Just the Facts about Adjustable Rate Mortgages (ARMs)

What is an ARM?
An ARM is a mortgage loan whose interest changes or fluctuates during the term of the loan. The interest rate charged is linked to an index. The interest rate—and your payments—are periodically adjusted up or down in accordance with the index.

ARM Terminology
Index
An index is a guide that lenders use to measure interest rate changes. Common indexes used by lenders include the activity of one, three, and five-year Treasury securities, but there are many others. Each ARM is linked to a specific index.

Margin
Think of the margin as the lender's markup. It is an interest rate that represents a portion of their operating cost to make and service the loan. The margin is added to the index to determine your loan interest rate. The margin usually stays the same during the life of the loan.

Adjustment Period
The adjustment period is the period between potential rate adjustments.

You may see an ARM described with figures such as 1-1, 3-1, and 5-1.

- The first figure in each set refers to the initial period of the loan, during which your interest rate will be the same as it was on the day of closing.

- The second number is the adjustment period, showing how often adjustments can be made to the rate after the initial period has ended. The examples above are all ARMs with annual adjustments.

If my payments can go up, why should I consider an ARM?
The initial interest rate for an ARM is usually lower than that of a fixed rate mortgage—where the interest rate remains the same during the life of the

loan. A lower rate means lower payments, which might help you qualify for a larger loan.

Other Issues to Consider

- How long do you plan to live there? The possibility of higher rates isn't as much of a factor if you plan to be in the home for a relatively short time.
- Do you expect your income to increase? If so, the extra funds may cover the higher payments that result from rate increases.
- Some ARMs can be converted to a fixed-rate mortgage. However, conversion fees may be high enough to take away all of the savings you saw with the initial lower rate.
- When comparing lenders, consider both the index and the margin rate being offered.
- If the lender doesn't plan to sell your loan on the secondary market, you might be able to avoid the Private Mortgage Insurance (PMI) that's normally required when a buyer makes less than a 20% down payment.