Info Sheet

Determining your loan structure

Are you looking to take on a home or investment loan? The first step should be to consider the loan structures available to you.

When it comes to applying for finance to purchase a property, we find people have three questions that dominate their thinking. Firstly, how much can I borrow? Secondly, what are the best rates available? Finally, what lender is the best? While these are important questions, we believe the starting place for debt conversations is what loan structure is right for you - taking into consideration your current situation, the loan purpose and long term investment strategy.

The right loan structure will help you maximise the tax effectiveness of an investment, manage cash flow and make loan restructuring straightforward in the future.

Why is the choice of loan structure so important? Let's take a look at two scenarios that highlight the difference selecting the right structure in the first place, makes.

First time home buyer wanting principal place of residence to become an investment property in the medium term.

Ashlee is looking at purchasing a town house that she will live in for 3 years, before upgrading and renting out the existing property. Her marginal tax rate is 39% (inc. Medicare levy). She wants to keep her loan tax effective (over the long term) in light of her future plans.

It becomes clear the most tax effective structure for Ashlee is an Interest only loan with an attached offset account. Her mortgage consultant explains that for this structure to be optimised all additional savings should be directed into her offset account, reducing the ongoing interest expense. The interest only loan maximises future tax deductibility of the loan when the property is used for investment purposes down the track, by holding the principle amount constant.

Self-employed in highly litigious industry.

John is married to Lara and works as a self-employed builder (sole trader).

They are looking to purchase their first home and unsure how they should structure their affairs. John is particularly concerned about the possibilities of being sued in his industry and what that means for his personal assets.

As a sole trader John has unlimited liability, meaning that if his business is sued then personal assets are subject to creditors. His mortgage consultant suggests that the title of the property be in Lara's name only. With the loan being setup either in joint names, or in Lara's name with John as guarantor where required.

By holding the property in Lara's name only, John has effectively protected the family home from the actions of creditors.

Different loan structures available.

Principal and Interest loan (P&I)

The basic P&I loan is often the starting point for people purchasing a principal place of residence. Under this structure, you make regular contracted payments of principal and interest over the life of the loan. Such a loan is typically designed to be fully repaid over a loan term of c. 25 or 30 years.

From a debt reduction perspective, the benefit of a simple P&I loan is that you are actually paying off capital and every month is the same.

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Interest only loan.

As the name suggests, if you take out this style of loan, you only pay interest and not the principal.

This loan structure is primarily aimed at property investors and the interest only term available is usually up to 5 years. At this time, the loan will revert to P&I, with the repayment calculated over 20 to 25 year timeframe.

The contracted loan repayment will always be lower on an interest only loan than a P&I loan. From a cash flow management perspective, it means you as the borrower have additional savings or spending capacity. The challenge is to manage this surplus cash flow wisely and not lose sight of long term investment goals.

Variable, Fixed and Split rate loans.

In Australia between 1990 and 2016, interest rates, as determined by the Reserve Bank of Australia, have varied between 17.50% and 1.50%.

With official current interest rates at a record low of 1.5%. The mortgage rates on offer across major financial institutions, competing for your business, are exceptionally low compared to historical rates.

The question of whether you proceed with a fixed rate, variable rate or split rate loan will depend on a number of factors. These may include the interest rate outlook, your investment purpose and available cash flow.

Redraw, Offset and Line of Credit.

A redraw facility enables you to pay additional money off your variable rate home loan, reducing total interest cost, while maintaining your ability to redraw a portion of the funds in the future if required.

An offset account is a savings or transaction account linked to your home loan. The balance in your offset account reduces the home loan amount that interest is charged on. An offset account can be used to great effectiveness by savvy home owners & investors, but it does require disciplined budgeting.

A line of credit is a loan that has a credit limit set by you, for example $200,000, and you are able to use up to that limit.

The credit limit available is usually set as a percentage of the property's value, generally around 80%. A line of credit can be successfully used for purchasing additional investment properties, completing home renovations and investing in other assets e.g. shares.

However, care should be taken not to use a line of credit like a 'big credit card' for discretionary spending.

If you are considering purchasing a property and applying for finance. We have compiled a brief checklist to get you started:

#1. Make sure your financials are in order.

The extensive loan application process requires you to show current assets, liabilities, household budget, bank statements and proof of income. Getting your personal finances in order is vital before you apply for a loan.

Don't forget the impact of State government stamp duty on property purchases.

#2. Understand if Lenders Mortgage Insurance (LMI) is applicable to your situation.

Traditionally, if your deposit is less than 20% of the purchase price you will be required to pay lenders mortgage insurance. Essentially it protects the lender should you be unable to repay your loan. Having to pay lenders mortgage insurance is not unusual, but understanding the cost is an important consideration.

#3. Only pay for the loan features you require.

We are strong believers in the KISS principle; 'Keep it simple stupid'. So when it comes to loans, make sure you pay for features that you will use and form part of your overall financial plan. If you are a spender rather than a saver by personality, be careful not to use lines of credit or offset accounts to inflate your standard of living.

If you require further advice regarding loan structuring, in the context of your personal situation. Please don't hesitate to call our office.

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