



Know the cost features of an adjustable rate mortgage (ARM) before they hit your pocketbook

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1) Make sure you know the principal difference between an adjustable rate mortgage (ARM) and a fixed rate loan.

The difference is that the interest rate charged on an ARM is subject to change over time. Your monthly loan payments can increase.

2) Before you apply for a loan, know what percentage your requested loan is to the value of the home you wish to purchase.

This is called the loan-to-value ratio (LTV). Value and sales price aren't necessarily the same. An appraisal is usually required to determine value. Banks lend on the basis of value not selling price (loans usually are limited to a percentage of total value). Find out what your bank's maximum LTV is before applying.

3) Understand the factors that determine your initial monthly payment.

Monthly payments will be determined by the size of your loan and the interest rate you are charged on it. The interest rate is subject to change over the life of the loan.

The **initial interest rate** and payment amount on an ARM will remain in effect for a limited period of time--ranging from just 1 month to 5 years or more. For some ARMs, the initial rate and payment can vary greatly from the rates and payments later in the loan term, even if interest rates are stable. Ask your lender or broker to quote the initial rate and payment on a loan and ask them for the annual percentage rate (APR). If the APR is significantly higher than the initial rate, then it is likely that your rate and payments will be a lot higher when the loan adjusts.

The interest rate on an ARM is made up of two parts: the index and the margin.

The **index** is a measure of interest rates generally, Your payments will be affected by any caps, or limits, on how high or low your rate can go. If the index rate moves up, so does your interest rate in most circumstances, and you will probably have to make higher monthly payments. On the other hand, if the index rate goes down, your monthly payment could go down. Lenders base ARM rates on a variety of indexes, so ask what index will be used, how it has fluctuated in the past, and where it is published

The **margin** is an extra percentage points that a lender adds to the indexed interest rate. The sum of the two is the interest rate you will pay. The amount of the margin may differ among lenders but it is usually constant over the life of the loan. Some lenders base the amount of the margin on your credit record – the better your credit, the lower the margin they add – and the lower the interest you will have to pay on your mortgage.

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4) Find out just how high your interest rate can go.

Most ARMs feature an interest-rate cap which places a limit on the amount your interest rate can increase. Interest caps come in two versions:

- (a) **Periodic adjustment caps** limit the amount the interest rate can adjust up or down from one adjustment period to the next. Some ARMs have interest-rate caps, that will hold your rate and payment below what it would have been if the change in the index rate had been fully applied. However, the increase in the interest that was not imposed because of the rate cap *might* carry over to future rate adjustments. Ask your lender if a carryover provision will apply to your loan.
- (b) **Lifetime caps** limit the interest-rate increase over the life of the loan. By law, virtually all ARMs must have a lifetime cap. If your ARM starts out with a 6% rate and the loan has a 6% lifetime cap, the maximum rate you might have to pay can never exceed 12%.

Many ARMs limit, or **cap the dollar amount your monthly payment may increase** at the time of each adjustment. However, any interest you don't pay because of this cap will be added to the balance of your loan, thus increasing the total amount you owe. (This is called **negative amortization**.)

5) Know exactly what your initial monthly payment be.

Be sure to **ask your lender to calculate** for you your monthly payment schedule reflecting your first adjustment and your monthly payment obligation after subsequent adjustments, should they occur. You want to know the maximum that your loan would cost you over its projected life. If at any point in the projection you see that your monthly payment will exceed your probably ability to make a monthly payment, that ARM is not for you. Your alternatives could be to increase your down payment (thus decreasing the amount you'd have to borrow and pay for); find a less costly property to purchase; or endeavor to secure a fixed rate loan with payments that will never change.

6) Explore these potential **downsides** with your lender:

- (a) What would happen if I am unable to make the monthly payment after an adjustment in rate?
- (b) Could the terms of this loan trigger negative amortization? How would that affect my ability to pay in the long run?
- (c) What, if any, are the prepayment penalties?
- (d) Do I have the option to convert your ARM to a fixed rate loan? Would there be a fee for this conversion? How much?

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http://www.federalreserve.gov/pubs/arms/arms_english.htm

<http://www.mtgfoundation.com/2007/05/adjustable-rate-mortgage-advice-know-the-terms.html>

<http://www.thetruthaboutmortgage.com/adjustable-rate-mortgage>

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