Cross-securitisation: don't get locked in

Cross-securitisation is when a lender uses more than one property to secure a loan and, according to STUART WEMYSS, it can create all sorts of headaches for investors.

Cross-securitisation is often described as insidious. Insidious is defined as "developing so gradually as to be well established before becoming apparent". In other words, the detrimental effects of cross-securitisation are not often felt, or identifiable, until it's too late.

That's why it's so difficult to explain to new investors the importance of structuring their loans correctly from the start, because the negative effects of a poor structure are not obvious at the beginning. However, if you speak to an investor who has been bitten by cross-securitisation, they certainly appreciate too well the importance of a correct loan structure. This is why I am writing this article. Hopefully, I can help investors learn more about cross-securitisation so they can avoid the fate of other investors who have had to learn from their mistakes.

WHAT IS CROSS-SECURITISATION?

Cross-securitisation is defined as a loan that is reliant upon more than one property for security (i.e. two or more properties securing one loan).

A classic example is where an investor purchases their first investment property and establishes one investment loan that is secured by their home and the new investment property. For example, assume the investor purchased an investment property for $300,000 (with the total cost being about $315,000 including stamp duty). The investor's loan structure would look something like this:

- home loan for $150,000, secured by the investor's home only; and
- investment loan for $315,000, secured by both the home and the new investment property.

The above structure involves cross-securitisation in that the investment loan is reliant upon more than one property for security – it's secured by the home and the investment property.

What is sometimes confusing is that there are many names for it, including cross-collateralisation and interlinking securities.

WHAT'S WRONG WITH CROSS-SECURITISATION?

Cross-securitisation can be a cause of many problems which may end up costing you money, or even stopping you from purchasing more property.

Below are a couple of problems cross-securitisation can cause, although there are an endless number of examples.

EXTRA COSTS

It can cause you to pay for more valuation and variation fees than you need to. For example, a client used a portfolio-type loan which allowed him to easily establish separate sub-loan accounts.

These products are very flexible (although, in my opinion, they are rarely the most appropriate product).

The main problem with these portfolio products is that all security is cross-securitised (i.e. all property is pooled together as security for all loan accounts and limits).

This particular client owned two investment properties plus his home. He wanted to increase one of his sub-loan

accounts by a small amount for some share investing.

To do this, the bank had to order valuations on all three properties because they were cross-secured.

This ended up costing the client a lot of money for just a small loan increase. However, if all loans were individually secured, the client would have had the flexibility to choose which property he wanted revalued.

That would have saved the client more than $500.

LIMITED CHOICES

You may not be able to choose the best deal in the market if your loans are cross-securitised. Consider the original example above, where the investor had a home loan for $150,000 and an investment loan for $315,000.

Assume this investor wants to fix the investment loan for three years, because there are a number of lenders offering some very attractive fixed rates on the market.

Due to the cross-securitisation, the client has three options:

➤ accept the fixed rate his existing lender offers,

➤ refinance all his lending to a new lender that offers the lowest fixed rates, or

➤ restructure his existing lending to uncross-securitise his loans and refinance a portion of his investment loan to a new lender.

None of the three options above are optimal, because they will probably trigger unnecessary costs or force the investor to settle for a fixed rate that is not the lowest in the market. However, if the investor's loans were not cross-securitised (or standalone), then it would make life a lot easier.

All he would have to do is refinance the standalone investment loan to a lender that offered the lowest-cost fixed rate.

It would not be necessary to alter the existing home loan at all, potentially avoiding costs in doing so.

LESS NEGOTIATING POWER

Cross-securitisation also reduces your negotiating power.

This is an extension of the above point. If you are negotiating with your existing lender (eg. negotiating a fixed rate like in the above example), a lender will consider consequences of not matching the best rate on the market.

If your loans are poorly structured, the lender will know that you will probably have to refinance all your lending to a new lender to get the lowest fixed rate.

They may assume that you can't be bothered doing this and therefore not match the lowest fixed rate. However, if your loans are standalone and you can easily refinance one away from your existing lender, they will feel that your business is "at risk" and are more likely to match the best fixed rate.

Banks will generally only discount their rates as a last resort. Most lenders won't offer you a discount just because you have been a good loyal customer. They need to fear that they will lose your business. Therefore, a flexible loan structure shifts some of the negotiating power back to you, because you are not handcuffed to the bank.

SWITCHING COSTS

It is particularly important to avoid cross-securitisation where fixed interest rate loans are involved. The reason for this is that it can be very costly to change a fixed rate loan during the fixed term.

Most lenders will charge borrowers fixed rate break fees if they alter a fixed rate loan during the fixed term.

These fees can range from nil to thousands of dollars (the quantum of the break fee depends on the fixed rates at the time).

Let's continue with the same example, but assume the investment loan for $315,000 was fixed for three years at 7.5 per cent at the time the loan was established.

One year on, fixed rates have since decreased and the current two and three-year fixed rates are approximately 6.5 per cent.

The investor has plenty of equity in his home and decides it's the right time to purchase another investment property. However, his existing lender has declined to lend him any more money due to serviceability.

Regardless, there are more than 10 other lenders that will lend him enough money to purchase another investment property.

It's just that his existing lender is ultra conservative (or maybe, even more frustratingly, the lender has become more conservative over time; that is, it was a good lender when he first established his investment loan a year ago, but has since significantly curtailed its lending policies).

The investor has two choices:

➤ refinance his existing loans to one of the 10 other lenders and therefore break the fixed rate loan and pay approximately $6000 in break fees (the investor has contacted his lender and they have indicated it would cost approximately $6000 for breaking the fixed rate loan due to the rate movements);

➤ or not to purchase another investment property until the fixed rate loan expires in two years (the investor would still have to refinance).

Once again, these two options are poor. If the loans were not cross-secured, the investor could leave the fixed rate loan

Pros

➤ Convenient for investors who only ever buy one investment property

➤ Lenders may offer interest rate discount of 1 per cent with cross-securitisation for investors who borrow a large amount (eg. more than $2 million)

Cons

➤ Reduces your negotiating power

➤ You can incur costs on changing a fixed rate loan during the fixed term

➤ You may end up offering the lender more security than is necessary

➤ It can get messy if you sell a property that is cross-securitised

➤ You can pay more for valuations and variations than you need to

with his existing lender and just refinance the home loan portion to a new lender so he can access some of the equity in the home for investment purposes.

GIVING UP TOO MUCH SECURITY

Cross-securitisation can result in offering a lender too much security.

In our original example above, the investor offered his home and investment property as security. I come across many examples where this may not be necessary.

The investor's home may be satisfactory security by itself if an investor has enough equity in it.

The security offered does not affect the tax effectiveness of the loan (i.e. a loan secured by your home can still be tax deductible).

However, there are many investors that end up giving their bank a mortgage over the new investment property when it's not necessary.

The investors could have held the title to this property without any encumbrances.

IF YOU SELL

Assume you have multiple properties and they are all cross-securitised with the same lender.

If you sell one of your properties, the lender will have to consent to releasing the title.

They may do this on the condition that you use all the sale proceeds to reduce other debt.

In this situation, the lender can start controlling how you use your money.

However, if the loan is 'standalone' (not cross-securitised), you only have to repay that loan and you can retain whatever money is left.

There are many more examples of how cross-securitisation can negatively affect you.

In fact, I come across new examples nearly every week.

WHAT'S GOOD ABOUT CROSS-SECURITISATION?

I would say there are limited situations where cross-securitisation is beneficial.

Cross-securitisation is probably not very detrimental for investors who only ever purchase one investment property and do not need to alter their lending in the future.

In this situation, they are unlikely to suffer any poor effects of cross-securitisation.

However, I would still advise people to proceed with caution here, because plans often change and consequently their lending may also need to change.

Some investors start out thinking they will only ever purchase one investment property.

However, after a couple of years, their plans may have changed.

One other example where cross-securitisation might be considered worthwhile is where an investor has borrowed a significant amount, say more than $2 million.

Some lenders will insist on cross-securitising loans at this debt level.

Therefore, investors might be presented with two options, such as one bank offering an interest rate discount of 0.7 per cent without cross-securitisation and another lender offering a discount of 1 per cent with cross-securitisation.

Given the potential interest saving, it might be worthwhile accepting the cross-securitisation to obtain the lower interest rate, but it very much depends on the lender and the customer's, or broker's relationship with that lender.

Another concern some people might have is that avoiding cross-securitisation might cost more in terms of establishment and ongoing fees, because you need to establish more separate loan accounts (see explanation below).

This may be a valid concern. However, there are many professional packages on the market that allow borrowers to establish many separate loan accounts without paying any extra fees.

HOW TO AVOID CROSS-SECURITISATION?

I wrote an article titled Loan structuring for the future which appeared in the February/March 2004 issue of API.

This article sets out, with a step-by-step guide, how to structure your loans.

There are also two follow-up articles in the series which were published in the May and June 2005 issues of API.

I recommend that serious investors read these articles to learn how to structure their loans correctly.

However, I set out below a brief explanation of the methodology applied to avoid cross-securitisation.

The general methodology is to establish a separate loan (secured by an existing property only) to finance a 20 per cent deposit plus costs and arrange a separate loan (secured by the new property only) for the remaining 80 per cent.

Continuing with the same example where the investor purchased an investment property for $300,000, the investor should have established two separate loans rather than one loan for $315,000.

The first loan (being 20 per cent plus costs) should have been for $75,000 (10 per cent is $60,000 and costs being $15,000), which would be secured by the investor's existing home only.

The second loan for the remaining $240,000 (being 80 per cent) should have been secured by the investment property only.

Therefore, the loan structure would have looked like this:

- home loan for $150,000 secured by the investor's home only;
- investment loan for $75,000 secured by the investor's home only;
- investment loan for $260,000 secured by the investor's new investment property only.

This methodology can be employed by investors who plan to purchase one investment property or multiple investment properties.

BEWARE AND THINK AHEAD

Many people do not prepare themselves for unexpected changes in their circumstances. They might set up a loan

structure that is suitable today, but may not be flexible enough to adapt to tomorrow's change in circumstances.

Remember, changes in life are often unexpected and unpredictable.

You should recognise that the thought of "I'm never going to buy another property" or "my bank's been fantastic for the last 10 years so I doubt I'll have any problems" might be true today, but not tomorrow. It's about seeking the best advice that is in your best interests and maintaining a flexible loan structure.

One thing to take away from this article is that cross-securitisation certainly reduces your flexibility and can potentially cost you in terms of additional fees or higher interest rates. ■

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