How to Decide if an adjustable rate mortgage is Right for You

An adjustable rate mortgage, called an ARM for short, is a mortgage with an interest rate that is linked to an economic index. The interest rate, and your payments, are periodically adjusted up or down as the index changes.

ARM Terminology

Index

An index is a guide that lenders use to measure interest rate changes. Common indexes used by lenders include the activity of one, three, and five-year Treasury securities, but there are many others. Each ARM is linked to a specific index.

Margin

Think of the margin as the lender's markup. It is an interest rate that represents the lender's cost of doing business plus the profit they will make on the loan. The margin is added to the index rate to determine your total interest rate. It usually stays the same during the life of your home loan.

Adjustment Period

The adjustment period is the period between potential interest rate adjustments.

You may see an ARM described with figures such as 1-1, 3-1, and 5-1.

The first figure in each set refers to the initial period of the loan, during which your interest rate will stay the same as it was on the day you signed your loan papers.

The second number is the adjustment period, showing how often adjustments can be made to the rate after the initial period has ended. The examples above are all ARMs with annual adjustments--meaning adjustments could happen every year.

If my payments can go up, why should I consider an ARM?

The initial interest rate for an ARM is lower than that of a fixed rate mortgage, where the interest rate remains the same during the life of the loan. A lower rate means lower payments, which might help you qualify for a larger loan.

How long do you plan to own the house? The possibility of rate increases isn't as much of a factor if you plan to sell the home within a few years.

Do you expect your income to increase? If so, the extra funds might cover the higher payments that result from rate increases.

Some ARMs can be converted to a fixed-rate mortgage. However, conversion fees could be high enough to take away all of the savings you saw with the initial lower rate.

ARM Indexes

While you can't dictate which index a lender uses, you can choose a loan and lender based on the index that will apply to the loan. Ask the lender how each index used has performed in the past. Your goal is to find an ARM that is linked to an index that has remained fairly stable over many years.

When comparing lenders, consider both the index and the margin rate being offered.

Discounted Rates and Buydowns

When you're buying a home you might encounter sellers who offer to pay a buydown fee that allows the lender to offer you an initial rate that's lower than the sum of the index and the margin. New home builders sometimes offer that type of purchase package to help get people into their homes.

The buydown rate will eventually expire and your payments could rise significantly if an ARM rate is adjusted upwards at the same time the discount expires.

Keep in mind that sellers sometimes raise the price of a home by the amount they pay to buydown your loan. The extra cost may in time override any savings from the initial discount.

Interest Rate Caps

Rate caps limit how much interest you can be charged. There are two types of interest rate caps associated with ARMs.

* Periodic caps limit the amount your interest rate can increase from one adjustment period to the next. Not all ARMs have periodic rate caps.

* Overall caps limit how much the interest rate can increase over the life of the loan. Overall caps have been required by law since 1987.

Payment Caps

A payment cap limits how much your monthly payment can increase at each adjustment. ARMs with payment caps often do not have periodic rate caps.

Carryovers

If an interest rate cap held your interest down at an adjustment even though the index went up, the amount of the increase can be carried over to the next adjustment period.

Beware of Negative Amortization

Amortization takes place when payments are large enough to pay the interest due plus a portion of the principal.

Negative amortization occurs when payments do not cover the cost of interest. The unpaid amount is added back to the loan, where it generates even more interest debt. If this continues you could make many payments, but still owe more than you did at the beginning of the loan.

Negative amortization generally occurs when a loan has a payment cap that keeps monthly payments from covering the cost of interest.

The Bottom Line

Lenders are required to give you written information to help you compare and select a mortgage. Don't hesitate to ask as many questions as it takes to help you understand every aspect of ARMs and other home loans that are offered to you.

For more information on adjustable rate mortgages, amortization tables, mortgage basics visit Independent Loan Information.

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