“ARMs”

Understanding ARMs

Adjustable-Rate Mortgages

If you are worried about rising interest rates and buying a home, there are options available that offer a lower rate at the beginning of your mortgage. These lower rates are fixed for a period of time and after that, are capped as to how much they can adjust up or down. These are called Adjustable-Rate Mortgages [ARMS] and are a good fit for some home buyers.

Let’s review how they work.

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What is an “Adjustable-Rate Mortgage” anyway?

Why would someone choose an ARM over a fixed-rate mortgage?

Q: Why choose an ARM?

A: To have options with Interest Rates.

The interest rate may be **high.**

The ARM allows the borrower to qualify at a lower rate
(depending on the agency program)

Property Investors like ARM programs to lower their monthly debt obligation compared to their rental intake. As rents go up over time, any change in payment can be justified.

People who relocate because of their job may find the lower rate more appealing.
Fixed rates are high, and borrowers seek a lower rate/payment during the first years of their mortgage.

It could make sense from a financial perspective. Depending on the area a borrower resides in and whether this is their first home, the average time a homeowner stays in their home is 7 years. So, the logic is, why pay for a 30-year mortgage at a higher rate when you plan to move in 5-7 years?

It could make sense from a financial perspective. Depending on the area a borrower resides in and whether this is their first home, the average time a homeowner stays in their home is 7 years. So, the logic is, why pay for a 30-year mortgage at a higher rate when you plan to move in 5-7 years?

Terminology

As you likely know, we sling around various terms in our industry that mean essentially the same thing. We will focus this training on the terminology used by the agencies so that you can better understand the guidelines. Once you know the basic concepts, you should be able to understand the various terms used by lenders and brokers.

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Terminology

ARM Initial Fixed Rate Period

This is the term of the beginning rate
for your selected ARM program.

This is also the “Note Rate” or “Starting Note Rate.”

Fully Indexed Rate

The fully Indexed Rate is the rate the borrower could be charged once the Initial Fixed Rate Period expires.

This is computed using the program index and margin and is also subject to the program caps and floors.

Terminology

Qualifying Rate

This is the rate that the agency will allow the borrower to qualify.

Qualifying Rate is outlined in the guidelines and depends on the type of ARM.

Index

Each ARM program is based on a market index
used to calculate the “adjusted rate”
once the initial fixed-rate period expires.

A good question to ask:

Which Index is the ARM based on?

Index Essentials

A good question to ask:

How does this Index perform?

Important

Understanding the performance history of the index for your various loan programs gives you the knowledge you need to explain indexes to the borrower adequately.

Index Examples

Secured Overnight Financing Rate

SOFR

Average rate at which institutions can borrow US dollars overnight while posting US Treasury bonds as collateral.

What is the Average SOFR?

30/90/180-Day Average SOFR are also reported daily by the FRBNY. These rates represent the compound average of SOFR of the respective time periods. For example, 30-Day Average SOFR is the compounded interest rate of the preceding 30 days as reported by the FRBNY. Similarly, 90-Day Average SOFR and 180-Day Average SOFR are the reported compounded interest rates of the preceding relevant period.

How are Average SOFR rates used to calculate interest?

The interest rate is determined at the start of each interest period (this is referred to as “in advance”) using the applicable 30-, 90-, or 180-Day Average, as reported by the FRBNY. Using simple interest methodology, interest accrues on a daily basis at the rate over the interest period.

Index Examples

Constant Maturity Index

CMT

This is formulated from the average yield of treasury securities.

Terminology

Margin

The margin is the profit that is added to the index rate.

Margin Example

A lender will

Index + Margin (their profit)

Round ("Rounding") to the nearest 1/8th rate

= NEW RATE

Terminology

Floors

“Floors” is the term used to define the maximum percent **<u>decrease</u>** that an interest rate can go down.

Caps and Floors

Important

Understanding how “Caps” and “Floors” work
during your client’s rate adjustment period
is essential knowledge!

Amortization

A monthly payment that is **calculated** to pay off the entire mortgage balance at the end of a 30-year term.

Difference

After the "Initial Fixed Rate Period," the rate will adjust,
and the new payment will be calculated based
on the number of years left in the mortgage.

Terminology

Caps

"Caps" is the term used to define the maximum percent **increase** that an interest rate can go up during any adjustment date.

Caps Examples

Lifetime Cap

A Lifetime Cap means the interest rate cannot go any higher than the specified lifetime cap.

Caps Examples

Lifetime Cap

Initial Rate (3%) + Lifetime Cap (6%) = Adjusted Rate (9%)

Caps Examples

Adjustment Cap

The Adjustment Cap is the highest a rate can go,
no matter the market conditions,
during an adjustment period.

Caps Examples

Adjustment Cap

Adjustment Cap (2%) + Present Rate (3%) = New Rate (5%)

Caps Examples

The Numbers

When you see ARMs offered by lenders, they look something like this.

1/1

3/1

3/3

5/1

7/1

Caps Examples

The Numbers

1/1
3/1
3/3
5/1
7/1

Initial Fixed Rate Period

This is how many years that rate will be the same, and as a result, the number of years the P & I will be the same.

Caps Examples

The Numbers

1/1
3/1
3/3
5/1
7/1

Initial Fixed Rate Period

Adjustment Period

This will tell you how often the rate will adjust.

Caps Examples

The Numbers

1/**1**
3/1
3/3
5/1
7/1

For instance, if the second number is 1…

Adjustment Period
The rate will adjust yearly AFTER the Initial Fixed Rate Period.

Caps Examples

The Numbers

1/1
3/1
3/3
5/1
7/1

If you see 3…

Adjustment Period
The rate will change every 3 years
AFTER
the Initial Fixed Rate Period.

How does an **Adjustment Calculation** work?

Adjustment Calculations

Assumptions

5/1 ARM
Rate of 5%
Index – 3.00
(i.e. SOFR/CMT)
Margin 250
Adjustment Cap – 2%
Lifetime Cap – 6%

Index is 3%
Margin is 250 (2.5%)
New Rate is 3% + 2.5% = 5.5%

Does not exceed the max adjustment cap

Adjustment Calculations

Assumptions

5/1 ARM
Rate of 5%
Index – 3.00
(i.e. SOFR/CMT)
Margin 250
Adjustment Cap – 2%
Lifetime Cap – 6%

Index is 3%
Margin is 250 (2.5%)
New Rate is 3% + 2.5% = 5.5%

Does not exceed the max adjustment cap

Payment 61
Rate is adjusted for payments #61 – 72 (12 months)

P & I
will be recalculated

Based on market conditions at that time.

Adjustment Calculations

Assumptions

5/1 ARM
Rate of 5%
Index – 5.00
(i.e. SOFR/CMT)
Margin 250
Adjustment Cap – 2%
Lifetime Cap – 6%

Index is 5%
Margin is 250 (2.5%)
New Rate is 5% + 2.5% = 7.5%

Does exceed the max adjustment cap

In this case, the lender is subject to the Adjustment Cap of 2%.
Since the present rate is 5%, the index is 5%, the margin 2.5% and the max adjustment cap is 2%, the rate cannot be higher than 7%.

So, now that you have reviewed ARMs the real question is…

Why ***wouldn’t*** you choose an

Adjustable-Rate Mortgage

over a Fixed-Rate Mortgage?

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