# *Truth or Consequences:*

## "The Mortgage Reality Show"

## Calculate what could happen when your loan adjusts

**In this Chapter you will learn:**

- Hybrid ARMs
  - ✓ How to calculate what could happen to your payment when a Hybrid ARM rate adjusts - both the best and worst case scenarios.
  - ✓ How to make an educated guess as to your future adjustable interest rate.
  - ✓ When - and how - to "check up" on your loan before it adjusts.
- Option ARMs
  - ✓ Recasting can be disastrous - how you can avoid it.
  - ✓ Know what may happen to your payment if the loan recasts.

Some people are analytical and like to fully understand everything. Others would rather take a short cut. Most of us are one or the other, depending on our level of interest in the topic. Reading this chapter in its entirely will be valuable for analytical people who want to completely understand all the risks and rewards of adjustable rate mortgages. However, as I mentioned in earlier chapters, I have provided forms that you can ask your loan officer to complete. The forms ask the lender to fully disclose all the terms of the loan in plain, simple English....not the "legalese" we normally see in loan documents. **It also asks the lender to calculate the best and worst payments you could experience with your particular loan,** which is what this chapter is all about.

Whether you read the chapter or not, I recommend you ask your lender to complete the form that corresponds to your loan type at two stages in your loan process:

1. When your loan is locked and/or submitted;

2. When you sign loan docs.

It is not possible to accurately complete the form before the loan is locked, because the terms are usually not set in stone until that point. If your loan officer does not know how to do the calculations required, simply ask them to read this chapter. I explain in detail how to do the calculations necessary to complete the form.

My hope is that these easy-to-understand and complete disclosures will become law. The software systems we use for loan origination and drawing up loan documents could easily be modified to complete these forms for the lender or loan officer.

# Hybrid ARM

This section will help you calculate the best, the worst, and the most likely new monthly payments when your Hybrid ARM loan adjusts. It is important for you to be aware of the potential for increasing your monthly payment with any loan you choose. If you are aware of the worst that may happen, you will be better prepared. If you are prepared, you will minimize the risk of defaulting if there are dramatic increases in your monthly payment. You may also be pleasantly surprised when your loan adjusts. Your interest rate could actually go down, leading to lower monthly payments. However, when the safety of your home is at stake, it is best to be prepared for the worst.

## Hybrid ARM Calculation

To calculate what may happen to your payment, the best and worst case scenarios, gather the following information from your loan officer or your loan Note.

1. Your Initial Rate = IR
2. The Margin = M
3. The Index = I
4. The First Adjustment Cap = FC
5. The Life Cap = LC
6. Principal Balance = P (This is the amount of money you will owe when the loan adjusts.)
7. Does the loan allow you to pay **interest only**? If so, how long will that option be available? Interest Only Hybrid ARMs come in two types. One allows you to pay interest only for the period of time that the rate is fixed (i.e. 1, 3, 5, 7 or 10 years). The other allows you to pay interest only beyond the fixed rate period, usually 10 years. Make sure you determine which type you have.

# What Could your Payment Become?

## Worst Case Scenario:

Initial Rate + First Adjustment Cap = Worst Case Rate

IR + FC = W

For example, if your initial rate is 6% and the first adjustment cap is 5%, your worst case rate is:

6% + 5% = 11%

To calculate **what your payment may become** if your loan adjusts to the worst rate possible, you need to know what your loan balance will be when it adjusts.

1. If you have a fully amortized loan (paying principal and interest with each payment), you will need to consult an amortization schedule to determine the future loan balance. Your lender should be able to generate the amortization schedule for you from his software system.
2. If you have an interest only loan and you pay only the interest, your balance when the rate adjusts will be exactly the same balance you began with.
3. If your loan terms allow you to pay interest only beyond the adjustment period, the payment calculation is:

(Principal x Rate) ÷ 12 = Interest Only Payment

For example, let's say you will owe $400,000 when the rate adjusts. If the loan allows you to pay interest only beyond that period, the worst your payment can become is:

($400,000 x 11%) ÷ 12 = $3,666

In this case, your start rate was 6%. You were used to paying $2,000 per month for the first 5 years ($400,000 x 6% ÷ 12). In our worst case scenario, you will need to prepare yourself for the possibility that your payment could increase by $1,666 per month. That is an increase of more than 80%.

If your loan will NOT allow you to pay interest only beyond the adjustment period, you will need a mortgage calculator to determine your possible payment. Mortgage calculators are easily found online, including on my website www.HollyHomeLoans.com.

Here is an example of what a fully amortized payment can become.

- If your original loan amount is $400,000, your interest rate is fixed for 5 years, and you pay interest only for the first 5 years, you will still owe **$400,000** when the rate adjusts, and your new monthly payment will be amortized for the remaining term of the loan (loan terms are usually 30 years).
- So the "Period," or number of years you need put into the mortgage calculator is determined by subtracting the years you have already had the loan, from the total term of the loan. In this case, we will use a 30-year loan term:

30 – 5 = **25 years**

- Your worst case interest rate, calculated above, would be 11%.

Using the Principal, Interest, and Loan Term numbers highlighted in gold, a mortgage calculator will give you a new monthly payment of **$3,920.** This payment is calculated to ensure you pay off the loan completely in the remaining 25 years of the loan term.

## Summary of Worst Case Scenarios:

If your interest rate adjusts to the maximum allowable (11%), your payment could increase to **$3,666** if you are allowed to pay interest only after the adjustment date, or to **$3,920** if you paid interest only for 5 years, and then have to pay principal and interest.

## Best Case Scenario:

When the LIBOR went down to about 1% and the Treasury to about a half percent, many people were very happy that they had an adjustable rate mortgage. Now we will calculate the best interest rate possible when your loan adjusts. The best possible interest rate at adjustment will be the **greater of the two following rates:**

Possible Rate #1

Margin + Index

M + I = PR1

Possible Rate #2

Initial Rate – First Adjustment Cap

IR – FC = PR2

## Example:

- ➢ You have an adjustable loan with an interest rate that is fixed for the first 5 years of the loan at 6% **(IR)**
- ➢ Your index is the LIBOR. For this example, let's assume that when your loan rate adjusts the LIBOR is at the lowest we have seen, approximately 1% **(I)**
- ➢ Your Margin is 2.5% **(M)**
- ➢ Your First Adjustment Cap is 5% **(FC)**
- ➢ Your loan allows you to pay interest only payments for the first 5 years, and then must be fully amortized (paid off) over the remaining term of the loan
- ➢ Your original principal balance was $400,000, and has not changed for the first 5 years **(P)**

Possible Rate #1

M + I

2.5% + 1% = 3.5%

Possible Rate #2

IR – FC

6% - 5% = 1%

(You use the **greater** of these two rates for your payment calculation.)

In theory, your rate could go down by 5%. However, in reality, your rate can only decrease as low as the index plus the margin will allow. **So the lowest your rate can become is the greater of the two rates we calculated above, or 3.5%.** Now let's do the same calculations we did in the Worst Case Scenario using the lowest possible rate of 3.5%.

Principal x Rate ÷ 12 = Payment

If you owe $400,000 when the rate adjusts, and the loan allows you to pay interest only beyond the fixed rate period, the lowest your payment can become is:

$400,000 x 3.5% ÷ 12 = $1,666

If the loan becomes fully amortized, the numbers you would put in a mortgage calculator are:

P =$400,000

R= 3.5%

Term: 30 – 5 = 25 years

Amortized (principal and interest) Payment at adjustment:

**$2,002**

## Summary of Best Case Scenarios:

If your interest rate adjusts to the minimum allowable (3.5%), your new monthly payment will be **$1,666** if you are allowed to pay interest only, or **$2,002** if you paid interest only for the first 5 years and now have to pay principal and interest over the remaining 25 years.

## What is most likely to happen?

**There is absolutely no way to know with certainty what an index value will be years from now.** Index values are determined by many factors that are impossible to predict. However, you can look at the history of your index to get a feel for *where it may go* based upon where it has been in the past. There are charts and tables online that give you valuable insight into the Indexes. I like to use the charts at www.mortgage-x.com. This site is a good source of charts and tables that show the history of the various Index values; it also provides descriptions of the characteristics of the various Indexes.

If you study the history of your loan's Index you can determine a likely value it may have when your loan adjusts. Then simply add that Index value to your Margin and you will have your best guess as to your future interest rate. You can then perform the same calculations we did above using your "best guess" future interest rate.

# It's Time for a Checkup!

Just as you have medical checkups, you need loan checkups. When and how should you do loan checkups? I recommend you put the following checkup times on your calendar:

- ✓ An interest rate checkup 4 to 6 months before your loan is scheduled to adjust;
- ✓ A loan qualification checkup 6 to 12 months prior to adjustment.

Place the following information on whatever calendar system you use:

1. The Start Rate;
2. The Margin;
3. The Index name (i.e. LIBOR, Treasury);
4. The First Adjustment Cap.

If you still have the loan when your checkup time rolls around, do this:

1. Go online, or call your loan officer, to determine the current value of your Index.
2. Add that index value to your Margin to determine one rate.

3. Add your Start Rate and your first Adjustment Cap to determine the highest your rate can go. Subtract the Adjustment Cap from your Start Rate to determine the lowest your rate can become.
4. Your new rate will be the lesser of the two numbers if the rate goes up. It will be the greater of those two numbers if your rate goes down.
5. Calculate your new payment using the calculation methods given earlier in this chapter.

## Example:

1. Start Rate is 6%.
2. Margin is 2.5%.
3. Index is the LIBOR.
4. First Adjustment Cap is 2%.

For our example, 4 months prior to your adjustment date we will say the **LIBOR is 3%.** If your loan were to adjust at that point, one possible rate would be the Margin plus the Index value:

2.5% + 3% = 6.5%

The maximum allowed adjustment would be the Start Rate plus the Adjustment Cap:

6% + 2% = 8%

Your rate will be the **lesser of those two rates,** or **6.5%.**

What if the **LIBOR has gone down to 1%**? Your Margin plus Index rate would be:

2.5% + 1% = 3.5%

The minimum rate allowed by your loan terms is the Start Rate minus the Adjustment Cap:

6% - 2% = 4%

In this case, your rate at the checkup date would be **4%**, not 3.5%, because **it cannot be lower than 2% below your Start Rate** (Adjustment Caps apply in both directions).

**I recommend you do a loan qualification check up 6 to 12 months before your loan adjustment date.** This is a good time to make sure your credit rating is in good standing. If any collections, late payments, high credit card balances, or other problems have arisen, you will have time to take care of them (if possible) and improve your "FICO" score in time to refinance. FICO stands for "Fair Isaac Company." FICO determine the formulas that dictate your credit rating score. In reality, only 2 of the 3 credit bureaus use the FICO formula. The other uses the Beacon scoring system, but that is a technicality. We use the middle score of borrowers' 3 scores to qualify them for a mortgage. We refer to that score as the borrower's "FICO Score" for simplicity and ease of conversation.

There is only one website that gives you a true FICO score as of the date I am writing this book: www.myfico.com. All the others will give you information on your credit, but they don't give you the score that mortgage lenders use. If an auto dealer runs your credit, the score he

gives you will not be the same score mortgage lenders use. Credit scores are specific to the industries they serve.

You may want to contact your loan officer six months, or so, in advance of your adjustment date, send him your income documentation, and ask if you will qualify for a new loan by the then-current lending guidelines. Basically, you want to be sure you can get another loan if you need one. Lender guidelines change constantly. It is important to know whether or not you can refinance when your loan adjusts, so that you can be fully prepared.

## Option ARM Recast

The characteristics of Option ARM adjustments are covered in the chapter dedicated to that loan type. This chapter will simply help you determine the worst case scenario if you allow your Option ARM loan to recast.

### Holly's Definition of a "Recast":

A recast happens when you have added the maximum allowable Principal to your original loan balance.

The maximum allowable increase percentage is stated in your Loan Note, and you loan officer should make it clear to you before you agree to choose an Option ARM. If you do not hit the maximum allowable Principal, your loan will recast at a specified point in the term of the loan, usually 5 or 10 years after origination. When your loan recasts, the lender recalculates your monthly payment based on the current accrual rate (the actual interest rate you are paying), your principal balance, and the remaining term of the loan. The recalculated payment is usually fully amortized, and your monthly payment usually changes drastically.

As discussed in the chapter dedicated to the Option ARM, **do not allow your principal balance to reach the maximum allowed prematurely!** Here is a simple way to avoid premature recast:

- ✓ Know your maximum allowable increase in Principal (usually 110%, 115%, or 125%, it will be outlined in your Note).
- ✓ Multiply your original loan balance by that percentage, and make a note of that amount (i.e. $400,000 x 115% = $460,000; $400,000 x 110% = $440,000).
- ✓ Check your loan balance on your mortgage statement every month, and **never allow your balance to reach the maximum allowed.**

Avoiding premature recast is easy if you are paying attention. Simply pay enough each month so that you do not add more principal to your loan balance than you absolutely have to. It is best to pay at least your interest only payment if your minimum payment is lower than the interest only payment. If that is not possible, then please watch your balance carefully. You don't want to be surprised by a lender recast notice.

# What Could your Payment Become if You Recast?

## Worst Case Scenario:

Here is what you need to know to calculate the worst case scenario for an Option ARM:

1. The recast point (i.e. maximum amount of principal you can add to your original loan balance).
2. Lender guidelines that determine whether or not you will be allowed to pay interest only when the loan recasts. (You should know that lenders rarely allow interest only payments after recasting occurs.)
3. Your original Principal loan amount = **P**
4. Your Margin = **M**
5. Your Index = **I**
6. Your First Adjustment Cap (there may not be a first adjustment cap) = **FC**

Lender guidelines vary greatly and, honestly, are not always clearly spelled out in the loan documents. So to prepare for your worst case scenario, you will need to go online and find the highest value your Index has been in recent history, and assume it will be that value at recast. For this example, we will use the MTA because that is a very common index for Option ARM loans. The highest value the MTA reached between 1998 and 2008 is 6.128%. So we will use that figure.

## Example:

We will use the following information for our example:

- Original loan amount - $400,000
- Maximum amount of principal allowed – 115% (of the original loan amount)
- Index – MTA (6.128% for our worst case calculation)
- Margin – 3%
- Recast point – 4 years into the 30-year loan term (this is a guess, but it is reasonable)
- We will assume that there is no cap to the rate adjustment at recast for this example

Now we will gather the information you will need to feed into a mortgage calculator to determine the payment at recast:

$$P \times 115\% = \text{Loan Amount}$$

$400,000 x 115% = **$460,000**

Index + Margin = Rate
6.128% + 3.0% = **9.128%**

Term: 30 – 4 = **26** years

Amortized Payment at Recast (using a mortgage calculator):
**$3,862**

If the lender allows interest only payment at recast:
Payment = Principal x Rate ÷ 12
($460,000 x 9.128%) ÷ 12 = **$3,499**

## Summary of Option ARM Recast Worst Case Scenarios:

If your loan recasts at 115%, and your rate goes to the full rate (determined by adding Index + Margin), your payment could become **$3,499** if you are allowed to pay interest only, or **$3,862** if you now have to pay principal and interest. If your minimum payment began at 2%, four years later your minimum payment would be **$1,837**. **If you are used to paying $1,837 and then are suddenly required to pay $3,862, the payment shock could make it impossible for you to pay your monthly mortgage payment. This is why it is critical that you prepare for what may happen if your Option ARM recasts. If at all possible, avoid allowing your loan to recast at all.**

- ✓ **To avoid premature recast,** pay enough each month to ensure you will never hit the maximum principal limit allowed by your loan terms.
- ✓ **To avoid the mandatory recast point,** you will need to refinance before the recast point.

I would like to point out that some lenders allow a 10-year period before mandatory recast, on a loan term of 40 years. If you are offered this loan type, take it. It is much safer to have a 40-year loan term because, when the loan recasts, the balance will be amortized over the remaining 30 years, so the payment will be more reasonable.

# Chapter Summary:

You will do yourself a great service if you take the time to calculate the worst that can happen when your loan adjusts. This is powerful information to arm yourself with when you need to make financial plans and decisions. Having that number in the back of your mind may guide your choices.

My hope is that you will protect yourself by putting more money into savings than you may have if you weren't preparing for the worst. Armed with this information, you may also make wise choices about your credit. If you know you may have to refinance in the next few years, you may be more motivated to keep your credit card debt low and pay your mortgage(s), credit card accounts, car payments and other debts on time; and avoid allowing medical expenses and other debts to go into collections.

**The best thing I can do to protect you is help you prepare for the worst. However, it is always best to focus on achieving the best.**
**Knowing your loan terms and future consequences makes you the master of your financial destiny.**