

# Adjustable Rate Mortgage

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Adjustable-rate mortgages (ARMs) are popular because they usually start with a lower interest rate and a lower monthly payment. The lower rate (and lower monthly payments) may also allow a higher loan amount. However, the interest rate can change during the life of the loan, which would mean that your monthly payment would increase (or decrease).

It's important to understand the specifics of an adjustable-rate mortgage, commonly called an ARM:

## **Adjustment periods**

All ARMs have adjustment periods that determine when and how often the interest rate can change. There is an initial fixed-rate period during which the interest rate doesn't change - this period can range from as little as 1 month to as long as 10 years. After the initial period, the interest rate will often adjust each year. For example, with a 3/1 ARM, your interest remains the same during the first 3 years, and then can adjust every year following, up to a maximum amount (the "lifetime cap").

## **Indexes and margins**

At the end of the initial period and at every adjustment period, the interest can change based on two factors: the "index" and the margin. Interest rate adjustments are based on a published index. There are many indexes but some commonly used for ARMs are the LIBOR and the U.S. Treasury Bill. The rates for indexes reflect current financial market conditions, which is why your interest rates can change at each adjustment period. The margin is the amount (shown as a percentage) that is added to the index to determine what your new mortgage rate will be until the next adjustment period.

## **Caps, ceilings, and floors**

All ARMs have rate caps, also known as ceilings and floors. Caps decide how much the interest rate can increase or decrease at each adjustment period and over the life of the loan. Most ARMs have a lifetime cap that limits the amount your interest rate can increase over the life of your mortgage.

## **The number system**

There are several types of ARMs, such as the 10/1, 7/1, 5/1 and 3/1. The first number (10 for example) is the length of the initial period, during which the interest rate can't change. The second number (1 for example) is how often the ARM is adjusted after the initial period. So, a 10/1 ARM won't change for the first 10 years, but can change in the 11th year and again every year after that. Depending on the initial cap the change could be as high as 5 percentage points above what it was before.

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There are additional considerations to be aware of with adjustable-rate mortgages:

- Because the initial interest rate is usually lower than a fixed-rate mortgage, your initial payments will be lower and you may qualify for a larger mortgage amount.
- If interest rates are high when you get your mortgage but drop during any adjustment period, your monthly payment may decrease.
- An ARM with a low initial interest rate and an initial adjustment period after 5 or 7 years can save you money.
- ARMs can, and often do, have interest rate increases at adjustment periods. You may have an increase in your monthly mortgage payment after each adjustment period. The amount your mortgage might increase would depend on the periodic cap (how much of an increase is allowed each year), the lifetime cap (the maximum interest rate or maximum number of increases allowed), and the size of your mortgage's margin. If the life cap is 5%, the maximum interest rate adjustment would be to 10.75%

Adjustable Rate Mortgages  
Source: FreddieMac.com

