

the Mortgage Bulletin

Last Century Mortgage

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Old Geezer

Conforming Loans to \$359,650

Type	Rate	APR	Trend
30 Yr FIX	5.875%	5.956%	→
15 Yr FIX	5.625%	5.506%	→
5/1	5.625%	6.293%	↑
3/1	5.500%	6.371%	↑

Jumbo Loans above \$359,650

30 Yr FIX	6.250%	6.311%	↑
15 Yr FIX	5.875%	5.973%	→
10/1	6.000%	6.1293	→
7/1	6.000%	6.359%	→
5/1	5.750%	6.337%	→
10 Yr Bond		4.361%	↑
Prime		6.750%	→

Is the APR meaningful?

The APR (annual percentage rate) was invented to inform borrowers of the “real” cost of borrowing. Few could quarrel with this noble endeavor. However (a big however) the APR is accurate only for fixed rate loans. The interest rate is fixed for the entire term of a fixed rate loan. But the interest rate is not fixed for the entire term of adjustable rate (ARM) loans.

Therein lies the problem. The APR is virtually meaningless for ARM loans. Not only is the APR meaningless, it is inaccurate and can be misleading. Here’s why.

Let’s calculate the APR for a 30 year fixed rate loan of \$650,000 at 6.125% and then let’s do it for a 5/1 ARM loan at 5.625%. Assume loan costs of \$2,500 for each loan, zero points.

First, the APR for each loan. For the 30 year fixed it is 6.185% and for the 5/1 ARM loan it is 6.144%.

The APR for the 30 year fixed is figured by (first) determining the monthly payment required to amortize \$650,000 over thirty years. The payment is \$3,949.47.

Next, deduct the cost of getting the loan (\$2,500) plus 15 days of advance interest (\$1,636) from \$650,000 = \$645,864. Use the same (\$3,949.47) payment against \$645,864 and solve for the interest rate and you get the APR -- 6.185%.

Those without HP12C calculators or something similar will have to accept on faith that this calculation is correct.

So now, figure the APR for an ARM loan. It is quite complicated, so you can skim the following calculations and just read the text to get the message. First, you do the same steps as above except that you base the first five year’s payments on the start rate of 5.625% (\$3,741.77) and the remaining twenty five years on the fully indexed rate payment.

To get the fully indexed rate, add the

2.250% margin to TODAY’S 3.960% index and you get 6.210%. NOTE: TODAY’S INDEX IS USED.

This fully indexed rate determines the monthly payment required to amortize the loan balance at the end of five years (\$602,954) over the remaining twenty five years. The payment is \$3,962.61.

The total payments for the first five years are added to the total payments for the remaining twenty five years then divided by 360 to get the average monthly payment for thirty years. Then solve for interest. You should get 6.144%, the APR.

So, if the APR as advertised, provides a reliable cost of borrowing, the 5/1 ARM is less costly than the 30 year fixed. But -- the flaw is using today’s index to set the fully indexed rate and assuming that rate will remain flat for the final twenty five years of the loan. The index used is the six month Libor, currently 3.960%.

Would you like to know what this index was five years ago? Would you believe 6.978%? And given the likelihood that the Fed will continue hiking short term rates it is quite likely that this index in five years will be closer to 6.978% than 3.960%. Adding the 2.250% margin to 6.978% gives an interest rate of 9.228%, and a monthly payment for the final twenty five years of the loan of \$5,154.53. This would generate an APR of 9.133%.

That’s considerably less advantageous to the borrower than 6.185% APR, don’t you agree?

Summing up, the APR for ARM loans is inaccurate because its calculation is based largely on today’s index which cannot be guaranteed to remain flat. In fact today’s indexes are just coming off historic lows and are almost certain to rise into the future. So, you cannot rely on it.

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