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1284 of 1000 words

Understanding ARM mortgages - Interest.com

monthly payment. What is an adjustable rate mortgage going to provide in the way of benefits? Occasional access to lower interest rates without refinancing and increased buying power for shoppers who need to stretch the budget. The loan type also proves more popular when mortgage rates go up because it provides buyers with lower monthly payments on the front end.

What is an ARM loan?

When home buyers apply for a mortgage and review financing options, a mortgage can be secured with fixed-rate or adjustable-rate interest. A fixed-rate mortgage has an interest rate that is consistent across the life of the loan, but an adjustable-rate mortgage has fluctuating rates. A hybrid ARM may feature a bit of both worlds by starting with a multi-year fixed rate before transitioning to an adjustable rate for the bulk of the loan period. Lenders typically abbreviate an ARM as 7/1, meaning the rate is fixed for seven years and can adjust every year thereafter.

However, adjustable rates aren't exactly the Wild West. Interest rate caps exist to protect buyers from massive swings. According to the [Consumer Financial Protection Bureau](#), an initial adjustment cap limits the first increase after the fixed-rate ends, typically to 2% or 5%. A subsequent adjustment cap limits the increase allowed between back-to-back adjustments, typically to 2%. A lifetime adjustment cap also states the limit of the loan's interest, such as 5% higher than the original rate. Lenders frequently abbreviate these caps as 5/2/5. A 5/2/5 adjustable rate mortgage would have an initial cap of 5% a 2% cap on periodic increases and a 5% cap over the life of the loan.

Types of adjustable rate mortgages

Common types of ARM mortgages include a 7/1 with seven years of fixed rates and annual adjustment in the following years. Other variations include the 5/1, 3/1 or 10/1. Other ARMs also feature only one year of fixed-rate interest before the rate swings start.

After you apply for a mortgage, your application is reviewed to determine if you qualify. This process is known as underwriting. Many mortgage applications are subject to automated underwriting but others are completed manually. Whether a person or computer reviews your eligibility, the three basics are the same — capacity, credit and collateral.

Capacity is your ability to repay the loan. The preferred debt-to-income ratio of your loan type, such as 45% or 36%, comes into play here. You will need proof of income and proof of other assets. A credit report is pulled to analyze your outstanding debts. Collateral includes the value of the home itself compared to the price you are paying. Credit is the area most buyers are familiar with going in and includes a review of your credit profile for score, any accounts in default and the overall amount of credit you utilize. Most mortgage lenders prefer a credit score of at least 620 while FHA loans can accommodate buyers with a score as low as 500.

The underwriting process can be time consuming based on the complexity of your financial situation and the home you are attempting to buy. If you have all necessary paperwork at the ready and the title searches on the property are easily completed, it can be done in several days. More complex cases may require several weeks.

Does an ARM Mortgage make sense for you?

Despite the potential risks of paying higher interest long-term with an adjustable rate mortgage, they are a favored option for certain buyers. If you are looking for a starter home but plan on upgrading after a few years, a 7/1 or 10/1 ARM will often provide you with a lower interest rate than a fixed-rate mortgage. By selling the home while in the fixed-rate period, you are never exposed to the higher rate. The same concept also applies to buyers who need to relocate regularly for work or for other reasons and do not intend to live in the home past the fixed-rate period.

Other buyers may be able to afford more house with an ARM because the monthly payments will be lower initially, skewing debt-to-income ratios in the buyer's favor. If you expect to earn more after several years and want to gamble with interest rates, an ARM can help you buy the house of your dreams if it is just out of reach with a fixed-rate loan. An added bonus is the home can be refinanced later with a fixed-rate mortgage if you see interest rates start to trend upward and qualify for a new loan.

Buyers who may benefit from an ARM:

- Workers who relocate periodically
- Starter home buyers
- Would-be homeowners who expect to qualify for better financing later

- Buyers who need a lower monthly payment to start

When to say no to an ARM mortgage

A hybrid adjustable mortgage with a longer period of fixed-rate interest, such as a 7/1 or 10/1 ARM, provides greater flexibility for improving your financial situation before being exposed to higher interest rates. If you cannot secure an ARM with these terms, they become a more risky proposition unless you are financially flush. Do not bank on being able to refinance or sell if you cannot afford a payment at the maximum interest rate for the loan.

An ARM scenario by [Quicken Loans](#) shows the payments on ARM at multiple interest rates, from the fixed rates at the start of the loan to the max loan cap. In the fixed-rate time period, a \$200,000 loan with 3.99% interest carries a \$953 per month payment. By year eight, the loan balance is reduced to \$171,474, but a theoretical interest rate cap of 8.99% is reached, making loan payments \$1,472. Unless your budget can accommodate that swing, you do not need to gamble on increased income or qualifying for refinancing at a fixed-rate in the future.

Banks that offer ARM mortgages

Adjustable rate mortgages featuring various terms are offered by most major lenders. When you are considering an ARM, always ask your lender to calculate the highest possible payment you will need to make on the mortgage or review your truth-in-lending statement to find this total.

ARM options include:

- Quicken Loans: 5-Year ARM, 4.412% APR, 2/2/5
- Chase: 7/1 ARM, 3.796% APR
- Chase: 5/1 ARM, 3.875% APR
- New American Funding: 5-Year ARM
- Bank of America: 10/1 ARM, 3.88%, 5/2/5
- Bank of America: 7/1 ARM, 3.841%, 5/2/5
- Bank of America: 5/1 ARM, 3.907%, 2/2/6
- Citi: 7/1 ARM, 4.125%

The bottom line

Adjustable rate mortgages can be a brilliant tactical move for home buyers in certain situations, such as those who are cash flush and are confident they will leave the home and be able to sell it within the fixed-rate interest period. For many other buyers, they are a risk where optimism about future buying power or refinancing options provides up-front savings but potentially higher costs in the long run. When you are considering an ARM, always know the maximum payment you would face any given month and know that you can meet it in your current financial situation before jumping.

Meta: Adjustable rate mortgages provide lower fixed interest rates for a set period of years at the front of the loan before higher interest rates are applied.