

FAQ: Adjustable Rate Mortgages

Q. How does an adjustable rate mortgage differ from a fixed rate mortgage?

A. Understanding the complexities of adjustable rate mortgages is no easy task. Unlike a fixed rate mortgage on which interest is paid at the same rate throughout the life of the mortgage, the rate of interest charged on an adjustable rate mortgages (commonly called an "ARM") will change at least once, and usually many times over the life of the loan. The most common ARMs will provide for interest rate changes either monthly, every 6 months or once every year. The rate changes periodically on a date known as the "change date".

Q. How is the rate determined on each change date?

A. On each change date, the interest rate which will be charged until the next change date under the terms of the mortgage note is determined by adding a number called the "margin" to an "index" which is commonly published in periodicals such as the Wall Street Journal. A common "index" which is frequently used to determine the interest rate charged by banks on loans is the "prime rate". On permanent mortgage loans, the most commonly utilized indexes are the yield on the "one year Treasury Bill", the "6 month LIBOR" (London Interbank Offered Rate), and the "11th District Cost of Funds (commonly called the "COFI"). Let's assume that on January 27th these indices had the following values:

One year Treasury Bill 7.020%
Six month LIBOR 6.938%
11th District Cost of Funds 4.387%

On the change date of the ARM the margin will be added to the index to determine the new interest rate. Margins on ARMs typically range from 2.500% to 3.000%. Thus, if the change date were on January 27th, the margin on an ARM were 2.750% and the index for the ARM was the One Year T-Bill, the new rate would be 9.77% (7.020% + 2.750%). The rate which results from sum of the index and the margin is referred to as the "fully indexed rate".

Q. What is the "start rate" on an ARM? **A.** As if the procedure of determining the indexed rate were not complicated enough, there are other factors which can result in a different rate than that derived from the above-described formula. It is not uncommon for ARMs to have a start rate or beginning interest rate that is considerably less than the fully indexed rate. For example, the note which had a fully indexed rate of 9.77% might have a start rate of 6.250%, far below the fully indexed rate.

Q. What are "caps"?

A. The amount by which the interest rate charged on an ARM can change from one change date to the next (or over the entire life of the loan) is typically limited by what are called "caps". There are

"per change caps" and "lifetime caps". The "per change cap" limits the amount by which the interest rate can be increased or decreased from one change date to the next. Thus, in our example, if an ARM has a "per change cap" of 2 and adjusted annually, the new interest rate on the first change date would be 8.25%, even though the fully indexed rate might be 9.77%. This is because the rate can never increase by more than 2 percentage points on any one change date. The maximum possible interest rate on an ARM is determined by the "lifetime cap". Thus, if an ARM has a lifetime cap of 6 percentage points and a start rate of 6.25%, the maximum interest rate to which the loan could increase would be 12.25% (6 percentage points greater than the start rate of 6.25%). Caps are often expressed as two consecutive numbers (e.g. 2/6). The first number refers to the "per change cap" and the second to the "lifetime cap".

The following example indicates how the interest rate on an ARM would be determined during the first few years of the loan's term.

We will assume that the index on the ARM in our example is the 11th District Cost of Funds (COFI) and that the interest rate adjusts every 6 months. The note evidencing the loan is executed on December 25, 1994 with a first payment due on February 1, 1995. The note provides that the first change date is on June 1, 1995 with a change date occurring on the 1st day of the month every six months thereafter. In this instance the first 6 change dates would be on June 1, 1995, December 1, 1995, June 1, 1996, December 1, 1996, etc. The note has a start rate of 6.50% and caps of 1/6. The margin is 2.750%. From the date the note is executed until June 1, 1995 the note would bear interest at the rate of 6.50%. We will assume that the COFI (Cost of Funds Index) goes up from its current level to 5.387% on June 1, 1995. The indexed rate on June 1, 1995 would be 8.137%. The 1% "per change" cap would, however, limit the new interest rate to 7.500% (1 percentage point over the existing rate). If on the second change date the COFI has declined back to 4.387%. The fully indexed rate would be 7.137%. Because the existing rate of 7.500% is less than one percentage point more than the fully indexed rate, the "per change cap" would have no effect on the second change date. Accordingly, the rate on the second change date would be the fully indexed rate of 7.137%. If the COFI eventually climbed to 10%, the fully indexed rate would be 12.75%. But the lifetime cap of 12.50% would prohibit the rate from changing to that high rate. The rate on that change date would be limited to 12.50% (the life capped rate).

Q. Can I convert my ARM to a fixed-rate mortgage later?

A. On some adjustable rate mortgages you can elect a "conversion option" which will allow you to convert the ARM to a fixed-rate mortgage (at the prevailing 30 year interest rate at the time of the conversion) for a nominal conversion fee. The option must typically be exercised between the 13th and 60th month of the mortgage.