

# Mortgage Minute

## Variable Rate Mortgages

Questions Answered Regarding This Often Misunderstood Loan Product

Variable or Adjustable Rate Mortgages, ARM's, can be great loan products for the right borrower. However, I find the true characteristics of these loans are generally not understood very well. Much of our information about them is derived from very general statements made in the media or misconceptions carried by other people we know.

I'd like to begin by explaining how a typical ARM loan works before discussing some of the more exotic types of ARMs that had a hand in the current housing crisis. The numbers I'll use throughout the article will be slight generalizations because the terms of every ARM loan vary from lender to lender, but they should give a good general understanding of how the loan product works.

In a standard ARM loan the interest rate and payment are fixed for a set period of time, 1, 3, 5, 7, or 10 years, before they adjust. The name of the ARM will tell you the length of time the rate and payment will be fixed for and how often the rate and payment can change. For example, a 5/1 ARM will be fixed for the first 5 years and will adjust every 1 year thereafter.

Once an ARM loan begins to adjust, the new rate is calculated by adding a previously agreed upon margin to an index. An index often used in conventional ARMs is the LIBOR index,

London Interbank Offered Rate. The margin range most commonly found in conventional ARMs is between 1.75% and 2.25%. So, for example if the ARM loan you had was set to adjust next month, the rate would be calculated by taking the 1 yr. LIBOR index, which as of September 2<sup>nd</sup> was 3.214%, and adding a margin of say 2.25%. You round this answer of 5.457% up to the nearest eighth resulting in a new rate of 5.5%, where it would stay until the next adjustment.

A misconception I often find with ARM loans is the thought that once the loan adjusts, the rate can only go up and that it will go up a lot. The reality is that the rate is just as likely to change very little or go down. There is also a maximum rate change on every ARM. Conforming ARMs can typically change at most 5% at the first rate change and 2% at each subsequent rate change with a lifetime cap of 5% of total change up or down.

There are several reasons a person may choose an ARM over a fixed-rate mortgage. The primary reason is rate and payment. An ARM loan usually has a lower starting interest rate, and subsequent lower payment, than a long term fixed-rate product. If someone was planning on having the mortgage for a shorter period of time, a first-time homebuyer for example or an investor who was planning on improving a

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## Today's Rates at a Glance

30-year fixed  
**5.875%**  
(APR 6.057%)

15-year fixed  
**5.750%**  
(APR 6.054%)

Rural Housing  
30-year fixed no MI  
Up to 102% LTV  
**6.000%**  
(APR 6.426%)

Calculations based on a first-time homebuyer purchase, loan amount of \$200,000 and an 80% loan to value (unless otherwise noted). Rates include a 1% origination fee and are as of 9-3-08 and are subject to change.

## Credit Score Tip of the Month

*In the very unfortunate even of a divorce, make sure all joint credit is closed. Establish new accounts individually. Joint credit is not converted even if it becomes an individual responsibility as outlined in the divorce decree.*

## Mortgage Question of the Month

**Q:** How much would I increase my monthly payment to pay off my 30 year fixed rate mortgage more quickly?

**A:** If you have a \$200k mortgage at 6%, the 30 year amortized payment is \$1199.10. To pay the loan off in 25 years the monthly payment would increase \$89.50, 20 years \$233.76 and 15 years \$488.61.

## Random Useless Piece of Information

The portrait of Abraham Lincoln on the penny shows him facing to the right while all other portraits of presidents on U.S. circulating coins face left.

property to sell, an ARM may be a very appropriate loan choice.

Another advantage to an ARM loan is that a feature like interest only is cheaper. On a 30 year fixed loan there is a rate increase for having an interest only feature but not usually with an ARM. So the rate on the 30 year fixed mortgage may be increased .25% to add an interest only feature but there may be no increase to the rate of a 5/1 ARM for the same interest only feature.

Standard ARM loans actually had little to do with the credit crisis we currently find ourselves in. The reality is that the following two types of ARMs caused much of the issues our credit and housing industry are facing.

The first is the pay-option ARM. This loan's rate adjusts every month and gives the borrower four payment options, one for a fully amortized 15 yr. loan, a second for a fully amortized 30 yr. loan, a third for an interest only payment and the fourth for a payment less than the interest only payment. This last payment option results in the loan amount growing, something that is referred to as negative amortization. Many borrowers in areas of high real estate prices, like parts of California and Florida, took out these types of loans because the minimum payment was what they could afford and/or they were banking on appreciation to keep pace with the loan amount. When the housing bubble began to burst, this resulted in many people having home loans larger than the home's value, and a default melee ensued.

A second culprit in the credit crunch was the subprime ARM. Subprime loans were for borrowers

typically with blemished credit, many of which were made at higher loan-to-values and structured as 2 or 3 year ARMs. In addition to the quick adjustment, they often also had pre-payment penalties with either 2 or 3 years respectfully.

This left borrowers with loans that couldn't be refinanced without incurring huge monetary penalties. Then home values in many parts of the county started to decline while at the same time the loans started to adjust. The margins on these types of subprime loans were in 6% range, much higher than their conventional counterparts. This was resulting in new interest rates in the 9%'s. Because so many of these loans were made at higher loan-to-values, borrowers again often found themselves owing more than their home's value with payments increasing dramatically. It became too much of a financial burden for many and they walked away from their mortgages and their homes.

Let me conclude by re-iterating that an ARM loan is a great product for the right borrower and right situation. Care must be taken though to make sure the loan product a borrower is entering into is fully understood and appropriate. Many borrowers who were and will be foreclosed on who were in the option payment or subprime ARMs didn't fully understand what they were signing on for, many did but there are lots who didn't. That is why it is so critical to have trusted professionals advise you in your lending needs.

I hope you now have a better understanding of adjustable rate mortgages and the next time the news anchor blames all our housing woes on the "variable rate loans", you'll know what they are speaking about a little better.



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