

Interest-Only Mortgages: A Great Cash Flow Tool

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The recent fervor in the financial press about the pitfalls of interest-only adjustable rate mortgages (ARMs) was predictable as soon as interest rate increases occurred. In fact, articles criticizing the interest-only mortgage began appearing with the anticipation of rising rates. Typically, articles from the financial press regarding interest-only ARMs do not distinguish between the segment of the population that should never borrow on an interest-only basis and those for whom the interest-only loan is a wise financial planning tool.

There is a tendency on the part of the financial press to focus on the average American homeowner, and to draw conclusions based on what pertains to that average American. As with just about anything, conclusions based on the average can lead to inaccurate and misleading perceptions. The ARM, and particularly the interest-only ARM, has suffered from this sort of generalization.

Interest-only loans have existed for a long time. In fact, in the early part of the twentieth century, most mortgage loans were granted on an interest-only basis, usually with a five-year balloon payment. During the Great Depression, these loans wreaked havoc on the average American homeowner. By paying only the loan interest and never reducing the principal, homeowners found themselves in a precarious situation. Depreciation in real estate values left many people with no equity in their properties and, for those who lost their jobs and had no savings, caused them to lose their homes. For many homeowners, the inordinate number of foreclosures that occurred during the Great Depression created a negative preconception about interest-only loans, a bias they subsequently passed on to their children and which is now shared by many in the financial press.

THE MODERN ARM

The modern ARM came into popular use during the Carter administration, when interest rates skyrocketed into the high teens and low twenties, and ARMs became the only way many Americans could qualify for a mortgage loan. With lower interest rates, ARMs allowed people to purchase a home, while fixed-rate mortgages, with their higher costs, made it difficult for a homebuyer to qualify for a mortgage loan.

Homeownership levels have become an integral part of public policy (and political gamesmanship) in the United States and the residential real estate sales and finance industries have benefited from the homeownership focus in the White House and in Congress. However, in many instances, this focus on increasing homeownership levels has been driven more by politics and profit than by a responsible definition of the requirements of homeownership. Programs have proliferated that allow borrowers to buy a home with little or no down payment, as have adjustable-rate financing programs which lever buyers into homes they may be unable to maintain on a fixed income. In some circumstances, the interest-only ARM has been a leveraging tool to put people into homes they really can't afford, and may lose, absent a high rate of appreciation in their local

housing market. Encouraging individuals and families to enter the ranks of homeowners when they have neither the down payment nor the income to sustain homeownership is irresponsible and counterproductive.

For instance, placing a first-time homebuyer into a home with little or no money down and on an interest-only basis has been a prescription for disaster in markets without significant appreciation rates. Certainly, markets such as Los Angeles, New York, and San Francisco have proven to be exceptions, and buyers have, in effect, successfully speculated on the purchase of a home. However, homeowners in every market must carefully consider the potential consequences of an interest-only loan, should significant appreciation in housing not materialize and interest rates escalate. The results can be dire, ruining the borrower's credit rating.

Both the real estate sales and the residential mortgage lending businesses are based in large part on commission-based sales organizations, and consequently, salespeople can base home purchase recommendations on self-interest and the naive assumption that real estate values will only increase. Commissioned sales forces need to concern themselves with questions every homeowner should also ask when it comes to considering an amortizing ARM or an interest-only ARM: What if depreciation occurs? What if the homebuyer finds himself under water - the mortgage balance is greater than the value of the property? Or, what if interest rates rise, causing the monthly interest payment to stretch the homeowner's income resources to the breaking point?

Clearly, an interest-only mortgage is not a viable option for the homebuyer who can only qualify for a mortgage loan based on the interest-only option. Still, there is an enormous group of homebuyers who do not fall within this category, and for these borrowers interest-only ARMs may be used as an excellent financial planning tool to increase the borrower's cash flow and afford a level of financial flexibility and freedom the traditional fixed-rate mortgage cannot provide.

REACHING GOALS

During the last decade, the mortgage industry has seen financially savvy homeowners and their financial planners employ the interest-only mortgage as an integral component for reaching a borrower's overall financial goals. Mortgage interest is one of the few tax-advantaged expenses that have survived a myriad of tax reform legislation over many decades. Also, mortgage interest rates tend to be relatively low compared to alternative financing products. If the borrower can leverage his or her investment in residential property, avoid paying down principal for some period of time (usually up to 10 years), and invest the principal equivalent in alternative investments, then the borrower creates a favorable arbitrage. And the larger the loan amount, the more pertinent this becomes.

Even in the early years of a mortgage, when the principal component can be relatively low, this arbitrage condition can accrue to the benefit of the borrower in a substantial fashion. For instance, on a \$1,000,000 loan (10/1 ARM at 5.5 percent, a loan that generally has a maturity of 30 years, with a fixed interest during the first 10 years and an annual adjustable rate thereafter), the borrower can realize approximately \$65,700 in cash

flow savings over five years and \$131,400 over 10 years simply by choosing an interest only option.

In actuality, the borrower's savings can be even greater because of the difference between the interest rate on a 10/1 ARM and a 30-year fixed-rate mortgage. The difference in interest rate between a jumbo 10/1 ARM and a 30-year fixed rate jumbo loan can be as much as one percent. A jumbo loan is any residential mortgage with a loan amount of \$359,650 or greater, which represents the limit set by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Because the investor market for jumbo loans is more restricted than the market for conforming loans (FNMA and FHLMC are only authorized to purchase conforming loans), and because most lenders view jumbo loans as being more risky, jumbo loans usually carry a higher interest rate. Normally, fixed-rate loans are not available on an interest-only basis. So, the difference in monthly payment between a \$1,000,000 10/1 interest-only ARM at 5.5 percent and a fully amortizing 30-year fixed-rate loan at 6.5 percent is \$1,737.35. The savings in cash flow would be \$104,241 over the first 60 months, and \$208,482 over the 10-year fixed rate term of the ARM. In other words, the borrower could invest a stream of cash flow totaling \$208,482 over a 10-year period in an alternative investment that could generate a net yield in excess of the 5.5 percent gross interest cost on the mortgage. Since mortgage interest is deductible, the actual savings are even greater.

In the meantime, if the borrower realizes appreciation on the underlying real estate, he has an additional financial gain. However, if the property value depreciates, this will not equate to a catastrophic event so long as the borrower has sufficient reserves and income. Many financially astute borrowers select an ARM because they are essentially anticipating that the average interest rate over the life of the loan will be less than a constant fixed rate. And when one considers that the average life of a mortgage loan in the United States is somewhere between six and seven years, locking into a 30-year fixed-rate loan can be a costly alternative for many borrowers. And the shorter time that the homeowner projects he will be in a home, the more sense it makes to elect to borrow on an interest-only basis.

THE SAVVY CHOICE

There are specific circumstances in which an interest-only ARM may be the savvy choice for a homeowner. For instance, if an individual who knows he will only be in a property for a short period of time (e.g., the borrower will have a work-related relocation in three years, is planning to retire and downsize, or has a growing family and needs to upsize), borrowing on an interest-only basis makes a lot of sense. An added benefit is that ARMs come in a variety of forms, including traditional ARMs that adjust their interest rates on a one month, six month, or one year basis, and hybrid ARMs that have fixed interest terms of three years (3/1 ARMs), five years (5/1 ARMs), seven years (7/1 ARMs), and ten years (10/1 ARMs). Usually, the shorter the fixed-rate term of the ARM, the lower the interest rate. The difference in interest rates between a 30-year fixed-rate mortgage loan and a 3/1 ARM rate can be as much as two percent. For the person with a \$1,000,000

loan, who is planning on relocating in three years, this can mean an interest savings alone of approximately \$60,000 over the three year period.

Even though the principal component during the first few years of a mortgage is a small part of the total payment (typically, less than 1.5 percent of the original loan amount in the first year, for instance), the cash flow savings can still be significant. And the borrower does not have to be in the market for a \$1,000,000 loan. Even the conforming borrower (loan amounts less than \$359,650) can benefit from the shorter term interest-only based loan. For instance, a \$250,000 3/1 ARM loan at 4.875 percent, on an interest-only basis, carries a monthly payment of \$1,015.63, versus a monthly payment of \$1,478.84 on a 5.875 percent, fully amortizing, 30-year fixed-rate mortgage. This equates to a \$463.21 monthly pre-tax cash flow savings, or \$16,675.72 over three years. Preserving cash for this type of borrower can be especially important. The cash flow savings can be used for home improvements or repairs needed to make the house more saleable prior to listing it on the market, or the savings may be used towards a down payment on a new residence. By saving the principal part of the payments and realizing a savings from the lower interest rate during this three-year period, the homeowner can mitigate cash requirements down the road pending the sale and closing of his or her present property.

OTHER EXAMPLES

There are other examples in which individuals can benefit from an interest-only mortgage. These include the self-employed borrower and the borrower who receives the bulk of his income via a one-time annual bonus. Self-employed individuals, as well as the recipient of an annual bonus, often depend on year-end, semi-annual, or quarterly distributions. An interest-only mortgage affords this borrower the ability to minimize monthly payments and then make lump-sum principal payments coincident with the receipt of a bonus or profit distribution. In fact, some mortgage lenders have found that these individuals tend to curtail their mortgage balance on a periodic basis, after receipt of their bonuses or profit distributions, by a larger amount than they would have reduced their mortgage balance had they borrowed on an amortizing basis.

The ARM, especially with its interest-only component, is an increasingly popular mortgage product among borrowers and members of the financial planning community. This is just one of the reasons that the Mortgage Bankers Association estimates that ARMs will represent a majority of loans taken out in the jumbo category, and that interest-only ARMs will represent a bigger and bigger share of the jumbo ARM market in the future. As financial planners focus more on the liability side of their clients' balance sheets, many within the mortgage industry anticipate an increased level of sophistication among borrowers. Homeowners will not only choose interest-only ARMs, but also will research the cash-flow advantages of other non-traditional mortgage products such as loan modification options (ability to change from one ARM term to another without the costs and hassle of a refinance) and pledged-asset loans (ability to finance up to 100 percent of the appraised value of a property with the pledge of marketable securities).

CONCLUSION

While the interest-only ARM is not for everyone, it is a viable financing mechanism for the segment of the population that can afford the risks associated with the product. Ironically, the ARM came into popularity as a result of high interest rates in the late 1970s and became the product of choice for many first-time home homebuyers. As a financing tool, the ARM allowed people to qualify for a mortgage who could not do so with a fixed-rate mortgage. Today, the ARM, and particularly the interest-only ARM, has been adopted by the more affluent members of our society—not as a means of qualification, but as a financial planning and cash flow device.