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Key Facts About Interest-Only and Payment Option Mortgages

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an interest-only mortgage or a mortgage with the option to make a minimum payment (a payment-option mortgage) is right for you.

Interest-Only Mortgages

An "interest-only" mortgage allows you to pay only the interest on the money you borrowed for the first few years of the mortgage. This is known as the "interest-only period" (for example, the first 5 years of the loan). If you only pay the amount of interest that's due, once the interest-only period ends:

- ▶ You will still owe the original amount you borrowed.
- ▶ Your monthly payment will increase – even if interest rates stay the same – because you must pay back the principal as well as interest.
- ▶▶ Ask what the payments on your loan will be after the end of the interest-only period. If you are considering an adjustable rate mortgage, ask about what your payments can be if interest rates increase.

Payment Option Mortgages

A payment option mortgage allows you to choose among several payment options each month, usually during the first few years of the loan (the "option period"). The options typically include:

- A payment of principal and interest, which reduces the amount you owe on your mortgage. These payments may be based on a 15-, 30-, or 40-year payment schedule.
 - An interest-only payment, which does not reduce the amount you owe on your mortgage.
 - A minimum payment, which may be less than the amount of interest due that month and does not pay down the principal. If you choose this option, the amount of any interest you do not pay will increase the amount you owe.
- ▶ The option period will end earlier than scheduled if the amount you owe grows beyond a set limit, for instance 110% or 125% of your original mortgage amount. Suppose you made only the minimum payments on a \$180,000 mortgage and your payments did not cover all of the interest due. If your balance grew to \$225,000 because of the interest due that is not covered by the minimum payment, your loan would be recalculated and it is likely that your payments would increase significantly.
- ▶ Your monthly payment could increase significantly, because:
- You will have to start paying back principal as well as interest.
 - Unpaid interest has been added to your principal and the total amount you owe has increased.
 - Interest rates may have increased (if your mortgage has an adjustable rate feature).
- ▶▶ Ask:
- What the monthly payments on your loan could be when you must start paying back principal.
 - How interest rate increases could affect your monthly payment (if your mortgage has an adjustable rate feature).
 - When the payment adjustments will be made, and
 - The maximum amount you could owe on the loan if you make minimum payments.

Additional Information

▶ Home Equity. Home equity is created when the value of your home increases and/or when you reduce the amount you owe on your home through your loan payments. If your home does not increase in value and you make interest-only payments, you are not building equity. And, if you make only the minimum payments on a mortgage with a payment option feature, you may be increasing the amount you owe because unpaid interest is added to the loan balance. This may make it harder to refinance your mortgage, or to receive funds from the sale of your home. In fact, if the amount you owe on your home, along with the costs associated with selling it (such as the real estate sales commissions and closing costs) exceeds the sales price, you will not receive any cash when you sell, and will have to pay additional funds to your lender or to other parties when you pay off your mortgage.

▶ Prepayment Penalties. Some mortgages have prepayment penalties. If you sell your home or refinance your loan during the prepayment penalty period, you could owe additional fees or a penalty. Ask whether your mortgage has a prepayment penalty and, if so, how much it can be. Most mortgages let you make extra, additional principal payments with your monthly payment -- this is not "prepayment" of the entire loan, and there usually is no penalty for these extra amounts.

▶ No Doc/Low Doc Loans. Lenders often charge more for "reduced documentation" loans. These loans typically have higher interest rates or other costs compared to "full documentation" loans that require you to verify your income and other assets. (By verifying your income, you help the lender to be sure that you can afford the loan payments.) If you are considering a loan with a reduced documentation feature, ask if you'll be required to pay more (in interest and/or fees) for not submitting income and asset documentation.