Option ARM (a.k.a. Negative-amortization) Loan

By Holly Gustlin

The Option ARM loan is the most misunderstood, misused and maligned loan in our industry. It is a good loan for the right person, used the right way, (I have one on my home). However, it is a horrible loan if used or sold incorrectly. It can get you into a lot of trouble if you misuse it, or are sold a loan with a high margin.

It is important to me that before getting an Option ARM, my clients, and anyone who accesses my website, have a thorough understanding of how this loan really works; and of the pros and cons of having an Option ARM.

Most people do not keep this loan beyond 5 years. However, my explanation here will be complete and include what happens if you do keep it.

Following is a thorough explanation of the Option ARM Loan. Please take a moment to read it and call me if you have any questions.

Interest Rates

The first, and most important point, is that there are 2 INTEREST RATES for this loan, the **minimum payment rate** and the **actual accrual rate**.

- The **minimum payment** is based on a low rate, typically 1% to 2% (some lenders have minimum payment rates much lower or higher).
- The **accrual rate** is the **actual interest rate you are paying the lender.** It is calculated by adding the margin plus the index. Your margin is determined by the lender's guidelines and is typically around 2.5% to 3.5%. I shop all the lenders who offer this program to find the lowest possible margin for you. The index is usually either the MTA or LIBOR. We will discuss those in a bit.

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Warning

If you are not getting the loan from me, it is critical that you watch the margin and the pre-payment period. It is scandalous how some mortgage lenders sell this loan as actually having a low rate; and then stick the client with a high margin and 3-year pre-payment period. They usually do this so that they can get a large rebate from the lender. (If you don't understand the concept of a "rebate from the lender" please read my article titled "Points")

Payment Options

Now let's discuss the reason for the name of the loan, and more about how it works.

ARM stands for "Adjustable Rate Mortgage." It is called an "Option ARM" because you will have payment options on every statement for the first 5 or 10 years of the loan term. (World Savings offers options for the entire 30-years of the loan term. To my knowledge, no other lender does). Your options are as follows:

- You can pay the **minimum payment.** The minimum payment is based on the fully amortized (Principal and Interest) payment calculated using the low rate advertised. This rate is usually 1% to 2%. However, some lenders have programs with a minimum payment rate higher or lower than the norm.
  - The minimum payment will **increase each year by 7.5%.** So, to calculate your payment for the second year, multiply the first year's payment by 1.075. Do that every year to calculate the next year's minimum payment. So for example, if your minimum payment is $1,000 the 1st year, it will be $1,075 the 2nd year.
  - Most lenders recalculate your minimum payment after 5 to 10 years. This is called a "recast." It may dramatically change your payment.
  - 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 5 years, please learn the lenders' recast guidelines for your particular loan, so you will be prepared.

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- You can pay the **interest only payment,** (only if it is greater than the minimum payment). The interest only payment is based on the ACTUAL ACCRUAL RATE. That is the rate that you are really paying.
  - **This rate and payment adjust regularly** (usually every month, but some are every 3 months).
  - The rate is calculated by adding the margin + the index.
  - The payment is calculated by this formula: Principal × interest rate ÷ 12.
- You can make a payment that includes **principal and interest.** On your bill, the lender will calculate the payment for you every month based on the actual accrual rate. They will give you the amount to pay if you want to pay off your home in 30 years, and an option for a 15 year pay off. You can make any size principal payment you like. The options given are for convenience of calculation for the borrower.

So, those are your payment options,

1. The minimum payment
2. The interest only payment
3. A payment that includes interest and principal

"Going Negative"

Now, let's discuss why it is sometimes called a "Neg-am" or "Negative Amortization" loan.

- Negative amortization happens if you pay the minimum payment, but the interest only payment is *greater than* the minimum payment.
  - For example, If your minimum payment is $1,000 and your interest only payment is $1,150, and you pay the $1,000 minimum payment, you will owe the lender $150 more the next month than you owed them this month.
  - You are effectively borrowing money from yourself 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 yourself." The maximum limit ranges from 110% to 125% of the original loan amount.

  - So for example, if your original loan was $500,000 a 110% lender will allow your loan balance to go as high as $550,000. A 125% lender will allow your loan balance to go as high as $625,000.
- What happens if you hit your maximum limit? The lender will **"recast"** your loan. Your new payment will be based on the new loan balance at the actual accrual rate.
  - Now this is important! **Do not ever hit the maximum loan balance and trigger a recast, unless you are prepared for a drastic change in your payment!**
  - Lenders' recast guidelines vary. If there is *any chance* that you will get to that limit by borrowing that much money from yourself, read the lender's guidelines and be prepared. If you already have the loan, the rules will be outlined in the "Note" you received in escrow. If you are considering getting an Option ARM Loan, and think you may hit the limit, ask for the guidelines up front before deciding whether or not to go with that lender or this loan type.

Indexes

Now we will have a brief discussion about indexes. Recall earlier I mentioned that your actual interest rate is calculated by adding the index + the margin. The index changes monthly. The most popular indexes for Option ARM loans are the MTA and LIBOR. World Savings uses the COFI, COSI and CODI. Some other lenders use the COFI as well.

The MTA is a monthly average of the CMT (Treasury). So the previous 11 month's values are averaged with this month's value.

The LIBOR is not an average and moves rapidly.

The index I prefer when values are increasing is the MTA. I prefer this because it is a 12-month average, so it moves slowly. The COFI, COSI and CODI are also good choices.

The LIBOR is not an average, so it moves very quickly. It is good if values are going down; and usually a poor choice when values are going up.

Pros and Cons

Our final discussion involves the personalities and circumstances for which the Option ARM loan is a good choice; and those for which it is a poor choice.

Pros - Positive Reasons to Choose the Option ARM Loan

Who is a good candidate for this loan? I have the Option ARM loan, as do my father and sister. It is a good loan for the right person.

- Many of my self-employed clients choose it because their income is unpredictable.
- The beauty of this loan is that you can remain current with your mortgage, even through the financial ups and downs of life. It often works well for people who can not predict their monthly income. While it is best if you do not add to your principal, (or "go negative") *it is better than defaulting on your mortgage or being 30-days late on a payment.* If either of those happens, you could lose your home and/or damage your credit rating for years to come.
- The Option ARM may be the only loan a borrower can afford at the time they receive it. It is better to have options and be able to keep their home, than to have to sell because they can not make the monthly payment of a 30-year fixed loan.
- Older people can use this as a better "Reverse Mortgage" than the standard reverse mortgage product, (please refer to the "Reverse Mortgage" tab on this site).
- People wise enough to save and invest their money, rather than spend up to their limit each month, are good candidates. These people choose this loan because it frees up more money for investment. In fact, if used properly you can actually pay your house off faster using your money in wise investments, than by paying down principal.
- I advise my clients who have self-discipline to pay the interest only payment to the lender and pay the amount that would go to principal to themselves by saving it.

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    - It is better to earn interest on your principal, than to give it to the lender and receive 0% interest on it.
    - The power of compound interest puts my clients ahead of the game if they choose to take my advice. (Please refer to a book called "Missed Fortune" by Douglas Andrew for an *exhaustive* explanation of this tactic). This choice works with either the Option ARM loan or any interest only loan.
- If you are buying an investment property short-term, (i.e. to fix it up and sell it) you may need the lowest payment possible. This loan allows you to free up your funds so that they can be used to rehabilitate the property.

Cons - Personality Types Who Should Avoid the Option ARM Loan

- People who lack self-discipline are poor candidates. These people use the lower payment as an excuse to buy more stuff, rather than an opportunity to invest the money they save. People with this personality type easily get in over their heads.
- If you can comfortably afford a 30-year fixed mortgage payment, and plan to keep the property for a very long time, you will probably want to get a 30-year fixed loan. Why pay an interest rate that varies, when you can choose a sure-thing? This is only valid at times in the Market when 30-year fixed loan rates are reasonably low.

Summary

We have covered

- How the interest rates and payments are calculated
    - You have 2 interest rates, the minimum and actual accrual rate
    - The actual rate is the index + the margin and moves monthly
- Warnings
    - How some brokers abuse this loan to get more money, but their profit comes at their client's expense
    - What "Going negative" means and how to avoid disaster
- The pros and cons
    - Personality types 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, can benefit you long term

My hope is that you understand the Option ARM Loan well enough now to decide if it is the right loan for you, or not. If you have any questions or concerns, please call me any time.

Working for your best interests!
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