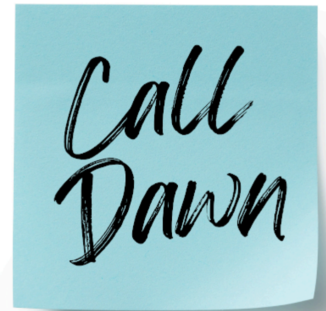
Adjustable Rate Mortgage (ARM)



An Adjustable Rate Mortgage (ARM) is a loan with an interest rate that can change. Nearly all ARMs available today have a fixed interest rate for an initial period, commonly 3, 5, 7, or 10 years. Because you are, in effect, sharing the risk of higher future interest rates with your lender, you will generally get a lower initial interest rate on an ARM than you will on a fixed-rate mortgage. And, generally, the shorter the initial fixed period, the lower the initial rate. The terms of an ARM are defined by its initial fixed term, adjustment period, margin, index, and caps (and possibly a floor).

When and how often can the rate adjust?

The initial fixed term and adjustment period tell you when and how often the interest rate can adjust. You'll see these two timelines written out with a slash between them, like this: "7/1" or "5/6". A 7/1 ARM is a loan with an initial fixed term of 7 years which then adjusts annually. A 5/6 ARM is a loan with an initial fixed period of 5 years which then adjusts every 6 months. (Yup, kind of inconsistent.)

The margin and index define what your rate will be after the initial fixed period ends and your rate starts adjusting. The margin is a constant number—2.25%, 2.5%, and 2.75% are pretty typical margins. Lower is better. The index is a market-driven benchmark interest rate to which your loan rate is tied. Common indexes are the London Interbank Offered Rate (LIBOR) and the 1-year T-Bill. When your interest rate is due for an adjustment, your lender adds the margin to the index to calculate your new rate.

So: Margin + Index = New Rate

The margin plus index is referred to as the "fully indexed rate". Most loans call for rounding to the nearest .125%.

Are there limits?

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Almost all ARMs also have caps that limit the maximum change to your rate. Caps are generally written like this: "2/6" or "5/2/5". The first number is the "initial" cap—the maximum change allowed the first time the rate adjusts. The

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last number is the “lifetime” cap—the most the rate can increase at any point. If there is a middle number, that’s the “intermediate” cap—the most the rate can change at any adjustment other than the initial adjustment. Look up the value of your index in the early 80s and you’ll see why caps are important.

Some ARMs also have a floor, which is (pretty obviously) the lowest the rate can ever be, regardless of the number derived by adding the margin and index.

Things to consider

If ever we talk about an ARM, we’ll provide you with a program-specific disclosure and go over the terms with you. Assessing whether an ARM is right for you entails peering into the future: How long will you this loan? How will your income and expenses change over time? The goal is to balance the risk of higher rates in the future with the benefit of the lower initial rate, with some worst-case contingency planning in the mix. And know yourself: Even if an ARM is the perfect loan on paper, will you sleep at night knowing your rate can change?

ARM Fun Fact

Every time your interest rate adjusts your loan is re-amortized, making an ARM an interesting loan to consider if you plan on making regular extra payments toward your principal (say, from annual gifts from family or annual bonuses).

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