Understanding About The Interest Only Loans

A lot of information about interest-only loans has been flying around.
We give you a helping hand getting to the bottom of some of it.

Some financial writers have put a big warning sign over interest-only loans; others have told people to dive right in. Which is correct? The answer, of course, is that it depends. A Realty Times article highlighted some key pieces of information that real estate consumers need to understand about interest-only loans in order to know whether they are right for them.

With the topic of interest-only loans, it is prudent to start with the conclusion: interest-only loans give the consumer more options, which is always a good thing. However, just because it is another option, that doesn't mean it is a good option for everyone.

The Basics

So what exactly is an interest-only loan? The basic premise of an interest-only loan is that, for a certain amount of time, typically five years, all you pay in your mortgage payments is the interest. You have the option to also pay some of the principal, but you don't have to.

The Bad Side

There are a number of downsides to any mortgage option; however, the biggest problem that is particular to an interest-only loan is as follows: once the interest-only term of the loan is complete, not only are you faced with now paying a higher mortgage payment because you are now paying principal as well as interest, but your interest rate may also go up. This can hit some families extremely hard, especially if your finances didn't improve as expected over the last few years.

The Good Side

The good news is that interest-only loans can make a lot of sense. Because you can choose to pay principal as well, you can pay out as much in principal as you would on a regular loan, but during those couple of months out of the year that expenditures tend to be higher than normal, you can cut out the principal portion of your loan, just make payments on the interest, and not run up a huge credit card bill! Another option is to invest the money you would be paying on the principal into a higher-interest savings option. The best way to think about this is to consider your home as an investment, with the rate of return on the investment (excluding home appreciation) is the after-tax interest rate of your mortgage, which, on a mortgage with an interest rate of 5.75%, roughly ends up being a borrowing cost of 4.31%. There are many places that can help you earn a higher return on your investment, which can then be used to pay off a huge chunk of your mortgage, or can be used for other investments.

The bottom line is that this is another option in your arsenal. However, it is not an option to use if you are relying on current house price rises to keep going, can barely make the interest-only payments and are not able to put any money down. Consider all your real estate options with a mortgage specialist, and come up with the best option for your unique situation.