

Adjustable Rate Mortgages: How Do They Really Work?

An adjustable rate mortgage (ARM) is one that provides for the interest rate to change (adjust) at fixed intervals throughout the term of the loan. How often the interest rate can change is determined in advance, and is spelled out in the loan agreement (note). The three most typical ARM loans adjust monthly, every six months, or annually.

The Basic Features of an ARM Loan

Index: The index is the cost of the money to the lender and is what the interest rate of an ARM is based upon. There are several indices in use today: the 1-Year Treasury Bond index (which is the one most commonly used), the Six-Month Treasury Bill index, the 11th District Cost of Funds index, and the LIBOR index, among a few others. The value of the index changes at regular intervals.

Margin: This is the spread between the value of the index and the interest rate actually charged to the borrower. Essentially, it is the lender's profit margin. The margin is set at the beginning of the loan and does not change for the life of the loan.

Initial interest rate: This is the interest rate that you pay until the first adjustment. Often the initial interest rate is lower than the sum of the current index value and the margin. When this happens, it is called a "teaser rate." If the ARM loan has a teaser rate, the interest rate will almost certainly increase at the first adjustment or two.

Adjusted rate: This is the new interest rate that the borrower pays for the next adjustment period. It is calculated according to a formula that involves the index value, the margin and the adjustment cap, the terms of which are set forth at the beginning of the loan in the mortgage note. (see How the Interest Rate is Calculated at Each Adjustment Period)

Adjustment cap: The adjustment cap limits the amount the interest rate can change from one adjustment period to the next. It is set at the beginning of the loan and does not change for the life of the loan.

Adjustment period: This is the fixed interval period at which the interest rate will adjust. The payment will then change based, in part, upon the new interest rate.

Life cap: The life cap of the loan is the maximum interest rate that can ever be charged on the loan, regardless of how high the value of the index rises. The life cap is typically quoted as an interest rate; i.e. a "five percent life cap" which means the life cap is five percent over the initial interest rate.

How the Interest Rate is Adjusted at Each Adjustment Period

For this example, Bill and Sue obtained an ARM loan with the following terms:

Index:	1-Year Treasury Bond	Margin:	2.50%
Initial rate:	4.50%	Adjustment cap:	2.00%
Adjustment Period:	1 year	Life cap:	9.00%

After paying 4.50% for the first year, Bill and Sue's interest rate will be adjusted, and a new payment calculated. The lender does this by calculating two possible interest rates and giving the borrower the lower of the two:

Interest rate calculation formula #1: Interest rate calculation formula #2:

Value of index	Current interest rate
+	+
Margin	Adjustment cap
-----	-----
New interest rate	New interest rate

Based on these formulas, here's the calculation of Bill and Sue's new interest rate:

Interest rate calculation formula #1: Interest rate calculation formula #2:

4.98	4.50
+	+
2.50	2.00
-----	-----
7.48%	6.50%

Since the interest rate in calculation #2 (6.50%) is the lower of the two, it becomes Bill and Sue's new interest rate for the next year. At the end of one year, and every year thereafter for the life of the loan, the lender will do this again. Each time, the new interest rate for the next year then becomes the current interest rate that is used in calculation formula #2 at the next adjustment.

Remember: the margin and the adjustment cap remain constant throughout the life of the loan. Only the value of the index and the interest rate change.

How does the life cap come into play? In this example, if the interest rates calculated according to both formulas ever exceed 13.50%, Bill and Sue will be given an interest rate of 13.50% - the life cap of their loan.

How to double-check your lender's calculation? The values of all the commonly used indices are published in the Wall Street Journal, and can also be found online.

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