

LINES OF CREDIT

Yes, they're convenient. But are there better alternatives?

By STUART WEMYSS

Many finance publications encourage borrowers to use line of credit ("LOC") products to facilitate property investing or as a means of repaying their home loan more quickly. It's true that these products can be convenient... however, are they the best product in terms of features and cost? Maybe not! Often, there are cheaper and more appropriate products that will save borrowers more.

I'll show you why I believe many borrowers are wasting their money by using expensive LOC products. In fact, many borrowers are probably paying significantly higher interest rates through choosing the wrong product (let alone the wrong lender). Inappropriate product selection is the most common mistake made by borrowers.

LOC VERSUS NORMAL LOANS — WHAT'S THE DIFFERENCE?

There are a couple of key differences between normal loans and LOC's. The notable differences include:

- ▶ **Not fully drawn** – most mortgages are 'fully drawn advances'. This means that the total loan amount must be paid out when the loan is set up. That is, the total loan is fully drawn on the settlement date. However, a LOC does not have to be fully drawn. In fact, you can set up a LOC and never draw down any money. You only pay interest on the outstanding balance. LOC's are very similar to credit cards. If the credit cards balance is zero then you don't pay any interest.
- ▶ **No term** – most loans have a specific term (normally 25 to 30 years) during which the borrowers must repay the debt. However, LOC's do not have a specific term. They are commonly termed "evergreen" facilities. However, a lender usually has the right to request the borrower to repay the complete line of credit within a

relatively short amount of time (i.e. call on the loan). Sometimes, LOC products may be subject to an annual review in that the lender will review how the borrower has conducted the debt over the past year to determine if it is still appropriate to offer the LOC facility. However, annual reviews are not as common as they used to be.

- ▶ **Minimum repayments** – as there is no term for a LOC, the principal loan balance does not have to be repaid over a specific period and as such the minimum repayments for a LOC facility is equal to interest only. If any loan principal is repaid, it can be redrawn at any time.
- ▶ **Capitalise interest** – any interest accrued in a LOC can be added to the loan balance (subject to the credit limit and lenders' policies). That is, if you don't pay the interest every month it can be added to the loan balance in exactly the same manner as when a credit card is not repaid in full. Obviously, interest can only be added where a sufficient credit limit exists.
- ▶ **All in one** – a LOC product combines a loan account and transaction account into one account. Borrowers normally have their salary (and rental income) paid into the line of credit account and have ATM, Internet and phone banking access to withdraw spending money and pay bills/expenses directly from the LOC.

WHY DO THEY COST MORE?

LOC interest rates can be 0.50% per annum more than normal loan products (i.e. above the standard variable rate). In addition, most lenders are less likely to discount LOC interest rates by as much as they discount other products. Discounting standard interest rates is very common amongst lenders especially within professional packages. For example, the lowest LOC interest rate that we've been able to negotiate

for clients is 5.91% p.a. compared to 5.61% which is the lowest negotiated interest rate for a normal term loan.

So why are LOC's more expensive? There are two primary reasons:

1. LOC's are full featured products. They're very flexible and allow borrowers to do almost anything. LOC's also include transaction banking facilities and product features like capitalising interest, splitting accounts, ATM access, etc. These are costly for the lenders to offer (especially the lenders that don't have a strong transaction banking network).
2. The lender's 'cost of funds' is higher for LOC products. The main reason for this is that LOC's do not have a specific term as discussed above. Therefore, a borrower's balance may be \$500 one week and then \$100,000 the next. A week later the balance may be down to \$500 again. This makes it more difficult for the lenders to manage their interest rate exposure and hence the cost of funds is higher. Overall lenders view these types of loans as exhibiting a higher risk compared to normal term loans (partly because that lender has no control over what the funds are being used for.)

WHY PEOPLE RECOMMEND LOC'S

There are a number of reasons cited by personal and investment finance gurus for recommending LOC products. The two most common reasons are:

► **Savings** – Some finance commentators have suggested that using a line of credit will save you heaps in interest costs, and thereby helping you repay your mortgage a lot sooner (e.g. some lenders have quoted savings of up to 40%!) Many lenders also use this argument to convince borrowers to choose the higher priced LOC product.

LOC can help borrowers save on interest. These savings arise by depositing your salary (and rental income) directly into the loan and thereby reducing your loan balance for a few weeks until you need your salary to pay for living expenses. Essentially, you can "park" spare cash and have it work for you (i.e. by saving you approximately 6%).

► **Flexibility** – Combining your loan and transaction account makes it very easy to manage your finances. You don't have to worry about making loan repayments. You're automatically repaying extra monies into your loan and you can easily access additional funds for personal and investing purposes. You can even have your credit card balance automatically "swept" into the loan each month.

However, this flexibility often comes at a cost. Sometimes borrowers find this ease of access to borrowed funds too tempting. It's often too easy to draw down an extra few thousand dollars to fund living expenses in a busy month while promising yourself that you'll have a lean next month. However, this doesn't always happen. Often, borrowers find that they make almost no progress in repaying their loan and their balance is exactly the same as it was years before they took out the LOC.

These facilities are not for everyone. You must be disciplined to ensure you stick to a particular budget and

not continually access additional borrowings each month. A good rule of thumb is, if you're one of the many people who struggle to repay the credit card balance to zero each month, a LOC is probably not for you.

WHY THEY MAY BE WRONG...

The above reasons for recommending LOC's may be correct. However, a more thorough assessment reveals that savings may not be as good as first thought and other cheaper loans will provide similar flexibility.

► **Savings** – How much do LOC's really save? My own calculations indicate that LOC's and offset accounts can save the average borrower in the range of nil to approximately 5% of the interest cost over the life of the loan.

The aim of a LOC is to have any monies working for you by reducing your loan balance and therefore saving you interest. I've assumed that a person's salary is deposited into his/her LOC at the start of every month and these funds are withdrawn to pay for expenses at the end of the month. Any surplus funds are withdrawn at the end of the month and either invested or left in the mortgage as "extra repayments." Therefore it stands to reason that the maximum amount of money that you can offset against your mortgage at any one time is your total salary. If that happens every month, then the maximum a LOC is saving you is equal to one year's interest on your monthly salary.

	Salary	LOC Balance
Opening Balance	\$0	\$300,000
01/7/03 Salary paid	\$4,500	\$295,500
31/7/03 Expenses paid	\$3,000	
31/7/03 Surplus withdrawn	\$1,500	
31/7/03 End Balance	\$0	\$300,000

In the above example, the full \$4,500 is reducing the mortgage balance for the full month, every month. Therefore, if your mortgage's interest rate is 6% per annum then you maximum saving would be \$270 per year (\$4,500 x 6%). If your loan balance is \$300,000 then you would be paying approximately \$18,000 of interest per year. Therefore a saving of \$270 represents a saving of approximately 1.5% (\$270/\$18,000). Not that compelling, really.

It's important to assume that any surplus is counted as an "extra repayment" so that we do not confuse saving generated by making extra repayments with savings generate by the LOC (i.e. dormant salary reducing the loan's balance). Often lenders combine these savings to make LOC's more attractive (in fact one lender was warned by ASIC about this in late 2002). However, extra repayments can be made with nearly all loans, not just LOC's.

Some people advocate the use of a credit card – typically with a 55-day interest free period – to pay for most expenses, to ensure that your salary is offsetting the loan for a longer period. Obviously it's critical to ensure the credit card is paid off on time each month, otherwise incurring interest at credit card rates would cost far more than the interest you saved by leaving the funds in the LOC longer!

Let's assume that the interest free period is 55 days (we'll

round it to two months for simplicity.) Therefore, if you paid for your expense with a credit card on 31 July 2003, you wouldn't have to pay off the credit card until 30 September 2003 (two months later). As your salary is now offsetting your mortgage for three months (one month because you don't pay for expenses until the end of the month and two months for paying for expense on a credit card), using a credit card could multiply your savings from \$270 to \$810 per year (or 4.5%).

However, choosing a cheaper loan (with an interest rate that is 0.50% lower) would save \$1,500 per year (\$300,000 x 0.50%) which is a saving of over 8% (\$1,500/\$18,000).

You must remember that I've been very generous with some assumptions (e.g. paying for expense at the end of the month, two months interest free period for a credit card) so the LOC savings stated above are probably overstated.

► **Flexibility** – An offset or basic variable product with redraw will often provide you with the same benefits as a LOC (see below for more). There is only one exception... no other mortgage product currently allows a borrower to capitalise the cost of interest (i.e. add interest to the loan balance).

USING AN OFFSET OR BASIC VARIABLE PRODUCT TO DO THE SAME THING FOR A HOME OWNER...

If you're a home owner, your strategy should be to obtain the cheapest mortgage and repay as much as you can, as often as you can. Don't be fooled by the advertising. You don't necessarily need to use a line of credit or offset product – especially if they cost more.

If you're borrowing in excess of \$250,000, you should be able to gain a very competitive offset product by utilising a professional package (at least 0.60% lower than lender's standard rates). This will provide you with exactly the same benefits as a line of credit. The only difference is that interest rates for offset accounts are normally lower than LOC's.

Homeowners borrowing less than \$250,000 may wish to consider using a basic variable. The interest rates for

these products are normally 0.50% to 0.70% lower than the standard variable interest rates. If you can get one with free redraw (or at least a very small cost) then that's the best. That way you can deposit all or most of your salary directly into your loan account. Therefore, your salary is reducing your loan balance from day one. You pay for as many expenses as possible on your credit card. You then pay your credit card off in full at the end of the interest free period by redrawing the money from your loan. The effect of this is that your salary has been offsetting your mortgage and saving you money. This arrangement essentially gives you the lowest cost of a basic variable and the savings of an offset.

FOR AN INVESTOR...

The benefit of a LOC for an investor is that you can establish a facility ready for use at some time in the future. You don't pay interest until you draw on some of the funds. Did you know that you can do the same with a basic variable?

As discussed above, a basic variable is a 'fully drawn advance'. This means that the funds are paid to you at the time of establishing the loan. As a result you're charged interest on the balance immediately. This may not suit investors, as there may be a significant amount of time between setting up the loan and actually drawing on the funds. However, you can use a basic variable like a LOC. What you need is a basic variable that allows interest only repayments and has a redraw facility. Then on the day the loan is set up, (and the borrowed funds are paid into your transaction account) you repay the funds (except for \$1) back into the loan. As a result you then have a loan balance of \$1 and access to redraw for the remaining monies.

As an example, assume you set up a loan for \$100,000 secured by your home. On settlement day the bank will pay \$100,000 into your transaction account. On the same day you repay \$99,999 back into the loan account. That way you have a loan balance of \$1 and access to \$99,999 via redraw for whenever you need it. As you've elected to repay interest only the lender will only charge you interest on \$1.

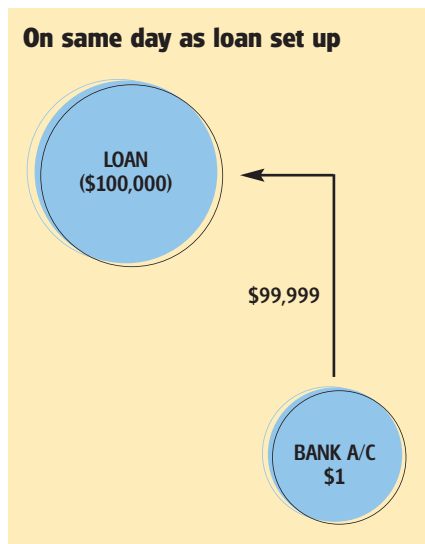
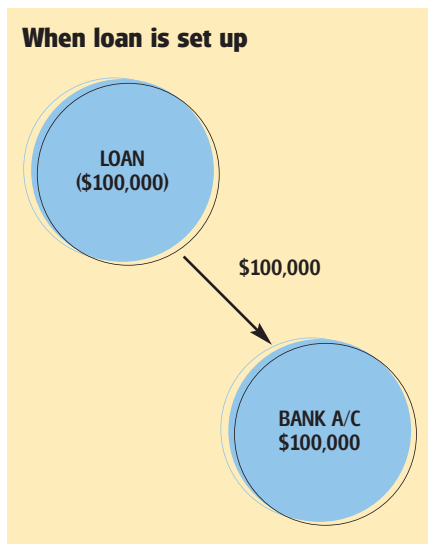
One thing you'll need to consider is early repayment fees.

You should check with the lender to see if you'll trigger any break or early repayment fees by repaying the majority of the loan within one day.

If you're able to get a competitively priced offset account, you won't have to repay any funds back into the account as discussed above. You can have your monies sitting in the offset account until you need to use these funds. In this circumstance an offset is just the same as a LOC.

BUT LOC CAN BE GOOD FOR SOME...

There's no doubt that LOC products are some of the most flexible and



The Truth About LOC's

- ▶ Savings are often overstated. LOC's generally save borrowers in the range of nil to 5% of interest costs over the life of the loan.
- ▶ Borrowers are often better off to choose an offset or basic variable loan instead of a LOC.
- ▶ LOC's do not offer many "additional" features that you can't get through using a standard loan.
- ▶ A basic variable interest only loan with redraw can operate in much the same way as a LOC, but generally at a significantly lower cost.

easy to use products available. Borrowers just need to recognise that this flexibility comes at a premium. Some borrowers are very familiar with the way LOC's operate and do not want to change. Other borrowers like the flexibility of being able to write a cheque directly out of their mortgage account. This is particularly advantageous for borrowers who may need to do many smaller value transactions (e.g. renovating or buying and selling shares).

All I'm suggesting is, have an open mind. When taking out a new loan, spend just as much time (if not more) considering which type of product is best for you as you do considering which lender is the best. In fact, choosing the wrong type of product may end up costing you more in financial terms than choosing the wrong lender. Getting the right advice in this regard can end up saving you thousands.

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