Choosing the right loan

When borrowers make mistakes, nine times out of ten, it's due to choosing the wrong loan product rather than the wrong lender. Stuart Wemyss puts loan products under the spotlight.

Most lenders offer the same suite of products. There is no doubt that there are differences between the same products offered by different lenders, but choosing the wrong product will probably have a greater financial impact than the wrong lender.

Borrowers need to first decide which product is best for them and then decide which lender offers the best deal for that particular product, thereby comparing apples with apples.

Let's look at the main products offered by lenders and in what circumstances they should be used.

The main types of products that you may consider using are:

- Discount variable
- Basic variable
- Line of credit
- Fixed rate
- Offset
- Standard Variable

A summary table (p.58) has an outline of the products' basic features. I will describe some of the unique factors about the products and where they're best used.

DISCOUNT VARIABLE

Generally, these products will offer a discounted interest rate for the first 12 months and then the interest rate will revert to the standard variable rate after this period. The trick is to entice you into the loan with a low rate and slug you a higher rate after the first year. Remember, your goal should be to attain the "lowest ongoing cost". These products usually don't achieve this and therefore have limited uses.

Most discount variable products have break fees. Therefore, if you try and exit the product by refinancing or switching products within the first three to five years, then you have to pay significant fees. This has the effect of essentially locking you into an uncompetitive loan.

The only time I would recommend anyone to use these products is where you only plan to hold the property for a short period of time (say, for approximately a year). Locate a loan that has minimal or no break costs (there are some around) and take advantage of a cheap rate for the first 12 months. If you dispose of the property quickly, then this may be the best loan product to use.

BASIC VARIABLE

This is a no-frills product that is offered by most lenders. It has minimal features. Be careful, not all basic variable loans offer interest-only repayments. Most basic variables offer redraw but at a higher costs (and perhaps a higher minimum redraw amount). Normally there aren't many other features to speak of. Again, many of these products have break costs. This is because the profit margin the lenders make from these products is a lot lower than standard variable products, and they need customers to remain in the product for at least a few years so that they make money.

The interest rate for these products is generally in the range of 0.50 per cent to 0.60 per cent below the standard variable rate.

The best use for these loan products is to finance investment property loans. They suit "set and forget" style arrangements. That is, most investors set up an interest-only loan and arrange for the interest-only repayments to be automatically debited from their transaction account. They hardly touch the loan

account or need any other features. These products are perfect for these situations.

Some lenders offer these loans within a professional package which is great, because it means that you don't have to pay for any application fee or additional ongoing fees.

LINE OF CREDIT

A lot of borrowers ask for lines of credit, but often they don't really need them. They're the most flexible products available, but they're also generally the most expensive. Lines of credit do not, by definition, have a loan term. Therefore, the minimum repayment is interest only. Some line of credit products don't even require a minimum repayment and interest is just added to the loan balance similar to credit card (within the approved credit limit, of course).

Line of credit products are essentially a transaction account and a loan account rolled into one. For example, you can withdraw money from your loan with a key card or credit card via an ATM. (For a detailed analysis of lines of credit, refer to the article in Dec 03/Jan 04 issue of API).

These products are good for investors who need to undertake regular small transactions. A perfect example is anyone who is renovating, or investors who trade shares. For example, if you're renovating, every time you go to the hardware store, you can pay by card and have the money directly debited from your loan account. This especially makes it easy to keep track of all expenses.

FIXED RATE

This is a pretty simple product. The interest rate is fixed for a specific period of time. In Australia you have the option to choose between a fixed rate period from one to five years, seven years, ten years and even 15 years with a new product recently released by the Commonwealth Bank. Normally fixed rate loans limit the amount of extra repayments you can make to approximately $10,000 per year. There are some lenders, such as Heritage Building Society, that allow unlimited extra repayments on fixed rate loans.

I always caution investors who want to fix their investment debt. There is no right or wrong decision with respect to fixed rates – it's a very personal thing. However, the difference with investment properties is that you can change your mind a lot quicker than with owner-occupier properties. You never know if you may want to sell the property, refinance to access more equity, or do something else. Choosing a fixed rate product may limit you from being able to do some of these things (without paying for potentially large break fees).

Due to the inflexibilities of fixed rates, these products are best used for investment properties that you're absolutely sure you will hold for the long term.

OFFSET

Offset accounts are normal loan accounts that are linked to a transaction account. Interest is calculated on the net balance between the loan account and the transaction account. That is, the transaction account balance is offset against the loan balance. For example, if your loan balance was $100,000 and your transaction account balance is $10,000, then you would be charged loan interest on a net balance of $90,000.

These products are best used for owner-occupier (or home loan) debt. The reason for this is that you're better off to offset non-deductible debt with any free cash rather than deductible debt.

The best way to maximise the benefit of an offset account is to direct as much cash flow as possible through your transaction account. Therefore, you could have all your salary income and rental income deposited into the transaction account. Once again, you're better off having your rental income offset against your non-deductible debt rather than your deductible debt.

The only time I would recommend using an offset account is within a professional package so that you should qualify for an interest rate discount of at least half a per cent off the standard variable rate (which makes the interest rate comparable with basic variables).

The professional package market is very competitive. (Refer to the article on professional packages in the April/May 04 edition of API).

STANDARD VARIABLE

Standard variable loans offer borrowers the most features. The average standard variable rate at the time of writing is 7.07 per cent.

The only time I would recommend people use a standard variable product is within a professional package and thereby the interest rate would be discounted to be comparable with basic variable loans (approximately half a per cent below the standard variable rate).

How do I choose the best product for me?

➤ Be realistic about the level of the loan features that you need. Remember that the more features a loan product has, the higher the cost. Separate the "must have" features from the "nice to have" features. Redraw is a good example. Often, people ask for an investment loan with free or cheap redraw. In reality, there are not many investors who make extra repayments on an interest-

Loan features and fees

	Discount variable	Basic variable	Line of credit	Fixed rate	Offset	Standard variable
Interest rate	Discount by 1% for first year	6.57%	7.00%–7.20%	Various	6.57%	7.07%
Ongoing fees	No	Yes	No	No	Yes	No
Break fees	Yes	Yes	No	Yes	No	No
Extra repayments	Yes	Yes	Yes	No	Yes	Yes
Redraw	Yes	Yes	Yes	No	Yes	Yes
Interest only	Yes	Yes	Yes	Yes	Yes	Yes

No – no, on average; Yes – yes, on average

only investment loan (because remember that borrowers can only redraw "extra" repayments). If they do make the odd extra repayment, then how likely is it that they'll want to redraw it? The tip is – focus on the features that matter.

➤ Loan term. Consider how long you'll hold the property or loan. If you're only going to hold the property for a few years, than consider using a discount variable loan. If you plan to hold the property for the long term then choose the loan with the lowest ongoing overall cost.

➤ Capital growth. Break (or early repayment) fees can be an ugly side effect of good capital growth. Consider the example where you expect your investment property's value to increase significantly in the short term. You plan to take advantage of this increased value by increasing the loan in three years time (and using this increase for future investing). However, if the loan has break fees that exist for five years, then you may be up for more fees. Ask about break (or early repayment) fees before entering into the loan.

➤ Overall flexibility. Most investors buy and hold property for the long term. However, an investor's needs, views, plans, goals, etc. can change over time. Make sure that you maintain your flexibility. Choose a product that will allow you to change the loan without any significant costs.

FORGET ABOUT THE SATELLITE BENEFITS

Excuse the pun, but don't "bank" on specific features saving you money. This mostly applies to offset and line of credit products. Some lenders and mortgage brokers will try and tell you that these products will save you thousands of dollars and allow you to repay the loan years earlier. This can be misleading as it's not really the product itself that's saving you the money, it's your management of the product. Ask these people for the assumptions they use in these calculations and you'll see the savings are the result of extra repayments rather than the actual offset or line of credit products. Remember, extra repayments can be made with most loan products.

My advice is, don't pay any extra for these products. It's not worth paying a higher interest rate and being reliant on these "potential savings" to materialise. If you can get a line of credit or offset for the same interest rate as a basic loan, that's great. If not, always choose the cheapest loan which offers the features you require.

DON'T OVERLOOK THE FIRST QUESTION

Most borrowers miss the first step to finding the right loan and jump to the second question: "who is the best lender for me?" However, the first question they should be asking is: "which product is the best for my situation?" Then ask which lender offers that product at the lowest overall cost. If you don't know the answer to the first question, seek advice from a person who does.

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