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## Adjustable Rate Mortgages

### What is an Adjustable Rate Mortgage?

Simply put, an Adjustable Rate Mortgage, known as an ARM, is a mortgage loan whose interest rate may change in the future. This differs from a fixed rate mortgage where the interest does not change during the term of the loan. What is not so simple are the various elements that determine when, how and how much the interest rate will change.

An ARM begins with a specified interest rate, called the *Initial Rate*. At some time in the future, and at regular intervals afterwards which are known as the *Adjustment Period*, the lender determines if there is to be a change in the interest rate. To calculate the new interest rate the lender refers to the interest rate in a particular financial market, the *Index*, and then adds an additional interest, known as the *Margin*. The amount that the lender actually changes the interest rate is limited to a certain percent called a *Rate Cap*. Sound simple enough?

### Initial Rate

When you apply for an ARM the lender will offer you an interest rate at which your loan repayment will begin. The important thing to keep in mind is that this rate is likely to change during the life of the loan. When determining your ability to repay the loan you should make allowance for the possibility that the interest rate will increase.

Some loans will begin with the current “market rate”, which is typically lower than the market rate for fixed rate loans. Lenders offer these lower rates because of their ability to raise the interest rate on your loan if interest rates in general go up in the future.

Other loans will be offered with initial “teaser rates” which are below the current market rate. Although these rates provide an initial advantage to you as a borrower, remember that they are almost certain to increase at your first interest rate change.



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Your initial interest rate will be in effect for a specified period of time before the lender calculates a new rate. The length of time may vary greatly from six months to seven years or longer depending upon your agreement with your lender. As a general rule, it is not a good idea to pay points to reduce your interest rate since the reduction will only affect the initial rate. The shorter the time before the first adjustment, the less sense it makes to pay rate reduction points.

### **Adjustment Period**

The adjustment period is the length of time between interest rate recalculations. Once the initial interest rate period is over and the lender has made the first new interest rate calculation, interest rate recalculations will occur at regular periods of time for the remainder of the loan. The adjustment period may be monthly, every six months, yearly, every three years or some other period of time. The longer the adjustment period interval the less volatile your payments will be. This will provide you protection when interest rates are rising but not give you full benefit when interest rates are falling.

### **Index**

At the time that your lender recalculates your interest rate it will begin with the interest rate of a particular financial market. This may be United States Treasury Securities, the Cost of Funds Index, the London Interbank Offered Rate, or even some measure of that lender's cost of borrowing money. Each of these indexes has its own history of volatility which you should investigate before you make a decision. The performance of many of the indexes used is published in financial papers or on the internet.

### **Margin**

After selecting the interest rate from the index that the lender is using, an additional amount of interest will be added to arrive at your mortgage rate. This amount will be predetermined and will remain the same for the entire period of the loan.

### **Rate Caps**

Despite the results of the lender's interest rate recalculation, the amount that your new interest rate will differ from your previous rate will be limited by a certain percentage amount set in advance. Rate caps apply to each individual rate calculation and the maximum interest rate that may be charged for the life of the loan.

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At each adjustment period the new rate will be compared to the current rate. If the new rate is more or less than the current rate by more than the specified rate cap, your interest rate will only change by the amount of the rate cap. Sometimes, the rate caps for the first rate recalculation will be higher than the caps for the balance of the recalculations, particularly if the initial interest rate period is for an extended period. Typically, the rate cap percentage increases as the adjustment period is extended.

The maximum interest rate for your loan will be limited to the initial interest rate plus the lifetime rate cap percentage amount.

### **Is an ARM right for me?**

Like most things in life, an ARM has its advantages and disadvantages. Over the long term, adjustable rate mortgages, on average, tend to have lower rates than fixed rate mortgages. With a fixed rate mortgage the lender adds what is essentially a “risk cost” to the mortgage to guarantee your rate will not increase despite the lender’s cost of money in the future. With an ARM, you assume this risk. Depending upon the length of your loan and the interest rate environment during your loan you may pay a higher or lower rate than the fixed rate alternative. Many people prefer to pay the risk cost associated with a fixed rate mortgage in exchange for the security that the interest rate will not increase beyond their comfort level, particularly when fixed rates are low.

In the recent past, adjustable rate mortgages have received a lot of bad press, largely due to their inappropriate use to get people into loans that they were able to afford at the initial teaser rates but not at the rates to which they later adjusted. However, besides the historically lower overall rates, ARMs do offer some particular advantages. If you will only be living in your home for a short period of time or expect to be able to pay the loan early, the lower initial interest rates offered by an ARM, particularly if a teaser rate is involved, may offer an advantage over fixed rate loans. In such a case, be sure that the initial rate period is longer than you expect to own your home or have the funds to pay off the mortgage. The same advantage is available if you expect your income to increase substantially during the first years of the loan. An adjustable rate mortgage may allow you to purchase a home that you might not otherwise be able to afford and begin to build equity.

Clearly, ARMs have their place in the lending world and offer certain advantages if used carefully. To take advantage of the benefits you must be prepared to assume a certain amount of risk. As with any loan, you should shop carefully to be sure you are receiving a good value. In addition to getting your best deal on the terms of the ARM you should compare costs and be sure that you are working with a reputable lender.

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