Adjustable vs Fixed Rate Mortgages

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Adjustable rate mortgages (ARM) used to be all the rage during the housing boom. As times changed, favor went to fixed rate mortgages with their steady interest rates across the life of the loan.

Despite the drop in popularity, home buyers can still acquire an adjustable rate mortgage from their lender. They must go into this process well informed about their options to make the best financing decision for their needs.

To help them get started, here's what home buyers need to know about adjustable versus fixed rate mortgages.

Adjustable Rate Mortgages Start with a Low Interest Rate

The most attractive thing about adjustable rate mortgages is that they start with a low interest rate.

The initial interest rate usually falls far below the market rate to entice home buyers to choose this option over a fixed rate mortgage. The low interest rate gives homebuyers an opportunity to pay down their principle before it increases. Until this brief period ends, the mortgage payment remains low as well.

After a Set Amount of Time, the Interest Rate Increases

Adjustable rate mortgages only remain at the same interest rate and payment amount for a predetermined amount of time. After that period ends, the lender can make adjustments that affect what home owners pay each month and how much goes to the principle.

Lenders offer many different adjustable mortgage products that allow for a certain number of years before changes then so many changes per year. The most popular products are 3/1,

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5/1 and 7/1 ARM loans. With these loans, home owners can expect to keep their initial rate for three, five and seven years, respectively. After that, the interest rate and other terms can change once per year.

When the interest rate changes, payments tend to increase, often substantially. Home owners can prepare for these changing rates by watching for an estimate card in the mail. This card will come from the lender and indicates what the new rate and payment amounts will be.

Even If the Interest Rate Stays the Same, Payments May Increase

Even when interest rates do not dramatically increase, home owners may still receive notice of an increase to their mortgage payments if they have an interest only ARM instead of a hybrid loan. With interest only adjustable rate mortgages, homeowners only make payments toward the interest during the initial period. As home owners start to pay off the principle in addition to the interest, these loans see an increase to the monthly mortgage payment to cover that amount.

Decreases in Interest Rates Do Not Always Result in Lower Payments

With adjustable rate mortgages, borrowers can potentially experience a decrease in interest rates applied to their loan. Although this decrease will help home owners pay less over the life of their loan, it does not guarantee a drop in monthly payment amounts. In fact, payments almost never return to their pre-adjustment range leaving home owners to budget in steadily rising mortgage costs.

To avoid these fluctuations, homebuyers can elect to go with a fixed rate mortgage instead of an adjustable loan. Mortgage lenders gauge the market to set a fair and competitive interest rate for their borrowers. They also use risk based pricing models to personalize the rate to each borrower. They use a number of factors, such as the credit score and income-to-debt ratios, to dial in the ideal interest rate.

Once they identify the custom interest rate, home buyers have a chance to review it and compare with the rate offered by other lenders. Upon taking the loan, borrowers can expect to see that same interest rate as long as they have that mortgage.

This Does Not Mean Mortgage Payments Will Not Change

More than just the interest rate affects the total monthly payments owed on the mortgage. Even with a fixed rate mortgage, borrowers can expect to see their payments change from year to year. In most cases, these payment adjustments result from a change in property taxes and home owner's insurance.

Lenders do not usually provide a significant amount of warning before these changes. Borrowers need to stay on top of their budget and allow for last minute changes to manage the fluctuations without strife.

There are Benefits to Going with an Adjustable Rate Mortgage

Although a bit more risky than fixed rate loans, adjustable rate mortgages offer benefits to savvy borrowers. Since Palmer new home borrowers take on the risk of interest rates changing over time, lenders tend to give them a much lower rate than the market value. This gives them a head start in paying down the total amount owed on the mortgage.

If they play their cards right, they can pay down an enormous portion of the principle before the rate changes. When the interest rate increases, it will only act on the remaining mortgage balance potentially keeping costs low over the life of the loan.

In the end, however, it is the fixed rate mortgage that offers the most stability. Since people cannot tell what the future will bring, fixed rate loans remain the top choice for home buyers in need of a mortgage.

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