

Mortgagor Suitability for Accelerator Mortgages

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Abstract: Accelerator mortgages are distinctly different from traditional methods of shortening the mortgage payment period for homeowners. They have only recently been introduced in the United States, but they account for a substantial portion of all mortgages in some large countries and they could become a major force in the United States. This article describes accelerator mortgages in some detail and explores their possible advantages and disadvantages. Financial advisors may want to be aware of the pros and cons of accelerator mortgages because they are a tool that can possibly offer a number of specific financial planning advantages.

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Homeowners have long recognized the financial advantages of making larger-than-required mortgage payments or making more frequent payments than required. Under these programs it is possible to build up equity faster and pay off a mortgage years ahead of schedule. To this end, a number of companies offer products and services to help homeowners. Mortgage companies are eager to promote “bimonthly” payment plans and similar programs, and some companies sell software packages to implement faster or larger mortgage payments. Popular examples of these approaches are: (1) the “round-up” approach in which a mortgagor’s actual payment is rounded up above the required payment by the nearest denomination of some amount such as \$20, \$50, or \$100; (2) the “bonus” approach in which the mortgagor simply applies, at his or her discretion, any irregular cash flow, such as a bonus, to the mortgage obligation; and (3) “biweekly plans” in which the mortgagor makes one-half of the required monthly payment every two weeks.

The term “accelerator mortgages” as used in this article, is a distinctly different concept and should not be confused with “frequent payment” and similar approaches. Accelerator mortgages only recently made their debut in the United States. These mortgages have been used for years in Australia, the United Kingdom, and other countries. They are said to account for more than one-third of all mortgages in Australia and about 25% of the mortgages in the United Kingdom.¹ While the treatment of mortgage interest for tax purposes is different in these countries compared to the United States, the popularity of accelerator mortgages in these foreign countries could be a harbinger that these mortgages will also become popular in the U.S. mortgage market.

Unique Feature

Most mortgagors have money flowing into a checking account from which they pay their mortgage obligation and other expenses. Normally some expenses occur regularly at about the same time every month, other expenses are irregular but are repetitive, and others are sporadic and unpredictable. Because cash outflows are not perfectly predictable (and in fact may be highly unpredictable), the excess of deposits over cash outflows produces a cash reserve that automatically provides some peace of mind. The problem, however, is that this cash reserve or “cushion” provides no investment return and, in fact, is nothing more than unused funds. In fact, even if outflows exactly matched deposits, the account would have unused funds (unless inflows and outflows occurred on the same day of the month).

The unique feature of accelerator mortgages is that they combine a home equity line of credit with an inherent means for using funds that otherwise would have been unused during the month. In its simplest form, an accelerator mortgage is an adjustable-rate line of credit with a checking account welded into the plan. It involves the direct deposit of a mortgagor’s income (and possibly deposits from other sources) into an account. The entire balance in the account is then automatically and immediately applied against the mortgage loan. Borrowers access these funds for various purposes, such as normal household expenses, by drawing from the home equity line of credit. They might have access to their funds by using checks, ATM/Visa point-of-sale cards, and free online bill-pay services that are incorporated into the account. With this approach, one account is used to meet mortgage obligations and all other payments.

An accelerator mortgage reduces the amount of interest paid by the mortgagor and the time required to pay off the debt. This result is achieved for two reasons: (1) an *accelerator* account uses funds that otherwise would normally be idle in the mortgagor’s checking account, and (2) funds in excess of expenditures are automatically invested in paying off the mortgage obligation. In effect, each time the homeowner makes a direct deposit or adds funds from another account, a principal payment is made on the mortgage. This contrasts dramatically with making principal payments on a

traditional mortgage, where the principal (even if extra is paid midmonth) is only reflected as a lower balance at month end. At the end of each monthly statement period, interest is charged and added to the principal balance based on the outstanding daily principal balance. Because interest is computed on daily balance, incoming principal payments begin to reduce interest costs immediately, not at the end of the month. As accelerated amounts are applied against the mortgage, the advantage compounds each month and this creates an increasing benefit to the borrower.

It is possible to manage one’s finances adequately with only the accelerator account. That is, a borrower does not need to close his or her previous checking account to operate an accelerated mortgage account. In practice, for convenience and flexibility, most consumers keep their previous checking account and maintain a small balance after they start an accelerator program. Of course, the effectiveness of the accelerator loan is maximized by flowing as much as possible through the account. The greater the funds in the account, the lower the daily principal balance and the more interest will be saved.

Advantages of Accelerator Loans

Accelerator mortgages, no doubt, offer the potential for very substantial financial advantages. Compared to traditional mortgages, accelerator mortgages will, in some cases, allow a homeowner to build up equity much sooner, and the time required to completely pay off the mortgage will be greatly reduced.

Consider this simplified example:

- Option 1: A traditional 30-year fixed-rate mortgage in the amount of \$300,000 with an interest rate of 6.25% and a monthly payment of principal and interest of \$1,847.
- Option 2: An accelerator mortgage of the same amount and interest rate. Further assume:
 - a) Monthly net income: \$6,000
 - b) Monthly living expenses: \$3,000

With these assumptions, the monthly breakdown will be:

Net income	\$6,000
Debt repayment	1,847
Living expenses	3,000
Net savings	1,153

In the above information, living expenses do not include the mortgage payment (covered under debt repayment figure). This means the residual \$1,153 will remain in the account after expenses are paid.

With Option 2 the mortgage will be paid off in 11.7 years instead of 30 years. Further, the total interest paid under the traditional mortgage will be \$364,975, but only \$120,453 with the accelerator account, which is a savings of \$244,522. To match these results a traditional mortgage would have to offer an interest rate of 2.39%.

Since the accelerator loan incorporates any residual funds left over after expenses and allocates them to principal reduction, the natural argument is to state that the traditional mortgage holder can make discretionary payments to his or her mortgage as well. Since no traditional borrower can allocate 100% of their residual funds, the question becomes, "How much of the residual funds can be used to aggressively reduce the mortgage balance?" Assuming one puts 50% of the residual to work (and leaves the remaining half for contingencies), an extra payment of \$576.50 per month can be made. In this scenario, the traditional loan would be paid off in 16.7 years, with a total interest cost of \$182,770, still 50% higher than the accelerator loan. The additional disadvantage is that the traditional borrower cannot retrieve those discretionary prepayments if the need arises, whereas the accelerator loan is fully liquid.

Obviously, the financial advantages to homeowners of accelerator mortgages can be substantial and can be of great importance to financial planners and other financial advisors.

Specific applications of how accelerator mortgages might be utilized by financial planners include the following:

- *Coordinating the date of the mortgage retirement with the client's retirement date:* Recent studies have shown that many people are reaching retirement with substantial mortgage payments, which is less than an ideal situation for most retirees. With an accelerator mortgage a homeowner can project, years ahead, when the mortgage will be retired, and sometimes he or she can adjust monthly spending to make the retirement and mortgage payoff dates coincide.
- *Providing a flexible, efficient cash management tool:* Budgeting, or the much more palatable term "cash flow management," is a difficult, central issue with

many clients. Payments on a traditional mortgage are rigid, presenting a monthly obligation that always takes a high priority. However, accelerator mortgages provide a flexible liability side tool, and because they are based on lines of credit, clients can adjust their inflows and outflows to meet other financial needs as necessary. Thus, accelerator mortgages are extremely flexible.

Further, accelerator mortgages apply the old rule—"pay yourself first"—and clients are able to visually watch the rapid pay-down of their mortgage. This can increase their motivation to spend less. Clients who have had trouble with traditional budgeting often can find reasons to spend less if they see the immediate impact on their mortgage obligation.

- *Providing an effective emergency fund:* Financial advisors have long recommended that clients should maintain an emergency fund by investing funds in safe, liquid assets. The traditional rule of thumb has been that the emergency fund should consist of six months' income, but often the rule has been softened to three to six months of expenses. In any event, the amount of the traditional emergency fund can be sizeable and the cost of maintaining such a fund in low-yielding investments can be substantial.

However, with an accelerator mortgage, available equity within the line of credit can be used as an emergency reserve to meet a temporary loss of income or unforeseen financial needs. Funds can be provided almost immediately and repayments can be flexible and convenient. As a result, the use of accelerator mortgages will allow the cost of the emergency fund to be reduced or eliminated.

- *Access to equity for investment:* Flexible access to equity can, subject to suitability and risk tolerance considerations, open up new opportunities for investments in securities, real estate, insurance, and other vehicles. Although "equity harvesting" is controversial among financial planners, the more rapid build-up of equity in accelerator mortgages can enhance the periodic withdrawal of home equity to allocate to other investments if this is desired.
- *Creating an informal "reverse mortgage":* The more rapid buildup of equity in an accelerator mortgage makes it possible to periodically withdraw funds and in effect, create a reverse mortgage substitute. In fact,

there may be some significant advantages of withdrawals from an accelerator account. With accelerator mortgages (1) costs might be lower, (2) there may be greater flexibility in withdrawals, and (3) withdrawals can be made when the homeowner might not be eligible for a reverse mortgage. For example, the homeowner might have substantial equity but not enough to qualify for a reverse mortgage.

Extra Costs of Accelerator Mortgages

There is an extra cost for an accelerator mortgage because of the highly transactional nature of the product. The lender might charge an annual fee, which is likely to be fairly nominal, such as \$50 or \$100. Other possible costs to consider include the possibility of a higher interest rate (perhaps 1% higher at par pricing, or alternately an extra 1.5 points up front for the same rate) on an accelerator mortgage.

In the past, the interest rate on traditional mortgages (fixed and variable) was critically important. Accelerator mortgages, however, raise the question: Is the interest rate itself the basic issue or is the time to pay off and total amount of interest paid more important? When the time for repayment is fixed, the interest rate is obviously important. However, when the time for repayment is not fixed, the authors argue that total interest paid and the time for repayment are generally more important. This line of reasoning requires individuals to change their traditional way of thinking.

Suitability Considerations

As attractive as accelerator mortgages might be for some borrowers, clearly they are not appropriate for every person.

Monthly Surplus

Accelerator mortgage results are driven by two factors: the interest savings generated by “float” of various living expenses parked in the loan for a given length of time (e.g., money that is needed) and interest savings generated by “residual” funds left over in the account after expenses (e.g., money not needed). In most cases, the latter is more important, so these loans have little or no advantage if the borrower does not generally have a surplus each month after expenses. In other words, a person needs to be cash-flow positive overall to benefit

from these mortgages. Some individuals know they have savings (and others know they have no savings), but it is easy to imagine a person who believes he or she will spend less than they earn only to learn later that they have been overly optimistic.

Using the same example as above, with no surplus the mortgage will be paid off in about 28.9 years—nearly the same as a 30-year fixed mortgage. However, the total interest paid with the accelerator account will be \$345,710 as opposed to \$364,975 with a traditional mortgage. Given the additional risk associated with the accelerator loan being an ARM, clearly an accelerator approach is not appropriate for a person who cannot apply excess payments to the principal.

Continuing the preceding example, the larger the surplus, the sooner the mortgage will be paid off, as follows:

Monthly Net Income	Monthly Expenses	Surplus	Years to Pay Off
\$6,000	\$5,000	\$1,000	12.7
\$6,000	\$4,000	\$2,000	8.3
\$6,000	\$3,000	\$3,000	6.3
\$6,000	\$2,000	\$4,000	4.9
\$6,000	\$1,000	\$5,000	4.2
\$6,000	\$0*	\$6,000	3.6

*A person could have zero monthly living expenses if the individual had another checking account or another person paid his or her expenses.

Financial Discipline

The credit line is the maximum amount the homeowner can borrow under the mortgage. The credit line is usually higher than the first draw amount, which may be used to pay off the old mortgage. Suppose the homeowner has a credit line of \$400,000 and the first mortgage is \$325,000. This would give the homeowner a \$75,000 “cushion,” or accessible equity in excess of the amount to pay off the mortgage. Some individuals do not have the financial discipline to refrain from using this available credit. For this reason, some authorities believe that credit scores provide a good indication of a person’s financial discipline and accelerator mortgages should not be used by those with a credit score lower than a certain level, e.g., 680.

If the homeowner’s expenditures are greater than the deposits into the account, the debt will grow, and if the negative cash flow continues ordinary spending could drive

up the borrower's long-term debt. Eventually the maximum debt allowed (the amount of the credit line) would be reached. In this worst case scenario, if an individual cannot make the required payment on the credit line, he or she would be in essentially the same position he or she would have been in with a default on a conventional loan.

The “Do It Yourself” Alternative

Is an accelerator mortgage appropriate for a person who believes he or she can duplicate the benefits of an accelerator mortgage with a bimonthly or similar prepayment plan?

No doubt, mortgagors can make extra payments on their traditional mortgage and thereby reduce interest charges and the time to repay the mortgage. These extra payment plans, however, have the following significant disadvantages compared to accelerator mortgages:²

- Many individuals do not have the desire and discipline to follow an extra payment plan, especially if it is on a voluntary basis. A recent study³ found that out of 103 million households observed, only 10% make accelerated payments to traditional mortgages, of which half is credited to short-term (15 year) loans, with discretionary payments averaging only about \$125 per month. The study found that in that same group, on average over \$300 per month was available for prepayment, yet held back.
- Prepaying with an extra payment plan locks up the funds permanently, unless the mortgagor refinances or uses a home equity line of credit to retrieve the funds. With an accelerator mortgage the homeowner can withdraw funds for emergencies, investment opportunities, etc. Further, no fixed monthly payment is required if the mortgagor is below the credit limit.
- Because of the preceding point, a mortgagor would not apply all of his or her spare cash against the mortgage under a prepayment plan. The need for liquid reserves always preempts discretionary payments to a traditional mortgage. An accelerator loan provides liquidity, so a low-interest cash reserve is not necessary. The accelerator mortgage allows the homeowner to apply every spare dollar against the mortgage balance and does it automatically without the borrower's intervention. An analysis of the CMG

Home Ownership Accelerator loan portfolio showed that the average borrower in the portfolio reduced his or her principal balance by about \$2,500 per month over the first two years, about eight times the usual principal reduction for average-sized loans during that time frame.⁴

- When home values rise new equity is created, usually providing ample liquidity for any unexpected needs, and ultimately the basis for a move up to a better home. Thus, there is no great incentive to stretch one's budget by accelerating a traditional mortgage. When home values fall, home equity is erased, which provides a disincentive to divert discretionary funds to paying down a traditional loan.
- The average homeowner moves or refinances on a frequency that is inconsistent with most do-it-yourself prepayment plans; Freddie Mac's quarterly refinance statistics report shows that since 2000, the median age of loans being refinanced averages just 2.8 years.⁵ If one simply sticks with prepaying a traditional mortgage for five years and prepays an extra 10% monthly, he or she would generate only 2% of the total potential interest savings generated if he or she had stuck with it until the loan is paid off. Put another way, most prepayers will never achieve the promised benefits of a regular prepayment plan because they will exit the loan long before the prepayment plan begins to generate the anticipated results. Because accelerator loans attack principal more aggressively, and more automatically, early results are likely to be better, even if a borrower exits the loan after a few years.

Short-Term Loans

A borrower who only needs a loan for a very short period of time—two years for example—will often be better off getting a low-interest, interest-only loan. Typical low-interest accelerator loans at similar rates will require one to three points up front which, for a cash-flow positive borrower, requires about two years of interest savings in order to recoup the initial point costs. Once the up-front costs are recouped, however, a cash-flow positive borrower who stays in the home over two years usually comes out ahead with a low-interest accelerator loan.

Interest Rate Concerns

For a traditional mortgage of a given term, interest costs depend on the interest rate and the amount borrowed. For an accelerator loan, interest costs are driven by four factors: the interest rate in effect each month, the amount borrowed, deposits to the loan, and withdrawals from the loan (and the timing of such). Thus, the effect of rising rates is often dampened by any net positive cash flow that reduces the balance on which interest is computed. Typical accelerator loans have reasonable maximum interest rate caps, usually about 5% above the starting rate (i.e., if the starting rate is 6%, then the lifetime maximum is 11%); in addition, an option to cap upward interest adjustments at 1% over the initial rate for the first three or five years—when loan balance is higher and the loan is most sensitive to rate adjustments—may also be available. If a borrower is living very close to his or her means, with very little positive cash flow, a sharp upward spike in rates may result in large enough monthly interest costs to push the borrower's cash flow into a negative position, in which case the loan balance would rise until either the borrower's living expenses were adjusted, rates came down again, or he or she hit his or her credit line maximum. Some borrowers with low loan balances relative to their credit line maximum (e.g., someone who owns his or her home almost free and clear) may be able to withstand high rates for a long time, even with negative cash flow. This would be akin to a reverse-mortgage type scenario.

Disaster Risk

Since accelerator loans are built using lines of credit, they usually contain provisions that allow the lender to freeze access to the line of credit should the borrower default, or where the lender has reason to believe that the borrower is no longer able to make payments, or where the property is no longer sufficient collateral for the outstanding debts, or where prohibited by (new) law. This can be a concern for some borrowers, who may worry that access to their paycheck could be frozen at some time in the future. It is important to realize that most of these situations are rare in nature, and that the lender presumably enjoys regular interest payments on the debt outstanding, or the lender would not have made the

loan in the first place. More importantly, job loss and natural disaster (fire, flood, etc.) usually do not rise to the level of permanently impairing a borrower's ability to repay the loan, or permanently impairing the collateral value of the home (which is why one is required to carry homeowners' insurance). Lastly, the highly liquid nature of an accelerator loan, in which a large amount of cash is available at a moment's notice, enables a borrower who may actually be concerned about the potential for the line to be frozen (i.e., Katrina hits, reshapes topography, and the property is deemed to be permanently at the bottom of a lake) to withdraw ample funds to place in a bank account and return to a more traditional loan-plus-bank-account structure.

Availability

Accelerator loans are now available in about 41 of the 50 states. Some states have certain regulations regarding use of lines of credit on real estate (Texas) and the use of checking and credit cards tied to home debt (Massachusetts and New York, for example), which have slowed introduction of these types of loans in some states. It is not clear how long until, or even if, the companies offering these loans will be able to overcome some of the regulatory challenges present in these states.

Conclusion

Accelerator mortgages can save borrowers interest by applying idle cash against their loan balance, and they can allow a borrower whose objective is to pay off ahead of schedule the ability to aggressively reduce his or her loan balance without the risk of diverting cash irretrievably into a traditional mortgage. These objectives work hand in hand—pursuing one often leads to success in pursuing the other. The potential savings in interest and acceleration of payoff can be substantial, because the loan automatically employs all idle income and left-over funds. For this reason, in practical application, using an accelerator loan is much more effective than trying to pay off a traditional loan by making extra payments. Because it is based on a line of credit, the loan can also be used as a means to harvest equity more flexibly and may provide a cost-effective reverse-mortgage substitute. That said, the loan is not for everyone. In addition to a slightly higher interest rate, the

rate on an accelerator loan can adjust monthly. While the effects of both of these can be more than overcome by a borrower with adequate positive cash flow through the loan, these features make the loan inappropriate for borrowers with neutral or negative long-term cash flow. Because the loan is an open line of credit, a measure of financial discipline is also required. All in all, accelerator mortgages can be extremely powerful tools for disciplined, cash-flow positive borrowers intent on saving interest, paying off their mortgage more quickly, or using their home equity as a base for investing or retirement cash. ■

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