

Interest Only Mortgage

-  An interest only mortgage does not require any principal reduction during the initial interest only period, which is usually three, five, seven or ten years and then converts into an amortizing mortgage, typically an Adjustable Rate Mortgage (ARM), for the remainder of the mortgage term
 - These mortgages are called 3/1, 5/1, 7/1 and 10/1 interest only ARMs
 - Interest only ARMs typically have 30 year terms
 - In the case of a 3/1 interest only ARM, the borrower's monthly payment is comprised of only interest for the first three years of the mortgage and then the payment is comprised of both interest and principal for the remaining 27 years of the mortgage
-  Because the borrower is not required to pay principal, the monthly mortgage payment during the interest only period is lower than the monthly payment for an amortizing loan such as a fixed rate mortgage or an ARM
-  Interest rate pricing for the initial interest only period is set by the lender and is typically lower than the prevailing interest rate for a 30 year fixed rate mortgage but slightly higher than the initial fixed period interest rate for an ARM
-  Because you are not paying down principal during the initial interest only period, you still owe the entire mortgage amount at the beginning of the adjustable rate period when the loan converts into an amortizing mortgage. For example, for a \$380,000 7/1 interest only loan, you owe \$380,000 at the beginning of year eight of the mortgage
-  Following the interest only period, the mortgage converts into an annual ARM, with the interest rate adjusting every year
 - This means that the interest rate and monthly mortgage payment for an interest only mortgage can change over the life of the mortgage
 - The mortgage payment typically increases after the interest only period because the borrower is required to pay both interest and principal instead of only interest
 - The interest rate can also increase during the adjustable rate period, which will also increase your monthly mortgage payment
-  Just like an ARM, the interest rate for the adjustable rate period is called the fully-indexed rate and is calculated by adding the index to the margin
-  The index and the margin are determined at the beginning of the loan and set forth in the mortgage note
-  The main benefit of an interest only mortgage is that the monthly mortgage payment during the interest only period is lower than the monthly mortgage payment for an amortizing mortgage such as a fixed rate mortgage or ARM. Additionally, you may qualify for a larger loan amount with an interest only mortgage
-  The Truth-in-Lending Statement will indicate if the mortgage is interest only and if the mortgage has a Variable Rate Feature, which is another term for ARM
-  If the Variable Rate Feature box on the TIL Statement is checked then the lender must provide a variable rate disclosure form that outlines the key details of the adjustable rate component of the interest only mortgage

Interest Only Mortgage – Key Items

 The table below summarizes the key items to focus on the evaluating an interest only mortgage

Key Adjustable Rate Mortgage Concepts

Term	- Indicates the length of the mortgage, presented in years - Interest only mortgages typically have a term of 30 years - A 30 year interest only mortgage has 360 monthly mortgage payments (12 payments per year * 30 years = 360 total monthly payments) - Monthly mortgage payments may change over the term of the mortgage
Interest Only Period	- Initial time period for an interest only mortgage during which the monthly payment is comprised of interest only - The interest only period is typically 3, 5, 7 or 10 years
Interest Only Interest Rate	- The interest rate for the initial interest only period - Fixed for the interest only period
Adjustable Rate Period	- The period of time from the end of the interest only period through the end of the term of the loan - The interest rate is typically re-calculated on an annual basis during the adjustable rate period - Interest only loans that convert into adjustable rate mortgages are called interest only ARMs
Adjustment Interval	- Indicates how often the interest rate for an interest only ARM adjusts during the adjustable rate period - The adjustment interval for most interest only ARMs is a year although some interest only ARMs have semi-annual (six month) intervals
Fully-Indexed Rate	- Interest rate for the adjustable rate period - Calculated by adding the index to the margin - The fully-indexed rate typically adjusts every year during the adjustable rate period and will change with fluctuations in interest rates
Index	- The index is an underlying interest rate that is one of two components of the fully-indexed rate - The value of the index can change over the term of the mortgage - Lenders typically use the 1 year LIBOR as the ARM index
Margin	- The second of two components used to calculate the fully-indexed rate - The margin is a set interest rate amount that does not change over the term of the loan - The margin is typically 2.0% - 2.5%
Initial Adjustment Cap	- A cap that limits the change in interest rate when it first adjusts following the interest only period - The initial adjustment cap is typically 2.0% or 5.0% - For example, if the initial adjustment cap is 5.0%, the initial fully indexed rate following the interest only period cannot go up by more than 5.0% as compared to the interest only period interest rate
Subsequent Adjustment Cap	A cap that limits the change in the fully-indexed rate in any adjustment period following the initial adjustment
Life Cap	- A cap that limits the maximum increase in interest rate over the term of the mortgage - The typical life cap for an interest only ARM is 5.0% which means the fully indexed rate cannot exceed the initial interest only period interest rate plus 5.0%