

## August 2006 Newsletter

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### Banks show less interest with offsets!

Comparing mortgage products involves more than just comparing the interest rate and filling out an application form. Choosing the wrong product can have a greater financial effect than choosing the wrong lender. In this article, I will discuss which products to use, which products to steer clear of and how choosing the right product can save you a lot of money. This is important information for anyone who has a mortgage.

#### Offsets are king!

Many lenders offer offset mortgage products. Offset mortgage products involve having two accounts, being a standard transaction bank account and a loan account. These two accounts are linked so that the bank charges interest on the net balance. Perhaps this is best explained by example. Assume that you have a home loan for \$100,000 and you have \$10,000 deposited in your transaction account. When calculating the interest to charge you on your home loan the bank will offset the transaction balance against the home loan. Therefore, in this example, the bank will charge interest on \$90,000 (\$100k - \$10k).

Any money deposited into an offset account is better than any high yielding deposit account or term deposit. Depositing money into an offset is saving you say 7.00% in interest costs (or whatever your home loan rate is). Therefore, you would need to earn an interest rate of more than 10% to be better off (because remember, you have to pay tax on any interest you earn, so the after tax gain would be around 7% or less). I don't know of any 'at call' or term deposit accounts that pay 10%.

There are some lenders that allow you to have more than one offset account linked to one loan. Therefore, perhaps you could have two offset accounts. You could have one for your savings and one for your normal day-to-day spending. This will allow you to keep track of savings and personal cash, while still enjoying the benefits of having all

spare cash offsetting your home loan.

There is one rule that all lenders must comply with. The offset account must be in the same name as the loan that it's attached to. This is a directive set down by the Australian Tax Office (ATO).

You can increase the benefits of an offset by using a credit card to pay for expenses. A lot of professionals use a credit card to pay for expenses to generate reward points. However, another benefit is that it allows your cash to remain in your offset account for longer, thereby saving you more interest on your mortgage. The longer the interest free day period, the greater the savings.

I prepared a spreadsheet to calculate the quantum of savings that an offset could generate. I estimate that an offset could save you in the range of 5% to 8% of interest costs over the life of the loan. This amounts to a reasonable saving. If your interest rate is say 7.12%, a 7% saving would be equivalent to an interest rate of 6.62% (i.e. rate after savings are deducted).

#### Problem products

Many borrowers are attracted to line of credit products, because they are very flexible products. However, many people who have lines of credit find it more difficult to repay their loans. There are two problems with lines of credit. Firstly, it is all too easy to withdraw money and therefore draw down on debt. Secondly, because all your money (cash) and lending is combined in one account it can be difficult to keep track of your month to month income, unless you maintain a strict budget.

However, an offset is split into two accounts. You still enjoy the same savings that a line of credit would generate, but it's easier to keep track of your income, because your loan and transaction account are separate.

Some lenders market products that are similar to lines of credit but they will call them offsets. With these products, you can deposit your salary directly into the loan account and then withdraw any cash for your normal monthly expenses. These products create the same problems as lines of credit because your income and lending are mixed into one account. Lenders may market these products as "offsets" when their system isn't flexible enough to accommodate a standard offset arrangement, or

they don't have a banking licence. It is really a second rate solution.

### Offsets preserve tax benefits

With the wrong product, you could potentially destroy your ability to claim interest as a deduction. The ATO has indicated that they treat every loan redraw as a separate loan. Therefore, if you deposit some surplus cash into an investment loan and then redraw it later, you will (from the ATO's perspective) have two loans. Perhaps this is best explained by an example.

Assume you have an investment loan for \$400,000. You have some surplus cash (say \$50,000), which you plan to spend on a holiday and some home renovations. Since you don't have a home loan, you decide to pay the money into the investment loan to save some interest for a few months before you need the money. After three months, you redraw the \$50,000 and spend it. The problem is that the ATO will now treat this as two separate loans. You will have a tax deductible loan for \$350,000 and a non deductible loan for \$50,000 (because the ATO will argue that the \$50,000 was spent on personal items and therefore is not deductible). An offset would have been a great solution. You can still make your cash work for you by saving interest, but the benefit is that the money never hits the loan account. Therefore, you can preserve the tax deductible balance of \$400,000.

This strategy can also be applied if you purchase a property which you might occupy for a few years, but you plan to rent out the property in the future. Assume you purchase a property for \$500,000 and you have a cash deposit of \$200,000. In this circumstance, you can borrow 80% of the property's value (\$400,000) when you purchase. You can then deposit the surplus cash in an offset account. We would set the loan up as interest only. You should only make interest only repayments to maintain the balance at \$400,000. However, the cash in your offset account could continue to accumulate (with the cash that you would have otherwise use to make principal repayments) to save interest. When you eventually move out of the property (and rent it out), you could withdraw all the money from the offset and claim the interest on the \$400,000 loan as a deduction.

### Make sure you have the right products

Hopefully this demonstrates that choosing a mortgage product is more than asking about the rate and fees. Lenders may try and sell you a

product that sounds good, or one that is the most profitable for the bank. However, it's important to obtain advice to ensure that the product is best for you, not the bank.

## Battling Bank Valuations

Bank valuations play a critical role in the wealth building process. They can often cause frustration, as a low valuation could retard your ability to add to your investment property portfolio. I have experienced an increase in valuation issues in the past six months. I am not sure why. Perhaps valuers are concerned about the property market. Maybe there are less sales and therefore less evidence. Maybe I have had a run of bad luck. Whatever the case, it can not hurt to know a bit more about the valuation process.

There are a few things you can do to avoid a valuation coming in below your expectations. The most important thing to do is some research into comparable sales. A good start is to talk with some local real estate agents. You should be mindful that most real estate agents will over value your property (i.e. they will give you the "best price on the best day" valuation). In addition, they may cite sales of comparable properties that are in fact not comparable. In my experience, information provided by real estate agents only gets you half of the way. You should then drive by some of the comparable properties to ensure they are actually comparable. This will then provide you with a good feeling for what your property is worth. It will also make sure that your expectations are in line with the current marketplace. You could also provide this comparable sale information with your application.

More information? The full article, written by Stuart Wemyss, will be published in the September issue of the Australian Property Investor magazine (at news agents at the start of September or visit [www.apimagazine.com.au](http://www.apimagazine.com.au)).

## Best Rates

Basic variable	6.99%
Offset (>\$250k)	7.12%*
3 years fixed	7.10%
5 years fixed	7.24%

\* Generally, we can negotiate lower rates for > \$500k.

Above rates are current as at 18/8/06 and are subject to change without notice. Standard lenders terms and conditions apply.