

Why accelerating a traditional mortgage is unpopular, and even dangerous.

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A reader of the Costco Connection magazine recently wrote to author Suze Orman about whether financing their home with a new “accelerator loan” is a good idea. The author responded by noting that the borrower would be stuck with a HELOC whose rate could possibly rise, and that if they spent more than they deposited, their balance would grow. Further, she pointed out that the borrower could simply accomplish the same thing by sending in extra payments to their traditional mortgage whenever they are able.

- ***Since the accelerator loan concept is steadily growing in popularity, it makes sense to examine whether a consumer is indeed better off trying to accelerate a traditional mortgage or going with a special accelerator loan, like the Home Ownership Accelerator®.***

Any home loan, regardless of type, can be paid off faster, and the borrower will save interest by doing so. Regularly sending in extra principal payments can cut years and thousands of dollars off of loan costs over the life of the loan. With one extra payment per year (or follow a bi-weekly program), the borrower can cut 5 years and about 25% off of interest costs, at today’s rates.

Behavioral data: As straightforward as early payoff may sound, very few people do it. In fact, a Federal Reserve Board of Chicago study (Amromin, Huang & Sialm, 8/06) found that out of 103 million households observed, only 10% make accelerated payments to their traditional mortgages (of which *half* is credited to 15-year loans), with discretionary prepayments only averaging about \$1,500 per year (\$125 per month) among that group. Further, the same study found that households that *could* make additional payments hold back on average \$3,800 per year that could be utilized. On a \$250K loan, that extra \$125 per month yields a 5 year acceleration and roughly \$60K in interest savings.

So why do fewer than 1 in 10 people do it? The answer is that there are several barriers which make accelerated payoff of a traditional mortgage very unappealing, if not dangerous.

First, while it's easy to recommend making extra payments, **the incredible discipline it requires just doesn't exist for most people.** The prospect of writing checks for the extra \$125 per month for *25 years without missing a beat* is daunting. Excuses abound for why consumers "take a month off" from making extra payments – a bad month, missed a bonus, holiday gifts, the big vacation, tuition payments, etc. With a traditional mortgage, the actual decision to pay extra occurs monthly, not once up front, so there are monthly tradeoffs.

Second and related to this, **making an extra payment never takes first priority.** With a traditional home loan and bank account structure, you cannot spend more than the sum of your liquid reserves and your net income. So the first priority is always on having ample liquid reserves, and extra payments to the loan are second priority at best.

Third, home appreciation and depreciation keeps discretionary cash on the sidelines. Home equity is often seen as a source of liquidity or (incorrectly) savings, and there has always been an expectation that long-term real estate prices will generally rise. If house prices appreciate significantly over time, then the amount of home equity present is likely to be sufficient to meet most liquidity needs, even without mortgage prepayment, and this removes an incentive for prepaying. Further, when prices fall, it erases home equity and with it, liquidity, creating further rationale for not making extra payments.

The typical behavior of regularly refinancing, and moving, renders prepayment programs virtually ineffective. Consistent with a fixed-rate mortgage market, where borrowers continually refinance to chase the best rates, the Mortgage Bankers Association reported recently that the average age of mortgages (February 2007) in the U.S. is 3 years old, and 80% of mortgages are 5 years old or less. However, in those early years of a mortgage, when balance is highest, prepayment has the smallest effect on total interest saved. For example, with a prepayment of 10% monthly (equivalent to about 1 additional payment per year), the amount of interest saved on a traditional mortgage amounts to *only about 2%* of the total interest originally due in the first 5 years, and *only about 2%* of the total potential savings if the borrower continues the process until payoff. Thus, even the most disciplined borrowers usually never realize even a fraction of the promised benefits of prepayment on traditional mortgages. Worse, every time a borrower restarts the clock on a 30-year loan, they go back to square one on their prepayment program.

Last, and most dangerous, is that traditional mortgages are one-way instruments. Once the prepayment is made, it cannot be retrieved. This is a huge barrier, both real and psychological, even for those with ample discretionary cash. Life throws many unexpected events at us over a 30 year timeframe, and liquidity is critical when that happens. If a borrower aggressively works to accelerate pay off their traditional mortgage and encounters a major financial problem such as a job loss, or major health issue, the lack of liquidity and difficulty in restructuring debt under those circumstances can be devastating.

In summary, trying to accelerate a traditional mortgage requires uncommon discipline, forces liquidity tradeoffs, is marginally effective given typical ownership timeframes, and increases risk due to the process being irreversible. While it's theoretically possible to accomplish early payoff, these factors make it impractical for most – a conclusion that the behavioral data appears to fully support.

- ***So, does the Home Ownership Accelerator (accelerator loan) solve these issues?***

Behavioral data: The Accelerator loan concept does appear to work as promised.

A study of over \$1.25 billion in Home Ownership Accelerator loans in the active servicing portfolio indicates that the average Accelerator client paid down their loan balance by an average \$2,500 *per month* in the first two years alone, compared to only about \$350-400 per month with a traditional mortgage of comparable size, rate, and age. This means that even compared to a borrower who makes discretionary prepayments to their traditional mortgage (an extra \$125 per month, as above), the typical Accelerator client reduces principal balance about 5 times faster. Why is this the case?

A closer look at the Accelerator loan shows that it removes the major barriers to aggressive paydown.

First, no special discipline is required. With the Accelerator, the borrower deposits their entire paycheck directly into the loan and only withdraws funds for living expenses, as they need them. Besides receiving the benefit of float on their unused funds (which saves them interest while the money isn't being used) this automatically results in the maximum prepayment possible each month. Effectively, anything they don't spend becomes their prepayment. This occurs automatically and without any action on the part of the borrower, so no discipline or decisions are required.

Second, with the Accelerator, the client no longer needs to maintain liquid reserves in a low-interest checking account. Instead, they have a home loan which is reduced in size when deposits arrive, then grows as they use funds, and then is reduced again when more deposits arrive. Because it is a line of credit, the Accelerator itself serves as the source of reserves. While on the surface it may seem that tapping the line of credit would be more expensive than tapping cash reserves under a traditional structure, the reality is that the cost of accessing funds is essentially the same. Traditional checking accounts (cash reserves) are not "free;" their true carrying cost is equivalent to the interest rate on the additional debt (larger home loan) carried on the other side of the consumer's personal balance sheet. The Accelerator eliminates the cost of reserves by instead parking the funds against the home loan, making it smaller and less costly.

Third, if home values increase, the line of credit limit on an Accelerator loan can often be increased to take advantage of additional equity, without refinancing.

Coupled with aggressive paydown results that are typical, the average homeowner with an Accelerator will have much greater liquidity than with a traditional loan. If home values decrease, the borrower still has access to cash from the line of credit to use, even if the loan-to-value ratio goes up. This is an advantage over a traditional scenario, where the borrower might have a difficult time securing a new line of credit (HELOC) if their home value has plummeted (this is occurring for many people right now).

With an Accelerator loan, borrowers find that they can focus on aggressively paying down without needing to stop and refinance in order to chase rates. The rate on the Accelerator adjusts monthly, giving the borrower the benefit of rate decreases automatically. As rates increase, much of the impact is offset by the reduced principal balance on which interest is computed and by the low fully-indexed rates at which Accelerators are currently originated (the majority of Accelerator clients are fully-indexed

at less than 5.5% today). Maximum interest rate caps are just 5% over start rate (much lower than a typical HELOC), and optional 1%-over-start-rate caps can be purchased for the first 3 or 5 years if the borrower is extremely rate-sensitive.

Last, and most important, the Accelerator is a two-way instrument, since it is based on a line of credit instead of a mortgage. Any prepayments can be retrieved in the event of an unexpected event, making it attractive to park the maximum amount against the loan balance each month. The borrower has full and instant access to cash via checks, ATM/Visa, online transfers, and bill-pay. This flexibility allows the loan to also be used as an investment platform, or as a source of funds in retirement when cash flow may be more limited.

In summary, though the loan is not for everyone, for many cash flow positive borrowers, the Home Ownership Accelerator will be a more effective, simple, and flexible method for prepaying a home loan compared to trying to accelerate a traditional mortgage. This is supported by the actual behavioral data on clients who are currently in the Accelerator loan.

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CMG Financial Services offers the Home Ownership Accelerator through Accelerator-Certified mortgage professionals coast-to-coast. More information on the Home Ownership Accelerator loan can be found at <http://www.homeownershipaccelerator.com>

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