

For your Interest Only

Investors have an affinity with interest only loans as they allow them to borrow money, make lower repayments and use the freed-up cash to make other investments.

Simply speaking, an interest only loan is a loan where the borrower repays only interest on the loan. The principal is repaid at the end of the interest only term. This means that while you are making lower repayments during the term of the loan, at the end of it you will still owe the entire loan amount.

In contrast, the principal and interest mortgage (P&I) will require larger payments for the same size loan, however at the end of the term everything will be paid off.

"The main appeal of an interest only loan is that it helps investors free up some cash that can be used elsewhere," explains Gino Marra, CEO of Carrington National. "As you are only paying the interest component of the loan during the interest only period, your financial outlay is lower so you can afford to buy more properties as well as bigger ones."

How does it work?

For example, if you take a \$500,000 mortgage at 8.57%, your monthly repayment on IO is \$3,571 compared to a P&I repayment of \$3,869. This essentially frees up \$298 each month for you to use in buying or maintaining other assets. The larger the amount you borrow, the greater the difference would be.

An interest only facility is becoming a common feature of a standard P&I loan, which can be taken as a variable rate or fixed rate loan. After a set period, the loan switches back to a regular P&I loan. Stand-alone IO loans are usually short term. A borrower may be able to get an IO loan for a term of up to 15 years, although they usually have a term of one to five years. After the end of that term, the borrower may either choose to refinance the loan, pay the balance in a lump sum, or start paying off the principal through a P&I loan.

The bet is that the investment will outperform a standard mortgage loan for the first five to 10 years. After the 10 years is up, the interest only mortgage loan holder will have the money to refinance or pay off the mortgage in a lump sum.

Buy more properties

If you are only paying interest on a loan it means that less of your cash is tied up in repayments and you can use the difference for other purposes.

For example, if you buy a house for \$400,000 and sell it five years later for \$550,000, taking an interest only loan to finance this means you have repaid none of the principal. However, you have been saving money on repayments over the last five years and also have an extra \$150,000 after the sale, which you can reinvest in another property.

"For many homebuyers, paying down the mortgage secured on the family home is considered to be the most effective way to build wealth," says Marra. "Some may build wealth more rapidly than others simply by investing excess cash flow into other areas, rather than concentrating all their cash flow into their mortgage."

Investing in the property itself

Another effective use for the freed-up cash from your IO is to add value to the home itself through renovations. From the example earlier, you can use the \$298 per month to embark on a \$3,576 a year makeover that will help boost the selling price or rental return later. For example, you can look at sprucing up your kitchen to boost your rental charges by \$10 per week or renovate the bathroom for an added value of around \$20,000.

Understanding the risks

With an interest only loan, you are essentially betting that the property you buy will rise in value in order for you to cover the interest and costs when you sell. You're also hoping that your earning capacity will increase so that you will be able to service the increased debts. Since you're not paying any principal, you are not accumulating equity in your property.

In the current market where property prices are going from strength to strength, the risk of falling values may seem remote. However, property markets in Australia have been known to be extremely fragmented, as evidenced by the rising values in the prime suburbs whilst the mortgage belt areas continue to languish. This means your local property market could fall even as the national trend is rising. So you could end up with a lower value property or worse, you may be forced to sell at a loss.

Rising interest rates is also a potential risk if you've taken a variable rate loan. If your income has not risen enough to cover the increased repayments you could find yourself struggling to keep your head above water. Even if you opted for a fixed rate loan, you will still face higher repayments when the interest only period ends.

Considering the relatively loose lending criteria at the moment, property buyers are allowed to borrow more money for the same income, so there is a risk of borrowing more than they can comfortably afford.

Luke Sheales, national sales and distribution manager at Mortgage House, believes the interest only mortgage tempts borrowers to over-commit, seeing that they can afford to service a big interest only loan, but ignoring the capital element.

"As always the big downside is over-commitment. I have seen people take an interest only loan because they need the cheaper payment to actually service the loan and live at the same time. This is dangerous and you should always make sure you can service the full principal and interest loan repayment amount and then have some up your sleeve as well," says Sheales.

How to pick the right product

Structuring your finances right and picking the most suitable product will help you avoid paying hefty fees when exiting or refinancing with another lender. When choosing an IO loan, make sure that the structure is flexible enough to allow you to buy more properties easily in the future.

Getting a competitive interest rate is a sure-fire way to save on monthly repayments, so shop around or talk to your mortgage broker before you sign up for a new loan. Also make sure that you have the full list of fees including start-up, ongoing and exit fees. Most lenders will hit you with a hefty exit fee when you decide to refinance so make sure that you add up all the costs before making the move.

Your Mortgage magazine regularly features practical tips on how to choose the best mortgage. You can also find top ranking investment loan products on its website

www.yourmortgage.com.au

Pay principal when you can

Interest only variable rate loans give you the flexibility to pay off the principal when it's convenient. Investors with fluctuating incomes may value the flexibility that an IO loan allows. When finances are tight, they can make IO payments and when they are flush with cash they can make principal repayments.

Sheales says this is something often misunderstood by consumers. "When you are on an interest only loan, the minimum payment you make is the interest portion, so you can pay as much as you like above this," he says. "Many people wrongly think that you are stuck paying the interest only. However, you have to make sure that your loan has the flexibility to pay as much as you like above that and you aren't penalised for doing so."

Splitting the interest rate

Investors with variable rate interest only loans will feel the impact of interest rate changes relatively more than those paying P&I loans. Each will have the same increase/decrease in interest rates, but the entire repayment on interest only loans is subject to a rise or fall. To counter that, you may want to take a split loan in order to mitigate the risk, while still hoping to take advantage of a fall in interest rates.

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