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Adjustable Rate Mortgages - The PROS & CONS

Now that you know what an ARM is and how it works, you may be wondering what the advantages and disadvantages are. So let's explore that issue.

Offering adjustable rates allows lenders to transfer part of the interest rate risk from themselves to the borrower. If you get a fixed rate mortgage and the interest rate then goes up, it costs the lender money. However, if you have an adjustable rate mortgage, as the interest rate goes up, so does your payment, thus compensating the lender. Adjustable rate mortgages are particularly useful when unpredictable interest rates make fixed rate loans hard to get.

One of the main advantages of an adjustable rate mortgage is that the initial interest rate is lower than that of a fixed rate mortgage. A lower rate means lower payments, which may help you qualify for a larger loan. This is an important detail if you expect your future earnings to rise. In this case, the ARM will allow you to qualify for a larger loan amount earlier rather than later.

However, this information should only be used with care. If you use an ARM to qualify for a larger loan amount than a fixed rate would allow you and the interest rate then rises drastically or your income doesn't rise, you may not be able to afford the larger monthly payments, thus causing you to default on your loan.

A situation in which an adjustable rate mortgage makes sense would be if you are only going to keep the house for a short period of time. If you are only planning to own your house for only a few years, the risk of the interest rate rising goes down. This means that you will get a better rate with an ARM, making it a good choice. However, if you plan on staying in your home for a long period of time, a fixed rate may be a better option.

The lesson here is to have a plan. Know what your goals are in purchasing a home and plan for all eventualities. Do your research when shopping for an ARM and consider the worst-case scenario.