

# DCC DOLLARS & SENSE

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## Interest Only Mortgages

### *Special points of interest:*

- Pros and Cons of Interest Only Mortgages
- Ask DCC

An interest only payment option on mortgages is not a new concept, however, it appears to be due to the increased availability to the general masses. As only the interest is paid for a specific period of time and eventually the principle balance will be due, this can be a risky option for most

consumers, as their payment amount will increase. For example, on a mortgage with a 30-year amortization schedule, the first five years of payments, would only be the interest owed, none of the principle balance. So on a \$100,000 mortgage at 6% interest, the payment amount for the first five years would be \$500 per month as opposed to \$600 (About 95% of your early payments on a conventional mortgage is interest). This could free up \$1,200 per year in cash flow.

An interest only option is typically added to an Adjustable Rate Mortgage (ARM). An important factor of an ARM is that there are specified time periods where the interest rate will change; this will affect a consumer's payment. Most ARM have a cap on how much the original interest rate can be increased, the highest being 5% above the original rate. With a \$100,000 mortgage, that would be the equivalent of an increase up to \$500 more than the original payment.

Originally the interest only mortgage was directed toward investors, individuals who could see themselves making better use of the additional income each month in one form of investment or another. A smart investor may be able to take that additional income and turn it into a much a larger amount. As, in the previous example a \$100,000 mortgage had a savings of \$100 per month, in the case of the investor, their purchase price was closer to \$1,000,000. Therefore the additional income per month would be \$1,000 and a smart investor

## Ask DCC

*Question:* I recently lost my job and I have one outstanding credit card debt. I have other debts like my car but I was able to defer payments on that. What exactly happens if I can't make payments on the credit card? I've been current up until now, and it's not that I don't want to pay them but food and my apartment need to be paid first.

Frank S, Philadelphia PA

*Answer:* The first thing you'll notice is the collection activity from your creditor. When the first payment is missed or partially received your creditors will send a polite letter and follow that with a phone call to make arrangements for the payment.

As the account goes unpaid the collection activity will continue to increase in intensity. The letters will be less friendly and the callers more persistent. Credit grantors will collect on their accounts for three months, or "buckets" as they're called. After ninety days, the creditor will stop utilizing their own efforts and send the account to

a collection agency. At this point, you'd make payments to them, or to the original creditor. It's advisable to send the payments to the credit grantor if you are able to make them in full. Partial payments would go to the collection agency.

The creditor will generally allow up to five months of non-payment prior to writing off the debt as uncollectible. At this point the account would reflect as a charge off your credit report. Aside from bankruptcy, this is the worst status an account can reach. The rating would be a "R-9", R for revolving, 9 for the payment history. A good rating would be a "R-1", meaning pays as agreed.

After the account is charged off, a creditor may sell the account to recoup some of its losses or, if the debt is substantial, they may pursue legal action to collect the debt. However, this is generally a substantial amount of time from the first delinquent payment.

Email you question to, [questions@delraycc.com](mailto:questions@delraycc.com)

## Interest Only Mortgages Cont.

could invest those funds into their choice of investment. Thus giving them a higher yield than the appreciation value of their home over the first five years. Making it possible for them to purchase a home and maximize their asset accumulation at the same time.

When the interest only portion of the mortgage expired, the investor would then have funds in a subsidy account to compensate for the increase in their payments, or pay off a large portion of the principle and maintain the lower payments. If the investor knew they could afford the increased payment amounts when they originally took out the mortgage, but they wanted to start an investment account early with the thought of a longer time frame for the interest to compound, then taking the additional monies each month to invest would be a wise decision.

Over the past few years the interest only mortgage has been available to the general population as a mortgage option, however, for a much different reason. Due to the reduction in interest rates, affordable housing initiatives and the innovations of financing options, millions of consumers have moved into the home buying market place. This increase in homebuyers has caused a decrease in desirable homes and an increase in property prices. Thus making it a “sellers market”, where an individual could ask a higher price for their home and get it.

Consumers entering the home buying market have found themselves outbid on the remaining selection of desirable homes. With an interest only mortgage option, consumers are being pitched on a way to buy the home they want and ensure they aren't outbid. With a full amortization schedule (paying interest and principle at the same time) a consumer may qualify for a \$100,000 home. With an interest only mortgage that consumer could effectively increase their qualification to \$120,000, thus allowing them to bid higher on the home they want.

The dangers of using an interest only mortgage to increase purchasing ability come to realization at the end of the interest only portion of the mortgage. There are four main risks that consumer will face:

1. Not repaying the principle
  2. An increase in monthly payment
  3. A possible decrease in resale value
- A possible increase in interest rates

Consumers using the interest only mortgage option to increase their purchase amount, are gambling that their income will increase in the next five years. Or, that the real estate market will climb and so will the value of their home.

During the first five years of the mortgage, no amount is being applied towards principle and if the value of the home doesn't increase, a consumer will owe more than what the home is worth. If the increase in the payment amount is too much for the consumer, and if the resale value will not cover the loan, and the consumer's investment will be “upside-down”. Meaning if the home needs to be sold, the consumer will need to come up with the selling costs, as well as the remainder of the balance on the loan. If the consumer cannot do this, they may face not only foreclosure, but also a loss of their down payment and a loss of the amount paid in the first five years.

After the initial “interest only” period is over, the consumer must now make payments on both the interest and principle. The problem is there are no longer thirty years to pay off the principle, there are only twenty-five years. This will mean a substantial increase in their payment amount. In the example of the \$120,000 mortgage, after five years of paying \$500 per month the new payment amount would be \$773 per month. An increase of \$173 of the original payment for a conventional ARM and an increase of \$273 from what the consumer had been paying, this without an interest rate increase.

At the present, interest rates are at or close to an all time low however, there are no guarantees they will stay there. Interest only mortgage options are coupled with Adjustable Rate Mortgages (ARM). If at the end of the initial “interest only” period interest rates have increased, consumers will find themselves making a much larger payment. In the previous example we used 6% as a starting rate, it is more than possible for the rates to increase to a more “normal” rate of 7% in the next five years. This would make the payment over \$800 per month on the \$120,000 loan. This is only looking at the potential for an increase to a normal rate, if at the end of the initial period, a consumer finds him or herself facing “high” interest rates such as 9%, their payment would be well over \$1,000 per month.

There are certainly pros and cons to the interest only mortgage option and consumers will need to look at their reasons for purchasing one. If the payment amount after the initial period is something a consumer knows they can afford, then it might be a viable option, especially if the amount saved is used for starting an early investment. In the case of an individual who knows their income will increase in five years and they want to purchase their home now, again, this option may be considered. However, in the case of a consumer who cannot afford a higher payment, with no guarantee of increased income, using this option to purchase a more expensive home is never recommended.