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t's in a Mortgage Loan? Fixed Rate vs. Adjustable Rate Mortgage L

With interest rates dropping consistently for the past several weeks and market predictions of further decreases, this might be just the right time for you to get into that new home. Once you've found the right place, what type of loan will suit you best? For the typical home buyer there are two basic options: fixed rate loans and adjustable rate loans (ARMs.) What is the difference between these options and which one is right for you?

Fixed Rate Loans

This type of loan locks you into a certain interest rate for the entire length of your loan. Fixed rate loans can have various lengths, but the most common are 15 and 30-year loans. Obviously the shorter your loan, the higher the payments, but you'll also pay less interest over the long run. Fixed rate loans are best for those who plan to stay in their home until the loan is paid off, and they're good for those planning to stay longer than 5-10 years. (Less than 10% of Americans stay in a single home longer than 5-7 years.) Interest rates on fixed rate loans are generally 1-2% higher then those with ARM loans, but fixed rate loans involve lower risk and give borrowers peace of mind knowing their payments will always stay the same.

Adjustable Rate Mortgage (ARM)

With an Adjustable Rate Mortgage, a borrower pays a certain low interest rate on a home loan for a period of 3, 5, or 7 years, after which the interest rate can vary based on formulas developed by the lender. What makes these loans so attractive to many borrowers is the promise of lower payments for the first few years of the loan. That means those who might not have the income or good credit to qualify for a fixed rate loan can apply for an ARM loan and still get into a home. It's also a great choice for those expecting to move within the next several years as they can secure a low interest rate until they are ready to sell.

ARM loans carry greater risk than fixed rate loans because the interest and payment amount after the initial period is unpredictable. Default rates (failure to pay interest or principal when due) on these loans are much higher than with fixed rate loans. This is probably because borrowers struggle to make the higher payments after the fixed rate period ends. Many borrowers with ARM loans avoid this problem by refinancing into a fixed rate loan at the end of their initial payment term. This is an especially popular choice right now as many who got into adjustable rates three years ago (when the market rate was about 4%) now face market interest rates at about 6%.

If you feel up to the risk and can handle the change in payments (especially if you anticipate an income increase before the payment hike), an ARM may be your best option as you could end up paying less than with a fixed rate loan if interest rates continue to drop or reach a low plateau.

Of course there are lots of variations of these loans and different programs offered to help you get into a home. To fully understand the best option for your home loan, schedule an appointment to talk to a trained loan officer or mortgage lender.