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# Fixed vs. Adjustable Rate Mortgages

Like homes themselves, mortgages come in many sizes and types, and one of the most important decisions you face as you consider your choices is whether to take out a fixed or an adjustable rate mortgage. The type of mortgage that's right for you depends on many factors, such as your tolerance for risk and how long you expect to stay in your home.

## Fixed rate mortgages

Fixed rate mortgages are very popular with homebuyers because loan payments are predictable. As the name implies, the interest rate on a conventional fixed rate mortgage remains the same throughout the term (length) of the loan. Your monthly payment (consisting of principal and interest) remains the same as well. The entire mortgage is repaid in equal monthly installments over the term of the loan (e.g., 15, 20, 30 years).

## The good news is, you're locked in; the bad news is, you're locked in

Locking in a fixed interest rate on your mortgage has its good and bad points. If interest rates rise, yours won't; as a result, your monthly mortgage payment will always remain the same. This can be reassuring to homeowners on tight budgets or with fixed incomes. For this reason, fixed rate mortgages often appeal to individuals with a low tolerance for the risk associated with fluctuating monthly payments.

But if interest rates go down, yours won't, and your (now high) mortgage payment will remain the same. While you might be able to refinance your home, paying off the higher-rate mortgage with one that carries a lower interest rate, this isn't always possible. In addition, the interest rate might need to drop significantly to offset the expenses associated with refinancing, and you'd need to remain in your home long enough to allow the monthly savings associated with the lower rate to recoup those expenses.

One special type of fixed rate mortgage that may be available is an interest-only fixed rate mortgage. With this type of mortgage, the term of the loan is divided into two periods. During the first period (e.g., 10 years) you pay only interest and no principal so your payment is lower. During the second period (e.g., 20 years) you pay both principal and interest until the loan is paid off so your payment is higher. Because these mortgages carry certain risks, they're not right for everyone; you should be certain you can afford the higher payment you'll need to make during the second period before considering this type of fixed rate mortgage.

## Adjustable rate mortgages (ARMs)

With an ARM, also called a variable rate mortgage, your interest rate is adjusted periodically, rising or falling to keep pace with changes in market interest rate fluctuations. Since the term of your mortgage remains constant, the amount necessary to pay off your loan by the end of the term changes as your loan's interest rate changes. Thus, your monthly payment amount is recalculated with each rate adjustment.

Depending on what's specified in the mortgage contract, an ARM can be adjusted semi-annually, quarterly, or even monthly, but most are adjusted annually. The adjustments are made on the basis of a formula specified in the mortgage contract. To adjust the rate, the lender uses an index that reflects general interest rate trends, such as the one-year Treasury securities index, and adds to it a margin reflecting the lender's profit (or markup) on the money loaned to you. Thus, if the index is 3.13% and the markup is 2.25%, the ARM interest rate would be 5.38%.

What's to keep the interest rate from going through the roof--or, for that matter, from plunging through the floor? Most ARMs specify interest rate caps. The periodic adjustment cap may limit the amount of rate change, up or down, allowed at any single adjustment period. A lifetime cap may indicate that the interest rate may not go any higher--or lower--than a specified percentage over--or under--the initial interest rate.

***Caution:*** *Some ARMs cap the payment amount that you are required to make, but not the interest*

*adjustment. With these loans, it's important to note that payment caps can result in negative amortization during periods of rising interest rates. If your monthly payment would be less than the interest accrued that month, the unpaid interest would be added to your principal, and your outstanding balance would actually increase, even though you continued to make your required monthly payments.*

The initial interest rates (referred to as teaser rates) on ARMs are generally lower than the rates on fixed rate mortgages. If you can tolerate uncertainty in your mortgage interest rate and fluctuations in your monthly mortgage payment amount, believe that interest rates will stay low or go lower in the future, or plan to live in your home for only a short period of time, then you may want to consider an ARM.

## Hybrid ARMs

Hybrid ARMs are mortgage loans that offer a fixed interest rate for a certain time period (3, 5, 7, or 10 years), and then convert to a 1-year ARM.

The initial fixed interest rate on a hybrid ARM is often considerably lower than the rate on either a 15-year or 30-year fixed rate mortgage. The longer the initial fixed-rate term, however, the higher the interest rate for that term will be. Generally speaking, even the lowest of these fixed rates is higher than the initial (teaser) rate of a conventional 1-year ARM.

Hybrid ARMs are ideal for individuals who plan to stay in their homes for a short period of time (3 to 10 years), since they can take advantage of the low initial fixed interest rate without worrying about how the loan will change when it converts to an ARM. If you think your plans may change or you are planning on staying put for a while, look for a hybrid ARM with a conversion option. This option will allow you to convert your loan to a fixed rate loan before it turns into an ARM.

| Conventional fixed rate mortgage | Adjustable rate mortgage | Hybrid adjustable rate mortgage |
|---|---|---|
| • Low risk<br>• 10- to 40-year term<br>• Interest rate doesn't change during term<br>• Payment remains the same | • Higher risk<br>• Initial interest rate often lower than fixed rate mortgage<br>• Interest rate may go up or down<br>• Interest rate usually adjusted annually<br>• Rate adjustments may be limited by cap(s)<br>• Payment caps can result in negative amortization in periods of rising interest rates | • Higher risk<br>• Initial rate often lower than fixed rate mortgage<br>• Fixed term for 1 to 10 years, then becomes a 1-year ARM<br>• May have option to convert to a fixed rate mortgage before becoming a 1-year ARM<br>• Interest rate may go up or down<br>• Rate adjustments may be limited by caps<br>• Payment caps can result in negative amortization in periods of rising interest rates |

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