5 - Adjustable Rate Mortgage (ARM) - ch. 5

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Supplemental

- adjustable rate mortgage
  - also called floating rate mortgage and variable rate mortgage
- SOFR
  - Secured Overnight Financing Rate
- LIBOR
  - London Interbank Offered rate
  - being replaced by SOFR

Resources

https://s3-us-west-2.amazonaws.com/secure.notion-static.com/32f455f6-9a05-4eeb-99f1-552ea55e5519/ADJUSTABLE_RATE_MORTGAGE_LOANS_-_Chapter_5.pdf

- ▼ the worldwide standard for variable interest rate for ALL types of loans
- ▼ taken by survey of the bank offerings offered by London international banks

▼ COFI

- ▼ 11th district Cost of Funds Index

▼ Prime

- ▼ US prime index - slow and high - currently 8.00
- ▼ with good credit you could do “prime minus”

▼ loan assignment

- ▼ lender (assignor) assigns rights to loan agreement to another lender (assignee)

▼ assumable vs “due on sale”

- ▼ when house is sold, assumable allows the mortgage to be picked up by the new buyer
- ▼ due on sale - mortgage is due on sale of the home, new buyer needs new loan

▼ recourse vs non-recourse

- ▼ recourse allows lenders to pursue borrowers other assets to pay off the loan balance

- non-recourse limits to the home itself and the listed collateral
- lockout
  - period of time which the loan cannot be repaid - prevents prepayment
- net-funded
  - when lender funds the seller, they will remove the point down payment so that it guarantees the borrower pays back the point (1%) immediately

Notes

- inderest rate changes
  - indexed to other market interest rates + margin
  - keeps lender’s profit margin when indices change
- index
  - includes SOFR (instead of LIBOR), US treasuries, COFI, Prime
  - index can be any time interest rate time series
- margin
  - lender’s profit margin (spread) over (above) the index
- composite rate

- ▼ index + margin - the composite interest rate on the loan

▼ reset dates

- ▼ date when interest rate changes (usually every half or full year)

▼ caps and floors

- ▼ max and min allowed periodic/lifetime adjustments to the interest rate or loan payment amount

▼ loan terms

- ▼ generally the same as fixed rate loans but with interest rate changes
- ▼ include <u>assumable or is it "due on sale",</u> recourse or is it non-recourse, prepayment (premium) and lockout, assignment, default and acceleration

▼ loan fees/costs

- ▼ same as fixed rate - origination, points, costs charged to borrower to increase lender's margin

▼ interest only or amortizing

- ▼ ARMs are usually fully amortizing, but can b interest only or partially amortizing

- negative amortization
    - unpaid interest is added to principal balance (unpaid)
    - if loan payment < accrued interest (because of payment cap) → negative amortization
    - interest rate caps don't cause negative amortization
- teaser rate
    - initial rate on the loan - usually far blow composite rate
- payment shock
    - when interest rate adjusts to the current composite rat → new loan payment is >> than teaser rate
- interest rate risk
    - the higher the frequency of reset dates → more risk to borrower and less risk to lender
    - due to ARM
- default risk
    - potential future rat increases → increase risk of borrower default on the loan
- hybrid ARMs
    - fixed rate for initial time period then become ARMs with annual interest rate reset dates

- ▼ 3/1, 5/1, 7/1, 10/1 → 3, 5, 7, 10 yr fixed then annual ARM
- ▼ conversion option
  - ▼ right of borrower to convert from ARM to fixed rate at future date
  - ▼ usually along with a fee

▼ Lecture

- ▼

▼ Textbook

📌 **SUMMARY**