

Adjustable-Rate Mortgage vs. Fixed-Rate Mortgage

Along with other decisions you will find yourself making while shopping for a mortgage, you will be deciding whether to take a fixed-rate mortgage (FRM) or an adjustable rate mortgage (ARM).

As the name implies, the interest-rate of a fixed rate mortgage will remain the same throughout the life of the loan. If interest rates are low when you are buying or refinancing a home, a fixed rate mortgage is a good choice, because you can lock in that low interest rate. Adjustable rate mortgages, however, will fluctuate as interest rates rise and fall. Your 6 percent rate today could drop to 5 percent next year or end up at 8 percent if the market rate goes up.

Exactly when the rate of your Adjustable Rate Mortgage loan will change depends upon the terms of your loan agreement, which could see rates change every three months, once a year, every three years, or not until five years. It's not uncommon to find Adjustable Rate Mortgages that start at a fixed rate and convert to an adjustable rate after several years.

Adjustable Rate Mortgages also generally come with a "cap," which limits the amount a lender can raise its rate. The cap for most Adjustable Rate Mortgages is 2 percent, meaning a lender can only increase its rate 2 percent within a single adjustment period. But several adjustments can turn a 4 percent interest rate at the beginning of the loan into a 10 percent interest rate later on.

As you might imagine, Fixed Rate Mortgages are more popular. Most home buyers want the security of knowing how much their mortgage paying will be each month. A Fixed Rate Mortgage will allow you to more easily manage your monthly and yearly budget. If you have an Fixed Rate Mortgage and rates do drop precipitously, you can always refinance.

On the other hand, some homebuyers are drawn to Adjustable Rate Mortgages, which often feature lower initial interest rates. For example, an Adjustable Rate Mortgage can be a good choice for a young couple purchasing their first home; they may not have a lot of assets now, but they anticipate making more money within a few years. An Adjustable Rate Mortgage can let them take advantage of low rates now, and they will be able to afford a slighter higher rate in the future. And in a few years, they can refinance with an Fixed Rate Mortgage to lock in a favorable rate.

Which type of mortgage is right for you? Basically, it comes down to two factors:

1. How comfortable you are with risk
2. How long you plan to live in the house

Clearly Adjustable Rate Mortgages are riskier than Fixed Rate Mortgages. But taking on more risk may result in a lower rate -- at least temporarily. But if you plan on staying in the house for a long time, an Adjustable Rate Mortgage can be particularly risky -- and potentially confusing -- since rates will fluctuate many times over and there will be more adjustments. Conversely, if you plan to move after five or six years, you could take a 5/1 Adjustable Rate Mortgage, meaning the first five years are locked in (at a low rate) and it converts to an adjustable rate after that -- right about the time you plan to sell.