

How to calculate adjustable-rate-mortgage reset

Learning 'current projected rate' will yield best estimate

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In recent weeks, my mailbox has overflowed with messages of distress from borrowers faced with an imminent rate adjustment on their adjustable-rate mortgages (ARMs). Most of them want to refinance, but many of those who had earlier taken 100 percent loans are stuck. With the current softness in the housing market, they now owe more than their homes are worth. Lenders are strongly resistant to refinancing loans with balances exceeding property values.

A striking feature of the letters I receive is that the great majority of the borrowers don't have a clue as to exactly what is going to happen to their ARM rate. They know it is going to go up but they have no idea how much. Many of them assume that it is worse than it is in fact, perhaps because this gives them an excuse for not doing anything to prepare.

If this describes you, it is time to shake the sand out of your eyes. While you can't know exactly what your ARM rate will be on the adjustment date -- that depends in part on what happens to market rates between now and then -- you can know what your ARM rate would be if the adjustment occurred today. Call this the "current projected rate," or CPR. As the adjustment date gets closer, the CPR becomes an increasingly good estimate of the actual rate on the adjustment date. You use the CPR to plan your next move.

To calculate the CPR, you need four pieces of information from your note. Piece one is the interest-rate index to which your ARM rate is tied. Indexes have names like COFI, Libor, CMT, MTA, CODI and Prime Rate. When you have identified the one used by your ARM, go to www.mortgage-x.com and find its most recent value. When I checked on July 31, most of the indexes were in the range of 4.3 to 5.4 percent.

Piece two is the margin, which is the amount added to the index to determine your rate. This is the critically important number because it varies so widely, from 0.75 percent to 7 percent or more. Because it is not a required disclosure, most ARM borrowers don't know what it is until they are hit with a rate adjustment.

The other two pieces of information you need from the note are the adjustment cap, which limits the size of a rate change, and the lifetime maximum rate. Not all ARMs have adjustment caps but they all have maximum rates.

The rate-adjustment rule is that the new rate will equal the most recent value of the index plus the margin, subject to the caps. Here are some examples:

1. Current rate 5 percent, current index 5 percent, margin 2.75 percent, adjustment cap 3 percent, maximum 10 percent. The new rate is the index plus margin of 7.75 percent; the caps are not a constraint.
2. Current rate 4 percent, current index 5 percent, margin 2.75 percent, adjustment cap 3 percent, maximum 10 percent. The new rate is the current 4 percent rate plus the 3 percent rate adjustment cap, or 7 percent, which is below the index plus margin.
3. Current rate 5 percent, current index 5 percent, margin 6 percent, no adjustment cap, maximum rate 10 percent. The new rate is the maximum of 10 percent, which is below index plus margin.

Where the rate is constrained by the rate-adjustment cap, as in example 2 above, the respite is only temporary. If the index value stays the same, the rate will increase to index plus margin at the next adjustment.

Articles such as this one would not have to be written if the lenders servicing ARMs reported the CPR every month, along with the payment associated with it. They calculate it now, but only for the month preceding a rate adjustment. It would be quite simple to do it every month so that borrowers always knew where they stood and had time to prepare for what they saw coming.

I have not done a survey, but would be surprised if there are any lenders who do this. It is symptomatic of the wretched level of service provided by mortgage servicing agents, a subject on which I have railed on numerous occasions. NOTE: If you service ARMs and do provide the CPR monthly, send me a copy of your monthly statement and I will happily eat my words in public.

The writer is professor of finance emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at www.mtgprofessor.com. By Jack Guttentag