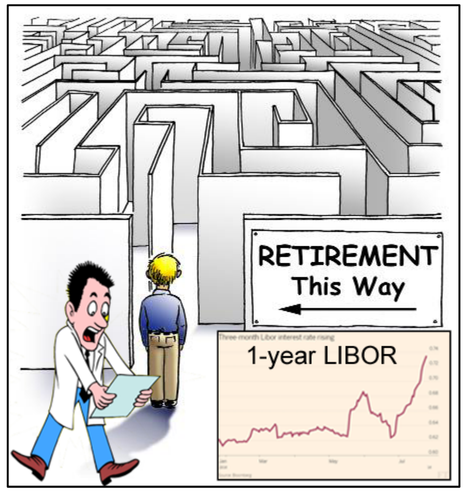
Interest rates: Prepare for ARMageddon

"Home is where the Wi-Fi connects automatically."
– Anonymous

Navigating the Retirement Maze



While you were happily signing your "zero percent loan" papers to buy that new car, or lamenting the pathetically small monthly payments from your bank certificates of deposit, it may have occurred to you that interest rates can't remain at this absurdly low level forever. In fact, you might have noticed that rates are slowly but surely beginning to move higher. No less an authority than Jeff Gundlach, the reigning "bond guru," has stated that we reached a rate bottom this past summer, and that the only direction for rates from here is up.

In my article last month, I said that I expect rates to rise slowly due to the bind in which the Federal Reserve has placed itself, where even the merest mention of "rate increase" by any of its members results in a stock market decline. Near-zero rates have been a disaster for retirees, insurance companies, and pension funds, all of which depend upon bond income to pay their financial obligations. So a rise in interest rates, no matter how small and gradual, will be welcomed by many.

However, there is one rate that has already risen considerably in the past year, affecting consumers who have floating rate debt. This includes adjustable rate mortgages (ARMs), student loans, and other consumer debt. This increase, as well as its cause, have mostly been out of the general news, but many consumers will experience it soon enough. I will briefly describe this situation, what caused it, and what you can do about it.

LIBORing but important

The most important short-term interest rates in the financial world are known as LIBOR, short for the London Interbank Offered Rates. These are the rates at which banks can borrow from each other for defined periods of time, ranging from overnight to twelve months. LIBOR rates are also used as the index value on many variable rate loans to consumers. Thus, an increase in LIBOR rates results in an equal increase for those consumer loan rates. For example, let's say you have an adjustable rate mortgage (ARM) with an outstanding balance of $500,000, and the interest rate is reset annually at 2.25 percent plus the one-year LIBOR rate. If your mortgage rate resets each October, then you have been paying around 3.125 percent for the past year.

However, the 1-year LIBOR rate has increased from 0.83 percent a year ago to 1.59 percent today. When your ARM resets this month, your new rate for the coming year will be 3.875 percent (rates typically round up to the next eighth of a percent). That additional 0.75 percent may not sound like much, but it translates to about $3,700 in additional pretax interest payments. In contrast, the Prime Rate, used as the index for home equity lines of credit (HELOCs) and many business loans, has risen by 0.25 percent in the past year, or only one-third as much. So why the large discrepancy between these two rates? Blame it on the Law of Unintended Consequences, resulting from a tightening of money market regulations that came out of the 2008 credit crisis.

Breaking the buck

Consumers have always assumed that their shares in a money market fund will always be constant, valued at one dollar per share. This has been the case even when the underlying value of the short-term loans made by the money market fund fluctuate in value, particularly if loans within the fund default. Up until this month, the financial institutions that manage money market funds were allowed to maintain this constant share price and make up any losses at their own expense, for fear that a panic would ensue if their shareholders saw the share price of these funds fall below a dollar.

What most people don't know is that when the credit crisis hit in 2008 and loans between financial institutions froze up, one money market fund actually "broke the buck," and many others were at a similar risk of doing so before the Federal Reserve stepped in to guarantee loans. So new government regulations that went into effect this past October 14th require all prime money market funds – those that hold corporate paper – to report per share rates based on their actual net asset value (NAV).

The result is that over $1 trillion in assets have moved out of prime money market funds and into government money market funds, as the latter are allowed to maintain a value of one dollar per share due to the higher safety of the government debt that they hold. Prime market funds are an important source of funds for banks and companies, so this large loss of assets has required borrowing from other banks at LIBOR to make up the difference. Increased demand results in higher prices, and thus the rapid increase in LIBOR.

Better fixed than floating

Consumers often opt for variable rate loans because they tend to be lower than those with fixed rates. This is inherently something of a gamble, because rates have the potential to change significantly during the duration of the loan. It's a win if variable rates stay constant or decrease, but a rate increase will have consumers wishing that they had locked in to a fixed rate back when it was lower. Looking at the current global financial situation, and recalling Jeff Gundlach's prediction, I'm willing to stick my neck out and state that holders of variable rate loans are going to see their loan payments increase over the next several years.

The obvious solution here is to convert your floating rate loans to fixed rates wherever possible. That could consist of refinancing your home mortgage, taking out a lump sum fixed rate home equity loan rather than maintaining a line of credit (particularly if you have earmarked a specific amount for home improvements, college tuition, or similar), and making a personal loan to your child at the Applicable Federal Rate (to keep it from being a gift) so that they can pay off their student loan with the proceeds.

It is difficult, if not altogether impossible, to predict the future path of interest rates. However, the indicators all seem to point in one direction: up. So as I help my clients prepare for financially situations that involve a considerably degree of uncertainty – investment returns, life expectancy, personal life crises – I am doing likewise with variable interest rate exposure. If you have a floating rate interest loan that you can convert to a fixed rate without too much difficulty or cost, now is the time to consider doing so.

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