erode the equity in the house. At best, the lender will determine if there is any "lendable equity" if the loan reaches is full potential negative amortization, and base their loan amount calculations on this amount.

**Effect of Negative Amortization on 2nd Mortgage Lendable Equity**

| | |
|---|---|
| Property Value | $ 200,000.00 |
| Lendable Equity % | 80% |
| a. Gross Lendable Equity | $ 160,000.00 |
| Original Loan Amount | $ 100,000.00 |
| Max Negative Balance | 125% |
| b. Max Potential Loan | $ 125,000.00 |
| Net Lendable Equity a - b | $ 35,000.00 |

**Homeowners and Title Insurance**: Title Insurance policies must offset potential negative amortization and will include a rider that protects the loan up to its full potential balance.

## Benefits of Monthly ARMs and Potential Negative Amortization

**"It's the Margin, Bro"** – Ultimately, if the loan offers a favorable margin, it may still be a competitive interest rate basis. This should be compared to the other interest only ARM products available, such as the 3/1 or 5/1 ARM.

**Low Risk for the Lender**: One of the risks lenders assume is the danger of rising or falling interest rates affecting the value of the lender's investments. In the case of the Option ARM, the lender is taking virtually no interest rate risk. Because of the mitigated interest rate risk, the lender is able to absorb more credit risk, on an actuary basis. As a result, these loans may offer more expanded criteria than other investment grade loans.



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