Interest only loans & repayment types

The repayment on your mortgage will always include the interest payable on the amount borrowed, no matter what kind of loan you have. If you have a Principal & Interest loan (P&I), part of your repayment will also be allocated to reducing the balance of the loan.

With an Interest Only loan (IO), your repayments only pay the interest that is due and do not reduce the balance (or the amount you borrowed). As a result, an IO loan can only be obtained for a limited period (usually up to five years). At the end of the IO period, the loan will automatically convert to a P&I loan unless you make an application to extend the IO period.

Who should use an Interest Only loan?

IO home loans are not designed for every type of borrower. For example, they are not recommended for standard owner- occupied home buyers. In this scenario, the less you pay off the principal amount, the more you end up paying in interest over the life of your loan. Your repayments are likely to be a lot higher as well, so there are very little benefits to an IO loan for owner-occupier home buyers.

However, IO loans can be very useful for property investors— that's because the interest on a loan for a property investment is usually tax deductible. In this scenario, an IO loan can help an investor to arrange their finances to maximise their investment strategy, tax advantages and cash-flow.

How do IO repayments differ?

You can expect your repayments to be lower initially if you commence your loan with an IO period. However, while the IO period is in place, you can also expect to be paying a higher rate of interest than if you started with P&I repayments from the outset.

At the end of the IO period, your repayments will increase to cover repayments on both the principal and the interest—so you can expect this increase to be significant. You also need to consider the period left to pay off the principal is reduced, which could drive up your repayment amount even further.

Because IO repayments will result in you paying more interest over the term of the loan, this option should only be chosen to fill a requirement that you have—such as maximising your tax advantages with a property investment. They are usually not a wise choice just to make loan repayments more affordable.

Even with an IO period in place, you may be able to reduce the principal during this time by making voluntary extra payments, or by depositing funds into an offset account. Flexibility to do this may be restricted with some lenders, and some additional fees may apply.

What are the benefits of IO loans?

- **Smaller repayments.** During the IO period of the home loan, your monthly repayments will be lower than with a P&I loan.
- **Improved cash-flow.** Lower repayments mean you could use your cash for other purposes that may be financially beneficial - pay off debts, make other investments, fund a loan to purchase another property, or pay the cost of additional educational qualifications that may increase your earning potential.

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- **Maximise tax benefits for property investors.** The interest on an investment property debt is usually tax deductible for property investors, as long as you follow the ATO rules. It should be noted, however, that owner-occupiers will not receive any tax deduction for interest if you take out an IO loan. Please speak to your accountant or financial planner to discuss if an IO loan is the right option for you.
- **Benefits are ongoing for the life of the IO term.** You can often choose an IO term of one, three, five or 10 years. This can be very beneficial for tax minimisation strategies and financial planning purposes, so please speak to your accountant or financial adviser to find out how to make it work for you.

Things to consider

- **You may not build any equity.** IO loan repayments do not help you to pay off the principal and build equity in your property. If property prices do not rise during the IO period of the loan, you will not have improved your financial situation. You may also be at financial risk if property prices should fall during the IO period.
- **The loan reverts to P&I as soon as the IO period ends.** If you take out an IO loan, you should plan for the end of your IO period. At that time, some lenders may allow you to renegotiate another IO term. Otherwise, you can plan for increased repayments, consider refinancing the loan, or selling the property.
- **Not all lenders allow extra repayments** during the IO period and the availability of additional features such as an offset account will vary between lenders and loan products.
- **A loan with an IO period will cost more** in interest over the life of the loan, than a loan that has P&I repayments from the outset. The cost differentials can be quite significant and should be clearly understood.

For example:
With a normal P&I 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.

For the same loan with an IO period of 10 years, the total cost of interest on the loan would be $440,443 over the 25-year period and therefore would cost you an additional $82,676 in interest compared to a loan that had P&I repayments over the full 25-year term.

- You could miss the opportunity to pay down the principal while interest rates are low. Paying as much as you can off the principal while rates are low could mean that when interest rates rise, you will be paying those higher rates on a reduced loan balance. This could mean lower loan repayments and/or paying less interest in the long-term.

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