



Adjustable Rate Basics

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An adjustable rate loan, most simply stated, means that your interest rate can be adjusted up or down over the months and years. By adjusting the interest rate your monthly payments might also change.

In order to make an intelligent choice between a fixed rate and an adjustable rate loan, you have to understand the jargon of the adjustable loan and how it works.

For example: Your initial rate will be 8 percent. The base rate will be 9 percent, with semiannual adjustments. The index will be the floating Treasury Bill rate, and there will be a margin of 3 points over that. You will have an annual cap of 1 percentage point, a lifetime cap of 5 percentage points.

Initial Rate. The initial rate might be an attractive rate. The initial rate will last until the first adjustment occurs, which is usually after six months.

Base Rate. The Base rate is the interest rate on which the lifetime cap is calculated. If you have a lifetime cap of 5 percent, that means that your interest rate over the life of the loan cannot be greater than 5 points above the base rate. In the above example, the base rate is 9 percent, and the lifetime cap is 5 percent. That means that your interest rate over the life of the loan cannot exceed 14 percent.

Index: The index is an arbitrary number, beyond the control of the lender, which is used to determine interest adjustments. The common indices are the so-called cost of funds for certain savings institutions or an interest rate that the U.S. government pays when it borrows money. In the example above, the index is based on the interest rate the U.S. government pays on its very short-term borrowings (Treasury Bills). All indices will move up and down as interest rate trends change.

Margin: The index plus the margin equals the interest you'll be required to begin paying at the start of each adjustment period. For example, if, after the first six months of your loan, the index has increased from 6.8 percent to 7.2 percent, the interest rate you will have to pay on your loan from that time on will be 10.2 percent: the index of 7.2 percent plus the margin of 3 percentage points. Similarly, if the index goes down, so will the rate you pay.

Lifetime cap: This fixes the maximum interest rate you will pay during the life of the loan. The lifetime cap is added to the base rate to get the ultimate maximum.

Annual Cap: The annual cap puts a limit on how much your payments can increase during the course of a year. (In some loans, this cap may be based on a shorter period of time, such as six months.)