Adjustable-Rate Mortgages

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An adjustable-rate mortgage (ARM) has an interest rate that can change during the life of the loan, with the possibility of both increases and decreases to the interest rate and the amount of the monthly mortgage payment.

ARM interest rates generally remain fixed during an initial period, after which rates adjust periodically—typically, annually, semi-annually, or monthly according to an index and a margin, each of which is specified in the related mortgage note. Rates are typically capped in terms of the size of the rate adjustment at the first change date (initial cap) and/or subsequent change dates (periodic cap) and the maximum rate over the life of the loan (life-of-loan cap).

The interest rate for an ARM is tied to a financial index. When comparing ARMs that have different indices, you may wish to consider how that index has performed over an extended period of time, although past index values may not be indicative of future index values. Commonly used indices include CMT (Constant Maturity Treasuries), LIBOR (London Interbank Offered Rate), and COFI (11th District Monthly Weighted Average Cost of Funds Index of the Federal Home Loan Bank of San Francisco).

Hybrid ARMs—also known as fixed-period ARMs—have fixed rates for a designated number of years (e.g., 3, 5, 7, or 10 years), after which the loan adjusts on a regular periodic basis as set forth in the related mortgage note. Hybrid ARMs have become more common over the last few years.

Some ARMs allow for "negative amortization." A negative amortization ARM is one in which the monthly payment does not change as often as the interest rate does, or a payment cap applies, or both. If any of your payments are not sufficient to cover the interest due, the difference is added to your loan amount. Generally, at the end of the year, the loan is re-amortized to calculate a new monthly payment. Interest is then charged on the higher principal balance. In the case of negative amortization ARMs, caps generally apply to the monthly payment amount rather than to the interest rate. Negative amortization ARMs also limit the amount by which the principal balance increases due to negative amortization. Some common limits require re-amortization when negative amortization causes the unpaid principal balance to exceed 110%, 115% or 125% of the original loan principal balance. You should note that with negative amortization ARMs, the amount of equity in a mortgaged property may be reduced and the principal balance could become higher than the original loan amount.

Loan Features

- The most common types of ARMs include:
  - 6-Month;
  - 1/1 (adjusts annually);
  - 3/1 (fixed for three years, adjusts annually thereafter);
  - 3/3 (fixed for three years, adjusts every three years thereafter);
  - 5/1 (fixed for five years, adjusts annually thereafter);
  - 7/1 (fixed for seven years, adjusts annually thereafter); and
  - 10/1 (fixed for ten years, adjusts annually thereafter).
- Changes to the interest rate are limited by initial rate caps, periodic rate caps, and life-of-loan rate caps (each as described above).

Adjustable-Rate Mortgages (cont'd)

- Adjustments are computed by adding a specified index value to the margin specified in the mortgage note.

Considerations

- Lower interest payments in the short-run compared to comparable fixed-rate loans. Because ARM rates are typically lower than rates for 30-year fixed rate mortgages, monthly payments are generally lower initially.
- Your rate and payment may increase, or decrease, during the term of the loan.

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