ARMs Can Give You a Leg Up on Buying a Home but Beware of the Reset

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

One of many mortgage options available to borrowers is an adjustable-rate mortgage (ARM). An ARM can potentially save borrowers a significant amount of money during the initial rate period when compared to a fixed-rate loan. But when the interest rate resets, the change in the monthly payment can be substantial. Here are some considerations if you have an ARM where the rate reset is forthcoming.

Understand Your Adjustment Period, Index and Caps

To determine the next appropriate strategy with your mortgage, it is important to understand that the adjustment period, index, and caps for ARMs are always fixed initially. When that period expires, the rate adjusts and remains fixed for a new period at that new rate.

Most ARMs have initial fixed-rate periods of one, three, five, seven, or 10 years. After the initial fixed-rate period, many ARMs adjust to a period that matches the initial fixed rate. However, a hybrid ARM (a 5/1 ARM) adjusts annually at the end of the fixed period. For example, the five-year ARM has a rate that adjusts every five years; the 5/1 ARM has a rate that is fixed for the first five years and then adjusts every year thereafter.

While ARMs have rates that are fixed for the initial period, the rate to which the mortgage adjusts is critical to understand. In most cases, ARMs adjust to rates tied to an index with a margin. A typical adjustment index is based on a US Treasury rate. Additionally, most ARMs have caps, which are the maximum amount that a rate can increase at each adjustment period.

Considerations for ARM Adjustments

If you have an ARM that is adjusting, an analysis of your circumstances is important to determine the next appropriate steps – most importantly, whether to refinance. These are among the steps you should consider:

Refinancing evaluation

Evaluate whether refinancing your mortgage is a viable option. Compare the current interest rates, terms, and closing costs of available mortgage options with your expiring ARM. Consider fixed-rate mortgages, hybrid ARMs, or other loan products that align with your financial goals and risk tolerance.

Budget assessment

Analyze your budget and financial situation to determine the impact of potential interest rate adjustments. Calculate the potential changes in monthly mortgage payments based on various scenarios, including worst-case interest rate increases. Assess whether your budget can accommodate the potential payment fluctuations or if refinancing to a more stable mortgage option is necessary.

Market interest rate comparison

Analyze current market interest rates to gauge the competitiveness of available mortgage products. Research prevailing interest rates for both fixed-rate and adjustable-rate mortgages. Consider economic forecasts and consult with mortgage professionals to gain insights into the direction of interest rates, enabling you to make informed decisions.

Risk evaluation

Work with your Relationship Manager to assess your risk tolerance and financial goals. Consider the potential risks associated with an ARM, such as the likelihood of further rate increases and subsequent payment adjustments. Evaluate your ability to handle potential payment increases and the potential impact on your overall financial stability. This analysis will help you determine whether to pursue a more stable mortgage option or if you are comfortable with the risks associated with another ARM.

Long-term financial planning

Consider your long-term financial plans and discuss with your Relationship Manager how your mortgage fits into those plans. Evaluate factors such as your expected tenure in the home, potential changes in income, and financial goals such as retirement planning. Assess how different mortgage options align with your broader financial objectives and select the options that best support your overall financial plan.

Consultation with professionals

Seek advice from KeyBank mortgage professionals or your Relationship Managers, who can provide expertise and insights tailored to your specific circumstances. They can guide you through the analysis process, help you understand the implications of different mortgage options, and assist in making an informed decision.

For more information, please contact your advisor.

About the Author

Jim Thomas is the National Head of Banking for Key Private Bank. He and his team support clients throughout the country by assisting in appropriately structuring and leveraging credit transactions within the context of a plan that benefits all of the client's long-term objectives. He joined Key in 2007, initially as a relationship manager in business banking. Prior to that, he served for many years in retail and commercial banking with another lending institution. A Baltimore native, he earned a Bachelor of Business Administration from James Madison University and an MBA, with a concentration in finance, from Xavier University. He and his family currently reside in Fort Myers, Florida. Jim serves on the advisory council of the Harry Chapin Food Bank, which annually distributes more than 12 million pounds of food to needy recipients in southwest Florida. He is a past Executive Board member of the Southwest Florida Council of the Boy Scouts of America, and is the former district chairman of the Boy Scouts' Seminole District in Southwest Florida.

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