Hybrid ARMs in Depth

Hope for the best, but plan for the worst

There are five aspects of Hybrid ARMs that should play an important role in your decision as to whether or not a Hybrid ARM is a good choice for you. Their relative importance is dependent upon your situation. Here they are:

1. **The likelihood that you will keep the loan beyond the fixed rate period** of, typically, 1, 3, 5, 7, or 10 years (as opposed to selling, refinancing, or simply paying off the loan within the fixed rate period).
2. **The Margin** is the lender's profit margin. The margin will be added to the index to calculate your new interest rate when the loan rate adjusts.
3. **The Index** to which your loan rate is tied. Index values typically change on a monthly basis. Each has its own characteristics. We will discuss the most commonly used indexes in this chapter.
4. **The Adjustment Caps** – These are the maximum increase or decrease percentages your rate can experience when it adjusts. It is expressed as a percentage that is added to, or subtracted from, your start rate. Hybrid ARMs usually adjust annually or semi-annually after the first adjustment. There are 3 types of Adjustment Caps:
   - First Adjustment Cap;
   - Subsequent Adjustment Cap;
   - Life Cap.
5. **If you have an interest only loan**, does the lender allow you to continue making interest only payments after the initial fixed rate period? Some lenders have gotten smart. They will allow you to pay interest only for 10 years, even though the interest rate ad-

justs sooner. This is a great feature to look for when deciding which loan is best for you. You will have less payment shock if your rate goes up when it adjusts and you will be pleasantly surprised if the rate goes down.

In Depth Discussion of Hybrid ARM Characteristics

How Long Will You Keep the Loan?

This is often difficult to determine. We make plans and then "life happens." We sometimes think we will move up to a larger house or downsize in 5 years. But 5 years fly by and we keep the house, anyway. We think we will refinance within 5 years to pull out some equity, but home values go down, or we lose our jobs, our credit ratings go down. Any number of life events can get in the way of our plans. **The entire process of choosing an adjustable rate mortgage balances risks and rewards.** This is why it is usually wise to choose an adjustable loan *only* if the rate and payment are significantly lower than a simple 30-year fixed loan.

Margin

As we mentioned above, the Margin is the profit margin for the lender. It is added to the Index to calculate your actual rate when the loan rate adjusts. In my experience, margins range from 1.5% to 2.75% for Hybrid ARM home loans in the prime lending market (loans for well-qualified borrowers). As of the date of this writing, there is virtually no sub-prime market (loans for those with poor credit ratings). There was a time when the Margins and Adjustment Caps for sub-prime loans were criminally high, which is one of the factors that triggered the mortgage crisis that began in mid-2007. (But I'll get on my soapbox about this later.) For your purposes, right now, you simply need to know what the Margin is.

Getting the lowest Margin you can find is important. It could make a *huge difference* in your payment if the interest rate adjusts upward. If you have a loan with a 1.5% Margin and your neighbor has a loan with a Margin of 2.75%, his rate will be 1.25% higher than yours when your loans adjust (if both loans adjust at the same time and are tied to the same Index). On a loan of $400,000, that is a difference of $416 per month in interest.

Index

Most Hybrid ARMs are tied to either the LIBOR (usually either the 6-month LIBOR, or the 1-year LIBOR) or to the Treasury Index . If you research the history of the indexes and decide

that you want the Treasury Index, make that clear to your loan officer so that he shops only those loans for you. There is a helpful website (www.mortgage-x.com) which has a calculator that helps you decide which index is better for your circumstances.

Choosing your index is more important for Option ARMs (see the next chapter) than it is for Hybrid ARMs, because the rate usually adjusts monthly with Option ARMs. If you choose a Hybrid ARM, you may just have to resign yourself to being tied to the LIBOR index. By the way, the LIBOR was a great index to be tied to in 2003 and 2004. People **loved** their adjustable rate mortgages in those years because the LIBOR was around 1%, so most people's rates adjusted to the 3.5% range. Even better, the Treasury Index was around 0.5% in late 2008, early 2009.

Adjustment Caps

The Adjustment Cap is the greatest percent above or below your start rate that the loan rate can adjust, periodically, when the fixed rate period is over. **This is a part of the loan that few borrowers care about, but you should definitely pay attention to it.**

- **First Adjustment Cap** – greatest percent difference from the start rate that the loan's interest rate can move on the first adjustment.
- **Subsequent Adjustment Cap** – greatest percent difference from the previously adjusted rate that the loan's interest rate can move on subsequent adjustments.
- **Life Cap** – the maximum percent over your start rate that the loan's interest rate can increase in the entire life of the loan.
- **Floor Rate** – Some banks have a "floor rate" written into the loan note, but most do not. Your rate can never go below the floor rate, even if the margin plus the index would give you a lower rate. Floor rates benefit the lender, but not the borrower. If you have a choice between a loan with a floor rate, and one without, obviously choose the one without (assuming the rate and other terms are similar). Some of the adjustable rate loans have a floor rate equal to the start rate. I only recommend this loan to my clients if the start rate is significantly lower than the competition.

Most lenders have a 5% first Adjustment Cap for loans whose rate is fixed for 5 years or more, and a 2% first Adjustment Cap for loans fixed 3 years or less. I have researched dozens of lenders' Adjustment Caps for Hybrid ARMs. Less than a half dozen of the lenders I studied had first adjustment caps less than 5% for their 5-, 7-, and 10-year loans. Of course, I shop the lenders with the lowest adjustment caps and recommend them if their initial interest rates and guidelines are similar to the other choices. You will probably get similar results if you have a loan officer who is a mortgage broker and can shop many different lenders and loan types for you.

Adjustment Cap Example:

If you have a start rate of 6%, Adjustment Caps of 2/2/5 and no floor rate, this means:

- ➢ Your first adjustment can be 8% if it goes up (6% + 2%) or 4% if it goes down (6% - 2%).
- ➢ Subsequent adjustments can be up to 2% above or below your previously adjusted rate.
- ➢ The highest your rate can go in its lifetime is 11% (6% + 5%). The lowest is technically 1% (6% - 5%). However, that is not possible in real life (please see the explanation, below).

With an Adjustment Cap of 5%, theoretically your rate can go up or down as much as 5% from your start rate. The reality is that it cannot possibly go *down* that much in most cases, but it can certainly go *up* by 5%. **You, not the lender, shoulder the greatest risk.** The reason it can't usually go down the full 5% is that the adjusted rate is calculated by adding the Index plus the Margin. The Margin is usually about 2.5%-- you will never find a Margin of zero. The lowest any of the Indexes have ever gone is about 0.5%. So, if your start rate is around 6%, the lowest it can reasonably expect to go is 3.0% (Margin 2.5% + Index 0.5% = 3.0% rate), which is only 3.0% lower than your start rate, not 5% lower. **In this example the lender's downside risk is about 3.0%, but your risk is the full 5%.** While studying for my Broker's License, I learned that adjustable loans are designed to shift the risk from the investor to the borrower.

Here's the soapbox I promised you:

This aspect of Hybrid ARMs brings my protective, mothering instincts out in full force. If I ran the world of lending (not much chance of that!), the first thing I would do is ensure that Adjustment Caps would never be greater than 2%. When loans have a 5% Adjustment Cap, the lender is essentially saying that the sky is the limit if rates go up, but their downside risk is limited by the reality of the factors used to calculate it. **Investors are in the business of taking risks, not homeowners.** When investors shift the risk from themselves to the homeowners, they are *asking* for defaults. **In my opinion, it is not a wise business practice to try to shift the risk to someone who is unprepared to shoulder it.** If you are an investor, you are *prepared to take risk*. Investing is risky by nature. Most homeowners are regular people who usually cannot afford the risk that most investors can afford. How many people do you know who can afford to double their mortgage payment overnight? FHA loans make more sense. Their first adjustment cap is 1%.

I am aware of one bank whose loan terms are even worse, in my opinion. The terms are solidly in the bank's favor, and contrary to the interests of the borrowers. *USBank Consumer Division* offers Hybrid Adjustable Rate Loans **whose start rate is the floor rate**[1]. This means that when it comes time for your loan to adjust, the rate can either remain the same or go up, but **it can never go down**. I discovered this aspect of their guidelines when I read the loan documents they gave my client. Neither my rep, nor the rate sheet, mentioned that fact. Many

1 This is the guideline as of September 2009.

sub-prime loans had the same terms, but I have never seen a prime lender whose guidelines do not allow the rate to decline if the market declines. When my rep questioned management about this aspect of their loans, their response was that it had always been that way so they weren't going to change it. So let me see if I understand their position. They have always been unfair to the borrower, so that is the reason they will *continue* to be unfair. Is that correct? Makes perfect sense to me!

There are three US Bank divisions that offer home loans: the consumer division, the correspondent division, and the retail division. This may sound like Greek to you. I want to make you aware of the 3 divisions because if your loan officer sends your loan application to the consumer division for an adjustable rate mortgage, you need to be aware that your rate may never go lower than your start rate (assuming they do not change the loan terms after date of publishing). So carefully examine your options. If any other lender offers a rate and terms similar to those that US Bank offers you, you will probably want to go with the other lender (assuming the other lender allows your rate to decrease). Please check our website on the "Updates" tab, as well. If after I publish this book, US Bank changes their adjustable loan terms, or if I find other lenders with similar terms, I will post the information there.

The chapter titled "Truth or Consequences" walks you through the calculations you need to do to determine the best- and worst-case payments you could experience at loan adjustment. I also created full-disclosure forms that ask your loan officer to provide you with *all the terms of your loan, and to calculate the highest and lowest payments you could experience when your loan adjusts*. The forms are in the back of this book and online at www.HollyHomeLoans.com. My hope is that these disclosure forms will be passed into law to protect all borrowers. In the meantime, at least you will have them for your home loan.

Life Cap

The Life Cap is usually 5% or 6% over the initial rate. There isn't much room for negotiation, here. I only mention it because if all other factors are the same, your decision could be made by this factor. It can be important for home equity lines of credit, however. Consequently, you should ask about the Life Cap when you apply for a line of credit. I have seen Line of Credit Life Caps over 18%, when the start rate was as low as 4%.

Interest Only or Fully Amortized Options

Some loans allow you to pay interest only for a period of time. If you choose that option, you will owe the same amount of money at the end of the period as your initial loan amount. A fully amortized loan payment includes paying off both interest and principal. So the amount you owe the lender goes down each month. The amortized payment is calculated to ensure complete loan pay off in the time frame defined by the loan, usually 15, 30 or 40 years.

Chapter Summary:

We have now discussed all the important features of Hybrid Adjustable Rate Mortgages:

1. The likelihood that you will need to keep the loan beyond the fixed rate period;
2. The Index;
3. The Margin;
4. Adjustment Caps;
5. Interest Only or Fully Amortized options.

We also discussed aspects of lending that, in my opinion, need to be modified, the first Adjustment Caps and many lenders' choice to shift the risk from themselves to homeowners. In reality, lenders aren't shifting risk at all. They are ensuring large "write downs" from defaults, thereby taking on greater risk.

You may have heard the old adage "Pigs get slaughtered," which cautions that being greedy and not accepting appropriate responsibility results in a "slaughter" for the greedy individuals. We have all observed this adage in action *big time* during the mortgage crisis.