ARMs Making a Comeback

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During the financial crisis and subprime mortgage meltdown, adjustable-rate mortgages (ARMs) earned a reputation as a dubious way for prospective homebuyers to finance the purchase of a home. Yet just a few years after the meltdown, a new breed of conservative, "no gimmick" ARMs are starting to make a comeback in popularity.

New ARM products making the most inroads with consumers are the "5/1" and "7/1" varieties in which the interest rate is fixed for the first five or seven years and then adjusts up annually toward a maximum rate, which is reported to cap at about 6% above the initial rate.[1]

Mortgage rates in general are at historic lows and a historic glut of homes has made it a buyer's market. According to Moody's Analytics, buying a home is cheaper than renting in a number of major metropolitan areas, including Chicago, Cleveland, Detroit, and Orlando.

Comparison Shop

When weighing a fixed-rate vs. a variable-rate mortgage, consider your financial situation, priorities, and longer-term outlook.

With a fixed-rate mortgage, the interest rate on your debt stays the same over the life of the loan. Generally speaking, the shorter the term of a fixed-rate mortgage, the lower the interest rate will be. But shorter terms also increase monthly payments.

Fixed-rate mortgages often attract buyers who value stability and who plan to stay in their homes for many years. One major drawback: the risk that interest rates could decline over the term of the loan. In that scenario, a homeowner could end up paying an interest rate that exceeds the market average. However, if your credit history is sound and you have sufficient income, you may be able to refinance your mortgage if rates decline.

As for ARMs, many home buyers are attracted by their affordability, particularly during the initial period of the loan. If you plan to stay in a home for a relatively short time -- say, no more than three years -- you might want to consider an adjustable-rate mortgage.

However, since rates on ARMs reset and are subject to increases, you should ensure that your future income will be sufficient if interest rates (and your monthly payments) go up. In the past, some homeowners started with variable-rate mortgages in the belief that they could refinance to a fixed rate when the mortgage rate was due to increase. Keep in mind that in certain circumstances, market conditions may limit the ability to refinance.

[1]Source: *The New York Times*, "More Borrowers Are Opting for Adjustable-Rate Mortgages," March 17, 2011.

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