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Adjustable Rate Mortgages - The Basics

An adjustable rate mortgage (ARM) has an interest rate that fluctuates periodically. This is in contrast to a fixed rate mortgage, which always has the same interest rate.

Every ARM has basic components:

1. An index
2. A margin
3. Adjustment Period
4. An interest rate cap
5. An initial interest rate

The Index

An ARM's interest rate is tied to one of many economic indices, some examples of which are the 1-year constant maturity Treasury security, the Cost of Funds Index, or the London Interbank Offered Rate. Different indices move at different rates so know the characteristics of the index used for your ARM.

The Margin

The interest rate for your ARM will be calculated by adding a margin to the interest rate from the index. The margin is basically the markup charged by the lender that allows them to make a profit off of your loan, such as adding 2% to the index, where the 2% is the margin. The margin of your loan usually does not fluctuate.

The Adjustment Period

The Adjustment Period controls when and how often your interest rate changes. For example, if your ARM has an adjustment period of 1 year, your interest rate will be subject to change at the end of each year and your monthly mortgage payment will be recalculated to reflect this change.

The Interest Rate Cap

Interest rate caps are built into the loan to protect the borrower from drastic interest rate fluctuations. The caps limit how much the interest rate or monthly payment can change at the end of each adjustment period. An ARM can also have a cap for the life of the loan. For example, during the life of a loan, the interest rate can only be increased by 5%.

The Initial Interest Rate

The Initial Interest Rate is the interest rate that you start with at the beginning of your loan period. The length of time your loan stays at this rate is built into the loan. For example, you may stay at the initial interest rate for 1 year, 5 years, or another length of time depending on your specific mortgage. This type of ARM is generally referred to as a Hybrid ARM. The initial interest rate for an adjustable rate mortgage is generally lower than that of a fixed rate mortgage.