

Farewell to ARMs? Not So Fast!

By Scott Hastings, CHL Direct

Used correctly, pay-option ARMs can help you build wealth

As interest rates and home prices continue to climb, pay-option ARMs have become increasingly popular in helping homebuyers get into the houses of their dreams. But option ARMs also have faced increased scrutiny.

Some people believe that these mortgages are so complicated that only the most “savvy” borrowers should be trusted to handle them wisely. How could the average couple be trusted to handle anything more than a “no-brainer” fixed-rate loan?

Another source of scrutiny is that some brokers and lenders have not taken the time to explain to borrowers how this mortgage product can be used properly. The main issue is that the terms of the option ARM is often misrepresented.

Many brokers cut corners by explaining the loan as simply having a 1-percent rate — that’s it. They don’t always explain that the interest rate will increase after the introductory period or that there are other risks to the mortgage type if it is not managed carefully.

At Silverstar, we educate you about what this strategy can actually do for you and the advantages it can provide, so that you are much better served. The fact is if used correctly as a financial tool, the option ARM could solve many of your problems.

Option-ARM basics

In simple terms, an option ARM is an adjustable-rate mortgage that offers a choice of three indices and as many as four monthly payment options: 1. Minimum payment; 2. Interest-only payment; 3. Amortized payment on a 30-year or 40-year schedule; and 4. 15-year-amortization payment.

The loan’s main selling point is that you can choose the type of payment you would like to make each month. One of the risks, however, is that pay-option ARM loans have the potential for negative amortization. If left unpaid, deferred interest is added to the principal amount of the loan.

Maximum deferred interest is allowed to as much as 115% of the loan’s original amount. If you hit that 115% deferred interest, they will be required to make an amortized payment. You will not be allowed to make the interest-only or minimum payment until they drop below the 115% mark.

A wealth-building option

In recent years, many Americans have become accustomed to a lifestyle that they cannot reasonably afford. In fact, **Americans in total actually have a negative savings rate. It has become clear that we must be responsible for our own retirement planning. Pensions are becoming a thing of the past, and it is possible Social Security will always not be around to take care of us.**

Additionally, Americans typically move every five to seven years, restarting their 30-year amortization each time. Thus, most Americans will never own their home through mortgage-payment reduction. One option to keep their finances on track is to look at their mortgage as a financial tool.

When we see high credit card debt or little to no savings, the payment-option ARM could be just the solution to help you. In a fully amortizing loan, the first few years of mortgage payments primarily go toward interest, it would be more prudent to use that money to invest in an interest-bearing product such as a 401(k), mutual fund or whole life-insurance policy instead.

Let's use the 401(k) as an example. Many homeowners cannot fully fund their 401(k)s because they are strapped with mortgage, car and child-care payments, and more. But because many employers match at least 50 percent on 401(k)s, these homeowners are essentially giving up "free money" by not contributing.

When we show you how to use an option ARM to lower their monthly payment on a \$400,000 home from \$2,582 with a 6.5-percent fixed-rate loan to \$1,286 with a pay-option ARM, for example, you have created cash flow.

What borrowers do with the cash flow is essential. Consider what happens if you take part of that cash flow — say \$500 a month — and put it toward their 401(k). If your company matches the contribution by 50 percent, their monthly investment becomes \$750 a month.

If you follow this formula for only three years and don't ever invest another dime, you will accumulate \$146,000 in their retirement account over 30 years, assuming a conservative 6-percent rate of return. That is regardless of whether you move or refinance after three years.

For the right borrowers, this is a better alternative to paying down their mortgage for two reasons. First, you maximize your tax benefit on the mortgage interest over an extended period. You also create liquidity that you might not have had if you chose to pay down your mortgage from the start.

If used wisely, the pay-option ARM can be an effective wealth-building tool. It should not be used to get into a house for a year because you can't afford it.

It is important to enlist the services of a financial planner who can show you a way to invest your money to earn a decent return on it. Even if you earn just a small return, it will be better than earning nothing with the traditional 30-year mortgage.

Pay-option ARMs can clearly be a beneficial tool for you. If you take the time and allow us to educate you about this product, you will discover the possibilities for you and your family.

We help you obtain the Right Knowledge and Define your Goals so that you make Smart Choices.

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