STRUCTURING FOR THE FUTURE

Investment loan structuring is one of the most important factors that is commonly overlooked by investors. By STUART WEMYSS

Perhaps this is because most investors lack knowledge when they're first starting out, or maybe they aren't receiving the best advice. As an investor, you need to not only consider what's best for you now, but also how your decisions will impact on you in the future. Put simply, you need to have a plan, and loan structure is an important part of that plan.

WEHY IS LOAN STRUCTURE IMPORTANT?

The answer to this is simple. A poorly structured loan portfolio reduces an investor's flexibility, increases their risk profile and can create reporting and tax nightmares.

➤ **Flexibility** – a poorly structured loan portfolio reduces flexibility through cross-securitisation, as it ties you to one lender and may impede investors' access to equity within their properties.

➤ **Risk management** – a poorly structure portfolio may not separate home and investment lending and may offer lenders excessive security (i.e. more security than is required).

➤ **Reporting** – A poorly structured loan portfolio will not adequately separate tax deductible and non-deductible expenses. It may also be important to separate debt that relates to individual properties.

Let's look a bit closer at the factors that affect loan structure.

CROSS SECURITISATION

Cross securitisation is where one loan is secured by two properties. A typical situation might be where an investment loan is secured by the home and the investment property as shown in the following example:

SECURITY		LOANS			
	Value		Balance	Bank	Secured By
Home	$400,000	Home	$200,000	A	Home
Investment	$300,000	Investment	$315,000	A	Home & Invt

This may not pose many problems to investors who own one investment property. However, if you plan to build a portfolio consisting of many properties, achieving an optimal structure will save you time and money later on. The structure above reduces the borrowers' flexibility. The investor cannot move the investment loan away from Bank A as the loan is 105% of the property's value and relies on the home for additional security. So what happens if Bank A decides to increase interest rates on investment loans? What happens if Bank A has a low borrowing capacity (compared to other lenders) and doesn't want to lend the investor any more money? In this case, the borrower would have to refinance all loans away from Bank A in order to borrower more money. This may not be a great hassle with two loans, but what if you have ten different loans?

EXCESS SECURITY

There is no benefit in offering lenders any more security than they need. That is why it's important to review your loan to value ratio ("LVR") on a regular basis (possibly annually) to determine if the bank still requires all the security they hold. Consider the following real life example from one of my clients:

SECURITY		LOANS			
	Value		Balance	Bank	Secured By
Home	$800,000	Home	$270,000	A	Home
Investment	$300,000	Investment	$205,000	A	Home & Invt

In this example, the client's lender had the first mortgage over $1.1 million of property to secure $475,000 of lending. That equates into a LVR of 43%. In this situation it was completely unnecessary for the client to offer the investment property as security – the home alone is satisfactory.

The rule of thumb here is to aim to maintain an LVR as

close to 80% as possible. If the LVR reduces significantly, then consider requesting the lender to release a property from security (as we did in the above example). A prudent investor should try and protect their assets as much as possible.

INTEREST ONLY VERSUS PRINCIPAL AND INTEREST

Most variable interest only products allow unlimited extra repayments on a regular basis. It's a common misconception that repayments on an "interest only" loan are limited to interest only. This is generally not true. Therefore a borrower could elect interest only and repay principal and interest if they so choose. The advantage of this is that you have the best of both worlds – you can repay either interest only or principal and interest. For example, consider a $100,000 at a variable rate of 7.0%. The interest only repayments would be $585 per month and the principal and interest repayments would be $665 per month (over a 30 year term). In this case a borrower could elect to repay interest only but make regular monthly repayments of $665. At any time the borrower has the option of reducing the repayments to the base 'interest only' level (i.e. $585 per month).

Any principal repayments made during an interest-only term are generally classified as extra repayments. As extra repayments can be redrawn at any time, the borrower can always redraw the loan back up to its original limit (similar to a line of credit).

You should check loan product specifications to make sure this is allowable, because some basic variable products set a minimum extra repayment amount.

Principal and interest is good for some people though. Some borrowers enjoy being "locked in" to repaying principal so that they know they're forced to repay their debt over time on a regular basis.

This article only addresses the "structure" topic of interest only versus principal and interest (i.e. how you set the loan up). I do not intend to enter into the debate of what investors should repay.

BORROWING CAPACITY

Everyone understands that some lenders are prepared to lend more money than other lenders. In fact, borrowing capacities can vary greatly amongst lenders (often by hundreds of thousands of dollars). Therefore, it's advantageous to have a flexible loan structure that allows you to draw deposits from your existing lender and use another lender (perhaps with a higher borrowing capacity or better products) to finance the remaining amount of the property. In fact, this has become even more prevalent in the current interest rate environment, where borrowers are more inclined to fix their interest rates. The reason for this is that your existing lender may not offer the best fixed rates in the market. However, by ensuring that you have the most flexible loan structure, you'll then have the flexibility to choose any lender you like (and not be tied to your existing lender).

DIFFERENT LENDERS

Some people recommend investors use a number of lenders.

Loan Structuring Tips

- **Avoid unneccessary cross-securitisation.**
- **Avoid over-securitisation... if the overall LVR across your entire loan portfolio drops sufficiently, request that some properties be released as security.**
- **Consider interest-only repayments.**
- **Split loans based on particular properties and purposes.**
- **Maintain an LVR as close to 80% as possible.**
- **Consider using different lenders for home and investment lending.**
- **Consider the future use of the property and the effect of repaying debt.**
- **Plan for the future.**

There is some merit in this. The concern is that if you have all your lending with one bank and something goes wrong (e.g. a breakdown in the relationship or a disagreement) then the lender is in a powerful position as it holds all the mortgages over your properties. This is particularly relevant where you have business and personal borrowings with the same bank.

However, borrowers need to weigh up the pros and cons. One benefit of consolidating your loans with one lender is that you may be able to negotiate better deals if you have a significant loan portfolio (e.g. interest rate discounts). Generally, interest rate discounts level out at around $500,000 to $750,000. Therefore perhaps consider moving to another lender when your borrowings reach this level.

Another tip is to use a different lender for your home and investment borrowings. That way if something goes wrong with your investment properties then there is a 'Chinese wall' between your home and investment properties (essentially protecting your home).

INTEREST ONLY OFFSET

Consider the future use of your properties. For example, what happens if you want to rent out your existing home in the future? Most people repay principal and interest on their home loan (which is sensible as it's non-deductible debt). However, consider the example where you purchase a property for $600,000 and have a loan of $480,000. You live in this property for five years and over that time you repay the loan down to $200,000. If you decide to move out of this property and rent it out (i.e. use it as an investment property) then the maximum deduction you can claim is the interest on the $200,000 loan. The point to note is that when you 'repay' a loan you essentially deny yourself a potential deduction in the future.

A good solution to this is an interest only mortgage with an offset account. In this case you repay interest only. However, while you're living in the property you continue adding monies into the offset account (thereby effectively reducing the net balance and interest costs). The critical point is that you're never "repaying" the loan. Therefore, at the end of the five year period you'll have a $480,000 loan and $280,000 in the

offset account (so a net balance of $200,000). When you move out of the property you can withdraw the $280,000 from the offset account and you now have an investment loan of $480,000 (from which you can claim an interest deduction).

As always, I strongly recommend people obtain their own tax advice to ensure these strategies will work for them.

A STEP BY STEP EXAMPLE

Perhaps the best way to describe how to structure your lending is to provide an example. Let's assume that these investors own their home worth $400,000 and have a home loan with a balance of $150,000. At this stage the investors do not have any investment properties.

Step 1: The first step is to set up a facility (we'll call it the master facility or "MF") so that the investors can access the equity in their property to use to pay for a deposit when they have purchased. This is done by setting up a separate loan secured by their existing home (MF).

SECURITY		LOANS			
	Value		Balance	Bank	Secured By
Home	$400,000	Home loan	$150,000	A	Home
		MF (limit $170K)	Nil	A	Home

At the same time, it's advisable to arrange a pre-approval for a loan size that is sufficient to finance the investment property (so that you can be confident you can afford the loans). This is advantageous as it provides you with certainty of finance and takes the pressure away from arranging unconditional finance within the time required (as dictated by the finance clause in the Contract of Sale).

➤ **Step 2:** The investors can then use the MF initially to finance a 10% deposit when purchased, plus financing another 10% plus costs (e.g. stamp duties) when the property settles. Let's assume the client purchases an investment property for $300,000 and pays a $30,000 deposit.

➤ **Step 3:** Set up an additional facility (which has been pre-approved) secured by the investment property only to the value of 80% of the investment property's value. In summary the property is financed as follows:

10% Deposit paid from the MF
80% New facility
10% From the MF
Costs Also from the MF (assume costs = $15,000)
100% + Costs

SECURITY		LOANS			
	Value		Balance	Bank	Secured By
Home	$400,000	Home loan	$150,000	A	Home
Invt 1	$300,000	MF (limit $170K)	$75,000	A	Home
		Invt 1 (80% loan)	$240,000	Any	Invt 1

Note that Investment 1 loan can be with any lender (or borrower – e.g. through an investment trust structure). The investors are not tied to Bank A.

Step 4: Repeat the process again by buying another property. Remember it's advisable to arrange a pre-approval for $240,000 again (i.e. 80% of the property) before you go out and make the purchase. Let's assume the investors purchase another $300,000 property. Once again the MF is used to finance 20% of the property's purchase price plus costs.

SECURITY		LOANS			
	Value		Balance	Bank	Secured By
Home	$400,000	Home loan	$150,000	A	Home
Invt 1	$300,000	MF (limit $170K)	$150,000	A	Home
Invt 2	$300,000	Invt 1 (80% loan)	$240,000	Any	Invt 1
		Invt 2 (80% loan)	$240,000	Any	Invt 2

➤ **Step 5:** Once the values of the properties have increased (say in seven years time), you can increase investment loans 1 and 2 and use the funds to repay the MF so that your investment properties are completely stand-alone. Let's assume that the two investment properties have increased in value from $300,000 to $400,000 each.

I've ignored any increases in the value of the home. However, if the value of the home has increased the investors could increase the limit on the MF to finance another 20% plus costs.

SECURITY		LOANS			
	Value		Balance	Bank	Secured By
Home	$400,000	Home loan	$150,000	A	Home
Invt 1	$400,000	MF (limit $170K)	Nil	A	Home
Invt 2	$400,000	Invt 1 (80% loan)	$315,000	Any	Invt 1
		Invt 2 (80% loan)	$315,000	Any	Invt 2

In this case we've increased each investment loan by $75,000 (which represents the original 20% plus costs) and used these funds to repay the $150,000 facility.

The MF can now be used to start the process all over again.

In time, the MF may be able to be secured by one of the investment properties (subject to there being sufficient equity). The advantage of this is that you can then build a wall between your home and investment lending. The disadvantage of this is that you may be underutilising the equity in your home.

IT'S ALL ABOUT THE FUTURE

If you think that you'll never want to own any more than one or two investment properties, then your loan structure is probably not critical. However, if you're a more serious investor and plan to build a significant property portfolio, then thinking about your loan structure from the beginning may save you a lot of heartache down the track.

One other tip which I cannot stress enough is to use pre-approvals before you actually purchase properties. This not only saves you (and your broker) time and stress, but it also puts you in a position of strength compared to other potential purchasers as you can be reasonably sure of finance approval. In addition, lenders can normally settle more quickly if they've pre-approved your loan, which is a good 'non-cash' bargaining tool.

In my experience, loan structure is a commonly overlooked subject by many investors, mortgage brokers and lenders. As the saying goes... if you fail to plan, then you plan to fail! Loan structure is an important factor that needs to be considered not only at the beginning, but also on a regular basis as your property portfolio changes.

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