

# Quick GUIDES

## The ins and out of interest only loans

When it comes to repaying your loan, there are two components that need your attention – the principal and the interest. If you have a Principal & Interest loan (P&I), part of your regular repayments will pay for the interest and part will pay for the principal. Over time, this means you are slowing reducing the amount you borrowed from the bank.

If, however, you opt for an Interest Only (IO) loan, your regular repayments only pay the interest that is due. No money goes towards reducing the amount you borrowed. If you had an interest only loan for the entire time you own the property, you would never pay down any principal (unless you made additional repayments).

To avoid this, lenders typically put a cap on how long you can have an Interest Only loan for – 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 it.

### 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.

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 remember that you will have less years to pay off the principal, 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. It's generally not a good idea to choose an IO loan just because you want 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 such as paying off other, higher-interest debts, making other investments, funding a loan to purchase another property or paying the cost of additional educational qualifications that may increase your earning potential.

### 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.

**GOT A QUESTION?**  
*Lets chat.*

Got a question? Need some help? The team at Nook is here to help. Go on, get in touch.

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## Thing 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 when 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 need to plan for increased repayments, consider refinancing the loan, or selling the property.

### Not all lenders allow extra repayments

During the IO period, the availability of additional features such as extra repayments and an offset account will vary between lenders and loan products. 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.

### A loan with an IO period will cost more

That's because you pay more interest over the life of the loan compared to a loan that has P&I repayments from the outset. The cost differentials can be quite significant and should be clearly understood.

## Important information

The information provided on this page is not legal, taxation or financial planning advice. It has been prepared without considering your specific needs, objectives and personal financial situation. Before acting on this information, we recommend that you consider carefully if it is appropriate for your needs, objectives and personal financial situation. All loan products are subject to lender criteria and approval. Fees, terms and conditions apply.