Interest-Only
Mortgages

Interest–Only Mortgages

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What is an interest–only mortgage?

As its name suggests, an interest–only mortgage allows you to make monthly payments, for a specified period of time, consisting only of the interest you're charged on the principal amount you've borrowed. The interest charge may be based on either a fixed rate or a variable rate. Once the interest–only period has ended, the principal (and the continuing interest charged on the now–declining principal balance) amortizes over the remainder of the original term of the loan.

Example(s): You take a 30–year interest–only mortgage of $200,000 at a fixed rate of 5 percent. The interest–only payment period is 10 years. Your annual interest is $10,000, which makes your monthly payment (rounded down to the nearest dollar) during this period $833. At the end of the 10–year interest–only period, your monthly payments (of principal and interest) will be $1,319 for the remaining 20 years of the original term.

If the $200,000 were repaid at the same interest rate over a conventionally amortized 30–year term, your monthly mortgage payment (of principal and interest) would be fixed at $1,073.

What are the advantages?

Because your monthly payments are lower during the initial phase of an interest–only mortgage than they would be with a conventionally amortizing mortgage, you might qualify to borrow a higher principal amount. This might allow you to buy a more expensive home than you could otherwise afford. Alternatively, you might borrow the amount you originally intended, but opt to do so with an interest–only mortgage to free up cash for other purposes. That is, during the interest–only period your payments would be less than they would be with a regularly amortized loan. You could use the difference for other purposes (e.g., paying off other debt, making other purchases, or investing in other opportunities).

Example(s): You can afford a mortgage payment of $1,073/month. With a regular amortization schedule, you could borrow $200,000 at 5 percent over 30 years. If you were to take an interest–only mortgage at 5 percent instead, your $1,073 monthly payment would be sufficient to meet the initial (interest–only) payments on a mortgage of $257,520.

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> As an alternative, you could borrow $200,000 at 5 percent as an interest–only mortgage, make monthly payments of $833 during the first 10 years of the loan (the interest–only payment phase), and use the $240 monthly difference ($1,073 – $833) for other purposes.

In addition, if you itemize your deductions for federal income tax purposes, your initial interest–only mortgage payments will be fully tax deductible. The amount of interest you may deduct, especially during the early years of repayment, will be greater than it would be if you were paying your mortgage on a conventionally amortizing 30–year term.

Are there any disadvantages?

While mortgage payments that consist of interest only may be fully deductible if you itemize your deductions on your federal tax returns, they do not reduce the principal balance of your mortgage. As a result, you won't build any equity in your home during the interest–only repayment period unless your home's market value increases. If this doesn't happen and you decide to sell your home before you begin to amortize the mortgage principal, your net proceeds from the sale (particularly after paying a real estate agent's commission) might be less than what you owe on the property.

Once the interest–only payment period is over and you begin repaying the principal, you'll have to be prepared to make higher monthly mortgage payments. Depending on the length of the interest–only payment period compared to the total term of the mortgage, your monthly payments might increase substantially. (Generally, the longer the interest–only payment period, the shorter the principal's amortization schedule and the higher the monthly payments required to repay the principal on that schedule.) These monthly payments will be higher than if you had chosen to amortize the principal over the full term of the loan. Moreover, you'll pay substantially more total interest on an interest–only mortgage carried to full term than you would have if you had taken a mortgage with a conventional amortization schedule.

> **Example(s):** You take a $200,000 30–year interest–only mortgage with a fixed interest rate of 5 percent and an interest–only payment period of 10 years. If you repay the mortgage as required over the full term, you will pay a total of $216,779 in interest. Had you borrowed the same amount at a fixed rate of 5 percent and repaid the mortgage on a 30–year conventional amortization schedule, you would have paid $186,513 in total interest.

Why is an interest–only mortgage risky?

While an interest–only mortgage may allow you to either buy a nicer home or exercise some flexibility in managing your finances, that doesn't mean it's always the best mortgage option for you. This type of mortgage can be risky if you plan to sell your home before the interest–only payment period is over and your home's market value doesn't increase. It can also be risky if you find you can't meet the higher monthly payments that'll be required when the interest–only payment period ends. An interest–only mortgage should probably be considered only if:

- You don't intend to remain in your home beyond the interest–only payment period, and

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you're reasonably confident the market value of your home will appreciate during the short time you live in it

- You expect your income to increase such that, if need be, you'll be able to meet the higher monthly mortgage payments required once the interest–only repayment period ends
- You can obtain a better "return on your dollar" by saving or investing the money you'll save on your initial monthly mortgage payments or by using those funds to reduce other high–interest debt

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