Doron F. Eghbali Residential Real Estate

Should You Refinance Your Adjustable Rate Mortgage In a Stabilizing Market?

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Millions of mortgage borrowers experienced intolerable hardship because of having adjustable rate mortgages. Now, again the specter of similar tragedy is somewhat looming. Given the Federal Reserve out of the mortgage market and a relatively stabilizing real estate market, the chances are rates eventually increase. The question is whether homeowners should refinance their adjustable rates to relatively higher fixed rates.

SOME BACKGROUND

1. Direct Correlation Between Federal Funds Rate and Adjustable Rate Mortgages

Adjustable rate mortgages are tied to short-term interest rates and rise when the Federal Reserve increase federal funds rate. Federal funds rate is the rate banks charge each other for overnight loans. The Federal Reserve decreases or increases federal funds to keep in check the amount of money being lent thus curbing inflation or stimulating economic activity. The financial markets are betting the Federal Reserve will raise Federal Funds Rate by the end of this year. However, How much those rates will increase is uncertain.

2. Withdrawal of Federal Reserve from Purchase of Mortgage-Backed Securities

In addition, the Federal Reserve during the recent financial crisis was very concerned about the health of real estate market. As such, it undertook to purchase mortgage backed securities from Fannie Mae and Freddie Mac. The mortgage backed securities contain huge bunches of home mortgages. Since Fannie Mae and Freddie Mac guarantee most home loans in the US and the decreasing value of homes were threatening the value of the mortgage backed securities with decreasing, defaulting or foreclosing home mortgages, the Federal Reserve bought some of these mortgage backed securities to increase demand and thus lowering the interest rates. The Federal Reserve ended this program. Now, despite assurances from the Federal Reserve, many economists fear such move would increase mortgage rates since demand decreases.

ADJUSTABLE RATE MORTGAGES REFINANCING

In analyzing whether you should refinance to fixed rate mortgage, probably, the most important barometers are:

- **How Long You Intend to Live in Your House; And**
- **How Much Interest Rates Will Rise.**

Analysis

The reality is that if the Federal Reserve raises rates by two percentage points, it would bring adjustable rate mortgages into parity with fixed rates. However, while boosting federal funds rate increases short-term interest rates, such boost would also raise fixed rates. As such, the question is whether you want to pay more now and guaranty your rate for years to come or want to take the risk that the rates will not rise sharply to cause seriously paralyzing financial pain. Hence, it becomes imperative to prudently deliberate over the duration of your stay at your current home and decide whether refinancing to fixed rate is prudent for your long-term financial health.

DORON EGHBALI *is a Partner at the Beverly Hills Offices of Law Advocate Group, LLP. He Primarily Practices Business, Real Estate and Entertainment Law. He Can Be Reached at: 310-651-3065. For More Information, Please, Visit: www.LawAdvocateGroup.com*