ADVERTISEMENT

Interest-Only Loans Make a Comeback. Is an Interest-Only Loan Right for You?

Interest-only mortgages are making a comeback. Having a full appreciation of how interest-only loans work is key to determining whether this type of loan is the best fit for you. I spoke to **Jaxzann Riggs** of **The Mortgage Network** to break down these loans for me.

By Jim Smith
Realtor®

Well, let's first answer the question: ***What is an interest-only mortgage?***

An interest-only mortgage allows you to pay only the interest due on the loan during the first 10 years of the loan – making your monthly payments lower when you first start making mortgage payments.

How do interest-only mortgages work?

A fully amortizing loan requires you pay an amount toward the interest ***and*** the loan balance (called the principal) for a set term, usually 15, 20, or 30 years. Lenders often refer to this as the P&I payment (principal and interest).

Interest-only mortgages, however, allow you to make monthly payments that equal only the interest due on the loan, for the first 10 years of the loan. At the beginning of the 11th year, you will begin paying both, the interest due on the loan and a portion of the loan balance.

For example, if you take out a $500,000 interest-only fixed rate mortgage at 4%, with an interest only period of 10 years and a fully amortizing period of 20 years, you'd have to pay about $1666 per month for the first 10 years. When the interest-only period ends, you will still owe the entire $500,000 and your monthly payment amount will almost double to about $3,029 with the inclusion of both principal and interest payments.

What are the Pros and Cons of an interest-only mortgage?

According to Business Insider, there are many pros and cons to think about.

<u>Pros</u>

The initial monthly payments are usually lower: Since you're only making payments towards interest the first several years, your monthly payments are lower compared to some other loans.

May help you afford a pricier home: You may be able to borrow a larger sum of money because of the lower interest-only payments during the introductory period.

Increase to your cash flow: Lower monthly payments can leave you with extra dollars in your budget. You can use that money to put towards other investments, home improvements, or you can start paying down the principal early.

<u>Cons</u>

You won't build equity in the home: With an interest-only loan, you aren't building equity until you begin making payments towards the principal.

You can lose existing equity gained from your payment: If the value of your home declines, this may cancel out any equity you had from your down payment, making it difficult to refinance or sell.

Low payments are temporary: Your low monthly payment won't last forever — when the interest-only period ends, your payments will increase significantly.

Interest rates can go up: Interest-only loans usually come with variable interest rates. If rates rise, so will the amount of interest you pay on your mortgage.

There are many homebuyers that may benefit from an interest-only mortgage. People who aren't planning to stay in their home long term can take advantage of the lower monthly payments for several years, and then sell their house before the higher monthly payments kick in. Buyers who are just starting in their careers may appreciate the lower payments while they are making an entry level salary. If your finances are strong and you're not worried about building equity, this may be a great option for you.

As with any large financial commitment, it's important for all prospective buyers to seek expert advice. Reach out to **Jaxzann Riggs** at **303-990-2992** with any questions.

It is important to note, however, that **once the initial interest-only term ends, you'd continue making payments toward the loan with both principal and interest included.**