The Danger of Adjustable Rate Mortgages When Interest Rates are Rising

March 29, 2018 - There are a wide variety of adjustable rate mortgages (ARM) available to home buyers. Their lure us undeniable. ARM loans start out with lower monthly payments than otherwise identical fixed rate loans. It's easy for home buyers to come to the conclusion that an ARM actually makes that home they are considering more affordable. In the short run, it's easy to see how they arrive at that conclusion. But over the long run as interest rates rise, monthly mortgage payments also increase. And interest rates are currently rising. That fact alone means that there hidden dangers in ARMs that can eventually lead to ruined credit and foreclosure for many.

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Today's ARMs are safer than many of the adjustable rate loans that banks were offering prior to 2008. That's because most negatively amortizing loans (meaning that the amount owed actually increases because monthly payments are too low to cover the interest charges) are now illegal. But other problems remain.

Banks still offer ARMs with an interest only payment option. Anyone who elects to take out a loan like this can reduce their monthly payment significantly for the first few years of their mortgage. But during that time, they are doing nothing to reduce the amount of principle in their loan. That may work out if housing prices continue to rise. But if housing prices fall, borrowers will quickly learn that they owe more money on their home that it is worth.

Borrowers also need to know that even if they elect to make only their interest payment on a loan, the loan will eventually adjust to a standard adjustable rate mortgage, requiring both principle and interest payments. When that happens, the monthly payment amount can go up by 50% or more. If housing prices have increased since you purchased your home, you may be able to refinance into another loan. But if they have dropped, you may be stuck with the loan you have. Your options will be either to find a way to make your monthly payments or face foreclosure.

What's frightening about this is that it is a very similar scenario to the one we went through in 2008 when housing markets across the country collapsed. We may be at the beginning of another cycle like this. Interest rates are beginning to go up. The President of the Philadelphia Federal Reserve Bank, Patrick Harker, said that he expects three interest hikes this year according to the Wall Street Journal.

All of this means that borrowers need to be very careful when selecting a mortgage product. They need to make sure they understand the product they select and how the payments will work over the life of the loan. ARMs may still be right for some people. For instance if you can get an ARM where the interest rate for first five years of the loan are fixed, that may be a great deal if you know that you will only be living in the house for three more years. But the vast majority of people can't say that with certainty; making fixed rate loans a much better option.

Selecting a fixed rate loan product may mean that you have to purchase a less expensive house. That can be a painful decision initially. But it's a decision you'll be glad you made if inflation gets out of control or once interest rates go up another point or two. When that happens, your home will be much more affordable to you than if you had selected and ARM.

byJim Malmberg

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