Appendix J

DCA Policy on Adjustable Rate Mortgages

Mike Beatty
COMMISSIONER

Sonny Perdue
GOVERNOR

MEMORANDUM

TO: All CHIP and CDBG Housing Recipients and Administrators

FROM: Bobby Smith, Director, Office of Grant Administration

RE: Determining Affordability of First Mortgages on Loans with CHIP or CDBG Down Payment/Second Mortgage Assistance and Effect of Adjustable or Variable Rate Mortgages and Other Flexible Mortgage Plans

DATE: April 12, 2004

During recent monitoring reviews, it has come to DCA's attention that adjustable rate mortgages (ARMs) also known as variable rate mortgages and other flexible first mortgage plans are being used by low income buyers under the CHIP and CDBG down payment or second mortgage assistance programs. This memorandum is to remind all CHIP and CDBG state recipients and their administrators of their responsibility to ensure that the low income purchaser under CHIP and CDBG obtain an affordable first mortgage loan that will remain affordable. HUD has published in their "Building HOME, A HOME Program Primer," that in negotiating first mortgage interest rates and fees that:

> **"to improve the likelihood of continued affordability, loans should normally be at fixed rates."**

Also, as a reminder, the proposed leverage partnerships that you developed with local lenders or other providers, like USDA, for providing affordable first mortgages were included in each of your applications for funding under either the CHIP or CDBG program. We have some concerns that buyers under the CHIP and CDBG programs are being offered various versions of adjustable or variable rate mortgages that were not set forth or contemplated in your initial applications for funding. The initial low "introductory" interest rate on these mortgages provides for a limited time a low monthly payment for principal and interest and possibly is used by the lenders to qualify the buyer for the loan amount. The borrower should be prepared to handle an increase in his/her monthly payment should the index rate attached to this type of loan increase.

borrow funds known as the London Interbank Offer Rate (LIBOR).

2 **Margin** – To determine the actual interest rate on an ARM, lenders add to the index rate a few percentage points (generally 1 to 3 points but could be higher) 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. The margin is also called "the spread" and it is added to the index to cover the lender's administrative costs and profits to come up with the adjusted or "calculated interest rate."

3 **Calculated interest rate** – By adding the index and the margin together, you arrive at the calculated interest rate, which is the actual rate the borrower pays. It is also the rate to which any future rate adjustments will apply, rather than the initial or "teaser" rate explained below.

4 **Adjustment Period and Teaser Rates** – Because the interest rate for an ARM may change due to economic conditions, a key feature to ask the lender is exactly how often the interest rate may change. This is referred to as the "adjustment period." Many ARMs have one-year adjustment periods, which means the rate and monthly payment is recalculated (based on the index) every year. Other ARMs have 3, 5, or 7 year adjustment periods.

An ARM can also have an initial adjustment period based on a "teaser rate," which is an artificially low introductory interest rate offered by a lender to attract homebuyers. Usually, teaser rates are good for the first 6 months or a year, at which point the loan reverts back to the calculated interest rate. (The lender does not typically use this introductory rate or teaser rate to qualify the buyer for the loan but instead uses an interest rate of 7.5% or the calculated interest rate if it is lower for loan qualifying purposes.) Oftentimes these discounted introductory rates are combined with large initial loan fees or (points) and with much higher interest rates after the discount expires.

Very large discounts are often arranged by the builder/seller or seller. The seller pays an amount to the lender so the lender can give a lower rate and lower payments early in the term of the mortgage. This is referred to as a seller buy-down. The low income purchaser needs to consider whether he/she will be able to afford payments in later years when the discount has expired and the rate is adjusted.

allow State Recipients to implement a recapture program design to recapture only the "net proceeds" in the case of a foreclosure, the waiver request is still under HUD review. Therefore it is even more imperative that State Recipients and their award administrators evaluate the affordability of the borrower's first mortgage loan.

We appreciate your attention to these concerns. If you have questions or require additional information, please contact Jane Keefe at (404) 679 – 3167 or Glenn Misner at (404) 679 – 3138.

Enclosure

JK/jk