

# Consumer's Guide to ADJUSTABLE RATE MORTGAGES

## All About ARMs

While the double-digit interest rates that created them are gone, adjustable-rate mortgages still offer financial flexibility for borrowers who need it. When interest rates soared into the double digits in the early 1980s, many people were completely priced out of the home-buying market. Lenders responded with a new kind of loan that tied mortgage interest to a variable index, such as U.S. Treasury Bills, in order to go below conventional loan rates. They tacked on an extra 2 or 3 percent—known as the margin—to originate the loan and the adjustable rate mortgage was born.

Because their interest rates are two to three points below conventional fixed-rate mortgages early on in an ARM, adjustable-rate mortgages are still an option for buyers stretching their budget to get into a home. In exchange for a low rate in the beginning of the loan, you must be willing to accept a monthly payment that can fluctuate, unlike a fixed-rate loan where the monthly payment is locked in.

That's because these loans are tied to indexes that go up and down. However, ARMs don't adjust every month. Most are adjusted every year or every three years and within proscribed limits, all of which should be spelled out clearly in your loan agreement. Because terms of adjustable loans can be complicated, it's important to understand how they work. Here are the key features you should know before you talk to a lender:

### ARM Talk: What's In An Adjustable Loan

- **Initial Interest Rate:** Starting rate of an adjustable loan; can be one to four points lower than conventional 30-year, fixed-rate mortgage.
- **Adjustment Interval:** How often the loan's rate can be changed; can range from six months to three years; new rate equals index plus margin.

- **Index:** Financial markets rate that measures lender's cost to borrow; used by lender as basis for loan rate. Goes up and down in response to interest rates. The best indexes are those that are the least volatile. An indicator would be how long it will take for the rate on the ARM to reach the maximum allowed under the loan program.
- **Margin:** Set percentage added by lender to index rate to calculate final loan rate; can range from one to three percent on individual loan; stays the same during life of the loan.
- **Interest Caps:** Limits on amount that interest rate can be increased when loan is adjusted; lifetime caps, required by law, limit rate changes over life of loan; periodic caps limit rate changes between adjustment intervals. Cap amounts widely vary.
- **Payment Cap:** Limit on amount that monthly payment can be increased; limit set at a percentage of previous payment; undesirable because it can result in negative amortization.

### Know Your Limits

When considering an adjustable-rate mortgage, always look at the worst-case scenario:

- How long will the initial interest rate remain in effect?
- What will the interest rate be after the first adjustment?
- How high can the interest rate go if interest rates continue to rise?
- How long will it take for the rate on the ARM to reach the maximum allowed under the loan program?

An adjustable-rate mortgage that adjusts only once a year but has a higher initial rate may cost you less than one that adjusts twice a year but has a lower start rate. ARMs that adjust only once a year also have the benefit of enabling you to prepare for monthly payment adjustments. Six-month adjustments can be more difficult to handle.

