Consider the following situations:

- o If a borrower with an option ARM chooses to make monthly payments that do not cover the full amount of interest and other fees accrued, the additional amount gets added to the principal balance due. Ultimately the borrower may end up owing more money than the original loan amount. This result is known as negative amortization.
- o If the borrower decides to sell the home before the interest-only term or payment option term expires and the home value decreases during that period, the borrower will owe more money than was originally borrowed.

You may not be able to refinance an interest-only loan or option ARM.

- Many borrowers who choose interest-only loans or option ARMs are under the assumption that the value of their homes will appreciate. These borrowers intend to make lower monthly payments in the short term, and then refinance. However, if the home value stabilizes or decreases, the borrower may be unable to refinance as originally planned, as the outstanding loan amount may be greater than the home's value.
- As with any adjustable rate mortgage, there is the possibility that interest rates will rise. Many borrowers with interest-only loans or option ARMs who intend to refinance may find it disadvantageous to do so in a rising or unstable interest rate environment.

If you're shopping for a new home, looking to refinance your current mortgage, or if you are a first-time homebuyer, make sure that you commit to a loan that is right for you. Be sure you can afford both the home and the loan, and that you understand how non-traditional mortgages such as interest-only loans and option ARMs work.

Where can I get more information?

For more information on these and other nontraditional mortgage products, contact the Massachusetts Division of Banks Consumer Assistance Hotline at 617-956-1501, or visit www.mass.gov/dob.

Produced in association with:

Massachusetts Office of Consumer Affairs and Business Regulation
www.mass.gov/consumer

Massachusetts Division of Banks
www.mass.gov/dob

Massachusetts Bankers Association
www.massbankers.org

Massachusetts Credit Union League
www.maleague.org

Massachusetts Mortgage Association
www.massmort.org

Massachusetts Mortgage Bankers Association
www.massmba.com

Interest-Only Mortgages and Option ARMs:

Are they right for you?

Non-traditional mortgage products are gaining popularity with consumers, including first-time homebuyers. If you are in the process of purchasing or refinancing a home, you may be offered an interest-only loan or a payment option adjustable-rate mortgage (option ARM); however, such non-traditional loan products are not for everyone. If you are wondering whether you are a good candidate, the following information will help you understand the benefits and the risks.

What are Interest-Only Loans and Option ARMs?

Interest-only loans are generally adjustable rate mortgages that permit borrowers to pay only the interest portion of their loan payments for a specified term. Unlike fixed or adjustable-rate traditional mortgage loans, borrowers may forego paying the principal for a set period, typically between five and ten years. Monthly payments during the interest-only term are significantly lower than monthly payments of traditional mortgages, which require borrowers to repay a portion of the principal with each monthly payment. When the interest-only term expires, the interest rate adjusts and the borrower is obligated to make payments toward both principal and interest for the remaining life of the loan. As a result, monthly payments increase dramatically.

Option ARMs give borrowers the ability to decide how much to pay from one month to the next, for a specified term. Borrowers may choose from payment options including an interest-only payment, a minimum payment which does not include all interest due, or may make a full principal and interest payment based on the remaining scheduled term of the loan or on a 15-year or 30-year term. Similar to interest-only loans, there is a significant payment increase when the payment option term expires. When the interest rate adjusts and the borrower is obligated to make payments toward both principal and interest, monthly payments increase.

What Would Typical Monthly Payments Be?

Let's suppose a borrower needs a $300,000 loan. The examples below outline three 30-year mortgage products and their monthly payment scenarios. Keep in mind that the rates used in the examples below are only assumptions.

a. **Traditional Fixed-Rate Mortgage:** At an interest rate of 6.0%, monthly payments would be $1,799 for the entire life of the loan. Monthly payments include both repayment of principal and interest.

b. **Interest-Only Mortgage:** Assume the interest rate is fixed for the first 5 years of the loan, the length of the interest-only term. At an initial interest rate of 5.5%, the monthly payments would be $1,375. At year 6, assuming the interest rate adjusts to 7.5%, the payments rise to $2,227, an increase of $852. Monthly payments at Year 6 increase because the repayment of principal is factored in and the interest rate adjusts.

c. **Option ARM:** Assume the initial fully indexed rate is 6.3% (the starting or "teaser" interest rate may be much lower). Initially, the borrower may pay as little as $1,035 (by deferring $557 in interest per month which is added onto the loan balance), or as much as $1,870 by paying both principal and interest. If the borrower makes only the minimum payment, monthly payments, including both interest and principal, may increase to as much as $2,612 once the option term ends and the full interest and principal due must be repaid.

What are the Benefits of Interest-Only Loans and Option ARMs?

Interest-only loans and option ARMs can be effective wealth management tools.

- Those borrowers with the expertise and ability to make wise financial decisions may benefit by investing the savings generated from the lower initial monthly payments. The lower initial monthly payments associated with these loan products may be well suited for the following:
- Borrowers whose income is commission-based, seasonal, or those who earn a salary and receive infrequent bonuses.
- Borrowers who expect their incomes to increase substantially within a few years.
- Borrowers who are planning to refinance their home before the expiration of the interest-only term or payment option term.
- Borrowers who know they will be in their home for only a few years, and who are not concerned with building equity.

During the interest-only term, the entire monthly payment may be tax-deductible.

- Borrowers are encouraged to consult a tax professional to evaluate the impact of deductions.

What are the Risks of Interest-only Loans and Option ARMs?

You can easily overextend yourself.

- Since initial monthly payments associated with these loan products are lower, borrowers may be tempted to buy a more expensive home than they can afford. However, at the end of the interest-only term or payment option term, monthly payments may increase dramatically. Absent a significant increase in income, repayment of the loan could become difficult or impossible for some borrowers.

You may not build equity.

- Equity is the difference between home value and outstanding loan balance. With traditional mortgages, borrowers generally build equity by paying down the principal. If a borrower only makes interest payments and does not make payments toward principal, no equity is built. The combination of the large mortgage debt and lack of equity limits the borrower's ability to manage wealth.