Interest-only loan

An **interest-only loan** is a loan in which, for a set term, the borrower pays only the interest on the principal balance, with the principal balance unchanged. At the end of the interest-only term the borrower may enter an interest-only mortgage, pay the principal, or (with some lenders) convert the loan to a principal and interest payment (or amortized) loan at his/her option.

US interest-only mortgages

In the United States, a five- or ten-year interest-only period is typical. After this time, the principal balance is amortized for the remaining term. In other words, if a borrower had a thirty-year mortgage loan and the first ten years were interest only, at the end of the first ten years, the principal balance would be amortized for the remaining period of twenty years. The practical result is that the early payments (in the interest-only period) are substantially lower than the later payments. This gives the borrower more flexibility because he is not forced to make payments towards principal. Indeed, it also enables a borrower who expects to increase his salary substantially over the course of the loan to borrow more than he would have otherwise been able to afford, or investors to generate cashflow when they might not otherwise be able to. During the interest-only years of the mortgage, the loan balance will not decrease unless the borrower makes additional payments towards principal. Under a conventional amortizing mortgage, the portion of a payment that represents principal is very small in the early years (the same period of time that would be interest-only).

Interest-only loans represent a somewhat higher risk for lenders, and therefore are subject to a slightly higher interest rate. Combined with little or no down payment, the adjustable rate (ARM) variety of interest only mortgages are sometimes indicative of a buyer taking on too much risk-especially when that buyer is unlikely to qualify under more conservative loan structures.[1] Because a homeowner does not build any equity in an interest-only loan he may be adversely affected by prevailing market conditions at the time he is either ready to sell the house or refinance. He may find himself unable to afford the higher regularly amortized payments at the end of the interest only period, unable to refinance due to lack of equity, and unable to sell if demand for housing has weakened.

Due to the speculative aspects of relying on home appreciation which may or may not happen, many financial experts such as Suze Orman advise against interest-only loans for which a borrower would not otherwise qualify.[2] The types of interest-only loans that rely on home appreciation would be negative amortization loans, which most financial institutions discontinued in mid-2008.

A recent study published by the Chicago Federal Reserve Board verified that most Americans can benefit from funding tax deferred accounts rather than paying down mortgage balances. Homeowners sometimes use interest-only loans for freeing up monthly cash to fund retirement accounts. 3.4 million households don't contribute at all to their retirement but do accelerate the pay down of their mortgages. "Those households are losing from 11 to 17 cents for each dollar they put into a faster mortgage payoff", per the Chicago Federal Reserve study published by the National Bureau of Economic Research[3] and reiterated in the Chicago Tribune.[4]

UK interest-only mortgages

Interest-only loans are popular ways of borrowing money to buy an asset that is unlikely to depreciate much and which can be sold at the end of the loan to repay the capital. For example, second homes, or properties bought for letting to others. In the United Kingdom in the 1980s and 1990s a popular way to buy a house was to combine an interest-only loan with an endowment policy, the combination being known as an endowment mortgage. Homeowners were told that the endowment policy would cover the mortgage and provide a lump sum in addition. Many of these endowment policies were poorly managed and failed to deliver the promised amounts, some of which did not even cover the cost of the mortgage. This mis-selling, combined with the poor stock market performance of the late 1990s, has resulted in endowment mortgages becoming unpopular.

Canada rarely allows interest-only loans

It is possible, though extremely rare, to obtain a Canadian Interest Only payment or first few payments on a standard amortizing mortgage.

Interest-only loans in India

After the entry of private banks into the Indian banking sector, which was earlier dominated by nationalized banks, interest-only loans have been introduced. These loans are given provided that the borrower hands over a security (like gold ornaments) or the documents of the same (house papers) to the bank. Gold loans are the most common interest-only loans in India.

From an investor's perspective

Interest-only loans are sometimes generated artificially from structured securities, particularly CMOs. A pool of securities (typically mortgages) is created, and divided into tranches. The cashflows that are received from the underlying debts are spread through the tranches according to predefined rules, an Interest-only (IO) loan is one type of tranche that can be created, it is generally created in tandem with a principal only (PO) tranche. These tranches will cater to two particular types of investors, depending on whether the investors are trying to increase their current yield (which they can get from an IO), or trying to reduce their exposure to prepayments of the loans (which they can get from a PO). The investment returns on IOs and POs depend heavily on mortgage prepayment rates and permit investors to benefit from different prepayment expectations.[5]

Many homeowners saw the values of their homes increase by as much as four times its price in some markets in a five-year span in the early 2000s. Interest-only loans helped homeowners afford more home and earn more appreciation during this time period. However, interest-only loans have contributed greatly to creating the subsequent housing bubble situation, because many borrowers could not afford the fully indexed rate. Interest-only loans may turn out to be bad financial decisions if housing prices drop, causing those borrowers to carry a mortgage larger than the value of the house, which in turn will make it impossible to refinance the house into a fixed-rate mortgage.[6]

References

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Source: http://en.wikipedia.org/wiki/Interest-only_loan
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