

Important Facts About Adjustable Rate Mortgages with a Reduced Initial Interest Rate

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an adjustable rate mortgage (ARM) is right for you. ARMs can be complicated, and it is important for you to understand the features and risks of these loans. **If you do not understand how ARMs work, you should not sign any ARM loan contracts, and you might want to consider other loans, including fixed rate loans.**

With an ARM, the interest rate and monthly payment on the loan is not fixed and may increase.

- The interest rate changes over time according to a formula – typically, a base interest rate (index rate) plus a certain percent (margin).
- For example, the rate could equal the one year U.S. Treasury rate plus 4 percent or the rate of the 6 month "LIBOR" index plus 3 percent.
- If the base interest rate increases, your interest rate and monthly payment will also increase.

If an ARM has a reduced interest rate for an initial period – for example, the first 2 years or first 5 years of the loan – the rate and the monthly payment may increase significantly. When that initial period is over:

- The interest rate and monthly payment may increase significantly even if the index rate stays the same.
- The interest rate and monthly payment will increase even more if the index rate increases.

Do not assume that you will be able to refinance an ARM to a lower rate in the future.

Additional Information

- **Payments for taxes and insurance.** In some mortgages, your monthly payment includes both principal and interest and an "escrow" amount to cover real estate taxes and insurance. Your lender then pays your taxes and insurance out of these escrow funds. In other mortgages, your monthly payment covers only principal and interest, and you are responsible for budgeting for and paying real estate taxes and insurance premiums when the bills arrive. These costs can be substantial. When you are comparing mortgages, or deciding whether you can afford one, you need to know whether or not the monthly payment includes an amount to cover taxes and insurance.
- **Prepayment penalties.** Some mortgages require you to pay a large prepayment penalty if you sell your home or refinance during the first few years of the loan – which you may need to do if your interest rate, and therefore your payment, is about to increase significantly, or if your circumstances change and you must sell your home before the prepayment period expires. The amount of the penalty will be added to your loan payoff amount. A prepayment penalty can make it difficult, or very expensive, to sell your home or refinance. You need to know whether your loan has a prepayment penalty, how much it is, and how long it will apply.
- **Balloon payments.** Most mortgages are set up so that you pay off the loan gradually by the monthly payments that you make over the loan term (for example, 30 years). Some mortgages, however, are set up with "balloon payments" – you make the same monthly payments that you would for a 30-year loan, but after a shorter period of time (for example, 10 years), you will owe one large final payment of the entire remaining balance of the loan. If you are unable to make the balloon payment when it is due, you would need to refinance your loan – or sell your home. You need to know whether your loan has a balloon payment.
- **No Doc/Low Doc Loans.** Be aware that "reduced documentation" or "stated income" loans usually have higher interest rates or other costs compared to "full documentation" loans that are available if you document your income, assets, and liabilities. These higher costs can be substantial.

Illustration 2A

SAMPLE MORTGAGE COMPARISON <i>(Not actual loans available)</i>			
Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only			
	Fixed Rate Mortgage 7.5%	Reduced Initial Rate "2/28" ARM 7% for two years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 3; 11.5% rate in Year 4; 13% maximum ARM rate in Years 5-30	
REQUIRED MONTHLY PAYMENTS (includes \$200 per month for real estate tax and insurance escrow)			
Years 1-2		\$1,598	\$1,531
Year 3 – even if index interest rate does not change		\$1,598	\$1,939
Year 4 – even if index interest rate does not change		\$1,598	\$2,152
Year 5 – if index interest rate rises 1.5% (maximum ARM rate)		\$1,598	\$2,370

Illustration 2B

SAMPLE MORTGAGE COMPARISON <i>(Not actual loans available)</i>			
Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only			
	Fixed Rate Mortgage 7.5%	Reduced Initial Rate "5/25" ARM 7% for five years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 6; 11.5% rate in Year 7; 13% maximum ARM rate in Years 8-30	
REQUIRED MONTHLY PAYMENTS (includes \$200 per month for real estate tax and insurance escrow)			
Years 1-5		\$1,598	\$1,531
Year 6 – even if index interest rate does not change		\$1,598	\$1,910
Year 7 – even if index interest rate does not change		\$1,598	\$2,109
Year 8 – if index interest rate rises 1.5% (maximum ARM rate)		\$1,598	\$2,311

Illustration 2C

SAMPLE MORTGAGE COMPARISON
(Not actual loans available)

Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only

	Fixed Rate Mortgage 7.5%	Reduced Initial Rate "5/25" ARM 7% for five years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 6; 11.5% rate in Year 7; 13% maximum ARM rate in Years 8-30	Reduced Initial Rate "2/28" ARM 7% for two years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 3; 11.5% rate in Year 4; 13% maximum ARM rate in Years 5-30
REQUIRED MONTHLY PAYMENTS (includes \$200 per month for real estate tax and insurance escrow)			
Years 1-2	\$1,598	\$1,531	\$1,531
Year 3	\$1,598	\$1,531	\$1,939
Year 4	\$1,598	\$1,531	\$2,152
Year 5	\$1,598	\$1,531	\$2,152
Year 6	\$1,598	\$1,910	\$2,152
Year 7	\$1,598	\$2,109	\$2,152
Year 8 – if index interest rate rises 1.5% (maximum ARM rate)	\$1,598	\$2,311	\$2,359