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# *Understanding* VA Hybrid ARM Loans

NMLS #1109426

# Decide if a Hybrid ARM is right for you...

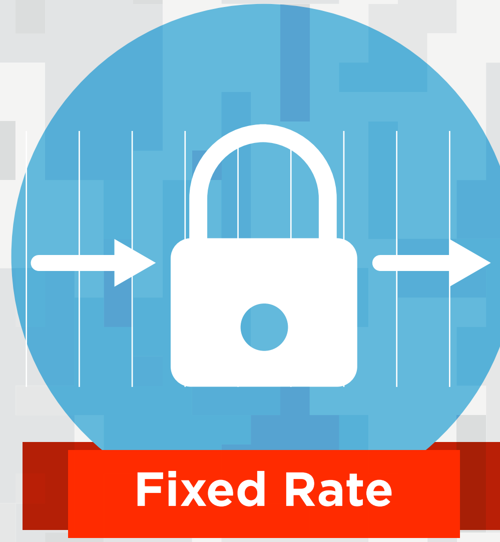
This guide is a start-to-finish explanation of the VA Hybrid ARM program. We'll begin by discussing what a VA Hybrid ARM is both in practice and on paper. Afterwards, we'll cover the specific benefits of a hybrid ARM, as well as some of the things to be aware of when deciding whether to choose a hybrid ARM. Finally, we'll cover a more technical nuts-and-bolts explanation of how a hybrid ARM works and how it compares to other types of mortgages. By the end of this guide, you should not only know everything you ever wanted to know about a hybrid ARM, but you should be prepared to decide whether a hybrid ARM is most appropriate for your situation.

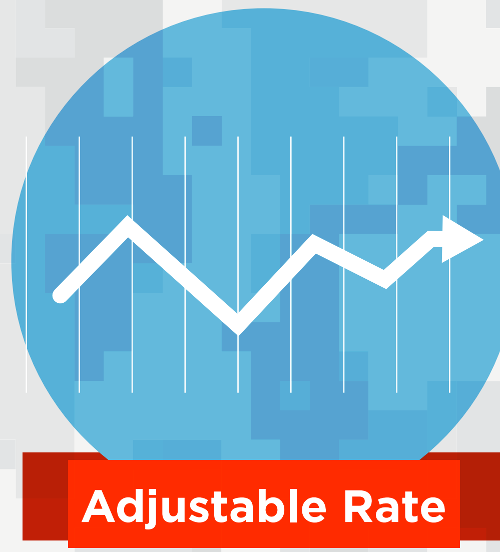
# Definitions and Context

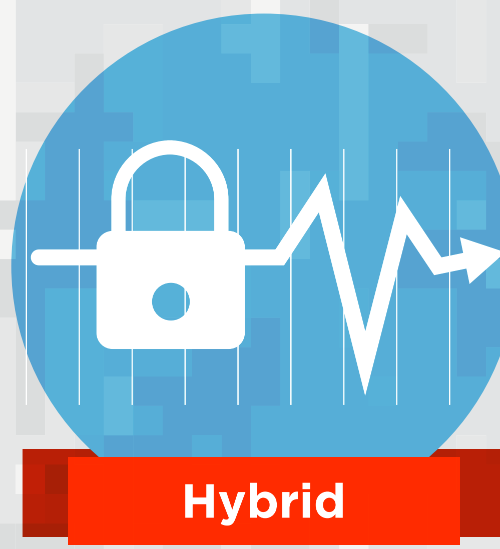
In order to understand the great benefits of a VA hybrid ARM, you need to know what the name is referring to in context. “Hybrid ARM” is a classification of the type of interest rate on a mortgage. **There are three main classifications of interest rates available on VA loans. They are as follows: fixed-rate mortgages, adjustable-rate mortgages (ARM), and hybrid adjustable-rate mortgages.** The different classifications generally mean exactly what they sound like they mean. A fixed-rate mortgage is where the interest rate is established at the time of application approval and locked in (fixed) for the entire term of the mortgage. While fixed-rate mortgages can sound good to those who aren’t fond of taking risks, let’s take a look at what an adjustable-rate mortgage and a hybrid ARM are like.

A normal adjustable-rate mortgage (ARM) is basically the opposite of a fixed-rate mortgage; the interest rate fluctuates throughout the life of the loan. ARM interest rates adjust annually to become closer to whatever the market interest rate is at that time. This fluctuation generally allows lenders to offer lower interest rates than on fixed-rate mortgages, because the lender knows if interest rates go up, the ARM rate will go up as well. **A hybrid ARM loan is a loan that combines aspects of both fixed-rate mortgages and ARMs. In a hybrid, your interest rate is fixed for the first 3-5 years (depending on what option you choose), after which it can be adjusted annually.** On a VA hybrid ARM loan, the rate cannot adjust more than 1% above or below the previous rate. Hybrid ARM loans also have a lifetime rate cap of 5% from the original rate. This means that if the original interest rate was 3.5% (2.25% from the Index, and a 1.25% margin), the rate could never rise higher than 8.5% throughout the duration of the mortgage. To many young people, 8.5% seems like an insanely high interest rate, but that actually wasn’t too bad of an interest rate in the ‘70s, and having a 5% cap is great insurance for the next 30 years.

In the above example, the terms “index” and “margin” were mentioned. **The index and margin are the two basic components of an interest rate.** The “index” is the weekly average yield on U.S. Treasury Securities adjusted to a constant maturity of one year. To put it more simply, this is how much interest those holding Treasury Securities are earning. While explaining the price and yield of U.S. Treasury Securities could be it’s own book, all you need to know is that this index fluctuates constantly, and affects the interest rate you’ll be offered on your mortgage. The margin is generally determined by the lender, but for VA ARMs, and consequently VA Hybrid ARMs, the margin is established by the VA at either 2.00% or 2.25%, which makes VA Hybrid ARMs much more attractive than conventional or FHA ARMs.



# So Why Choose a VA Hybrid ARM?

The first and most obvious reason is because **you can get offered a lower starting interest rate than on a fixed-rate mortgage.** Why do lenders offer better interest rates on Hybrid ARMs than on fixed-rate mortgages? It's quite simple: a lender has no way of knowing what interest rates are going to do in the future. When a lender offers a fixed-rate as opposed to an adjustable-rate, they are risking losing a lot of money if interest rates rise later on because the borrower will be locked-in at the lower interest rate. On the other hand, if interest rates get lower, the borrower will likely refinance their loan to take advantage of the lower interest rate anyway. Therefore, to a lender, the risk of a dropping interest rate is no greater on an ARM or Hybrid ARM than it is on a fixed-rate, but the ability to take advantage of rising interest rates is much greater with an ARM or Hybrid ARM. It is because of this advantage to the lender that they are willing to make it advantageous to the borrower by offering a lower interest rate.

A Hybrid ARM finds a fantastic middle-ground between fixed-rate and adjustable-rate mortgages. Fixed-rate mortgages can be frustrating if interest rates fall after you've gotten your loan, and adjustable-rate mortgages can be risky if interest rates rise significantly over the life of the loan. In a Hybrid ARM, you and the lender both get the potential benefit of having your interest rate adjust with time, but you also have two assurances to mitigate your risk: your rate is only adjustable after the first 3 years or the first 5 years, and it can adjust by no more than 1% per year. This offers an amazing amount of benefits to you as the borrower.

*Consider the following example:*

You purchase a home using a 5-year Hybrid ARM, which means that your interest rate will be fixed for the first 5 years of the mortgage, after which it will adjust annually no more than 1% in either direction and a lifetime cap of 5%. No matter whether interest rates got lower or higher during the first 5 years, you're in a great position. If interest rates got lower, your interest rate will automatically begin adjusting accordingly, without you having to go through the time, trouble, and a fair amount of money to get a refinance. If interest rates got higher, your loan may still take years to catch up to the current rate, and if the rise was dramatic enough (more than an additional 5%), your loan may always stay lower than what you could get if you refinanced. In other words, **no matter what your plans for the home you are buying are, getting a VA Hybrid ARM instead of a fixed-rate or a regular ARM can save you money.**

# Best-Use Cases

Being quite honest, VA Hybrid ARMs are advantageous in almost every situation, but there are some situations that get even more benefit out of the Hybrid ARM than others. For example, if you are not intending to live in your home longer than 5 years, you get an enormous amount of value in a Hybrid ARM because you get a lower interest rate than you could in a fixed-rate mortgage, and you never have to worry about it adjusting because you'll be selling before it does. Hybrid ARMs also offer a more significant benefit if you expect to be able to make more than the minimum payment for the first few years of the loan term, but not necessarily after (e.g. your children will be college-age in about 5 years and at that time you will likely need to divert more money to helping them through college). Since the rate stays fixed and relatively low for the first 5 years, you can knock the principal down each month ahead of the amortization schedule, so even if the rate gets higher after the initial term, your monthly payment doesn't get as much higher, if it increases at all.

Lastly, if you are expecting to live in your home until it is completely paid off, a VA Hybrid ARM can save you tens of thousands of dollars over the life of the loan. How?

Consider the following example:

You buy a house intending to grow old in it. By choosing a Hybrid ARM, you get the benefits of a refinance (a lower interest rate if rates have gone down) without the cost (thousands of dollars in closing costs). Unless you're looking to get cash-out to consolidate debt, there is no need to refinance a Hybrid ARM, because it adjusts annually towards the current interest rate. In addition to the thousands of dollars saved due to not needing to refinance, you are also enjoying a lower interest rate than you could have gotten with a fixed-rate mortgage (especially during the initial 3 or 5-year term, where you pay more interest per month than any other time during the loan), which can save you thousands of dollars more over the life of the loan. How much money can you save? Let's say you buy a $200,000 home at an interest rate of 4.0%. How much money do you save compared to a $200,000 home at 4.5%? Roughly $20,000 of interest over 30 years. Imagine how much money a difference of an entire percent or more could save you.

# Potential Disadvantages of a VA Hybrid ARM

As one of the biggest advantages of a VA Hybrid ARM is the lower interest rate you can get compared to a fixed-rate, sometimes when interest rates are already very low, there may not be a significant difference between the rates for a Hybrid ARM and a fixed-rate. Also, during times when interest rates are already very low, they are not likely to get even lower throughout the life of the loan; therefore, not only are you not getting that much better of an interest rate than you would on a fixed-rate, but you're also very likely to see an increase in your interest rate after the initial term, where a fixed-rate would remain the same. Even in these cases, a Hybrid ARM can still be better than a fixed-rate, but it becomes a numbers game - is the Hybrid ARM interest rate enough lower to compensate for an inevitable increase later and/or the cost of refinancing the loan? Sitting down with your lender and crunching the numbers can be a very good idea when trying to decide which type of loan you want to use.

# In-Depth Point-by-Point on the VA Hybrid ARM

The first thing to know is where a Hybrid ARM sits in relation to fixed-rate mortgages and normal ARMs. Hybrid ARMs sit somewhere in between the other two; a fixed-rate mortgage carries a fixed interest rate that does not change throughout the term of the loan, while an adjustable-rate mortgage (ARM) fluctuates (usually annually) as interest rates change over time. A VA Hybrid ARM is the happy marriage of both types. When you are looking at a VA Hybrid ARM, you'll have two choices: either a 3-year Hybrid ARM or a 5-year Hybrid ARM. The number of years indicated is the amount of time that the interest rate will remain fixed. This is often referred to as the "initial period" or "initial fixed period" of the loan.

Choosing between a 3-year and a 5-year Hybrid ARM is something best worked out with your lender. Considerations include (but are certainly not limited to) projections for interest rate fluctuation over the next 3-6 years, your plans for the home (are you 'flipping' the home or are you going to raise your children in it), and your career and finances (do you expect to be making more money 3 years from now? 5 years?)

Once you've chosen either a 3-year or a 5-year Hybrid ARM, you can compare the interest rate you're being offered for the Hybrid ARM with what's available for a fixed-rate mortgage, and determine if the interest rate is enough better to make up for the risk of a higher interest rate in years to come. Chances are you're not too savvy when it comes to investing and how the bond market relates to the housing market, and very few people are savvy enough to be able to predict what the market is going to do in the next few years, let alone what it will do over the course of the next 30 years. For this reason, it's best to do as much research as possible and to exhaust your lender with the thoroughness of your questioning.

# Conclusion and Summary

VA hybrid ARMs are one of the best-kept secrets of the VA loan program. The VA has instituted several safeguards to mitigate the risks associated with conventional hybrid ARMs, while retaining their value to both the lender and, more importantly, to the borrower. Consult with a VA-approved lender today to find out how you can benefit from a VA hybrid ARM.