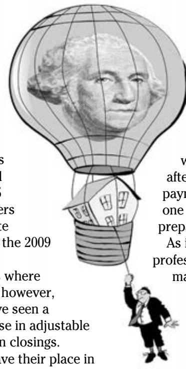
FINANCIAL

Determining if an adjustable rate mortgage is right for you

By Shari Biediger



There was a time when adjustable rate mortgages were the answer for many homebuyers to rising rates and costs. Almost 1.95 million homeowners had adjustable rate mortgages during the 2009 U.S. Census.

With fixed rates where they stand today, however, lenders say they've seen a significant decrease in adjustable rate mortgage loan closings.

And yet they have their place in today's home-loan market.

"Recently, I had a young, professional couple buying their first home. Both were in fields that would yield significant pay increases in the future," says Scott Cummins, production manager and senior loan officer at Cornerstone Home Lending. "An adjustable rate mortgage made sense as they could apply additional payments early on to student loans and then aggressively pay down the mortgage as their income rose."

He adds that they had done their homework and had a plan – key for anyone who thinks an adjustable rate mortgage (ARM) might work for them.

"If you understand how your ARM works, you can prepare and anticipate those changes," explains Cummins. "The rate is calculated by taking the base rate or Indexed Rate (LIBOR, COFI, Treasury) and adding the markup or margin."

For instance, if your Index is LIBOR and the current rate is 1.50 percent, then you would add your margin – let's say 2.25 percent. Your new effective rate would be 3.375 percent.

If you are on a 5/1 ARM, then your rate will adjust once per year after the fifth year, making payment number 61 the one you would want to be prepared for.

As in the case of the young professional couple, ARMs make sense for consumers with changing income, such as physicians, attorneys and accountants. They opt for a lower house payment early on, through the ARM, knowing they can pay the loan down as their career progresses and income goes up.

But an ARM also works well for buyers who expect significant pay increases in the future or who know they will own the home for less than five years, such as military or people who relocate for work often.

Despite the large military presence in San Antonio, however, ARMs are not as popular as in other places, according to Cummins. "With a lower cost of living and average home price point, the payment associated with the average-priced home is well within the purchasing power of the median household family income.

"In addition, the local market has a high level of military influx, making the fixed-rate VA product very attractive."

No matter where you buy, adjustable rate mortgages aren't what they used to be thanks to Dodd-Frank regulations meant to protect consumers. Gone are interest-only mortgages and short-term ARMs, such as six-month, one-year and three-year terms. Gone are negative amortizing and balloon mortgages.

Also, with the recent quantitative easing from the Federal Reserve, and their purchase of mortgage backed securities, the spread between a 30- or 15-year fixed rate and a 5-year adjustable mortgage is just not high enough to attract most borrowers, says Cummins.

"With the overall feeling that rates will rise in the future, most are opting for a fixed rate with the safety of a static payment, over the risk of higher payments down the road," he said.

Last year, he met a visiting retired couple on a fixed income who was so worried about an impending rate increase on their adjustable rate mortgage they spent the days leading up to their daughter's wedding here "lugging around their loan papers" to discuss with Cummins.

"It turned out that they had plenty of room in their household budget for a rate increase. But, more importantly, they learned that their ARM would actually adjust down," he says.

"Once the color returned their faces, I sent them on their way to enjoy the big day."

For more information about adjustable rate mortgages, talk to a financial planner or visit www.federalreserve.org.

Bankrate offers an Adjustable Rate Mortgages chart at http://www.bankrate.com/calculators/mortgages/adjustable-rate-mortgage-arm-calculator.aspx