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The Difference Between Principal & Interest and Interest Only Loan Repayments

When someone takes out a loan, particularly a home loan, they usually consider 2 repayment options:

- principal and interest, or
- interest only

➤ Principal & Interest Loan (P/I)

Example: \$500,000 home loan, borrowed to help fund the purchase of \$800,000 property.

When calculating the loan repayments on a P&I loan, a lender and borrower have to agree on 3 variables:

1. principal - in this case \$500,000 (also called principal borrowing, borrowed capital, the “loan”)
2. loan term
3. interest rate

P&I loans are amortised, or repaid over a specified timeframe. The most common timeframe for residential loans is 30 years, but it can vary by negotiation.

To illustrate P&I repayments for this example, the variables are:

1. \$500,000 principal or capital amount
2. 30-year term
3. 5% per annum (pa)

Repayment: \$2,684.11 per month

If the borrower only paid \$2684.11 per month over the next 30 years, at an interest rate of 5% pa, the original \$500,000 would be repaid. You can find these [financial calculators on my website](#).

The interest repaid over the total 30-year loan term would have been \$466,278.92. Sounds significant I know. The only way to minimise the interest bill is to focus on paying off the principal more quickly.

➤ Interest Only (I/O)

The key point: an obligation to make I/O repayments meets the borrower’s commitment to the lender, but it does not reduce the principal, or loan amount.

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Example:

1. \$500,000 principal
2. loan terms are much shorter, usually 3 to 10 years (but not relevant when calculating repayments).
3. 5% pa

Repayment: \$2,684.11 per month (a difference of \$601 when compared to P/I repayment).

Summary:

- P&I loan - the borrower would pay \$2,684/mth, chipping away at the principal over the years.
- I/O loan – the borrower has a lower commitment, \$2,083/mth, but at the end of I/O term, the borrower still has a debt of \$500,000 to repay.
- Each type of loan repayment has its advantages and plays its roll.

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