The 1% "OPTION ARM" MORTGAGE

The 1% option arm mortgage program is designed for clients who would like to **minimize their current monthly home mortgage payments** while at the same time **invest** the saved money for future retirement savings.

This program is **not** designed for home owners who are looking to reduce their monthly mortgage payments with an eye on paying off their home mortgage in the standard time frame 15-30 years.

The whole point of the 1% arm is to minimize current costs, which frees up money for investing.

The 1% option arm is a five year arm where the **payments** of the arm increase at the rate of 7.5% a year (see the following chart for an example).

At the end of the 5th year (or any time after the third year without a penalty), the client can re-finance the loan back into a 1% arm (or the client can keep the going interest rate on the loan or completely re-finance with any other loan program).

The numbers speak for themselves.

For the following example, assume a client (male, age 42) has a $400,000 mortgage on a home with a fair market value (FMV) of $500,000. The first chart shows what will happen to the client's home mortgage payments with a 1% arm vs. a 6% 30 year conventional loan. The amortization with the 1% arm is 40 years.

Option Arm Cash Flow Analysis	30 Year @ 6.000%	Option Arm @ 1.000%	Option Arm Cash Flow Over Other
Year 1	$28,778	$12,137	$16,641
Year 2	$28,778	$13,047	$15,731
Year 3	$28,778	$14,026	$14,753
Year 4	$28,778	$15,078	$13,701
Year 5	$28,778	$16,209	$12,570
5 Year Totals	**$143,892**	**$70,497**	**$73,395**

Remember that the client who is a candidate for the 1% arm is looking to lower the mortgage payments to as low as possible so the saved money can be invested. With the 1% arm, the client freed up **$73,395** of cash flow over the five year window.

If the client invested the money saved from lowering the mortgage and had a return of 8%, the client would have $93,993 built up at the end of the fifth year (see the following chart).

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Option Arm Investment Analysis	Equity Indexed Annuity @ 8.00%
Year 1	$17,972.64
Year 2	$36,399.99
Year 3	$55,244.69
Year 4	$74,460.87
Year 5	$93,993.03

In the example, I assumed a client used an indexed annuity as the investment which allows the money to grow tax deferred.

If the client at age 63 started taking money out of the indexed annuity, he would be able to take out $28,000 each year for 20 years (the growth above basis would be income taxed, thereby netting $18,450 a year after tax).

If the client took the money saved from the first five years and invested it into an equity indexed life insurance policy earning 7.9% a year, the client could take out of his life insurance policy $22,000 a year income tax free from age 63-82.

Remember the numbers above are simply from the savings on payments from the first five years. Also remember that the client is writing off the interest on the loan.

Equity Stripping

Would a client refinance a property if he could have payments on a 1% loan and invest the borrowed money in a tax favorable environment? Many would say YES.

Example: assume a client has a $1,000,000 home with no debt or very little debt. Assume the client decides to sell the home and buy a new home. In that process, assume that he removed $600,000 of equity from the sale of the home and invested it for retirement income later. Assume the client used the 1% option arm and is in the 40% tax bracket.

The following would be the interest payments on the loan for the first five years:

Option Arm Cash Flow Analysis	Option Arm @ 1.000%	Cost Out of Pocket After Tax
Year 1	$18,206	$10,923
Year 2	$19,571	$11,743
Year 3	$21,039	$12,623
Year 4	$22,617	$13,570
Year 5	$24,313	$14,588
5 Year Totals	$105,745	$63,447

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

If the client took the $600,000 and invested it returning 8% in an indexed annuity, the numbers would look as follows at the end of five years:

Year	Start of Year Balance	Contribution	8.00% Growth	Year End Balance
1	$600,000	$0	$48,000	$648,000
2	$648,000	$0	$51,840	$699,840
3	$699,840	$0	$55,987	$755,827
4	$755,827	$0	$60,466	$816,293
5	$816,293	$0	$65,303	$881,597

If the money continued to grow at 8% until the client reached age 63, he could take out $296,000 each year for 20 years. The client would pay income taxes on the amount above basis in each payment. After income taxes on the growth at 40%, the client would be left with $159,000 a year.

If the client invested the $600,000 into an equity indexed life insurance policy earning 7.9%, the client could take out of the life insurance policy **$191,000 income tax free** for 20 years starting at age 63.

So again, the question is, would you or your clients like to use a 1% arm to build wealth for retirement? Most clients with equity in their houses will say yes. Most clients will want to lower their current mortgage payments and invest the difference in order to build more wealth for retirement.

The Mechanics of the 1% Option Arm

As stated above, the 1% option arm is a five year arm where the **payments** of the arm increase at the rate of 7.5% a year (see the following chart for an example).

The main question everyone asks is whether the loan is really a 1% loan? The answer is that the payments a client pays over a five year period are based on a 1% introductory rate.

The ultimate rate charged to the client is however linked to a measuring index such as LIBOR or MTA. In addition to an interest rate linked to an index, there is a "margin" charged to the client. This creates a situation where there can be a "deferred interest payment" due at the end of the 5th year.

In this example, I will use the following numbers:

Loan amount = $250,000; Margin = 2.450%; LIBOR Index = 2.590% (02/18/2005)

"Fully Indexed" is the margin + index, i.e. 5.040%.

1% "Minimum Payment" arm: A starting minimum payment is calculated by using the loan amount over 30 years at the start rate (1.25% for example). This gives the first year minimum payment of $833.13. This is a "plug number" calculation, used just to determine the starting minimum payment, and not intended to provide amortization.

The "Minimum Payment" for the following year is calculated each year based on the "fully indexed" number on the anniversary date. However, the payment amount cannot change by more than 7.5% each year. This is the payment, not the interest rate. In the above example, the second year minimum payment could not be higher than $ 833.13 (+/-) 7.5% = $895.15, or lower than $770.65.

Additionally, if continued payment of the "minimum payment" results in "deferred interest", as in this case ($1,050.00 - $833.13 = $216.87/mo), the mortgage is "recast" every five years with a new "minimum payment" to keep it on track to reach a zero balance at the end of the original 30 year period. The annual "minimum payment" changes would more than likely prevent this from accumulating to a significant sum in a five year period.

What does the above mean? It means that a client will most likely have some sort of deferred interest payment due at the end of the 5th year. While initially, a client will not like the thought of a deferred interest payment, let's explore the logic behind the 1% arm.

What would the client normally have done? The client would have traditionally had a 6% 30 year mortgage. The client would have very high mortgage payments, thereby not freeing up extra money for investment.

With the 1% arm, the client freed up significant money to invest NOW, and the interest rate with even the worst case scenario would be lower than a traditional 30 year mortgage. If the client wanted to pay off the deferred interest he/she could do with the money that was saved and invested from lowering the mortgage payments the first five years (and the client will have money left over due to the nature of the program).

Real World Planning

In the real world when clients use this loan, they traditionally will refinance back into the 1% arm every 3-5 years. This keeps their payments to a minimum and allows the maximum amount of money to be used for investment purposes.

While a client could use the money saved and invested to pay the deferred interest, most clients, when they refinance, will refinance the deferred interest (if any) into the new 1% arm. This allows the invested money to grow and to be used for retirement when the time comes.

Remember that the client's home is appreciating at a minimum of 3.5% a year and in many parts of the country at 10%+ a year. So while the client's debt could increase when refinancing the home, the increase in equity more than offsets this debt.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Summary

From a financial standpoint (without emotion), the 1% arm is virtually a no lose proposition for clients. Money is borrowed at 1% and invested where, even in the worst case scenario over the long haul, the money should grow at 5% and more likely will grow at 8%.

Clients who can take the emotion out of the idea of paying down the debt on their home because it is better long term financially will gravitate to the 1% arm. Those clients will not only refinance current debt in order to free up investment dollars, but will also take equity out of their homes in order to build that retirement nest egg quicker.

If clients cannot objectively look at the numbers and will sleep better at night because they are paying off the debt on their homes, then they are not candidates to build wealth in an accelerated manner through the 1% arm.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)