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What is an ARM?

To first-time homebuyers, the terms used for various types of home financing can be confusing. One of the most common of these terms is “ARM,” the acronym for “adjustable-rate mortgage.”

Arm’s can be most easily understood by comparing them to fixed-rate mortgages. In a fixed-rate-mortgage, the interest rate is established at the beginning, and it never varies. If the loan is for thirty years, the interest rate in the first year is the same as the interest rate in the thirtieth year.

In an ARM, on the other hand, the interest rate is adjusted periodically (usually every one, three, or five years,) based on some particular economic index, such as the cost of U.S. Treasury securities. After the adjustment, depending on the terms of the loan, your new interest rate will be one to three points above the index your loan is tied to.

For example, if the index goes to six percent at the time of your adjustment, and your interest rate is supposed to be two percent above the index, your new interest rate will be eight percent.

Most likely, then, your monthly payments will change every one, three, or five years (depending on the terms of your loan). Will they go up? Not necessarily. Interest rates decrease as well as increase.

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But this is exactly what makes ARM's popular will both lenders and borrowers. For a fixed-rate loan, lenders must gamble that interest rates will not change significantly. To protect themselves from that risk, they often charge higher interest for fixed-rate loans than for ARMS.

Borrowers, then, can often get a lower interest rate by choosing an ARM, and because there are usually limits to how much the interest rate can be increased for an ARM, borrowers have historically saved money in the loan run.

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