SPECIAL REPORT

The 7 Common Mistakes people make when Choosing a Loan

By Ben Kingsley

Introduction

Whether it's your very first home loan, your first investment property loan or maybe even a refinance of an existing loan, the decision you make about what lender and what loan product you choose carries a significant financial impact on you, so you need to get it right.

This special report is about ensuring those of you just starting out, or those of you who need your financial affairs brought back into order, don't make common mistakes.

The 7 Common Mistakes

1. Paying too much Lender's Mortgage Insurance (LMI)

For those new to lending, Lender's Mortgage Insurance is an insurance policy that protects the lender against the borrower defaulting on paying their loan. So it protects the lender only, not the borrower, but the borrower has to pay the one off premium to obtain the loan. LMI kicks in when the Loan to Value Ratio (LVR) of the property exceeds 80%. In simple terms if you have a $500,000 property and a $400,000 loan, then the LVR is 80%, resulting in no LMI premium being due. But if the loan amount was $450,000 on a $500,000 property then the LVR would be 90%, so a premium is due and payable by the borrower.

There are four main ways in which too much LMI is paid:

A. The Borrowing Bracket Levels:

What is little known by most borrowers is that LMI premium calculations change in two different ways;

i) Loan Size

ii) LVR %

The table in the next page shows an example of LMI Premium Rates:

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LVR Bands	Borrowing Bracket Levels		
	Band Up to $300,000	**$300,001 to $600,000**	**$600,001 to $1,000,000**
80.01% - 81%	0.45	0.58	**0.80**
81.01% - 82%	0.45	0.58	**0.80**
82.01% - 83%	0.68	0.87	**1.12**
83.01% - 84%	0.68	0.87	**1.12**
84.01% - 85%	0.84	1.10	**1.39**
85.01%- 86%	0.84	1.10	**1.39**
86.01% - 87%	1.01	1.31	**1.67**
87.01% - 88%	1.01	1.31	**1.67**
88.01% - 89%	1.36	1.78	**2.24**
89.01% - 90%	1.36	1.78	**2.24**
90.01% - 91%	1.87	2.44	**3.68**
91.01% - 92%	1.87	2.44	**3.68**
92.01% - 93%	2.10	2.74	**3.96**
93.01% - 94%	2.10	2.74	**3.96**
94.01% - 95%	**2.33**	**3.04**	**4.18**

If a borrower was thinking of borrowing $300,500 to fund a purchase or refinance and the LVR was 86.5% they would be charged 1.31% for the entire loan amount, in this table example. However if someone explained to them (bank staff are unlikely to ever tell them) that simply reducing this amount to $300,000 would result in a charge of 1.01%; in overall savings that represents a 22.9% saving on the LMI premium.

B. Different Lenders Set their Own Premiums:

Here’s a further way to save big that is little known. Different lenders have different LMI premiums rates – meaning that one lender might charge up to several thousand more in a LMI premium fee than another lender fee. So in this case the borrower is thinking they have chosen a great loan and lender because their interest rate was cheaper than the other lender, but in reality the cost of their LMI premium means the other lender with the slightly higher interest rate is actually a cheaper product!

C. Different LVR band Tier Levels:

Another way in which borrowers are being duped is via different LVR Band Tier Levels. What if a borrower had a $400,000 loan and the value of the property was $439,000 – that equates to a LVR of 91.1%. Following the example table above, the LMI premium will be 2.44%. Now what if the lender or broker tells the borrower if you can get the LVR to 90% - i.e. only borrow $395,100, then the LMI premium will drop to 1.78%. A saving to the borrower in premium fees of 27%, which could be hundreds or even thousands of dollars to the borrower.

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D. Cross Securitisation:

Firstly, cross securitisation in simple terms means that a bank or lender will take more than one security you own to secure the money they lend you i.e. If you have a home and an investment property or a holiday home, lenders and banks will also try to protect the money they lend you by taking as much of your property as their security to get their money back if something were to go wrong. *Sneaky, right!*

Now imagine if they did this and the overall LVR went above 80%. They would charge the LMI premium base on all of the total lending involved, meaning the borrower would be charged the premium in the higher borrowing bracket level. However, if they had not cross securitised the properties and had calculated the LMI premiums separately, the borrower would be significantly better off with a better structured loan. In fact, Empower Wealth's team have helped in many of these instances – they've taken over customer's loans before settlement and managed to restructure them correctly, i.e. saved that client over $18,000 in LMI premium. Needless to say they are now clients for life!

It's amazing to think that on any given day around the country hundreds if not thousands of new loans are being written where unsuspecting borrowers are likely paying too much LMI. The challenge is that most lenders won't openly disclose their premiums; their staff just use calculators to work it out and tell the unsuspecting clients what the premium is and they tell them they have to pay it with any lender you choose and there is no getting out of it. Wrong – in our business as an example, all 800 odd loan products show the breakdown of the LMI premium when we input the loan amount and LVR, so Empower Wealth can work out effectively how to save clients' money.

Extra tips

What are the Costs associated with Buying a Property?

Did you know that you that you can borrow up to 95% of the value of your property with LMI? For many home buyers, this means you only need approximately $45,000 for a $500,000 property. In this article, Ben explains what LMI is and how you can use it to secure a home.

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2. People chasing Best Interest Rates of the Day

Since the Global Financial Crisis (GFC), a lot has changed in the lending markets around the world and more changes are inevitable. In Australia, the biggest recent change is the move by the big banks to now set their own interest rates outside of what the Reserve Bank of Australia (RBA) provide them in the form of the cash rate.

But what is interesting about this is that every mortgage product in the country has clauses in the contract that borrowers sign giving the lender the right to adjust fees and charges and interest rates (outside of any fixed period within the contract) at their absolute discretion. It's only coming to light more and more because of the recent media attention placed on the RBA rates decision and also the recent moves by lenders to set their own agenda on rates.

Using a couple of well-known Mortgage Lenders pre GFC as examples, namely Wizard Home Loans and the original Rams Home Loans, there is a critical point to make here. They were entrenched in the consumer psyche as being cheaper home loan lenders with the best interest rates. Then the GFC hits - so their access to cheap money internationally dries up and they punish their customers by passing on higher interest rates than the rest of the market, a LOT higher. The result was that anything possibly saved by borrowers was more than given back in the end.

In today's marketplace, there has been some regulation changes and now it's less costly to move to different lenders, because banks and lenders have been forced to drop any exit fees. Yes they still charge other fees (Discharge Fees) and so does the government (Mortgage Registration and Discharge Fees), so it's not all that easy or cost effective to be jumping from lender to lender, especially when you factor in the inconvenience of setting up new accounts and new direct debits and payment transfers etc.

So with banks and lenders now doing their own thing and this becoming more of the norm, coupled with the still present costs of refinancing and moving lenders, there is absolutely no guarantee whatsoever that the best interest rate with any lender today will remain the best interest rate tomorrow. Banks and lenders will 'go on sale', buy some new mortgage business and then to the surprise of the borrower, they will announce an interest rate 'adjustment' or not pass on the full rate cuts etc. This will be the new norm.

Now, *it's not time to give up finding the best interest rate*, but Empower Wealth can confirm from firsthand experience in setting up thousands upon thousands of new loans, that anyone claiming to have the very best deal today, may not have the very best deal tomorrow. Empower Wealth's strategy is to stay at the right end of great interest rates and undertake annual reviews to ensure clients are getting a great deal on their home loans. And if you are thinking of tackling this space alone, then the message is be realistic and make sure you know as much as you can about the financial security of the lender you are choosing.

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3. Not Shopping Around

Shopping around pays off – and not only when LMI is involved.

Different lenders use different calculations to determine how much they are willing to lend a borrower. In fact, if you grouped together 10 different lenders you would get 10 different borrowing power outcomes.

Here's an example: Take a couple on a combined income of $150,000 with one child aged 6 and with a credit card limit of $8,000 and a car loan of $500 per week. 15 lenders gave 15 different maximum loan amounts as shown below.

LENDER	MAX LOAN AMOUNT
Lender A	$732,024
Lender B	$721,453
Lender C	$686,362
Lender D	$680,266
Lender E	$671,996
Lender F	$665,907
Lender G	$659,597
Lender H	$653,298
Lender I	$616,030
Lender J	$597,410
Lender K	$553,200
Lender L	$535,000
Lender M	$501,405
Lender N	$480,830
Lender O	$411,348

The discrepancy between lenders is amazing. Now if you were looking to buy a home or even invest in an investment grade property, this type of borrowing variance could result in the unknowing borrower choosing an inferior location or property to live in or invest in.

Another example of the benefits of shopping around is getting a great deal. If you really break it down, a home loan is simply a product you buy to meet a need. In this case it's usually a property purchase of some type. Sure it is a bigger amount than going out to buy a pair of shoes, but it works on the same principles. If you shop for shoes and you know that the basic function of one pair of shoes to another is the same, then the appeal and satisfaction of a purchase when there are sales on is no different to nabbing the best home loan.

So if you don't look around you don't really know what's available. And if you don't negotiate you may not get a special discount that might be on offer. Mortgage Brokers / Finance Advisors do have an advantage here, as they know what deals are worth looking at and which ones are no good. Also,

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some top performing Brokerage businesses often get special deals that the general consumer may not be privy to, because the lenders know they are a great source of business and bring in more loans every week, as opposed to a consumer shopping for a single loan (a bit like getting a discount for buying more than one pair of shoes or buying in bulk).

The very clear message here is that it does indeed pay to shop around. It is very time consuming to be able to compare lender after lender after lender to get an idea of who's going to lend you the amount you want, but there are benefits and gains to be had. If you don't have the time, you can engage the service of a qualified Mortgage Broker/Finance Advisor who will do all the running around and shopping for you.

4. Being Enticed by an Attractive Short Term Interest Rate

It's usually first home buyers who get 'sold' good old honeymoon rate loans. These are loans that offer a very attractive cheap interest rate for usually a 12 month period and then revert to a higher interest rate, which is often higher than the life of loan discount rates on offer through most lenders.

The sales pitch to these unsuspecting borrowers is that their repayments are going to be much lower in the first year, and they therefore will be able to buy more things for the property to make it more 'homely'. But once they come out the other side of the special honeymoon period they end up paying more for the privilege of the cheaper repayments over the longer term.

Empower Wealth has vast experience in helping set up thousands of loans, and know that the first loan you are going to get will last you between 3 to 5 years before you may refinance it, or restructure your lending to accommodate changes in your life. And this usually coincides with the timing of when you should be looking to see if you still have a great home loan that's meeting your needs and with a very competitive cost.

Ultimately, jumping from lender to lender every year is still a very costly and time consuming exercise and there are absolutely no guarantees that the lender you are moving to each year will keep their rates low forever. It could end up costing you more to move than it would have to stay.

So the message when deciding to select a home loan, investment loan, line of credit etc, take the view that this loan will be the product that you will be using for around 3 – 5 years and not just a 12 month honeymoon period. Otherwise be prepared for lots of extra costs.

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5. A Home Loan is NOT a Prison Term

As much as there are often no benefit to continually refinancing your loan every year, there are still people out there who think that once you select a lender and loan product, you are locked into that product for the term of the loan, which is usually 25 or 30 years or until you pay if off.

This couldn't be further from the truth. A loan is an evergreen product, and can be renewed by refinancing to another lender from your existing lender. Furthermore, if you have gained equity in your home, you can actually seek to get more funds out for other purposes, such as a deposit for an investment property, or funds to do renovations or buy a car at cheaper interest rates than car loan rates etc. Just make sure the 'hidden costs' of switching lenders are factored in, and be sure to ask your mortgage broker to demonstrate the proposed savings and to ensure all costs of refinancing are factored into their calculations.

6. Looking at a Home Loan in Isolation

It's true that some people have a home loan with one lender and their day to day banking with another financial institution. And often the compelling reason to do this is once again the attraction of what looks like a cheaper option.

Empower Wealth, who help clients build significant property investment portfolios, often use more than one lender to accommodate all the lending and properties, the same way in which big business also use several lending partners. But they also advocate for one primary lending partner and it usually includes getting clients' money affairs linked in for efficient usage.

You see, a home loan is only part of the bigger financial picture for either a person or a household. Money coming in, money going out and money left over for paying down debt, savings or investing for greater wealth. Having the convenience of one primary lending partner provides time saving benefit to a household. Most internet banking services now offer automated transfers, B-Pay payments, auto-sweep payment of credit cards, offset account benefits, account keeping fee waivers etc.

In a time poor world like the one we live in today, it's never been more important to put a value to your personal time. Having to run around to branches, pay bills online, transfer money between accounts, set credit card payments up etc, this all takes time. So the more you can automate it the more time savings you can achieve. And there's real value on this personal time, so it is worth looking at your loan as part of your bigger financial picture to really get greater benefits.

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7. Loan Strategy and Structuring

We've left the most important point to the last. Pages and pages could be written on this point, but for these purposes there are some key technical elements to consider.
Home loan strategy and structuring refers to the strategic planning and tactical structuring of loan products to achieve significant objectives and goals, both short and long term. Let's explore this more with a couple of examples:

- A borrower is seeking to secure a loan and wants to lock in the vast majority of it into a fixed loan, as he thinks interest rates are going to go up. So he thinks he's done a great job when following the loan settlement over the next 12 months as rates go up a couple of times. Now the following year, he gets the long awaited inheritance from the passing of a father which he knew was coming before he set the loan up and it's a significant figure. He goes to put this money into the loan to pay it down, but is informed that the loan product has a cap on how much he can pay down in principal reductions and this extra money will significantly exceed this limit, meaning he has two options, pay a significant penalty fee to get the money put on the loan or put the money into a term deposit which will earn him interest (that he will have to pay income tax on). Both do not give him the same positive financial outcome that he would have achieved if he had kept the loan as variable and paid the higher interest rate. **He had no idea that he would be penalised for paying down his loan, as he wasn't informed of this and he didn't mention the inheritance because he didn't think it was important at the time of getting the loan**.

Now this is an extreme case, but there are far more common cases of people not adequately forecasting the income they will generate and therefore exceeding the capped limited on their loans, meaning them missing out on good to very good amounts of interest savings and missing out on paying down their loans earlier. Another example:

- A household is looking to create wealth through investing in property. They have a property investment plan drawn up and they are ready to improve their financial wellbeing over the long term. They secure the first property and have it rented and things are looking good, so they go back to their existing lender to obtain more finance. However, they are declined because the servicing criteria of that lender won't allow them to borrow the money they seek, because they only took into account 50% of the rental income and didn't take into account the negative gearing add backs in assessing their income. So they decide to wait it out until their income position improves, which is frustrating for them as the area they were looking to buy the property values went on to increase by 15% that year, meaning this result has cost them a significant windfall.

If they had known that they could have refinanced to a new lender who took 80% of rental income and also included the negative gearing add backs, they could have bought that investment property, and they would likely be a lot wealthier thanks to the smart and strategic finance planning they undertook. One more example:

- A couple are seeking to invest in property and are feverously saving a deposit for their first investment property. Based on what they are saving it will take them another 3 years before

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they have this money to invest. Unbeknown to them, they could in fact have bought the property straight away, because they had equity in their existing home. Through a re-structuring of their loans they would have been able to release a separate loan split which would have been enough to cover the 20% deposit on the investment property now and by structuring it away from the existing owner occupier debt, they will be able to claim the interest on this loan as a tax deduction on their personal income tax assessment each year. But the tax benefit is not the reason they have investment, it's again to enjoy the capital growth and rental return income they are hoping to obtain to build greater household wealth.

– Another couple have settled on their home and via the so called wisdom and direction of their parents they are focusing on paying down their loan as quickly as possible, so all their surplus money is going into the home loan account. Fast forward five years and they are ready to purchase a bigger home. They have solid income which allows them to be in a position to turn their current property into an investment property. Because they have done such a great job in paying down the loan, the property in now generating them a positive cashflow each month, which will result in them having to pay income tax on this extra money they are making. That's ok, because they realise that the more passive income they generate the less work they have to do to earn an income.

However, they could still be getting the same income from the property, but also be getting a tax refund as well, instead of having to pay more tax. This is because they didn't have the correct loan structure and strategy to start with. Overall they have lost a real opportunity to gain a greater financial benefit because they didn't know what was possible because they didn't get professional advice to help them plan strategically and tactically.

There are many more ways in which having the right strategy and structure of your lending will benefit you in the short and long terms. Ensure you either do your own investigations or get specialist advice from experienced and proven professionals.

Extra tips

Retire Sooner and Richer (Your Investment Property Magazine)

We have been told that property investing is for the long term but it does not necessary mean that you need to wait a long time to get started! In this article, Ben shares a golden tip on fast-tracking your portfolio by tweaking your strategy without putting your finances and sanity in danger. They will be a step-by-step explanation on his tips and he will also use real life figures to further demonstrate the results. Read the article now!

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Next step

We hope this special report has provided you with some valuable tips and insight into the very challenging, somewhat daunting and often competitive world of buying property. If you would like to learn more about Home Loans, we recommend you to visit Empower Wealth's How To Sessions page or our Newsletter page. Wishing you all the very best of luck in this adventure.

Invitation for a FREE One Hour Consultation

If you would like a free no obligation consultation with one of our qualified Mortgage Broker, all you need to do is call 1300 123 842 (1300 1 ADVICE) or complete the consultation form on our Home Loans page and one of our team will be in touch to organise a convenient time to talk over the phone or meet with in person.

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