COFI-indexed ARMs And Their Advantages

The 11th District Cost Of Funds is one of the most commonly used ARM indexes, because many lenders believe that an index that moves with their cost of funds reduces their risk. ARMs based on this index can adjust every month, every six months, or every year. Many COFI-indexed ARMs often have payment caps, but no periodic interest rate caps creating the possibility for negative amortization (your loan balance can increase). However, it's not necessarily a bad thing because you may consider any unpaid (deferred) interest to be an extended loan at a very attractive rate. You can use your monthly savings (the difference between the fully indexed payment and the minimum monthly payment) for investments, or you can use them to pay off credit card and/or car debt. This makes the negatively amortizing COFI ARMs a great financial tool for homeowners (especially for people with unsteady income, such as self-employed or commissioned salespeople). In addition, you will always have the option to never increase your loan balance (by making the fully indexed payments instead of the minimum monthly payments).Advantages of COFI ARMs:

Flexibility in the monthly payment. It is one of the main advantages of COFI ARMs. With COFI-indexed ARMs you will usually have a choice of payment options. Besides fully indexed and minimum payment options your COFI ARM will probably have an interest only payment option and you will be able to change payment options every month if you like.
Tax Planning. COFI ARMs may be used for tax planning. The borrower can defer interest payments and at the end of the year, analyze their tax situation. If it serves their tax interests, they can make a lump sum payment toward any interest that has been deferred and deduct it for tax purposes.
Easy qualifying. Many COFI lenders allow homebuyers with good credit to apply without documenting their income, assets, or source of down payment. This is helpful for self-employed borrowers or those who have jobs where it is difficult to document their income.
Low initial rate. Most COFI ARMs are offered with a very low initial rate. Some lenders will allow you to qualify for a larger loan due to this initially lower rate.
Summary
COFI ARM products provide more opportunities for financially savvy borrowers who seek more customized, and ultimately less costly, home-finance choices. However, because some of the COFI products do not offer rate caps or other key features to protect the borrower, you need to be particularly careful to study the product before you make your choice.

The negatively amortizing loan

These types of ARMs offer payment caps rather than interst rate caps, which limit the amount the monthly payment can increase. If a loan has payment cap but has no periodic interest rate cap, then the loan may become negatively amortized: if the interest rates rise to the point that the monthly mortgage payment does not cover the interest due, any unpaid interest will get added to the loan balance, so the loan balance increases. However, you always have the option to pay the minimum monthly payment, or the fully amortized amount due.

Example:

Your loan has a payment cap of 7.5%. If your payment is $1,000 per month and interest rates rise, your new payment would normally be $1200/mo (for example). But your capped payment is only $1075. The other $125 get added to your loan balance, to be paid off over time, unless of course you decide to pay that additional amount now.

The advantage of negatively amortizing loans is that you can control cash flow (relatively stable payment), take advantage of low interest rates relative to the market at any given time, and pay back the money borrowed today at a depreciated value years from now (because of natural inflation). This makes such loans a great tool for homeowners as long as you understand the mechanics of what's going on.
With most ARMs, the interest rate can adjust every six months, once a year, every three years, or every five years. The interest rate on negatively amortized loans can adjust monthly. A loan with an adjustment period of 6 months is

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COFI ARMs

COFI ARM (Cost of Funds Index Adjustable Rate Mortgage) - the rate is normally fixed for a 3 month period (this initial rate is sometimes referred to as the teaser or start rate) after which your rate is based on the 11th district cost of funds index (COFI) which is added to a pre-determined margin (typically ranging between 2.25-3.00%) to arrive at the new monthly rate. This loan may also have periodic payment caps and therefore the potential for negative amortization. Ask what the margin, life cap and periodic caps of your ARM will be.

The cost of funds index (COFI) is not an interest rate. It reflects the average interest paid by savings institutions for their various sources of funds over a specified period of time. Deposits in checking and savings accounts — including certificates of deposit, money market deposit accounts, transaction accounts, and passbook accounts — are the primary source of funds for most savings institutions. Other sources of funds include loans obtained through the credit programs of the Federal Home Loan Bank of San Francisco (known as "advances") and money borrowed from other financial institutions.

In general, the COFI does not move up or down as rapidly as market interest rates (such as the prime rate, the discount rate, or Treasury bill rates) because many savings institutions rely on fixed rate deposits of medium- and long-term maturities as a primary source of funds. Since rates on these deposits are not affected by changing market interest rates until the deposit matures, the total interest expense paid by savings institutions in a particular month reflects, to a significant degree, interest rates that were prevalent in previous months or years.

COFI History - (11th District Cost of Funds Index)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2002	2.823	2.744	2.653									
2001	5.514	5.426	5.198	4.946	4.745	4.498	4.274	4.106	3.974	3.628	3.368	3.074
2000	4.901	4.967	5.002	5.078	5.196	5.357	5.456	5.509	5.548	5.589	5.607	5.617
1999	4.608	4.562	4.519	4.490	4.480	4.504	4.500	4.562	4.608	4.666	4.773	4.852
1998	4.987	4.968	4.917	4.903	4.881	4.881	4.911	4.899	4.882	4.762	4.691	4.655
1997	4.821	4.759	4.780	4.822	4.864	4.853	4.887	4.904	4.941	4.957	4.949	4.963
1996	5.033	4.975	4.874	4.841	4.823	4.809	4.819	4.839	4.834	4.839	4.835	4.842
1995	4.747	4.925	5.007	5.064	5.141	5.179	5.144	5.133	5.111	5.116	5.119	5.059
1994	3.710	3.687	3.629	3.672	3.726	3.804	3.860	3.945	4.039	4.187	4.367	4.589
1993	4.360	4.333	4.245	4.171	4.103	4.050	3.998	3.958	3.881	3.823	3.822	3.879
1992	6.002	5.800	5.611	5.427	5.290	5.258	5.069	4.874	4.805	4.597	4.508	4.432
1991	7.858	7.848	7.654	7.501	7.329	7.155	6.998	6.845	6.714	6.566	6.414	6.245
1990	8.369	8.403	8.258	8.211	8.171	8.086	8.109	8.075	8.091	8.050	8.044	7.963
1989	8.125	8.346	8.423	8.648	8.797	8.923	8.844	8.763	8.807	8.643	8.595	8.476
1988	7.615	7.647	7.509	7.519	7.497	7.618	7.593	7.659	7.847	7.828	7.914	8.022
1987	7.396	7.448	7.314	7.245	7.223	7.274	7.275	7.277	7.394	7.444	7.562	7.645
1986	8.770	8.964	8.744	8.587	8.441	8.374	8.196	8.018	7.901	7.717	7.602	7.509
1985	10.217	10.160	9.976	9.872	9.704	9.565	9.365	9.273	9.129	9.027	9.036	8.867

The Cost of Funds Index is considered by many to be the least volatile index. Therefore the COFI ARM is often preferred by savvy borrowers.

called a 6-month ARM, with an adjustment period of 1 year is called a 1-year ARM, and so on.
Most ARMs offer an initial lower interest rate than the fully indexed rate (index plus margin) during the initial period of the loan, which could be one month or a year or more. It is also known as teaser rate.
All ARMs are available with 30-year terms and some with 15-year terms.
Adjustable rate mortgages generally have a lower initial interest rate than fixed rate loans.

A **periodic or adjustment cap** limits how much your interest rate can rise at one time. Generally, a 6 month ARM will have a cap of 1% while a 1 year ARM will have a 2% cap. Periodic and lifetime caps are quoted as two numbers as in 2/6 which would mean that periodic cap is 2% and the lifetime cap is 6%. Examples:

1. The initial interest rate is 4.5%, the index is 7%, and the margin is 3%,
then the new interest rate = 7% + 3% = 10%.
If the lifetime cap is 5% then
the actual new interest rate will be 4.5% + 5% = 9.5%.

2. The initial interest rate is 6%, the index is 5%, and the margin is 3%,
then the new interest rate = 5% + 3% = 8%.
If the periodic cap is 1% then
the actual new interest rate will be 6% + 1% = 7%.