Mortgage Finance

ARM Survey Reveals Big Rate Discounts

Teaser-rate lending and convertibles are two dominant features of the current ARM primary market. These are the major findings of Freddie Mac's fifth annual survey of the characteristics of Treasury-indexed ARM lending programs. Conducted the week of December 5 in conjunction with Freddie Mac's weekly Primary Mortgage Market Survey (PMMS), the survey revealed that the initial rate discount on one-year ARMs with a 2 percent annual rate cap averaged 315 basis points, while discounts on three-year ARMs averaged nearly 200 basis points. It also showed that, on average, half of the one-year ARM applications recently accepted by lenders were for convertibles.

Compensating for Discounts

Big rate discounts appear to be the mainstay of current ARM offerings. To compensate for the reduced interest revenues from lower initial rates, lenders have increased the amount of points charged as well as the ARM margin over the past year.

About one-fifth of all lenders also offered a one-year ARM with a 1 percent annual cap. These ARMs had a higher initial period rate to compensate the lender for the additional interest rate risk.

More than half of the lenders we surveyed offered three-year ARMS. Virtually all the lenders we polled used a 2 percent periodic rate cap for their three-year ARM.

The 3/3 ARM was the most popular. Of those lenders offering three-year ARMs, 52 percent offered *only* a 3/3 ARM, while one-third offered *only* a 3/1 ARM. However, 15 percent had both types of programs.

Homebuyers have to pay more for the security afforded by the three-year adjustable. The average initial rate on 3/3 ARMs was 146 basis points higher than the composite rate on one-year ARMs. And due to the greater payment certainty (and increased interest-rate risk for the investor), the initial rate tends to be the highest on 3/3 ARMs—about 1/4 percent higher than the rate on 3/1 ARMs.

Characteristics of ARM Lending Programs (Averages)

	1-year ARMs		3-year ARMs	
ARM feature	**2% annual cap**	**1% annual cap**	**3/3**	**3/1**
Initial-period rate	8.35	8.96	9.81	9.57
Points	2.4	2.5	2.5	2.7
Margin	2.75	2.75	2.76	2.72
Fully-indexed rate[1]	11.50	11.50	11.74	11.70
Initial-period discount	3.15	2.54	1.93	2.13
FRM-ARM spread[2]	2.11	1.50	0.65	0.89
Percent of ARM lenders offering	100	18	38	28

[1]Based on the value of the weekly average 1-year or 3-year CMT released December 5 (8.75 and 8.98 percent, respectively).
[2]Calculation uses average fixed-rate mortgage (FRM) commitment rate of 10.46 percent from PMMS.

Note: The sample is limited to ARMs indexed to either the 1-year or the 3-year CMT. 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.

Convertible ARMs

Proportion of 1-year ARM applications that are for convertibles	Percent distribution
None	26
Some, but no more than half	21
More than half, but not all	21
All convertibles	32

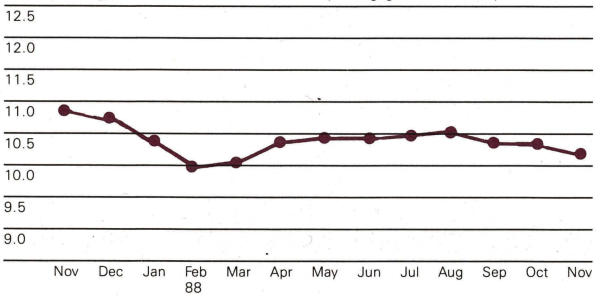
Convertibles

ARMs that can be converted to fixed-rate mortgages continue to be popular with consumers. On average, half of the one-year ARM applications received recently by lenders have been for convertibles. However, about one quarter of the lenders surveyed either had not received any new convertible applications or did not offer such a program, while nearly one-third of all lenders reported that convertibles accounted for all of their new one-year ARM applications.

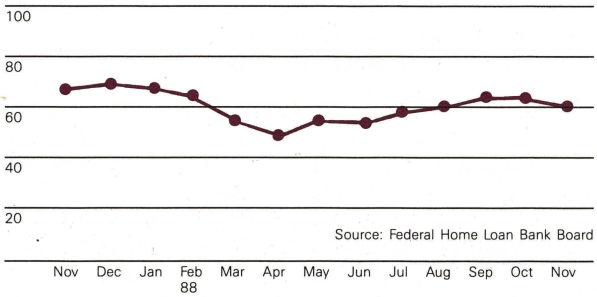
by Frank Nothaft and Dana Martin, with survey assistance from Laura Goodman

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



Source: Federal Home Loan Bank Board