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Option Adjustable Rate Mortgage loans: Know the facts

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This is definitely a great time of year for sports enthusiasts. The College Basketball Tournament always provides excitement as a prelude to opening day for major league baseball. Fans are filled with optimism about their team's chances to win the pennant and reach the World Series. On opening day, every team is in first place with dreams of achieving baseball's grand prize in October. Fans are hoping that their team can emulate the miracle ride of the 2006 Detroit Tigers. The Tigers went from 71 wins and 91 losses in 2005 to the World Series in 2006. Even though the Tigers' miracle ride of 2006 was an aberration, fans remain optimistic towards their team's chances every opening day. Unfortunately, the baseball season for 28 teams will end before the 2007 World Series.

Real estate owners utilizing an Option Adjustable Rate Mortgage (Option ARM) can also be lulled into a false sense of optimism. The Option ARM mortgage has become famous over the past 5 years as a vehicle to provide a very low monthly mortgage payment on a real estate loan. We have all seen or heard some type of advertising for a $150,000 loan with a monthly payment of less than $500.

The Option ARM is basically a glorified Adjustable Rate Mortgage with a negative amortization feature (principal balance increases). Therefore, the mortgage is based on an index (i.e. prime rate, LIBOR, etc…) similar to other conventional ARMs. The most common index used for Option ARMs is the Monthly Treasury Average (MTA) which is calculated by adding together the annual treasury yields (as published by the Federal Reserve Board) for the most recently available 12 months and then dividing by 12. Since this index is a 12 month average, the volatility is significantly reduced. Unfortunately, the MTA has risen significantly from 3.0192 to 5.0267 since August 2005 and this trend is similar to most of the other indexes utilized by Option ARMs.

The major feature of an Option ARM is the low monthly payment option which is based on an interest rate as low as 1% and illustrated in the following example:

Purchase Price: $200,000
Loan Amount: $150,000
Index: MTA (currently) 5.03%
Margin: 1.50
Current Fully Indexed Rate (FIR): 6.53%
Payment based on 1%/30 year Amortization: $482
Payment based on FIR/30 year Interest Only: $816
Payment based on FIR/30 year Amortization: $951

The minimum payment option of $482 seems enticing however; the difference between this option and the interest only option of $816 is added back to the principal resulting in negative amortization of the loan. In this example, assuming the minimum payment option, the outstanding balance will rise to $150,334.

Every month you will have the option to pay:

• The minimum payment which results in negative amortization;

• The Fully Index Rate (FIR) interest only option - no change in the outstanding balance or;

• The FIR at 30 year or 15 year amortization which reduces the outstanding balance.

Every month you also have the option to catch up on negative amortization from prior months.

A home owner or real estate investor should be familiar with the following crucial aspects of Option ARMs:

• The history and volatility of the index and the impact of the associated margin.

• The minimum payment increases every 12 months for 5 years but at a maximum of 7.5%, therefore, the minimum payment for this example would increase to $518 in year 2 (starting with the 13 month).

• The interest only payment is based on the outstanding balance which includes negative amortization (not the original principal).

• The loan recasts every 5 years which means that the payment options above are recalculated based on the outstanding balance at that time without regard to the 7.5% limit.

• Negative amortization is deferred interest added to a loan's outstanding balance and is only deductible in the year which it is actually paid. As the IRS explains, "Generally, home mortgage interest is any interest you pay on a loan secured by your home."

• If the outstanding balance ever reached 115% of the original principal balance or $172,500 in this example (110% in New York), the loan automatically converts to a fully amortizable loan over the remaining years based on the FIR.

The 115% (110% in New York) rule is by far the most important facet of an Option ARM and one should make sure that they clearly know how long they can make the minimum payment before this trigger occurs.

The Option ARM can be a great vehicle for certain real estate investors to reduce the monthly cash outflow and for home owners whose salary fluctuates because it is significantly based on monthly commissions and year-end bonuses. Please understand the facts before electing to use this loan product and don't be lulled into a false sense of security.

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