

Adjustable Rate Mortgages:

What are they and How do they work?

by Dave Muti

Over the years a lot has been written about Adjustable Rate Mortgages (ARMS) but no one has really broken them down until now. This article is not going to advocate one opinion over the other; rather I will simply explain different types of ARMS as well as their different working components. Adjustable Rate Mortgages initially grew in popularity for first time buyers due to the fact that they typically have lower interest rates than the traditional 30-Year fixed rate mortgage and thus a lower monthly payment. However, their use today has grown tremendously and they are now common place for first time home buyers as well as experienced investors.

Over the last decade and especially in the last five years or so lenders have gotten very creative with the types of mortgages they offer. Today you can get an ARM for as short as one month or as long as ten years. The longer term ones are commonly referred to as “hybrid mortgages” by the media but they are ARMS nonetheless. There are four different components that you need to be aware of for every type of ARM; the “term”, the “index”, the “margin” and the “CAPS”. As an example to refer to throughout I will use a 5/1 ARM starting out at 6.25% based on the MTA Index with a margin of 2.75% and caps of 5/2/5. I know that is a mouthful but once you understand each component you will know exactly what type of ARM you have or are being quoted and how it affects YOU.

TERM: This refers to the “type” of ARM that you end up with. As mentioned above the term of an ARM can be as short as one month or as long as ten years. No matter what you choose the total length of the mortgage is usually 30 years. The key is to pay attention to the type you have or are being quoted. Popular ARMS will be



quoted as a 3/1, 5/1, 7/1 or a 10/1 and you need to know what the numbers mean. (There are other programs but they are beyond the scope of this article). The first number before the slash (/) is referring to a fixed period of time that your interest rate and monthly payment will NOT change. The number after the (/) refers to how often the interest rate will adjust after the initial fixed period. Again the media typically refers to these types of mortgages as “hybrids” because they have a fixed component (the first number) and an adjustable component (the second number).

In our example a 5/1 ARM is referring to a mortgage that will have a fixed period for 5 years and then the interest rate will adjust every anniversary thereafter for the balance of the loan beginning of the 61st month. If you have a 3/1 ARM or a 7/1 ARM it simply means your “fixed rate” period is for 3 years and 7 years respectively. In the event the program being quoted to you is for a 5/6 ARM the second number here means that it will adjust every six months after the initial period not every year or every six years.

INDEX: While different people will offer their expertise as to one index over the other that opinion is not important for this article. The “index” part of the mortgage is referring to what the interest rate is tied to. Here different lenders will offer different products that are based on the index or indices of their choice. Some of the more common ones are The 11th District Cost of Funds (COFI), the Monthly Treasury Average (MTA), The One Year Treasury Bill and the London Interbank Offer Rate (LIBOR) and no this is not the bank of London. Rather it is a weighted opinion of a dozen or so international banks used for overnight lending. This index typically moves in pace with the Federal Funds Rate that we have all come to know through the Fed meetings now chaired by Ben Bernake and previously by Alan Greenspan. The actual documents you will sign at a closing will indicate “how” the rate for the index is applied to you, where you can find it and your lender should explain this up front.

MARGIN: This component is usually one that the consumer does not have much control over. For most ARMS, this component is set by the actual provider of the loan. This is a KEY component because this figure is added to your Index and it will ultimately determine your actual interest rate as your loan comes into its adjustment periods limited by the CAPS discussed below.

CAPS: This part of the mortgage can be the most complicated and often it is the portion that is left out of a proposal by a lender to the consumer. Yes it will be in the fine print but most loan officers will gloss over it. This component of the mortgage will always come in a series of three numbers; we are using 5/2/5 in our example. The first number refers

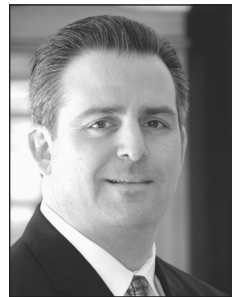
to the maximum amount your interest rate can go up on the first change date. The second number refers to the maximum amount your interest rate can go UP or DOWN for each and every change thereafter. The third number refers to the lifetime cap that your interest rate can reach. Lets see how this applies to our example of a 5/1 ARM starting out at 6.25% with a margin of 2.75% and caps of 5/2/5.

Since we started out at an initial rate of 6.25% the loan can increase by a total of five percentage points on the first change for an interest rate of 11.25%. This is not an arbitrary increase as it is based upon the published index (usually in the Wall Street Journal) for your program. So as your first adjustment comes up you will receive a notice from your lender what the published rate was, they will then add your MARGIN and first adjustment CAP and that will be your rate for the next 12 months. The formula is your Index+ Margin = New Rate. So lets again go back and look at how our hypothetical mortgage might adjust. Let's say that at the first change date the index for our program was 9.00%. We would then add our Margin of 2.75% and come up with a proposed rate of 11.75%. However we would be limited by our first CAP of five percentage points so our new interest rate for the sixth year (the 61st month through the 72nd) would be 11.25%. If the index was 7.00%, we would add our margin of 2.75% and come up with a new rate of 9.75% which is within the five point cap for our first change.

This formula will be used to determine each and every other change for our mortgage however the CAP will now be controlled by the second number in the series of CAPS. In our example the second number is a "2". This means that after the first adjustment to the interest rate, each and every adjustment UP or DOWN cannot exceed two percentage points. So lets again go back and look at how our hypothetical mortgage might adjust. Let's say that at the first change date the index for our program was at 5.00%. We would then add our Margin of 2.75% and come up with a new rate of 7.75% for the sixth year; the 61st month through the 72nd month. Then at the next anniversary (the next change date) the index was 8.00%. We would then add our margin of 2.75% and come up with a new proposed rate of 10.75%. However, since our CAP is set at 2.00%, the rate applied to our mortgage would be limited to 9.75% (7.75% + 2.00%) for the third year or months 73 through 84. This formula will be applied each and every year for the remaining life of the loan. But remember we still have a third number in the series of CAPS. This number means that no matter what happens the maximum interest rate we could ever have is "capped" at five percentage points over where we began. In our example it is a "5" so no matter what happens our loan will NEVER be more than 11.25%. So if you end up keeping your ARM beyond the first change date your interest rate will adjust each and every year (six months if you have that program) within a set range.

Again, the purpose of this article is not to advocate any one

choice over the other or make the argument for or against ARMS. It is simply to educate you on HOW these mortgages work. If you are in the market to purchase a new home or refinance your existing loan make sure the person you are dealing with is able to provide you with a detailed explanation of the program they are quoting you. Take the time to research, read and then sit down to discuss different options available with a qualified Mortgage Planner to make sure you are in the right program for YOUR circumstances.

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