ARM Yourself with Knowledge

Knowing the ins and outs of option ARMs and fixed-option ARMs can help you use them properly

By **Joseph Badal,** senior executive vice president and chief lending officer, Thornburg Mortgage

A generation ago, paying off the mortgage was every conscientious homeowner's first priority. But these days, with homeowners moving more often, with baby boomers buying second homes or investment properties and with consumers' increased financial sophistication, owning a home outright is not necessarily the priority it once was.

Sophisticated borrowers are asking lenders for mortgage products that allow for greater cash-flow management to meet their overall financial needs. In other words, mortgage-loan products increasingly are becoming financial-planning tools. Despite the Mortgage Bankers Association's reports of a recent decline in their use, the option ARM and the fixed-option ARM are examples of financial-planning-oriented mortgage products.

Know the basics

The traditional option ARM is a specialized loan product that typically allows borrowers greater control of their monthly mortgage payment and therefore of their cash flow.

As with traditional ARM loans, the interest rate of an option ARM is subject to adjustments on a scheduled basis, which could be every month, every six months or annually. Borrowers can choose to make a payment that includes interest and principal, an interest-only payment or an alternate minimum monthly payment that is less than the scheduled interest payment.

By offering flexible monthly payments and lower interest rates, option ARMs can be a good solution for homeowners who have nontraditional income sources. These can include commissioned salespeople, borrowers with income derived from royalties or structured settlements, self-employed borrowers and homeowners whose annual bonus comprises most of their annual income.

For instance, real estate agents whose income depends solely on whether they close a sale could benefit from having an option ARM. During their slow season, they can manage their cash flow by making interest-only or minimum monthly payments. Then, when their commission income increases, they can arrange to make a significant payment that month, reducing principal.

In most ways, the fixed-option ARM is nearly indistinguishable from its cousin, the option ARM. But one feature can provide borrowers with an added sense of security through its fixed-rate period. Instead of having a floating interest rate, the fixed-option ARM carries a fixed interest rate for a set time, usually 10 years.

Like traditional option ARMs, fixed-option ARMs also offer several monthly payment options.

Understand negative amortization

Option ARMs' minimum-payment feature lets borrowers make a smaller payment on their mortgage during tight cash-flow months. They can catch up when their cash flow improves.

But when homeowners pay only the minimum payment, any unpaid amount is added to the loan's principal balance, thus increasing the amount that is owed against the home. This is known as negative amortization.

For some borrowers, negative amortization can be useful from a cash-flow-management perspective or as part of an overall investment strategy. This is particularly true if the money that is not applied to the monthly payment is directed to a high-yield stock or mutual fund or is used to support the self-employed borrower's own business. But negative amortization can create debt problems for borrowers whose property is located in an area with minimal property appreciation.

Who can benefit?

Option and fixed-option ARMs are not one-size-fits-all mortgage products. They tend to work best for nontraditional, sophisticated borrowers who want to manage their monthly cash flow. For those who fit the profile, it can be the key to owning their dream home while, at the same time, investing freed-up cash for financial-planning purposes. Those who have an irregular income because of commission-based salary, self-employment or seasonal employment also may benefit from the flexible monthly payments.

An option ARM or fixed-option ARM also may be a wise choice for people who are planning to live in their house for only a couple of years. For instance, a newly married couple who buy a starter home or a family who moves around the country because of frequent job transfers know they will not stay in the home until the mortgage is paid off. This changes their mortgage goals from establishing equity and toward affordable payments and low-interest rates.

A fixed-option ARM could be an especially good fit for these homeowners because it allows them to lock in a low interest rate for 10 years.

Not for everyone

Although option ARMs and fixed-option ARMs can offer some homeowners an attractive alternative to traditional fixed-rate mortgages, they are not right for everyone. In the past few years, they have gained attention after unscrupulous lenders used these products to qualify borrowers for mortgages for which they would not otherwise have qualified.

Homeowners should not take an option ARM or fixed-option ARM simply because it is the only way to qualify for financing to purchase a home. Doing so can be a prescription for

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Joseph Badal is senior executive vice president and chief lending officer of Thornburg Mortgage Inc., a single-family residential mortgage lender with $52.9 billion in assets focused principally on the jumbo sector of the adjustable-rate-mortgage market. Visit the company's Web site at www.thornburgmortgage.com or contact Badal via e-mail at lendingpartners@thornburgmortgage.com.

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disaster. And electing to take an option ARM or fixed-option ARM because they are convinced that their property value will only increase and never fall is simply foolish.

Allowing homeowners to use the flexible monthly payments to achieve their financial goals is one of the purposes of these products. But borrowers who only make the minimum monthly payment without making any additional payments against the loan balance can see negative long-term effects.