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The Skinny on ARM Rate Resets

If you are one of the millions of Americans paying off an adjustable rate mortgage (ARM), you know that the interest rate on your loan is susceptible to change from time to time. Most ARM loans these days start off with a fixed interest rate period, anywhere from one to ten years, after which the rate is allowed to adjust based on market indexes. It is estimated that roughly $50 billion worth of ARM loans will be adjusting come October. If your loan is included in this number, or if it will be resetting sometime in the fall, you are likely wondering how much your rate will increase. Fortunately for you, the recent troubles in the mortgage market may mean you will receive less of a 'payment shock' when your rate resets.

Here is what's going on in the markets. The increase in defaults and foreclosures on subprime mortgage loans has scared off investors for those types of home loans, which has led many lending companies to sell of their subprime divisions or even file for bankruptcy. These rougher market conditions have put pressure on mortgage interest rates, causing them to drop in the past two weeks.

Adjustable rate mortgage rates specifically are generally tied to one-year Treasury bonds, which tend to shadow the Federal Reserve federal funds rate. Most economists are predicting the Fed to cut that rate currently held at 5.25 percent. Lawrence Yun, senior economist for the National Association of Realtors said Tuesday, "we expect the Fed to cut rates two times before the end of the year, which will lower interest rates for prime borrowers and FHA-insured loans."

Already Treasury yields have dropped to 4.09 percent as of Sept.10, from a July high of 5.02 percent. That means ARM reset rates will be approximately 6.84 percent (4.09 percent plus a 2.75 percent margin for the lenders.) That is much more digestible than the 7.77 percent it might have been. The rate drop could mean the difference in several hundred dollars on monthly payments.

The market news, however, may not mean so much to those with ARM loans tied to the London Interbank Offered Rate or LIBOR. According to some sources, as many as half of ARM borrowers fall into this category. This index rate has been moving higher lately, with the 30-day LIBOR reaching 5.80 percent on Sept.5, jumping up dramatically from the month before when it stood at 5.33 percent. Adding in the lender margin, that will mean an ARM reset rate of about 8.45 percent, a rate that could mean several extra hundred dollars a month in mortgage payments.

The common way to avoid the resetting rates is to refinance. Unfortunately, the housing market turmoil has made it much more difficult for subprime borrowers especially to obtain refinance funding. While there may not be much help right now for LIBOR-based loan borrowers, those with treasury-tied ARMs may be able to wait out the refinance credit crunch while their interest rates stay low and affordable.