

Felt the Pinch From Your Adjustable Rate Mortgage Yet? Be Ready for the Moment You Will

The Federal Reserve has taken what many believe is a temporary pause in the interest rate hikes it began back in 2003. But that won't be much comfort to mortgage holders who signed up for adjustable rate mortgages (ARMs) set to readjust this year, particularly those who signed on for interest-only mortgages.

According to a 2005 study by Deutsche Bank Global Markets Research, "resettable" debt was scheduled to approximately double in 2005, 2006 and 2007. Those are truly staggering figures – a sign that a sudden slowdown in the economy could shatter the lives of tens of thousands of American families.

Trouble seems to be accelerating. According to the Mortgage Bankers Association, the second quarter delinquency rate for ARMs, climbed 0.51 percentage points compared with the second quarter of 2005, to 2.7 percent – an increase of 23 percent in the number of borrowers in this category who are falling behind in their payments.

A January 2006 study by the Federal Reserve said that 35 percent of people with ARMs didn't know when their rates would reset or the potential maximum they might pay on those loans. For some people who last refinanced one, two or three years ago – particularly those who went with interest-only loans - an increase based on current rates could raise the size of the payment as much as 60 percent.

Don't want to get caught with a rate adjustment nightmare? It may happen, but at least you can prepare. Keep these questions in mind:

Do you know whether you have an ARM? It may sound silly, but if you're not sure, check. Fixed-rate mortgages carry an interest rate that stays the same during the life of the loan. But with an ARM, the interest rate changes periodically based on your loan agreement, usually in relation to a particular financial index. Payments may go up or down depending on where that index is heading.

When's my adjustment period? If you've already signed on the dotted line, dig out those mortgage documents and look for the margin. "Margin" is the percentage amount the lender adds to the index rate to get the ARM's interest rate. With most ARMs, the interest rate and monthly payment change every year, every three years, every five years or possibly longer, depending on what you agreed to. The period between one rate change and the next is called the "adjustment period." A loan with an adjustment period of one year is called a one-year ARM, and the interest rate can change once every year. You need to ask your lender how much warning you'll get about an approaching adjustment period and how your current payments may be affected.

Did you get an introductory rate with your loan? During the height of the mortgage boom, lenders took a cue from credit card companies by offering customers a lower rate during the first year of the ARM. When that rate goes off, it's quite a shock. Realize that you'll have to adjust to the possibility of significantly higher payments later on, especially if interest rates keep heading up. Make sure you understand the relationship of any introductory rate to a permanent rate.

What's the cap? On most conventional ARMs, the lender caps the percentage increase in the interest rate. It's very important to ask your lender – or review your loan documents - about how your rate cap works on your particular loan. Interest caps come in two versions: Periodic caps, which limit the interest rate increase from one adjustment period to the next, and Overall caps, which limit the interest-rate increase over the life of the loan. Ask whether there are any other conditions under which your

monthly payment might change.

Are there restrictions on prepayment and conversion? For borrowers with lower credit scores or those who had to go to sub-prime lenders, there may be interesting language in your loan agreement restricting prepayment or converting your loan to a fixed rate whenever you want. Obviously, at some point you might need to create an escape plan, and if you got stuck with this language, figure out how much the divorce is going to cost.

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