

# STEVE FOX'S MORTGAGE FINANCE

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## Understanding Adjustable Rate Mortgages (ARMs)

Adjustable Rate Mortgages (ARMs) can save money and lower mortgage payments for homeowners when they choose the best loan program for their needs. ARMs evolved in the '70s when rates on fixed rate mortgages rose above 16%. Unfortunately, the housing crisis of 2007 was partially caused by consumers who took out ARMs with very poor features and used them to buy homes they were not qualified to own. Those "bad", "subprime" ARMs are not available today! Fortunately, only the "GOOD" ARMs are available now. Fully understanding ARMs, and how they work, is the fundamental element in choosing the best ARM program. Hopefully, the guide below will allow you to understand ARMs and help you to choose the best mortgage for your financing needs.

### How do ARMs Work?

**Arms Have 4 Main Components: Borrowers must understand these terms!**

- **Initial Rate** - The start rate your lender is offering – A 5/1 ARM's initial rate is fixed for 5 years, a 7/1 is fixed for 7 years
- **Index** - The financial security by which your ARM loan rate will eventually adjust. The most popular is the Libor Index (London Inter Bank Offering Rate) and the 1-year U. S. Treasury Security. Regardless of which **Index** you have, it is safe to estimate that all indexes will adjust proportionally in upward and downward moving markets.
- **Margin** - (Short for "Profit Margin") - The amount over the **Index** that your ARM adjusts. The most common margin is 2.25% for Libor indexed loans and 2.75% for U. S. Treasury indexed loans. Margins can range between 1.875% and 3.0%
- **Caps** – Yearly and lifetime limits on periodic changes your ARM rate can adjust. There are several "Cap" variations.

**Example – the most common variation is a Cap of - 5%/2%/5%.**

- 5 % (1<sup>st</sup> rate change "cap" (up or down) after the initial start rate period runs out)
- 2 % (after the 1<sup>st</sup> change listed above, then it can adjust 2% up or down per year)
- 5 % (the rate can never go higher than 5% above the initial start rate)

### Types of ARMs

There are several variations of ARMs. Today, the most popular ARMs are those which are "fixed" for a specific period and then start to adjust. These programs give customers security that their rate will not increase for a specific period of time. Usually, the shorter the period of time the lender guarantees the start rate, the lower the initial rate and payment. Most ARMs will be advertised showing three features: the amount of time the initial rate remains unchanged, the time until further changes will occur, and the **Index**.

- **Example: 7/1L** - An ARM - fixed for the first 7 years (NO changes), then adjusts every 1 year off the Libor Index.
- **Example: 5/1** - An ARM which is fixed for the first 5 years (NO changes) and then adjusts every 1 year off the Treasury Security Index (if the lender does not specify the index one would assume it adjusts off the U. S. Treasury Security index).
- **Example: 5/1L IO** - An ARM - fixed for the first 5 years (NO changes) and then adjusts every 1 year off the Libor Index and has the "Interest Only" Feature.

### How do ARMS Adjust?

**After the initial rate lock in period runs out, ARMs adjust using the following formula:**

- On the change date (after 3, 5, 7, or 10 years) the new rate will equal:  
**Index** (Whichever Index your ARM loan is based on – the Treasury or the Libor Index)  
+ **Margin**  
= **Your New Rate**, so long as, the caps (mentioned above) have not been exceeded.

### Saving Money with an ARM

**GOOD QUESTION: Why pay more to lock in your rate for 30 years when you do not need to?** If customers plan to move within 5 years, why not consider a 3/1 ARM, 5/1 ARM, or 7/1 ARM? The following are popular reasons to consider an ARM:

- \* Your Income is expected to rise significantly in the future
- \* Higher mortgage loan qualification
- \* Possibility that you may move or pay off the loan within 7 years
- \* "Interest Only" options are available

*Steve Fox with First Savings Mortgage has provided the following newsletter as a service.  
Steve has 23 years of Mortgage Banking experience. Let his experience work for you.*