

In Defense of ARMs

With the recent credit crunch, commentators have rushed to blame whomever they can find: borrowers, lenders, the Federal Reserve -- anyone who deals in dollars.

But perhaps no one has taken more blame than those lenders who dealt in adjustable-rate mortgages (ARMs). Some media coverage has even suggested that if it weren't for ARMs, the market would still be booming.

Yes, there have been problems. A few disreputable lenders extended credit beyond their borrowers' ability to repay their loans. Some borrowers deceived themselves into buying more home than they could afford. Income and assets weren't verified. And credit was extended where it should not have been. Often, it was a combination of these factors.

But the key point is the problem wasn't with adjustable-rate mortgages, per se. Rather, it was with

some ARMs and some lenders. The same problems are found with car loans, for example. In some cases, a sweet-talking salesman will sell a buyer with marginal credit a loan that will likely pummel him with steep interest-rate payments and leave him owing more on the car than it's worth. Such a buyer is likely to default and it would be wrong to sell him such a loan in the first place. But that doesn't mean that all car loans are bad or that all finance companies are disreputable.

Adjustable-rate mortgages are no different. They were created to give today's homebuyers greater flexibility in an economy that is increasingly fluid. People move much more often than they used to; the typical American family stays in a home for about five to seven years. For many of these families, a traditional fixed-rate, 30-year mortgage doesn't make sense, because the period of actual homeownership is so short.

Conventional fixed-rate loans offer long-term predictability -- the homeowner knows what his monthly payment will be next month and what it will be 15 years from now.

An ARM might be a better option for a young family that will likely relocate to another city within five years, perhaps as a

result of a promotion or job transfer. ARMs can also be a great deal for older buyers for whom a commitment of three decades just isn't realistic. In both situations, buying into a rigid, 30-year commitment may not be the best option.

Why is it that some lenders only offer consumers a 30-year guaranteed loan, when that product both costs more and simply is not needed? With an ARM, monthly payments can be structured to take advantage of interest rates right now -- not 15 years down the road.

The result? Families spend less money on their monthly mortgage payment during the period that they are actually in the house -- and thus have more cash each month for other needs. And when the time comes to move, they'll come out in much better shape than they might have with a traditional loan structured for a long-term commitment.

Consider a mortgage of \$225,000 -- the approximate cost of the typical new-construction single-family home. Assuming the mortgage has a 30-year fixed rate of 6.75%, one would pay \$87,540 over five years. If instead, one had an ARM and a rate of 6.125%, that person would pay just \$82,020 over five years.

In other words, long-term payment stability comes with a price tag of \$1,100 each year. So it's the 30-year fixed mortgage that gives consumers the short end of the stick.

If, after five years, a borrower employing an ARM doesn't move, he can either refinance or accept the reset rate. Refinancing, of course, often allows the borrower to take advantage of a lower interest rate, which can reduce monthly payments and the overall cost of the mortgage. What's more, it allows the borrower to reduce the term of his loan, cutting his total cost and enabling him to build home equity more quickly than he would otherwise.

And when it comes to the current bogeyman, the reset rate, it turns out that most highly-regarded lenders offer extremely reasonable resets. It's only the mortgages that were offered by subprime lenders that reset (and are still resetting) at unaffordable rates. These lenders enticed buyers through incredible introductory offers. And buyers, banking on pay raises and continued bullishness in the economy, willingly signed, despite the fact that some of these subprime loans reset at rates comparable to those on high-interest credit cards.

The bottom line is that any lending tool -- whether it's a bar tab or a bank loan -- can be abused. But just as we shouldn't

get rid of bar tabs, ARMs are worth keeping around. When used responsibly, adjustable-rate mortgages can be a financially sound and cost-effective way for modern families to purchase a home.