Title:
Adjustable Rate Mortgages - How they work

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Summary:
Many homebuyers choose adjustable rate mortgages for the initial financing on their home purchase. Rising interest rates and other terms can be confusing to the borrower.

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Article Body:
Many homebuyers choose adjustable rate mortgages for the initial financing on their home purchase. Rising interest rates and other terms can be confusing to the borrower.

Adjustable rate mortgages (ARMs) are loans in which the rate varies. Adjustable rate mortgages loans will follow how interest rates rise and fall. There are many reasons why a consumer might choose an ARM, but they can be risky loans. One reason a consumer might choose an adjustable rate mortgage is the rates are generally lower in the beginning than a fixed rate loan. If you expect to be in your property for a short time, say for 5 years, then an ARM with the first 5 years fixed can be a good choice.

There are three main types of ARM loans offered by lenders. They include:
A 5/1 ARM loan is where the payment is fixed for 5 years adjusting for the remaining 25 years.
When you get a 3/1 loans payments are fixed for three years and adjust for 27 years.
The 2/1 ARM is fixed for two years and adjustable for 28 years.

An adjustable rate mortgage works like this. It is usually fixed for a certain amount of time initially, anywhere from 1 month, 5 years or something in between. After this period the loan then becomes adjustable according to the published “index”, such as LIBOR Prime rate, Cost of Funds Index, or other index plus a margin, which is the lender profit. If the index rises, your rate rises. If it lowers, your rates should fall. There is a lifetime cap on the amount interest can increase over the life of the loan.

What happens when there is a sudden higher mortgage rate?
You have some options when it comes to dealing with higher rates.

The most common is to refinance to a mixed rate mortgage. If you have enough equity built up and can afford the higher payments this is a good option. Watch out for prepayment penalties in your current mortgage. Be sure to know what the costs of refinancing are and how they will affect your loan.

Another option is the talk to a reputable credit counselor. They may be able to help you lower your payments, deferring the unpaid interest. This will increase your loan balance though. On other debts try to work out a lower payment plan to offset the higher mortgage payment. Or persuade your lender to agree to forbearance or have them postpone the increase to a future time when you will be able to pay.

You can also sell your home. List it with a real estate agent if you have the equity to pay commissions and costs of the sale. Or sell it yourself. Deed your house to the lender in a deed-in-lieu-of-foreclosure agreement. You will receive no money for your equity and your credit will be adversely affected.

Of course foreclosure is an option, but it’s not desirable. The worst thing to do is to do nothing.
When choosing an adjustable rate mortgage, be aware that rates could increase over the life of your loan. Your payments can rise and you may need to make adjustments in your other debt. If you plan on living in the home for only a short time, an ARM might be the best option in financing your new home.