

Affordable, Risk-Free Alternatives to Adjustable-Rate Mortgages



THE ADJUSTABLE-RATE MORTGAGE (ARM) was designed to make owning a home possible for those who couldn't afford the higher cost of the standard fixed-rate mortgage. Unfortunately, the low initial payments came with the transfer of the interest-rate risk that would have been assumed by the lender with a fixed-rate mortgage. Expected manageable payment increases over time became explosive and unpredictable. Apparently, the goal was to sell and refinance homes to generate commissions, fees, and profits, regardless of the consequences. Mission accomplished.

ARMs have low payments for a period of time but are unpredictable. Traditional fixed-rate mortgages have level payments but are less affordable. Does the desire for low initial payments have to mean sacrifice of predictability over the long term? Absolutely not. As a matter of fact, there have been attempts to combine the best of both types. Unfortunately, they were designed in a manner that included disincentives for their use.

For example, the graduated-payment mortgage (GPM) has a fixed interest rate and payments that start low, increase annually for a period of five or 10 years and then remain level. The problem is that it tries to do too much at once. To make it attractive, the initial payment is reduced so much that it isn't sufficient to cover the interest. This leads to negative amortization, where the loan balance actually increases. Lenders view this as extra risk and charge a higher interest rate for this type of mortgage. Also, borrowers are warned against it because of the high payment-increase rate. These factors combine to account for its lack of popularity.

Another attempted solution is the step-rate loan. One version is a fixed-rate mortgage with a 2-1 buydown. The scenario here is that the interest rates during the first two years are 2 percent and 1 percent lower than the fixed rate that takes effect in the third year. A lump sum or buydown is required to compensate the lender for the loss of income due to the low initial rates. An alternate version of the 2-1 step-rate loan boosts the fixed rate and the adjusted rates by .50 percent in lieu of the buydown. The problem with that in a 6 percent-fixed-interest-rate environment is that the extra charge is about double the actual cost of providing those low initial rates. Another problem with both versions

is that the payments increase more than 10 percent after each of the first two years.

Thus, many people view the adjustable-rate mortgage as the only attractive alternative to the fixed-rate mortgage, in spite of the risks. It doesn't have to be that way. Here are three types of mortgages that have the advantages of all the above and the disadvantages of none of them.

Market-Rate GPM

The GPM features what actuaries would call select and ultimate payments. Payments escalate at a constant rate for a number of years, called the select period, then remain level at an ultimate payment rate. This version of a GPM would start with a payment during the first year that is enough to cover the interest, thus eliminating negative amortization and the need to charge an interest rate any higher than the prevailing rate on a traditional level-payment mortgage. Depending on the borrower's expectations of income growth, the select period could be any number of years that would yield a manageable payment escalation rate. Figure 1 (see Page 12) shows an example of a 30-year \$300,000 loan at 6 percent interest that would normally require a level payment of \$1,798.65 per month. It has a five-year select period and a payment escalator that might be suitable for an employee covered by a union contract.

The most affordable case would be one in which the payments increase annually throughout the term at a constant gradual rate. The payment escalator for this loan would then be 1.696 percent per year, much less than the historical inflation rate. The payments would be \$1,500 per month during the first year, \$1,525.44 the second year, and so on. Anyone who buys a home expecting to be able to keep up with rising property taxes can surely afford this type of mortgage.

Customized Step-Rate

If the first year's payment for a market-rate GPM is still too high, this is a way to combine the low initial interest rates of an adjustable-rate mortgage with the certainty of a traditional fixed-rate mortgage, at no extra charge. Since lenders

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are willing to guarantee a fixed interest rate for 30 years with a traditional mortgage, they should be willing to guarantee a gradually and predictably increasing interest-rate schedule with a level equivalent that is identical to that same long-term interest rate. The cost of subsidizing the borrower in the early years will be earned back with a higher ultimate interest rate. If not, prepayment penalties should afford enough protection for the lender. As in the alternate version of the step-rate loan described above, the cost of subsidizing the borrower in the early years would be offset by the effect of a higher ultimate interest rate.

Figure 2 (see right) shows an example with a five-year select period. The payments do not rise at a constant rate because in each year of the select period, they are based on the applicable interest rate, along with the balance and remaining term as of the beginning of the year. The ultimate interest rate depends on the ultimate payment, which is derived with the application of the equivalent level interest rate.

Using a lower interest rate or a longer amortization period to calculate the initial payment would require a longer select period to keep the payment increases within reason.

Customized Step-Rate GPM

This is a way to combine a constant payment escalator with the low initial interest rates of an adjustable-rate mortgage and the certainty of a traditional fixed-rate mortgage, again at no extra charge. With the customized step-rate mortgage above, the payments and their escalation rates are dictated by the mechanics of the process. This type of mortgage would allow an arbitrary initial payment and a constant payment escalation rate to drive the other figures.

The initial payment can be any amount sufficient to avoid negative amortization in the first year. The payment escalation rate must then be high enough to avoid the negative amortization that could result from higher interest rates in subsequent

FIGURE 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	ULTIMATE
Balance	300,000	300,000	299,160	297,390	294,594	290,665
Payment	1,500.00	1,525.44	1,639.26	1,713.66	1,791.45	1,872.76
Increase	N/A	4.54%	4.54%	4.54%	4.54%	4.54%
Term	30	29	28	27	26	25

FIGURE 2	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	ULTIMATE	LEVEL EQUIVALENT
Balance	300,000	294,717	289,662	284,793	280,068	275,450	300,000
Payment	1,432.25	1,517.77	1,603.50	1,689.21	1,774.73	1,890.98	1,798.65
Increase	N/A	5.97%	5.65%	5.35%	5.06%	6.55%	N/A
Interest	4.00%	4.50%	5.00%	5.50%	6.00%	6.68%	6.00%
Term	30	29	28	27	26	25	30

FIGURE 3	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	ULTIMATE	LEVEL EQUIVALENT
Balance	300,000	294,918	290,082	285,390	280,735	276,002	300,000
Payment	1,415.79	1,500.74	1,590.78	1,686.23	1,787.40	1,894.65	1,798.65
Increase	N/A	6.00%	6.00%	6.00%	6.00%	6.00%	N/A
Interest	4.00%	4.50%	5.00%	5.50%	6.00%	6.68%	6.00%
Term	30	29	28	27	26	25	30

years. Lower payment escalators require higher initial payments. It helps to use the method above to test for feasibility before using this one to settle on a constant escalation rate and an initial payment, which would have a lower limit of \$1,000 per month as in Figure 3 (see above).

Affordability and Predictability

In my opinion, mortgage interest-rate risk should be borne only by financial institutions and sophisticated investors with the expertise to manage it. Adjustable-rate mortgages that shift the risk to the borrower and cause financial chaos should not be allowed, at least when it comes to owner-occupied homes. Period.

The three mortgages described above may be the best way to achieve the twin goals of affordability and predictability. There is no negative amortization, and the lender's rate of return on all of them is either defined as the prevailing 30-year fixed mortgage rate or mathematically equivalent to it. Thus, there is no excuse for any of the extra charges that discourage use of the current versions of the GPM or step-rate loan. Also, payments can gradually increase in coordination with expectations of income growth. The select period, during which the increases occur prior to reaching their ultimate level, can be whatever will

produce a desirable escalation rate.

The good news is that the world doesn't have to wait for large financial institutions to start writing these mortgages. It can start today at the grass-roots level with home builders, investors, ethical community lenders, and homeowners willing to offer seller financing to attract a buyer. Buyers can also incorporate them in their offers for seller-financed homes.

All it takes is a competent financial professional, in consultation with a borrower and/or a lender, to design a plan and print out a self-checking amortization schedule to include in the mortgage documents. In the current economic environment, any entity holding troubled mortgages would be well-served by using these methods to restructure them. Foreclosures can be avoided and affordability can be restored without sacrificing asset values or market stability. If these ideas catch on, large financial institutions may adopt them and make them a permanent part of the landscape. ●

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