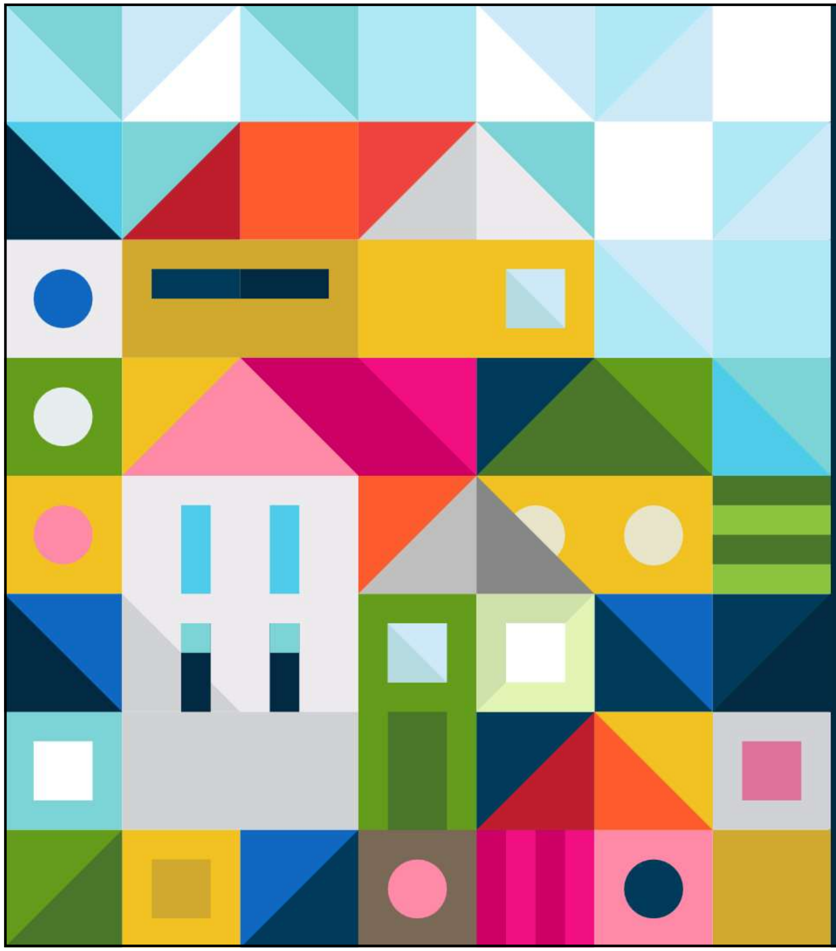

Getting Comfortable with ARMs

Presented by: Sandra Sweeney

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Legal disclaimer

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ARM basics

Qualifying with ARMs

Product comparison

GSE guidelines and pricing

Borrower considerations & tradeoffs

Additional considerations

Q&A

3

Adjustable-rate mortgage (ARM)

A home loan with an interest rate that changes periodically, either up or down, during the loan term

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ARM types

3/6, 5/6, 7/6 and 10/6 Secured Overnight Financing Rate (SOFR) ARMs

(fixed for 3, 5, 7 or 10 years and adjusts every 6 months after)

3/1, 5/1, 7/1 and 10/1 Constant Maturity Treasury (CMT) ARMs

(fixed for 3, 5, 7 or 10 years and adjusts every 1 year after)

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Decoding ARMs

Fixed period before adjustment

Subsequent or period adjustment cap

7/6 SOFR ARM with **5/1/5** caps

Frequency of change after initial fixed period

Initial adjustment cap

Lifetime adjustment cap

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ARM terminology

Initial fixed rate period

During this time, the interest rate on the loan does not change.

Start rate

Also called a "teaser rate" or "intro rate," this is the FIAR minus the lender's discount.

Qualifying rate

This is the rate the investor stipulates be used in qualifying the borrower.

Fully indexed rate

This is the highest rate the loan can potentially reach when it adjusts.

How is the rate determined at time of adjustment?

Key ARM components

INDEX

measure of interest rates reflecting trends in overall economy

MARGIN

the extra percentage that the lender adds to the index

CAPS

limits the change in interest rate at time of adjustment

INDEX

- Determines *how* the interest rate adjusts
- Reflects *borrowing costs* at the time of adjustment
- Typical *ARM indices* include:
  - SOFR (Secured Overnight Financing Rate)
  - CMT (Constant Maturity Treasury)
  - Others (COFI, COSI, Prime)

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MARGIN

- *Added to the index* to compute the new adjusted interest rate
- Varies *based on the product*, typically 2% to 3%
- *Does not change* over the life of the loan

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CAPS

- **Initial cap:** Limits the amount the rate may change *at* the first adjustment
- **Periodic cap:** Limits the amount the rate may change *after* the first adjustment
  - Adjustments are based on the prior interest rate
  - May differ from the initial cap
- **Lifetime cap:** *Lifetime maximum* interest rate adjustment, often 5% or 6%

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ARM basics – Interest rate caps

Common **interest rate caps** (%):

- 2/1/5 (for 3/6 and 5/6 SOFR ARMs)
- 5/1/5 (for 7/6 and 10/6 SOFR ARMs)
- 2/2/6 (for 1/1, 3/1 and 5/1 CMT ARMs)
- 5/2/5 (for 5/1, 5/5, 7/1 and 10/1 CMT ARMs)

What about an **interest rate floor**?

- The *floor* is the margin unless otherwise identified

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ARM basics – Fully indexed rate

Definition:
Fully indexed accrual rate (FIAR) = Index + margin (rounded to nearest one-eighth percent)

- The fully indexed rate at origination *may or may not* be equivalent to the Note Rate
- Borrower *qualifying* may be based on the fully indexed rate

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ARM basics – Adjustment example

Index + margin = New adjusted interest rate

30-day SOFR	3.643%	1-year CMT	3.68%
+ Margin	2.50%	+ Margin	3.00%
Total	6.143%	Total	6.625%
New interest rate	6.125%	New interest rate	6.625%

Will my payment always increase with an ARM?

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Historical 30-day SOFR Index

SOFR Averages and Index Data - FEDERAL RESERVE BANK of NEW YORK (newyorkfed.org)

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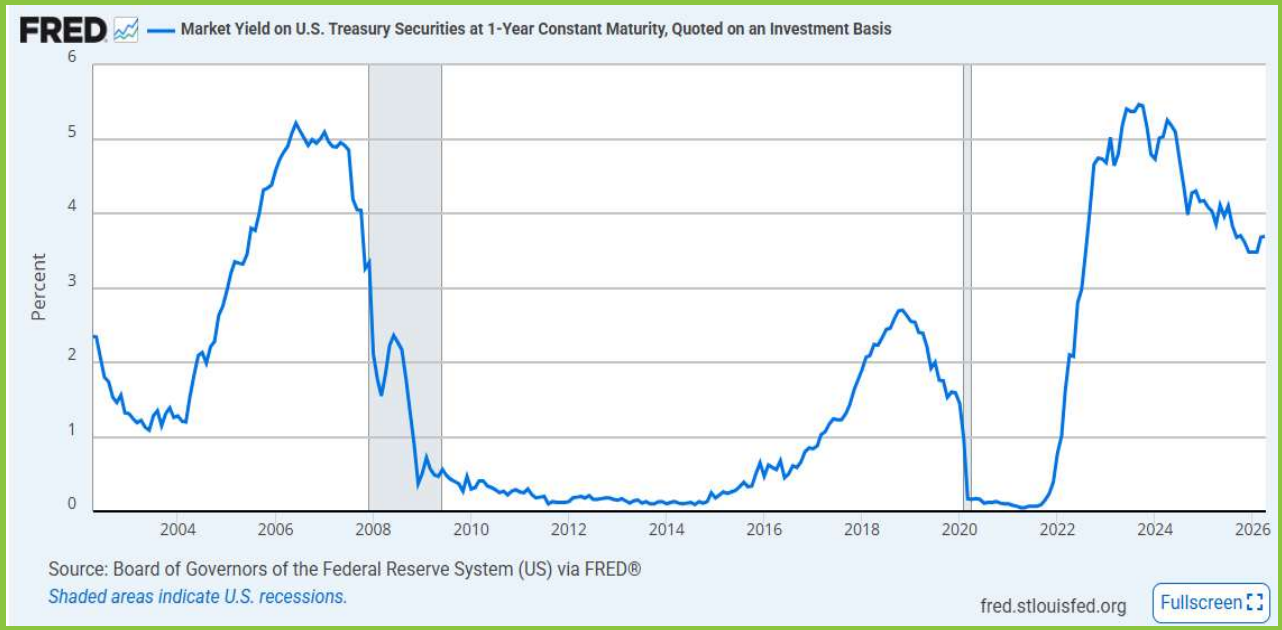
Historical 1-year CMT rates

FEDERAL RESERVE BANK of ST LOUIS



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What about payment shock?

Avoiding payment shock

ARM Payment Shock

ARMs that provide for low initial payments based on fixed introductory rates that expire after a short period of time and then adjust to a variable rate for the remaining term of the mortgage loan have the potential for payment shock. "Payment shock" refers to the impact on the borrower's ability to continue making the mortgage payments once the introductory rate expires. After the rate and payment increase, the borrower is subsequently faced with a large increase in monthly PITIA.

Lenders must limit the impact of any potential payment shock on an ARM with an initial fixed-rate period of five years or less by qualifying borrowers based on the qualifying rate described in B3-6-04, Qualifying Payment Requirements.

Fannie Mae Selling Guide B2-1.4-02

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Qualifying for an ARM

Fannie Mae Selling Guide

B3-6-04, effective 02/07/2024

Qualifying Interest Rate Requirements	
Transaction Type	**DU and Manual Underwriting**
Fixed-rate mortgages	Note rate
ARMs with initial fixed-rate period of three years or less	The maximum interest rate that could apply during the first five years after the first payment is due.
ARMs with initial fixed-rate period of five years	Greater of • the maximum rate that could apply during the first five years after the first payment date (note rate plus first rate change cap), or • the fully indexed rate
ARMs with an initial fixed-rate period of greater than five years	• No less than note rate Exception: Greater of the note rate or the fully indexed rate for loans that are higher-priced mortgage loans or higher-priced covered transactions under Regulation Z. If the fully indexed rate is higher, the loan must be manually underwritten.

Freddie Mac Seller/Servicer Guide

4401.2, effective 07/02/2025

(b) ARM qualifying rates

The following table provides the minimum Borrower qualification requirements for each eligible ARM product.

Borrower qualifying rate requirements by ARM product	
SOFR ARM product	**Borrower qualified at no less than the:**
3/6-Month ARM[1]	Note Rate + Life Cap (5%)
5/6-Month ARM[1]	Greater of the Note Rate plus two percentage points or the fully indexed rate[2]
7/6-Month ARM 10/6-Month ARM	▪ Note Rate for Mortgages that are not Higher-Priced Covered Transactions (HPCTs) or Higher-Priced Mortgage Loans (HPMLs) ▪ Greater of the Note Rate or the fully indexed rate[2] for Mortgages that are HPCTs or HPMLs

[1]The qualifying rate must, at a minimum, equal the maximum interest rate that may apply during the first 5 years after the first payment Due Date. If the ARM qualifying rate requirements above are more restrictive, those requirements must be satisfied.
[2]For purposes of this section, the fully indexed rate is the sum of the Margin plus a value of the applicable Index (at any time within 90 days preceding the Note Date), rounded to the nearest one-eighth of 1% (0.125%).

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Qualifying for an ARM – Example

5/6 ARM with 5% Note Rate **2/1/5 caps and 2.5% margin** **Index = 2.5%**	**7/6 ARM with 5.5% Note Rate** **5/1/5 caps and 2.5% margin** **Index = 2.5%**
Greater of: Note rate + 2 or FIAR Note Rate (5%) + 2% = 7.0% **OR** FIAR (2.5% + 2.5% = 5.0%) Qualifying rate of 7.0%	Note Rate (5.5%) Qualifying rate of 5.5% *Note Rate for Mortgages that are not Higher-Priced Covered Transactions (HPCTs) or Higher-Priced Mortgage Loans (HPMLs)*

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Fannie/Freddie ARM guidelines & pricing

Max LTV (Single Family Primary Residence)

- **Fixed-rate** – 97% (with limitations)
- **ARM** – 95% (with limitations)
  - ➢ Same for HomeReady® and Home Possible® loan programs

LLPAs/Credit fees

ADJUSTABLE RATE MORTGAGES [4]	
Product	LTV Ratios
	All Eligible
	> 90%
All Eligible ARMs	0.25%

7/1 and 10/1 ARMs that are Home Possible Mortgages meeting the requirements of Chapter 4501 are not subject to the Adjustable Rate Mortgage Credit Fee in Price.

Other investors may have different guidelines and pricing.

ARM guidelines

Fannie Mae Selling Guide

B2-1.4-02

B2-1.4-02, Adjustable-Rate Mortgages (ARMs) (12/14/2022)

Introduction

Print Share

This topic contains information on ARMs, including:

- Overview
- Acceptable ARM Characteristics
- ARMs and Temporary Interest Rate Buydowns
- ARM Plan Indexes
- Standard Conventional ARM Plans
- Initial Note Rate Limitations
- Calculating the Fully Indexed Rate
- Determining ARM Acceptability
- Mortgage Margin
- Interest Accrual Rate Calculation
- ARMs and MBS Pools
- Pooling Standard Fannie Mae ARM Plans Without Special Disclosure
- ARM Disclosures
- Disclosures Regarding Availability of Index Values
- Disclosures Regarding Below-Market Interest Rates
- Disclosures Regarding Conversions
- Disclosures Regarding Assumption of ARMs
- Requirements Regarding Interest Rate and Monthly Payment Adjustments
- ARM Payment Shock
- DU Generic ARM Plans
- Generic ARM Underwriting Guidelines
- Loan-Level Price Adjustments

Freddie Mac Seller/Servicer Guide

4401.1

Freddie Mac Single-Family | Seller/Servicer Guide

Guide Home | Seller/Servicer Relationship | Selling | Servicing | Search the Guide | View All

4401.1 < Prev Next >

General ARM eligibility requirements

Effective 07/02/2025

Guide Home > Selling > Series 4000 : Mortgage Eligibility > Topic 4400 : Special Mortgage Eligibility Requirements > Chapter 4401 : ARMs

Copy Link | Print

This section contains information related to:

- Eligible ARM products
- Common requirements for all ARM products
- ARM Note Rate change requirements
- Credit Fees for ARMs

(a) Eligible ARM products

Freddie Mac will purchase rate-capped ARMs that have an Initial Period followed by subsequent Note Rate adjustments. The following table shows, for each eligible ARM product, the applicable Initial Period and the subsequent periodic adjustments:

Initial Periods and periodic adjustments for eligible ARM Products

Eligible ARM product	Initial Period	Periodic adjustments (subsequent to the Initial Period)
3/6-Month ARM	36 months	6 months
5/6-Month ARM	60 months	
7/6-Month ARM	84 months	
10/6-Month ARM	120 months	

Note: See Section 4401.1(c) for first Interest Change Date requirements.

Related Bulletins

Bulletin 2025-9 Selling

Related Exhibits

Exhibit 17S Available Mortgage Products

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What about MGIC mortgage insurance?

What about MGIC mortgage insurance?

- **Borrower qualifying:**
  - ARMs with initial fixed periods of 5 years or less
    - Qualify at the greater of the Note Rate + 2% or FIAR
  - ARMs with initial fixed periods more than 5 years
    - Qualify at the Note Rate
  - For non-GSE/portfolio loans, see the full details in the MGIC Underwriting Guide at mgic.com/uwguide

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Check your ARM knowledge!

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ARM quiz

ARM type: 5/1 CMT
Index: 3.5%
Margin: 2.5%
Caps: 2/2/6
Discount: 1.0%

6th year Index: 5.0%

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1. What is the fully indexed accrual rate (FIAR)?
2. What is the start/teaser rate?
3. What is the FIAR in year 6?
4. Does this exceed the cap?

It’s about tradeoffs

Lower initial payment for an unknown future payment

Fixed or adjustable?

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Tradeoff example with a loan amount of $640,000

	30-year fixed	7/6 ARM 2.5% margin 5/1/5 caps
Interest rate	6.50%	6.00%
P&I payment	$4,045.24	$3,837.12
Difference	N/A	**$208.12**
Savings over initial period	N/A	$17,482.08
Additional equity	N/A	$4,971.90
Total initial savings	N/A	**$22,453.98**
Maximum interest rate	**6.50%**	**11.00%**

ARM reset scenarios – Month 85

Possible scenario: Rates fall (SOFR = 3.5%)

- New rate: 3.5% + 2.5% = 6.0%
- Resulting payment: $3,837.12, remains the same

Probable scenario: Rates remain stable (SOFR = 4.5%)

- New rate: 4.5% + 2.5% = 7.0%
- Resulting payment: $4,257.94, increase of $420.82 per month

Worst-case scenario: Rates increase (SOFR = 8.5%)

- New rate: 8.5% + 2.5% = 11.0% (adjustment cap of 5.0% = 11.0%)
- Resulting payment: $6,094.87, increase of $2,257.75 per month

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ARMs or fixed

	ARMs	Fixed
Advantages	• Lower initial interest rate and payment plus greater equity in the short-to-intermediate term • Helps borrowers save and invest money elsewhere initially • Less-expensive path for borrowers to buy a home initially	• Interest rate and payment remain constant • Easy to budget long-term • Easy to understand/explain
Disadvantages	• Rates and payments can rise significantly • Risk of payment shock • ARMs can be difficult to understand/explain	• Higher initial payment, less equity • Rising rates have impacted affordability • Little variability from lender to lender (hard to differentiate)

Is an ARM right for your customer?

- How long do they plan to own the home?
- How important is payment certainty?
- Are they comfortable with the risk of their payment increasing? Maximum rate?
- Is it likely that their income will increase? Might it decrease?
- Do they anticipate any major expenses – tuition, new car, etc.?
- What are their interest rate expectations? CAREFUL!
- Show them the options – run the numbers!

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Who should consider an ARM?

ARM candidates	ARM adverse
Tech workers	First-time homebuyers
Medical residents	Retirees
Military families	Looking for forever home
Investors/flippers	Budget-conscious
Temporary relocators	Risk-adverse

Other ARM considerations

- What ARM products does **your company** offer?
- ARM disclosures and Consumer Handbook on Adjustable-Rate Mortgages (CHARM booklet available from the CFPB)
- Annual percentage rate (APR): Calculated based on a **blend** of the initial rate and the fully indexed rate

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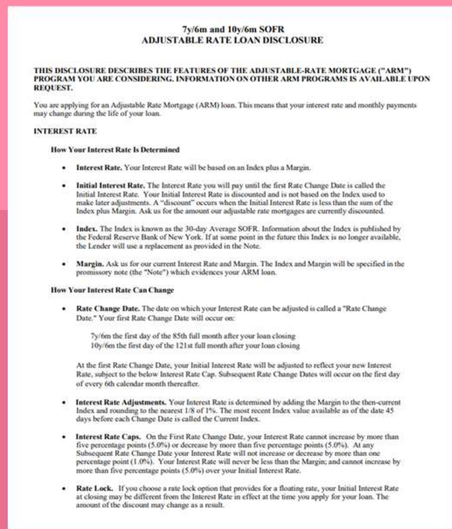
Regulation Z & ARM disclosures

ARM disclosure



7y/6m and 10y/6m SOFR
ADJUSTABLE RATE LOAN DISCLOSURE

THIS DISCLOSURE DESCRIBES THE FEATURES OF THE ADJUSTABLE-RATE MORTGAGE ("ARM") PROGRAM YOU ARE CONSIDERING. INFORMATION ON OTHER ARM PROGRAMS IS AVAILABLE UPON REQUEST.

You are applying for an Adjustable Rate Mortgage (ARM) loan. This means that your interest rate and monthly payments may change during the life of your loan.

INTEREST RATE

How Your Interest Rate Is Determined

- **Interest Rate.** Your Interest Rate will be based on an Index plus a Margin.
- **Initial Interest Rate.** The Interest Rate you will pay until the first Rate Change Date is called the Initial Interest Rate. Your Initial Interest Rate is discounted and is not based on the Index used to make later adjustments. A "discount" occurs when the Initial Interest Rate is less than the sum of the Index plus Margin. Ask us for the amount our adjustable rate mortgages are currently discounted.
- **Index.** The Index is known as the 30-day Average SOFR. Information about the Index is published by the Federal Reserve Bank of New York. If at some point in the future this Index is no longer available, the Lender will use a replacement as provided in the Note.
- **Margin.** Ask us for our current Interest Rate and Margin. The Index and Margin will be specified in the promissory note (the "Note") which evidences your ARM loan.

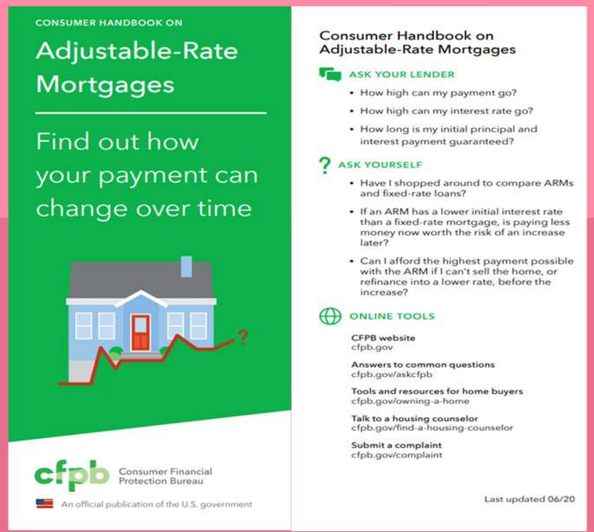
How Your Interest Rate Can Change

- **Rate Change Date.** The date on which your Interest Rate can be adjusted is called a "Rate Change Date." Your first Rate Change Date will occur on:

  7y/6m the first day of the 85th full month after your loan closing
  10y/6m the first day of the 121st full month after your loan closing

  At the first Rate Change Date, your Initial Interest Rate will be adjusted to reflect your new Interest Rate, subject to the below Interest Rate Cap. Subsequent Rate Change Dates will occur on the first day of every 6th calendar month thereafter.
- **Interest Rate Adjustments.** Your Interest Rate is determined by adding the Margin to the then-current Index and rounding to the nearest 1/8 of 1%. The most recent Index value available as of the date 45 days before each Change Date is called the Current Index.
- **Interest Rate Caps.** On the First Rate Change Date, your Interest Rate cannot increase by more than five percentage points (5.0%) or decrease by more than five percentage points (5.0%). At any Subsequent Rate Change Date your Interest Rate will not increase or decrease by more than one percentage point (1.0%). Your Interest Rate will never be less than the Margin; and cannot increase by more than five percentage points (5.0%) over your Initial Interest Rate.
- **Rate Lock.** If you choose a rate lock option that provides for a floating rate, your Initial Interest Rate at closing may be different from the Interest Rate in effect at the time you apply for your loan. The amount of the discount may change as a result.

CHARM



[CHARM Adjustable-Rate Mortgages]

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Loan Estimate – Loan terms

Loan Terms		Can this amount increase after closing?
Loan Amount	$216,000	**NO**
Interest Rate	3%	**YES** · Adjusts **every year** starting in year 6 · Can go **as high as 8%** in year 8 · See **AIR Table** for details
Monthly Principal & Interest *See Projected Payments Below for Your Total Monthly Payment*	$910.66	**YES** · Adjusts **every year** starting in year 6 · Can go **as high as $1,467** in year 8
		Does the loan have these features?
Prepayment Penalty		**NO**
Balloon Payment		**NO**

Example from CHARM booklet

Loan Estimate – Projected payments

Projected Payments

Payment Calculation	Years 1-5	Years 6	Years 7	Years 8-30
Principal & Interest	$910.66	$838 min $1,123 max	$838 min $1,350 max	$838 min $1,467 max
Mortgage Insurance	+ 99	+ 99	+ 99	+ —
Estimated Escrow *Amount can increase over time*	+ 341	+ 341	+ 341	+ 341
Estimated Total Monthly Payment	$1,290	$1,217 – $1,502	$1,217 – $1,729	$1,179 – $1,808

Estimated Taxes, Insurance & Assessments *Amount can increase over time*	$341 a month	**This estimate includes**	**In escrow?**
		☒ Property Taxes	**YES**
		☒ Homeowner's Insurance	**YES**
		☐ Other:	
		See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.	

Example from CHARM booklet

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Loan Estimate – Adjustable interest rate table

Adjustable Interest Rate (AIR) Table	
Index + Margin	1 Year Cmt + 2.5%
Initial Interest Rate	3%
Minimum/Maximum Interest Rate	2.5% / 8%
Change Frequency	
First Change	Beginning of 61st month
Subsequent Changes	Every 12 months after first change
Limits on Interest Rate Changes	
First Change	2%
Subsequent Changes	2%

Example of "AIR table" section. Find this on page 2 of your own Loan Estimate

Example from CHARM booklet

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Check your ARM knowledge . . . again!

ARM quiz

General knowledge

1. Which regulation requires lenders to disclose ARM-specific risks and to provide the CHARM booklet?

2. A borrower being temporarily relocated may want to consider an ARM due to:

3. To be eligible for delivery to the GSEs, ARMs must be tied to what index?

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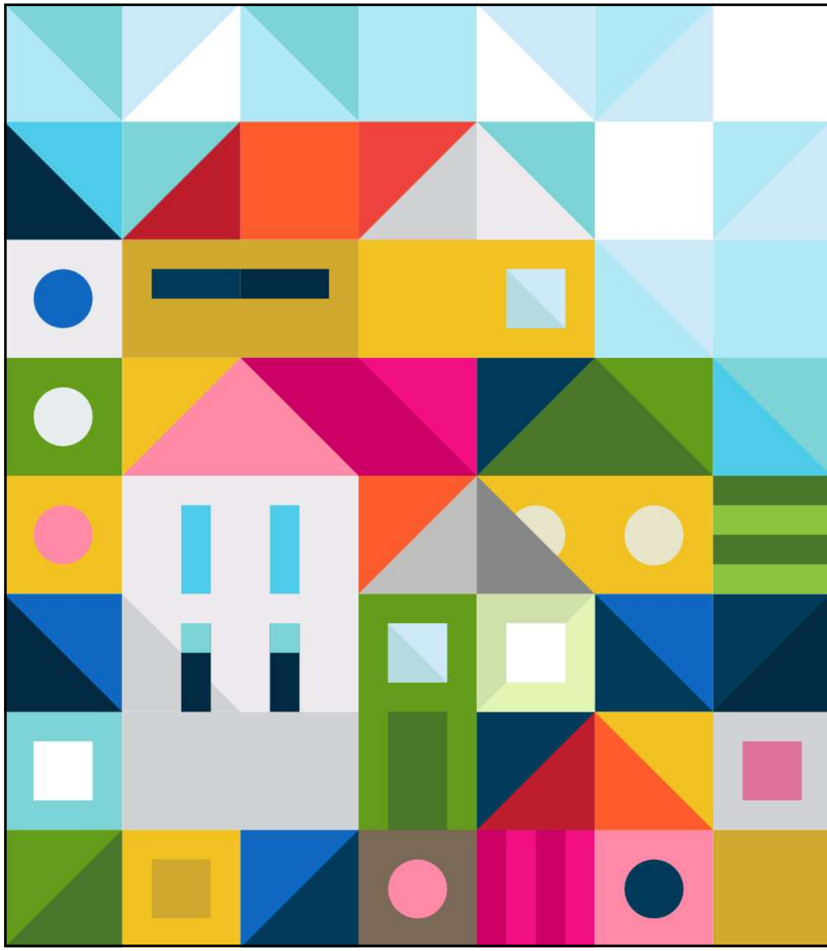

Getting Comfortable with ARMs

RECAP

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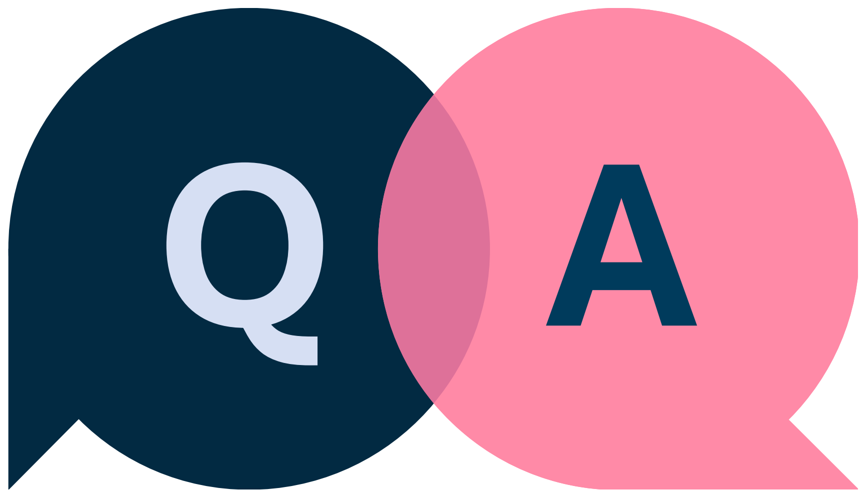

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