

## **Option ARM Loans – The Next Wave of Foreclosures**

The next wave of the mortgage meltdown is only starting to rear its ugly head and all early signs indicate that this is going to be even worse than the subprime mortgage collapse.

Understand that we are in the midst of a debt bubble, not simply a collapse fueled by the subprime market in which lower income Americans purchased overpriced homes using financing that never should have been offered to them. Welcome to the uglier side of things which is only in stage one at the moment. We now enter the Option ARM (also known as a negative amortization loan) recast period.

The Option ARM loan, originally created as the “Pick-A-Pay” loan some 20 years ago, became extremely popular in early 2000 as lenders fought to compete while home values were appreciating at unprecedented rates (especially in markets such as California, Florida and Arizona). With the bursting of the real estate bubble seemingly nowhere in sight, lenders were offering 100% financing with minimum payments based on rates as low as 1%, some even amortized over 40 years. Additionally, the Option ARM loan did not follow typical conforming loan amounts and was offered to borrowers with little or no verification of income or assets.

As crazy as it may seem, when properly utilized in a stable or appreciating markets, the Option ARM loan can be a valuable tool for real estate investors. Savvy and disciplined investors could maximize cash flow by making the minimum payment which allowed them to invest in markets with the potential of rapid appreciation. Unfortunately many unscrupulous lenders and mortgage brokers misrepresented this product and inexperienced investors and home owners had unrealistic expectations.

The time is fast approaching, what is referred to as the ‘recast period.’ In order to minimize the amount of potential negative amortization (this occurs by making the minimum payment and deferring interest which increases the principal balance of the loan), these loans automatically recast after five years, but many will recast sooner as loan balances hit specific maximum balance caps—typically between 110% and 125% of the initial loan amount.

Those accustomed to making the minimum (negative amortized payment) will now be faced with a fully amortizing principal and interest payment, at current interest rates, based on the remaining loan balance and term.

For Example: A \$300,000 loan with a minimum payment rate of 1.25% would have had a payment of \$964. When the loan recast in 5 years at lets say 110%, the loan amount would now be \$330,000, with an interest rate around 7.5% amortized over the remaining 25 years. The new payment would be approximately \$2450 per month.

The end result is many real estate investors will be position of huge negative cash flow, while unable to refinance or sell the property.

There are an estimated \$500 billion dollars in total Option ARM loans outstanding in the US scheduled to recast within the next few years. The majority of these loans are in California and other states hit hardest by plummeting property values. Many real estate investors and homeowners alike have already contemplated letting these properties go to foreclosure when the time comes. Considering the significantly higher loan amounts and more difficulty in selling these properties, the banks are not looking forward to this next wave and are willing to negotiate (see article on loss mitigation or call for more information – 303-770-4101).

