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UNDERSTANDING ADJUSTABLE RATE MORTGAGES

INTRODUCTION TO ARMs

An adjustable rate mortgage ("ARM") is a loan where the interest rate and monthly payment are not fixed, but change periodically during the life of the loan to correspond with movements in an index rate. The concept of adjustable rate financing is based on the borrower and the lender sharing the risks of a fluctuating economy. If interest rates rise, the borrower's interest rate and monthly payment increase; if interest rates fall, the borrower's interest rate and monthly payment decrease.

This article is intended to provide basic information about ARMs, and to assist home buyers in understanding and comparing the complex features of ARMs.

BASIC FEATURES OF ARMs

Adjustment Interval. The adjustment interval is the frequency with which the interest rate and/or monthly payment can be changed. With most ARMs, the adjustment interval is every year, every three years, or every five years. Usually, the monthly payment is adjusted at the same time as the interest rate is adjusted. However, with some ARMs, the interest rate can be adjusted more frequently than the monthly payment.

Index. The index is the rate used to determine changes in the ARM interest rate. The most commonly used indexes are the rates on Treasury bills or securities. However, some lenders use other indices, such as the average cost of funds to savings and loan associations.

Margin. The margin is the amount or percentage added to the index at each adjustment interval to determine the new interest rate on the ARM. Lenders set different margins, typically ranging from 2% to 4%.

Interest-Rate Cap. An interest-rate cap is a limitation on the amount that the ARM interest rate can increase. There are two types of interest-rate caps: periodic caps, which limit the interest-rate increase from one adjustment interval to the next; and overall caps, which limit the interest-rate increase over the life of the loan. For example, on a one-year ARM with a periodic cap of 2% and an overall cap of 5%, an initial interest rate of 10.5% could increase to a maximum of 12.5% for the second year and 15.5% over the life of the loan.

Payment Cap. A payment cap is a limitation on the amount that the monthly payment can increase at each adjustment interval. The most common payment cap is 7½% per year. For example, on a one-year ARM with a payment cap of 7½%, an initial payment of $1,000 per month could increase to a maximum of $1,075 for the second year, $1,155.63 for the third year, and so on.

Because most ARMs with payment caps do not have interest-rate caps, it is possible that the maximum monthly payment on a payment-capped ARM may not cover all of the interest owed on the loan. This shortage, called "deferred interest" or "negative amortization," is added to the loan balance. As a result, the loan balance may be higher than the original loan amount. Most ARMs contain a cap on negative amortization limiting the loan balance to a maximum of 125% of the original loan amount.

OTHER FEATURES OF ARMs

Convertibility. Most ARMs contain a conversion clause that permits the borrower at designated times to convert the ARM to a fixed-rate loan at the then-current market rate for fixed rate loans.

Assumability. Most ARMs are assumable, provided that the new buyer meets the lender's credit and underwriting criteria. On the other hand, few fixed-rate loans are assumable these days.

"AFFORDABILITY" OPTIONS

Graduated payments. A graduated payment adjustable rate mortgage ("GPARM") combines the features of an ARM with a monthly payment schedule that starts out lower, then increases gradually over the early years of the loan, typically one to five years. A GPARM does involve negative amortization during the graduated payment period.

Buydowns. A buydown simply involves prepaid interest collected at closing to lower the monthly payment. Buydowns often are paid by the seller to enable the buyer to qualify for the loan. Buydowns may be permanent or temporary. A common program is the "3-2-1" buydown, in which the monthly payment is based on a "payment rate" below the actual note rate by 3% during the first year, 2% the second year, and 1% the third year. A buydown does not involve negative amortization.

ADVANTAGES AND RISKS OF ARMs

Lenders generally charge lower initial interest rates for ARMs than for fixed-rate loans. Lower interest rates mean lower monthly payments, and therefore, more house for the buyer. On the other hand, borrowers assume the risk that interest rates may increase. If interest rates remain steady or decline, an ARM could be significantly less expensive than a fixed-rate loan.

MORE INFORMATION

A meaningful comparison of the various loans available should take into consideration all the features discussed above in light of the needs of the individual buyer. Shopping for a loan used to be a relatively simple process; it now is a complicated maze to most buyers.