Compare principal and interest and interest-only home loans

Finding out which home loan is right for you depends on your personal situation. Are you looking for a home loan to buy your first home, update your current one or as an investment in retirement? Are you confused by all the jargon and what type of home loan is right for you?

We delve into two of the most popular home loans: principal and interest and interest-only.

What is a principal and interest home loan?

As the name suggests, your loan repayments go towards paying both the principal (the amount you borrow) and the interest (which is calculated over the term of the loan).

Why take out a principal and interest loan?

As you are paying off both the principal and the interest, you'll be paying more than you would for an interest-only loan. However, you'll own your home sooner. Owner-occupiers (people buying a house to live in)[1] often prefer this type of loan.

What is an interest-only home loan?

You only pay back the interest charged on the loan and not the principal amount (the original amount borrowed).

Why take out an interest-only loan?

The main benefit is that you will pay less day to day but you won't pay anything off the amount you owe on your home. If you are an owner-occupier, you may be able to take advantage of an interest-only home loan over a short period to take the pressure off day-to-day expenses. While this may help you in the short term, it could affect your ability to achieve your long term financial goals, such as paying off your home loan and being debt free.

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What should you consider?

- Interest-only loans can be risky because you are not paying off the principal amount of the loan. So, if the value of the property falls, you could end up owing more than the property is worth, if the outstanding loan amount is more than the value of the property.
- With an interest-only loan, you will only be paying interest for the an agreed time (such as five years)[2]. Then your loan will revert to a principal and interest loan (for say 25 years) — paying off the principal over a shorter period, after the interest only period ends, means your monthly repayments will be larger, so make sure you can afford the higher repayments.

Let's look at a case study

A couple takes out an interest-only home loan for five years which then reverts to the higher principal and interest payments for the remaining 25 years and the difference in repayments if they had an interest and principle loan over 30 years:

- Kate is 35 years old with a gross salary of $120k (taxed at 39%)
- Sam is 32 years old with a gross salary of $75,000 (taxed at 34.5%)
- Their house is worth $850k, they have a $500k home loan payable over 30 years.

If they use an interest-only loan at 4.09% pa, the repayments for the first five years will be $1,705 per month ($709 per month less than the principal and interest loan payments which are $2,414).

After five years, the principal and interest repayments rise to $2,665 per month to ensure they pay the loan off over 30 years.

The total repayment over 30 years will be $901,479.

If they had used a principal and interest loan over the entire period the cost would have been $868,714, a saving of $32,765 in interest paid over the life of their loan.

This is money that could have been saved or invested elsewhere.

Assumptions:
The interest rate of 4.05% pa remains the same over the 30-year loan period. Interest rates are subject to change and may increase during the life of the loan. No fees or charges have been considered.