

# FIXED-RATE *vs.* ADJUSTABLE-RATE Mortgages



## ▶ WHAT IS A FIXED-RATE MORTGAGE?

- A fixed-rate mortgage is a type of mortgage that offers consistent monthly payments and interest rates.
- The most common term lengths are 30, 20 or 15 years.
- Fixed-rate mortgages typically start with a higher interest rate than adjustable-rate mortgages, but the interest rate on the loan remains consistent for the length of the loan, even if interest rates rise.

## ▶ WHAT IS AN ADJUSTABLE-RATE MORTGAGE (ARM)?

- An ARM is a type of mortgage where the interest rate is fixed for a specified period of time, usually ranging from 1 month to 10 years.
- The most common types of ARMs are 3/1, 5/1, 7/1, and 10/1. In these mortgages, the interest rate is fixed for three, five, seven, or 10 years, respectively.
- ARMs typically start with a lower interest rate than fixed rate loans, but the rate will adjust either up or down (depending on how the index has moved) once the fixed-rate period expires.
- Interest-only ARMs allow the borrower to pay just the interest for a specified number of years. After this initial period, the payment will adjust to include both principal and interest.

## ▶ IMPORTANT ARM TERMS:

- Index is the measure of interest rates; as an index increases, rates can increase and cause higher monthly payments. The most commonly used index is the London Interbank Offered Rates (LIBOR).
- Margins are percentage points that are added to the index rate and are constant over the life of the loan.
- Fully indexed rate is the margin + the index. For example: if the index is 3.5% and the margin is 2.25%, then the fully indexed rate is 5.75%.
- An interest rate cap limits the amount the interest rate can adjust either up or down from one adjustment period to the next.
- A lifetime cap limits the interest rate increase over the life of the loan and protects the borrower against a large increase.



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