A-Cir No. 10221
February 2, 1988

TO THE ADDRESSEE:

Enclosed -- for depository institutions in the Second Federal Reserve District and others who maintain sets of the regulations of the Board of Governors of the Federal Reserve System -- is a copy of two corrections to the Board's recent amendment, effective December 28, 1987, to its Regulation Z (Truth in Lending) regarding adjustable rate mortgages. The amendment was sent to you on January 12, 1988, together with this Bank's Circular No. 10221.

Also, in that circular, we indicated that a copy of the Consumer Handbook on Adjustable Rate Mortgages, published by the Board of Governors and the Federal Home Loan Bank Board, would be sent to depository institutions in this District. Accordingly, a copy of the Handbook is being furnished to the head office of each depository institution; single copies will be furnished to others upon request directed to this Division (Tel. No. 212-720-5215 or 5216). Multiple copies of the Handbook may be obtained directly from the Board's Publications Section for a small fee; information regarding those charges may be obtained from the Board (Tel. No. 202-452-3244).

The Regulation Z amendment requires that prospective borrowers of adjustable rate mortgages be given a copy of the Handbook or a suitable substitute. The amendment became effective December 28, 1987, but compliance is optional until October 1, 1988.

Questions regarding Regulation Z may be directed to the Compliance Examinations Department of this Bank (Tel. No. 212-720-8136).

Circulars Division
FEDERAL RESERVE BANK OF NEW YORK

2015C

Board of Governors of the Federal Reserve System

TRUTH IN LENDING

CORRECTION OF REGULATION Z

The amendment to Regulation Z, effective December 28, 1987, is corrected to read as follows (corrections are underscored):

§ 226.19 Certain residential mortgage and variable-rate transactions.

* * *

(b) * * *

(2) * * *

(VIII) * * * Thereafter, the example shall reflect the most recent 15 years of index values. The example shall reflect all significant loan program terms, such as negative amortization, interest rate carryover, interest rate discounts, and interest rate and payment limitations, that would have been affected by the index movement during the period.

* * *

Appendix H — [Amended]

* * *

H-4(c) * * *

H-14 Variable-Rate Mortgage Sample

* * *

Example

The example below shows how your payments would have changed under this ARM program based on actual changes in the index from 1977 to 1987. This does not necessarily indicate how your index will change in the future. The example is based on the following assumptions:

Amount	$10,000
Term	30 years.
Payment adjustment	1 year.
Interest adjustment	1 year.
Margin	3 percentage points.
Caps	2 percentage points annual interest rate.
	5 percentage points lifetime interest rate.
Index	Weekly average yield on U.S. Treasury securities adjusted to a constant maturity of one year.

* * *

Note: This correction appears in the *Federal Register* of January 7, 1988 (Vol. 53, No. 4)

PRINTED IN NEW YORK

[Ref. Cir No. 10221]

CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES

Federal Reserve Board
Federal Home Loan Bank Board

This booklet was prepared in consultation with the following organizations:

American Bankers Association

Comptroller of the Currency

Consumer Federation of America

Credit Union National Association, Inc.

Federal Deposit Insurance Corporation

Federal Reserve Board's Consumer Advisory Council

Federal Trade Commission

Independent Bankers Association of America

Mortgage Bankers Association of America

Mortgage Insurance Companies of America

National Association of Federal Credit Unions

National Association of Home Builders

National Association of Realtors®

National Council of Savings Institutions

National Credit Union Administration

Office of Special Advisor to the President for Consumer Affairs

The Consumer Bankers Association

U.S. Department of Housing and Urban Development

U.S. League of Savings Institutions

With special thanks to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation

The Federal Reserve Board and the Federal Home Loan Bank Board have prepared this booklet on adjustable rate mortgages (ARMs) in response to a request from the House Committee on Banking, Finance and Urban Affairs and in consultation with many other agencies and trade and consumer groups. It is designed to help consumers understand an important and complex new product available to home buyers.

We believe a fully informed consumer is in the best position to make a sound economic choice. If you are buying a home, and looking for a home loan, this booklet will provide useful basic information about ARMs. It cannot provide all the answers you will need, but we believe it is a good starting point.

PEOPLE ARE ASKING . . .

"Some newspaper ads for home loans show surprisingly low rates. Are these loans for real, or is there a catch?"

Some of the ads you see are for adjustable-rate mortgages (ARMs). These loans may have low rates for a short time—maybe only for the first year. After that, the rates can be adjusted on a regular basis. This means that the interest rate and the amount of the monthly payment can go up or down.

"Will I know in advance how much my payment may go up?"

With an adjustable-rate mortgage, your future monthly payment is uncertain. Some types of ARMs put a ceiling on your payment increase or rate increase.

"Is an ARM the right type of loan for me?"

That depends on your financial situation and the terms of the ARM. ARMs carry risks in periods of rising interest rates, but can be cheaper over a longer term if interest rates decline. You will be able to answer the question better once you understand more about adjustable-rate mortgages. This booklet should help.

Mortgages have changed, and so have the questions that need to be asked and answered.

Shopping for a mortgage used to be a relatively simple process. Most home mortgage loans had interest rates that did not change over the life of the loan. Choosing among these fixed-rate mortgage loans meant comparing interest rates, monthly payments, fees, prepayment penalties, and due-on-sale clauses.

Today, many loans have interest rates (and monthly payments) that can change from time to time. To compare one ARM with another or with a fixed-rate mortgage, you need to know about indexes, margins, discounts, caps, negative amortization, and convertibility. You need to consider the maximum amount your monthly payment could increase. Most important, you need to compare what might happen to your mortgage costs with your future ability to pay.

This booklet explains how ARMs work and some of the risks and advantages to borrowers that ARMs introduce. It discusses features that can help reduce the risks and gives some pointers about advertising and other ways you can get information from lenders. Important ARM terms are defined in a glossary on page 19. And a checklist at the end of the booklet should help you ask lenders the right questions and figure out whether an ARM is right for you. Asking lenders to fill out the checklist is a good way to get the information you need to compare mortgages.

WHAT IS AN ARM?

With a fixed-rate mortgage, the interest rate stays the same during the life of the loan. But with an ARM, the interest rate changes periodically, usually in relation to an index, and payments may go up or down accordingly.

Lenders generally charge lower initial interest rates for ARMs than for fixed-rate mortgages. This makes the ARM easier on your pocketbook at first than a fixed-rate mortgage for the same amount. It also means that you might qualify for a larger loan because lenders sometimes make this decision on the basis of your current income and the first year's payments. Moreover, your ARM could be less expensive over a long period than a fixed-rate mortgage—for example, if interest rates remain steady or move lower.

Against these advantages, you have to weigh the risk that an increase in interest rates would lead to higher monthly payments in the future. It's a trade-off—you get a lower rate with an ARM in exchange for assuming more risk.

Here are some questions you need to consider:

- Is my income likely to rise enough to cover higher mortgage payments if interest rates go up?
- Will I be taking on other sizable debts, such as a loan for a car or school tuition, in the near future?
- How long do I plan to own this home? (If you plan to sell soon, rising interest rates may not pose the problem they do if you plan to own the house for a long time.)
- Can my payments increase even if interest rates generally do not increase?

HOW ARMS WORK: THE BASIC FEATURES

The Adjustment Period

With most ARMs, the interest rate and monthly payment change every year, every three years, or every five years. However, some ARMs have more frequent interest and payment changes. The period between one rate change and the next is called the adjustment period. So, a loan with an adjustment period of one year is called a one-year ARM, and the interest rate can change once every year.

The Index

Most lenders tie ARM interest rate changes to changes in an "index rate." These indexes usually go up and down with the general movement of interest rates. If the index rate moves up, so does your mortgage rate in most circumstances, and you will probably have to make higher monthly payments. On the other hand, if the index rate goes down your monthly payment may go down.

Lenders base ARM rates on a variety of indexes. Among the most common are the rates on one-, three-, or five-year Treasury securities. Another common index is the national or regional average cost of funds to savings and loan associations. A few lenders use their own cost of funds, over which—unlike other indexes—they have some control. You should ask what index will be used and how often it changes. Also ask how it has behaved in the past and where it is published.

The Margin

To determine the interest rate on an ARM, lenders add to the index rate a few percentage points called the "margin." The amount of the margin can differ from one lender to another, but it is usually constant over the life of the loan.

Index rate + margin = ARM interest rate

Let's say, for example, that you are comparing ARMs offered by two different lenders. Both ARMs are for 30 years and an amount of $65,000. (All the examples used in this booklet are based on this amount for a 30-year term. Note that the payment amounts shown here do not include items like taxes or insurance.)

Both lenders use the one-year Treasury index. But the first lender uses a 2% margin, and the second lender uses a 3% margin. Here is how that difference in margin would affect your initial monthly payment.

Home sale price: $85,000
Less down payment: −20,000
Mortgage amount: $65,000

Mortgage term: 30 years

First Lender

One-year index = 10%
Margin = 2%
ARM interest rate = 12%
Monthly payment @ 12% = $668.60

Second Lender

One-year index = 10%
Margin = 3%
ARM interest rate = 13%
Monthly payment @ 13% = $719.03

In comparing ARMs, look at both the index and margin for each plan. Some indexes have higher average values, but they are usually used with lower margins. Be sure to discuss the margin with your lender.

CONSUMER CAUTIONS

Discounts

Some lenders offer initial ARM rates that are lower than the sum of the index and the margin. Such rates, called discounted rates, are often combined with large initial loan fees ("points") and with much higher interest rates after the discount expires.

Very large discounts are often arranged by the seller. The seller pays an amount to the lender so the lender can give you a lower rate and lower payments early in the mortgage term. This arrangement is referred to as a "seller buydown." The seller may increase the sales price of the home to cover the cost of the buydown.

A lender may use a low initial rate to decide whether to approve your loan, based on your ability to afford it. You should be careful to consider whether you will be able to afford payments in later years when the discount expires and the rate is adjusted.

Here is how a discount might work. Let's assume the one-year ARM rate (index rate plus margin) is at 12%. But your lender is offering a 10% rate for the first year. With the 10% rate, your first year monthly payment would be $570.42.

But don't forget that with a discounted ARM, your low initial payment will probably not remain low for long, and that any savings during the discounted period may be made up during the life of the mortgage or be included in the price of the house. In fact, if you buy a home using this kind of loan, you run the risk of . . .

Payment Shock

Payment shock may occur if your mortgage payment rises very sharply at the first adjustment. Let's see what happens in the second year with your discounted 10% ARM.

ARM Interest Rate	Monthly Payment
First year (w/discount) 10%	$570.42
2nd year @ 12%	$667.30

As the example shows, even if the index rate stays the same, your monthly payment would go up from $570.42 to $667.30 in the second year.

Suppose that the index rate increases 2% in one year and the ARM rate rises to a level of 14%.

ARM Interest Rate	Monthly Payment
First year (w/discount) 10%	$570.42
2nd year @ 14%	$767.67

That's an increase of almost $200 in your monthly payment. You can see what might happen if you choose an ARM impulsively because of a low initial rate. You can protect yourself from increases this big by looking for a mortgage with features, described next, which may reduce this risk.

HOW CAN I REDUCE MY RISK?

Many ARMs have "caps" that protect borrowers from extreme increases in interest rates or monthly payments. Others allow borrowers to convert an ARM to a fixed-rate mortgage. While these may offer real benefits, they may also cost more, or add special features, such as negative amortization.

Interest-Rate Caps

An interest-rate cap places a limit on the amount your interest rate can increase. A cap is like insurance, so ARMs with caps may cost more than ARMs without them. Interest caps come in two versions:

- Periodic caps, which limit the interest-rate increase from one adjustment period to the next; and
- Overall caps, which limit the interest-rate increase over the life of the loan.

An ARM may have both a periodic and an overall interest rate cap.

Let's suppose you have an ARM with a periodic interest rate cap of 2%. At the first adjustment, the index rate goes up 3%. The example shows what happens.

ARM Interest Rate	Monthly Payment
First year @ 12%	$668.60
2nd year @ 15% (without cap)	$820.43
2nd year @ 14% (with cap)	$769.16

Difference in 2nd year between payment with cap and payment without = $51.27

A drop in interest rates does not always lead to a drop in monthly payments. In fact, with some ARMs that have interest rate caps, your payment amount may *increase* even though the index rate has stayed the same or declined. This may happen after an interest rate cap has been holding your interest rate down below the sum of the index plus margin.

With some ARMs, payments may increase even if the index rate stays the same or declines.

Look below at the example where there was a periodic cap of 2% on the ARM, and the index went up 3% at the first adjustment. If the index stays the same in the third year, your rate would go up to 15%.

ARM Interest Rate	Payment
First year @ 12%	$668.60
If index rises 3%...	
2nd year @ 14% (with 2% rate cap)	$ 769.16
If the index stays the same for the	
3rd year @ 15%	$820.00

Even though index stays the same in 3rd year, payment goes up $50.84.

In general, the rate on your loan can go up at any scheduled adjustment when the index plus the margin is higher than the rate you are paying before that adjustment.

An ARM might also have an overall rate cap. The next example shows how a 5% overall rate cap would affect your loan. Let's say that the index rate increases 1% in each of the first ten years:

ARM Interest Rate	Monthly Payment
First year @ 12%	$ 668.60
10th year @ 21% (without cap)	$ 1,121.51
10th year @ 17% (with cap)	$ 919.91

With a 5% overall cap, your payment would never exceed $919.91, no matter how much rates continue to rise.

Payment Caps

Some ARMs include payment caps, which limit your monthly payment increase at the time of each adjustment, usually to a percentage of the previous payment. In other words, with a 7½% payment cap, a payment of $100 could increase to no more than $107.50 in the first adjustment period, and to no more than $115.56 in the second.

Let's assume that your rate changes in the first year by 2 percentage points, but your payments can increase by no more than 7½% in any one year. Here's what your payments would look like:

ARM Interest Rate	Payment
First year @ 12%	$668.60
2nd year @ 14% (without payment cap)	$769.16
2nd year @ 14% (with 7½% payment cap)	$718.75

Difference in monthly payment = $50.41 per month.

Many ARMs with payment caps do not have periodic interest rate caps.

Negative Amortization

Be sure to find out about "negative amortization" if your ARM contains a payment cap. Negative amortization means the mortgage balance is increasing. This occurs whenever your monthly mortgage payments are not large enough to pay all of the interest due on your mortgage.

Because payment caps limit only the amount of payment increases, and not interest-rate increases, payments sometimes

do not cover all of the interest due on your loan. This means that the interest shortage in your payment is automatically added to your debt, and interest may be charged on that amount. You might therefore owe the lender more later in the loan term than you did at the start. However, an increase in the value of your home may make up for the increase in what you owe.

The next illustration uses the figures from the preceding example to show how negative amortization works during one year. Your first 12 payments of $668.60, based on a 12% interest rate, paid the balance down to $64,764.11 at the end of the first year. The rate goes up to 14% in the second year. But because of the 7½% payment cap, payments are not high enough to cover all the interest. The interest shortage is added to your debt (with interest on it), which produces negative amortization of $471.47 during the second year.

Beginning loan amount = $65,000

Loan amount @ end of first year = $64,764.11

Negative amortization during 2nd year = $471.47

Loan amount @ end of 2nd year = $65,235.58 ($64,764.11 + $471.47)

(If you sold your house at this point, you would owe almost $236 more than the amount you originally borrowed.)

To sum up, the payment cap limits increases in your monthly payment by deferring some of the increase in interest. Eventually, you will have to repay the higher remaining loan balance at the ARM rate then in effect. When this happens, there may be a substantial increase in your monthly payment.

Some mortgages contain a cap on negative amortization. The cap typically limits the total amount you can owe to 125% of the original loan amount. When that point is reached, monthly payments may be set to fully repay the loan over the remaining term, and your payment cap may not apply. You may limit negative amortization by voluntarily increasing your monthly payment.

Be sure to discuss negative amortization with the lender to understand how it will apply to your loan.

Prepayment and Conversion

If you get an ARM and your financial circumstances change, you may decide that you don't want to risk any further changes in the interest rate and payment amount. When you are considering an ARM, ask for information about prepayment and conversion.

Prepayment. Some agreements may require you to pay special fees or penalties if you pay off the ARM early. Many ARMs allow you to pay the loan in full or in part without penalty whenever the rate is adjusted. Prepayment details are sometimes negotiable. If so, you may want to negotiate for no penalty, or for as low a penalty as possible.

Conversion. Your agreement with the lender can have a clause that lets you convert the ARM to a fixed-rate mortgage at designated times. When you convert, the new rate is generally set at the current market rate for fixed-rate mortgages.

The interest rate or up-front fees may be somewhat higher for a convertible ARM. Also, a convertible ARM may require a special fee at the time of conversion.

WHERE TO GET INFORMATION

Before you actually apply for a loan and pay a fee, ask for all information the lender has on the loan you are considering. It is important that you understand index rates, margins, caps, and other ARM features like negative amortization. You can get helpful information from advertisements and disclosures, which are subject to certain federal standards.

Advertising

Your first information about mortgages probably will come from newspaper advertisements placed by builders, real estate brokers, and lenders. While this information can be helpful, keep in mind that the ads are designed to make the mortgage look as attractive as possible. These ads may play up low initial interest rates and monthly payments, without emphasizing that those rates and payments could later increase substantially. Get all the facts.

A federal law, the Truth in Lending Act, requires mortgage advertisers, once they begin advertising specific terms, to give further information on the loan. For example, if they want to show the interest rate or payment amount on the loan, they must also tell you the annual percentage rate (APR) and whether that rate may go up. The annual percentage rate, the cost of your credit as a yearly rate, reflects more than just a low initial rate. It takes into account interest, points paid on the loan, any loan origination fee, and any mortgage insurance premiums you may have to pay.

Ads may play up low initial rates. Get all the facts.

Disclosures From Lenders

Federal law also requires the lender to give you information when you get a mortgage. You should get a written summary of important terms and costs of the loan. Some of these are the finance charge, the annual percentage rate, and the payment terms.

The lender is required to give you specific information about the kind of adjustable-rate mortgage for which you have applied. This information should include the circumstances under which the rate could increase (for example, a rise in the index), what the effects of an increase would be (for example, an increase in your payments or in the length of the loan), and any limitations on the increase (such as any interest rate caps).

Read information from lenders—and ask questions—before committing yourself.

Selecting a mortgage may be the most important financial decision you will make, and you are entitled to all the information you need to make the right decision. Don't hesitate to ask questions about ARM features when you talk to lenders, real estate brokers, sellers, and your attorney, and keep asking until you get clear and complete answers. The checklist at the back of this pamphlet is intended to help you compare terms on different loans.

GLOSSARY

Annual Percentage Rate
A measure of the cost of credit, expressed as a yearly rate. It includes interest as well as other charges. Because all lenders follow the same rules to ensure the accuracy of the annual percentage rate, it provides consumers with a good basis for comparing the cost of loans, including mortgage plans.

ARM (Adjustable-Rate Mortgage)
A mortgage where the interest rate is not fixed, but changes during the life of the loan in line with movements in an index rate. You may also see ARMs referred to as *AMLs (adjustable mortgage loans)* or *VRMs (variable-rate mortgages).*

Assumability
When a home is sold, the seller may be able to transfer the mortgage to the new buyer. This means the mortgage is assumable. Lenders generally require a credit review of the new borrower and may charge a fee for the assumption. Some mortgages contain a *due-on-sale* clause, which means that the mortgage may not be transferable to a new buyer. Instead, the lender may make you pay the entire balance that is due when you sell the home. Assumability can help you attract buyers if you sell your home.

Buydown

With a buydown, the seller pays an amount to the lender so that the lender can give you a lower rate and lower payments, usually for an early period in an ARM mortgage. The seller may increase the sales price to cover the cost of the buydown. Buydowns can occur in all types of mortgages, not just ARMs.

Cap

A limit on how much the interest rate or the monthly payment can change, either at each adjustment or during the life of the mortgage. ARMs may contain one or more types of caps. Payment caps don't limit the amount of interest the lender is earning, so they may cause *negative amortization.*

Conversion Clause

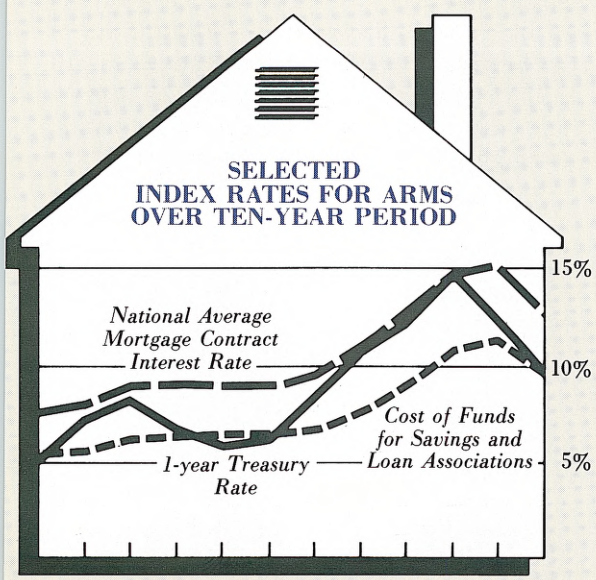
A provision in some ARMs that allows you to change the ARM to a fixed-rate loan at some point during the term. Usually conversion is allowed at the end of the first adjustment period. At the time of the conversion, the new fixed rate is generally set at one of the rates then prevailing for fixed-rate mortgages. The conversion feature may be available at extra cost.

Discount

In an ARM with an initial rate discount, the lender gives up a number of percentage points in interest to give you a lower rate and lower payments for part of the mortgage term (usually for one year or less). After the discount period, the ARM rate will probably go up depending on the index rate.

Index

The index is the measure of interest rate changes that the lender uses to decide how much the interest rate on an ARM will change over time. No one can be sure when an index rate will go up or down. To help you get an idea of how to compare different indexes, the following chart shows a few common indexes over a ten-year period (1973–83). As you can see, some index rates



tend to be higher than others, and some more volatile. (But if a lender bases interest rate adjustments on the average value of an index over time, your interest rate would not be as volatile.) You should ask your lender how the index for any ARM you are considering has changed in recent years, and where it is reported.

Margin

The number of percentage points the lender adds to the index rate to calculate the ARM interest rate at each adjustment.

Negative Amortization

Amortization means that monthly payments are large enough to pay the interest and reduce the principal on your mortgage. Negative amortization occurs when the monthly payments do not cover all of the interest cost. The interest cost that isn't covered is added to the unpaid principal balance. This means that even after making many payments, you could owe more than you did at the beginning of the loan. Negative amortization can occur when an ARM has a payment cap that results in monthly payments not high enough to cover the interest due.

Points

A point is equal to one percent of the principal amount of your mortgage. For example, if you get a mortgage for $65,000, one point means you pay $650 to the lender. Lenders frequently charge points in both fixed-rate and adjustable-rate mortgages in order to increase the yield on the mortgage and to cover loan closing costs. These points usually are collected at closing and may be paid by the borrower or the home seller, or may be split between them.

MORTGAGE CHECKLIST

Ask your lender to help fill out this checklist.

Mortgage amount

Basic Features for Comparison

Fixed-rate annual percentage rate
(The cost of your credit as a yearly rate which includes both interest and other charges)

ARM annual percentage rate

Adjustment period

Index used and current rate

Margin

Initial payment without discount

Initial payment with discount (if any)

How long will discount last?

Interest rate caps: periodic

overall

Payment caps

Negative amortization

Convertibility or prepayment privilege

Initial fees and charges

Monthly Payment Amounts

What will my monthly payment be after twelve months if the index rate—

stays the same?

goes up 2%

goes down 2%

What will my monthly payments be after three years if the index rate—

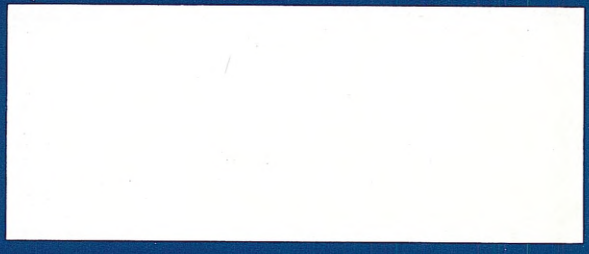
stays the same

goes up 2% per year

goes down 2% per year

Take into account any caps on your mortgage and remember it may run 30 years.

Mortgage A	Mortgage B
	$




EQUAL HOUSING
OPPORTUNITY