

July 2005 Newsletter

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One thing most investors overlook...

Most people aim to borrow less than 80% of a property's value when purchasing property. The reason for this is so they don't have to pay for Lenders Mortgage Insurance (LMI). LMI is a one off fee that a borrower pays when taking out a loan. LMI can be quite expensive. However, some investors chose to pay for LMI so that they can borrow more than 80% to magnify their equity. But is this worthwhile? Our example shows how an investor can create \$65,000 more wealth over 5 years.

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% of a property's value. 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 where a borrower defaults on their mortgage and the lender then takes possession of the property and sells it.

The cost of LMI is calculated based on a percentage of the loan amount. The greater the proportion of the property's value that you borrow, the higher the percentage cost of mortgage insurance. Generally, the cost of LMI can range from 1% to 2.5% of the loan amount. This cost can normally be added to the loan amount (often referred to as 'capitalising LMI').

How much can you borrow?

Mortgage insurers generally split loans into two groups being loans under \$650,000 and loans over \$650,000.

Most mortgage insurers and lenders will lend a maximum of 95% of a property's value where the loan amount is less than \$650,000. If the loan amount is over \$650,000 then the maximum LVR is generally reduced to 90% (up to a loan amount of \$750,000). The maximum LVR for loans over \$750,000 is 85% 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% of a property's value. There are two lenders that I know of that will lend up to 105% of a properties value (so that you can include stamp duty, etc.).

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 term where the term is less than five years). 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 \$5,000, then you can claim a deduction of \$1,000 per year for five years.

As always, you will need to obtain independent taxation advice to ensure the deductibility of LMI applies to your situation.

So is LMI worth paying for?

Let's look at an example. Assume John is just beginning investing and owns his home worth \$400,000 with an outstanding mortgage of \$270,000. This new investor has two options:

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

John could increase his existing loan to \$320,000 (being 80% of his homes value). This would provide him with access to \$50,000 (\$320k - \$270k) to use as a deposit to pay for 20% plus costs (stamp duty) of the new investment property. His \$50,000 deposit would allow him to purchase a property for up to \$200,000 (allowing 5% for costs). In summary, John will finance the investment as follows:

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

LVR 80%

John's overall LVR is 80% and he avoids the cost of LMI.

2. Borrow 90% and pay for mortgage insurance.

John could increase his existing loan to \$360,000 (being 90% of his homes value). This would provide him with access to \$90,000 (\$360k - \$270k) 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	\$9,900
Total loan	\$444,900
LVR (exc. LMI)	87%

John's overall LVR is 89% (inc. LMI). I estimate the cost of LMI to be as follows (exc. stamp duty):

Loan for \$360,000 (90% LVR) =	\$4,900
Loan for \$435,000 (87% LVR) =	\$5,000
Total =	\$9,900

Assume that the two properties (purchased in scenario 1 and 2) are identical in terms of rental yield (income) and capital growth prospects (and all other aspects). At an average capital growth rate of 5% per annum (which is conservative over the long term), 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 is quite clear from a capital growth perspective that the investor is better off in the long run by paying for LMI (i.e. extra \$83,000 in capital growth versus cost of \$9,900). 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 (5% yield)	\$55,250	\$138,000
Interest expense (7%)	(\$73,500)	(\$183,750)
Other costs (1% of value)	(\$11,000)	(\$27,650)
Cash flow deficit	(\$29,250)	(\$73,400)
Tax benefit (at top rate inc LMI)	\$14,200	\$40,400
Net cash deficit	(\$15,050)	(\$33,000)
Capital growth	\$55,000	\$138,000
Increase in wealth	\$39,950	\$105,000

As you can see, an investor is \$65,050 (\$105,000 - \$39,950) better off by borrowing a higher amount and paying for mortgage insurance. The cash flow deficit difference is approximately \$17,950 (\$33,000 - \$15,050) over five years which is not a huge commitment

(approximately \$3,590 per year) given the potential upside in capital growth.

After 20 years, the difference in wealth blows out to over \$410,000 just by spending an extra \$9,900 on mortgage insurance.

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

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

You may be able to start investing sooner. The old adage says... its time in the market, not timing the market. You might be able to purchase a better quality property in a better quality location if you spend more 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. 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. 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 should pay dividends in the long term.

Don't just dismiss it

Many investors dismiss the cost of mortgage insurance as an avoidable expense. Whilst this is true, you may be limiting your investment ability. Establishing a larger investment sooner rather than later can make a big difference in the long run. Remember, this strategy is not for everyone so you must consider your own risk profile, objectives and financial situation.

(This article was adapted from an article we wrote for *Australian Property Investor* magazine in June 2004.)

CBA & ANZ Matches 0.70% Discount

ANZ announced on 10 June that it will now offer a 0.70% interest rate discount for customers that borrow more than \$700,000 with ANZ. Discounts do not apply to fixed rates, lines of credit and some basic variable products.

From 1 July 2005, CBA will offer a 0.70% interest rate discount for any customer that borrowers more than \$250,000. This offer is valid until 30 September 2005.