

Special: Manhattan Real Estate Offerings

# Real Estate

Section 11

## Rates Drop, but Adjustable Loans Persist

By EDWIN McDOWELL

**M**ORTGAGE rates in the last couple of years have been consistently low, with costs of 30-year fixed-rate loans in recent weeks down to their lowest point in more than 30 years. But rather than locking up these low rates, a substantial number of borrowers continue to opt for adjustable-rate loans, whose rates, while initially lower than those on fixed-rate loans for a specified period, can fluctuate substantially over time.

What at first glance may sound imprudent, however, may be just the opposite. In some cases borrowers opting for adjustable-rate mortgages expect to sell their houses before it comes time to adjust the rates — an ARM might have a one-year, five-year or seven-year period before its rates are adjusted upward or downward based on a specified financial point of reference, typically the three-year Treasury note.

In others, especially for those taking out large loans, the sharp run-up in home prices in the New York metropolitan area in recent years has meant that a buyer may be able to afford the payments under the initial rate of an ARM but not the higher monthly payment of a fixed-rate mortgage. Such a buyer would be gambling that interest rates will not rise sharply before his mortgage payments must be adjusted or that his income will increase sufficiently to cover the higher payments.

In the week ended Dec. 13, the interest rate on 30-year fixed rate mortgages averaged 6.04 percent, according to the Federal Home Loan Mortgage Corporation (Freddie Mac), which issued its report in midweek, slightly above the 31-year low of 5.94 percent in mid-November. It is hardly surprising, then, that 82 percent of conventional home mortgages through the first 10 months of this year were for fixed rate loans, according to the Federal Housing Finance Board. But what may surprise many homeowners is that 18 percent of the mortgage loans through October of this year were for adjustable rate mortgages, according to Joseph A. McKenzie, the deputy chief economist of the finance board.

The average interest rate for one-year ARM's (those with a initial interest rate that remains unchanged for the first year of the loan) in the week ended Dec. 6 was 3.79

**Interest on fixed-rate mortgages remains low, but even-lower ARM's still suit some borrowers.**

percent. ARM's, which were introduced in the early 1980's and are also known as variable-rate mortgages, have accounted for between 15 and 20 percent of mortgages nationwide for some time, and as recently as the first quarter of 2000 they accounted for 31 percent.

A borrower who took out a \$300,000 30-year fixed-rate mortgage at an interest rate of 6.00 percent this week would have a monthly payment of \$1,014, according to Keith T. Gunninger, a vice president of HSH Associates, a financial publisher in Butler, N.J. If the same borrower instead chose a five-year ARM, the rate would be 9.13 percent and the monthly payment \$1,634, a saving of \$180 a month.

But after five years, the interest rate on the ARM would change and could rise as much as five percentage points at the first adjustment. If that maximum five-point increase were to happen, the new interest rate of 10.13 percent would result in a monthly payment that increased by 54 percent, to \$2,533. It is also theoretically possible, of course — though unlikely given the historically low rates now being offered — that the rate could be adjusted downward after five years.

**Steven Schnall, chief executive of the New York Mortgage Company in Manhattan, said the ratio for his company, which has offices in Manhattan as well as nine cities in five other states, is about 70 percent fixed-term loans and 30 percent adjustables. A similar ratio prevails at Withers & Company in New Rochelle.**

“Although people are looking at adjustables,” said Robert Withers, the owner, “they’re still mostly taking fixed-term mortgages.”

In many cases, borrowers who prefer adjustable-rate mortgages tend to be those with very expensive homes, according to Pili Colling, an economist with the Mortgage Bankers Association. As a result they also tend so have

bigger loans, known as jumbos — loans that exceed the dollar ceiling set for purchase and repackaging as tradable securities by Freddie Mac and Fannie Mae, the government-chartered enterprises that buy home loans from lenders, giving the lenders the cash to make more loans. The agencies' current limit, \$275,000 for single family homes, will increase to \$322,700 on Jan. 1.

According to Mr. Colling, the average adjustable-rate mortgage loan this year is about \$300,000 while the average fixed rate loan is about \$165,000. So far this year, according to Mr. McKenzie, ARM's have accounted for a large percentage of jumbos. For example, through this October adjustable-rate mortgages accounted for 49 percent of all mortgages for \$300,701 to \$400,000, 52 percent of those from \$400,001 to \$500,000, and 62 percent of those from \$500,001 to \$748,400.

When Bonnie McNab, a broker Mortgage Center in Roslyn on Long I sells an adjustable-rate mortgage these days she said the loan is likely to be at least \$300,000 with the median price of a home at \$340,000 in October in Nassau County and \$382,000 in Suffolk, large mortgage areas are common. Nevertheless, adjustable-rate mortgages appeared to be headed for extinction's times in recent years. In September and October of 1998 they represented a mere 8 percent of the market, according to Frank Notha, chief economist at Freddie Mac, and 6 percent for that whole year. By 2000, the percentage tumbled to 12 percent.

A reason for the drop is that even though rates were low, so were fixed-rate mortgages. The spread between the two did impress homeowners. Most home buyers for the low fixed-rate mortgages, Mr. McNab said, which were at levels not seen for in the previous 30 years.

Over the years, consumer taste has shifted somewhat in the kinds of ARM's taken in the early 1990's. Mr. Notha said, on ARM's dominated the adjustable-rate market, so much so that only 30 percent of lenders offered three-year terms, mortgages whose initial low rate, or “teaser rate,” was fixed for three years before adjusting annually. By 1998, 80 percent of lenders offered three-year terms, and now five-year and seven-year ARM's are just about everywhere, because they offer low rates for longer terms. The rule of thumb

on ARM's is that the shorter the initial term, the lower the initial rate.

Sometimes ARM's are tailored for a specific customer, and on most very large mortgages the terms tend to be customized. For example, three years ago, Bill and Hillary Rodham Clinton bought their \$1.7 million house in Chappaqua with an adjustable-rate mortgage in the form of a \$1.36 million loan from PNC Mortgage, a subsidiary of the PNC Bank Corporation of Pittsburgh. The \$340,000 down payment represented 20 percent of the purchase price.

A White House spokesman said at the time that the loan would carry an annual interest rate of 7.5 percent for the first three years, after which the rate would be set at the one-year Treasury rate plus 2.75 percentage points. According to Mr. Gunninger of HSH, if the

for a specified period of years, and then adjust according to contemporary interest rates. Such loans are especially popular with borrowers who plan to be in their house no longer than for the length of the fixed-rate period of their loan. And if circumstances make it necessary or advisable to remain longer, some ARM agreements enable borrowers to convert to a fixed-rate mortgage — but even then, in the words of many other advertised bargains, “restrictions apply.”

A type of adjustable-rate mortgage that has been around for almost 20 years in some parts of the country — but has become widely available in the Northeast only in recent years — is the interest-only mortgage. As its name suggests, the borrower's monthly payment covers only interest and none of the principal.

rest-only term, the principal over the term. This results in a series of \$300,000 over the first five years and pay \$1,657 a month for an initial rate of 10.13 percent. But, he said, “but many borrowers feel that is mitigated because they're building equity by appreciation. And at the end of the interest-only period on a typical 10-year interest-only ARM with a term of 30 years and a rate fixed for five years, the borrower is forced to amortize the entire principal balance over the remaining 20 years, thus resulting in higher payments for that 20 years.”

**For example, a borrower of \$300,000 over 30 years with an ARM with an initial rate of 5.25 percent, fixed for the first five years and adjustable thereafter, would pay \$1,657 a month for the first five years, according to Mr. Schnall of New York Mortgage. But, he said, the monthly payment for an interest-only mortgage at the same rate for the same term would be \$1,313 per month for the first five years. Not only is the interest-only loan no more risky than the other loan, Mr. Schnall said, the payments are lower and the entire mortgage payment is fully tax deductible.**

“The only disadvantages are that during the interest-only period the borrower does not build equity by amortizing principal,” he said, “but many borrowers feel that is mitigated because they're building equity by appreciation. And at the end of the interest-only period on a typical 10-year interest-only ARM with a term of 30 years and a rate fixed for five years, the borrower is forced to amortize the entire principal balance over the remaining 20 years, thus resulting in higher payments for that 20 years.”

If the rate in the example stayed the same after the initial fixed rate period, the monthly payment over the next 20 years would increase to \$2,022, compared with a payment of \$1,657 on the ARM on which the borrower is paying principal as well as interest from the beginning. If the rate went up to 10.25 percent and remained there for the balance of the loan, the monthly payment would be \$2,945.

Among those choices are hybrid ARM's — the term refers to the fact that rates are unchanged payment over the next 20 years would increase to \$2,022, compared with a payment of \$1,657 on the ARM on which the borrower is paying principal as well as interest from the beginning. If the rate went up to 10.25 percent and remained there for the balance of the loan, the monthly payment would be \$2,945.