

**LendingTree**<sup>®</sup>  
WHEN BANKS COMPETE, YOU WIN.<sup>®</sup>

Guide to:

## **Adjustable Rate Mortgages**

How to shop for and compare adjustable rate mortgages



## Take Control of Your Mortgage and Save Money



Our free guide will help you:

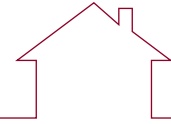
- Calculate your payments
- Compare your loan options
- Know what questions to ask your lender

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The LendingTree Knowledge Center offers a range of articles about mortgages and home equity loans and can help you decide which type of loan best meets your needs.

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In recent years, more and more homeowners have begun to pass over the traditional fixed rate mortgage in favor of a newer variation, the adjustable rate mortgage (ARM). These mortgages work differently from a fixed rate mortgage in that their interest rate can rise or fall over the life of the loan. That means you could pay less money in the long run, but you could also end up paying more.

ARMs offer a low initial interest rate that may help you to qualify for financing, buy a bigger house, or obtain more money for expenses and other investments. But taking out a large ARM without measuring the risks can leave you with a monthly payment that's too big to handle if rates rise sharply.

While all ARMs work on the same principle, not all ARMs are created equal. There are different types of ARMs, with different features that can affect the way they work and the interest rate you pay. So it's important to look carefully at what you're being offered.

## HOW DO ARMS WORK?

With a fixed rate mortgage, the interest rate and your payments stay the same throughout the life of the loan. However, with an adjustable rate mortgage, the interest rate changes periodically – typically once a year. This interval between potential rate changes is called the adjustment period. The rate is usually set in relation to an *index*; your payments go up or down according to changes in the index rate.

For example, suppose you are going to take out a \$100,000 mortgage. Your lender offers you a 30-year fixed rate mortgage at 6 percent, or a one-year ARM at 4.25 percent. After that first year, however, the rate on the conventional 30-year mortgage remains 6 percent, while the rate on the ARM is adjusted to match the current index rate. If that rate has gone up one percent, you'd now be paying 5.25 percent. If it's fallen one percent, you'd be paying 3.25 percent.

So, in exchange for a lower initial rate, you give up the security of knowing what interest rate you'll pay from year to year, and what your monthly payment will be. You get the potential for lower payments if interest rates fall while you hold the mortgage. But you also face the possibility of paying more if interest rates rise.

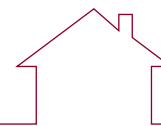
## IS AN ARM RIGHT FOR YOU?

To help determine if an ARM is the right mortgage for you, ask yourself the following questions:

- Are interest rates likely to go down during the time you hold the mortgage, or are they more likely to trend upward, exposing you to higher payments?

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- Is your income likely to increase enough to cover higher mortgage payments if interest rates go up?
- Will you be taking on other sizable expenses such as a car loan or school tuition payments in the near future?
- Are you comfortable with the uncertainty of not knowing what your mortgage payment will be in years to come?

**Pros**

Lower initial interest rates.

If interest rates remain steady or decrease, could be less expensive over time.

**Cons**

You assume risk of future rate increases.

If interest rates increase, you'll be faced with higher monthly payments in the future.

**The effect of interest rates**

In general, ARMs are the best choice when interest rates are falling, since your payments will decrease, too. However, some people choose an ARM even when rates are rising. This is because the initial interest rate on an ARM can be as much as two percent below that of a 30-year fixed rate mortgage (although the gap has narrowed recently). That means you'll pay less each month until mortgage rates have increased enough to match the rate on a fixed-interest mortgage.

One key consideration is how long you plan to stay in your home. If you plan to move in one to three years, an ARM might be the right choice since there's less chance interest rates will increase significantly in that time. The longer you hold your mortgage, the greater your chance of paying a higher rate.

**DIFFERENT TYPES OF ARMS**

There are many different types of ARMs, offering a variety of terms and ways to structure your payments. To choose the one that's right for you, it's important to understand their differences.

**Hybrid ARMs**

A hybrid mortgage combines the features of a conventional mortgage and an ARM. It starts off like a fixed rate mortgage, with a stable interest rate for a few years. But then it converts to an ARM, with the rate adjusted every year for the remaining life of the loan.

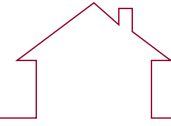
Hybrids are growing in popularity and have become almost as popular as traditional ARMS. They are referred to as 3/1, 5/1, 7/1 and so on. The first number is the length of the fixed term – usually three, five, seven or ten years. The second is the *adjustment interval* that applies when the fixed term is over. So with a 7/1 hybrid, you pay a fixed rate of interest for seven years; after that, the interest rate will change annually.

A hybrid has an initial payment that is lower than a fixed rate loan, but slightly higher than a regular ARM. As a rule of thumb, the rate of a 5/1 hybrid is about one percent below that of a 30-year fixed rate mortgage. And you get more peace of mind than with a regular ARM, since your monthly payment is consistent for the first three or more years.

A hybrid can be a good choice if you plan to sell your house or refinance after five to seven years. That way, you can get a low rate without risking increased payments once the initial fixed rate period is over. If you stay in the house after the first adjustment period, however, your interest rate – and payment – could increase.

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## Some lenders also offer variations on the hybrid ARM:

- The short-term hybrid has a much shorter fixed rate period than a normal hybrid – say, six months or a year. It typically has a very low initial rate. However, it leaves you vulnerable to rising rates after a very short time. It's best for those intending to sell in a few months.
- The interest-only hybrid offers an initial period of three, five, seven or ten years during which you pay only the interest on the mortgage. After that, your rate is adjusted yearly. You get a very low payment during the fixed-interest period, but build no equity. Also, once the interest-only period ends, your payments will increase to include both principal and interest.

## Option ARMs

An option ARM – also called a flex ARM or pick-a-payment loan – allows you to vary your payment depending on your cash flow. Each month, the lender sends you a statement with up to four payment options to choose from. Some common options:

- Minimum payment: This is calculated using an "initial rate" that can start as low as 1.25 percent. With this option, your first payments do not cover the full interest cost of the loan, and any unpaid interest gets deferred, or added to the principal of the loan.
- Interest only: You pay all the interest due, but none of the principal, so your mortgage balance stays the same and you are not building equity.
- 30-year amortized: This matches the monthly payment of a mortgage amortized over 30 years at your current interest rate.

- 15-year amortized: The same as above, but amortized over 15 years. This is the highest monthly payment and allows you to reduce your principal the fastest.

An option ARM's low initial rate may last only a short period, so remember that your minimum payment could rise quickly. In addition, every five years a new amortization schedule is drawn up, which can push the minimum payment even higher. And, if you defer too much interest, you can reach *negative amortization* – that is, you could end up owing more than you originally borrowed. In some cases, your loan can be recast and your payments recalculated to ensure that the interest and principal of your loan is repaid according to the original schedule. The new minimum payment becomes the amount required to fully amortize the loan over the remaining term.

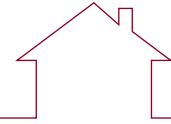
An option ARM can be a good choice if your income fluctuates – for example, if you get much of your pay from commissions. You can choose a low payment some months and a larger one to “catch up” when you have more cash on hand.

## Negative amortization ARMs

These ARMs offer a payment that is less than required to pay the interest due each month. These low payments last for a specified period, often a year. But at the end of the period, you actually owe more on your house than you did at the beginning, and you will be paying interest on this increased amount until you retire your mortgage. These mortgages may be worthwhile if your income is temporarily reduced, or if you will own the house for only a short time during a period of rising real estate prices.

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## THINGS TO LOOK FOR

Aside from the various types of ARMs, there are other differences that can affect how the mortgage works and how much you end up paying. Here are some things to look for.

### The index

The interest rate for an ARM is based on an index, such as the average yield of Treasury Securities or the Certificate of Deposit Index (CODI). When this rate goes up or down, so will your mortgage rate. For example, if your mortgage is linked to the average Treasury yield, and the index rises from 2.5 to 3 percent, your mortgage rate will also rise half a percent. If it falls to 2 percent, your mortgage rate will fall half a percent. Some indexes fluctuate more than others, and that affects how much your payments will change.

### The margin

Your lender will add a couple of percentage points, called the *margin* or spread, to the index rate to get the total interest rate you'll pay. For example, if the index rate is 2.5 percent and he adds a 2 percent margin, your final mortgage rate will be 4.5 percent. The total rate including both the margin and the index is called the fully indexed rate. Margins can differ between lenders, however, they usually stay the same throughout the life of the loan.

### Caps

By law, ARMs must have a maximum, overall *cap* on how much the interest rate can increase over the life of the loan. Some also offer a periodic cap, which limits how much your rate can increase in each adjustment period – say 2 percent. For example, if the index rate to which your mortgage is linked rises from 2.5 to 5.5 percent during an adjustment

period, your mortgage rate would normally rise from 4.5 to 7.5 percent. However, a 2 percent cap would limit the increase to 6.5 percent. This protects you from large increases in your payment. If the cap holds your rate below the real index rate, however, you might be hit with an increase at the next adjustment date as it “catches up,” even if the prevailing rate stays the same or falls.

Some ARMs have a payment cap rather than an interest rate cap. This limits how much your payment can rise at each adjustment; for example, with a 7.5 percent payment cap, your \$500 payment could only rise a maximum of \$37.50 to \$537.50 at the next adjustment date, and \$40.31 to \$577.81 at the following one. However, if this keeps your payments too low to cover all the interest due, you could end up with negative amortization.

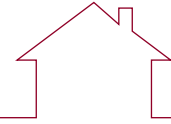
### Points

Often you can buy extra points, or discount points, to get a lower mortgage rate. One discount point costs one percent of the mortgage amount, and generally lowers your interest rate by .25 percent. As a general rule, dividing the cost of the points by the savings to your monthly payment will tell you the number of months you need to stay in your house to recoup the cost of the points.

For example, on a \$100,000 mortgage at 7 percent interest for 30 years, your payments would be roughly \$665 per month. If you were to pay two points (\$2,000) to reduce the interest rate to 6.5 percent, your monthly payment would be reduced to \$632 per month (a savings of \$33 per month). Dividing \$2,000 by \$33 equals 60.6. So you would need to stay in your house 60.6 months in order for it to be worth it to buy two points.

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## Prepayment

Some ARMs allow you to pay off some or all of the principal before maturity. However, there may be a penalty that can offset the savings you achieve.

## Convertibility

The lender may also offer the option of converting your ARM to a fixed-interest mortgage if interest rates start to rise. This offers some security, but you may pay a higher initial rate or a special fee when you convert.

## Frequent payments

Some ARMs allow you to make more frequent payments – for example, biweekly – in order to pay off the principal more quickly. This can be worthwhile if you have sufficient cash flow and intend to stay in the house for a long time.

## PROTECT YOURSELF

While most lenders are honest, it pays to be careful when considering a mortgage offer. LendingTree lenders are screened before joining our Network. In addition, you can research a lender's service using the [Lender Scorecard](#) under the LendingTree Advantage on LendingTree.com.

Some lenders, however, use unscrupulous methods to persuade you to pay more for a mortgage than you need to. This is called predatory lending, and it often targets people with a lower credit rating. Here are some things to beware of.

**Pressure tactics:** Some lenders may try to pressure you into signing a high-cost mortgage without checking the details or looking at other offers. Always take the time to compare mortgage offers, or check with an advisor.

**“Teaser” rates:** Lenders may offer an initial rate that is below the real index rate. It may look good, but your payments can rise significantly at the first adjustment date when you have to pay the real index rate. Always understand what your index rate is, so you know whether the rate you're offered is too good to be true.

**Steering:** Some predatory lenders use “bait-and-switch” tactics to steer you into a higher-rate loan when you could qualify for a lower-interest one.

**Excessive fees:** Typically, loan fees on a competitive mortgage are about one percent of the mortgage amount. However, some lenders charge excessive fees that can total five percent or more.

**Unnecessary insurance:** Predatory lenders sometimes require that you take a single-premium credit life insurance policy as a condition of getting the mortgage. This is usually unnecessary and just adds to your costs.

**High prepayment penalties:** These are sometimes used to prevent borrowers from refinancing out of a bad mortgage deal. Prepayment penalties generally shouldn't last more than three years or cost more than six months' interest.

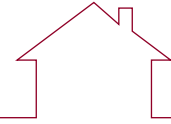
**Loan “flipping”:** The lender urges you to refinance your mortgage without benefit to you, in order to generate fees.

**Misleading information:** Some lenders may hide the fact that the mortgage is adjustable rate. Insist on getting all the information on the loan you're considering.

**Balloon payments:** These are large payments that are due when the mortgage matures. Lenders may hide this feature to make a low monthly payment

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look like a great deal, or offer to refinance the unpaid debt at a high interest rate when the balloon payment comes due.

## HOW TO COMPARE MORTGAGES

How do you determine which is the right mortgage for you? The best way is to look at all the features of the mortgage, not just the posted interest rate. The attached worksheet can help you compare two or more mortgages to see which really offers the best terms.

The first thing to consider is the type of mortgage: simple ARM, hybrid (for example, a 5/1 term), or fixed rate. Next, note the interest rate, and the date; it's best to get all your offers on the same day, since rates can change. Then, check the amortization period. Find out which index is used to set the rate for each mortgage, and how much it changes from year to year, as well as the margin added to the index rate to get the actual rate you'll pay. Is the quoted rate discounted? If so, how long does the discount last?

Next, look at the fees. The worksheet shows a number of common closing costs. If one lender is adding more or higher fees, this can raise the overall cost of that mortgage. These fees may be expressed as points – one point is typical. Are you paying any extra points to reduce the rate further?

Adding the interest rate, margin, points and extra fees produces the *annual percentage rate* (APR) that shows the overall long-term cost of the mortgage. The lender is legally obliged to tell you the APR, and it's a good way to compare mortgages.

(However, don't consider this as the final word: the APR assumes you'll hold the mortgage for the entire term. If you sell in less than 10 years, the lowest APR may not be the best deal.) Also, find out your initial monthly payment.

Next, check if there is a lifetime or a periodic cap on the interest rate, or a payment cap. If so, what is the maximum payment you could face? Will you incur negative amortization if rates rise quickly? And is the mortgage set up so that you could face a large "balloon payment" at the end of the term?

Also, does the mortgage allow you to pay off the principal at any time, or to make extra payments to reduce the principal? Can you convert to a fixed rate mortgage if interest rates go up? Check if these privileges carry penalties, either up front or when you complete the transaction. (If possible, try to negotiate for no penalty.)

Finally, use the [Calculators](#) in the LendingTree Consumer Education Center to see what would happen to your payment if the interest rate were to go up 2 percent at the first adjustment date, and if it were to go down 2 percent. This will help you determine whether you could afford the mortgage if circumstances were to change.

WORKSHEET 1:

# Compare Your Mortgage Options



Description	Mortgage 1	Mortgage 2	Fixed rate mortgage
Type of mortgage			
Adjustment period			
Interest rate			
Date quoted			
Index based on			
Margin added			
Initial monthly payment			
Discount from basic rate			
Discount period			
Annual percentage rate			
<b>Fees</b>			
Application/origination fee			
Credit report fee			
Lender's attorney fee			
Document preparation fee			
Transfer taxes			
Appraisal fee			
Survey fee			
Title search/insurance			
Life insurance required (y/n)			
Other fees			
Discount points			
Total fees			

WORKSHEET 1:

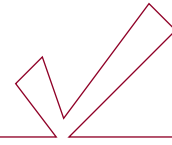
# Compare Your Mortgage Options



Description	Mortgage 1	Mortgage 2	Fixed rate mortgage
<b>Caps</b>			
Lifetime rate cap			
Periodic rate cap			
Payment cap			
Maximum possible payment			
Negative amortization (y/n)			
<b>Prepayment</b>			
Prepayment allowed (y/n)			
Penalty			
Duration of penalty			
Extra payments allowed (y/n)			
<b>Conversion to fixed-interest</b>			
Conversion allowed (y/n)			
When allowed			
Penalty			
<b>Payments (ask your lender to calculate)</b>			
Initial monthly payment			
<b>Payment at first adjustment date</b>			
If rates fall 2 percent			
If rates rise 2 percent			
<b>Payment at second adjustment date</b>			
If rates fall 2 percent			
If rates rise 2 percent			

WORKSHEET 2:

# What to Ask Your Lender



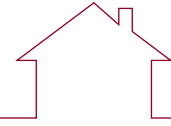
It's important to get all the facts when you are considering an ARM. Have this worksheet with you when you talk to prospective lenders and use it to help you compare their offers.

	Offer 1	Offer 2	Offer 3	Offer 4
Is this the lowest interest rate I can get with my credit rating?				
What index is used to set the interest rate? How has it fluctuated in recent years, and where can I check it?				
What margin do you add to the index rate?				
Must I buy points to get the advertised interest rate?				
What other fees will I pay?				
Am I obliged to buy mortgage insurance? If so, why?				
What is the annual percentage rate (APR), including interest, points, origination fee, mortgage insurance, and any other fees?				
How long will the initial interest rate be in effect?				
What rate will I pay if interest rates go up 2 percent?				
Can I pay down this mortgage before maturity? If so, is there a penalty?				
Can I convert to a fixed rate mortgage? Is there a fee for doing this?				
What legal action can I take if I find the mortgage is abusive?				

Remember, the Federal Truth in Lending Act obliges your lender to give you a written summary of the mortgage offer containing the finance charge, APR and payment terms. This can help you understand what you're being offered.

## Glossary

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**Adjustment interval:** On an adjustable rate mortgage, the time between changes in the interest rate and/or monthly payment, usually one, three or five years.

**Annual percentage rate (APR):** The annual cost of a loan to a borrower. Like an interest rate, the APR is expressed as a percentage of the loan amount. Unlike an interest rate, however, it includes other charges or fees to reflect the total cost of the loan. The Federal Truth in Lending Act requires that every consumer loan agreement disclose the APR in large, bold print. Since all lenders must follow the same rules to ensure the accuracy of the APR, borrowers can use the APR as a good basis for comparing the cost of loans.

**Cap:** Consumer safeguards that limit the amount the interest rate may change per year and/or over the life of a loan. Payment caps limit the amount monthly payments on an ARM may change.

**Conversion option:** An option allowing you to convert an ARM to a fixed rate mortgage. You will likely pay a higher rate or more points to have this option.

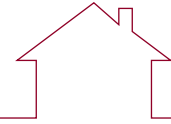
**Index:** A published interest rate against which lenders measure the difference between the current interest rate on an adjustable rate mortgage and that earned by other investments (such as one-, three-, and five-year U.S. Treasury Security yields, the monthly average interest rate on loans closed by savings and loan institutions, and the monthly average Costs-of-Funds incurred by savings and loans). This is used to adjust the interest rate on the mortgage up or down.

**Margin:** The amount a lender adds to the index on an adjustable rate mortgage to establish the adjusted interest rate.

**Negative amortization:** Occurs when your monthly payments are not large enough to pay all the interest due on the loan. This unpaid interest is added to the unpaid balance of the loan. The danger of negative amortization is that the buyer ends up owing more than the original amount of the loan.

**Points:** A borrower may lower the interest rate on a loan at closing by buying points. Each point is equal to 1 percent of the loan amount – for example, two points on a \$100,000 mortgage would cost \$2,000. Also referred to as discount points.

# The LendingTree Advantage



Thanks for trusting LendingTree to help you refinance your home. We put you in control of your loan by asking Lenders to compete for your business.

Why is LendingTree better? It's simple: **LendingTree Lenders beat the national average on mortgage rates.\*** Comparing real loan offers from different lenders just makes sense. Just like you comparison shop for other large purchases, smart consumers know a mortgage is no different. Except at LendingTree, we do all the work, and you reap the benefits with a more competitive rate.

## **Our Lender Network**

Our Lender Network currently has more than 200 Lenders, most of them LendingTree Certified. All our Lenders have passed a rigorous selection process, including a review of financial condition and reputation. Some are household names, while others are smaller, with regional, product or customer segment specialties that may make them ideal for you. Rest assured – every Lender competing for your business is capable of delivering your loan, usually with more service and attention than you'll find anywhere else.

We carefully built the LendingTree Network to help you have a better loan experience. That's why we monitor customer service constantly, and add new Lenders to our Network as they meet our level of excellence. When a Lender joins our Network, we train them on the LendingTree philosophy, your expectations as a borrower, and we monitor their performance to make sure they're delivering on their promises. Our Lenders know they compete for your business, so they strive to deliver excellent service as well as a great value. In fact, you can see how real-life customers rate each Lender by viewing our [Lender Scorecard](#) at LendingTree.com.

## **You're in control**

Remember, with LendingTree you're in control of the loan process. So if you want a product other than what our Lenders present, call them so they can work to find the loan that's right for you. These Lenders are working for you, and they really *are* competing for your business.

## **We're here for you!**

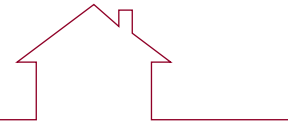
If you need help or have questions, please contact us. Our Customer Care Consultants will help you understand your options, and help you select the best loan for you. At any stage of the loan process, you can email [customercare@lendingtree.com](mailto:customercare@lendingtree.com), or call us at 1-888-272-1355.

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\*Based on an APR comparison of offers made by lenders to LendingTree consumers and the Freddie Mac Primary Mortgage Market Survey for the 30 year fixed rate mortgage for the period January 1, 2005 through January 31, 2005. This is not a guarantee that any consumer will qualify for a loan or receive a particular rate, which will be determined independently by each lender considering your loan request. LendingTree, LLC is not the Lender in any transaction and rates and terms are the responsibility of the participating Lenders. Rates and terms offered by LendingTree Lenders may vary depending on your credit history and other qualifications, amount of equity in the property, location, and type of property, and other factors.

# Additional Resources

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## **WHERE TO LEARN MORE**

[www.LendingTree.com/cec](http://www.LendingTree.com/cec)

The LendingTree Consumer Education Center offers a range of articles about mortgages and refinancing and can help you decide which type of loan best meets your needs.

### **Additional sources of information:**

The Federal Reserve Board:

[www.federalreserve.gov/consumers.htm](http://www.federalreserve.gov/consumers.htm)

Fannie Mae Foundation:

[www.homebuyingguide.org](http://www.homebuyingguide.org)

Freddie Mac:

[www.freddiemac.com](http://www.freddiemac.com)

Federal Citizen Information Center:

[www.pueblo.gsa.gov](http://www.pueblo.gsa.gov)

Department of Housing and Urban Development:

[www.hud.gov](http://www.hud.gov)

Center for Responsible Lending:

[www.responsiblelending.org](http://www.responsiblelending.org)