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Adjustable Rate Mortgages Wrongfully Accused

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In the frantic search for scapegoats to blame for the housing crisis of the last two years, Adjustable Rate Mortgages (ARMs) have been a favorite target. Only sub-prime lending, mortgage-backed securities and credit default swaps have been more vilified by the media. We have all seen stories where the first adjustment came, the house payment increased beyond the homeowner's ability to pay and foreclosure took hold with all the punishing vengeance of a medieval plague.

Is the ARM really to blame? Is the housing crisis a pandemic of predatory lending, or are borrowers to blame for exuberantly rushing to take out loans they neither understood nor legitimately could afford?

To be sure, mortgage lenders often took advantage of the premiums they could make by selling the borrower on the benefits of a low teaser rate for the first three years. And many borrowers made foolish choices. But ARMs in general were not the problem. Even in today's economic mess, ARMs have a legitimate and essential place in the range of options available to prospective homebuyers.

An ARM is simply a mortgage loan whose interest rate adjusts, usually once a year, to a few percentage-points spread over common bank industry indexes that measure costs of short-term borrowing, often the London Interbank Offered Rate or the yield on short-term Treasury debt. Some ARM loans are offered with fixed interest rates in their early years and caps on changes to their interest rates once the fixed-rate period concludes. A "five-one 4.5% ARM" is going to be fixed at 4.5% for five years, and then adjust up or down once a year. If the loan's adjustment is capped at 1%, it means that even if Libor leaps by several percentage points, the ARM's interest rate won't rise past 5.5% in year six.

ARMs first became available in the U.S. in 1959. The Wisconsin state legislature approved their use as a way to help savings-and-loans struggling with huge portfolios of low-interest, fixed-rate loans in an era when interest rates started to rise significantly. After taking off slowly at first with homebuyers, ARMs had gained nationwide popularity by the 1980s, especially in California where real estate values seemed to rise continually and predictably. Many borrowers believed the risk of missing the opportunity to get into a relentlessly booming real estate market outweighed the interest-rate risk of an ARM. ARMs were especially popular with young white-collar professionals with high expectations of regular salary increases.

In truth, most borrowers who researched the options available to them and settled on an ARM benefitted from the flexibility of their loans. In today's climate, however, many potential homeowners question whether they should even consider an ARM. The answer is yes.

Buying a house is a large and expensive commitment. Every buyer owes it to herself to evaluate all the available financing options and to make the best choice for her individual circumstance. The key is understanding when an ARM is really the right choice.

The decision boils down to some basic questions. Answer these objectively and dispassionately, and you'll know whether an ARM is the best solution for you. Once you've figured out your answers, run them by someone you trust to give you objective feedback. An ARM is a big commitment. You'll

benefit from reviewing your decision with a financial advisor, lawyer or an accountant. The cost of that advice is trivial compared to how much your mortgage payment might rise in one month alone.

Consider these questions when deciding if an ARM is really the right choice for you:

1. *Is the ARM really one of several options you have, or are you forced to accept an ARM in order to qualify?*

The biggest mistake is accepting the ARM because you have no other options. This is a red flag that you are either attempting to purchase more house than your budget can handle or refinancing in an attempt to cure existing budget problems. Avoid this mistake at all costs because it puts you on a trajectory towards foreclosure.

2. *How long do you plan to keep this mortgage or stay in your home?*

If you're reasonably certain you'll keep the property or retain the mortgage for less than 10 years, an ARM could be the better choice. Work the numbers to see how much each different loan option would cost you during that period. If the ARM comes out costing less, and if the payments could never get above your ability to pay, then the ARM is the better choice.

3. *Do you genuinely understand how long your initial interest rate will remain fixed?*

This would seem an obvious question, but it is one that an alarming number of buyers now in foreclosure overlooked. Don't forget to consider this question in light of your other financial plans. If you have a child starting college the first year your ARM can start rising, for example, you'll want to work the numbers hard to make sure you really will be able to afford a higher mortgage payment.

4. *Do you understand the amount your payment could increase if your plans change or you were unable to refinance?*

If the rate will remain fixed for, say, five years, what is the maximum the house payment can rise in month 61? Life has a way of throwing surprises at us. Your best laid plans to sell after five years might run into an unexpected downturn in the real estate market, for example. Make sure you could handle the interest-rate increase for at least a year or two after your planned timeframe for selling.

5. *Do you understand the caps?*

The caps dictate how much and how quickly your house payment can rise. If an increase in your payment takes you by surprise, it's no one's fault but your own. If you've done your homework, you won't ever be surprised.

6. *Are you aware of the ceiling?*

The ceiling is the maximum rate and corresponding house payment the borrower could pay. It's a number to take seriously. If you don't believe in good faith that you could handle the ceiling if it were hit at the earliest possible time, then you shouldn't take out the ARM.

Make sure you understand all of these questions. Compare all of your options. In many cases a fixed rate loan will be a better choice. If you're confident that you'll be selling your home within a fixed timeframe, however, there's a good chance that an ARM might be your best decision. Take your emotions out of the decision and become an educated buyer. Over the life of your home loan, it could save you a fortune—and save you from foreclosure.

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<http://www.forbes.com/2010/04/09/adjustable-rate-mortgage-personal-finance-housing-property.html>