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FINANCING

Interest-only risk management

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Young homeowners are taking a fresh look at an old idea. Some are prepaying the principal on their mortgages -- even if their loans are the popular new interest-only variety.

Lenders now say that when they make interest-only mortgages, borrowers often discuss the possibility of prepaying the loan principal.

Interest-only loans -- often favored by younger buyers struggling to afford their first home -- allow borrowers to lower their monthly payments for a certain period by paying nothing toward the actual amount owned.

And though interest-only loans offer an entry to homeownership, they carry the specter that on a designated future date, the monthly bills will jump when principal payback kicks in.

But borrowers can voluntarily submit more money than they are required by their monthly bill and stipulate that the extra money go toward reducing principal.

By chipping away at principal early, borrowers holding any type of mortgage pay less overall interest. That's because interest charges are figured on the outstanding principal.

Owners holding interest-only loans will also cut their payment shock when their principal payback starts, because there's less total principal to be divided into monthly bills.

While whittling debt is laudable, financial planners caution that prepaying the mortgage may not be a wise idea for some homeowners.

"Have all the basics in place before you prepay," says John S. Davis of Mentor Capital, a financial planning firm in Elmhurst.

Such basics include savings worth a couple of months' salary that can be tapped in an emergency, and a life insurance policy on the breadwinners whose earnings pay the mortgage, he says.

Homeowners who cover the basics and then have extra cash might very well consider pre-paying, especially if they are "mortgaged to the max," says Carol Pankros of CCP Inc. Financial Planning Services in Palatine.

Owners who hold a mortgage worth nearly as much as their house run the risk of owing more to their lender than they collect when they sell, she notes. Biting into principal reduces that risk.



But some mortgage contracts contain restrictions on prepaying. So, first check the mortgage note, the contract between you and the lending company that you should have received when you took out the loan, advises Robert Wesley Brown, president and CEO of MACC-TRAC, a Denver firm that provides quality assurance programs for lenders.

When prepayments are allowed, Brown advises borrowers to write a separate check for the prepayment, not simply adding an extra amount to the regular bill.

"More money flows through the economy in the form of mortgage payments than just about anything else," he asserts, and it's important to make prepayments stand out so that mortgage processors will properly credit them, Brown says.

In addition to a separate check, he advises writing the mortgage loan account number and a note that it's a prepayment on the memorandum portion at the bottom of the check. Attaching a short letter explaining that prepayment is enclosed is also advisable, Brown says.

Though many lending companies have systems to credit a principal prepayment correctly, "as a safety net, the two-check approach is good advice," says Jim Linnane, north central division manager of Wells Fargo Home Mortgage.

Then, after sending in a prepayment, Brown adds, make sure that the amount sent was properly credited toward principal reduction.

Address questions to Financing, Chicago Tribune, Real Estate section, 435 N. Michigan Ave., 4th Floor, Chicago, IL 60611. You may also e-mail realestate@tribune.com.

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