GEARING UP FOR INVESTMENT

How much should you borrow when buying an investment property? Stuart Wemyss examines the pros and cons of borrowing more than 80 per cent of the property's value.

Many people recommend investors and homebuyers borrow a maximum of 80 per cent of a property's value. The obvious reason for this is so that the borrowers do not have to pay for lenders mortgage insurance (LMI), as this expense can be costly. But if we assume an investor's long-term goal is to build wealth, would they be better off borrowing a greater amount of a property's value and increasing their exposure to the property market? Is the cost of LMI really material in the long run? Let us take a closer look at these issues.

WHAT IS LMI AND HOW IS IT CHARGED?

LMI is an insurance contract that is arranged by the lender when a person borrows more than 80 per cent of a property's value. Most lenders use external mortgage insurance companies (sometimes a lender will use more than one company). There are only a few mortgage insurance companies in Australia. PMI Mortgage Insurance and GE Mortgage Insurance are the two largest companies. LMI insures the lender's risk, not the borrower's, against the potential shortfall between the loan amount and the net proceeds from selling the property (security). It only comes into play if a borrower defaults on their mortgage and the lender then takes possession of the property and sells it. If the net proceeds from the sale are less than the outstanding loan amount, then the lender may suffer a loss. In this situation, a lender could then recover this loss or shortfall from the mortgage insurer. In reality, very few mortgage insurance contacts are acted upon. In fact, data shows that the mortgage insurers have only had to pay out on 0.12 per cent of loans1.

Lenders only insist upon mortgage insurance when they lend more than 80 per cent of a property's value, because these loans represent a greater risk of shortfall occurring (particularly where lenders extend a high proportion of the property's value, say 90 per cent to 95 per cent).

LMI premiums are calculated based on a percentage of the loan amount. These premiums (or percentages) increase as the loan-to-value ratio (LVR) and the loan amount increases. Premiums vary greatly amongst the lenders. For example, the cost of mortgage insurance can differ by more than $1000 on a loan of $300,000 between the big four banks. The table below sets out the average insurance premium (from a selection of large lenders).

LVR	Up to $300,000	$300,000 to $500,000	Greater than $500,000
80% - 85%	0.65%	0.80%	1.20%
85% - 90%	1.00%	1.35%	2.30%
90% - 95%	1.45%	2.00%	N/A
100%	2.50%	2.50%	2.50%–3.00%

N/A= Not available.

To calculate how much LMI is going to cost, you must multiply the loan amount by the premium percentage and add Government stamp duty (which varies among the States). For example, let's assume you're purchasing a property in Victoria for $400,000 and you want to borrow 95 per cent (or $380,000). The mortgage insurance premium would be calculated as follows (the stamp duty rate in Victoria is 10 per cent):

$380,000 x 2.00% x (1 + 10%) = $8360

The cost of LMI can normally be added to the loan amount (often referred to as capitalising LMI). Some lenders will actually capitalise LMI over and above the maximum loan value. Therefore, using the example above, some lenders will lend $380,000 plus $8360 thereby essentially lending 97 per cent of the property's value. More lenders are allowing borrowers to do this. In fact, many lenders have changed their policies only in the last few months to allow capitalisation of mortgage insurance.

If a loan needs mortgage insurance, the application may go through two approval processes. First, the lender will perform an assessment to confirm that the application conforms to their credit policies. If the lender is happy with the application, they will then refer it to the mortgage insurer for approval. Sometimes the mortgage insurer's policies can be stricter than the lender's (particularly in terms of location of properties, stability of employment and the types of income that they will take into account). In some circumstances, applications do not always have to be approved individually by the mortgage insurers and the lender can approve it on behalf of the mortgage insurer.

Some lenders will refund a proportion of the mortgage insurance premium if a loan is repaid or refinanced within a certain period (normally within the first one to two years). They will not do this voluntarily, so be sure to ask if you think you are entitled to a refund.

Some lenders will consider waiving mortgage insurance. This is generally only available through the larger lenders and where the loan-to-value ratio is only marginally over 80 per cent (say less than 85 per cent). The lender may ask for an accelerated repayment program so that your LVR will be reduced to 80 per cent in a couple of years. Once again, this will not be offered to you so there's no harm in asking.

HOW MUCH CAN YOU BORROW?

Mortgage insurers generally split loans into two groups: loans under $500,000 and loans over $500,000.

Most mortgage insurers and lenders will lend a maximum of 95 per cent of a property's value where the loan amount is less than $500,000. If the loan amount is over $500,000 then the maximum LVR is generally reduced to 90 per cent (up to a loan amount of $750,000). The maximum LVR for loans over $750,000 is 85 per cent or less and these loans would be assessed and approved on a case-by-case basis. Mortgage insurance is generally not available where the loan amount is in excess of $1 million.

There are a small number of lenders in Australia that will lend up to 100 per cent of a property's value. Some lenders restrict these loan products to owner-occupier purchases only. Properties (securities) need to be located in major metro locations if the lender is to consider lending 100 per cent. The maximum loan value for a 100 per cent loan is in the range of $500,000 to $600,000 (depending on the borrower). The interest rates for these loans are equal to the standard variable rate plus or minus half a percent. However, if you're prepared to pay a higher interest rate (approximately 9.25%) you can borrow up to $750,000 at an LVR of 100 per cent. 100 per cent loans are only available to applicants with strong serviceability (income), stable employment history and the like.

I would envisage that more lenders will introduce 100 per cent loans in the future. These products particularly appeal to (and are aimed at) high-income professionals who have lived an expensive lifestyle for the past few years and have very little savings. They live in a capital city (say Melbourne or Sydney) and have only just realised that they need a deposit of at least $60,000 to $80,000 to get into the property market. This is more likely to be the trend as housing affordability decreases, and I forecast that more lenders will want to assist these clients.

One lender used to lend a maximum of 110 per cent of a property's value. However, this product has been withdrawn from the market, but may return in the future.

IS LMI TAX DEDUCTIBLE FOR INVESTORS?

The cost of LMI is classified as a borrowing cost. As the cost of LMI is always over $100, investors are entitled to claim the cost of LMI equally over five years (or over the loan's term where the term is less than five years)2. If you repay or refinance the loan within five years then you can claim the balance of the remaining cost as a deduction. For example, if mortgage insurance costs $5000, then you can claim a deduction of $1000 per year for five years.

As always, you'll need to obtain independent taxation advice to ensure LMI is deductible in your situation.

SO IS LMI WORTH PAYING FOR?

Now that you have a basic understanding of LMI and how much it will cost, is it worth paying, particularly for investors?

As an example, assume an investor is just starting out and owns his owner-occupier property worth $400,000, and the existing mortgage is $270,000. This investor has two options:

1. Borrow up to 80 per cent and avoid the cost of LMI.

The investor could increase his existing loan to $320,000 (being 80 per cent of its value). This would provide the investor with access to $50,000 ($320,00–$270,000) to use as a deposit to pay for 20 per cent plus costs of the new investment property. Therefore, using this $50,000 he could purchase a property for up to $200,000. This assumes that costs (e.g. stamp duty) will equate to 5 per cent of the property's value. In summary, the investor has financed the investment as follows:

Purchase	$200,000
Costs (5%)	$10,000
Deposit (from loan increase)	($50,000)
Loan required	$160,000
LVR	80%

Therefore, the investor's overall LVR is 80 per cent and he avoids the cost of LMI.

2. Borrow more than 80 per cent and pay for mortgage insurance.

The investor could increase his existing loan to $360,000 (being 90 per cent of its value). This would provide the investor with access to $90,000 ($360,000–$270,000) to use as a deposit and to pay for costs. Let's assume he purchases an investment property for $500,000.

Purchase	$500,000
Costs (5%)	$25,000
Deposit	($90,000)
Loan	$435,000
LMI	$12,500
Total loan	$447,500
LVR (exc. LMI)	87%

Therefore, the investor's overall LVR is 87 per cent. I estimate the cost of mortgage insurance to be as follows:

Loan for $360,000 (90% LVR)	= $6300
Loan for $435,000 (87% LVR)	= $6200
Total	= $12,500

I have assumed the two properties are identical in terms of rental yield and capital growth prospects (and all other aspects). Assuming an average capital growth rate of 5 per cent per annum, the properties will generate the following equity in five years:

	Purchase price	Value in 5 years	Equity
Without LMI	$200,000	$255,000	$55,000
With LMI	$500,000	$638,000	$138,000
Difference			$83,000

So it's quite clear from a capital growth perspective that the investor is better off in the long run by paying for mortgage insurance. However, let's consider the cash flow effects of purchasing a larger investment property over a five-year period.

	$200,000 property	$500,000 property
Rental income	$56,600	$141,600
Interest expense	($73,500)	($188,125)
Other costs	($10,000)	($25,000)
Cash flow deficit	($26,900)	($71,525)
Tax benefit	$13,000	$40,750
Net cash deficit	**($13,900)**	**($30,775)**
Capital growth	$55,000	$138,000
Increase in wealth	**$41,100**	**$107,225**

See footnote for a list of assumptions used in calculating these projections3.

As you can see, an investor is $60,125 ($107,225–$41,100) better off by borrowing a higher amount and paying for mortgage insurance. The cash flow deficit difference is approximately $17,000 ($30,775–$13,900) over five years which is not a significant commitment (approximately $3400 per year) given the potential upside in capital growth.

It's very clear in this example that the investor is better off paying for mortgage insurance and obtaining a larger exposure to the market.

100 per cent loans are becoming more popular even for investors. These products allow investors to lever their assets to a greater extent, without a large amount of additional cost. Generally, investors only have to pay for mortgage insurance (approximately 2.5 per cent) and on costs, such as stamp duty (which ranges from 3 to 5 per cent). Therefore, an investor can purchase over three times more property by using 100 per cent loans and paying for mortgage insurance as opposed to contributing 20 per cent and avoiding mortgage insurance.

Notwithstanding the financial benefits of being able to purchase a higher value property, there may be some other benefits including:

- You might be able to purchase a better quality property and/or in a better quality location for the higher amount which may provide better capital growth prospects.
- Because of the better property and/or location, the risk of vacancy may be reduced.
- Alternatively, you may be able to spread your risk and purchase two properties instead of one.

BUT BE VERY CAREFUL...

Borrowing a larger proportion of a property's value does not come without increased risk. Warnings by experts on the danger of over-gearing should be heeded, although what constitutes 'over-gearing' depends on the investor's particular financial circumstances. As always, you need to be comfortable with the level of debt. Consider the risk of vacancies, interest rate increases, slower capital growth or even capital depreciation. Strategies involving higher gearing levels are best reserved for high-income investors with enough financial expertise to accurately evaluate the risks involved.

Ability to meet repayments is an absolutely critical factor. So long as you can service the debt, borrowing a higher proportion of a property's value can pay dividends in the long term, provided the property you've bought delivers the capital growth you expect.

However, if you struggle to make repayments and you need to sell one of the properties in the short term, then there is a risk of crystallising a loss (due to the upfront costs such as stamp duty and LMI).

Therefore, do your sums and don't push yourself too far too quickly.

DON'T JUST DISMISS IT

Many investors dismiss the cost of mortgage insurance as an avoidable expense. While this is true, they may be limiting their investment ability. Purchasing more property in the next five years will make a huge difference in the long term. For example, in 20 years the investor who purchased the more expensive property (refer above example) will have accumulated approximately $800,000 more equity compared to purchasing a cheaper property. The cost of $12,500 doesn't seem much to earn an additional $800,000, does it?

All I'm suggesting is to keep an open mind. Remember your investment strategy and think long term. Don't dismiss paying for mortgage insurance as a waste of money.

Considerations for gearing up

- ➤ Do the numbers and compare the two scenarios such as borrowing 80 per cent and borrowing more than 80 per cent.
- ➤ Consider the cash flow benefits of paying for LMI (i.e. tax deduction).
- ➤ Compare the pros and cons of purchasing a higher value property.
- ➤ Recognise that the more you borrow, the smaller the pool of potential lenders is. Most lenders lend 90 per cent, a smaller amount lends 97 per cent and there are only a few that will lend 100 per cent. This obviously reduces your options.
- ➤ Compare the cost of LMI between lenders.
- ➤ Crunch the numbers to make certain that you can afford the higher debt.
- ➤ Ensure you understand all the risks entailed by higher gearing levels.
- ➤ If you want to borrow more than 80 per cent, make sure that you obtain a pre-approval.

As always, these strategies are not for everyone so you must consider your own risk profile, objectives and financial situation. It's of utmost importance to ensure you're comfortable with whatever level of debt you choose to take on.

Make sure you pre-approve it

If you've decided that borrowing a larger proportion might be the way to go for you then I cannot stress enough the importance of obtaining a pre-approval before purchasing a property. The involvement of mortgage insurance can increase the complexity and length of the approval process. Therefore, the more work you can do upfront the less stressful the purchasing process will be. A pre-approval doesn't take long to arrange, it costs nothing and may save you lots of heartache.

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1 Per APRA (www.apra.gov.au)
2 Income Tax Assessment Act 1997, Section 25-25.
3 Assumptions:
· Rental income is based on a 5 per cent yield (based on average capital value of the property)
· Average interest rate is 7%.
· Other costs are estimated to be equal to 1 per cent of the property's value (for things like property management and upkeep, etc.)
· Tax benefit is based on the highest marginal rate of 48.5% and the taxable loss of the property. This assumes that the investor has other sources of taxable income.