The Comeback of the Adjustable-Rate Mortgage

(FDIC Consumer News)

Adjustable-rate mortgages, also known as ARMs or variable-rate loans, have been out of favor with many people in recent years because of the low interest-rate environment and the perception that rising payments on ARMs contributed to foreclosures during the recent financial crisis. But with new federal disclosures and protections for consumers, some borrowers are wondering if they should consider an ARM if the initial interest rate is significantly lower than what's being offered for a 30-year fixed-rate loan. Here are ideas to keep in mind when choosing between the two types of loans.

Decide how long you plan to be in the home. In general, borrowers who are certain they will move out of a home within a few years are more likely to benefit from a low-rate ARM than those who plan to stay in the home for as many as 30 years. "Because it's difficult to predict the future, seriously consider what could happen if you agree to an ARM and then stay in the home much longer than you expected," said Luke W. Reynolds, Chief of the FDIC's Outreach and Program Development Section.

Remember that the features of adjustable-rate mortgages can differ considerably so it pays to comparison shop. For example, some ARMs may have a fixed rate for 10 years before the interest rate could "reset" (change) and do so again every year thereafter. Other ARMs may start to reset after three years. The maximum rate increases, both periodic as well as during the life of the loan, also can vary significantly between lenders and loan products. In addition, the initial rate on an ARM may be "discounted" — to make it more attractive to you — and that means your payments are very likely to increase substantially beginning with the first reset period.

Be comfortable that you'll be able to make your loan payments on an ARM if the interest rate soars to the highest level it could go while you own the home. The lender must disclose to you both the maximum interest rates and the resulting payments for an ARM within three business days of receiving your complete application.

"Factor in the possibility that your income may not increase but your property taxes and insurance likely will," said Jonathan Miller, Deputy Director in the FDIC's Division of Depositor and Consumer Protection. "And don't assume that you will have the option to refinance the loan or sell your home to escape higher payments down the road." For example, he said that given the low mortgage interest rates over the past few years it is reasonable to expect higher rates in the future, and that could mean refinancing your ARM may not significantly lower your payments.

Carefully review the disclosures from your lender and ask for help if you don't understand something. Make sure that each disclosure reflects the terms you saw advertised or the lender quoted before you applied. Also keep these disclosures and compare them to the loan agreement you receive before you go to closing. In certain circumstances, the lender must provide you with an updated copy of the disclosures three business days before you close.

If you want the stability of a fixed-rate mortgage, research cost-saving alternatives. You may have options for reducing interest costs over the life of the loan by, for example, making mortgage payments on a bi-weekly basis instead of monthly or increasing your payment a little each month.

If you plan to stay in the home for the long-term, you also could consider paying the mortgage lender some "points" at closing. Each point equals one percent of the loan amount, and it is a fee to lower the interest rate on the loan. Again, shop around to make sure you are receiving an adequate reduction in rate for each point paid.