General Mortgage Knowledge

Adjustable Rate Mortgages

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ADJUSTABLE RATE MORTGAGE

An **adjustable-rate mortgage (ARM)** is a type of mortgage in which the interest rate periodically **adjust up or down** – according to a specific index.

- Frees lender from being locked into fixed rate
- The **Index + Margin = RATE (fully indexed rate)**
- The **Index** is often referred to as the ***cost of money.*** An example of an index would be the London Interbank Offered Rate (LIBOR). Other examples include: COFI, COSI, PRIM, US Treasury, etc.
- The **Margin**, which is sometimes referred to as a *spread*, remains fixed for the life of the loan.

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The interest rate on an ARM at closing is called the **"introductory rate"** (sometimes referred to as the **"start rate"** or **"initial rate".**

- When the introductory rate is lower than the fully-indexed rate at the time of closing, it is known as a **"teaser rate"**
- The **Rate Adjustment Period** is *the length of time between interest rate changes with ARMs*.
- A rate floor is the **lowest interest rate** to which an ARM may adjust.
- **Conversion option - ** Gives the borrower the right to convert from an adjustable rate loan to a fixed rate loan.

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A **rate cap** is a limitation on the amount that an interest rate may increase or decrease at the **adjustment date** or over the **life of the loan**.

These are referred to as **"adjustment caps".** There are **two types** of rate caps on most ARM loans:

1. The **periodic cap** applies to all subsequent adjustment periods.
2. The **life cap** sets the maximum number of percentage points that the rate can increase for the life of the loan.

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Often shown as two numbers; for example, **2/6**, - For example: **CAPS = 2/6**. In this scenario:

- **2/**6 – The first number indicates the maximum amount the interest rate can increase (or potentially decrease) from one adjustment period to the next.
- 2**/6** – The second number indicates the maximum amount the interest rate can increase during the life of the loan.

If using a "teaser" rate: a rate cap described as **5/2/6**, the interest rate cannot increase more than:

- 5% first adjustment. / 2% subsequent adjustment periods. / 6% total over the life of the loan.