

LOAN CHARACTERISTICS...

Fixed Rate Loans

A fixed rate loan has an interest rate that stays the same during the term of the loan. This means that your loan payments are set from the initial amortization, or repayment, schedule. The clear benefit of a fixed rate loan is that it offers stability in fluctuating market conditions.

Hybrid Loans

Commonly known as 3/1's, 5/1's, 7/1's and 10/1's or 3 year fixed, 5 year fixed loans, etc.; these loans are impart a fixed loan coupled with an adjustable loan that usually provide a lower rate and payment of interest over that of the fixed rate loan. See previous pages for examples.

Adjustable Rate Mortgages

Adjustable rate mortgages (Arm's) are home loans with interest rates that change periodically. They may have lower initial rates for a short time at the beginning of the term. After that, the interest rate used to calculate repayment is adjusted on a regular basis.

Since the monthly payments may go up or down with changes in interest rates, the future monthly loan payments may be uncertain. Arm's carry risks in periods of rising interest rates, but can be less costly over the life of the loan if the average interest rate is below the fixed rate.

Some important components of Arm's include:

- The Index
- The Margin
- Periodic and Lifetime Caps
- Rate and Payment Adjustments
- Deferred Interest (negative amortization)

How Do Arm's Work?

Lenders usually charge lower initial interest rates for ARMs than for fixed rate loans because the borrower is sharing the risk if interest rates go up. Arms therefore are less expensive in the beginning than fixed rate loans. This may mean that a borrower can qualify for a larger loan if they select an ARM. The risk here is that if rates rise substantially, the payments can become prohibitive.

Indexes

Arm's interest rate changes are tied to changes in an index rate. An index usually moves with the general trend of the economy. The most commonly used indices are listed below:

Six-Month Certificate of Deposit (6 Month CD):

This index is the weekly average of the secondary market interest rates paid on Bank's Six-Month CDs. This index is generally considered to react quickly to changes in the market.

One Year Treasury (1 Year T-Bill):

This is the weekly average yield on the U. S. Treasury Securities adjusted to a constant maturity of one year. This index generally reacts quickly to market changes.

11th District Cost of Funds Index (COFI):

The average cost of deposits and borrowings for Savings & Loans in the Federal Home Loan Bank's 11th District, that consists of California, Arizona and Nevada. This index is slow moving due to the size of the deposits (approximately \$3.5 Billion) and generally lags behind market fluctuations.

London InterBank Offered Rate (LIBOR):

The LIBOR is an average of the daily lending rates from several major English banks, used as a common international interest rate index. Like the CD, it tends to react quickly to changes in the market.

Prime Rate:

The Prime is the lowest commercial rate charged by banks on short-term loans to their most credit worthy customers. Mortgage rates and consumer loans rates are generally close to the prime rate, but exceptions occur.

Margin

To establish the ARM rate, percentage points are added to the index value. These percentage points are called the margin. The margin is established by the lender at the inception of the loan and remains constant for the term of the loan. To calculate the interest rate at the time of adjustment, the new rate is the index plus the margin ($Rate = Index + Margin$). The ARM interest rate will move as close to this new value as the period caps permit.

Periodic & Lifetime Caps

When an adjustable rate loan is established, in the note a schedule is broken out for the frequency of adjustment. A typical example would be a one year ARM based on the One Year Treasury Spot. The loan would have a low start rate, and after the 12th month, it would adjust, and would continue to adjust annually for the term of the loan. ARMs are usually named for the frequency of the rate and payment adjustments. A loan that adjusts annually with the rate based on the One Year Treasury Spot is called a 1 Year T-Bill.

To make ARMs an attractive alternative to fixed rates, caps or limitations are built in so that the adjustment cannot be too severe. For example, on the 1 Year T-Bill, usually there is a 2.00% annual cap. This means that to calculate the rate for month 13 ($Rate = Index + Margin$), the lender will look at the fully indexed rate and adjust the new rate as close to this as the cap will permit. For example, if the loan started at 5.00% and had a 2.00% annual cap, the maximum rate for the second year would be 7.00% and the maximum for the third year would be 9.00% regardless of what $Index + Margin$ is.

In addition to these periodic caps, ARMs will also contain a lifetime cap or ceiling. That is the maximum rate for the life of the loan, regardless of what market dictates. This amount can be considered the "worst case" interest rate and will usually exceed current fixed interest rates.

Payment Caps and Deferred Interest (*Negative Amortization*)

In addition to periodic caps there are payment caps. This is a fine but important distinction. These loans will not have a built in periodic cap, usually just a lifetime cap. What they offer is a payment cap. This is the maximum that the minimum payment can change in any given period. The lender is still calculating the rate on $Index + Margin$, but they offer a minimum payment which may be less than this fully indexed rate. The difference in the payment is called deferred interest.

Annually the loan will be reviewed to determine how short the minimum payments were compared to the fully indexed rate. This difference is then added to the loan balance, hence the term negative amortization. The way to avoid this is to not make the minimum payment, but to make the fully indexed payment. Cost of Funds (COFI) loans are usually structure this way.