Adjustable-Rate Mortgages (ARMs)

Payment Caps, Negative Amortization, Prepayment, Conversion

ARM Payment Caps

Some adjustable-rate mortgages (ARMs) include payment caps, which limit your monthly payment increase at the time of each adjustment, usually to a percentage of the previous payment. For example, with a 7.5% payment cap, a payment of $100 could increase to no more than $107.50 in the first adjustment period, and to no more than $115.56 in the second.

Let us assume that your rate changes in the first year by 2 percentage points but your payments can increase by no more than 7.5% in any one year.

Here is what your payments would look like:

ARM Interest Rate	Monthly payment
1st year @ 10%	$ 570.42
2nd year @ 12% (without payment cap)	$ 667.30
2nd year @ 12% (with 7.5% payment cap)	$ 613.20
Difference in monthly payment =	*$ 54.10*

Many ARMs with payment caps do not have periodic interest-rate caps.

Negative Amortization

If your ARM includes a payment cap, be sure to find out about "negative amortization." Negative amortization means that the mortgage balance increases. It occurs whenever your monthly mortgage payments are not large enough to pay all of the interest due on your mortgage.

Because payment caps limit only the amount of payment increases, and not interest-rate increases, payments sometimes do not cover all the interest due on your loan. This means that the interest shortage in your payment is automatically added to your debt, and interest may be charged on that amount. You might therefore owe the lender more later in the loan term than you did at the start. However, an increase in the value of your home may make up for the increase in what you owe.

The next illustration uses the figures from the preceding example to show how negative amortization works during one year. Your first 12 payments of $570.42, based on a 10% interest rate, paid the balance down to $64,638.72 at the end of the first year.

The rate goes up to 12% in the second year. But because of the 7.5% payment cap, your payments are not high enough to cover all the interest. The interest shortage is added to your debt (with interest on it), which produces negative amortization of $420.90 during the second year.

Beginning loan amount = $65,000
Loan amount at end of 1st year = $ 64,638.72
Negative amortization during 2nd year = $ 420.90
Loan amount at end of 2nd year = $ 65,059.62 ($ 64,638.72 + $ 420.90)

If you sold your house at this point, you would owe almost $60 more than you originally borrowed.

To sum up, the payment cap limits increases in your monthly payment by deferring some of the increase in interest. Eventually, you will have to repay the higher remaining loan balance at the ARM rate then in effect. When this happens, there may be a substantial increase in your monthly payment.

Some mortgages include a cap on negative amortization. The cap typically limits the total amount you can owe to 125% of the original loan amount. When that point is reached, monthly payments may be set to fully repay the loan over the remaining term, and your payment cap may not apply. You may limit negative amortization by voluntarily increasing your monthly payment.

Be sure to discuss negative amortization with the lender to understand how it will apply to your loan.

Source: http://www.mortgagesfinancingandcredit.org/mortgages/adjustable-rate-mortgages/payment-caps-negative-amortizationarm5.htm
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