BASICS

Is an Adjustable-Rate Mortgage Right for You?

With fixed rates rising, ARMs offer lower monthly payments for the initial term. But know the risks. BY LAURA PETRECCA

WHEN MORTGAGE RATES were at record lows not so long ago, adjustable-rate mortgages (ARMs) were sidelined in favor of the more stable 15- and 30-year fixed-rate mortgage. But as rates rise, ARMs—which typically have lower initial rates than their fixed-rate cousins—have gained popularity.

"The rate on the fixed-rate mortgage has gone up much faster than the rate on the adjustable-rate mortgage," says Joel Kan, deputy chief economist at the Mortgage Bankers Association. Over the past year through early December, the 30-year fixed-rate loan has more than doubled, from 3.11% to 6.49%, according to Freddie Mac. Meanwhile, the average initial rate of a popular 5/1 ARM was 5.48%.

The share of home buyers applying for an ARM has almost quadrupled since the start of 2022, coming close to 11% of all applications for the week ending November 11, according to the MBA. In October, ARMs accounted for nearly 13% of mortgage applications, the highest share since March 2008.

How ARMs work. As the name implies, most ARMs adjust after the initial lower-rate period ends. Once the adjustment period kicks in, the interest rate changes occur at regular intervals, such as annually or every six months, until the end of the loan term. The new rate is based on a predetermined index and margin and, depending on market conditions, can make your monthly payment higher or lower than what you paid previously.

ARMs come in an array of mix-and-match forms, such as combining a five-, seven- or 10-year initial term with recurring six-month or one-year adjustments. For example, a 5/1 ARM maintains an initial rate for five years, then adjusts annually. Another option is a 7/6 ARM, in which the initial rate lasts for seven years, then adjusts every six months.

The naming conventions—such as 5/1 and 7/6—reflect how the mortgage is structured. The first number indicates the length of the introductory interest rate, and the second number shows how often the rate will change after that initial period.

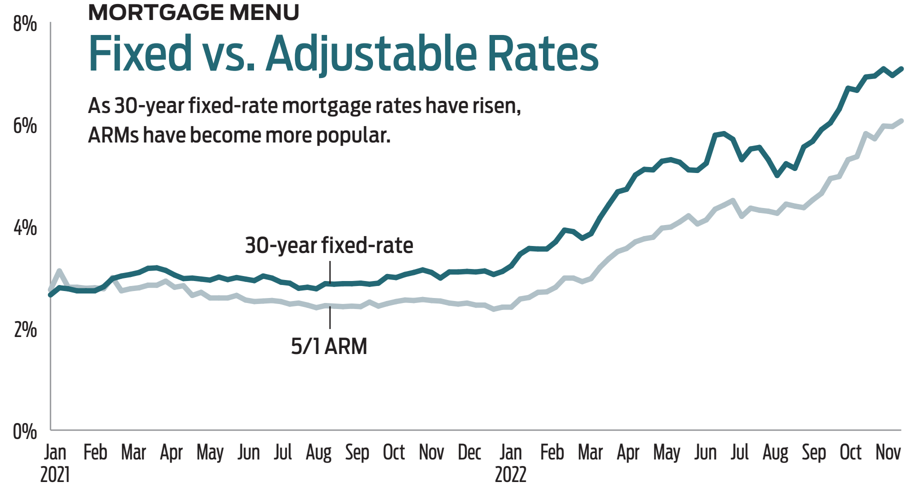
ARMs got a tarnished reputation during the housing market crash and financial crisis in 2008 and 2009, when borrowers who bought their homes with low-interest loans couldn't keep up with higher payments as rates rose. Since then, new regulations have made ARMs safer. For instance, loans with short fixed-rate periods, such as one-year ARMs, are rare (5/1 and 7/1 ARMs are the most common, according to the MBA).

Potential savings but greater risk. Although you'll know when the interest rates will adjust, the rates themselves are more unpredictable because they're based on a benchmark index, such as

MORTGAGE MENU

Fixed vs. Adjustable Rates

As 30-year fixed-rate mortgage rates have risen, ARMs have become more popular.



SOURCE: Freddie Mac

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the U.S. prime rate or the Constant Maturity Treasury (CMT). You'll pay more if the rates go up and less if the rates go down. In exchange for the lower initial rate, "you're shouldering some of the interest rate risk," says Greg McBride, chief financial analyst at Bankrate.

With a 15- or 30-year fixed-rate mortgage, in comparison, the lender bears much of the risk. If rates rise, homeowners with a fixed-rate mortgage won't have to worry about paying more.

When fixed rates were at historic lows, borrowers had little incentive to take on an ARM's extra uncertainty, which is why there was less demand for ARMs. But as fixed rates rise, borrowers are turning to ARMs to reduce their initial mortgage costs.

Although an ARM's adjustments fluctuate, you won't be completely blindsided by any potential rate increases. When applying for a mortgage, you should receive a Loan Estimate, a document that describes the terms of the loan and shows ranges for your future payments. The Consumer Financial Protection Bureau provides helpful details on what to examine in that estimate at www.consumerfinance.gov/owning-a-home/loan-estimate. The Loan Estimate will include the underlying index plus the margin added to that index.

In addition, most ARMs have rate caps: an initial cap, a periodic cap and a lifetime cap. The initial cap affects how much the rate can change when the first adjustment comes. A periodic rate cap pertains to all subsequent recurring increases during the life of the loan. The lifetime cap limits how much the rate can change throughout the entire term period.

Like an ARM's designation, rate caps are represented with numbers and slashes. For example, 5/2/5 represents a 5% initial cap, a 2% periodic cap and a 5% lifetime cap.

As you explore ARMs, be mindful that caps don't only apply to increases. They can also keep your rates from going below a certain level.

Does an ARM make sense for you? Choosing an ARM can be advantageous for someone who is making a sizable down payment and doesn't intend to stay in a home for the long run. But though you may plan to sell your home before the adjustment rate kicks in, unexpected factors could affect that decision, such as a decline in the value of your home.

Don't assume you can refinance if you end up in the home longer than expected, because there's no guarantee that rates will be lower at a future date, McBride says. If you can't afford the increased payments, you could lose your home to foreclosure. Online tools, such as Freddie Mac's calculator (http://myhome.freddiemac.com/resources/calculators/adjustable-rate-mortgages) can help you estimate how changes in interest rates will affect your monthly payments.

If you're risk-averse, plan to spend decades in the same home or have a limited, fixed income—such as in retirement—you could be better off with a fixed-rate mortgage, even if it means a higher monthly payment. Knowing that the interest rate on your mortgage will remain the same for the life of a fixed-rate loan "can provide peace of mind for budgeting purposes, as you'll know well into the future what your mortgage payment will be," says Leanna Devinney, a certified financial planner in Framingham, Mass. ■

IF YOU HAVE QUESTIONS OR COMMENTS, E-MAIL FEEDBACK@KIPLINGER.COM.