

Best Bang For The Mortgage Buck: 30 Year Fixed Rate Interest-Only

by Leif Larsen

Want more financial flexibility with the security of a rate that's fixed for the life of the loan? Then the 30 year fixed rate interest-only mortgage is the best choice for you! This mortgage offers a lower payment than traditional 30 year and 40 year principal and interest mortgages but the biggest benefit is that it allows you to pay down principal whenever you choose to do so. For example, you can pay it down once a year when you receive a bonus or you can pay it down monthly as though you had a principal and interest mortgage. But here's the best part – every time you pay down the principal you lower your monthly interest-only payment because it's based on the current principal balance (unlike a principal and interest mortgage where the monthly payment doesn't change). If you choose to never pay down principal it is extremely likely that you will still gain equity through the properties' appreciation over time. For example, if a home purchased for \$500,000 appreciates 4% a year it will be worth \$608,327 at the end of 5 years (it will have appreciated \$108,327).

An additional benefit to an interest-only mortgage is that you can qualify for 20% more home with the same payment as a principal and interest mortgage. Translated, that means someone who could qualify for a \$500,000 house on a traditional 30-year fixed-rate mortgage would be able to purchase a \$600,000 home with an interest-only loan!

As the table below shows, a small amount of principal is paid down at the beginning stages of a principle and interest mortgage, as a big portion of the payment goes toward interest:

Loan Amount of \$250,000					
Program	Rate	Payment/Mo.	Difference	Principal Pd. After 1 st Yr.	Principal Pd. After 5 th Yr.
30 Yr. Fixed	6.00%	\$1,499	-	\$3,070	\$17,364
40 Yr. Fixed	6.00%	1,376	\$123	1,549	8,759
30 Yr. Fixed Interest Only	6.00%	1,250	249	-	-

With most interest-only mortgages, the interest-only period is for 10 years and then reverts to a principal and interest loan for the remaining 20 years (the rate is fixed for the entire 30 year term). As a result, whatever the principal balance is at the end of 10 years will dictate what the monthly payment will be for the next 20 years. With that in mind, I advise clients to devise a strategy to pay down principle that best fits their lifestyle but also advise them to consider all of their monetary obligations, such as high interest credit card payments, and investment opportunities, such as retirement plans, before thinking about using their money to pay down principal. This is especially true if your company has 401(k) retirement plan and your employer offers to match every dollar you contribute up to a certain percentage of your salary. For example, if your employer matches up to 6% of your salary and the plan offers an array of mutual funds to invest in, any of which are likely to yield at least a 5% annual return, you will reap a much greater benefit by contributing to your 401(k).

Very simply, before paying down principal evaluate whether your after-tax mortgage interest rate is less than the before-tax return on a relatively safe investment, such as a retirement account, and whether your after-tax mortgage interest rate is lower than the interest rate charged on revolving (credit card) debt.

Whether you are purchasing a new home, or refinancing your current mortgage, the 30 year fixed rate interest-only mortgage offers the best bang for the buck!

Leif Larsen is a National Mortgage Banker with Chicago Bancorp in South Barrington, Illinois and can be contacted by phone at (847)602-4343 or e-mail at Leif@ChicagoBancorp.com.