Board of Governors of the Federal Reserve System
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Interest-Only Mortgage Payments and Payment-Option ARMs— Are They for You?

Board of Governors of the Federal Reserve System

Owning a home is part of the American dream. But high home prices may make the dream seem out of reach. To make monthly mortgage payments more affordable, many lenders offer home loans that allow you to (1) pay only the interest on the loan during the first few years of the loan term or (2) make only a specified minimum payment that could be less than the montly interest on the loan.

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an interest-only mortgage payment (an I-O mortgage)—or an adjustable-rate mortgage (ARM) with the option to make a minimum payment (a payment-option ARM)—is right for you. Lenders have a variety of names for these loans, but keep in mind that with I-O mortgages and payment-option ARMs, you could face

- *payment shock.* Your payments may go up a lot—as much as double or triple—after the interest-only period or when the payments adjust.

In addition, with payment-option ARMs you could face

- *negative amortization.* Your payments may not cover all of the interest owed. The unpaid interest is added to your mortgage balance so that you owe more on your mortgage than you originally borrowed.

Be sure you understand the loan terms and the risks you face. And be realistic about whether you can handle future payment increases. If you're not comfortable with these risks, ask about another loan product.

What is an I-O mortgage payment?

Traditional mortgages require that each month you pay back some of the money you borrowed (the principal) plus the interest on that money. The principal you owe on your mortgage decreases over the term of the loan. In contrast, an I-O payment plan allows you to pay only the interest for a specified number of years. After that, you must repay both the principal and the interest.

Most mortgages that offer an I-O payment plan have adjustable interest rates, which means that the interest rate and monthly payment will change over the term of the loan. The changes may be as often as once a month or as seldom as every 3 to 5 years, depending on the terms of your loan. For example, a 5/1 ARM has a fixed interest rate for the first 5 years; after that, the rate can change once a year (the "1" in 5/1) during the rest of the loan. More information on ARMs is available in the Federal Reserve Board's *Consumer Handbook on Adjustable Rate Mortgages*.

The I-O payment period is typically between 3 and 10 years. After that, your monthly payment will increase—even if interest rates stay the same—because you must pay back the principal as well as the interest. For example, if you take out a 30-year mortgage loan with a 5-year I-O payment period, you can pay only interest for 5 years and then both principal and interest over the next 25 years. Because you begin to pay back the principal, your payments increase after year 5.

What is a payment-option ARM?

A payment-option ARM is an adjustable-rate mortgage that allows you to choose among several payment options each month. The options typically include

- *a traditional payment of principal and interest* (which reduces the amount you owe on your mortgage). These payments may be based on a set loan term, such as a 15-, 30-, or 40-year payment schedule.

- *an interest-only payment* (which does not change the amount you owe on your mortgage).

- *a minimum (or limited) payment* (which may be less than the amount of interest due that month and may not pay down any principal). If you choose this option, the amount of any interest you do not pay will be added to the principal of the loan, increasing the amount you owe and increasing the interest you will pay.

Interest rates. The interest rate on a payment-option ARM is typically very low for the first 1 to 3 months (2%, for example). After that, the rate usually rises to a rate closer to that of other mortgage loans. Your monthly payments during the first year are based on the initial low rate, meaning that if you only make the minimum payment, it may not cover the interest due. The unpaid interest is added to the amount you owe on the mortgage, resulting in a higher balance. This is known as *negative amortization.* Also, as interest rates go up, your payments are likely to go up.

Payment changes. Many payment-option ARMs limit, or cap, the amount the monthly minimum payment may increase from year to year. For example, if your loan has a payment cap of 7.5%, your monthly payment won't increase more than 7.5% from one year to the next (for example, from $1,000 to $1,075), even if interest rates rise more than 7.5%. Any interest you don't pay because of the payment cap will be added to the balance of your loan.

Payment-option ARMs have a built-in recalculation period, usually every 5 years. At this point, your payment will be recalculated (lenders use the term *recast*) based on the remaining term of the loan. If you have a 30-year loan and you are at the end of year 5, your payment will be recalculated for the remaining 25 years. **The payment cap does not apply to this adjustment.** If your loan balance has increased, or if interest rates have risen faster than your payments, your payments could go up a lot.

Ending the option payments. Lenders end the option payments if the amount of principal you owe grows beyond a set limit, say 110% or 125% of your original mortgage amount. For example, suppose you made minimum payments on your $180,000 mortgage and had negative amortization. If the balance grew to $225,000 (125% of $180,000), the option payments would end. Your loan would be recalculated and you would pay back principal and interest based on the remaining term of your loan. It is likely that your payments would go up significantly.

What do you need to ask when shopping for an I-O mortgage or a payment-option ARM?

Use the Mortgage Shopping Worksheet to compare different loan products. Ask lenders or brokers about the details of their loans and about the different loan options they offer. And don't be afraid to make lenders and brokers compete with each other by letting them know you are shopping for the best deal. Look for a mortgage that allows you to buy the house and continue to afford the payments, even if payments go up over time.

Mortgage Shopping Worksheet

(See the *Consumer Handbook on Adjustable Rate Mortgages* to help you compare other ARM features and *Looking for the Best Mortgage* to help you compare other loan features.

	Example
Name of lender or broker & contact information	ABC Mortgage Co. 800-123-4567
Mortgage amount	$180,000
Loan description	Payment-option ARM; 1-month introductory rate; 30-year term
Is this an I-O payment or a payment-option ARM?	Payment-option ARM
If different payment options are available, what are the options?	1. First year's minimum payment based on initial interest rate 2. Interest-only payment based on rate after adjustment 3. Fully amortizing payment based on 30-year term
What is the full term of the mortgage?	30 years
How long is the option period?	The loan will be recalculated (recast) every 5 years. Payment options are available every month except (1) when loan is recast every 5 years, (2) when balance is 125% of original loan, or (3) if you fall more than 60 days behind in your payments.
What is the initial interest rate?	1.6%
For a payment-option ARM, how long does the initial interest rate apply?	1 month
What will the interest rate be after the initial rate?	6.4%
How often can the interest rate adjust?	Monthly
What is the periodic interest rate cap?	2% per year
What is the overall interest rate cap?	6% lifetime cap (maximum interest rate is 12.4%)
How often will the monthly payments adjust?	Annually

Mortgage Shopping Worksheet—continued

	Example
What is the payment cap?	7.5% per year; does not apply to recalculation every 5th year
Can this loan have negative amortization?	Yes
Is there a limit to how much the balance can grow before the loan will be recalculated?	Up to 125% of original amount borrowed (loan will be recalculated if balance grows to $225,000)
Is there a prepayment penalty if I end this mortgage early by refinancing or selling my home?	Yes
How much is the penalty?	3% of amount borrowed in 1st year ($5,400), down to 1% of amount borrowed in 3rd year ($1,800); no prepayment penalty after year 3
What will my monthly payments be for the first year of the loan?	$630
Does this include taxes and insurance? Homeowner's association fees?	No
What is the **most** my minimum monthly payment could be after **12** months?	$677 (based on 7.5% cap)
What is the **most** my minimum monthly payment could be after **24** months?	$728 (based on 7.5% cap)
What is the **most** my minimum monthly payment could be after **36** months?	$783 (based on 7.5% cap)
What is the **most** my minimum monthly payment could be after **48** months?	$2,491 (based on recalculation of the loan when balance is $225,000)
What is the **most** my minimum monthly payment could be after **60** months (5 years)?	$2,491 (based on recalculation of the loan after 4 years)
What would my minimum monthly payment be after **60** months (5 years) **if the interest rate stays the same?**	$1,308 (based on recalculation of the loan after 5 years)
What are the fees and charges due at closing on this loan?	See good faith estimate

When might an I-O mortgage payment or a payment-option ARM be right for you?

Despite the risks of these loans, an I-O mortgage payment or a payment-option ARM might be right for you if the following apply:

- you have modest current income but are reasonably certain that your income will go up in the future (for example, if you're finishing your degree or training program),
- you have sizable equity in your home and will use the money that would go toward principal payments for other investments, or
- you have irregular income (such as commissions or seasonal earnings) and want the flexibility of making I-O or option-ARM minimum payments during low-income periods and larger payments during higher-income periods.

When might an I-O mortgage payment or a payment-option ARM *not* make sense?

Interest-only or option-ARM minimum payments may be risky if you won't be able to afford the higher monthly payments in the future. For example, suppose you are in the market for a home and can afford a monthly payment of about $1,100. Depending on the interest rate, with a traditional 30-year, fixed-rate mortgage, you might expect to get a $180,000 mortgage. A lender or broker could offer you an I-O mortgage payment of $1,100 monthly that might enable you to get a $215,000 mortgage—and, therefore, a more expensive house. But keep in mind that your payments could go up because of interest rate increases when the I-O period ends, or when the loan is recalculated. Your $1,100 monthly payment could jump to $1,340 or more. If you cannot reasonably expect to make this larger payment when the time comes, you might want to think about a different type of loan.

Mortgage Shopping Worksheet

Use this worksheet to compare mortgages.

	Mortgage 1	Mortgage 2
Name of lender or broker & contact information		
Mortgage amount		
Loan description		
Is this an I-O payment or a payment-option ARM?		
If different payment options are available, what are the options?		
What is the full term of the mortgage?		
How long is the option period?		
What is the initial interest rate?		
For a payment-option ARM, how long does the initial interest rate apply?		
What will the interest rate be after the initial rate?		
How often can the interest rate adjust?		
What is the periodic interest rate cap?		
What is the overall interest rate cap?		
How often will the monthly payments adjust?		

What is the payment cap?		
Can this loan have negative amortization?		
Is there a limit to how much the balance can grow before the loan will be recalculated?		
Is there a prepayment penalty if I end this mortgage early by refinancing or selling my home?		
How much is the penalty?		
What will my monthly payments be for the first year of the loan?		
Does this include taxes and insurance? Homeowner's association fees?		
What is the **most** my minimum monthly payment could be after **12** months?		
What is the **most** my minimum monthly payment could be after **24** months?		
What is the **most** my minimum monthly payment could be after **36** months?		
What is the **most** my minimum monthly payment could be after **48** months?		
What is the **most** my minimum monthly payment could be after **60** months (5 years)?		
What would my minimum monthly payment be after **60** months (5 years) **if the interest rate stays the same**?		
What are the fees and charges due at closing on this loan?		

What are the alternatives to I-O mortgage payments and payment-option ARMs?

If you are not sure that an I-O mortgage payment or a payment-option ARM makes sense for you, there are several other alternatives you could consider.

- Find out if you qualify for a community housing program that offers lower interest rates or reduced fees for first-time homebuyers, making homeownership more affordable.
- Consider a fixed-rate mortgage or a fully amortizing ARM. Shop around for terms and features that fit your needs and your budget.
- Take more time to save for a larger down payment, reducing the amount you need to borrow and making your mortgage payments more affordable.
- Look for a less expensive home. Once you build up equity, you could buy a more expensive home.

What should I keep in mind when it comes to an I-O mortgage payment or a payment-option ARM?

- Both types of loans can be flexible and allow you to make lower monthly payments during the first few years of the loan. You can repay some of the principal at any time to help keep future payments lower.
- Neither loan may be the right choice if the attraction of an initial smaller monthly payment leads you to take out a larger mortgage than you will be able to afford when the interest-only period ends or when the option payments are recalculated.

- Eventually you will have to pay back the principal you borrowed, plus any amounts added to the principal as negative amortization.

- You will have lower monthly payments only during the first few years. You will have larger payments later—and you will need to have the income to cover those larger payments.

Also, note that

- with an adjustable-rate mortgage, interest-only and option-ARM monthly payments can increase, even during the I-O-payment or option period.

- by making I-O or minimum payments, you will not be building equity in your home by paying down the principal on the loan, even though you are making monthly payments. The equity in your home may increase if the market value of your home increases, but the equity could also go down if the market value of your home goes down.

- with payment-option ARMs, you may be adding to the amount you owe on your mortgage if you pay less than the full interest owed each month.

Glossary

Adjustable-rate mortgage (ARM)

A mortgage that does not have a fixed interest rate. The rate changes during the life of the loan in line with movements in an index rate, such as the rate for Treasury securities or the Cost of Funds for SAIF-insured institutions.

Amortizing loan

Monthly payments are large enough to pay the interest and reduce the principal on your mortgage.

Cap, interest rate

A limit on the amount your interest rate can increase. Interest caps come in two versions:

- periodic caps, which limit the interest-rate increase from one adjustment period to the next, and
- overall caps, which limit the interest-rate increase over the life of the loan. By law, virtually all ARMs must have an overall cap.

Cap, payment

A limit on how much the monthly payment may change, either each time the payment changes or during the life of the mortgage. Payment caps do not limit the amount of interest the lender is earning, so they may lead to negative amortization.

Equity

The difference between the fair market value of the home and the outstanding mortgage balance.

Good faith estimate

The Real Estate Settlement Procedures Act (RESPA) requires your mortgage lender to give you a good faith estimate of all your closing costs within 3 business days of submitting your application for a loan, whether you are purchasing or refinancing a home. The actual expenses at closing may be somewhat different from the good faith estimate.

Index

The index is the measure of interest-rate changes that the lender uses to decide how much the interest rate on an ARM will change over time. No one can be sure when an index rate will go up or down. Some index rates tend to be higher than others, and some change more often. You should ask your lender how the index for any ARM you are considering has changed in recent years, and where the index is reported.

Interest

The price paid for borrowing money, usually given in percentages and as an annual rate.

Margin

The number of percentage points the lender adds to the index rate to calculate the ARM interest rate at each adjustment.

Negative amortization

Occurs when the monthly payments do not cover all the interest owed. The interest that is not paid in the monthly payment is added to the loan balance. This means that even after making many payments, you could owe more than you did at the beginning of the loan.

Prepayment penalty

Extra fees that may be due if you pay off the loan early by refinancing your home. These fees may make it too expensive to get out of the loan. If your loan includes a prepayment penalty, be aware of the penalty you would have to pay. Ask the lender if you can get a loan without a prepayment penalty, and what that loan would cost.

Principal

The amount of money borrowed or the amount still owed on a loan.

For More Information

Additonal information about interest-only mortgages and payment-option ARMs is available on the Federal Reserve Board's web site at www.federalreserve.gov/pubs/mortgage_interestonly/default.htm.

See also these sites:

Looking for the Best Mortgage – Shop, Compare, Negotiate
(at www.federalreserve.gov/pubs/mortgage/mortb_1.htm)

Consumer Handbook on Adjustable Rate Mortgages
(at www.federalreserve.gov/pubs/arms/arms_english.htm)

A Consumer's Guide to Mortgage Settlement Costs
(at www.federalreserve.gov/pubs/settlement/default.htm)

Partners Online Mortgage Calculator
(at www.frbatlanta.org/partnerssoftwareonline/dsp_main.cfm)

This information was prepared in consultation with the following agencies and organizations:

Center for Responsible Lending

Consumer Federation of America

Consumer Mortgage Coalition

Consumers Union

Credit Union National Association

Federal Deposit Insurance Corporation

Federal Reserve Bank of New York

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Financial Services Roundtable

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Office of the Comptroller of the Currency

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University of Illinois Cooperative Extension

To request additional copies of *Interest-Only Mortgage Payments and Payment-Option ARMs*, please send your name, address, and the number of copies requested to Publications Fulfillment, Board of Governors of the Federal Reserve System, Washington, DC 20551.

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