Hybrid ARM Characteristics Explained

There are six main features of a Hybrid ARM that are an important part of your decision as to whether or not that loan is a good choice for you. Their relative importance is dependent upon your situation. Here they are:

1. **The likelihood that you will keep the loan** beyond the fixed rate period (typically 1, 3, 5, 7, or 10 years).
2. The **Index** it is tied to - The index + the margin determine your interest rate when the loan adjusts.
3. The **Margin** that will be added to the index to calculate your interest rate when the loan adjusts.
4. The **adjustment cap** - That is the maximum increase or decrease your rate can experience when it adjusts.
5. The **life cap** - The maximum rate your loan can be no matter what the other factors are.
6. If you have an **interest only loan**, does the lender allow you to make interest only payments beyond the term of the fixed rate period? Some lenders got smart. They allow you to pay interest only for 10 years, even though the rate adjusts sooner. This is a great feature because you will be less shocked if your rate goes up when it adjusts; and pleasantly surprised if the rate goes down.

How Long Will We Keep the Loan?

This is often difficult to determine. Life happens. We sometimes think we will move up to a larger house in 5 years, but 5 years fly by and we keep the house anyway. We think we will refinance within 5 years to get out some equity, but values go down, or you lose your job, or destroy your credit rating, any number of things can get in the way of our plans. **The entire process of choosing an adjustable rate mortgage balances risks over rewards.** This is why it is usually wise to choose an ARM only if the rate and payments are significantly different from a simple 30-year fixed loan.

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Index

Most Hybrid ARM's are tied to either the LIBOR (usually either the 6-month LIBOR, or the 1-year LIBOR) or to the Treasury (usually the 1-year CMT). Almost all Hybrid ARM's are tied to the LIBOR. If you go online and research the history of the indexes and decide that you want the Treasury Index, make that clear to your loan officer so that he or she can shop only those loans for you. There is a helpful site www.mortgage-x.com. They have a calculator that helps you decide which index is better for your circumstances. This is more important for Option ARM's than it is for Hybrid ARM's, however. If you choose a Hybrid ARM, you may just have to resign yourself to the fact that you are tied LIBOR index. It was a great index to be tied to in 2003 and 2004. People LOVED their adjustable rate mortgages in those years because the LIBOR was around 1%.

Margin

The Margin is the profit margin for the lender that is added to the Index to calculate your actual rate. **The margin and how long they intend to keep the loan are the most important factors for me when choosing a loan for my client.**

In my experience, margins range from 1.5% to 2.75% for the Prime lending market. As of the date of this writing, there is virtually no sub-prime market. The margins and adjustment caps in sub-prime loans were criminally high; which is one of the factors that triggered the crisis that began in late 2007. But I'll get on my soap box about this another time. For your purposes, right now, find out what the margin is.

Getting the lowest margin you can find is important. It could make a *huge difference* in your payment if the loan adjusts upward. If you got a loan with a 1.5% margin and your neighbor got a margin of 2.75%, his rate will be 1.25% higher than yours (if they both adjust at the same time and are tied to the same index). On a loan of $400,000, that is a difference of $416 per month in interest.

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Adjustment Cap

The adjustment cap is the percent above your start rate that the loan can adjust up or down when the fixed rate period is over. **This is a part of the loan that few people pay attention to, but you should.** Most lenders have a 5% first adjustment cap for loans whose rate is fixed for 5 years or more; and a 2% adjustment cap for loans fixed 3 years or less.

The 5% first adjustment cap guideline of most Hybrid ARM's really chaps my hide. If I ran the world, first adjustment caps would never be greater than 2%. With a 5% cap, the lender is basically saying that the sky is the limit if rates go up, but their downside risk is limited by the reality of the factors used to calculate it. I think lenders are asking for defaults when they allow the rate to go up that much on the first adjustment.

Let's put this in real numbers.

- If you get a 5-year hybrid ARM at a start rate of 6%, the rate could conceivably go to 11% after 5 years.
- If you had an interest only payment for the first 5 years, and you have to start paying principal and interest after 5 years, the loan would be amortized over 25 years when the rate adjusts.
- So if you have a loan of $400,000, your interest only payment for 5 years would be **$2,000**.
- In the worst case scenario, if your loan adjusted to 11% and became fully amortized over the remaining 25 years, your payment would go up to **$3,920** for the first year after adjustment.
- That is almost double the payment you are used to paying. I am not trying to scare you. That jump in rate will most likely not happen; but it is possible, so you need to be aware of it.

Life Cap

The life cap is usually 5% or 6% over the initial rate. There isn't much room for negotiation here. I only mention it because if all other factors are the same, your

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decision would be made by this factor. It can be important for home equity lines of credit, however. So you should ask about it when you apply for a line of credit.

Summary:

Fixed rate loans offer security, but security has a price. The rate is usually higher than adjustable rate loans. Everything in life is a balance of risks over rewards. Loans are no different. But when it comes to a loan, you are gambling with your home. It is important to carefully examine the risks and rewards; and then plan for the worst if the risks you choose result in a significantly higher payment.