THE INTEREST ONLY REGULATION MYTH

The two regulators for the banking industry have been hitting interest-only loans hard. APRA regulates banks, dictating how they are able to lend, the rules around investment lending, owner-occupier lending, and interest-only versus principal and interest loans. ASIC regulates the people that deal with consumers - so brokers (like us), bank managers, mobile lenders, and anyone else who is a conduit to the client dealing with the bank.

In recent times, APRA has been putting pressure on lenders to slash the number of interest-only loans being approved, while ASIC has flagged its intention to crack down on those writing interest-only loans, which they describe as “much more expensive”.

As a result of the new regulations brought in, clients are now faced with 4 different types of interest rates:

Principal & Interest – Owner Occupier (Cheapest Rate)	Interest Only – Owner Occupier
Principal & Interest – Investor)	Interest Only – Investor (Most Expensive Rate)

The perception from both regulators seems to be that interest-only loans are extremely risky, as well as costing more than a normal principal and interest (P&I) loan. These are half-truths. You can reduce lending by making people pay back more (which is P&I) which means that affordability is more difficult, and dries up demand because the repayments for P&I loans are generally much higher.

As an example, consider a couple, Jack and Jill, who are both aged 55. They have built substantial equity in their home and want to borrow $300,000 for investment. At an interest rate of 5 percent, their repayments would be as follows:

Age at Loan Payout	N/A	65	85
Loan Type	Interest Only	10 Years P&I	30 Years P&I
Loan Amount	$300,000	$300,000	$300,000
Monthly Repayment	$1,250	$3,182	$1,610

As this is an investment loan, the interest component is tax deductible. But, the principal repayments are not tax deductible, and effectively means that you have to pay tax on that extra repayment in order to pay to meet the loan payments.

In some clients’ cases, they may not have the affordability to buy a property that has aggressive pay down requirements with P&I, and therefore they may find the repayments too much for their budget. In many cases, the particular couple may be forced to forego acquiring the investment, which means that they are not investing for their retirement, and may end up short of the asset values that are generally required to give them a comfortable, independent retirement.

If they get the loan, they would be stuck with 10 years of heavy P&I repayments, which would get more onerous every year as a bigger proportion of those repayments comes from after-tax dollars.

The initial monthly P&I repayments of $3,182 consist of $1,250 tax-deductible interest, and $1,932 principal, which is non-deductible and comes from after-tax dollars. The pre-tax equivalent of $1,932 in their tax bracket is $3,168. If they manage to make those payments for 10 years they will arrive at age 65 with the $300,000 loan paid off.

Now, suppose Jack and Jill can get a loan that is interest-only, and they can afford to pay as much as a P&I loan would have been. What they should do is pay the bank $1,250 a month interest, and salary-sacrifice a total of $3,168 a month into super (using both salaries to get around the $25,000 cap per person on concessional contributions). After a 15 percent contributions tax, the amount credited to their super accounts would be $2,693 a month.

Fast-forward 10 years, using the P&I option their loan is paid off. But, using the interest-only option their superannuation should be boosted by an extra $491,000. That is, the same money has been used to put the full $25,000 super contribution into their superannuation fund, and also allowed them to keep their super in a friendlier tax environment.

There is another option at the 10-year mark. If they can get another interest-only loan, they can withdraw $15,000 a year from super to pay the interest on the loan and leave the balance growing in the super fund. In a further 10 years, the super could be worth $950,000, at which time they could withdraw $300,000 to repay the loan, leaving themselves with a surplus of $650,000.

By keeping an interest-only loan for 10 or even 20 years in this way, Jack and Jill would have paid more interest to the bank than with a P&I loan for the same period. But, overall they would also be much more financially comfortable and secure.

If you have any questions or need more information, please call the Client Services team on (08) 9227 6300 or email clientservices@austasiagroup.com.

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