



What's the difference between an adjustable rate mortgage (ARM) and a fixed rate mortgage (FRM)?

A: A **fixed rate mortgage (FRM)** provides the classic method for calculating interest that accrues on principal over the life of a mortgage. With an FRM, the interest rate and scheduled payments remain fixed for the life of the mortgage, giving certainty to future payment obligations.

The FRM is the most consumer-friendly and risk-free type of mortgage financing. While always available for homebuyers in need of a mortgage, FRM financing for business or investment properties typically has short due dates of three to seven years.

An **adjustable rate mortgage (ARM)**, as diametrically opposed to an FRM, calls for periodic adjustments to the interest rate. In turn, the amount of the scheduled payments fluctuates with each interest rate adjustment over the period remaining on the mortgage's original amortization period.

The unique feature defining all ARMs is an interest rate formula, typically comprised of:

- an introductory interest rate applicable for a short period of several months, also known as a teaser rate or qualifying rate;

- an **index figure**, a proxy for future changes in the lender's cost of funds;
- a **margin rate**, which does not change during the life of the mortgage and is the earnings spread a lender adds to the index figure to determine the annual rate of interest charged on principal following each adjustment in the mortgage rate; and
- an **adjustment interval** at the end of which the mortgage interest rate is changed to reflect a rise or fall in the index figure.

The ARM's adjusted interest rate is determined by adding the index figure to the margin rate (at set intervals, and subject to any caps or floors as limitations beyond which the mortgage rate cannot change).

ARMs become popular when property prices or FRM interest rates rise faster than the rise in personal incomes. ARMs allow you to leverage the lower initial interest rate charged on an ARM (compared to the FRM rate) into a higher mortgage amount to fund the purchase of a home. In turn, you are able to pay a higher price for a home, but take on the risk your payments will increase over the coming years.