

# Interest-only loans: what to do now?

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The banks have been making mortgages with interest-only repayments more difficult to obtain over the past 18 months. The typical 30-year interest-only mortgage is structured as five years interest only plus 25 years of principal-and-interest repayments. As such, at the end of the interest-only term, repayments automatically switch to principal and interest.

Borrowers, particularly investors, are attracted to interest-only loans because they provide more flexibility to manage cash flow.

It is worth knowing that just because a loan is set up with interest-only repayments, it does not mean you are not allowed to make principal repayments. The vast majority of products allow principal repayments. The advantage is that it's at the borrower's discretion. Also, unlike with principal-and-interest loans, depositing money in a linked offset account reduces monthly repayments.

This flexibility suits investors who also have an owner-occupier home loan. In this case, an investor could minimise investment holding costs by repaying interest only on all investment loans. This would free up as much cash flow as possible, which they could use to repay their home loan. Typically, it's wise to repay non-tax-deductible debt before you begin repaying tax-deductible debt.

The volume of interest-only mortgages peaked in early 2017 when they accounted for about 40 per cent of all new mortgages. APRA then stepped in and introduced its benchmark, which stipulated that the proportion must be less than 30 per cent of new loans.

The prudential regulator subsequently removed this benchmark in December last year but the level has not bounced back and only 20 per cent of new loans are structured as interest-only. The banks dissuaded borrowers away from interest-only loans by doing three things.

- First, they increased variable interest rates, which for interest-only loans are now 0.42 per cent higher than their principal-and-interest counterparts.
- Second, they made it more difficult to roll over onto a new interest-only term by requiring borrowers to go through a full application process.
- Third, almost all banks reduced the maximum interest-only term to five years.

And then they tightened credit parameters — for example, they have become reluctant to allow - interest-only repayments for owner-occupier loans.

Over the past few months, some lenders have loosened credit policies for interest-only loans. Some lenders no longer require borrowers to go through a full application process if they request a second interest-only term. Also, a few banks have introduced interest-only terms of up to 10 years.

If you have a loan with an interest-only term that is approaching its expiry, you have three options.

- You can ask the bank to roll your loan over onto another interest-only term. Typically, this is possible as long as your loan was established less than 10 years ago.
- If your lender is not willing to offer another interest-only term, you can consider refinancing to a new lender, but this will require you to go through an arduous application process.
- You could do nothing and let the loan's repayments convert to principal and interest. One of the advantages of the low interest rate environment is low principal-and-interest repayments. For example, on a \$500,000 loan, principal-and-interest repayments would be about \$2640 a month. Interest-only repayments would be about 30 per cent lower at \$1875 a month. Five years ago, when interest rates were about 6 per cent, interest-only repayments would have been about \$2500 a month. That said, you must consider whether principal-and-interest repayments are still affordable when interest rates do eventually rise.

Given house price volatility, it might be a wise to begin repaying investment debt. Doing so will build more equity in your investment assets, rather than relying on appreciating property values.

Interest-only loans still have merit. An investment strategy should address debt exit strategies that could include principal-and-interest repayments.

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