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The New Adjustable-Rate Mortgages

Lenders are rolling out new versions of the loans. But there are risks.

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Banks are trying to make adjustable-rate mortgages more appealing, offering loans with initial interest rates that are fixed for a longer period or that allow borrowers to pay only interest on the loans for many years.

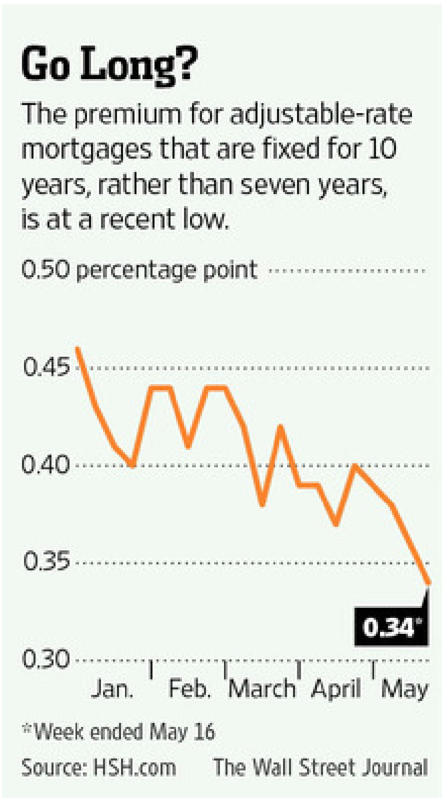
The new mortgages give home buyers an opportunity for lower monthly payments. But borrowers should consider the risk that they won't want or be able to sell their home when the fixed-rate period ends—and that they could face sharply higher costs at that point.

Adjustable-rate mortgages, or ARMs, typically offer an initial interest rate that is lower than that of a traditional 30-year fixed-rate mortgage, often by a full percentage point, and the chance to lock in that rate for years before it begins to fluctuate.

The most popular ARM has a fixed rate for five years, but other common varieties fix the initial rate for seven or 10 years. Generally, the shorter the fixed-rate period, the lower the initial rate.

Some lenders now are offering ARMs that lock in the initial rate for up to 15 years, in a bid to lure borrowers at a time when demand for new mortgages is weak. The longer period pushes further off into the future the point at which a higher rate could kick in.

Pentagon Federal Credit Union, a national lender based in Alexandria, Va., whose members include government employees, military personnel and their families, launched a type of 15-year ARM in February, which currently carries a 3.625% interest rate for the first 15 years of the 30-year mortgage. Family Trust Federal Credit Union, which is based in Rock Hill, S.C., introduced a similar ARM in January that now has a 3.75% interest rate.



Banks also are expanding their ARM offerings. In February, Salt Lake City-based Zions Bank introduced an ARM that has a fixed rate for 10 years. Its longest fixed-rate ARM before that lasted seven years. National lender Quicken Loans rolled out a 10-year ARM for larger loans this month.

Some banks also are offering ARMs that allow borrowers to make only interest payments for as long as 10 years. Interest-only ARMs largely disappeared for all but well-heeled home buyers after the financial crisis, and many borrowers who had such mortgages lost their homes in foreclosure after their monthly payments spiked.

PNC Bank, a unit of PNC Financial Services Group, introduced several interest-only ARMs this month that allow borrowers to postpone paying any principal for as long as 10 years. The interest rate also can remain fixed for up to 10 years. HSBC Bank USA, a unit of HSBC Holdings, started offering similar loans to a wider range of borrowers this month.

The banks say the loans are less dangerous this time around because borrowers need to meet tighter lending standards.

The moves come as interest rates on fixed-rate mortgages, though higher than they were a year ago, remain low in historical terms. The average rate on a traditional 30-year fixed-rate mortgage was 4.24% in the week ended May 16, up from 3.66% a year earlier, according to HSH.com, a mortgage-information website.

Higher interest rates have spurred more borrowers to consider ARMs, and a growing number are drawn to loans that fix the initial rate for longer periods, experts say.

Citigroup, for example, says more than 10% of all mortgage applications it reviewed last month were for ARMs with a fixed rate for seven or 10 years. A year ago, the percentage of applications for those kinds of loans was in the low single-digits, according to a bank official.

Greg Wojcicki, 50 years old, says he and his wife, Margaret, refinanced their home in Chicago in January with a 10-year ARM with an initial interest rate of 3.65%, one percentage point lower than the rate on their previous mortgage. Mr. Wojcicki, an information-technology manager at an insurance company, says his lender recommended the loan and that the lower initial interest rate will free up cash.

He was initially reluctant to take out an ARM, he says, but he is optimistic the couple's income will rise during the initial fixed-rate period. "Ten years is long enough away," Mr. Wojcicki says.

After the fixed-rate period ends, interest rates on most ARMs change once a year. The new rate is usually based on the one-year London interbank offered rate—the rate at which banks often lend to one another—though the increase is typically capped at five or six percentage points. The rate can increase by the full amount the first year the loan resets, depending on the loan's terms and market-rate conditions.

In most cases, a borrower who takes out a 10-year ARM with a 3.74% interest rate now—the current average rate, according to HSH.com—won't have to pay a higher interest rate than 8.74% on the mortgage, for example.

Buyers should consider what will happen if they are unable to sell their home. Refinancing may not help if rates on new mortgages are higher.

If you take out an ARM, "you have to be able to say, 'I can stomach the downside,'" says Peter Boomer, head of mortgage production at PNC Bank.

The loans appeal to banks because they take in more money if interest rates do rise. Higher mortgage-interest payments help banks maintain a profitable gap between the interest they earn on outstanding loans and the interest they pay to depositors. Banks tend to keep most ARMs on their books, rather than selling them.

In seeking to make ARMs more appealing, banks are essentially betting that some borrowers will hold on to the loans after the interest rate changes, and that those borrowers who don't are likely to turn to their current lender for a new mortgage.

Borrowers should look for a loan that locks in the initial low interest rate for at least as many years as they plan to keep the home. Homeowners who sold last year had owned their homes for nine years, on average, according to the National Association of Realtors, a trade group. As a result, experts say a 10-year ARM is often the best option for borrowers interested in such a loan.

The savings can be considerable. Borrowers who sign up for a $400,000 10-year ARM with an initial interest rate of 3.74% would save more than $19,100 in interest payments over the first 10 years of the loan, compared with a 30-year, fixed-rate mortgage with an interest rate of 4.24% over the same period.

Borrowers who take out an ARM with a shorter fixed-rate period can save even more initially, but that advantage has shrunk. The average initial rate on a 10-year ARM was 0.34 percentage point higher than the average initial rate on a seven-year ARM in the week ended May 16, according to HSH.com, down from 0.46 point in the week ended Jan. 3.

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