What do I need to know when arranging finance?

How much can I borrow?

The first question most potential borrowers want answered is 'How much can I borrow?'.

Irrespective of the purpose of the borrowing we first need to get an understanding of the assessment criteria of different types of lenders and how the application of those relate to your personal situation.

All lenders, regardless of whether it is one of the big four banks (CBA, ANZ, Westpac or NAB) or one of the numerous other lenders, assess your borrowing capacity based on the same criteria known as the 4 Cs - namely Capacity, Collateral, Character and Credit. However each lenders interpretation and application of these criteria can result in different answers to the question 'How much can I borrow?'.

Capacity - refers to your ability to service the debt (read: loan) i.e. to meet loan repayments. Your borrowing capacity can vary by tens of thousands dollars, sometimes hundreds of thousands of dollars, between different lenders as a result of each lenders interpretation and assessment of your ability to service the loan.

In assessing your capacity lenders will take into account your personal income as well as investment income such as rental from property and/or dividends from shares.

Loans for residential purchases in individual/s names are regulated, requiring lenders to establishment a borrowers ability to service the debt. Commercial Property loans or loans in the name of companies and trusts are not regulated allowing more flexibility in assessment of capacity.

Collateral - is the security for the loan. In the case of residential property, this would be a mortgage over the property. Most lenders need to be satisfied that if you default on the loan, they will be able to recover the funds owed including outstanding interest and costs from the sale of the property.

For residential property, the maximum percentage of the value of the property you can borrow (known as loan to value ratio, LVR) is generally 95% for owner occupiers, 90% for investors with mortgage insurance and 80% for both without mortgage insurance. Some lenders will go to 95% for investors depending on where the property is located and the strength of the borrower subject to mortgage insurance approval. LVR ratios apply to house prices up to a certain value based on median prices in that area. Once the value of the property exceeds median prices generally the percentage reduces.

The maximum loan to value ratio for commercial properties will vary greatly, unlike residential property where the maximum loan to value ratios are generally standard across lenders. Commercial property loan to value ratio are dependent on the type of property - retail, office, industrial, specialised, the location, general market conditions and the value of the property, as well as the financial position of the borrower.

As a general guideline for non specialised securities, i.e. retail, office and industrial, most major banks will normally lend up to 65-70% of the property value while other lenders will go up to 80% for loans for less than $3m.

For specialised securities such as hotels, motels, nursing homes etc. the maximum loan to value ratios are generally lower. However, with commercial property it is very difficult to generalise as each application and property will be assessed on its own merits in different ways from lender to lender.

Credit - is all about your credit history. Have you had loans in the past and met your obligations? Do you have any summons or judgments for non payment of accounts? Are you, or have you ever been bankrupt or have you entered into a part 10 arrangement for payment of creditors?

Historically anyone with a poor credit history has had difficulty in obtaining approval for finance from a bank, building society or credit union. However, there are quite a number of non bank lenders who specialise in lending to borrowers with various degrees of credit impairment. The greater the severity of credit impairment the higher the interest rate. These types of loans are generally known as non conforming loans.

Character - is about your general circumstances and employment history. How long have you been living at your current address? How long have you been employed in your current position? Do you move or change jobs every six months? If you are self - employed how long have you been trading (e.g. 10 years or 12 months)? What is your occupation?

Obviously the more stable your employment history, the more confidence a potential lender has in your income levels, and, accordingly, your ability to service the debt.

What is a variable interest rate loan?

As the name suggests, with variable rate loans the interest rate moves up and down in response to market conditions, albeit usually up a lot faster than down. Typically variable rate loans are for up to 30 year terms and may have additional features such as 100% offset accounts and redraw facilities.

One of the most important benefits of a variable rate loan is the capacity for the borrower to pay back any amount at any time without incurring penalty interest or costs. Being a variable rate, in a falling rate environment your interest rate will decrease, conversely in a rising rate environment your interest rate will increase.

Variable rate loans provide great flexibility allowing borrowers to accommodate changing circumstances.

What is a fixed rate loan?

Fixed rate loans give borrowers certainty as the interest rate is fixed for the term of the loan. By fixing the rate, borrowers have the peace of mind of knowing exactly what their repayments will be for the period of the fixed rate. So if interest rates go up, your loan repayments are not affected.

Generally terms for fixed rate loans are 1-5 years, with some lenders offering terms of 7 and 10 years but they are the exception. However the huge disadvantage of fixed rate loans is the potential to incur large break penalties if you wish to substantially reduce or payout the loan prior to the maturity of the fixed rate term. The longer the remaining term of the fixed rate at the time of payout the larger the potential break costs. For this reason borrowers considering fixing the rate on their loan/s need to be reasonably confident of maintaining the loan for the fixed rate period.

Typically lenders do not offer 100% offset accounts or full redraw facilities with the fixed rate loans.

What is a principal and interest loan?

A principal and interest loan has set repayments which pay the debt off over a period or time. Typically principal and interest loans are for terms of up to 30 years with monthly repayments for residential security and 10-15 years with commercial security.

What is an interest only loan?

An interest only loan has regular payments, usually monthly, which only pay the interest on the loan. As the repayments are only paying the interest, they will vary from month to month depending on the number of days in the month. Typically interest only loans are for terms of 1-5 years with some lenders offering terms of 10 and 15 years.

What is a fixed rate loan reverting to a variable rate loan?

A fixed rate loan reverting to a variable rate loan is one where the interest rate is fixed, generally for the first 1-5 years, then automatically reverts to a variable rate for the balance of the loan period up to a total maximum term of 30 years.

What is an interest only loan reverting to a principal and interest loan?

An interest only loan reverting to a principal and interest loan is one where the repayments are interest only generally for the first 1-5 years then automatically revert to principal and interest for the balance of the period up to a total maximum term of 30 years.

Should I fix my interest rate?

There is no universal yes or no answer. Typically, people are motivated to fix their rate because they believe the fixed rate will generally be less than the variable rate, for the majority of the time during the fixed rate period, i.e. they'll pay less interest. Remember that if you do fix your rate then significant penalties may be incurred if you choose to break that contract prior to the end of the term.

Whether to fix your rate or not really does depend very much on your personal circumstances as much as market conditions. The factors you need to consider are:

- What exposure do you have to an increase in rates and what is your capacity to absorb the increase in loan repayments?
- How important is having the flexibility to pay back any amount at any time without penalty?
- What degree of priority do you place on redraw facilities and offset accounts?
- Is there a possibility you will need to adjust your gearing levels during the fixed rate period being considered, perhaps due to a change in personal circumstances such as loss of income, retirement or redundancy?
- Where are we in the interest rate cycle?
- Are the borrowings tax deductible or not?

As a homebuyer

As a home owner/home buyer you may wish to sell your home for a number of reason such as to move interstate, move into a larger home for a growing family or move closer to work, schools or family.

Whatever your reason if you fix your rate on your home loan you need to be concerned about the possibility of incurring large break costs as a results of paying off a fixed rate loan prior to the maturity date.

Loans to purchase a home or to refinance one are not tax deductable. A great feature of variable rate loans is the ability to pay off any amount at any time without cost combined with the option of 100% offset accounts and redraw facilities.

Linking a 100% offset account to a variable rate home loan will not only assist in reducing the amount of interest paid on the loan it will also save tax as well. For principal and interest loans as they have set repayments the 100% offset facility will shorten the term. One hundred per cent offset accounts are generally not available for fixed rate loans.

Variable rate loans also have redraw facilities which gives the borrower access to any additional payments that have been made. This allows borrowers to tax effectively build cash reserves for unseen emergencies in addition to funds for personal use such as buying a car, house extensions, swimming pool or holiday. Fixed rate loans generally don't offer redraw facilities or if they do limited facilities.

As an investor

Investors who borrow to acquire income producing real estate receive rentals to assist with the repayment of the loan. Any shortfall between the interest and net rent after deduction of expenses such as rates, management fees, rates etc. is deductable against other income.

As an investor personal consideration about moving home are not relevant. The decision whether to fix the rate on all or part of the borrowing tends to be more dependent on two factors - whether you believe and interest rate advantage will be achieved by fixing the rate, secondly your capacity to absorb an increase in interest rates, especially for investors with larger borrowings.

Most investors are borrowing the majority of the purchase price, if not all. Consequently, the average size loan for investors is generally larger than for a homebuyer. For this reason, investors are much more vulnerable and sensitive to an increase in interest rates. If an investor has more than one property then their exposure to interest rate increases multiplies greatly. Fixing the rate on all or part of the borrowings mitigates this risk.

When is the best time to fix my interest rate?

For existing borrowers a real difficulty is not only deciding to fix, but also deciding when to fix. If contemplating a fixed rate, do not try and wait to pick the bottom of the market. The time to fix an investment rate is when rates are low and rising, definitely not when rates are high and falling. Locking into a fixed rate when rates are high and falling increases both the probability and the amount of potential break costs from paying out the fixed rate prior to the maturity date.

If interest rates are low then as surely as night follows day, interest rates will rise. Picking the precise bottom of any interest rate cycle can be difficult, however, fixed rates are determined by the ‘wholesale’ market which anticipates reductions in official interest rates before they happen and factors them into the fixed interest rate.

Consequently there is a lag time between fixed rate interest movements and variable rate movements, both up and down. Therefore, in general the best time to fix your rate is a month or two prior to when you expect official interest rates and therefore variable interest rates to fall. Work out a range for fixed rates that is acceptable to you. Then, when the fixed rates are within this range, lock in.

Should I get an 'interest only' or a 'principal and interest' home loan?

The answer to this question is generally dependant on the purpose of the borrowings.

As a homebuyer

The interest paid on borrowings to purchase a home is not tax deductable, with most borrowers wanting to pay off the loan as soon as possible. For this reason, the majority of home owners have principal and interest loans.

As an investor

The interest paid by investors on borrowings used to acquire income producing property is generally able to be offset against net rental income. Any shortfall may be able to be claimed as a deduction against other income. The principal component of a principal and interest loan is not deductable.

Some investors prefer interest only loans for investment because they have lower tax deductable payments which allows the investor to own more property for the same cashflow compared to principal and interest loan/s. Assuming the property grows at a greater rate than the principal reductions on a principal and interest loan the investor increases their returns and their overall wealth accumulation.

A word of caution - if as an investor you elect to have interest only loans the above is only true if you invest the difference between the interest only payment and the principal and interest payment.

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