

Adjustable Rate Mortgage Loan

The adjustable rate mortgage (ARM) loan has an initial contract rate that is fixed for a specific period of time, followed by an adjustable interest rate that increases or decreases over the life of the loan (based on market conditions). The initial rate is normally lower than the rate offered on a fixed-rate mortgage loan. The lender adjusts the interest rate at specified intervals as outlined in the promissory note.

The adjustable rate is determined by adding a margin (sometimes called a spread) to an index mandated by the loan documents. The most common indices are six-month, one-year, three-year, and five-year Treasury bills; California's (Federal Home Loan Bank of San Francisco) 11th District Cost of Funds Index; and the London Interbank Offered Rate (LIBOR). Rates based on 30-day U.S. Treasury Bills are also possible.

ARM loans contain certain safeguards that limit the incremental increases of the payments. One type of safeguard, called a *periodic cap*, limits the amount the interest rate can change at each adjustment. There is also a *lifetime cap* which determines how much the rate can change over the life of the mortgage.

For example, if the ARM has a periodic cap of two percent and a lifetime cap of five percent, the interest rate will not change by more than two percent at any single adjustment, and will never be more than five percent above the initial contract rate.

A *payment cap* is a safeguard that limits the increase in the monthly payment. While easily understood, it has a definite downside: it can prevent a borrower's monthly payment from increasing enough to match a rapidly increasing interest rate. Thus the payments may not "keep up" with the loan schedule (that is, the borrower is neither reducing the principal nor paying the entire monthly interest figure). This is called *negative amortization* and results in the borrower owing more than the original mortgage loan amount.

Adjustable Rate Mortgage Components

There are four basic components to all ARM loans:

- **Initial Interest Rate** (teaser rate) – The benchmark for the ARM loan, it will typically be one to three percent lower than a comparable fixed-rate mortgage.
- **Index** – The economic indicator used to determine changes to the ARM's interest rate. The loan is "tied" to this index. As the index rises and falls, so does the interest rate. An example of an index commonly used for ARMs is the yield on a one-year U.S. Treasury bill (T-bill).
- **Margin** – The percentage points the lender adds to the index to establish the actual interest rate of the ARM. The margin remains fixed throughout the life of the loan.

- **Adjustment Interval** – The time between changes in the ARM's interest rate. If the ARM has an adjustment interval of one year, the rate – and as a result the monthly payment – will be changed every year, based upon the current index plus the margin.

Variations on Adjustable Rate Mortgage

ARMs remain a good choice for borrowers who expect their income to increase or who don't expect to be in their home for a long period of time. Generally ARMs are also a good choice when interest rates are relatively high. Borrowers should discuss the appropriateness of the various products with mortgage lenders. Some of the most common ARM types are listed below:

- **Interest Only ARMs** – only monthly interest payments are required, and thus, the mortgage's principal balance is not decreased.
- **Option ARMs** – a payment-option ARM provides several payment options each month, including the following:
 - **Principal and interest payment:** the principal payment reduces the amount owed on the mortgage while the interest payment pays the interest owed.
 - **Interest-only payment:** the interest on the mortgage is paid but there is no principal payment made towards reducing the amount owed on the mortgage.
 - **Minimum payment:** this may be less than the amount of interest due that month and may not reduce the amount owed on the mortgage. This may lead to the amount of any interest not paid being added to the principal of the loan, potentially **increasing the amount owed, the monthly payments**, and amount of interest paid over the life of the loan. Making only the minimum payment in the last few years of the loan, may result in a larger payment at the end of the loan term, called a *balloon payment*.
- **Convertible ARMs** – An ARM that can be converted to a fixed-rate mortgage under certain circumstances. The borrower is usually required to pay fees to change from a convertible ARM to a fixed-rate loan, and the conversion can often only happen during a specific period of time (typically during the first five years on the adjustment date). The new rate is then established at the current market rate for fixed-rate mortgages. The conversion interest rate may sometimes be set slightly above the market rate at that time.

About PolicyNotes

PolicyNotes is produced by the Mortgage Bankers Association. It is designed to explain and educate on specific policies surrounding the real estate finance industry.

- **Graduated Payment Mortgages** – Have payments that start low and gradually increase at predetermined times. The monthly payments eventually increase in order to catch up from the initial lower payments. The loan itself will be negatively amortizing during the early years of the loan and then increased monthly principal payments will pay off the principal at an accelerated pace through the later years of the loan.
- **Balloon Loan** – Are typically short-term fixed rate loans that have fixed monthly payments often based upon a 30-year fully amortizing schedule with a lump sum payment at the end of its term. The terms typically range from 3, 5, to 7 years. The advantage of this type of loan is that the interest rate on balloon loans is generally lower than 30- and 15- year mortgages resulting in lower monthly payments. The disadvantage is that at the end of the term a lump sum payment is required from the borrower to pay off the balance of the loan.

Why the Adjustable Rate Mortgage Loan

Many different factors can, and should, influence the borrower’s selection of a mortgage. As borrowers research the different loan products that are available and discuss specific options with lenders, they should keep the following five factors in mind:

1. Their current financial situation and resources
2. How they expect the finances to change in the future
3. How long they intend to keep the home
4. How comfortable they are with the idea of the payment changing from time to time
5. How rapidly they want to build equity

Below is a quick reference of the advantages and disadvantages of each mortgage category.

Type of Mortgage	Advantages	Disadvantages
Fixed-rate Mortgages	<ul style="list-style-type: none"> • Payment is stable so borrowers are able to budget more easily. • Interest rate does not fluctuate so there are no surprises or anxiety. 	<ul style="list-style-type: none"> • Higher income is necessary to qualify due to higher initial mortgage rate. • If interest rates decrease, borrower will need to refinance to get lower interest rate.
Adjustable Rate Mortgages	<ul style="list-style-type: none"> • Lower initial interest rate means initial payments are lower. • If interest rates decline, the interest rate and payment will decline. • Easier to qualify because of lower initial interest rate and payment amount. 	<ul style="list-style-type: none"> • If rates increase so will interest rate and payments. • There is always the danger of a large increase in interest rates, and therefore large increase in payments. • If interest rates increase too much, borrower may not be able to afford the home.
Pay Option ARMs	Borrowers with incomes that fluctuate have the option to make one of four payment choices: 15-year amortizing, 30-year amortizing, interest-only or minimum.	<ul style="list-style-type: none"> • Minimum payments are insufficient to pay all the interest accrued. • When negative amortization exceeds 10-25% of the original mortgage amount, the loan is recast and payments increase to amortize over the remaining term.
Hybrid ARMS	<ul style="list-style-type: none"> • Provide up-front savings for borrowers needing a lower rate to qualify. • The 3-, 5-, 7- and 10-year hybrid ARMs combine the benefits of fixed and adjustable mortgages. • Borrowers have time to improve their credit to get a better rate. 	<ul style="list-style-type: none"> • Borrowers who do not use the time to improve their financial situation or do not refinance to a lower rate may experience an average rate increase of 2-3 percentage points.

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