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FINANCIAL FAQs

New ARM Regulations Released

What to make of the new government regulations on so-called “non-traditional”, negatively amortized option ARMs, or recent remarks made by Federal Reserve Governor Janet Yellen, who said that parts of Phoenix, Arizona and Las Vegas, Nevada were turning into ghost towns because of so many unsold new homes? Both are signs that the boom times are over for real estate investors.

"Though the situation isn't that bad everywhere, a significant buildup of home inventory implies that permits and [housing] starts may continue to fall, and the market may not recover for several years," warned Yellen in a recent speech.

This is while government regulators have issued long-anticipated guidelines to lenders on what are called variously “non-traditional”, “alternative”, or “exotic” mortgage loans. They include interest-only and payment-option adjustable-rate mortgages that “allow borrowers to exchange lower payments during an initial period for higher payments later”, in the words of the regulators’ joint press release.

The new regulations could put a big dent in the hottest home markets, like Florida, Arizona, Idaho, Oregon, and Hawaii, according to Business Week, where more than 40 percent of all new loans have some of these features.

Chief among recommendations are for lenders who offer such programs to insure borrowers will be in a position to repay these loans in future years. This means that they not only have a good credit history, but there be some method to verify income. Only government-insured loans by FHA/VA, or conforming mortgages sold to Fannie Mae and Freddie Mac, still require actual incomes to be verified. Most programs allow incomes to be stated by the borrower, or for no income or assets to be verified at all.

The problem? More than $1 trillion in such ARMs will adjust this year, according to OFHEO. This is probably the reason that Fed officials like Yellen are voicing caution on raising short-term interest rates further. "Holding the stance of policy steady for a time makes sense to me," Yellen said Monday. "We have yet to see the full effects of the series of 17 federal funds rate increases -- some are probably still in the pipeline."

Why should borrowers be concerned? The damage to such Option ARM borrowers comes from 2 directions. If borrowers make just the minimum 1 percent payment, then the difference to the underlying monthly-adjusting interest rate can be 6.5 to 7 percent, depending on the margin and index. (The MTA, or Monthly Treasury Average ARM index @ 4.77 percent is the lowest index, since the 11th District COFI index @ 4.29 percent is seldom offered with ARMs these days.)

The second danger is that the maximum allowable amount of negative amortization may cause an unexpected payment jump. If the maximum that can be added to principal is less than 125 percent of initial principal, the monthly payment could kick up to the fully amortized amount before the fifth year, for example, when payments are re-amortized anyway. This is because while short-term interest rates on which the indexes are based have soared, lenders have managed to hold the first-year minimum payment steady at 1 percent, or 1.75 percent for a 5-year fixed payment option.

What are borrowers to do? Federal regulators have listed the pitfalls to look for when applying for such mortgages. Those applying for Option Arms should ask the following questions, for example:

--What monthly payments could be when you must start paying back principal?

--How interest rate increases could affect your monthly payment (if an adjustable rate mortgage)

--When payment adjustments will be made, and

--The maximum amount you could owe on the loan if you make minimum payments.

Additionally, interest-only mortgages allow you to pay the interest on the money you borrowed for the first few years of the mortgage, but once the interest-only period ends:

--You still owe the original amount you borrowed, and
-- Your monthly payment will increase—even if interest rates stay the same—because you must (ultimately) pay back the principal as well as interest.

There is much more to the new requirements that could cause banks to cut back on their lending volumes. This includes possible higher capital levels "commensurate with the risks", and an allowance for loan and lease losses that reflects the "collectibility" of the portfolio. We will have to wait and see how banks respond to the new regulations.

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