Applications for Adjustable Rate Mortgages Have Doubled - A Bad Sign

April 27, 2022 - According to a new report from CNBC, the number of home buyers applying for adjustable-rate mortgages has doubled over the past few months. The reason is that interest rates for home mortgages have skyrocketed this year and adjustable-rate loans (ARMs) have a lower starting interest rate. In many cases, the difference in initial mortgage payment amounts can be significant. But ARMs come with a significant downside. At some point, the interest rates adjust. And those adjustments can be downright unaffordable.

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ARMs do have a place in the market. And they do come with an initial fixed rate period that can be as long as ten years depending upon the loan. If you are purchasing a home and you know that you're only going be living in a place for three or four years, and ARM may make sense. But if you're buying a home and you don't know how long you will be in it, or if you are buying your "forever home," ARMs can be a dangerous gamble.

In most cases, the longer the fixed rate period associated with a loan, the higher the interest rate. Because of this, buyers are often incented to take the shortest fixed period to get the lowest initial monthly payment. But if the fixed rate is only a couple of years, you could be in for a big surprise in the not-too-distant future.

Most ARMs can adjust up as much at 5% from their initial rate. So if you get an ARM with an initial interest rate of 4.2% (which is about what they are running right now), in a few short years you could wind up with an interest rate has high as 9.2%. Loans also have caps on how much the interest rate can go up with each adjustment, but you'll need to read the fine print in your loan documents to make sure you know what that cap is.

To give you an idea of what all this means, your initial monthly payment on a $500,000 home with an ARM at 4.2% would be $2,442. At a fully adjusted 9.2%, it would be $4,095. You can see the issue here. A monthly payment increase of more than $1,600 per month isn't going to be affordable for most people.

As important as this is, it is also important for borrowers to realize that they need to be educated and asking questions about loan scenarios before they sign any loan documents. You have to understand that purchasing a home is an adversarial process with a lot of competing interests. Loan officers and brokers have a vested interest in getting borrowers to sign on the bottom line regardless of whether or not the loan is in the borrower's best interest. Likewise real estate agents don't make any money working with clients that can't get a loan, so you really shouldn't rely on them for a decision like this. Licensing and ethics requirements in each state will help to protect buyers, but educating yourself is the best protection you can have.

Signing up for the wrong loan, when we are currently experiencing inflation of more than 8%, could turn an American Dream into a complete nightmare.
by Jim Malmberg
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