Should You Chase the Rate?

INVESTORS CHOICE Mortgages

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Should You Chase the Rate?

The Perils of Not Looking Beyond the Interest Rate for a Home Loan

Robert F. Kennedy once said: “May you live in interesting times”.

But interesting is also confusing. And if you know the origin of this phrase, you’ll know that it actually derived from an ancient Chinese curse! The person saying it isn’t hoping for you to live an interesting and happy life. They’re hoping that you’ll face challenges along the way that could topple you.

We’ve certainly seen some interesting times in the Australian property market…

Despite the substantial price appreciation in Sydney and Melbourne in recent years, affordability in these cities has improved by a significant margin.

In fact, it’s at its best level since 2014!

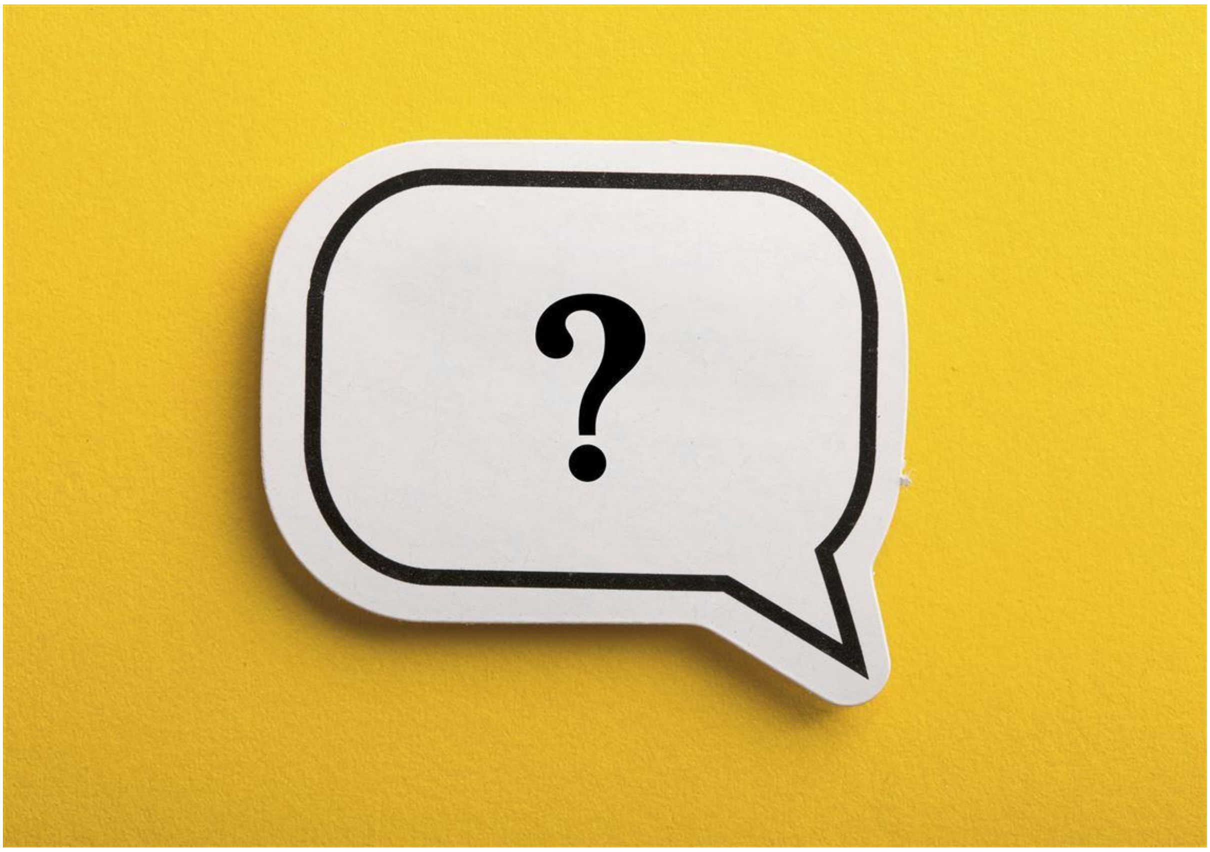
The HIA Affordability Index published in September 2019 highlighted some important figures. It showed affordability rising by 2.2% during the third quarter of 2019. Capital cities received a reading of 80.8. with more regional properties getting an average reading of 94.8.

Simply put, affordability has improved across all major capital cities in the country.

Better yet, late 2019 rally of the property market with the reduction in interest rates, despite not being passed on in full by the major lenders, has boosted the ability of households to service home loans.

So you might be asking yourself - should I be rethinking my mortgage rate? After all we can see rates with lenders in the low 3%'s and no view in sight of anything but future rate drops or them stabilising at the current record lows. Is it even possible to think of rates climbing to the long term 10 year average of 7+% again?

Before you rush into getting a new mortgage, there are a few dangers of chasing the better interest rate that you need to know.



Why is there Such a Difference in Rates?

In late 2014 ASIC and APRA started corrective measures to reduce a runaway property market and what they felt was irresponsible lending, especially to investors.

This led to them putting limitations on the number of investors that lenders could lend too. And to create further slowdown, they also put restrictions on interest only loans.

Specifically, lenders were restricted to no more than 10% annual growth of their lending to investors in 2014. And in 2017, the APRA added a second restriction that said that interest-only (IO) mortgages could only make up a maximum of 30% of a lender's offering.

So what resulted was less of an appetite and harsher assessment for investors.

The end of both restrictions towards the end of 2018 eased this sentiment a little. However, there is still a vigilant concentration on living expenses. Furthermore, we also saw the creation of a rate market. There was no longer one rate for everyone, as you'll see below.

- Principal and interest (P&I) for home loans - the cheapest, i.e. the base, and what is quoted in lender's marketing is the SVR, standard variable rate, in reality over 80% of people are on a discount of up to 1.75% below the SVR based on loan size

- Interest only for home loans rate - about 0.5 - 0.75% higher than discounted SVR
- Principal and interest for investment loans - 0.25 - 0.75% higher than discounted SVR
- Interest only for investor's interest rates - 0.75 - 1.0% higher than discounted SVR

So now this is why you are reading this - someone just told you they are on 3.13%pa and you want to know how you can get some of that.

Be aware it is not a matter of horses for courses. Making the 'simple' switch may not only cost you but it could also put you in a worse scenario.

One big warning - you might think that moving from IO to P&I will save you. For example, let's say you move from a 3.8%pa interest only rate to a 3%pa rate with your new P&I mortgage. The reality is that you've now added the Principal component, which means your monthly or weekly repayment is now higher.

That's right!

You have a lower rate but more out of your pocket. So if you are doing this for cashflow - think twice.

However you do get a better rate. Plus, you do need to pay back your loan sometime right?

True but how does that fit into your bigger picture?

Did you want to do renovations on your home, did you want to buy another property in the future, or add a granny flat onto your investment property (or for the truly brave…add one to your home)? If so you are going to need cash, either money you save or money you earn. Both of these take time. However depending on the lender they may allow you to use the equity in your property to fund these.

It is possible you can get there quicker by using an IO loan and an offset account. So your future plans can be greatly curtailed if your not with the right lender that allows you to execute those plans as they are not in their policy.

When it All Goes Wrong

I spoke to one client who was happy to buy a home. We got a great rate as that was their #1 priority, made in IO so he could use the property in 5 years' time as an investment property.

With a small 10% deposit, he was in.

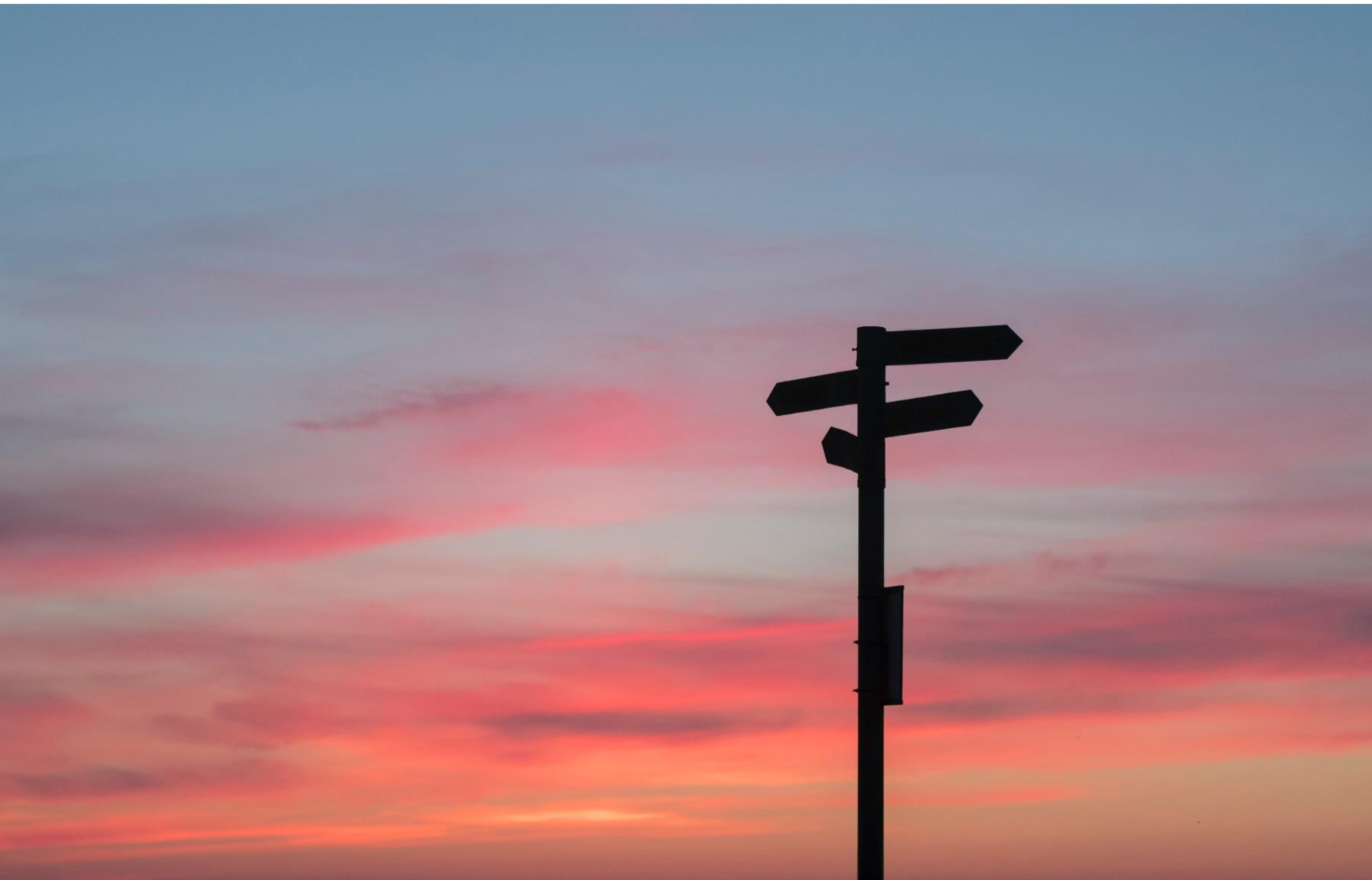
Then after settlement - literally in a matter of weeks - he decided he wanted to build a granny flat and make it an investment now. The cheaper rate he'd gotten on the mortgage cost him $20,000 so that he could move to another lender that would allow constructions loans.

Why so much?

Because he had to pay Lender's Mortgage Insurance (LMI) again.

What about the client who was feeling cashflow stress? After a recent health issue in the family and reduced hours at work she saw the advertised rate for another lender, which was much lower than what she was paying. She didn't want to bother us - her mortgage brokers - so she rang and switched to P&I hoping for a break.

Her new repayment ended up rising to $600 per month more.



This put even more stress on her and when she rang to ask what to do we went to bat for her to work it out with the lender. But that mistake nearly destroyed her ability to support her family during their time of need because of the extra stress.

Another client was chatting to a mate - they engaged in the Aussie BBQ property and rate chat sport - and his mate was on a lower rate. Not wanting to bother us, he called the lender directly and moved his home loan - only to find out that the exit costs and government fees in changing actually cost him over $1000. The extra $90 a year he ended up saving with the lower rate would take over 10 years to recoup.

Here's the simple point we're making.

It's always best to speak to us before you make any changes to your mortgage.

It's what we're here for!

One of the significant differences you will find in rate is the rates quoted for Principal and Interest loans and those quoted for Interest Only (IO) loans.

So before we go any further let's get an understanding of the differences.

What is an Interest-Only Loan?

Lenders expect you to pay back all the money they gave you, with interest, over a typical 30 year period. However, they realise that you might have used up all your savings when buying and need to rebuild your buffer or concentrate on paying off personal debt. Hence most lenders will offer you 5 years of paying only the interest component.

Once that period ends, you pay both the principal and interest over the remaining 25 years of the loan.

Something you may not know is that for the first 20 years of a 30-year loan, your monthly repayments are over 50% of just paying interest.

It is not till year 21 when you really start paying off the principal.

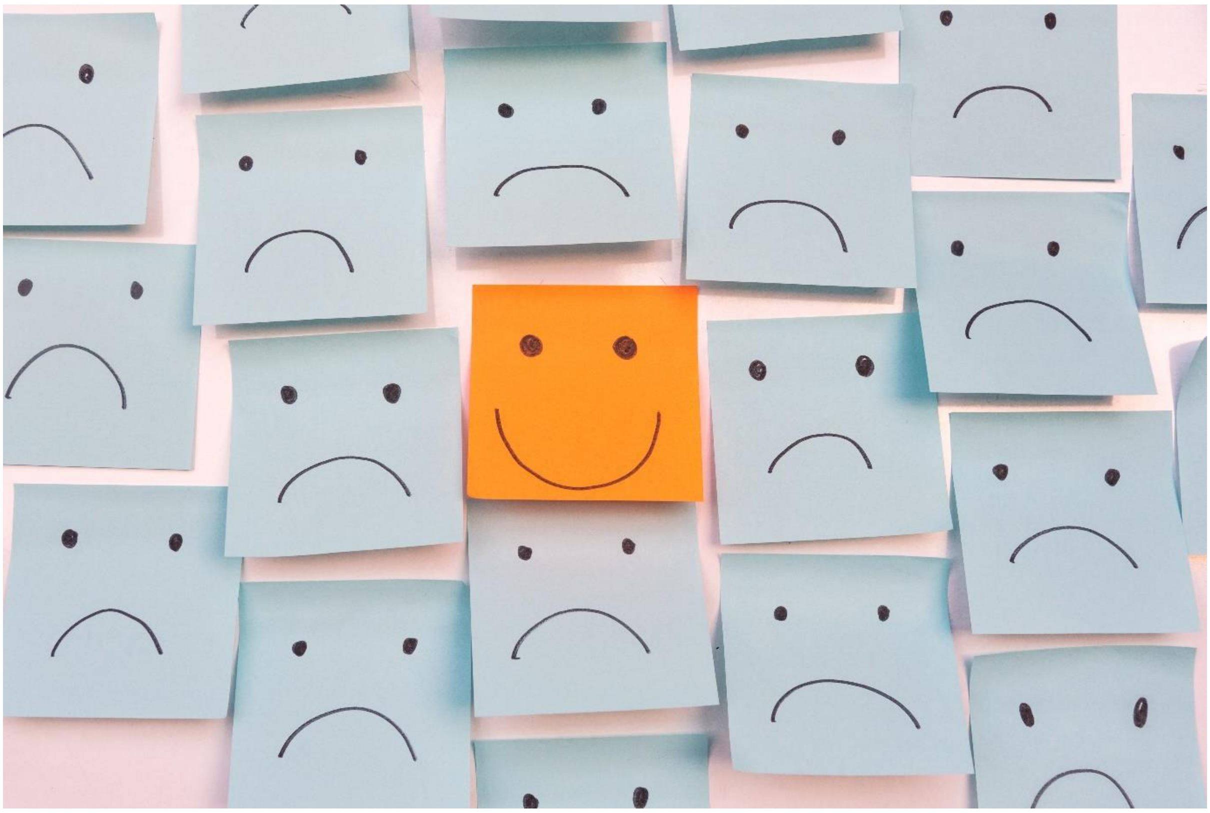
So if your plan is to only hold a property for 10 -15 years - why have an incremental amount come out that you could use in an offset account, or to pay off personal debt, or to build a buffer or a deposit for the next property or even a renovation budget?

Astute investors have for years preferred IO loans and tried to get them as long as possible. Some lenders offer up to 10 years on their IO loans.

In the good old days, you could just ask for another 5-year extension with a click of the button. Today, it requires a whole new assessment - which is why we at Investors Choice Mortgages set our clients up with a loan for 10 years IO to start with.

Who knows what changes for employment, interest rates, banks future lending policies might stop you getting another IO in the future.

However, more and more home owners also use IO loans, in fact with most people moving on average every 9 -11 years and facing the pressure of lifestyle costs and often expensive school fees more and home owners see this as a strategic approach.



The IO Plus Offset Account Approach

Let's look at an example of how you can make your home loan work to your advantage.

Let's say that you're buying a $500,000 property with a 5% deposit. That means you're putting $25,000 of your wealth into the property. And you have $475,000 of the principal to repay.

Now, your mum and dad will tell you that the best thing to do from here is to pay down the principal of the loan. Get a P&I mortgage because each payment will reduce that principal.

So, let's say that you have $10,000 to put towards that principal.

The traditional thing to do is to call up the bank and ask to make a large repayment of that $10,000. In our example, that knocks the principal down to $465,000.

But that's also money that you can't get back. That $10,000 is now tied up in the equity of the house and you're not in a position to release it yet. That means you can't use it if you need it, you need to make an a whole new application to access those funds.

The alternative way to do things is to create an IO mortgage with an offset account.

An offset account is essentially a savings account that's tied to your mortgage. When you put money into the account, it reduces the loan's principal. So, in our example, you still get your interest repayment calculated on $465,000.

But here's the key difference.

The money you put into an offset account *does not* go into the loan.

It stays in an account that you can access at any time. That means you can draw that money back out whenever you need it. Better yet, any cash windfall that you get can go into that account and pull down the principal further. Every dollar you add to the account also lowers the amount of interest that you're paying on the loan on the next repayment.

So, in essence, an IO mortgage with an offset account gives you all of the benefits of a P&I mortgage without the drawback of tying your money into the loan.

You have access to it at any time.

But we must also offer a word of warning…

The IO mortgage plus offset account strategy is not for you if you are constantly 'dipping in' and if you don't keep a savings plan. In this scenario, you may see your savings get eroded because you're not sticking to a solid plan.

When is Chasing the Rate a Good Idea?

A lower rate can help in any of the following scenarios:

1. You are no longer planning to buy or spend funds and are in the consolidation phase of home ownership (i.e. you are good and this is the house for life) or investing (done and dusted).

2. When there is a like-for-like product and a lender that gives you a better outcome and fits into your long-term plan, including plans to access equity for future purchases, property renovations, constructions like a granny flat, to pay for a wedding, cruise etc.

3. You realise that your investment property, which is now your home, could get a better rate by converting to a owner occupier loan.

4. Shh, this is a little known fact, but banks have a whole department dedicated to retaining you and we speak to this department regularly for our clients to ask them to get a better rate. For example, we did this for one client this year saved over $7,179 in interest. So, chasing the rate may be a good idea if your advisors know that they can get you a better rate.

When is Chasing the Rate a Bad Idea

1. When you don't understand the overall costs of refinancing elsewhere, exit costs or break fees on fixed loans.

2. When moving actually hampers, or worse still, kills your future investing plans. Being with a new lender who will not allow you to execute your plans.

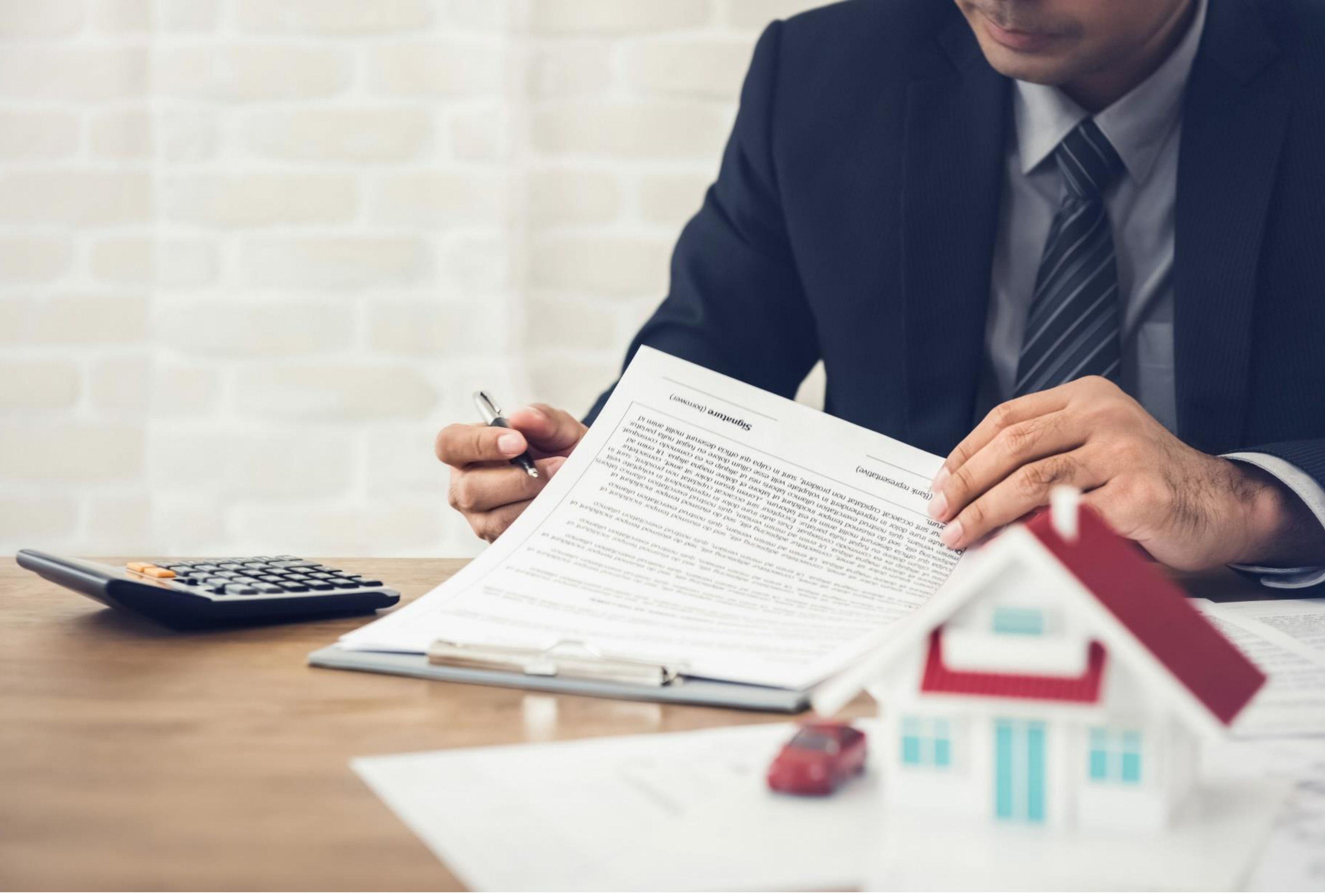
3. The move from IO to P&I actually costs you more out of pocket and you have cash flow concerns or savings goals you need those funds for.

4. You don't realise you are moving to a honeymoon rate and it may revert to a higher rate than you are currently paying when the honeymoon period is over.

5. You don't qualify for the new lender due to new tighter servicing requirements and your credit file gets a permanent record of the decline, which affects your access to credit in the future.

6. The new lender has policies, such as no granny flat, that could severely affect your future strategy to achieve financial freedom.

7. The new lender has a lot of small print, such as signing up for a shorter loan term or paying a high annual fee.



Another Fact to Consider…

The lenders have a two-tier pricing policy - current clients and new clients.

Can you guess who gets the best rate?

Loyalty gets you nowhere with a lender these days. In fact, an article in the *Australian Financial Review* shows us that the banks use the money from their "sleepy" existing customers to fund acquisitions of new customers.

Here's how this 'Loyalty Tax' works…

The bank keeps charging you at the rate that you're on, which is probably much higher than the rate you could get. Bolstered by that extra income, they're able to offer discounts to new customers.

And worst of all, they don't tell their existing customers about these discounts.

They allow you to keep paying the higher rate while their new customers get to pay less thanks to the money you're pouring into the bank's coffers.

This is just one example of why the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in 2019.

There's a simple message here…

The bank is not always on your side. And if you're a current customer, the banks may actively avoid rewarding you and will not make adjustments based on current rate changes.

This earns them millions at the expense of you and their other loyal customers.

That's why it's so important to review your mortgage every year with a good advisor. You never know what you're missing out on because the banks aren't going to tell you.

It’s Time to Get Started

The simple fact is that it’s not always in your best interests to chase the rate.

And if you’re really unlucky, that “better” interest rate could end up costing you thousands of dollars. That means you have to put your wealth creation plans on hold while you sort out the mess!

We can help you to make sure you’ve got the not just the loan that suits your needs now but one that considers your property investing strategy, your future plans and goals.

Knowledge is power and you get access to tons of it when you work with Investors Choice Mortgages.

You need a professional by your side to ensure you’re making the right choices.

We want to be those professionals, so make time to talk to us today.
www.investorschoice.com.au/bookacall

Why Go with Investors Choice Mortgages?

We could just tell you that we've just won we have been awarded Australia's Mortgage Broker of the Year on multiple occasions.

We could also tell you that we're a platinum broker, which means we're a part of the elite 60 of the top mortgage brokers in the country. The truth is we measure our success by our happy customers and their success.

But, we know that you want to know what working with us is actually like…

At Investors Choice Mortgages, we offer our complimentary Silver Service package to all of our clients. With this package, we aim to help you on every single step of your property journey.

Here's what you can expect when you sign up:

- A complimentary call with one of our mortgage professionals to assess your situation.
- A borrowing capacity assessment that examines where you are now and where you need to be in the future, taking into consideration over 33 lenders.
  - This Lender Recommendation Report also covers the full cost of your lending solution, saving you hours visiting banks and keeping up to date on their policy and servicing changes.
- Access to your own credit file, which we provide free of charge making sure there are no nasty surprises that could affect your future borrowing.

But that's not all.

If you need help with refinancing, we'll work with you so that you get the deal most suited to your current AND future plans. That means we handle negotiations with your current lender while looking at all of the other options that are on the market.

We'll also take a detailed look at your borrowing capacity. Plus, you'll get a one-to-one Strategy call with Jane Slack-Smith, a property investing expert with over 20 years of personal investing who has assisted thousands of Australians purchase investment properties that's valued at $495.

During that call, we leverage our proprietary Trid3nt Strategy® to help you find work out where you might buy with your borrowing capacity or what strategy suits your achieving your goals in the timeframe you set.

You also get free access to CoreLogic's RP Data Pro software (valued at $150 per month). This allows you to laser focus where to buy, get daily 'on the market' property alerts that fit your specific buying criteria and you can even use the same software the banks do to generate your own valuations.

That means you're getting $1,000 of value without paying a cent.

And we're still not done!

We also provide you with access to our trusted network of conveyancers, negotiators, and professional building and pest inspectors. Plus, you'll usually get a discount on the services that these professionals provide.

Finally, we have our Diamond Investors Choice Mortgage package for those who want just a little more hand holding and support.

This comes with all of the benefits of the Silver Package, plus:

- Instant access to our Location Masterclass (RRP $995pa).
- Access to our Suburb Selector Software, which compares over 8,530 Australian suburbs.
- 5 Deal Reviews from a property expert who assesses your possible purchase against your buying criteria, valued at $495 each.

So enough about us, we would really like to start talking to you about your needs and help you navigate the maze of lending and work out if chasing the rate does suit you, for many it does, but only with the lender whose policies and products that will assist them in achieving their goals.

You need a professional by your side to ensure you're making the right choices.

We want to be those professionals, so make time to talk to us today.
www.investorschoice.com.au/bookacall