Box B: Interest-only Housing Loans

There has been a notable increase in the use of interest-only housing loans in recent years. With this type of loan, borrowers are not required to make any repayments of principal for up to 10–15 years, after which the loan typically converts to a principal-and-interest loan. The structure of these loans means that, for a given loan size and interest rate, servicing costs are initially lower than on a principal-and-interest loan. Conversely, for a given initial repayment amount, a larger loan can be serviced. Either way, when the interest-only period expires, required payments rise to above those on a standard loan.

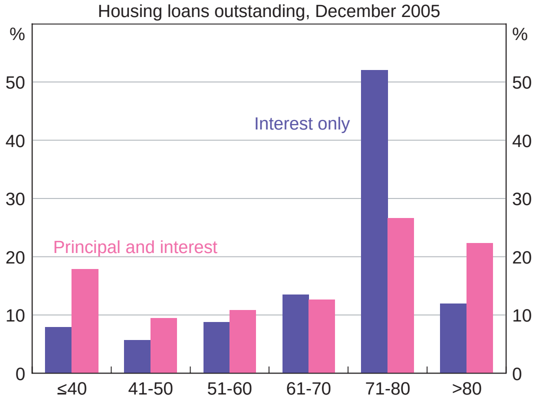
The majority of interest-only housing loans are extended to investors, reflecting the tax-deductibility of interest payments on investor loans. Interest-only loans are, however, also becoming increasingly popular with owner-occupiers, partly as a result of being able to service a larger loan for a given initial repayment amount. Interest-only loans are, on average, larger than principal-and-interest loans for both owner-occupier and investor loans. Available evidence from various banks and securitisation data suggests that, in 2005, around 60 per cent of new investor housing loans and a little over 15 per cent of new owner-occupier loans were interest-only – the corresponding figures for 2003 were just under 50 per cent and a little over 10 per cent. Overall, this suggests that, in 2005, interest-only loans accounted for around 30 per cent of all new housing loans and a slightly lower share of loans outstanding.

With a principal-and-interest loan, a borrower making scheduled repayments would typically pay off about 10 per cent of the loan's principal over the first five years, establishing a buffer against a fall in house prices. For interest-only loans, however, the absence of required principal repayments during the interest-only term means that, for a given loan-to-valuation ratio (LVR), any fall in the value of the property would be more likely to result in the borrower having negative equity than otherwise. Partly mitigating this risk is the fact that initial LVRs tend to be lower on interest-only loans than on principal-and-interest loans; the available evidence suggests that just over 10 per cent of interest-only loans outstanding at the end of 2005 had initial LVRs in excess of 80 per cent, compared with a little over 20 per cent of principal-and-interest loans (Graph B1). In addition, over the past few years, many borrowers

Graph B1

Initial Loan-to-valuation Ratio*

Housing loans outstanding, December 2005



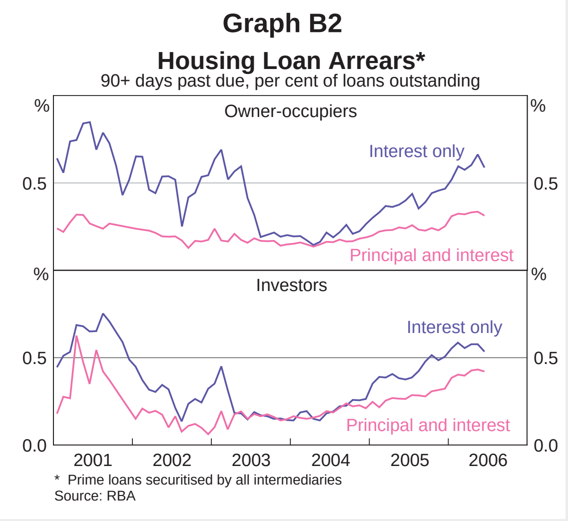
* Based on prime securitised loans from a sample of lenders, weighted by lender type

Source: RBA

with interest-only loans have made some principal repayments during the interest-only term of their loans.[1]

In recent years, interest-only loans have been made available to a wider variety of borrowers, including low-doc and sub-prime borrowers. Available evidence suggests that low-doc borrowers accounted for around one quarter of prime interest-only loan approvals in 2005 compared to a little over 5 per cent of prime principal-and-interest loan approvals. Moreover, around one third of sub-prime loan approvals were interest-only in 2005.

According to securitisation data, the arrears rate on prime interest-only loans has been somewhat higher than on principal-and-interest loans for both owner-occupier and investor loans (Graph B2). Consistent with this, rating agencies assess that interest-only loans have a higher probability of default and lenders tend to charge a premium, of around 15 basis points, above the average actual rate paid by prime borrowers on principal-and-interest loans. ✠



1 *Principal repayments can be made without penalty on variable-rate loans, which are estimated to have accounted for around 90 per cent of interest-only loan approvals in 2005. For fixed-rate loans, the same prepayment penalty typically applies for principal-and-interest and interest-only loans.*