

Financial Planning

The 1% Solution

Here's a new way to monetize real estate while still paying interest on a mortgage.

By Rocco DeFrancesco

September 1, 2005- There's a new product on the market that might be a good fit for clients who are looking to monetize their real estate. The 1% option adjustable rate mortgage (ARM) enables a client to minimize current monthly home-mortgage payments and invest the saved money to build up a retirement nest egg. This program is not designed for homeowners who want to reduce their monthly mortgage payments with an eye to paying off their mortgage in the standard 15-to-30-year time period.

The 1% option ARM is a five-year ARM in which payments increase at the rate of 7.5% a year. At the end of the fifth year (or any time after the third year without a penalty), the client can refinance the loan back into another 1% ARM. Alternatively, the client can keep the going interest rate on the loan- or refinance completely, using any other loan program.

Here's how the 1% ARM might work. Assume that a 42-year-old male client has a \$400,000 mortgage on a home with a fair market value (FMV) of \$500,000. The table on page 120 compares the client's mortgage payments on a 1% ARM with payments on a 30-year conventional loan at 6%. The amortization period for the 1% ARM is 40 years (yes, the program can amortize over 40 years).

How It Works

Here's the cash flow a 1% option ARM can generate on a \$400,000 mortgage.

| | 30-Year Mortgage at 6% | Option ARM at 1.0% | The Cash-Flow Difference |
|------------------|---------------------------------------|-----------------------------------|---|
| 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 |

With the 1% ARM, the client has freed up \$73,395 in cash flow over the five-year window. Financial planners can show their clients how to invest that money (typically in indexed annuities, life insurance or tax free bonds). If the money saved from lowering the payments returned 8%, at the end of the fifth year the client's investment would have grown to \$93,993. This assumes that the client invested the money in an tax-deferred indexed annuity. If the client let the money grow until he was age 63 and then started to make withdrawals, he could take out \$28,000 a year for 20 years (\$18,450 after tax).

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

Remember that the numbers in the table on page 120 are derived simply from the savings on payments during the first five years. And that whole time, the client is also writing off the interest on the loan.

EQUITY STRIPPING

Now assume that a client has a \$1,000,000 home with very little or no debt. The client decides to sell the house and buy a new one. He removes \$600,000 of equity from the sale and invests it for retirement income later on. Assume the client used the 1% option ARM and is in the 40% tax bracket.

The average cost to the client over the first five years, after deducting the interest payments in the 40% tax bracket, would be \$12,689 a year. If the client invested the \$600,000 in an indexed annuity returning 8%, he would have \$881,597 in the account. If the money continued to grow at 8% until the client reached age 63, he could take out \$296,000 a year for 20 years (\$159,000 after tax each year).

Alternatively, if the client invested the \$600,000 in an equity-indexed life insurance policy earning 7.9%, the client could take \$191,000 out of the life insurance policy tax free for 20 years starting at age 63 (assuming the client was healthy).

These are all ways clients could use a 1% ARM to build wealth for retirement. Even better, the 1% rate on the option ARM is a starting rate. The payments as illustrated in the table increase at 7.5% a year for five years.

At the end of the fifth year there is the potential for a deferred interest payment. Why? Because the ultimate interest that can be charged to the client is linked to a measuring index such as LIBOR or the monthly Treasury average. In addition, there's a margin charged to the client. This means there can be a deferred interest payment due at the end of the fifth year. The maximum increase of the loan is 110% of the initial loan. So if the loan is \$400,000, the maximum deferred interest charge is \$40,000.

If we took the \$400,000 refinance example and assumed a 3% LIBOR rate and a margin of 2.45%, the client in the first year still has a minimum payment of \$1,011 a month. However the fully indexed rate equals the margin plus LIBOR (2.45% + 3% = 5.45%). Therefore, the amount of interest that would be accruing in year one would be \$1,247 month (\$2,258 minus the \$1,011 minimum mortgage payment).

Remember that the client's payments are increasing each of the first five years and that the increased payment will be allocated against any deferred interest charge. At the end of the fifth year, the client can choose to pay the deferred interest or to roll that interest into a new 1% option ARM. Or, the client could refinance into a conventional 15- to 30-year loan, or else accept the interest rate on the current loan.

In this way, the 1% ARM can help clients raise capital for investing. If they invest wisely, they will have more than enough money to pay back the deferred interest. Most clients with property that appreciates at a rate between 3.5% and 10% a year will continue to refinance the deferred interest payment into a 1% ARM so the maximum amount of money can be invested for retirement. Also, remember that the client can write off the interest on the loan while the maximum amount of extra cash flow is invested in a tax-favorable environment (bond, annuities, life insurance).

With a 30-year conventional mortgage, the client would have an interest payment of approximately \$2,400 per month on a 6% loan (without taxes and insurance). But if you have clients that simply do not like debt, they are not candidates for this program. However, those companies that offer 1% option ARMs indicate that about 80% of their mortgage clients choose the 1% option ARM over the more traditional 15-to-30-year fixed programs.

BUYER BEWARE?

There are some caveats to this strategy. Due to the negative amortization structure that is built into the 1% ARM, the borrower will have a much higher loan balance at the end of five years. In fact, if the underlying loan rate is really 5.45%, the borrower's mortgage balance (which may be refinanced,

extended with a new 1% option, etc.), will have hit its ceiling of \$440,000, 10% more than the original \$400,000 starting balance.

This growing balance will need to be paid off eventually. In contrast, if the same client were making standard mortgage payments, the balance would have been paid down to about \$372,000.

There are also some risks planners should consider that are inherent to this loan structure. One is that the side investments could underperform the 8% return assumption. Meanwhile, the real estate itself may or may not have appreciated.

Planners might also want to consider the risk that there's a real estate bubble occurring right now, at least on a regional scale. If the property were actually worth 10% less in five years, (which is likely in a rising interest-rate environment that dampens demand for housing), the client could be saddled with a loan that exceeds the value of the house. In that case, clients would need to dig into the cash-flow savings just to pay off the mortgage if they wanted to move, because they would have negative equity in the home.

Nonetheless, the 1% option ARM does offer clients a new way to build wealth in a tax-favorable manner.

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