National Mortgage News

5 things to know about adjustable rate mortgages

1. **Adjustable rate mortgage originations are on the rise**

Adjustable rate mortgage offers made to consumers searching for loans on LendingTree have zoomed in the past 12 months, increasing 230% through the first half of this year from the same period in 2021.

While still not an overwhelming share of mortgage applications, ARMs made up 9.1% of the volume for the week of July 22, down from 9.5% the prior week and compared with just 3.6% one year prior, as rising interest rates are driving consumer interest, the Mortgage Bankers Association said.

In the first half of 2022, the average introductory annual percentage rate on the 3/1, 5/1 and 7/1 ARMs examined in the LendingTree study was 89 basis points lower than the same for a conventional 30-year fixed-rate loan.

However, LendingTree participants made 11 fixed-rate mortgage offers for every one ARM in the first half of 2022. That is still more than a year-ago, when it was a 41-to-one ratio.

2. **The average credit score for an ARM borrower is getting lower**

Offers are now going deeper into the credit scale, LendingTree reported. In particular, the share of ARMs offered to borrowers with credit scores between 620 and 679 increased by 19.98 percentage points year-over-year. That is below the average credit score of 714, as determined by Experian.

Fewer borrowers with a credit score over 680 received an ARM offer, a 21.32 percentage point decline from the first half of 2021.

"While the findings of our study are not necessarily a cause for concern in the immediate future, if the trend of ARMs becoming more common and being offered to borrowers with lower scores continues, then ARMs may once again contribute to a future housing crisis," LendingTree Senior Economist Jacob Channel said in a press release. "Because of this, it is very important for both lenders and borrowers to know the risks associated with adjustable-rate mortgages and to not become too cavalier about issuing/seeking out these types of loans."

First-time home buyers in particular are likely to be attracted to the increased purchase power that an ARM gives.

First American Financial Chief Economist Mark Fleming used an example from May, in which a 99-basis point spread arose between the 30-year fixed and the 5-year ARM as tracked by the Mortgage Bankers Association.

"In fact, at those rates, an ARM increases consumer house-buying power by nearly $44,000 when compared with a traditional 30-year, fixed-rate mortgage," Fleming said in a press release. "This could be a game-changer for many first-time home buyers."

3. Sometimes ARMs aren’t the money-saver they appear to be

An inversion where the 10-year yield is actually lower than shorter term instruments makes the case that the economics often don't work for these loans, said Shayan Salahuddin, Angel Oak's managing director of lending capital markets.

While Angel Oak is a non-qualified mortgage lender, it offers a full set of products including conventional, conforming and government loans. It mostly originates fixed-rate mortgages.

"We get plenty of folks that are inquiring about ARMs, but once you go through the numbers, borrowers tend to see that the fixed rate product is actually more advantageous for them," Salahuddin said.

Despite the lousy reputation ARMs received as a result of the financial crisis, consumers are still conditioned by the marketplace to ask for these loans in a rising interest rate environment.

But the shape of the yield curve, with the 10-year Treasury actually being lower than shorter term debt instruments, eats up any advantage an ARM might have, Salahuddin argued.

The difference between the two is "incredibly small in a lot of cases, and there's just not enough bang for the buck for a borrower to actually go through with that and take the risk of higher payment three, five [or] seven years down the road," said Salahuddin.

And with the increasing likelihood of a drawn out recession in the future, which could end up pushing rates back down, it doesn't make economic sense for borrowers to take the risk, he said.

4. Banks may be more likely to issue ARMs than nonbanks

One segment of the lending industry might be pricing ARMs differently — depositories, Salahuddin said. That is because of the history of the product.

In the early 1980s, the thrift industry was dealing with an asset-liability duration mismatch that threatened their financial stability. So ARM products entered the scene in 1982 as part of the Garn-St. Germain Act. That law included the Alternative Mortgage Transaction Parity Act, which preempted state laws that permitted only FRMs to be originated.

From there, thrifts started originating ARMs to keep on their balance sheets to address the mismatch, and that continues through today.

As a result, while nonbanks may offer ARMs, Salahuddin expected much of the action cited in the LendingTree survey came from banks because they can price them differently. LendingTree does not keep data on who makes the offer, a company spokesperson said.

This was confirmed by another nonbank lender, which said it and anecdotally other mortgage bankers were producing just a single digit share of ARMs.

Meanwhile, some depositories are bingeing on ARMs

“Last quarter we saw a shift from fixed to ARMs with over 50% of our production being intermediate ARMs,” said Ellen Steinfeld, executive vice president and head of consumer lending for Berkshire Bank

At Navy Federal Credit Union, ARM applications are up 55% from a year ago, but that number is skewed downward because half of its volume comes from Veterans Affairs-guaranteed mortgages, which are only fixed rate products, said Kevin Parker, vice president of field mortgage originations.

Given the affordability issues pressuring the housing market, an ARM might be the only choice for some borrowers, they might not want an ARM, he continued.

"A lot of times it also comes down to those individual situations of the borrower in terms of if they plan on being at home for a long period of time or not," Parker said. If the borrower definitively plans on moving within the fixed rate period, they will end up ahead with hybrid ARMs versus a normal FRM.

In terms of credit quality, Parker noted that Navy Federal has some of the industry's lowest default rates, and if anything, "we actually are trying to find ways that we can be more aggressive in the underwriting box."

Navy Federal's customer demographics match the profile of a typical depository, since its charter allows it not only to have membership from active

5. ARMs offer a future refinancing opportunity

While one year is the typical adjustment period after the first change, some newer products to the market adjust every six months. Navy Federal, on the other hand, offers a 5/5 product, for which the second change comes five years later.

But no matter what the adjustment term is, the unpredictability of rate cycles leaves an opportunity for refinancing an ARM borrower after the initial period expires.

"We want to make sure that when borrowers are coming due, we give them options at that time, whether they want to refinance or whether it makes more sense to let the rate go," Parker said. "There's a lot of uncertainty going forward with the economy and so we do want to be advisors to our members, to our borrowers and we do want to make sure that we are helping them and giving them some advice and letting them know what the options will be."

Navy Federal has breakeven calculators on its website for customers to examine the various options in the market, and ARMs are a big part of that conversation in today's environment, Parker said.