

# Interest-Only Mortgages

Here is what you will learn in this tutorial:

1. What is an interest-only mortgage?
2. For what types of borrowers is it suitable?
3. What are the hazards you should watch out for?

## What Is An Interest-Only Mortgage?

A mortgage is “interest only” if the scheduled monthly mortgage payment – the payment the borrower is required to make --consists of interest only. The option to pay interest only lasts for a specified period, usually 5 to 10 years. Borrowers have the right to pay more than interest if they want to.

If the borrower exercises the interest-only option every month during the interest-only period, the payment will not include any repayment of principal. The result is that the loan balance will remain unchanged.

For example, if a 30-year loan of \$100,000 at 6.25% is interest only, the required payment is \$520.83. In contrast, borrowers who have the same mortgage but without an IO option, would have to pay \$615.72. This is the "fully amortizing payment" – the payment that would pay off the loan over the term if the rate stayed the same. The difference in payment of \$94.88 is “principal”, which go to reduce the balance.

## For What Types Of Borrowers Are Interest-Only Mortgages Suitable?

Interest-only mortgages are for borrowers who have a valid use for a lower initial required payment, and are prepared to deal with the consequences.

*Pay Principal When Convenient:* Borrowers with fluctuating incomes may value the flexibility the IO mortgage gives them. When their finances are tight, they can make the IO payment, and when they are flush they can make a substantial payment to principal.

Ask yourself whether you are disciplined enough to make the payment to principal when you aren't obligated to.

*Buy More House:* It is common for families to begin with a "starter house", then move into a more expensive house as their incomes rise. This process of "trading up" carries high transaction and moving costs.

You can avoid these costs by skipping to the second house now. In the short term, this will cause a cash flow strain, but the IO mortgage may make it manageable.

Ask yourself whether you are comfortable with the risk that the expected higher income

won't materialize.

***Invest the Cash Flow:*** When you learn certain techniques of arbitrage, you may be able build wealth more rapidly by investing excess cash flow rather than paying down your mortgage.

A valid example is the young borrower with a long time horizon who invests in a diversified portfolio of common stock. This should generate a yield of 9% or more over a long period. Another example is a business owner who might earn a high return investing in his/her own business.

Ask yourself whether you really will invest the excess cash flow, as opposed to spending it; and whether you have a firm basis for believing that your investments will yield a return higher than the mortgage rate. When using certain tax-advantaged investment vehicles, you can earn a rate lower than your mortgage, and still make money. These investments are also generally safer and much more liquid.

### **What Are The Hazards You Should Watch Out For?**

The major hazard of implementing an Interest-Only or Payment Option Loan is not having a PLAN (or not sticking with the PLAN). Don't fall into the trap of spending the amount saved each month with this type of mortgage. The key is to put it somewhere where it can grow on its own. The benefits far outweigh applying this amount towards principal if you follow your PLAN. We can help you develop a PLAN of your own.

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