Many homeowners with ARMs stand to gain

By Sandra Block, USA TODAY
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The biggest beneficiaries of the Federal Reserve Board's rate cut will be borrowers with adjustable-rate mortgages linked to one-year Treasury bills, says Greg McBride, senior financial analyst for Bankrate.com. About 1.8 million subprime adjustable-rate mortgages will reset in coming months, often to rates sharply higher than their initial "teaser" rates.

The decline in short-term interest rates will make the increases much less painful, McBride says.

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The Fed cuts Tuesday and in October and September have caused one-year Treasury yields to plunge from 5% to just over 3%, McBride says.

On an ARM with a margin of 2.5 percentage points above the Treasury index, the new rate would be 5.7%, McBride says, instead of the 7.5% it would have been if the loan had reset in July. For a homeowner with a $200,000 mortgage balance and 27 years left on the loan, that works out to an increase of $140 a month, vs. $370 if the rate had reset a few months ago, he says.

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About half of adjustable-rate mortgages are tied to Treasury securities. However, the Fed rate cut will not help borrowers whose adjustable-rate mortgages are tied to the London Interbank Offered Rate, or LIBOR index. Most subprime loans are tied to the LIBOR. That index has remained high because many banks are still reluctant to lend.

The White House last week brokered a deal with the mortgage industry to speed up loan modifications and freeze interest rates for five years for some borrowers with unaffordable subprime adjustable-rate loans. The Fed next week is expected to announce new rules for all mortgage lenders addressing common subprime practices, such as penalties for early repayment, failure to offer escrow accounts for taxes and insurance, and loans that don't factor in the borrower's ability to repay.

But the White House plan will reach only a small number of troubled borrowers. The Fed move, though an important step, will affect future lending, not current problem loans.

Other interest rates that will be affected by Tuesday's Fed move:

Credit cards

Card holders may see a slight decrease in their interest rates after Tuesday's rate cut, but only if they have excellent credit. The average interest rate for variable-rate credit cards was 13.46% last week, down slightly from a week earlier, according to Bankrate.com.

But it's becoming increasingly difficult for borrowers to qualify for the best rates. After the credit crunch, lenders are seeking to limit their exposure to bad loans. They've tightened standards for new credit and increased so-called penalty rates for customers who are considered high-risk.

At a hearing held last week by the Senate Permanent Subcommittee on Investigations, several borrowers testified that interest rates on their credit card balances had soared as high as 30%, even though they hadn't missed any payments. The reason: Their credit scores had declined.

Today's Fed rate cut isn't going to help such borrowers, McBride says. "If you're paying 32%, a quarter-point move by the Fed isn't going to help a whole lot."

Home-equity lines of credit

These loans are typically tied to short-term interest rates, so rates are expected to fall. The average rate for a home-equity line of credit was 7.6% last week, according to Bankrate.com.

The Fed rate cut may not affect home-equity loans, which typically carry fixed interest rates. The average rate for a home-equity loan was 8.02% last week, and hasn't changed much since the Fed started cutting rates in September, according to Bankrate.com.

Certificates of deposit

Savers will see rates on certificates of deposit decline, although not by much. CD yields are "falling like a feather rather than falling like a rock," McBride says. The average rate for a one-year CD was 3.49% last week, but some of the highest-yielding CDs are still paying 5% or more. Savers can thank the credit crunch, which has made banks eager to attract deposits, McBride says.

"It's a lot cheaper to pay 5% on a CD than it is to try to raise capital in the credit markets," he says.