What is the True Interest Cost for Buying a Property?

By PAUL HO

Many self-styled Finance or Property gurus have touted some universal motherhood statements to people who are awed by their "brilliance" or fanfare.

"Do you know that you could end up paying more interest than the price of your house? For example, if you were to take a 100% loan for a property priced at $2m. At an interest rate of 5.30404% p.a., with a 30-year tenure, the total interest payable is $2,000,000.05."

The guru asked. And soon, he/she shows you an interest table. And bingo!!! Everyone claps in agreement. They have just been shown financial utopia. How true is that?

Sensationalization: trivial or true financial wisdom?

These kind of "education" smacks of sensational half truths. At the same time, they do not fully impart knowledge to people about the cost and benefit of debt.

Total avoidance of debt hurts your financial well-being as you may miss out on many investment opportunities while total acceptance of debt could give you very high returns and make you a multi-millionaire or a bankrupt in a very short time.

In this study, we try to limit this debt issue to Singapore property investment for simplicity.

As an illustration of home loan interest costs: -

The scenario that these finance or property gurus often use applies only to a very narrow set of conditions. Only when interest rates are higher than 5.30404% and inflation must be ZERO before the total interest (at present value) that you paid will be higher than the price of the house.

Let us assume a loan quantum of $2,000,000 and the property price is also $2,000,000. (For simplicity's sake)

- Tenor = 30 years
- Home Loan Interest Rate = 5.30404%
- Assumed Inflation = 0%
- Total Interest Paid = $2,000,000.05 (Nominal value)
- Total Interest Paid = $2,000,000.05 (Present value)

Only at a rate of 5.30404% and above will the total interest exceed the price you paid for the house. However as you can see, this is on the condition that the inflation is 0%. Therefore, it is costly only if inflation is zero.

This is because it makes no sense to compare the value of $2,000,000 which you have to pay now to interest payments in the future. It's not a fair comparison. You have to bring these future costs back to the present for a valid comparison.

How does inflation affect your property investing decision?

If inflation is not ZERO, but 4.5%, then the total interest paid, adjusted for inflation to reflect the present value will be $1.291m and not $2m. Therefore, it will be relatively cheaper.

Of course, this is the official inflation figure, if you are currently about to purchase a 2.5m dollar landed property, it is evident that you are fairly well off.

At this wealth bracket, your consumption pattern may be different (perhaps higher) from that indicated by the Consumer Price Index.

- Tenor = 30 years
- Home Loan Interest Rate = 5.30404%
- Assumed Inflation = 4.5%
- Total Interest Paid = $2,000,000.05 (Nominal value)
- Total Interest Paid = $1,291,258.96 (Present value)

Therefore the interest cost at present value is actually much lower - $1,291,258.96.

If interest rates stay low at 2.5% throughout the 30 years

- Tenor = 30 years
- Home Loan Interest Rate = 2.5%
- Assumed Inflation = 0%
- Total Interest Paid = $844,870.47 (Nominal value)
- Total Interest Paid = $844,870.47 (Present value)

As you can see, the cost would be dramatically reduced to $844,870.47 over the course of the loan.

If Inflation stayed at 2.5% throughout the 30 years

- Tenor = 30 years
- Home Loan Interest Rate = 2.5%
- Assumed Inflation = 2.5%
- Total Interest Paid = $844,870.47 (Nominal value)
- Total Interest Paid = $664,771.43 (Present value)

If inflation is greater than zero (let's say 2.5%), then the total interest paid adjusted to present value is less than that of the nominal value. This is because the value of money in the future is smaller. After adjusting for inflation, the money that you pay in the future (say at the 20th year) is only 61.81% of the value today. If you paid $21,947 in interest for the 20th year, that is only worth $13,566 after adjusting for inflation.

If we modify the inflation figure to 5% throughout the 30-year loan

- Tenor = 30 years
- Home Loan Interest Rate = 2.5%

- Assumed Inflation = 5%
- Total Interest Paid = $844,870.47 (Nominal value)
- Total Interest Paid = $536,410.68 (Present value)

This time, you end up incurring $536,410.68 in interest cost when inflation is set higher.

Therefore, the higher the inflation rate, the lower the interest cost (at present value).

What is the "Rental Cost" of property in Singapore?

But let's assume a not so ideal case where you are paying 5.30404% interest and an inflation of 4.5%.

- Tenor = 30 years
- Home Loan Interest Rate = 5.30404%
- Assumed Inflation = 4.5%
- Total Interest Paid = $2,000,000.05 (Nominal value)
- Total Interest Paid = $1,291,258.96 (Present value)

Your interest cost per month is $1,291,258.96 / 30 / 12 = $3,586.83. At a cost of $536,410.68 (based on 2.5% interest and 5% inflation) over 30 years, marked to present value, you will end up paying $1,490 per month of "Rental" interest cost. ($536,410.68 / 30 / 12)

So the “interest” or “rental” costs would be around $1490 to $3586 per month.

For the same class of property, you would probably be paying $6,000 to $8,000 a month for rental in today's Singapore landed property market.

So buying a property is better than renting a landed property?

The answer for whether it is better to buy or rent lies in answering these few questions: -

- Although the interest cost may be cheaper than renting, but don't forget the principal payment as well. The outlay is significant. Can you afford it?
- Is the price of the property already at an elevated level that looks likely to fall back?
- Are you planning to stay or to invest?
- Are you buying a landed property to pounce on future opportunities or waiting to expand the building when it is allowed?

Once you have these answers, you can get in touch with the mortgage consultants at www.iCompareLoan.com to sort through the details at (sms/text) 9782 8606 or through email.

What about the opportunity cost of committing the principal amount for a landed property?

If you didn't buy a property, and assuming you had the discipline to invest the money that would have gone into paying down the principal. Then you will need to calculate what you could have earned (annualized returns) of your funds.

If you did not buy a landed property and instead invested that $2 million dollars, at zero returns over 30 years, you would end up accumulating $2 million in cash (30 years later), if you invested at a return of 0%.

What is the opportunity cost of buying a landed property at 6% returns?

- Tenor = 30 years
- Home Loan Interest Rate = 2.5%
- Assumed Inflation = 2.5%
- Total Interest Paid = $844,870.47 (Nominal Value)
- Total Interest Paid = $664,771.43 (Present value)
- Investment Return = 6%
- Total Sum of Money from Investments = $4,646,154.13 (future)

At 6% annual returns, you would have accumulated $4,457,510.41 (future value at end of 30 years) at 0% inflation. This value is equal to a potential value to of $4.46m.

At 2.5%, the time-value of money 30 years later is equal to 47.99% of today's value. The potential gains from investment is $2,229,602.63 in present value if you had not invested in the landed property.

So if you include the opportunity cost , housing loan interest cost and other factors such as risks of holding onto the property, then buying a property becomes a less clear and less straight forward decision.

The key parameters things that affect these decisions will be (non-exhaustive): -

- Interest rate
- Loan tenor
- Inflation rate
- Expected average investment returns

Total interest cost and opportunity cost

By adding $2,229,602.62 (opportunity cost) + $664,771.43 (Interest cost) and dividing it by 30 and then by 12, you end up with $8,039.93 of "rental" per month. The better you are at investing, the higher the "cost" for you to buy a landed property.

Landed properties have option value (especially those sitting on land of 999 years or free hold leases). And these potential capital gains contribute towards reducing the opportunity cost of owning a landed property, making the decision process even more complicated and interesting.

For advice on a new loan, go here.
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