

Adjustable Rate Mortgage

With an adjustable rate mortgage (ARM) the interest rate is subject to change, in response to changes in the Treasury bill rate or the prime rate. The purpose of the interest rate adjustment is primarily to bring the interest rate on the mortgage in line with market rates. The mortgage holder is protected by a maximum interest rate (called a ceiling), which can be reset annually. Traditionally ARMs specify limits as to how high or low the interest rate can go, and how frequently the changes can be made. Usually ARMs start out with better interest rates than fixed rate mortgages, in order to compensate the borrower for the additional risk that future interest rate fluctuations will create.

ARMs come in many shapes and sizes; 3/1, 5/1, 7/1, 10/1…etc. These are fixed period ARMs and they feature a fixed rate period before adjusting.

The first digit (5/1) represents how long the initial rate period is fixed for. With the 5/1 ARM, that would be 5 years or 60 monthly payments. The second digit (5/1) is how often the ARM will adjust after the fixed period (with a 5/1 ARM the adjustments would begin at the 61st payment). Your rate will then continue to adjust once annually on the anniversary of the first adjustment date. A 5/6 ARM adjusts every 6 months instead of once a year.

CAPS are also part of an ARM, the CAPS are in place to restrict how high or low your ARM can adjust. They too can vary. Common CAPS are 5/2/5 or 2/2/6 for the 5/1 ARMs.

The first digit of the CAP (2/2/6) represents how much the interest rate can adjust at the first adjustment point. So a 5/1 ARM, with a 2/2/6 CAP may adjust up or down no more than 2% at the first adjustment date.

The second digit (2/2/6) signifies how much the rate may be adjusted up or down after the first adjustment and every adjustment point thereafter (once a year for a 5/1 ARM; every 6 months for a 5/6 ARM).

The last digit (2/2/6) is also known as the ceiling and represents the highest that the rate can ever be adjusted to.

It is very important to find out from your Loan Officer what the CAPS are and what the margin is.

Someone that is considering not retaining the mortgage or property for a long term can benefit financially by choosing an adjustable rate mortgage.