

Pay Option ARM

exclusive metro mortgage

From the Desk of: Chip Hundredmark - Atlanta, GA - 678-591-6321
Subject: Pay Option Adjustable Rate Mortgage

PayOption ARM - An Adjustable Rate Mortgage Option

Imagine an adjustable rate mortgage that allows you to pick one of four payment options on your monthly mortgage bill. It is an ARM on which the interest rate adjusts monthly and the payment adjusts annually, with borrowers offered options on how large a payment they will make. The options include interest-only, and a "minimum" payment that may be less than the interest-only payment. The minimum payment option results in a growing loan balance, termed "negative amortization".

How Will I Know an Option ARM When I See One?

Ask the loan officer if the mortgage has more than one payment option. Does the rate adjust monthly, and if negative amortization is allowed. If the answer to both questions is "yes", you almost certainly have an Option ARM. Their names are all over the map and include "1 Month Option Arm", "12 MTA Pay Option ARM," "Pick a Payment Loan", "1-Month MTA", "Cash Flow Option Loan", and "Pay Option ARM".

What Are the Advantages of an Option ARM?

Their main selling point is the low minimum payment in year 1. It is calculated at the interest rate in month 1, which can be as low as 1%, and it rises by only 7.5 % a year for some years. The low initial payment allows borrowers to buy a more expensive home than they would be able to afford. Other reasons are to use the monthly payment savings for other purposes, like: paying down the principle, and amortizing credit card debt. Be aware that they seldom explain the risks.

What's Are the Risks of an Option ARM?

For those electing the minimum payment option, the major risk is "payment shock" ?a sudden and sharp increase in the payment for which they are not prepared. The rule that the minimum payment can rise by no more than 7.5% a year has two exceptions. The first is that every 5 or 10 years the payment must be "recast" to become fully-amortizing. It is raised to the amount that will pay off the loan within the remaining term at the then current interest rate ?regardless of how large an increase in payment is required. The second exception is that the loan balance cannot exceed a negative amortization maximum, which can range from 110% to 125% of the original loan balance. If the balance hits the negative amortization maximum, which can happen before 5 years have elapsed if interest rates have gone up, the payment is immediately raised to the fully amortizing level. Either the recast provision or the negative amortization cap can result in serious payment shock. That is why I tell my clients that unless you have a financial plan for paying the minimum payment, always pay the Interest Only Option or higher.

How Do I Protect Myself Against The Risks?

First of all, if you can't maintain financial discipline do not engage in this type of loan. You will be tempted to pay the minimum payment from day one. When it recasts, you will be stuck between a rock and a hard place. If you have sound financial principles, and can adhere to them, go for it.

Make sure your loan officer discloses the margin. The lower the margin, the lower your cost and your vulnerability to payment shock. You can also minimize the risk by taking the highest initial payment you can afford. The higher your initial payment, the smaller the potential payment shock down the road.