

A Fixed Vs. a Variable Rate Home Mortgage

When buying your home, one of the first big decisions you'll have to make is whether to go for a fixed rate or an adjustable rate mortgage (ARM).

Before knowing which is best for you, however, you need to be aware of how each one works.

A Home Mortgage with Fixed Rate Interest

A fixed rate mortgage has an interest rate that does not change. This interest rate will not change during the entire length of the loan, and will not be affected by changes in others interest rates. Oftentimes, new buyers decide to use a fixed rate home mortgage, as this kind of loan is easier to plan for in the long term. Because the interest rate on your home mortgage never changes, neither do your payments. This means that if you purchase a home for \$175,000 at rate of 6.5% for 30 years, your monthly home mortgage payments will stay at \$1106 (excluding any escrow costs), and never deviate during the course of the term.

There are pros and cons to signing up for a fixed rate home mortgage. While you will always be able to depend on a fixed mortgage payment (excluding property tax and insurance), you will typically have a higher interest rate than if you used an ARM. The reason for the higher rates is that the banks typically take a greater risk on fixed rate mortgages and therefore can charge a premium to lock in a rate for the entire term of the mortgage.

A Home Mortgage with Adjustable Rate Interest

An adjustable rate home mortgage is often called a floating rate, as your rate changes along with interest rate indexes. Normally, this kind of home mortgage will start off with a fixed rate for a predetermined amount of time (generally three to ten years). After that time, the rate will adjust at predetermined intervals. At these adjustment periods the rate you pay will rise and fall along with whatever index your rate is tied to. To put it simply: if interest rates go down, your payment will go down also.

In general, a variable rate home mortgage starts with a lower interest rate than a typical 30 year fixed rate mortgage. But if interest rates go up, your payments will go up. To reduce some of that risk, many ARMs come with a rate cap, allowing your rates rise only a specified number of percentage points.

The most important part of deciding on the best loan for you is having a thorough understanding of your acceptance of risk, as well as a plan for the amount of time you will own the home. If you plan to stay in your home only a few years, its possible for you to save money by choosing an adjustable rate home mortgage with a lower fixed rate for the first few years of the loan. Chances are, you will have left the house before your rates ever change. If you plan to be in your home longer and dont want to face a rate adjustment, the longer term fixed rate option may be the best fit for you.

About the Author

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