

ARM Borrowers Match Loans to Their Uncertainty Tolerances

by Michael Schoenbeck

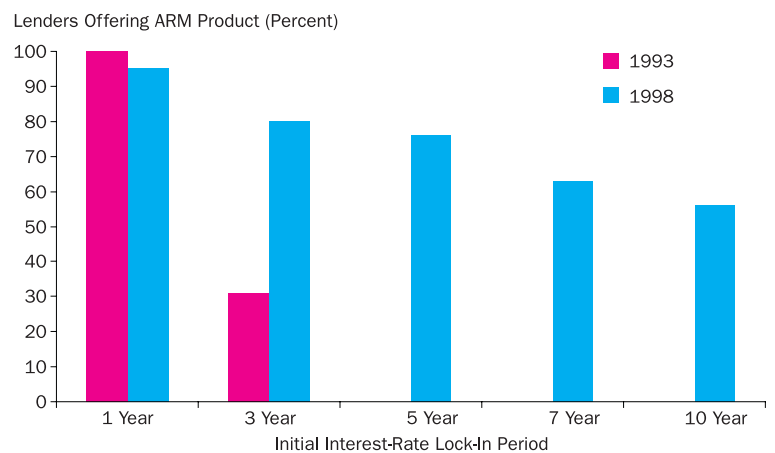
A GROWING BORROWER preference for longer initial-adjustment periods that neutralize some of the unpredictability of the adjustable-rate mortgage (ARM) has led to a wider selection of ARM alternatives, according to the results of Freddie Mac's 15th annual ARM survey.

Not so long ago—in 1993, for example—the so-called 1/1 ARM dominated the ARM market. The 1/1 ARM locks in the **initial interest rate** for one year and adjusts annually thereafter to reflect the prevailing market interest rate.

These days, though, longer-term options, such as the 5/1, 7/1 and 10/1 ARM, have grown plentiful compared to five years ago (*Exhibit 1*). The Freddie Mac survey—based on a national sample of 108 lenders polled in early November 1998—reveals that 76 percent now offer the 5/1 ARM, 63 percent offer the 7/1 ARM and 56 percent make available a 10/1 product. The longer-term alternatives allow ARM borrowers to defer the first payment adjustment for 5, 7 or

Michael Schoenbeck is a senior financial analyst in Freddie Mac's financial research department.

EXHIBIT 1
Historical Market Penetration of ARM Products



Note: ARM product designations refer first to the length of the initial interest-rate lock-in before the loan begins to adjust. Figures are based on conforming loan products.

Source: Freddie Mac

Longer-term adjustable-rate-mortgage (ARM) plans were rare five years ago; the 1/1 ARM was practically the only game in town when it came to floating-rate products. Recent survey results, however, show that one-half to three-quarters of lenders now offer longer-term adjustable plans, including the 5/1, 7/1 and 10/1 options.

10 years, respectively, before the payments start fluctuating annually to reflect changes in the financial index to which the loan is tied.

The front-end savings afforded by ARMs—the biggest advantage the product wields over fixed-rate loans—are a function of the initial interest rate charged. ARM borrowers and lenders share the **interest-rate risk**, so ARM interest rates typically are lower

than those on fixed-rate loans. The more interest-rate risk a borrower is willing to assume, the lower the interest rate that is charged during the initial-adjustment period.

In some sense, then, the longer-fused ARMs are hybrids of fixed-rate mortgages and the earlier ARMs. The hybrids begin with initial rates that are lower than fixed-rate mortgages, as illustrated by the various **starting**

rates displayed in Item 5 of *Exhibit 2*. Nonetheless, the starting rate on the hybrid ARMs is not quite as low as those on 1/1 ARMs. The 1/1 ARM offered the largest savings with respect to fixed-rate mortgages, with a 1.41 percentage-point pricing advantage in late 1998, as detailed in *Exhibit 2*'s rate-spread data.

Then again, the longer initial-period ARMs provide better protection against unexpected interest-rate hikes than the 1/1 ARM. However, they are not quite so insulated against nasty payment shocks as the fixed-rate mortgage. Any of the ARM options, though, can carry **interest-rate and payment caps** that afford some intermediate protection against movements in the economy. The features effectively limit how high a homebuyer's current interest rate and monthly payment can adjust upward when interest rates climb.

Providing some of the stability of a fixed-rate loan by drawing out the initial interest-rate period, hybrid ARMs thus give their borrowers more time to prepare financially when interest-rate increases loom. The varying adjustment periods also enable ARM borrowers to tailor their financing terms to suit not just current income levels but also expected future income streams. Similarly, borrowers also can tie their ARM selection decisions to the length of time they expect to stay in the home.

EXHIBIT 2 1998 ARM Product Features

	1-Year ARMs		3-Year ARMs		Longer Initial-Period ARMs		
	1/1 Conforming	1/1 Jumbo	3/1	3/3	5/1	7/1	10/1
Loan Terms							
1. Index Rate (Percent)	4.46	4.46	4.46	4.50	4.46	4.46	4.46
2. Margin (Percent)	2.79	2.80	2.80	2.79	2.80	2.79	2.79
3. Fully Indexed Rate (rows 1 + 2)	7.25	7.26	7.26	7.29	7.26	7.25	7.25
4. Initial Discount (Percent)	1.77	1.66	1.07	0.85	0.82	0.63	0.48
5. Starting Rate (rows 3 – 4)	5.48	5.60	6.19	6.44	6.44	6.62	6.77
6. Discount Points & Fees	1.0	1.0	0.9	0.9	0.8	0.8	0.8
Fixed-Adjustable Rate Spread	1.41	1.96	0.70	0.45	0.45	0.27	0.12
Product Penetration (Percent)	95	90	80	45	76	63	56

Notes: The sample is limited to ARMs indexed to either the 1-year or the 3-year Constant Maturity Treasury (CMT) yield. Data were collected from 108 ARM lenders during the week ending Nov. 6, 1998. The 3-year, 5-year, 7-year and 10-year ARM results are limited to conforming loans. The initial discount is based on the value of the weekly average 1-year or 3-year CMT yield for the week ending Nov. 6, 1998. The rate spread is based on the average 30-year conforming fixed-rate mortgage (FRM) commitment rate of 6.89 percent from Freddie Mac's Primary Mortgage Market Survey for the week ending Nov. 6, 1998, and the average 30-year jumbo FRM commitment rate of 7.56 percent from BankQuote for the week ending Nov. 6, 1998.

Source: Freddie Mac

The expanding variety of ARMs helps maintain the small but important market share that ARMs tend to command. For example, 1998's historically low 12-percent market share of all conventional dollar-volume origination (see "Housing Markets Continue to Roll with the Good Times," page 19) would be lower still if not for the new varieties of ARMs.

To demonstrate how even new ARMs can offer substantial savings over their fixed-rate counterparts, consider the example of a borrower who opted for a 3/1 ARM in early November 1998. By obtaining the then-average initial ARM start

rate of 6.19 percent, as depicted in *Exhibit 2*, the borrower would save 0.7 percentage points in annual interest-rate charges over the 30-year fixed rate, then averaging 6.89 percent. On a 30-year, \$100,000 mortgage, the lower 3/1 ARM rate results in savings of \$1,700 within the first three years of the loan.

Freddie Mac's survey also suggests that ARM borrowers would do well to comparison shop among several lenders. The study found a considerable range of prices offered on the same type of 1-year ARM plan. The initial rates quoted varied by more than three times that reported for fixed rates. *SMM*