

LIBOR ARMs

This tutorial will answer the following questions:

What is Libor?

What is a Libor ARM?

What is special about a Libor ARM?

In what ways are Libor ARMs like other ARMs?

Why should anyone select a Libor ARM?

What Is Libor ?

Libor is short for the London Inter-Bank Offered Rate, the interest rate offered for U.S. dollar deposits by a group of large London banks. There are actually several Libors corresponding to different deposit maturities. Rates are quoted for 1-month, 3-month, 6-month and 12-month deposits.

What Is a Libor ARM?

A Libor ARM is an adjustable rate mortgage on which the interest rate is tied to a specified Libor. After an initial period during which the rate is fixed, it is adjusted to equal the most recent value of the Libor plus a margin, subject to any adjustment cap.

For example, on April 26, 2004, one lender was offering a 6-month Libor ARM at 3%, zero points, and a margin of 1.625%. The new rate 6 months later will be 1.625% plus the 6-month Libor at that time. If that is (say) 2.625%, the new rate will be $1.625\% + 2.625\% = 4.25\%$. If the adjustment cap that limits the size of rate changes is 1%, however, the new rate will be only $3\% + 1\% = 4\%$.

What Is Special About a Libor ARM?

Low Margins for A-Quality Borrowers: Libor ARMs were developed to meet the needs of foreign investors looking to minimize their interest rate risk on dollar-denominated investments. A foreign bank that buys the 6-month Libor ARM containing a 1.625% margin can borrow the funds it needs in the inter-bank market for 6 months at the 6-month Libor. The bank pays the depositor Libor, and it earns Libor + 1.625% on the ARM. The margin is locked in, except to the extent that changes in Libor are not fully matched by changes in the ARM rate because of rate caps.

Because of the reduced risk, investors in Libor ARMs are willing to accept a smaller margin than is common on other ARMs. On April 26, 2004, for example, the Libor margin available to A-quality borrowers was as low as 1.50%, compared to 2.25 – 2.75% on ARMs indexed to other series.

But not everyone can benefit from the low margin. On the same day that the lender cited

above was offering a 6-month Libor ARM at 3% with a 1.625% margin, a sub-prime lender was offering a 6-month Libor ARM to borrowers with D-credit at 10% with a 7% margin!

Attractive Buydowns: On 30-year fixed-rate mortgages, borrowers can usually "buy down" the rate by ¼% by paying about 1.5 points. I have seen 30-year Libor ARMs that allow the borrower to buy down the rate and margin by ¼% for only 3/8 of a point. This is an incredible bargain, but the Libors that offer it may have an unusually high maximum rate.

No Negative Amortization: Libor ARMs don't offer the payment flexibility, nor the associated risks, of negative amortization ARMs.

High Index Volatility: Libor is about as volatile as rates on short-term US Government securities, and more volatile than the COFI, CODI and MTA indexes.

In What Ways Are Libor ARMs Like Other ARMs?

The remaining features of Libor ARMs are very similar to those of other ARMs.

Initial rate period. This is the period during which the initial rate holds. Initial rate periods on Libor ARMs range from 6 months to 10 years.

Subsequent adjustment period. This is period between rate adjustments after the first adjustment. For example, an ARM on which the initial rate holds for 3 years and is then adjusted every year is a "3/1". Most Libor ARMs adjust every 6 or 12 months.

Rate Adjustment Caps: Rate adjustment caps that limit the size of a rate change are generally 1% on 6-month Libors, and 2% on 1-year and 3-year Libors. On 7 and 10-year Libors, the cap is usually 5% on the first adjustment and 2% on subsequent (annual) adjustments. On some 5-year Libors, however, the adjustment cap is the same as that on 1-year and 3-year Libors, while on others it is the same as on 7-year and 10-year Libors.

Maximum Interest Rate: This is the highest interest rate allowed on the ARM over its life. The maximum rate on some Libor ARMs is set at 5% or 6% above the initial rate. On others it is set at an absolute level – 11%, for example, regardless of the initial rate.

Why Should Anyone Select a Libor ARM?

You select a Libor loan not because it uses Libor but because it has a combination of other features that in combination add up to an attractive ARM for you. An ARM is attractive if, during the period you expect to have the mortgage, the interest savings early in that period (relative to a FRM or an ARM with a longer initial rate period) outweigh the risk of interest rate and payment increases later on.

The best way to make such a judgment is by using interest rate scenario analysis. An interest rate scenario is an assumption about what will happen to rates in the future. Usually, we focus on rising rate scenarios, because those are the ones we worry about.

For any given scenario, we can calculate exactly how high the rate and payment will go, and when it will get there. Using the same scenario, we can compare different ARMs, as well as ARMs against an FRM. We can also calculate the cost of an ARM or FRM over any period specified by the borrower.

Because their margins can be small, borrowers who take Libor ARMs may find it attractive to reduce the risk of future rate increases by adopting the FRM payment strategy. This involves making the payment they would have had to make had they chosen an FRM, for as long as the FRM payment remains above the Libor ARM payment.

**L.S. Mortgage Services
216 W. University Ave
Georgetown, TX 78626
Toll Free 866-914-5626
www.LSMTG.com**