All You Wanted to Know About ARM Mortgages

Practical Tips to Enhance Your Fin ancial Freedom
From The Desk Of Joe & Bonnie Tufo

Here is what you will learn in this tutorial

1. What is an interest-only mortgage?
2. For what types of borrowers is it suitable?
3. What are the hazards you should watch out for?
4. What information do you need to assess an Interest Only (IO) mortgage?
5. How do you get this information?

What Is An Interest-Only Mortgage?

A mortgage is "interest only" if the scheduled monthly mort gage payment – the payment the borrower is required to make --consists of interest only. The option to pay interest only lasts for a specified period, usually 5 to 10 years. Borrowers have the right to pay more than interest if they want to.

If the borrower exercises the interest-only option every month during the interest-only period, the payment will not include any repayment of principal. The result is that the loan balance will remain unchanged.

For example, if a 30-year loan of $400,000 at 6.25% is interest only, the required payment is $2083.33. In contrast, borrowers who have the same mortgage but without an IO option, would have to pay $2462.87. This is the "fully amortizing payment" – the payment that would pay off the loan over the term if the rate stayed the same. The difference in payment of $379.54 is "principal", which go to reduce the balance.

For What Types Of Borrowers Are Interest-Only Mortgages Suitable?

Interest-only mortgages are for borrowers who have a valid use for a lower initial required payment, and are prepared to deal with the consequences.

Pay Principal When Convenient: Borrowers with fluctuating incomes may value the flexibility the IO mortgage gives them. When their finances are tight, they can make the IO payment, and when they are flush they can make a substantial payment to principal.

Ask yourself whether you are disciplined enough to make the payment to principal when you aren't obliged to.

Buy More House: It is common for families to begin with a "starter house", and then move into a more expensive house as their incomes rise. This process of "trading up" carries high transaction and moving costs.

You can avoid these costs by skipping to the second house now. In the short term, this will cause a cash flow strain, but the IO mortgage may make it manageable.

Ask yourself whether you are comfortable with the risk that the expected higher income won't materialize.

Invest the Cash Flow: For most homeowners, paying down mortgage debt is the most effective way to build wealth. Nonetheless, some may build wealth more rapidly by investing excess cash flow rather than paying down their mortgage. For this to succeed, their return on investment must exceed the mort gage interest rate, since that rate is what they earn when they repay their mortgage.

A valid example is the young borrower with a long time horizon who invests in a diversified portfolio of common stock. This should generate a yield of 10% or more over a long period. Another example is business owners who might earn a high return investing in their own businesses.

Ask yourself whether you really will invest the excess cash flow, as opposed to spending it; and whether you have a firm basis for believing that your investments will yield a return higher than the mort gage rate.

What Are The Hazards You Should Watch Out For?

The major hazard is being deceived into accepting an interest-only mortgage that does not meet any of the suitability tests described above. The deceptions are about alleged desirable features of IOs that don't exist.

Borrowers can immunize themselves against most deceptions by remembering one critical fact. If two mortgages are identical except that only one has an interest-only option, lenders view that one as riskier. The reason is that, after any period has elapsed, the loan with the IO option will have a larger balance.

Deception 1: *An interest-only loan carries a lower int erest rate.* Lenders sometimes charge a higher rate for an identical loan with an interest-only option, for reasons indicated above. They never charge a lower rate.

The deception arises from comparisons of apples and oranges. Most interest-only loans are adjustable rate mort gages (ARMs), and ARMs have lower rates than fixed-rate mort gages (FRMs). ARMs with the IO option have lower rates than FRMs because they are ARMs, not because they are IO.

Deception 2: *An interest-only loan allows the borrower to avoid paying for mortgage insurance.* Since loans with an IO option are riskier to the lender, the option cannot cause the disappearance of mortgage insurance.

The lender is insuring any IO loans with down payments less than 20% that don't carry mortgage insurance from a mortgage insurance company. The borrower is paying the premium in the interest rate rather than as an insurance premium.

Deception 3. *On an ARM with an interest-only option, the quoted interest rate is fixed for the interest-only period.* It is not. The interest-only period is the period during which you are allowed to pay interest only, usually 5 or 10 years. The period for which the initial rate holds can be as long as 10 years or as short as one month.

Deception 4. *It is less costly to amortize an interest-only loan.* This is patently ridiculous, but some variant of it keeps popping up in my mail.

There is no magic connected to amortizing an interest-only loan. A borrower who takes an interest-only option but decides to make the fully amortizing payment instead will amortize in exactly the same way as the borrower who takes the same mortgage without the option.

What Information Do You Need To Assess An IO Mortgage?

While future interest rates are not known, we can make assumptions about what will happen to rates; these are called *interest rate scenarios.* Usually, we focus on rising rate scenarios, because those are the ones we worry about.

For any given scenario, we can calculate exactly how high the rate and mort gage payment will go, and when it will get there. This is *scenario analysis.* We can also calculate the total cost over any period specified by the borrower. In assessing ARMs with an IO option, borrowers will want to compare scenarios with and without the option.

When ARM rates are much lower than FRM rates, shrewd borrowers may take an ARM but make the payment that they would have had to make had they taken an FRM. By paying the balance down faster, the cost imposed by rising rates in the future is reduced. Hence, it is useful to perform scenario analysis based on the assumption that the borrower pays at the FRM rate for as long as that payment is larger than the ARM payment.

This is an alternative to an IO, and based on the opposite premise. Where an IO attempts to minimize the borrowers payments in the early years, for any of the reasons noted earlier, the FRM payment option is designed to pay down the balance as much as possible in the early years.

	ARM 1	**ARM 2**	**ARM 3**	**ARM 4**	**ARM 5**
Type of ARM					

Initial Interest Rate					
Most Recent Index Value					
Margin					
First Rate Adjustment Cap					
Later Adjustment Caps					
Maximum Interest Rate					
Loan Term (Years)					
Number of Years Interest Only					

INSTRUCTIONS: Enter information for up to 5 ARMs. They could be 5 different types of ARMs, or 5 of the same type of ARM with different features, or any combination of the two.

Worksheet Explanations

ARM Type: two numbers describe Each ARM type. The first number indicates the length of the initial rate period, during which the ARM rate is fixed. The second number indicates how often the rate is changed after the initial rate period ends.

1mo / 1mo:	2yr / 6mo:	5yr / 1yr:	7yr / 23yr:
3mo / 1mo:	3yr / 6mo:	5yr / 5yr:	10yr / 6mo:
6mo / 1mo:	3yr / 1yr:	5yr / 25yr:	10yr / 1yr:
6mo / 6mo:	3yr / 3yr:	7yr / 6mo:	
1yr / 1yr:	5yr / 6mo:	7yr / 1yr:	

Initial Interest Rate on ARM: This is the interest rate on the ARM that is fixed for the initial rate period.

Most Recent Value of the Interest Rate Index: You do this in two steps.

a. Identify the rate index used by the ARM: The list below covers 95% or more of all ARMs.

A. Cost of Funds, Eleventh District (COFI) - Monthly
B. 1-Year Treasury Constant Maturity Rate - Weekly
C. 2-Year Treasury Constant Maturity Rate -Weekly
D. 5-Year Treasury Constant Maturity Rate - Weekly
E. 10-Year Treasury Constant Maturity Rate - Weekly
F. MTA (a 12-month moving average of B) - Monthly
G. 1-Month Libor - Weekly
H. 3- Month Libor - Weekly

I. 6-Month Libor - Weekly
J. 1-Year Libor - Weekly
K. Certificate of Deposit Index (CODI), a 12-month moving average of 3-month CD rates
L. Bank Prime Loan Rate - Intermittent

b. Find the most recent value: If it is a series published monthly you want the last monthly figure. If it is also published weekly, you want the last weekly figure. Some series are also available daily but we don't advise using daily figures.

BankRate.com has the most recent figures for all the series except K which can be found at American Advantage Mortgage, Inc.

Margin: This is the amount that is added to the index value on a rate adjustment date to determine the new rate. The new rate equals index plus margin, subject to the adjustment caps and maximum rate indicated below.

First Rate Adjustment Cap: This is a limit on the size of any increase in rate at the first rate adjustment. These caps can range from 1%, which would be common on an ARM that adjusts after 6 months, to 5% on an ARM that doesn't adjust for 10 years.

Later Adjustment Caps: This is a limit on the size of any increase in rate at rate adjustments after the first adjustment. These caps are usually 1% or 2%. As an Illustration, a 7/1 ARM might have a cap of 5% on the first adjustment and 2% on all subsequent adjustments.

Maximum Interest Rate: This is the highest interest rate allowed on the ARM over its life. It is often set at 5% to 7% above the initial rate.

Loan Term: This is the period over which the mort gage payment is calculated. Most ARMs have a term of 30 years, but 15s are also available.

Years Interest-Only: If the ARM has an interest-only option, indicate the period.

Our Upfront Commitment to You

1. The broker will be the customer's representative or agent, and will endeavor to act in the best interests of the customer.

2. The broker will establish a price for services upfront, in writing, based on information provided by the customer.

*The price may be a fixed dollar amount, a percent of the loan, an hourly charge for the broker's time, or a combination of these.

*The price or prices will cover all the services provided by the broker. This includes loan processing, for which customers always pay a broker or lender.

*On third party services, such as an appraisal, ordered by the broker but paid for by the customer, the broker will provide the invoice from the third party service provider at the customer's request. Alternatively, the broker may have the payment made directly by the customer to the third party service provider.

3. Any payments the broker receives from third parties involved in the transaction will be credited to the customer, unless such payments are included in the broker's fee.

*If the broker's fee is 1.50 points, for example, and the broker collects 1.50 points from the lender as a " yield spread premium", the broker either charges the customer 1.50 points and credits the customer with the yield spread premium, or charges the customer nothing and retains the yield spread premium.

4. The broker will use his best efforts to determine the loan type, features, and lender services that best meet the customer's needs, and to find the best wholesale price for that loan.

5. The wholesale prices from which the broker's selection is made will be disclosed at the customer's request.

6. When directed by a customer who has met lender lock requirements, the broker will lock the terms (rate, points, and other major features) of the loan, and will provide a copy of the written confirmation of the rate lock as soon as it has been received from the lender.

7. If a customer elects to float the rate/points, the broker will provide the customer the best wholesale float price available to that customer on the day the loan is finally locked.

BROKER COMPENSATION

The total compensation to ________________, including any rebates from the lender, will be:_____________

A separate processing fee will be:____________

Signature of BST   Signature of borrower

_______________   __________________

Date: Date:

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