

mortgage

watch

Issue: 1
2007

Welcome to the Mortgage Watch for 2007.

In our first article for the year we highlight some good reasons to make your investment loan "interest only". Paying down the principal may not always be in your best interests.

Our second article examines the potential benefits and pitfalls of buying an investment property with a friend or family member.

We continue with our new Insider column and again highlight the fantastic Homekit software.

If this newsletter raises some questions for you please feel free to contact me on the numbers listed on the back page.

Eugene Buchner



Interest Only Loans

Making them work for you

Whilst paying down a loan always feels good, there are often situations where it makes sound financial sense to keep the debt high and only repay the interest.

When applying for an investment loan you are asked if you want to repay some of the principal with each loan repayment ("Principal and Interest") or just the interest due ("Interest Only").

In this article we highlight situations where it makes good sense to pay the bare minimum and not repay any of the capital.

Lower Repayments

Investors usually opt for making interest only repayments for several reasons.

Firstly, the repayments are lower each month. In the early days of owning an investment property, the rental receipts often don't

cover the mortgage repayments and other ongoing expenses. So to minimise this out-of-pocket drain

most investors choose to pay the minimum required.

Secondly, many investors buy their first investment property before they have paid off their home loan or other personal debts. If they find themselves with any spare cash they usually focus on paying the highest interest rate debts first, such as credit cards and personal loans and leaving the loans that are eligible for a tax deduction till the end. (See Breakout box "Advice from FIDO".)

(Continued on page 2)



ALSO IN THIS ISSUE:

Sharing an Investment Property

Information included in our newsletters is for general information purposes only and must not be considered financial advice. You should seek independent professional advice in relation to financial, taxation and legal matters relevant to your individual circumstances.





Interest Only Loans (cont)

For example, in the situation where the borrower has a running balance on their credit cards each month then it would make good sense to put any spare cash into reducing the monthly balance to zero so that interest is not payable on the card.



The next priority for a person with both a home loan and an investment loan would be to pay down the home loan. This is because home loan repayments are an expense for which the tax payer can not claim a tax deduction.

The final option once high interest or non-deductible debt have been paid down would be to make head-way into paying off the investment loan however many choose to keep their investment loans at the original level as it maximises the interest deduction that they can claim.

Taking an interest only loan doesn't mean however that you can't make principal re-

used to fund an investment.

However, you could instead put the same amount of money into an offset account. When you later withdrew the funds the ATO would not be interested in what you used the funds for and would allow you to claim all the interest repayments in your tax return.

This is because the ATO does not view putting money into an offset account as 'paying down' the loan. It has the same effect of reducing the interest payable each month along with the amount that you can claim as a tax deduction for that period, but is not considered to be a principal repayment.

So transferring a regular amount each month into an offset account could be a great means of forced savings, regardless of whether the savings are to be used for a car or for a deposit on your next investment property.

Borrowing Capacity

Even though a lender may offer the interest only option to investors and possibly homeowners it is important to understand the effect this has on the amount they will lend you.

When calculating whether a borrower can afford the loan they have requested, the lender will generally use the corresponding principal and interest repayment in their loan servicing calculation. In other words the lender is still assuming the borrower must cover the minimum principal and interest repayments regardless of the option that has been selected.

There is one vital difference in the calculation. If you take the first 5 years as interest only then the lender will calculate how much you can borrow assuming that the loan must then be repaid in 25 years rather than the standard 30 years. This reduces the maximum loan size slightly and may force some borrowers to accept a 30 year principal and interest loan for the amount they need.

Interest Only for Non-Investors

Many people buy an affordable unit as their first home and then upgrade to a house when they need more space. If they want to retain the original unit as an investment property after having paid down the loan then they will find themselves unable to make the maximum possible tax deduction each year.

For example, let's say the original loan for the purchase of the unit was \$300,000 of which \$100,000 was paid off before the new purchase. The new property cost \$600,000 of which all of it has to be borrowed. After the purchase there would be a \$200,000 tax

deductible investment loan and a \$600,000 home loan that is not tax deductible.

Now let's instead say that only interest payments were made on the original loan and the \$100,000 was accumulated in an offset account. This money would be used as the deposit on the new property so that after the purchase the investment loan would still be \$300,000 and fully tax deductible. The home loan would only be \$500,000, ensuring the maximum tax benefit from holding an investment property.

It may feel counter-intuitive to recommend that only the interest repayments be made each month rather than trying to reduce the principal as quickly as possible and pay off the debt. But with a bit of planning and clever use of an offset account it can be possible to maximise your tax deduction, minimise your repayments and save money for the future.

Advice from FIDO

ASIC, on their Financial Tips and Safety Tips website (called FIDO) suggests the following:

Pay at least the minimum amount due to every lender on time. If you can afford extra payments, start with the loan charging the highest interest. Only put extra into other loans once the most expensive one has been paid off. The lowest-priority loan is one that has tax-deductible interest – for an investment property loan, for instance.

payments. In fact you can reduce the loan if you want and for people who need to see their loan balance reducing progressively over time, it remains a good option. Having the bank demand that the repayment be made each month prevents many borrowers from frittering away their spare cash. It is also a strategy common to people approaching their retirement who are looking to minimise debt and build strong rental income streams.

Offset Accounts for Savings

The ATO has ruled that if you pay down your investment loan and then redraw the loan back to the original amount you can not claim the entire loan's interest unless you can clearly demonstrate that the redraw was



Did you know that you have free access to all the back-issues of Mortgage Watch?

Some of the topics we have covered in previous issues include:

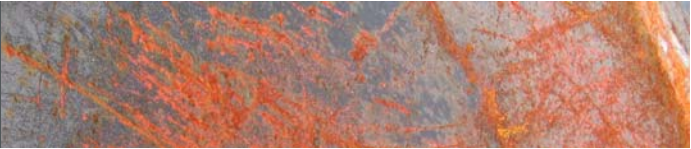
- Loan Minimisation and the Role of the Offset account
- Positive Gearing
- Reverse Mortgages
- Parents Help in Buying Your First Home
- Residential Vs Commercial Property
- Non-Conforming Home Loans

To read back-issues of Mortgage Watch visit www.homekit.com.au.

Homekit is internet-based software, provided free to all of our clients. It is filled with tools for home-loan borrowers and investors alike.

If you can't remember your user id or password please give me a call or just click on the [forgotten your password](#) link.

Once you have logged in select the My Newsletter tab from the top.



Rates & News

Highlighting recent changes in loan products and the latest fixed rates from our panel of lenders.



Maximum Loan Size

Many lenders have been reviewing the upper limit they place on new loans and have decided to increase maximum loan sizes.

Whereas previously lenders asked you to offer more than one property as security against a million dollar loan, this may no longer be necessary. Even loans up to two million dollars in value are being offered by many lenders, against the one property.

At the same time the mortgage insurers are also allowing the LVR (loan to property value ratio) to increase for large loans.

You can now borrow one and half million dollars with an LVR of up to 90%.

Of course as the loan approaches the value of the property the Lender Mortgage Insurance premium can be quite expensive.

Fixed Rates *

- 1 Year Fixed 6.65% pa
- 2 Year Fixed 7.08% pa
- 3 Year Fixed 6.95% pa
- 4 Year Fixed 7.09% pa
- 5 Year Fixed 6.95% pa
- 7 Year Fixed 7.39% pa
- 9 Year Fixed 7.39% pa
- 10 Year Fixed 7.39% pa
- 15 Year Fixed 7.44% pa

*Indicative rates at newsletter issue date for our panel of lenders. Any listed specials may or may not apply to your circumstances. Please contact me for more information about any of the offers mentioned in the Newsletter.

All rates are quoted as indicative variable unless stated otherwise.

Please call me for the relevant comparison rate schedules.

Sharing an Investment Property

Buying an investment property with a friend or family member can make the purchase more affordable however there are some important factors to consider before going down this path.

One way to get into the property market is to buy a property with a friend or family member. This way you can combine your savings to buy a better property or take on a smaller loan. Of course you would be receiving only your share of the rent however it still makes buying property an achievable step for many people.

Having a partner in the property investment sounds fairly simple but there are quite a few things to consider before putting down the deposit.

Percentage split

Firstly you need to agree on the percentage ownership each of you will hold. In most cases this will determine the amount you each contribute to the purchase from either savings or borrowings. This percentage will also dictate your share of the ongoing expenses and the rental income.

Structuring the Loans

Most of the time both partners will need to get a loan to help finance the purchase. Some lenders will insist that you apply for the funds together so that both of your names are on the loan and it exactly matches the names on the title deed. You can ask them to split the loans into two parts, matching your respective contributions however the lender will still put both names against both parts of the loan.

What most people don't realise when they think of 'sharing' an investment property with a friend is that from the bank's point of view they are liable for the entire loan, not just their agreed portion.

It is this 'catch' that can cause problems down the track not only for your future borrowing capacity

but also if the loan becomes a problem for either of the partners.

Is there a different way of structuring the loan so that you are both not fully liable for each other's debt?

Not really.

Some lenders will allow you to apply for separate loans against the same property however they ensure that you remain fully liable by asking you to be guarantor against your partner's loan. In this way



you are agreeing to make good any repayments and fees on your partner's loan so this structure yields the same result for both the lender and the borrowers.

Nevertheless having separate loans, even if the loan has both partners names on it is still very useful.

This is because it becomes easier for you to track your repayments and clearly shows any additional money you have paid into the loan. It also makes calculating your interest expense when you go to complete your annual tax return much easier.

(Continued on page 4)



Sharing an Investment Property (cont)

Future Finance

One factor rarely considered by people when they purchase a property with someone else is the effect the loan will have on their future borrowing capacity.

Say for example you borrow \$300,000 with a partner, split 50/50, to buy an investment property. Several years later you apply for another 400,000 to buy another property, but in your name alone.

The bank will assess your ability to repay the new loan after taking into account your existing financial commitments. It will assume that you are liable for 100% of the original loan, and sometimes only allow you to include 50% of the rental income. They are taking a very cautious approach as they know that you are in fact liable for the full amount under the other lender's contract even if your percentage ownership is significantly less than this.

The end result of this assessment is that your borrowing capacity can in some cases be significantly reduced. You may consider that you only owe \$150,000 however the bank penalises you for the other half of the loan and you no longer have the benefit of including your partner's income or the entire rent into the equation.

Whilst understanding your mortgage liability and the effect this has on your future borrowing capacity can become an issue for owners, managing the day to day issues often prove to be more problematic.

Repairs and Renovations

During the period you own the property there are sure to be repairs required in addition to the regular outgoings. Make sure that you have discussed this possibility with your partner and have put aside an annual allowance that you feel you can both afford without stretching the budget.

This allowance is unlikely to cover the cost of major repairs however unless they are unforeseen emergencies it should be possible to plan these works in advance and put aside the money.

In fact getting agreement on expensive maintenance work is the most common source of friction for partners. Reaching agreement on the budget, style or timing of work to be done can be very difficult, turning what was a friendly relationship into one under the strain of financial woes.

Reviewing the Structure

Probably the best way to prevent your relationship from being put under stress is to agree upfront to review the arrangement every few years.

At this meeting you can review how the property is being managed, discuss any upcoming costs and, should your priorities change, the possibility of selling your portion of the investment.

One of the things you can discuss upfront is the approach you will take when someone wants to sell. Should one party want to move on, the other party is usually given the first right to buy out the investment, using an independent valuation as the basis for the part-purchase. This will probably require a new loan to be established and the property transferred into the name of the remaining owner.

Should this not be possible then the only other choice will be to sell the property, with the proceeds split according to the original percentage split that was outlined in the purchase.

Getting into the property market with a friend can be a great first start. If you keep in mind the way the lender views your liability and work closely with your partner on financial and timing issues then it is sure to be a successful strategy.

The Insider

Tips from inside the Mortgage Market

Bank Statements—What they tell a new lender

When you apply for a new loan or to refinance an existing loan the lender will generally ask to see the latest statement from your savings accounts, credit cards and existing home loans.

If you are buying a property, then the lender is making sure that you have enough money to make up the difference between the purchase cost and the loan they are providing.

They are also checking that your savings account does not regularly get overdrawn as this could indicate that you are not managing your money carefully.

The same goes for your credit card statement. They will show if you pay down the full amount owing each month or let it remain at or even above the limit.

Home Loan Statements

Whilst lenders may accept your explanation as to why you occasionally run your credit over the limit, they are going to be less inclined to give a person additional funds or even refinance their current loan if they can see that the person has recently missed a home loan repayment.

Banks in general look very seriously at any missed repayments, even if it has not resulted in a Credit File blemish.

If the late payment was a small hiccup in an otherwise clear history then it may not prevent you from obtaining additional funds in the near future.

Be prepared to give a good reason as to why you temporarily fell behind if your statement identifies any missed payments.

If you are likely to have ongoing trouble making your repayments then you should contact your lender immediately to discuss ways of getting back on track.

LoanSpot

Eugene Buchner

Phone : 1800 99 61 16

Mobile: 0409 304 138

Email : eugene@loanspot.com.au

Information included in our newsletters is for general information purposes only and must not be considered financial advice. You should seek independent professional advice in relation to financial, taxation and legal matters relevant to your individual circumstances.

