Choosing Between Adjustable Rate and Fixed Rate Loans: The Best Financial Decision May Surprise You

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Home buyers have a wide choice of home financing options today, and the most basic decision they have to make is whether to choose a fixed rate loan or an adjustable one. It isn't easy to break through media hype and find real data on which to make a sound, objective decision about which type of loan would be better long-term. Most borrowers are not clear about what to look for when shopping for the best adjustable loan.

The surprising result of an objective investigation, for most people, is that the fixed rate loan is often not the best choice. This paper attempts to outline why that might be, and how to investigate the choices yourself.

A Short History

Americans have been regular customers of lenders selling fixed-rate loans since just after World War II. The fixed rate and payment provided a secure way for a growing middle class to achieve home ownership. Back then, adjustable rate loans as we know them today did not exist, so borrowers had little choice.

More recently, adjustable rate home loans have become widely available; however, they are still largely viewed with suspicion by a majority of borrowers. Adjustables make up only 15-25% of all home loans funded in any given period. Many of these are actually hybrid loans that have an initial fixed rate period of 3-10 years. Borrowers with hybrid loans generally plan to refinance out of the loan when the fixed period ends, so they are really choosing a "short-term" fixed rate loan rather than a true adjustable rate loan.

The "Problem" with Adjustables

The decision to choose an adjustable rate home loan over a fixed rate loan is a hard step to take for most people, for one reason: A fear of rising rates. This fear is not specifically about the rate itself, but on whether the resulting monthly payment might become unaffordable, putting the borrower at financial risk. Many borrowers are old enough to remember, or have heard of, the Carter-era mortgage rates in the high teens, and it is not uncommon to hear concern about a return to rates at those levels. This fear of the unknown motivates borrowers to choose the "safer" fixed rate alternative.

Unfortunately, this decision is usually not in the best long-term interest of the borrower. It seems paradoxical, but in many cases choosing some sort of adjustable rate loan is actually the better financial decision. This is driven by two factors:

- The security of a fixed rate comes at a price (a higher rate compared to adjustable loans long-term).
- Over time, the interest rate risk of an adjustable rate loan diminishes, as the rises and falls of rates even out with the rhythms of the American economy.

Let's work through these two factors to get a better understanding about why adjustable rate loans can outperform fixed rate loans over time.

The Cost of Fixed-Rate Security

The main selling point of a fixed rate loan is security. The borrower knows what his or her rate and payment will be for as much as thirty years. The lender assumes all the risk of changes in interest rates. That comfort comes at a price, however. Lenders are not philanthropic organizations. In order to protect themselves from periods of increased rates (when the fixed-rate loans in their portfolio might be at rates that are below-market), they hedge their bets by adding a percentage to fixed rate loans. This bump, usually .25-.50%, is why in most years adjustable rates are lower than fixed rates.
This price premium is, in effect, insurance that the borrower buys annually to have the lender assume the interest rate risk.

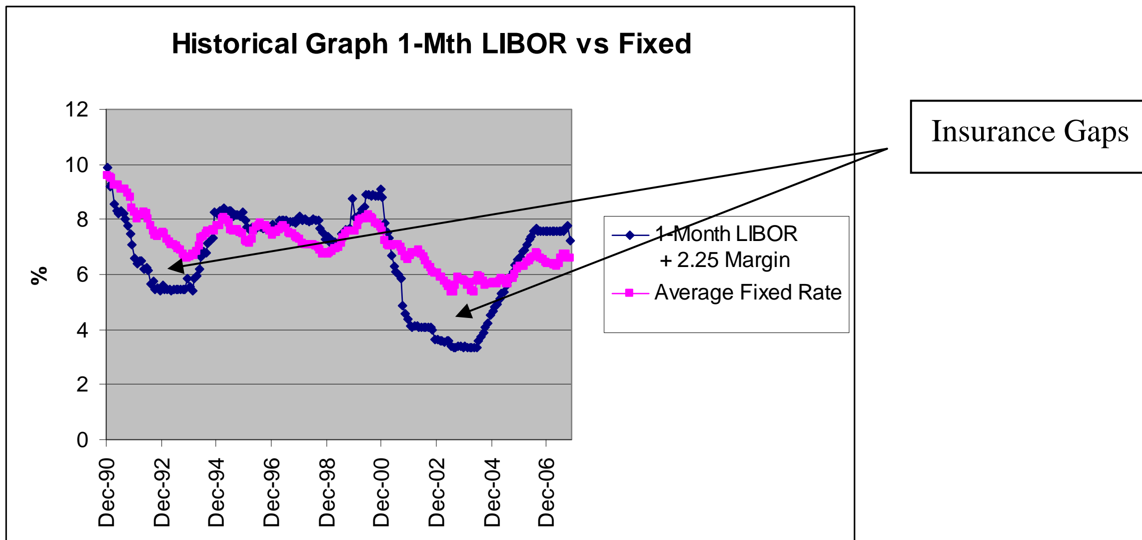
Over the life of the loan, the cost of that insurance can add up:

Loan Amount	.25% cost at 10 years	.25% cost at 30 years	.50% cost at 10 years	.50% cost at 30 years
$100,000	$2,500	$5,000	$5,000	$10,000
$200,000	$5,000	$10,000	$10,000	$20,000
$300,000	$7,500	$15,000	$15,000	$30,000
$400,000	$10,000	$20,000	$20,000	$40,000

Interest rates on adjustable loans do not carry that insurance premium. Lenders are willing to offer lower rates if you share the interest rate risk with them. They do this by basing the interest rate of the loan on an "index" (such as LIBOR or the Prime rate) which varies, so that as the market for mortgages adjusts, the loans they hold in their portfolio are always at-market. In addition to the index, the lender sets a "margin" on each loan, which is a set percentage that never varies. The borrower can choose from a range of margins, with smaller margins achieved by paying discount points up front. The sum of index plus margin is called the "fully indexed rate."

Expressed another way, consider the graph below, which maps the history of one-month LIBOR (plus a typical 2.25% margin) against the average fixed rate loan for each year since 1990.[1] You will see that in many years the available LIBOR rate is below the fixed rate. The gap between the two could be called the "insurance gap", or the premium a fixed rate loan demands.

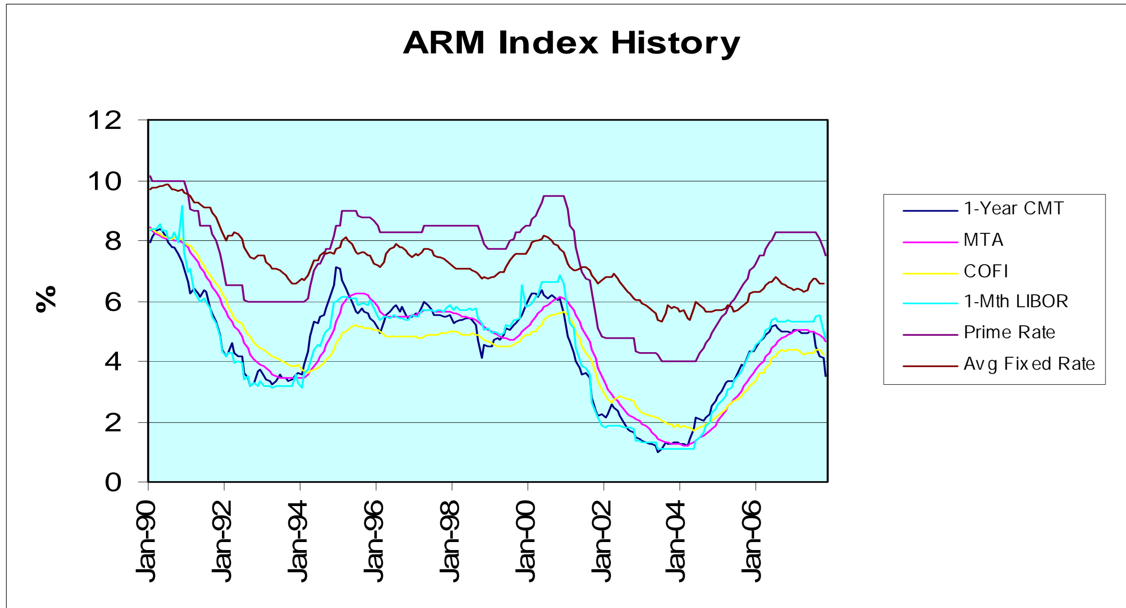
[1] Source: www.bankrate.com, www.mortgage-x.com.



The Cost and Benefit of Accepting Risk

It is an oddity of the loan business that most lenders sell "adjustable rate loans" by offering an initial fixed rate period and declaring "you will be out of the loan before it adjusts!" This marketing positioning in effect reinforces the fear that borrowers have of "skyrocketing rates". Here is the reality however: Rates drop as often as they rise over time. Our economy runs in cycles. In good economic times, rates tend to rise as the demand for credit rises. When the economy cools, so do interest rates. Borrowers who stay in adjustable rate loans find that these cycles even out, and that the overall cost of the loan ends up being less. Look at the graph of the history of the more popular indexes to which most home loans are tied. You will see that even significant moves upward are matched by compensating moves downward.

(See graph on next page)



Here also are the historical averages of those indexes, compared to an average of fixed-rate 30-year loan rates over the same period. The gap between them is the "insurance gap" borrowers pay to fix the rate and payment[2].

Index	Average Value (1/1990-11-2007)
COFI	4.45%
1-Year CMT (Treasury Bill Rates)	4.53%
1-Month LIBOR	4.56%
MTA (also tied to Treasury Bill Rates)	4.62%
Prime Rate	7.29%
Average Fixed Rates Available	7.20%

The Prime Rate runs very close to average fixed rate mortgage rates, and is often available with little or no "margin" as a result, which borrowers may have already experienced when shopping for traditional home equity lines of credit.

Dealing With the Fear of Rising Rates

Even with all this evidence about the qualities of adjustable rates, the common fear of taking out an adjustable rate loan is still usually expressed this way:

> "Rates could rise to 10% and stay there! How could I make my payments?"

The source of the fear is easy to spot: The adjustable rate loan could require a big jump in payments down the road. This fear is driven by two factors today:

1. Ongoing media coverage of defaulting borrowers who got into adjustable loans two years ago when rates were rock bottom, and now are being forced into foreclosure because their monthly payments are adjusting up

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[2] Source: www.mortgage-x.com

significantly. The issue for most, however, was not “adjustable rate loans”. It was people being put into loans who could only afford the initial low payment of the “teaser rate”. These borrowers had no demonstrable financial ability to cover the future, higher payment. Loose underwriting standards caused this problem, not the type of loan itself.

2. People always overemphasize the bad that could happen (rising rates) and minimize the potential good that could happen (falling rates). Studies have documented this risk-averseness, noting that people will take a “less bad” option rather than one that balances the risks evenly. The irony here is that “interest rate risk” actually diminishes over time as the ups and downs even out.

The borrower must assess how realistic it is to expect high long-term adjustable rates to become “normal”.

Historical rate fears are unfounded

When asked why they fear rising rates, many borrowers refer to the late ‘70’s and early ’80’s when rates were very high. They associate high rates with the oil crisis which occurred during those years, and many believe that the cause of high rates was the oil crisis itself. Such fears are largely unfounded. The dominant drivers of high rates during those years were the expense of the Cold War, including the Vietnam conflict, and the “Great Society” policies started by Lyndon Johnson. In addition, the lack of economic globalization made much of the world “off limits” from an economic standpoint. Each economy had to stand more or less “on its own.” So, when the oil embargo did occur, the shock to U.S. economic system was more pronounced.

Today, the world’s economies are much more interconnected, and a shock to one part of the system is more quickly absorbed by counterbalances in other parts of the world. As a result, interest rates have steadily trended downward on a large scale. The history of long-term U.S. government securities - - a solid benchmark for bank lending rates, bears this out. In fact, except for the Late Cold War/Great Society era, long-term government securities have averaged between 3% and 7% since as far back as 1790!

Is it likely that we could return to Carter-era rates? For this to happen, large parts of the world economic interconnectivity would have to break - - (inflation, for instance, would have to rise to 10% - - something that is highly unlikely, and certainly not something most borrowers should plan a mortgage around.

However, the issue is not just whether interest rates will permanently rise. What borrowers are also worried about is whether even a brief period of higher rates will require monthly payments that the borrower will not be able to meet.

The key to protecting the borrower from this sort of 'payment shock' (as this phenomenon is called), is to have a financing solution that allows both payment flexibility and aggressive principal reduction. Being able to use both can minimize and even eliminate the need to make higher interest payments if rates rise.

- Payment flexibility comes with loans, like the Home Ownership Accelerator, that allow less than the total interest due to be "paid" in given months, as long as the borrower has available credit.
- Conversely, the loan allows greater principal payments when rates are lower, which positions the borrower to have a smaller balance due by the time rates rise. This is important, because a smaller balance over time can blunt the impact of any rise in rates. ("The less you owe, the less you pay").

The best protection is a low margin

The most critical element of an adjustable rate loan is the "margin". An adjustable rate is set using the index chosen for the loan plus a margin, which is named that because it is the lenders "profit margin". The index is the 'adjustable' part of the interest rate, and changes as often as monthly as financial markets move. The margin, however, is fixed for the life of the loan, unlike the index. So, it is in the borrower's best interest to shop for the lowest margin they can afford based on how long they plan to be in the loan. The longer they are in the loan, the more important a low margin can be, because it will keep interest charges lower long-term, and offer greater protection against periods of elevated interest rates. Here is an example using the LIBOR index that underlies the Home Ownership Accelerator loan[3]:

Loan Amount	Margin	Interest Paid
$200,000	2.50%	$128,844
$200,000	0.75%	$93,844

Shopping for a Low Margin

[3] Calculated using historical 1-month LIBOR figures. Assumes interest-only payments (no principal reduction) and an upfront payment of $5,500 to buy down the margin to 0.75. Results calculated using online calculators at www.mortgage-x.com.

Lenders offer a lot of indexes, and each comes with its own range of margins, so shopping for the "lowest margin" will find you comparing apples and oranges. Some work has been done, however, to help you decide which index-margin combination will be the best for you. Good work in this are has been done by Jack Guttentag, Emeritus Professor of Finance at the Wharton School of Business in Philadelphia.

"The two most widely used indexes are the Treasury One-Year Constant Maturity series, and the 11th District Cost of Funds Index (COFI)," wrote Prof. Guttentag in 2002. "Since 1977, they have averaged out about the same. The COFI, however, is much less volatile. This benefits the borrower when rates are rising because COFI doesn't rise as much as other indexes. But [as with a fixed-rate loan] it works against the borrower when rates fall...Several other indexes average out about the same and show about the same volatility as the Treasury one-year series. These include 6-month CDs, 1-month LIBOR and 6-month LIBOR. In making a decision about the ARM index, remember that a less favorable index can be offset by a smaller margin. My index rankings below show the difference in margin that you should receive as compensation for accepting a less favorable index. They should be viewed as informed guesses and nothing more[4]:"

Here are the rankings that Prof. Guttentag developed then:

Index	Reduction to Margin needed to balance risk (%)
COFI, MTA and Treasury Bill indexes (12-mth ave or shorter)	0.00
1-Year CMT, 6-Month CD, 6-Month LIBOR	0.15
3-Year CMT	0.65
Prime Rate	1.30

Writers on Mortgage-x.com readdressed this issue in 2006, based on 15-year moving averages of these indexes. They studied the movements in the popular indexes and calculated what margin changes you should seek when comparison shopping. In effect, some margins are more volatile than others, and would require a smaller margin to balance out that volatility. They suggested the following rankings:

Index	Reduction to Margin needed to balance risk (%)
COFI	0.00
1-Month LIBOR	0.10
1-Year CMT, MTA, 6-Month CD	0.15
6-Month LIBOR	0.30
3-Year CMT	0.60
Prime Rate	2.75

[4] Jack Guttentag, *Which Adjustable Rate Mortgage Index is the Best*, www.mortgage-professor.com, 2002.

The basic lesson here is that COFI and 1-month LIBOR are indexes to seek if you wish to minimize the up-and-down movement of your rate. And if you can find a low-margin version of those indexes, you will be better off.

The web site www.mortgage-x.com provides a useful shopping tool for adjustable rate mortgages that focuses on how to compare the various indexes and their margins. Find their comparison tool here:

http://www.mortgage-x.com/general/indexes/comparison_tool.asp

Conclusion

The security of a fixed rate loan is attractive because you don't have to worry about what happens to future interest rates. That security comes at a cost, however, that a savvy financial manager may not want to pay. In most cases, adjustable rate loans offer a less expensive long-term option. The lender is willing to take a lower rate (index + margin) because the borrower is sharing the risk, and paradoxically that risk diminishes over time as interest rates rise and fall.

As long as the loan program gives the borrower the flexibility to manage the changes in interest payments due each year, the borrower should be able to reap the rewards of an adjustable rate loan without significant financial hardship.

Adjustable rate loans do not deserve their poor reputation. They are not appropriate for every borrower, but are the better financial option for borrowers who manage their finances well and tend to have positive cash flow. For such borrowers, the premium paid for a fixed rate loan and payment is probably not worth the money.

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CMG Financial Services offers the Home Ownership Accelerator through certified mortgage professionals nationally. More information on the Home Ownership Accelerator loan can be found at www.homeownershipaccelerator.com.

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