The Mortgage Connection
Financing your property dreams

Interest Only Loans

A helpful guide for buyers

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Introduction

If you are thinking of taking out an interest only loan, there are some important things to bear in mind. Like all loan products there are advantages and disadvantages in using an interest only loan for either a property purchase or a refinance. Below are listed some things for you to consider. The list is by no means exhaustive and there may be other aspects that are relevant depending on your personal circumstances.

Advantages

- **Smaller repayments.** During the interest only period of the home loan your monthly repayments will be lower than with a principal and interest loan.
- **Free up cash.** Lower repayments mean you could use your available cash for other purposes that may be financially beneficial. You could use the money to pay off debts, make other investments, fund a loan to purchase another property, or to pay the cost of additional educational qualifications that may increase your earning potential.
- **Tax deductible for property investors.** The interest on an investment property debt is usually tax deductible for property investors, if they follow the ATO rules. This can be very beneficial to property investors with regard to maximising their tax deductions and cash-flow. You should always seek the advice of your accountant in relation to taxation benefits for your particular circumstances. It should be noted, however, that owner-occupiers will not receive any tax deduction for interest if they take out an interest only loan.
- **Benefits are ongoing for the life of the interest only term.** Consumers can often choose an interest only term from 1, 3, 5 or 10 years. This can be very beneficial for tax minimisation strategies and financial planning purposes.

Disadvantages

- **You may not build up any equity.** Interest only loan repayments do not help the borrower to build equity in their property. Unless property values rise during the interest only period of the loan, you will not have improved your financial position.
- **As soon as the interest only period ends, the loan will revert to principal and interest and your repayments will increase.** It is important to plan ahead for the end of your interest only period. At that time, some lenders may allow you to renegotiate another interest only term. Or, if you convert to principal and interest, you will have to plan for increased payments. Other alternatives may include refinancing the loan, or selling the property.

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- **An interest only loan will cost more in interest over the life of the loan than a principal and interest loan.** The cost differentials can be quite significant, for example*:

  With a normal principal and interest loan for $500,000 at 4.78% p.a. based on an LVR of 80% over 25 years, the total cost of interest on the loan would be $357,766 over the 25 year period. On an interest only loan for $500,000 at 4.78% p.a. based on an LVR of 80% over 25 years with an interest only period of 10 years, the total cost of interest on the loan would be $440,443 over the 25 year period, which means that the interest only loan would cost the borrower an additional $82,677 in interest compared to a principal and interest loan.

- **It may be a better idea to pay down the principal while interest rates are low.** Paying as much as you can off the principal now could mean that when interest rates do rise you would be paying those higher rates on a reduced loan size, which could mean lower loan repayments and/or paying less interest in the long-term.

*Information source: http://www.canstar.com.au/

If you would like to discuss any of these items or if you have any questions in relation to interest only loans, please contact me.

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