Mortgage Finance

ARM Survey Reveals Big Rate Discounts

Big discounts and convertibles are hot.

Sounds like the U.S. auto market. In fact, those are two of the major findings of Freddie Mac's fourth annual survey on the characteristics of one-year adjustable-rate mortgages (ARMs). The survey, conducted the week of November 2 in conjunction with Freddie Mac's weekly Primary Mortgage Market Survey (PMMS), revealed that the initial rate discount averaged 134 basis points, although some lenders were quoting first-year rates that were as much as 250 basis points below the fully indexed rate (the index rate plus the ARM margin). It also showed that 76 percent of the lenders surveyed are offering convertible ARMs. (See accompanying box for full details.)

Compensating for Discounts

Lenders are using low initial rates to attract borrowers to ARMs. They compensate for the reduced revenues from lower initial rates by charging more up-front points and including higher margins to enhance interest earnings after the first year. ARMs with a discount of 200 basis points or more had, on average, a 281 basis point margin and 2.6 points. In contrast, lenders offering discounts of less than 50 basis points had an average margin of 265 basis points and charged an average of 2.0 points.

Because lenders are offering large initial-period discounts, spreads between start rates for ARMs and fixed-rate mortgages (FRMs) have widened substantially. They soared to nearly 300 basis points between mid-September and mid-October, but narrowed to 268 basis points in early November. In comparison, the FRM/ARM rate spread was only about 150 basis points last spring before the yield curve steepened and initial-period discounts became prevalent.

Convertible ARMs

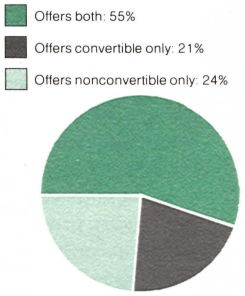
This summer, ARMs that can be converted to FRMs became the hot new product (see *Freddie Mac Reports*, November 1987). Among lenders surveyed, 55 percent offer both convertible and nonconvertible ARMs and another 21 percent offer convertibles exclusively. Although 30 percent of lenders offer the convertible option free to consumers (charging a fee only at conversion), most charge either a higher initial rate or more points for the option. On average, the initial rate on convertibles was seven basis points higher than on nonconvertibles.

The survey also revealed that many lenders allow borrowers to lock-in the initial rate on their ARM at application. Most offer a 60-day lock-in, although some will guarantee a rate up to 90 days. *by Frank Nothaft*

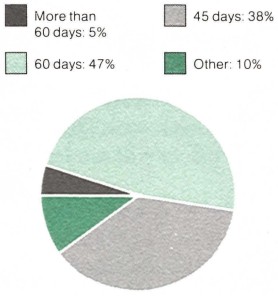
Characteristics of Lending Programs for One-Year ARMs

ARM Pricing:	Average	Median	Minimum	Maximum
First-year rate	8.11	8	7	9
Points	2.3	2	1	4
Margin	2.72	2.75	2.00	3.00
Fully indexed rate*	9.45	9.48	8.73	9.73
Initial-period discount*	1.34	1.48	.5	2.5
FRM-ARM spread	2.68	2.75	1.625	3.625
Convertible ARMs:				

Percentage of Lenders Offering Convertible and Nonconvertible ARMs



Length of rate-lock period

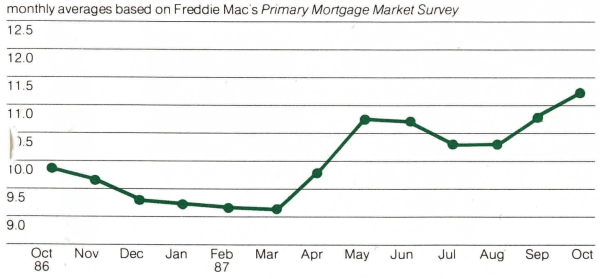
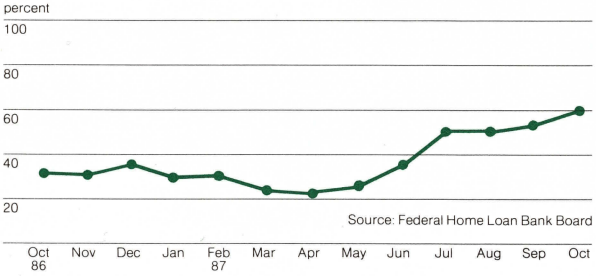


*Based on the value of the one-year constant-maturity Treasury released November 2 (6.73 percent).

NOTE: Sample limited to ARM programs indexed to the one-year Treasury. Since the PMMS canvasses programs offered by lenders, the actual characteristics of commitments made, as well as ARM loans closed, is likely to differ from PMMS averages.

The Primary Mortgage Market

Conventional Commitment Rates
monthly averages based on Freddie Mac's *Primary Mortgage Market Survey*



ARMs' Share of Total Loans Closed
percent