



# ***ISSUE PAPER***

## ***Subject: FHA Single Family Hybrid Adjustable Rate Mortgages (ARM)***

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**Issue:** The Federal Housing Administration (FHA) hybrid ARM program has not kept pace with conventional ARM products.

**Background:** Hybrid ARMs are mortgages that have a fixed interest rate for an initial period of time, after which the rate adjusts annually based on a certain spread over an agreed upon index rate. Typically, hybrid ARMs have a three, five, seven, or ten year fixed period, with the interest rate adjusting annually thereafter. These are commonly referred to as 3/1, 5/1, 7/1 and 10/1 hybrid ARMs. Due to the fact that a hybrid ARM converts to an adjustable rate mortgage after the initial fixed interest rate period, lenders can offer these loans with an initial interest rate that is lower than the interest rate for a 30-year fixed rate mortgage. The lower rates available with hybrid ARMs enable more families to qualify for home loans. Although these products have been available in the conventional market for several years, FHA has only recently implemented regulations offering insurance on hybrid ARMs.

The original authorizing legislation, passed in November 2001, capped the initial and annual interest rate adjustment for 3/1 and 5/1 ARMs at 1%, with a lifetime cap of 5%. The 7/1 and 10/1 hybrid ARMs have an initial and annual rate adjustment cap of 2% with a lifetime cap of 6%.

At MBA's urging, a technical fix to the authorizing language was made with the signing of Public Law 108-186 on December 16, 2003. This law provides an initial rate adjustment cap of 2% and a lifetime cap of 6% for any loans with an initial fixed rate period longer than 3 years, thereby making the 5/1 hybrid ARM product viable.

On March 10, 2004 FHA published the final rule for the hybrid ARM product. The final rule was followed by Mortgagee Letter 2004-10 giving additional detail on the program. FHA was unable to incorporate the technical fix authorized by Public Law 108-186 into the final rule.

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On June 1, 2004 MBA sent a letter to FHA urging the technical fix to the 5/1 hybrid ARM be implemented as soon as possible. On January 7, 2005, MBA sent a letter to the Office of Management and Budget (OMB) urging that the amendments to the 5/1 cap structure be implemented as an interim final rule, which allows the rule to take effect while at the same time soliciting comments. A full rulemaking process would have required comments to be received and reviewed prior to implementation, creating a delay of 8 months or more.

On March 29, 2005 the FHA published an Interim Final Rule raising the initial and annual interest rate adjustment cap to 2% for hybrid ARMs with an initial fixed period 5 years. This rule was followed by Mortgagee Letter 2005-14 which gave additional details.

On June 19, 2006, FHA issued a proposed rule for comment that would add the London Interbank Offered Rate (LIBOR) as an acceptable index in addition to the currently acceptable Treasury securities adjusted to a constant maturity of one year ("1-year CMT").

**MBA Position:** MBA believes the hybrid ARM program will be a great benefit to FHA borrowers, allowing them access to the lower rates offered by these products that are already available to conventional borrowers.

Originations of 5/1, 7/1, and 10/1 hybrid ARMs have been low to date, mostly due to the current flat yield curve in the market. MBA believes, though, that the new cap structure will make these products more viable in the market and that FHA should experience an increase in demand.

MBA supports adding the LIBOR option as an additional index for adjusting the interest rates for ARMs as it would be an incentive for more lenders to use the FHA program.

**Status:** The new interest caps on the 5/1 hybrid ARM product took effect on April 28, 2005. In response to the request for comments on the addition of LIBOR as an acceptable index, MBA sent a letter to HUD on July 28, 2006, in support of adding the LIBOR option for adjusting the interest rates for ARMs.

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