Adjustable-Rate Mortgages

Adjustable-rate mortgages (ARMs) differ from fixed-rate mortgages in that the interest rate and monthly payment can change over the life of the loan. ARMs also generally have lower introductory interest rates vs. fixed-rate mortgages. Before deciding on an ARM, key factors to consider include how long you plan to own the property, and how frequently your monthly payment may change.

Why choose an adjustable-rate mortgage?
The low initial interest rates offered by ARMs make them attractive during periods when interest rates are high, or when homeowners only plan to stay in their home for a relatively short period. Similarly, homebuyers may find it easier to qualify for an ARM than a traditional loan. However, ARMs are not for everyone. If you plan to stay in your home long-term or are hesitant about having loan payments that shift from year-to-year, then you may prefer the stability of a fixed-rate mortgage.

Components of adjustable-rate mortgages

Adjustable-rate mortgages have three primary components: an index, margin, and calculated interest rate.

- **Index**
- The interest rate for an ARM is based on an index that measures the lender's ability to borrow money. While the specific index used may vary depending on the lender, some common indexes include U.S. Treasury Bills and the Federal Housing Finance Board's Contract Mortgage Rate. One thing all indexes have in common, however, is that they cannot be controlled by the lender.
- **Margin**
- The margin (also called the "spread") is a percentage added to the index in order to cover the lender's administrative costs and profit. Though the index may rise and fall over time, the margin usually remains constant over the life of the loan.

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Calculated interest rate

By adding the index and margin together, you arrive at the calculated interest rate, which is the rate the homeowner pays. It is also the rate to which any future rate adjustments will apply (rather than the “teaser rate,” explained below).

Adjustment periods and teaser rates

Because the interest rate for an ARM may change due to economic conditions, a key feature to ask your lender about is the adjustment period–or how often your interest rate may change. Many ARMS have one-year adjustment periods, which means the interest rate and monthly payment is recalculated (based on the index) every year. Depending on the lender, longer adjustment periods are also available.

An ARM can also have an initial adjustment period based on a “teaser rate,” which is an artificially low introductory interest rate offered by a lender to attract homebuyers. Usually, teaser rates are good for 6 months or a year, at which point the loan reverts back to the calculated interest rate. Remember, too, that most lender will not use the teaser rate to qualify you for the loan, but instead use a 7.5% interest rate (or calculated interest rate if it is lower).

Rate caps

To protect homebuyers from dramatic rises in the interest rate, most ARMs have “caps” that govern how much the interest rate may rise between adjustment periods, as well as how much the rate may rise (or fall) over the life of the loan. For example, an ARM may be said to have a 2% periodic cap, and a 6% lifetime cap. This means that the rate can rise no more than 2% during an adjustment period, and no more than 6% over the life of the loan. The lifetime cap almost always applies to the calculated interest rate and not the introductory teaser rate.

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Payment caps and negative amortization

Some ARMs also have payment caps. These differ from rate caps by placing a ceiling on how much your payment may rise during an adjustment period. While this may sound like a good thing, it can sometimes lead to real trouble.

For example, if the interest rate rises during an adjustment period, the additional interest due on the loan payment may exceed the amount allowed by the payment cap–leading to negative amortization. This means the balance due on the loan is actually growing, even though the homeowner is still making the minimum monthly payment. Many lenders limit the amount of negative amortization that may occur before the loan must be restructured, but it's always wise to speak with your lender about payment caps and how negative amortization will be handled.

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