# How Interest Only Loans work

- *Originally used immediately before the GREAT DEPRESSION, these loans were marketed, and still are, toward the people who get large bonuses or someone who wants a real low payment now, a sophisticated investor and jet setter that wants to divert their money that would have gone toward loan principal to investments and other purposes.*
- Interest-only mortgages also work well for people who plan to stay in their home for only a short period of time, are very disciplined with money, would like to get into a bigger home and impress someone, or anticipate a large annual bonus, or work mostly on commission or otherwise have uneven streams of personal income.

Most interest only loans cover a total period of 30 years. The borrower agrees to a lower interest rate for a specific time period (for example, the first 5 to 15 years). At the end of the specific time period, the loan converts to a conventional loan in which the remainder of the loan is paid off over the rest of the loan term in addition to the interest, insurance and taxes you were already paying. This usually means a much higher payment.

The interest rate should remain fixed until the loan is required to be paid back.

There should be **<u>no prepayment penalty</u>**.

The interest rate may be higher than the typical 30 year conventional fixed rate.

The only equity you build is from market appreciation (if there is any).

The longer you stay in the home, the higher the monthly mortgage payments.

| Pros | Cons |
|---|---|
| - Lower monthly payments because you're not paying principal.<br>- Allows prudent/competent investor to place extra into better returns.<br>- If market appreciates, you gain.<br>- Defer larger mortgage payment so you can get larger home now.<br>- qualify you for a bigger loan<br>- Deduct the entire mortgage payment during interest only period instead of monthly difference in interest. | - You don't build any equity in the ownership of your home in the initial interest only period because you don't pay any loan principal.<br>- If housing prices drop during the interest-only period, you lose equity & owe more than home is worth. If you have to sell, you could wind up paying to get out of the loan because you haven't cut into the principal.<br>- When you refinance your home, will the interest rate at that time be lower when the initial interest only time period expires? |

Questions to ask lender

1. Does the interest rate remain fixed or will it vary with any index, margin or other factor?
2. Is there any prepayment penalty?
3. Will the interest rate be lower when the initial interest only time period expires?
4. (BEWARE: The lender can't tell you that. If they do, RUN!)
5. How will the principal balance and mortgage payments be affected if I make random contributions toward my principal loan balance during the interest only period?
6. Can I pay my own homeowner's insurance and property taxes during the loan?

Sources: http://classifieds.dallasnews.com/realestate/story/realmortgage_5-28.1597c37.html
www.bankrate.com