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Interest-only loans attract attention

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For North Puget Sound Assn. of Realtors

Recently, you may have heard about interest-only mortgages and wonder what they are all about. Quite simply, interest-only loans allow you the option of paying only the interest portion of your mortgage payment each month.

This interest-only option can be coupled with most loan programs, whether it's a fixed-rate mortgage or an adjustable rate mortgage (ARM). You can choose to make a principal payment at any time, but when the interest-only period expires, you are expected to start repaying the outstanding principal over the remaining life of the loan.

Most lenders either charge a small fee or increase the interest rate slightly for adding the interest-only option to a loan. Also note that the interest-only period varies from program to program — it could be as short as three years or as long as 10 years or more.

I've heard financial talk show hosts say you should avoid an interest-only loan. Unfortunately, providing this single-minded advice might be like saying you should never buy bonds. That's because most of

these "experts" are believers in "pay off your debts at all costs" and "live in your house until you die." However, interest-only loans are not going to be right for all people.

So, who might benefit from interest-only loans? They can be summarized into three main categories:

- People who live in the house for short time periods before refinancing or selling.

- People who want to lock in today's low rates for a long time, and have an immediate, short term need for relief from the full payment.

- Financially savvy individuals who understand cash flow models and opportunity cost.

Let's look at some examples

People in the first category are going to need the loan for only a short period of time; they are going to either sell the house or refinance. Let's say a couple want to buy a home, but know they will move in four or five years. By selecting an interest-only loan, they acquire a lower monthly house payment by not having to pay the

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principal each month.

Additionally, the house value still will increase as the housing market appreciates, regardless of the fact no principal payments have been made. The market doesn't care if there is a mortgage against a house or if it's owned free and clear. The house still is worth whatever the prospective buyer is willing to pay for it.

An example of the second category might be the couple that buys a home, and dad is staying home with the kids for the next three years while mom continues to work, after which time dad will return to the work force. They plan to be in this home for a long time and want to lock in today's low rates. However, they cannot afford the monthly cash flow associated with a fully amortized payment on just mom's salary.

So, they select an interest-only loan and make lower payments while dad isn't working. Then when Dad goes back to work and their income has increased, they can start making the fully amortized payment without having to refinance. They can do this without having to pay an extra set of closing costs to refinance, and they get today's low rates.

The third category is for the savvy investor who understands financial models and is disciplined enough to take advantage of the leverage interest-only loans can provide.

First, they understand that every dollar paid towards principal creates no return on the equity invested. Second, they realize they can take that same dollar and instead invest it in a well-diversified portfolio which

should yield a positive return over a period of time. Third, they know that if they needed to access these funds, they would have to pay the costs associated with refinancing to get the equity out of the home versus simply liquidating funds in an investment portfolio.

This approach requires dedication and a certain level of sophistication, so it's not for everyone. For an excellent analysis of this approach, take a look online at the Journal of Financial Planning's article on interest-only loans at www.fpanet.org/journal/articles/2004_Issues/jfp1004-art7.cfm.

What about the negatives?

The interest-only period doesn't last forever. When it expires, the remaining principal balance is re-amortized, or equally divided, among the remaining years on the loan. So, instead of having \$200,000 evenly divided into equal payments over 30 years, when a 10-year interest-only period expires, that same \$200,000 would be equally divided over the remaining 20 years of the loan.

Also, if you select a 3- or a 5-year ARM with interest-only payments and plan to refinance at the end of the fixed-rate term, your house may not have the equity you might have expected, especially if the housing market does not appreciate as you anticipated.

While we have seen double-digit appreciation in housing values in recent years, that rate may be too aggressive to continue in order to provide equity appreciation. Instead, it would be more advisable to consider a more average, historical appreciation rate.

Using an interest-only line of credit for a second mortgage in a 80/20 combo is asking for danger in today's interest rate climate. That's because short-term rates have been steadily increasing over the past 18 months while long-term rates have remained low — so much so that most line-of-credit second mortgages have interest rates

priced about the same as a fixed-rate second mortgage, and the rates on lines of credit run the risk of going even higher as the prime rate moves upwards.

While interest-only loans are creative financial tools, they work best if they are part of a carefully orchestrated personal financial plan, and they can be a virtual dagger when used inappropriately. Make sure you seek the advice of a local, professional loan officer who can adequately analyze your individual situation and offer sound advice. Remember, this is your mortgage — your home. You need to be as well informed as possible so you can make the right decision about your financial structure.

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