

Course Objective

This course was created to educate CPAs, accountants, EAs, attorneys, life insurance agents, and financial planners about mortgages. This course will cover the typical mortgages most clients purchase but, more importantly, this module will discuss the cash flow arm (option arm) mortgage program.

This course will teach advisors about the concept of equity harvesting (taking out more debt through a mortgage where that money is invested to create a sizable retirement benefit) and the opposite program which is to show clients how to pay off their mortgage in the fewest years possible.

Finally, advisors will be educated on how mortgages can be incorporated into their practice as a tool to help existing clients, attract new clients, and generate significant additional income for advisors.

Mortgages

Help your clients and build a more profitable practice through the use of mortgages

Introduction

Many advisors wondered why an “advanced” planning certification course needs to cover a topic that sounds as simple as mortgages? Isn’t it true that nearly every client and advisor reading this module who is over the age of 50 has had a mortgage and probably several mortgages during their lifetime.

Most clients and advisors at one time or another have researched the various options for a traditional home mortgage. Isn’t it true that most clients and advisors know the basics about 30-year and 15-year amortization mortgages sold by local banks or mortgage brokers? Isn’t it true that most clients and advisors have heard of 1-, 3-, 5-year adjustable rate mortgage (ARM) programs? Isn’t it true that most clients and advisors have heard of interest-only loans? While not everyone is familiar with loans with the interest pegged to the London Inter Bank Offering Rates (LIBOR), many are.

Don’t most clients know how to pay off their mortgage in X years instead of 30 years on a 30-year amortization mortgage? Sure—simply make an extra payment each year, and you turn a 30-year mortgage into a 24 year and change mortgage.

If the above is true, why do we need an education module on mortgages? Because there is so much more clients and advisors are not familiar with and this module covers several useful and not well known issues.

Most clients and advisors are not familiar with:

- 1% cash flow arm mortgage program
- Equity Harvesting
- 40-year amortization loans
- MTA, COFI, COID loans
- How to pay off a mortgage in X years (less years) instead of 30 years WITHOUT making any extra payments.
- How advisors also can make literally hundreds of thousands of dollars each year by selling mortgages to clients.

Conventional Loans

While this module focuses on “advanced” planning, the basics of conventional mortgages need to be discussed. Conventional mortgages are the typical 30- and 15-year amortization mortgages as well as the 1-, 3-, 5-year adjustable rate mortgages (ARMs).

*Side Note: Unless specifically stated, the material in this module explains mortgages in the context of home/residential mortgages (not commercial).

Amortization schedules

It is absolutely amazing how the American public views amortization schedules when it comes to a home loan.

See if the following sounds like a typical conversation you would have with a client.

Advisor: Jim, I understand you just re-financed your home?

Jim: Yes I did.

Advisor: What kind of loan did you end up going with?

Jim: I went with a 15-year amortization mortgage.

Advisor: Really, why? Doesn't that increase your mortgage payments?

Jim: Well, the 15-year mortgage had a slightly lower interest rate (6% instead of 6.5%), and I can pay off my house in 15 years instead of 30.

Advisor: Ok, I guess that makes sense.

Does that make sense to you?

Protecting the client

Certified Wealth Preservation Planners (CWPP™) and Certified Asset Protection Planners (CAPP™) are supposed to “protect” their clients and, if possible, show them a way to build wealth in the most tax-favorable manner possible. Master Mortgage Brokers (MMBs™) while not asset protection specialists should know mortgages better than anyone in the country and should be able to provide the best advice to their clients when it comes to residential or commercial mortgages.

Do you see a protection problem for Jim?

What happens if Jim in the above conversation becomes disabled? What if he was an executive at GM or Ford in a period of downsizing and Jim lost his job? The answer is that Jim will have a significant drop in income (maybe to zero). If this happens to Jim, what does he think about his 15-year amortization loan?

Jim will curse the banker or mortgage broker who suggested a 15-year loan instead of a 30-year loan.

But the client really wanted a loan where he could pay off the home in 15 years instead of 30 years, and we all know the odds are Jim is not going to get laid off or become disabled. What’s the big deal?

The big deal is that the client should have been counseled as follows:

CWPP™, CAPP™ and/or MMB™ Advisor: “Jim, I wanted to explain to you how mortgages work. If you obtain a 30-year mortgage and want to pay off your home in 15 years, you simply have to make monthly payments just as if you had a 15-year mortgage.

For example, if you have a mortgage of \$400,000, the payments for a 30-year amortization would be: \$2,528 a month if the interest rate was locked at 6.5%.

If you had a 15-year amortization loan, your monthly payments would be \$3,375 a month if the interest rate was locked at 6%.

Jim, I also wanted to let you know that there are also loans that can be amortized over 40 years; and I thought you might want to look at the numbers. If you had a 40-year amortization loan, your monthly payments would be \$2,200 a month.

So Jim, can you confirm that you understand that, if you go with a 30- or even a 40-year amortization schedule, you can still pay a \$2,538 payment which will pay off your house in 15 years.

Jim's response should be a simple: Yes, I do understand and thank you for helping me purchase a mortgage that also protects me should I run into financial troubles.

Types of Mortgages

As stated above, most clients and advisors know certain types of mortgages typically sold by their local bank or mortgage broker. Most simply, think of 15- and 30-year conventional mortgages. Because this education module is supposed to set you apart from other advisors, we will categorize mortgages as they do in the mortgage business. This will allow you to “talk turkey” with a mortgage broker (which is important as you want to be the team leader when helping your clients (or help you be the mortgage broker for your clients (which The WPI recommends)).

All mortgage plans can be divided into categories in two different ways. First: conventional and government loans. Second: all the various mortgage programs may be classified as fixed-rate loans, adjustable-rate loans, and their combinations.

Conventional and Government Loans

Any mortgage loan other than an FHA, VA, or an RHS loan is a **conventional** loan.

FHA Loans

The Federal Housing Administration (FHA), which is part of the U.S. Department of Housing and Urban Development (HUD), administers various mortgage loan programs. FHA loans cannot exceed the statutory limit (which varies per state and caps out at \$261,609).

The FHA loan program was created to help increase home ownership. The FHA program makes buying a home easier and less expensive than other types of real estate mortgage home loan programs. Some highlights of the FHA loan program are:

Minimal Down Payment and Closing Costs.

- a) Down payment less than 3% of Sales Price
- b) 100% financing options available*
- c) Gift for down payment and closing costs allowed
- d) No reserves are required
- e) FHA regulated closing costs
- f) Seller can credit up to 6% of sales price towards buyers costs

Easier Credit Qualifying Guidelines such as:

- g) No minimum FICO score or credit score requirements
- h) FHA will allow a home purchase **two** years after a **Bankruptcy**
- i) FHA will allow a home purchase **three** years after a **Foreclosure**

Easier Debt Ratio & Job Requirement Guidelines such as:

- j) Higher Debt Ratio's than other home loan programs
- k) Less than two years on the job is allowed
- l) Self-Employed individuals o.k.

* Except Alaska, Hawaii, Guam, and the Virgin Islands where the limit is adjusted 150% to \$555,147

These advantages of the FHA loan program has made it one of the best options for most first-time home buyers as well as move-up home buyers.

The greatest disadvantage of FHA home loans is the upfront mortgage insurance premium (MIP). On a 30- or 15-year FHA home loan, that equals to 1.50% of the loan amount in addition to the 0.5% annual renewal premium that a borrower will pay for the life of the loan. In addition, FHA limits the amount a borrower can borrow.

VA Loans

VA loans are guaranteed by U.S. Department. of Veterans Affairs. The guaranty allows veterans and service persons to obtain home loans with favorable loan terms, usually without a down payment. In addition, it is easier to qualify for a VA loan than a conventional loan. Lenders generally limit the maximum VA loan to \$203,000. The U.S. Department of Veterans Affairs does not make loans—it guarantees loans made by lenders. VA determines your eligibility; and, if you are qualified, VA will issue you a certificate of eligibility to be used in applying for a VA loan. VA-guaranteed loans are obtained by making application to private lending institutions.

RHS Loan Programs

The Rural Housing Service (RHS) of the U.S. Department of Agriculture guarantees loans for rural residents with minimal closing costs and no down payment.

Ginnie Mae, which is part of HUD, guarantees securities backed by pools of mortgage loans insured by these three federal agencies - FHA, VA, or RHS. Securities are sold through financial institutions that trade government securities.

State and Local Housing Programs

Many states, counties, and cities provide low-to-moderate housing finance programs, down-payment assistance programs, or programs tailored specifically for a first-time buyer. These programs are typically more lenient on the qualification guidelines and often designed with lower upfront fees. Also, there are often loan assistance programs offered at the local or state level such as MCC (Mortgage Credit Certificate) which allows you a tax credit for part of your interest payment. Most of these programs are fixed rate mortgages and have interest rates lower than the current market.

Conforming Loans

Conventional loans may be conforming and non-conforming. Conforming loans have terms and conditions that follow the guidelines set forth by Fannie Mae and Freddie Mac. These two stockholder-owned corporations purchase mortgage loans complying with the guidelines from mortgage lending institutions, packages the mortgages into securities, and sell the securities to investors. By doing so, Fannie Mae and Freddie Mac, like Ginnie Mae, provide a continuous flow of affordable funds for home financing that results in the availability of mortgage credit for Americans.

Fannie Mae and Freddie Mac guidelines establish the maximum loan amount, borrower credit and income requirements, down payment, and suitable properties. Fannie Mae and Freddie Mac announce new loan limits every year.

Conforming loan limits may adjust annually. The conforming loan limits adjustments are based on the October-to-October changes in the mean (average) home price as published by the Federal Housing Finance Board (FHFB). The FHFB figures come from its monthly survey of lenders. Both new and existing homes are included in the survey.

Property Type	2006 Loan Limit (Except for AK, HI, GU & VI)	2005 Loan Limit (Except for AK, HI, GU & VI)	2006 Loan Limit for AK, HI, GU & VI	2005 Loan Limit for AK, HI, GU & VI
1-unit	\$417,000	\$359,650	\$625,500	\$539,475
2-unit	\$533,850	\$460,400	\$800,775	\$690,600
3-unit	\$645,300	\$556,500	\$967,950	\$834,750
4-unit	\$801,950	\$691,600	\$1,202,925	\$1,037,400

The maximum amounts for one-to-four-family mortgages and second mortgages in Alaska, Hawaii, Guam and the U.S. Virgin Islands are 50 percent higher than the limits for the rest of the country.

Jumbo Loans

Loans above the maximum loan amount established by Fannie Mae and Freddie Mac are known as "jumbo" loans. Because jumbo loans are bought and sold on a much smaller scale, they often have a little higher interest rate than conforming; but the spread between the two varies with the economy.

B/C Loans

Loans that do not meet the borrower credit requirements of Fannie Mae and Freddie Mac are called 'B','C' and 'D' paper loans vs. 'A' paper conforming loans. B/C loans are offered to borrowers who may have recently filed for bankruptcy, foreclosure, or have had late payments on their credit reports. Their purpose is to offer temporary financing to these applicants until they can qualify for conforming "A" financing. The interest rates and programs vary based upon many factors of the borrower's financial situation and credit history.

Fixed-Rate Mortgages

With fixed rate mortgage (FRM) loans, the interest rate and the mortgage monthly payments remain fixed for the period of the loan. Fixed-rate mortgages are available for 30, 25, 20, 15 years and 10 years. Generally, the shorter the term of a loan, the lower the interest rate you could get. Some lenders will go out 40 years on the amortization which is important to many clients (and no known to many advisors).

As discussed earlier, the most popular mortgage terms are 30 and 15 years. With the traditional 30-year fixed rate mortgage, your monthly payments are lower than they would be on a shorter term loan. But if you can afford higher monthly payments, a 15-year fixed-rate mortgage allows you to repay your loan twice as fast and save more than half the total interest costs of a 30-year loan. We at The WPI do not recommend shorter term loans because it is not a way to asset protect a client in the event of financial hardship.

The payments on fixed-rate fully amortizing loans are calculated so that, at the end of the term, the mortgage loan is paid in full. During the early amortization period, a large percentage of the monthly payment is used for paying the interest. As the loan is paid down, more of the monthly payment is applied to principal.

With bi-weekly mortgage plan, you pay half of the monthly mortgage payment every 2 weeks. It allows you to repay a loan much faster. For example, a 30-year loan can be paid off within 24.7 years with a 6% interest rate. This topic is covered in full detail in the MMB™ certification course.

Balloon Loans

Balloon Loans are short-term, fixed-rate loans that have fixed monthly payments based usually upon a 30-year fully amortizing schedule and a lump sum payment at the end of its term. Usually, they have terms of 3, 5, and 7 years.

The advantage of this type of loan is that the interest rate on Balloon Loans is generally lower than 30- and 15-year mortgages resulting in lower monthly payments. The disadvantage is that at the end of the term you will have to come up with a lump sum to pay off your lender either through a refinance or from your own savings.

Balloon Loans with refinancing option allow borrowers to convert the mortgage at the end of the balloon period to a fixed rate loan based upon the outstanding principal balance if certain conditions are met. If you refinance the loan at maturity, you need not be re-qualified nor the property re-approved. The interest rate on the new loan is a current rate at the time of conversion. There might be a minimal processing fee to obtain the new loan. The most popular terms are 5/25 Balloon, and 7/23 Balloon.

Adjustable Rate Mortgages (ARMs)

Variable or adjustable loan is a loan whose interest rate, and accordingly monthly payments, fluctuate over the period of the loan. With this type of mortgage, periodic adjustments based on changes in a defined index are made to the interest rate. The index for this particular loan is established at the time of application.

Well known indexes include:

- Constant Maturity Treasury (CMT)
- Treasury Bill (T-Bill)
- 12-Month Treasury Average (MTA)
- 11th District Cost of Funds Index (COFI)
- London Inter Bank Offering Rates (LIBOR)
- Certificates of Deposit (CD) Indexes
- Prime Rate

“Margin”

It is vitally important for advisors to understand what a margin is and how it is used in ARMs. The margin is where the lender is typically making its money. The lender will procure funds pegged to an index (like LIBOR) and then will add to that a “margin” which is really code for profit margin.

The margin is fixed percentage points added to the index to compute the interest rate. The result will then be rounded to the nearest one-eighth of a percent.

Example:

If the index is 5.3% and the margin is 2.5%, then the new interest rate = $5.3\% + 2.5\% = 7.8\%$. The nearest to 0.8% is 0.75% = 6/8%. The result will be 7.75%.

The margins remain fixed for the term of the loan and are not impacted by the financial markets and movement of interest rates. Lenders use a variety of margins depending upon the loan program and adjustment periods.

Most ARMs have interest rate caps to protect clients from enormous increases in monthly payments. A lifetime cap limits the interest rate increase over the life of the loan. A periodic or adjustment cap limits how much interest rates can rise at one time.

Examples:

1. The initial interest rate is 4.5%, the index is 7%, and the margin is 3%, then the new interest rate = $7\% + 3\% = 10\%$. If the lifetime cap is 5%, then the actual new interest rate will be $4.5\% + 5\% = 9.5\%$.

2. The initial interest rate is 6%, the index is 5%, and the margin is 3%, then the new interest rate = $5\% + 3\% = 8\%$. If the periodic cap is 1%, then the actual new interest rate will be $6\% + 1\% = 7\%$.

The mortgage disclosure form will show the exact index, to be used, whether the weekly or monthly value applies, the lead time for the index, the margin, and any caps.

Negatively amortizing loans

Some types of ARMs offer payment caps rather than interest rate caps, which limit the amount the monthly payment can increase. If a loan has a payment cap but has no periodic interest rate cap, then the loan may become negatively amortized. If the interest rates rise to the point that the monthly

mortgage payment does not cover the interest due, any unpaid interest will get added to the loan balance so the loan balance increases. **However, you always have the option to pay the minimum monthly payment or the fully amortized amount due.**

Example:

Your loan has a payment cap of 7.5%. If your payment is \$1,000 per month and interest rates rise, your new payment would normally be \$1,200/mo (for example) but your capped payment is only \$1,075. The other \$125 gets added to your loan balance to be paid off over time unless, of course, you decide to pay that additional amount now.

The advantage of negatively amortizing loans is that you can control cash flow (relatively stable payment), take advantage of low interest rates relative to the market at any given time, and pay back the money borrowed today at a depreciated value years from now (because of natural inflation). This makes such loans a great tool for homeowners as long as you understand the mechanics of what's going on.

With most ARMs, the interest rate can adjust every six months, once a year, every three years, or every five years. The interest rate on negatively amortized loans can adjust monthly. A loan with an adjustment period of 6 months is called a 6-month ARM, an adjustment period of 1 year is called a 1-year ARM, and so on.

Most ARMs offer an initial lower interest rate than the fully indexed rate (index plus margin) during the initial period of the loan, which could be one month or a year or more. It is also known as teaser rate.

All ARMs are available with 30-year terms and some with 15-year terms. Adjustable Rate Mortgages generally have a lower initial interest rate than fixed rate loans.

Indexes

Constant Maturity Treasury (CMT) Indexes

These indexes are the weekly or monthly average yields on U.S. Treasury securities adjusted to constant maturities*. Yields on Treasury securities at "constant maturity" are interpolated by the U.S. Treasury from the daily yield curve, which is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market.

* Constant Maturity Treasuries is a set of "theoretical" securities based on the most recently auctioned "real" securities: 1-, 3-, 6-month bills, 2-, 3-, 5-, 10-year notes, and also the 'off-the-runs' in the 7- to 20-year maturity range. The Constant Maturity Treasury rates are also known as "Treasury Yield Curve Rates".

The CMT indexes are volatile and move with the market. They reflect the state of the economy and respond quickly to economic changes. These indexes react more slowly than the CD index but more quickly than the COF index or the MTA index.

1-Year Constant Maturity Treasury index (1 Yr CMT)

This is the most widely used index. Roughly half of all ARMs are based on this index. It's used on ARMs with annual rate adjustments. It is also referred to as the 1-Year Treasury Bill (1 Yr T-Bill), the 1-Year Treasury Security (1 Yr T-Sec), or the 1-Year Treasury Spot index.

3-Year Constant Maturity Treasury index (3 Yr CMT)

This index is less popular than the 1-Year CMT. ARMs based on the 3-Year CMT will adjust every three years (3 Yr ARMs).

5-Year Constant Maturity Treasury index (5 Yr CMT)

Same as the 3-Year CMT, but ARM loans indexed to the 5-Year CMT will adjust once every five years (the ARM's adjustment period is usually the same as the security's constant maturity).

Treasury Bill (T-Bill) Indexes

These indexes are based on the results of auctions that the U.S. Treasury holds for its Treasury bills, notes, and bonds. Treasury bills are issued by the U.S. government with maturities of 1, 3, and 6 months (4-week, 13-week, 26-week bills or 28-day, 91-day, 182-day bills) in order to pay for the national debt and other expenses. The 3- and 6-month Treasury bills are auctioned every Monday, and the resulting figures are released to the public the next day. Treasury bill auction results provide the discount rate*, investment yield, and price for recently auctioned bills.

* The discount rate is an annualized rate of return based on the par value of the bills and is calculated on a 360-day basis. The investment yield, or coupon-equivalent yield, is calculated on a 365-day basis and is an annualized rate based on the purchase price of the bills and reflects the actual yield to maturity.

Treasury bills can be bought at original issue or on the secondary market. At original issue, the Treasury Department sells new securities to the public. On the secondary market, traders buy and sell previously issued securities.

Following is the definition of the weekly 6-Month T-Bill index (Auction High):

The Weekly 6-Month T-Bill (Auction High) Mortgage (ARM) Index is the discount rate for the 26-week Treasury Bill bought at original issue (at the most recent auction of U.S. Treasury bills).

T-Bill indexes have both weekly and monthly values. Monthly values are averages of the past month's weekly T-Bill rates.

The monthly 6-Month Treasury Bill index (6-MoT-Bill) is the most often used. ARMs tied to the 6-Month T-Bill usually adjust once every six months.

The Treasury Bill indexes move with the market and respond quickly to economic changes like the CMT indexes. The following graph reflects the movement of the 3- and 6-Month monthly Treasury Bills and compares them with the monthly 1-Year CMT index.

12-Month Treasury Average (MTA)

The Monthly Treasury Average, also known as 12-Month Moving Average Treasury index (MAT) is a relatively new ARM index. This index is the 12-month average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. It is calculated by averaging the previous 12 monthly values of the 1-Year CMT. Because this index is an annual average, it is steadier than the 1-Year CMT index. The MTA and CODI indexes generally fluctuate slightly more than the 11th District COFI, although its movements track each other very closely as illustrated on our historical graph.

11th District Cost of Funds Index (COFI)

This index reflects the weighted-average interest rate paid by 11th Federal Home Loan Bank District savings institutions for savings and checking accounts, advances from the FHLB, and other sources of funds. The 11th District represents the savings institutions (savings & loan associations and savings banks) headquartered in Arizona, California, and Nevada.

Since the largest part of the Cost Of Funds index is interest paid on savings accounts, this index lags market interest rates in both uptrend and downtrend movements. As a result, ARMs tied to this index rise (and fall) more slowly than rates in general, which is good for if rates are rising but not good for if rates are falling.

It should be noted that, although COFI generally follows trends in market rates, it can move in an opposite direction over the near term.

The COFI is one of the most widely used Option ARM indexes.

London Inter Bank Offering Rates (LIBOR)

London Inter Bank Offering Rate (LIBOR) is an average of the interest rate on dollar-denominated deposits, also known as Eurodollars, traded between banks in London. The Eurodollar market is a major component of the international financial market. London is the center of the Euromarket in terms of volume.

The LIBOR is an international index which follows the world economic condition. It allows international investors to match their cost of lending to their cost of funds. The LIBOR compares most closely to the 1-Year CMT index and is more open to quick and wide fluctuations than the COFI rate.

There are several different LIBOR rates widely used as ARM indexes: 1-, 3-, 6-Month, and 1-Year LIBOR. The 6-Month LIBOR is the most common.

LIBOR-indexed ARMs offer borrowers aggressive initial rates (lower than many other ARMs) and has proved to be competitive with such popular ARM indexes as the 11th District Cost of Funds, the 6-Month Treasury Bill, and the 6-Month Certificate of Deposit. With the LIBOR, ARM borrowers are generally protected from wide fluctuations in interest rates by periodic and lifetime interest rate caps. LIBOR ARMs usually do not have negative amortization.

Certificates of Deposit (CD) Indexes

These indexes are averages of the secondary market interest rates on nationally traded Certificates of Deposit. The Certificates of Deposit, also known as CDs, are usually issued by banks and other financial institutions. They pay a fixed rate of interest for a specific period of time.

The Certificates of Deposit of various maturities, including 1-Month, 3-Month, 6-Month and 1-Year, are used as ARM indexes. The 6-Month Certificate of Deposit (6-Mo CD) is the most popular of the CD indexes.

The 12-month moving average of the monthly 3-Month CD is called CODI.

Prime Rate

The Prime Rate is the interest rate charged by banks for short-term loans to their most credit-worthy customers whose credit standing is so high that little risk to the lender is involved. Only a small percentage of customers qualify for the

prime rate, which tends to be the lowest going interest rate and thus serves as a basis for other, higher risk loans.

The rate is almost always the same amongst major banks. Adjustments to the prime rate are made by banks at the same time; although, the prime rate does not adjust on any regular basis. The prime rate is not a very volatile index; however, it generally rises quickly but declines very slowly.

Many home-equity loans and lines of credit are tied to the prime rate as published in the Wall Street Journal. The Journal number is derived from the rate posted by at least 75 percent of the 30 largest U.S. banks.

Should clients pay off their mortgages?

This is the age old question—should a client pay off their mortgage or keep debt on the house long term while investing the saved money in something tax favorable for retirement.

While it might make sense to deal with this topic at his juncture of the material, we instead deal with it near the end of the material when we discuss equity harvesting.

The Cash Flow Arm Mortgage

There are a number of “option arm” mortgages in the marketplace.

This section of the material is meant to deal with what we call the “cash flow” arm mortgage, also known as the 1% CFA mortgage program.

It should be noted that while the mortgage is sometimes called the “1%” CFA, the 1% number varies per lender and can go up periodically depending on a number of variables in the mortgage marketplace. For purposes of this material, it will be called the 1% CFA mortgage.

1% Cash Flow Arm Mortgage

The 1% CFA 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 homeowners who are looking to reduce their monthly mortgage payments with an eye on paying off their home mortgage in the standard time frame of 15-30 years.

This cannot be stressed enough. Certified advisors through The WPI are not supposed to use this powerful loan to help clients buy houses they really can't afford because the initial mortgage payments are low. This is a recipe for disaster and will subject certified advisors to the stripping of their credential(s).

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

The 1% CFA is a five-year ARM where the **payments** of the ARM can (but don't have to) increase at the rate of 7.5% a year (see the following chart for an example).

At the end of the 5th year, 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). Technically speaking, the client can re-finance anytime after the third year without penalty. Also, the client can choose to pay a higher interest rate if he/she wants to have a no pre-payment penalty.

The numbers on investing will be discussed below in the section on Equity Harvesting.

Mechanics of the 1% CFA Mortgage

As stated earlier, the 1% option ARM is a five-year ARM where the **payments** of the ARM can, but do not have to, 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 that linked interest rate, 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.

Let's look at an example using the following numbers:

Loan amount = \$250,000; Margin = 2.450%; LIBOR Index = 5.25%

"Fully Indexed" is the margin + index, i.e., 7.70%.

1% "Minimum Payment" arm: A starting minimum payment is calculated by using the loan amount over 30 years at the start rate. This gives the first year minimum payment of \$804.10. 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 \$804.10 (+/-) 7.5% = \$864.40 or lower than \$743.79.

Side note: Like with any mortgage, the client can choose each month what payment to make towards the loan. The client could make an interest-only payment which would guarantee that there would be no deferred interest. The client could choose to pay it as if it were a 15-year loan. Obviously, the reason the client chose this loan was so money could be invested; but it is important to know that the client (short of paying off the loan in full) can make payments above the minimum.

Additionally, if continued payment of the “minimum payment” results in “deferred interest” as in this case ($\$1,604.00 - \$804.10 = \$800.07/\text{mo}$), 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.

	30 Year	Option Arm	Option Arm
Option Arm	@	@	Cash Flow
Cash Flow Analysis	6.000%	1.250%	Over Other
Year 1	\$17,987	\$9,649	\$8,337
Year 2	\$17,987	\$10,373	\$7,614
Year 3	\$17,987	\$11,151	\$6,836
Year 4	\$17,987	\$11,987	\$5,999
Year 5	\$17,987	\$12,886	\$5,100
5 Year Totals	\$89,933	\$56,046	\$33,886

The following is what the deferred interest would look like if the rates stayed the same throughout the five-year window.

Minimum	Interest only		
Monthly Payment	loan balance	Deferred interest	Deferred interest
	x fully indexed rate	month	Year
\$804.10	\$1,604	\$800.07	\$9,600.81
\$864.41	\$1,604	\$739.76	\$8,877.13
\$929.24	\$1,604	\$674.93	\$8,099.16
\$998.93	\$1,604	\$605.24	\$7,262.85
\$1,073.85	\$1,604	\$530.32	\$6,363.81
		\$3,350.31	\$40,203.76

To calculate the potential deferred interest, you simply take the **minimum payment** (\$804.10 in year one in the example) and subtract that from the **interest only** payment (which is calculated by taking the fully indexed rate (which is 7.7% in our example) and multiplying that by the loan balance).

As you can see by the above numbers, there was deferred interest the first four years; and as the minimum payment went up, the last year the payment actually paid down the deferred interest charge.

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 that 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).

You may believe the above is complicated, and it kind of is. What you need to know is that 95%, maybe 98%, of the mortgage consultants selling this loan have little idea how it works. If you go over it and understand this material, you will get it and, therefore, will be able to give fully informed advice to your clients.

Investing the money saved by lowering current mortgage payments

With the 1% CFA, remember that we lowered the client's current mortgage payments; and we have a client who is disciplined enough to invest that money for wealth building. When doing so, 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% CFA 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 to invest.

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).

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, it was assumed that the 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. Life insurance is discussed in more detail in the upcoming section on Equity Harvesting.

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.

Real World Planning

In the real world when clients use this loan, they traditionally will refinance back into the 1% CFA 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 should be 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. If the client lives in a part of the country where property is decreasing in value, that needs to be taken into consideration when deciding if the 1% CFA is the proper loan.

Equity Harvesting (also known as equity stripping)

Have you ever heard of the book "Missed Fortune" by Doug Andrews? It's become a best selling book that those who know little about the subject matter think is a great book.

Mr. Andrews in a long drawn out and not so clear manner (in The WPI's opinion) tries to explain equity harvesting in his book. While this material cannot cover equity harvesting in a complete manner, you will learn about the basics in a way that will help you know and understand the truth about the topic, the pros and cons, and why the topic can be a terrific wealth building tool for many clients.

To become an expert in mortgages and equity harvesting, you should consider taking the Master Mortgage Broker (MMB™) certification course.

Why would a client want to equity harvest?

Would a client refinance a property if he could have starting payments based on a 1% loan? Would it help if the client could invest the borrowed money in a tax favorable environment? Many would say YES. (Most advisors are not aware of the 1% CFA and, typically, will pitch this topic using an interest-only loan ARM).

That's the essence of equity harvesting. Clients have been told for years to buy 30-year mortgages and pay them off as quickly as possible. Why? Does it make good financial sense? The answer is—it depends.

It is vitally important to qualify the client when looking at equity harvesting (which is different than simply using the 1% CFA to lower a client's mortgage payments so money can be freed up for investing).

With equity harvesting, you will be telling your client to withdraw \$25,000, \$100,000, \$250,000, and sometimes \$500,000 or more in equity from their homes so that money can be re-invested in something tax favorable.

Why?

To build wealth in the most efficient manner possible using an asset that has "dead equity." What is dead equity? It is equity in the home that is not being used for investment purposes. It's sitting there, and so people use the term dead equity.

Understand that the client's home is going to appreciate each year at 2%, 5%, 10%+ sometimes, and it will do so no matter if the house has debt on it or not. Think about that for a minute.

Then the question for the client is: Can the equity in the house which is not being used for investment purposes be used in a better manner?

Many times the answer is yes.

The classic response

What is the classic response you'll get from clients when discussing this topic? The equity in their home is making them money because they are not paying interest on the loan to a bank. That's correct, but then you have to look at the numbers.

The client thinks that, when they have a 6% loan on their home, their equity is making them 6% a year as an investment. So the client would say: I've paid down my home \$100,000 over the last 10 years and this year, because I don't have to pay interest at 6% on that \$100,000 of equity, I really made \$6,000 this year. Wrong.

The interest on the home loan is **deductible**. Assuming the client is in the 40% income tax bracket, IF the client had to pay interest on the loan, the cost would not have been \$6,000, but instead would have been \$3,600 out of pocket. Therefore, the client only made 3.6% on their money (and it is not compounding every year because the client isn't really investing it every year).

Real World

As anyone who read The WPI's material, you will know that it is grounded in real-world advice and what really happens and not what a non-real world planner says might or could happen on paper.

In the above example, does the client think that he/she is saving \$6,000 (or in the real world \$3,600) a year by not having a mortgage on that extra \$100,000 of equity? No. Does the client invest the saved money in anything (let alone something tax favorable)? No. The client does nothing and simply pays down the debt on a home which does not help him/her accelerate wealth building in a tax favorable manner.

Interest deduction

The interest deduction for higher income clients is one of their most powerful tax planning tools. The IRS allows for a massive deduction for the home mortgage. If that's the case, why are we all in such a hurry to pay down a debt on an asset that provides us one of our biggest tax breaks? The answer is simple—because clients and their advisors are not educated on the topic of equity harvesting.

There is a whole educational section on the interest deduction with mortgages in the Master Mortgage Broker (MMB™) certification course. For purposes of this material, what you need to know is quite simple.

Interest on debt on a new house up to 1 million dollars is 100% tax deductible.

If a client takes out a home equity loan or re-finances a home and take out more than \$100,000 of equity, the interest deduction is limited to debt on the first \$100,000 of removed equity.

Most people “selling” equity harvesting ignore this issue. Most will not tell the client and let them send the entire interest deduction to their CPA/accountant for the full write off.

While in the real world, the CPA/accountant probably won't know any better and will write off the entire amount of interest, that's not what you want to advise your clients. You want to tell them the truth, and they can make the decision for what they will tell their CPA/accountant.

So doesn't the interest deduction limit the viability of this topic? It could, but it doesn't have to.

By the way, to show you the ridiculous nature of the tax code, if a client who has more than \$100,000 of equity in their home sells the home, invests all the proceeds from the sale, and then buys a new home with debt above \$100,000, the ENTIRE interest payment is deductible. So a client could sell a \$600,000 home with no debt, invest that money in something tax favorable, and buy a new \$600,000 home with \$600,000 in debt and write off the entire interest payment.

Not for everyone

While the arguments in this material for why clients should use equity harvesting are very powerful, the concept is not for everyone. If a client will sleep better at night knowing he/she does not have a home mortgage payment, then it is worth foregoing the wealth building to have that peace of mind.

Having said that keeping debt on a personal residence is not for everyone, it is important to think about not only the wealthy but also the middle class.

Again, the conventional wisdom is to pay off your house as soon as possible so you can be “debt free.” Being debt free makes you feel good, but is it the best thing to be especially when it comes to the personal residence?

See if this sounds familiar—If you are debt free and have financial problems, you can borrow against your house in a short-term cash crunch.

What’s the problem with the previous sentence? If the client loses his/her job and has no income, how much money is a bank going to lend to such person? Maybe nothing. But the client has \$200,000 in equity in the home. That’s true, but there is NO income to make the payments.

What’s the other problem? Again, think of the people who lost their homes in the hurricane. Can they borrow against their homes? No. So not only do many of those people not have jobs, they have no home to borrow against. What’s worse is that the banks who hold mortgages on those homes with equity expect to have the home mortgage payment due even though the house is no longer there or is totally ruined.

How much protection did having equity in their house afford those clients? NONE.

Would the client have been better off keeping debt on the home and investing the money somewhere else in a tax favorable manner? Absolutely.

The point with some of this material is to let readers know that the topic is not that simple, and different clients can and should receive different advice.

Getting to the numbers behind equity harvesting

Would a client refinance a property if he/she could have payments based on a 1% start rate where the borrowed money is invested 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% cash flow program and is in the 40% tax bracket.

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

Cash flow Cash Flow Analysis	Payments Starting @ 1.00%	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

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% a year, the client could take out of the life insurance policy **\$191,000 income tax free** for 20 years starting at age 63 (plus the client would have a sizable death benefit to protect the family). The following is an example of what you would see from a life insurance illustration based the life of this particular example client. The illustration will obviously look better or worse depending on the investment returns. This particular illustration comes from using an indexed equity life insurance policy where the growth is pegged to the S&P 500 index.

Age	Tax Free Loans	Cash Surrender Value	Death Benefit
63	\$193,000	\$2,099,000	\$2,639,000
64	\$193,000	\$2,068,000	\$2,607,000
65	\$193,000	\$2,035,000	\$2,552,000
66	\$193,000	\$1,999,000	\$2,531,000
67	\$193,000	\$1,960,000	\$2,506,000
68	\$193,000	\$1,918,000	\$2,476,000
69	\$193,000	\$1,873,000	\$2,441,000
70	\$193,000	\$1,824,000	\$2,358,000
71	\$193,000	\$1,772,000	\$2,263,000
72	\$193,000	\$1,717,000	\$2,153,000
73	\$193,000	\$1,658,000	\$2,027,000
74	\$193,000	\$1,597,000	\$1,883,000
75	\$193,000	\$1,533,000	\$1,844,000
76	\$193,000	\$1,464,000	\$1,803,000
77	\$193,000	\$1,390,000	\$1,758,000
78	\$193,000	\$1,310,000	\$1,711,000
79	\$193,000	\$1,224,000	\$1,659,000
80	\$193,000	\$1,130,000	\$1,603,000
81	\$193,000	\$1,028,000	\$1,542,000
82	\$193,000	\$917,000	\$1,476,000
87		\$1,314,000	\$2,092,000
94		\$1,550,000	\$2,468,000

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

Side note: While clients might want to use the borrowed money to invest in stocks or mutual funds, that not advisable and could potentially be a problem for an advisor who recommends such an investment choice. Additionally, it makes little sense to put borrowed money in an environment where it can go

backwards and where there are annual tax consequences with dividend income and/or capital gains taxes upon sale.

Non-1% cash flow arm equity harvesting

You should be aware of the fact that the vast majority of the consultants pitching equity harvesting to clients use interest only loans (which have much higher monthly payments). The fundamentals are still the same with equity harvesting whether you use an interest only, 1-, 3-, 5-, 7-year ARM or a 15-, 30-, 40-year conventional mortgage. The key is you are taking out equity to invest in something tax favorable.

The WPI likes the 1% CFA for most clients with wealth because it frees up more money for investing on an annual basis.

Summary on Equity Harvesting

From a financial standpoint (without emotion), equity harvesting when done right can be a no-lose proposition for clients. Money is borrowed 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%. That money can grow tax deferred in an annuity or tax free in a life insurance policy. The client will be able to write off some or all of the interest on the loan which further enhances the financial viability of the concept.

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 specifically and to equity harvesting. 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.

Also clients are in a much better position to protect them when their money is in an investment with liquidity rather than in a home. Remember, if the client's wealth is in their home, the client will have to rely on someone lending them money. This could be problem if the client loses his/her job or if the house is destroyed by natural disaster or fire or whatever. When a client has money in principally protected products such as annuities or life insurance, the client will have control of their money not a lender.

Finally, 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 or equity harvesting.

Should you be selling mortgages?

Most of the advisors reading this material do not sell mortgages.

Why? For financial planners, insurance agents, and any other kind of advisor who makes their money on product sales, the reason typically is because of a lack of familiarity with the topic.

For hourly billing consultants (attorneys, CPAs, accountants, EAs), the concept of making money on a non-hourly billing concept is a difficult one to come to grips with.

Why should you sell mortgages?

-Once you learn the topic you can provide superior advice to your clients (which will in turn save them money, build their wealth, and help make you the most trusted advisor).

-Because, if you sell mortgages through the right broker, you can allow your clients access to hundreds of lenders instead of the handful of local banks/lenders. This allows your clients to obtain the best terms no matter what their financial situation is.

-If you are an insurance advisor or a financial planner, you can help your clients “find” money to invest in wealth building tool through equity harvesting and/or the 1% CFA mortgage.

Aren't mortgages a pain in the neck to sell?

Would you be interested in selling mortgages if you could take a client's application online (which means you can do take it over the phone or in the client's office or house).

Would you be interested in having your own loan coordinator who would help you through every step of the process?

People who think mortgages are a pain to sell simply do not understand the system and do not work with a company that is user friendly for the mortgage broker.

Since this is an education module and not a sales module, we do not list mortgage brokers you can work with who can help you. If you'd like a list of brokers recommended by The WPI, please e-mail info@thewpi.org

What kind of money can be made selling mortgages?

Good question. Most consumers and their insurance, accounting, financial planning, or legal advisors have no idea how much money a mortgage sales person makes on a loan. It is covered in this module to help readers determine if mortgages should be sold in their business.

The answer is that there is a significant amount of money that can be made from selling mortgages.

As a general rule of thumb, on a 15-30 year conventional mortgage, the amount of total compensation available is between 1.5-2% of the entire mortgage balance.

For the cash flow ARM mortgages, the amount available is typically 3% of the mortgage balance.

Think about that. How many clients do you have who have \$500,000 mortgages? If you helped them put their mortgage in place, the total amount of available compensation is \$7,500-\$10,000 on a 15-30 year mortgage and \$15,000 on a CFA mortgage. That should be a real eye opener to most readers.

If you are the broker selling the mortgage, there are hands that get fed out of the previously mentioned amounts. There are loan coordinators and a master brokerage company that you work under. Also, if you work at a local bank, the local loan officer is not making this kind of money. The money mentioned are for “independent” brokers who do not work in lending institutions.

Summary on Mortgages

This is a must topic for advisors to learn. The topic is not difficult, and those who read this education module and certainly those who take the Master Mortgage Broker certification course will be prepared to help their clients make sure they are not being placed in the wrong loan by some local bank or unethical mortgage broker who is simply looking out for his/her own interest.

The fact that you now have knowledge on the cash flow arm (CFA) mortgage program puts you way ahead of most advisors, even those in the mortgage business who sell the CFA (because most really don't understand it).

If you have higher income clients who are looking to build wealth in a tax-favorable manner, you can significantly benefit them by educating them on the concept of equity harvesting. It is a very powerful tool and one that is misused by most in the industry. Now that you have read this module, you will be able to properly counsel your clients on this very important wealth building topic.

Finally, if you are interested in increasing your bottom line, adding mortgages as a revenue generating topic is really a terrific idea and one that does not require you to change your current business model. Mortgages should be a simple add-on topic to discuss when the opportunity arises.