

ARMs Lose Popularity as Interest Rates Drop in 1995

The popularity of adjustable-rate mortgages (ARMs) seen in early 1995 waned considerably as the year progressed, due largely to the sharp decline in interest rates for fixed-rate mortgages and a reduction in teaser-rate pricing for ARMs. The ARM share fell dramatically from nearly 60 percent in January 1995 to around 20 percent in December. According to Freddie Mac's Primary Mortgage Market Survey (PMMS), the average commitment rate for fixed-rate mortgages fell over two percentage points in 1995.

Meanwhile, spreads between 30-year fixed-rate conforming mortgages and one-year ARMs narrowed roughly 80 basis points to 1.65 percent, making ARMs less attractive to homebuyers. A decline in teaser-rate pricing contributed to the narrower spread; the average initial-year discount from the fully indexed rate fell from 3.18 percent in November 1994 to 2.62 percent in December 1995.

Although ARMs were less desirable to the average homebuyer, lenders continued to expand their menu of ARM products. ARMs are attractive to lenders because the interest rates are roughly tied to the lender's cost of funds. Freddie Mac surveyed 116 ARM lenders during the first week of December 1995 and compiled the following results regarding the ARM market:

- Of the lenders surveyed, 92 percent offered jumbo one-year ARMs (loans greater than the 1995 conforming limit of \$203,150), up from 85 percent in 1994. Further, the interest rate on jumbo ARMs carried a small premium over conforming ARMs.
- More than 75 percent of lenders offered 3/1 ARMs and nearly the same number offered 5/1 ARMs. (A 3/1 ARM is fixed for three years and then adjusts annually, while a 5/1 ARM is fixed for five years before it adjusts.) The initial rate

	1-Year ARMs		3-Year ARMs		5-Year ARMs
	Conforming	Jumbo	3/3	3/1	5/1
Initial Period Rate	5.53%	5.62%	6.98%	6.65%	6.98%
Points	1.5	1.5	1.3	1.6	1.6
Margin	2.80	2.81	2.79	2.80	2.79
Fully Indexed Rate	8.15	8.16	8.17	8.15	8.14
Initial Period Discount ¹	2.62	2.54	1.19	1.50	1.16
FRM-ARM Spread ²	1.65	1.56	0.20	0.53	0.20
Percent of ARM Lenders Offering	100	92	30	82	72

Note: The sample is limited to ARMs indexed to either the 1-year or 3-year Constant Maturity Treasury (CMT). Data were collected from 116 ARM lenders during the week of December 8, 1995.

¹Based on the value of the weekly average 1-year or 3-year CMT.

²Based on the average 30-year conforming fixed-rate mortgage (FRM) commitment rate of 7.18 percent from Freddie Mac's Primary Mortgage Market Survey.

Source: Freddie Mac

on the 3/1 ARM averaged a little more than a percentage point above the standard 1-year ARM because of increased interest-rate risk associated with the longer fixed-rate period. Lenders charged an additional third of a point above the 3/1 ARM for the extended fixed-rate term of the 5/1 ARM.

- About one-third of the lenders offered 3/3 ARMs, which adjust every three years. The initial rate was one-third of a percentage point higher than the 3/1 ARM to compensate lenders for the longer reset periods.
- There was little difference between the average number of points or average margins across ARM products. (A margin is the amount added by lenders to the ARM index to calculate the fully indexed rate.) This indicates that lenders largely price the differential interest-rate risk by varying the initial-period rate.
- Interest rates on ARMs varied nearly three times more across lenders than on fixed-rate products. Borrowers, therefore, can likely benefit by shopping around and comparing ARM features among lenders.

—Michael A. Schoenbeck, financial analyst