"Here are the figures provided by my loan officer. The payment on the 30-year 5.5% fixed-rate mortgage is $567.79 for each $100,000 of loan, of which only $109.46 is reduction of principal. On the interest-only, the rate is 3% and the payment only $250. If you take the IO and then make the $567.79 payment, $317.79 of it will go for principal. This means that you will pay off your loan much sooner."

I receive letters similar to this every day, and the number of them seems to be increasing. The pitch is evidently very effective, so more and more loan officers are adopting it. Interest-only (IO) is HOT, and one of the major reasons is that it is now being sold as a way to amortize a mortgage more quickly.

A fascinating thing about the rapid amortization pitch is that it is the exact opposite of an earlier and still popular pitch for IOs: that the lower payment allows the borrower to invest the payment savings and earn a return higher than the mortgage rate. This pitch is for no amortization. "Why invest in repaying your loan balance, which is only costing you 5.5%, when you could put that money into common stock that will yield 10% or more."

Although I don’t think many borrowers would profit from adopting the no amortization strategy, the pitch is at least straightforward. Most borrowers understand the costs and potential benefits of investing (or spending) monies that would otherwise go to paying down the loan balance. The rapid amortization pitch, in contrast, is extremely deceptive.

Everything in the statement of your loan officer is true, yet it is extremely misleading. The rate on the IO is not 3% because it is IO but because it is an adjustable rate mortgage (ARM). Rates are lower on ARMs than on FRMs because ARMs are riskier to the borrower. The real choice that is being made here is not between IO and non-IO but between FRM and ARM.

By making it appear as if the rate differential is IO vs something else, borrowers are encouraged to ignore all the features of ARMs that they should be concerned with in making a selection. The writer above and all the others don’t tell me how long the 3% rate lasts.

Borrowers making this choice do indeed have the option of taking the lower-rate ARM while making the larger payment. This is a good risk-reduction strategy when selecting an ARM because, if the ARM rate rises in the future, the payment increase won’t be as large. ARM borrowers can adopt this strategy, whether their ARM has an IO option or not.

Indeed, borrowers who plan to do this may do better with an ARM that does not have an IO option, because in many cases the rate will be lower. If the ARM in the example above were available at 2 7/8% without an IO option, the borrower would be better off selecting it. The sales pitch obscures this possibility.