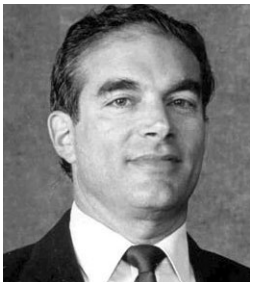

FOCUS ON THE ECONOMY

Is Greenspan Wrong?

BY DR. MARK LEE LEVINE, CRE AND DR. LIBBI ROSE LEVINE SEGEV

IS GREENSPAN WRONG?

IT DOES SEEM WORTHWHILE TO ASK THIS QUESTION OF THE Federal Reserve Board Chairman, Alan Greenspan, based on his recent testimony before Congress as to mortgages. (He has also appeared before a number of professional groups, discussing the issue of the "right" type of mortgage that one should hold.)

The article by Ruth Simon and Rachel Emma Silberman, "Is Greenspan Right About Your Mortgage?" *Wall Street Journal* (Wednesday, February 25, 2004), raised the issue of the propriety or reasonableness of Mr. Greenspan's speech to credit unions. Mr. Greenspan mentioned that "Many homeowners might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages."

Historically, "corrective vision," in hindsight is 20-20! Notwithstanding that interest rates have fallen during the last several years and have stabilized at a low level, the lowest interest rates in 45 years, it is nevertheless clear that interest rates are rising. The issue is: When will interest rates rise? How much will they rise?

Mr. Greenspan said in essence that if one had chosen to undertake an adjustable-rate mortgage (ARM), the initial rate and continuing rate over the last few years would have been less than a fixed-rate mortgage. Clearly homeowners who financed or refinanced with an adjustable-rate mortgage, with rare exception, would have paid less interest over the past several years than one who had a fixed-rate mortgage.

Lenders often "fix" the interest rate on an ARM over a given period of time, such as 6 months, allowing for the potential of increased interest rates over the entire term of the loan.

As stated in numerous pieces of research, the fixed interest rate of a 30-year loan is higher than the adjustable-interest rate. The article by Sue Kirchoff and Barbara Hagenbaugh, *USA Today* (Tuesday, February 24, 2004) noted the Mortgage Bankers Association (MBA) position that the average rate for a 30-year fixed mortgage was about 5.5%, as opposed to about 3.25% for a variable-rate mortgage (adjustable-rate mortgage). Over this time frame, Mr. Greenspan's comments are obviously correct: One could have saved approximately 2.25% simply by having an adjustable-rate mortgage at approximately 3.25%, as opposed to 5.5% with a fixed-rate mortgage.

One can win or lose by "gambling" in various ways, such as buying lottery tickets, picking correct stocks or other investments. Many argue that obtaining a mortgage determined by adjustable interest rates is not "gambling." However, unless one is clearly prophetic, it is difficult to determine exactly what interest rates will be over a given term. The penalty for being wrong on the adjustable-rate mortgage is obvious: Variable interest rates (adjustable interest rates) eventually could rise above fixed interest rates.

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Further, interest rate increases often result in greater difficulty for the homeowner to service a loan.

As a simple example, if a homeowner experiences a 2% increase on an adjustable-rate mortgage of $300,000, obviously this is $6,000 more annual interest on the $300,000; and, the monthly interest would increase by $500 per month. This is a substantial monthly increase and would be difficult for many homeowners to pay.

Likewise, if one assumes that the mortgage is $150,000, a 2% adjustable-rate increase is $3,000 per year in additional interest; this is $250 per month more to pay, which could strain the budget of many homeowners.

Additionally, with such an increase in rates, new homeowners would have to qualify for the new home mortgage. Risk factors must also be considered, such as a potential job loss or a reduction in salary. In such event, homeowners may struggle all the more to keep mortgage payments current.

BACKGROUND ON CONTRASTING LOANS

A review of even basic real estate textbooks indicates over a dozen types of loans in the marketplace for home buyers. (One of the leading textbooks in this field was written by Fillmore Galaty, Wellington Allaway and Robert Kyle, *Modern Real Estate Practice*, 16th Edition, published by Dearborn Real Estate Education (2004). Such loans are reflected in this work.)

1. BASIC AMORTIZING LOAN (BAL): The Basic Amortizing Loan (BAL) has a fixed interest rate and the same amount of monthly payments are used to amortize a loan over a certain period of time (term) to pay off the entire loan. As an example, a $200,000 BAL would result in the full loan being paid off over 30 years, at 6% fixed interest, by paying the same amount of amortized payments of approximately $1,200 each month of principal and interest.

   Although it is not the focus of this short note, other required costs must also be considered by the homeowner. Whether the loan is structured on a fixed interest rate, or adjustable-interest rate, these cash-flow items must be paid and can be added to the actual monthly mortgage payment. These additional costs often include taxes and insurance, among other items.

2. ADJUSTABLE-RATE MORTGAGE (ARM): As an example, a $200,000 ARM loan would be paid in full in 30 years, at 4.25% adjustable-rate interest, by paying monthly payments of $1,013 each month of principal and interest. The savings of approximately $200 per month is very attractive with an ARM.

   However, when the market changes—which it eventually will change—and interest rates increase so that the interest rate for the $200,000 mortgage becomes a 7.5% adjustable interest rate, then the monthly payment increases to almost $1,400 per month (which is approximately $200 more per month over the 30-year fixed interest rate of 6%, as noted in the prior example).

3. FLUCTUATING MARKETPLACE: The above three simple examples illustrate the concern with volatility in the marketplace and fluctuating interest rates which can substantially impact monthly payments that a homeowner would face—especially with an Adjustable-Rate Mortgage (ARM), which payments may eventually be significantly higher than the originally contracted monthly payment.

   It is important in many instances for the homeowner to have a "stable" payment amount in the monthly payments over the term of the loan.

   Focusing specifically on the current "savings" using an "Adjustable-Rate Mortgage" (ARM) may distort the long-term view for some homeowners who do not have the financial sophistication to understand which type of loan is best and when to make important decisions to change the ARM loan to a "fixed" interest rate.

4. MODIFIED ADJUSTABLE RATE MORTGAGE (MARM): It is true that one might obtain a "Modified Adjustable-Rate Mortgage" (MARM) where the interest rate is actually fixed for a certain period of time, and the amount of adjustments each year may be limited. This type of loan will often limit the lender from increasing the loan rate by more than usually 1% during a 12-month period.

5. LENDERS: The lender must calculate into the cost of the mortgage the interest rate over a longer period of time, and the risk factors to the lender, as opposed to the borrower (homeowner).

ADVANTAGES TO USING THE "ADJUSTABLE-RATE MORTGAGE" (ARM) IN THE FIRST PLACE?

The main advantage to using the "Adjustable-Rate Mortgage" (ARM) is that the ARM has an initial lower interest rate, when compared with "fixed" interest rate loans.

Another major advantage in using the ARM is that interest rates may decrease during a certain time period, if rates are falling; therefore, monthly payments can also decrease.

DISADVANTAGES TO USING THE "ADJUSTABLE-RATE MORTGAGE" (ARM)

Since interest rates have recently been the lowest in the past 45 years, it seems incredible that one would assume that interest rates for the Adjustable Rate Mortgage (ARM) would continue to be low, or move much lower than the current rates.

Ultimately, the ARM interest rate will increase over a longer-term loan. In such event, the lender is normally able to increase the interest rate, based on the terms of the contract.

There is substantial risk to the homeowner/borrower insofar as the borrower may not be able to make the payments on the new, increased monthly payments when interest rates increase!

The uncertainty that interest rates may increase can create a discomfort level for many borrowers.

If a homeowner anticipates living in the property for only a short period of time, then the risk factor is very low that interest rates could significantly increase during the short term of the "Adjustable-Rate Mortgage" (ARM), such as over a period of 3 years to 5 years. As an example, the contractual agreement with the lender may restrict the ability of the lender to increase the interest rate by only 1% per year up to 3 years or 5 years, at which time the borrower (homeowner) must refinance or pay off the mortgage.

However, the counter to this argument is that perhaps one should not even purchase a home in the first place, given acquisition costs, closing costs and related costs, if one is only to be in a home for a short period of time. (Financial consultants argue that one should generally not acquire a home if the owner will not keep the home for a minimum of between 2 to 5 years, to recoup costs. Too short a term of ownership would probably defeat the financial rewards and desire to acquire the home.)

Therefore, the argument of using the ARM to "save" when one anticipates keeping the home for only a "short time" is not particularly financially sound advice in most settings.

It is entirely unlikely that interest rates will significantly decrease much lower, especially from the time of Mr. Greenspan's recent comments, as noted.

Homeowners and investors with a current "Adjustable-Rate Mortgage" (ARM) may consider refinancing to "fix" interest rate at this time. An "Adjustable-Rate Mortgage" (ARM) contract with the lender may have a "prepayment penalty," if the homeowner/investor breaks the mortgage contract early. The cost of paying an additional "prepayment penalty" should be weighed as to when the homeowner/investor should refinance over the time the homeowner/investor keeps the home.

CONCLUSION

One can argue that the proof of the "savings," as Mr. Greenspan has indicated, can be reflected by looking to only recent years in comparing the lower "Adjustable-Rate Mortgage" (ARM) interest rate to that of a "fixed-rate mortgage."

The article by John D. McKinnon, and James R. Hagerty, *Wall Street Journal*, Page 1 (February 25, 2004) noted that Federal Reserve Chairman Alan Greenspan concluded that mortgage giants FANNIE MAE and FREDDIE MAC involved "... very serious risks relative to our financial structure." Mr. Greenspan also suggested that Congress should certainly pull in or curb the amount of activity by these two giant mortgage entities that acquire loans within the marketplace. Mr. Greenspan's concern was that these two entities borrow a great deal of money to finance the acquisition of the mortgages that they acquire from lenders.

One quote by Mr. Greenspan indicated this concern: "The Federal Reserve is concerned about the growth and scale ..." "of the mortgage entities in question." The article went on to note that Mr. Greenspan feels the outstanding debt involved with these two entities is so great that if they falter, there will be a huge burden on the Federal government. And, the Federal government cannot afford to allow these two entities to be in a default position. Do these comments mean , as seen by Mr. Greenspan, that rates are about to move up?

Many ingredients impact current interest rates, such as concerns with the changing marketplace, increased deficit spending by the Federal government, strains on the economy as a result of war, loss of jobs, increasing unemployment, etc. If these factors turn negative, such as defaults by a major institution, and interest rates increase because of tightening of the money supply, or for other reasons, those holding an "Adjustable-Rate Mortgage" (ARM) are exposed. Homeowners/borrowers should consider "fixing" their interest rates. It might be worthwhile to consider terminating the "gamble" of these adjustable interest rates and to "fix" interest rates at this time to avoid what might be a substantial increase in future ARM monthly payments.

The likelihood of the ARM producing a much stronger benefit to the homeowner/borrower today is fairly limited. Prognostications by most economists, including Mr. Greenspan, are that interest rates are on the increase. The real questions are: When will interest rates increase? By how much will interest rates increase?

There is very little justification that in the near term interest rates will significantly decrease.

Therefore, the factors of knowing that interest rates will rise, coupled with the uncertainty of when interest rates will rise, should convince most borrowers for home loans to refinance to lower "fixed" interest rates now available. This issue also applies to commercial property.

As Chairman of the Federal Reserve Board, Mr. Greenspan is recognized as being the key to U.S.A. monetary policies and positions. However, notwithstanding Mr. Greenspan's position and his comments, homeowners/borrowers should not focus, today, on past "savings" from using the ARM and project comparable future "savings" using the "Adjustable-Rate Mortgage" (ARM). Interest rates will not likely fall much lower.

Past performance is no guarantee of future performance! ■