Section 13 – Part 2

SLIDE 5 – Common Types of Mortgages (Cover Page)

SLIDE 6 - Common Loan Structures

Variations in the structure of interest rate, term, payments, and principal payback produce a number of commonly recognized loan types. Among these are the following.

Amortizing loan – Amortization provides for gradual repayment of principal and payment of interest over the term of the loan. The borrower's periodic payments to the lender include a portion for interest and a portion for principal. In a fully amortizing mortgage, the principal balance is zero at the end of the term. In a partially amortizing loan, the payments are not sufficient to retire the debt. At the end of the loan term, there is still a principal balance to be paid off.

SLIDE 7

Amortization – The paying off of debt in regular installments, or payments of principal and interest, over a period of time to gradually reduce funds owed

Most conventional loans are fully amortized

SLIDE 8

Interest rate charged on loan remains constant through loan term

- Considered industry standard
- When market rates vary, loan rates do not

SLIDE 9

Repayment Periods

- Can range from 10-40 years
- 30-year loans still standard
- 15-year loans gaining popularity

SLIDE 10

ARM allows lender to adjust loan’s interest rate to reflect changes in cost of money

- Transfers risk of rate fluctuations to borrower
- Generally lower interest rate than fixed-rate loans

SLIDE 11

How ARMs work:

- Borrower’s interest rate first determined by market interest rates at time loan is made
- After loan made, interest rate tied to an index and adjusted accordingly
    - Index chosen by lender when loan made

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ARM may have all or some of these elements:

- Note rate
- Index
- Margin
- Rate adjustment period
- Mortgage payment adjustment period
- Look-back period
- Interest rate cap
- Mortgage payment cap
- Negative amortization cap
- Conversion option

SLIDE 13

NOTE RATE:

- A loan's note rate is its initial interest rate, as stated in promissory note
- Lenders used to attract borrowers by offering discounted initial rate lower than index rate
- Initial rate can be fixed for one, three, five, ten years, etc.
    - For ARMS with initial periods of five years or less
    - Borrowers will be qualified at the greater of the note rate plus two percent, or
    - The fully indexed rate (index plus margin)

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INDEX:

- An index is a statistical report used as an indicator of changes in cost of money
- Several published indexes used by lenders:
    - Treasury securities indexes
    - 11th District cost of funds index
    - LIBOR index

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MARGIN:

- ARM's margin is difference between index rate and interest rate lender charges borrower
- Lenders add margin to index to cover administrative expenses and provide profit

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RATE ADJUSTMENT PERIOD:

- ARM's interest rate is adjusted only at specified intervals
    - Such as every 6 months, once a year, or every 3 years
    - One-year adjustment period most common
    - Lender checks index at end of period and adjusts interest rate

Hybrid ARMs – Combination of ARM and fixed-rate loan with two-tiered adjustment structure. Longer initial period, with more frequent adjustments after that.

NOTE: When advertising a Hybrid ARM, although the initial rate is fixed for "x" amount of years, it cannot be advertised as a "fixed rate"

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ADJUSTMENT PERIOD:

- A payment adjustment period determines when lender changes amount of principal and interest payment due to change in interest rate
  - Payment usually adjusted at same time as interest rate
  - But payment amount not always adjusted when interest rate is

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LOOK BACK PERIOD:

- Typical look-back period is 45 days.
- Loan’s rate and payment adjustments are determined by what index was 45 days before end of adjustment period

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INTEREST RATE CAP:

- When ARMs were introduced, borrowers experienced payment shock.
  - *As market interest rates rose, indexes also went up, resulting in sharp increase in monthly payments*
  - *Sharp increase in interest rates meant some borrowers couldn’t afford payments anymore*
- Interest rate cap limits how much interest rate on a loan can increase, regardless of index
  - *Prevents monthly payment from increasing too much*
- ARM rate caps limit how much interest rate can increase
  - *Per adjustment period*
  - *Over the life of the loan*

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MORTGAGE PAYMENT CAP:

- A payment cap directly limits how much a mortgage payment can increase
- Many ARMS only have interest rate cap, and no payment cap

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Negative amortization:

- Negative amortization occurs when unpaid interest is added to principal balance of a loan, increasing amount owed
  - *Normally, loan balance declines steadily*
- Negative amortization causes principal balance to go up instead of down
- ARM features that can lead to negative amortization:
  - *Payment cap without rate cap*
  - *Payments adjusted less often than interest rate*
- Today, lenders rarely make ARM loans that allow negative amortization
- But if it is a possibility, lenders will include a negative amortization cap
  - *Limits amount of unpaid interest that can be added to principal balance*

EXAMPLE

- W borrows $190,000 to buy home. Loan is a one-year ARM with 7.5% annual payment cap. No interest rate cap. Initial interest rate: 4.5%. Monthly payment: $962.70
- By end of first year, index of ARM has risen 2.75%. Lender adjusts loan by 2.75%. Without payment cap, monthly payment would increase by $325
- But W's payment cap limits increase to 7.5% of payment amount per year—preventing payment from increasing enough to cover interest charged for second year

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Negative amortization:

- Lender adds unpaid interest to loan balance – negative amortization
  - Causes size of loan to grow
  - When a limit of growth is reached, loan is recast
  - The recast with new payment is often much higher than initial payment
  - Can recast every 5 years
  - New payment may be unaffordable

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CONVERSION OPTION:

- Many ARMs allow borrower to convert loan to fixed-rate mortgage at certain times during loan term
  - Usually involves a limited time to convert, and requires a conversion fee