MORE THAN MORTGAGES

How to structure your property loans for maximum stability and control

Part One

INTRODUCTION

Welcome to this Special Report for property investors. It explains how to structure your new or existing loans so you retain maximum control over your assets.

To make this Report easier to understand and digest, I've broken it up into 2 parts. Here's an outline of how the Report is structured:

Part 1: 'Crossing' of loan securities: the 'fine print' on your loan documents that gives too much power to your bank and can leave you unnecessarily tied up.

Part 2: How to structure new loans to avoid 'crossing'

Although the topics and examples in this Report give you a good overview of some important issues to consider when structuring your loans, you should also bear in mind that every situation is different. We recommend that you always seek qualified and professional advice before making any loan or investment decisions.

Successful investing,

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PART 1

'Crossing' of loan securities: the 'fine print' on your loan documents that gives too much power to your bank and can leave you unnecessarily tied up.

So you have some bank loans, but have you ever considered **how** your loans are secured?

Sure, you know the loan is secured by a residential property, but is it secured by all the other properties in your portfolio as well?

In other words, are your loans 'stand-alone' or are they 'cross-collateralised'?

Many property investors believe that their loans are stand-alone when in fact they are 'crossed' with other properties.

'Crossing' is very widespread (my estimate is that up to 75% of residential property investors are affected).

SO WHAT IS 'CROSS-COLLATERISATION?'

It used to be the way loans were structured years ago: borrow 105% of a property's purchase price to cover all acquisition costs and secure it against another property that had enough equity.

This is called 'cross-collateralisation', and as an investor you should know that it **is not always a suitable way to borrow.** There are certain situations when crossing is a useful vehicle, but in the vast majority of cases it offers no benefit to you. Instead, it benefits your bank or lender.

'Cross-collateralisation' explained:

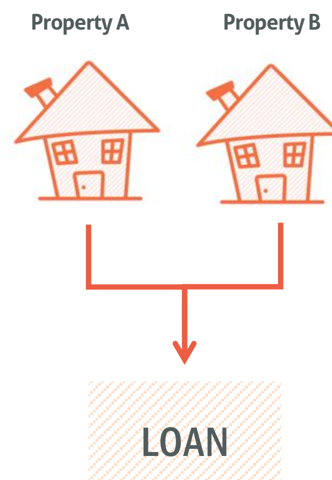
Collateral is defined as 'Security used for the payment of a loan' and to cross-collateralise is to **use multiple securities for the payment of a loan or loans.**

A simple example:

John owns **Property A** outright.

John wishes to buy **Property B** but has no funds to raise a deposit.

John buys **Property B** using a 105% loan and the Bank holds both Properties A and B as security against the loan for the purchase of Property B.



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It sounds fairly straightforward.

However, many investors buy subsequent properties, offering previous properties as security for the next transaction. Eventually you can end up with a 'chain' of properties that are securing each of your loans. (in a moment we'll look at the negative implications of this).

Even if you only have one investment property, crossing is often unnecessary and ties you up with no benefit to you.

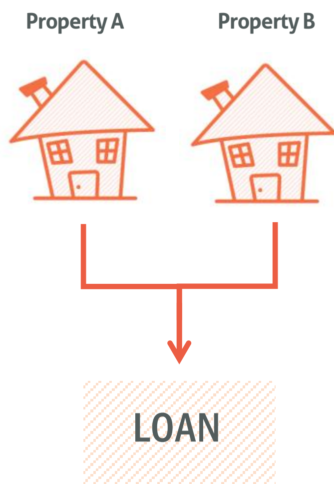
So if there's no benefit to you, why are so many loans crossed?

Because in many cases lenders automatically cross your loan securities, whether you realise it or not, so they can add extra strength to their position.

Example:

Property A & B are said to be

cross - collateralised, or 'crossed'.



'HOW DO I KNOW IF MY PORTFOLIO IS CROSS COLLATERALISED?'

The only true way to find out whether or not your portfolio is crossed is to look at your loan contract (that's the one put in a safe place that you can never find!). Have a look to see which properties have been used to secure the loan, listed under the heading 'Security'. If there is more than one property listed, your loans are crossed.

THE TWO PARTS OF YOUR LOAN DOCUMENTS

Remember when you signed your documents, there were two parts:

There is the loan contract: this is a legally binding agreement that sets out the terms, fees and charges of the loan. It's also sometimes referred to as a 'credit contract' or 'loan offer'.

Then there is the mortgage documents: This places a 'dealing' or 'encumbrance' over your property and allows the lender to take possession of the property and sell it if you default on your loan contract.

This is registered in the registry for land titles in each state.

'So what? Why should I care if my portfolio is crossed?'

Because in most cases, crossing of loans is not beneficial to you, the borrower. It favours the bank.

Cross – collateralisation isn't a problem until it becomes a problem.

Then, untangling it can be a long, expensive and traumatic experience. You can lose time, money and opportunities as a result of cross – collateralised structures.

If your portfolio is crossed, you're at the mercy of 'bank policy'.

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We have had clients come to us to help get them a loan because their bank insisted that their next loan be Principal and Interest as opposed to Interest Only, or they have been told, 'no more money because you're too rent reliant'. Other clients have simply been told, 'we are comfortable at your current level of debt'.

In many instances, these problems could have been avoided if the loan has been structured correctly in an uncrossed, 'stand alone' structure.

SEVEN REASONS WHY YOU SHOULDN'T CROSS YOUR PROPERTY PORTFOLIO

reason 1

You may not be able to access your funds when you sell a property

When you sell a property in a cross – collateralised structure, you may not be able to access all the funds you expected. The bank may request some or all of your funds go back against the existing loans you have with them to strengthen their position. They don't need your permission at that time as they already sought this when you first accepted the loan terms.

Picture this: you're selling one of your properties for an opportunity or, worse still because you are suffering a cash flow squeeze, and the bank deducts some or all of the surplus funds to strengthen their position. Where would that leave you? I've seen this happen to some very asset – strong and successful property investors. Answer given: 'Bank Credit Policy'!

reason 2

Unnecessary paperwork and fees when you buy or sell

When you sell a property, the bank will often require your whole portfolio to be revalued (often at your cost) to determine whether the bank is exposed and/or how much, if any, of the surplus funds you can have. After the revaluation, you also have to complete additional paperwork known as 'Variation of Security'.

The same occurs when you want to realise equity in a property that has grown in value. You may be required to get your whole portfolio revalued (possible multiple valuations instead of one – and additional and unnecessary inconvenience).

reason 3

You may lose product selection and control if you're with only one bank

When you take out multiple loans with one bank, the bank may insist on a crossed structure to strengthen their position. This may cause problems when you want to borrow again.

For example, the bank may say, ''no more Interest Only loans for you. We want you to take Principal and Interest loans from now on to reduce your debt with us'. This is quite common when the dollar value of your debt is high with one funder, regardless of your overall asset position.

Having at least two lenders lets you play one off against the other, or pick and choose either lenders, which gives you more product choice and control.

We typically recommend that you only borrow $1m - $1.5m per lender, this way you achieve maximum interest rate discounts and stay inside many credit assessors delegated lending approval limits (known as DLA's). In turn this typically gives you a quick answer and keeps you under the radar so to speak.

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reason 4

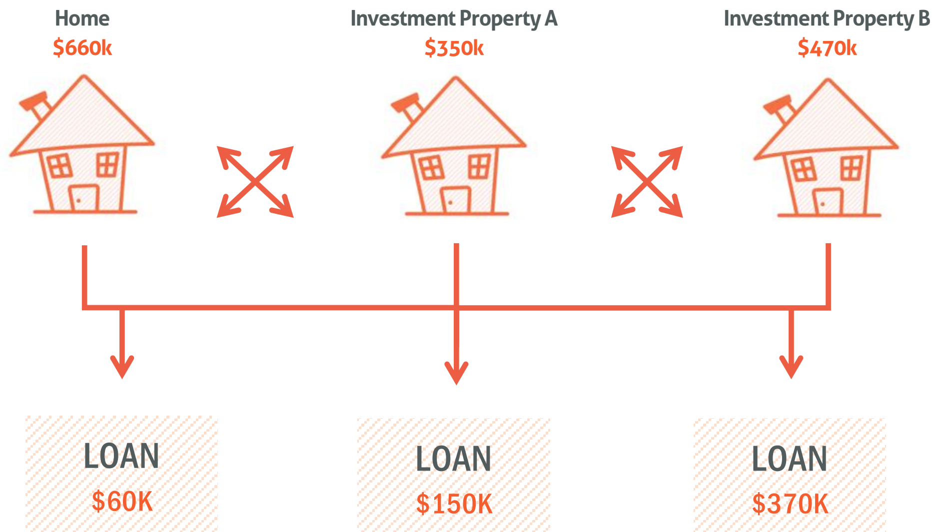
The bank holds far more security than necessary

For example:

Your Home is worth $660,000 with a loan balance of $60,000.

Investment Property A is worth $350,000 with a loan balance of $150,000 (secured against your home).

Investment Property B is worth $470,000 with a loan balance of $370,000 (secured against Investment Property #1 and your home).



Calculating the Loan to Value Ratio – $580,000 / $1,480,000 ='s 39.19% Loan to Value Ratio

In the example above, you can see how the bank holds $1,480,000 of assets against only $580,000 worth of loans – a 39.19% Loan to Value Ratio! In this example the bank holds far more security than necessary.
(Lenders are quite happy to have a funding ratio as high as 80%)

reason 5

Difficulty and inconvenience changing banks

It becomes harder to change banks if you no longer like or agree with their service – or lack of it. If you choose to move banks, you may be subject to exit fees. Though exit fees were abolished they still exist for loans settled before 1st July 2011. These exit fees may be substantial, especially if you have fixed some of your loans. This can make it a very difficult decision to swallow.

reason 6

Inability to revalue properties individually to obtain equity

With the economy often running at two speeds we have seen cases of some properties dropping in value and then being linked to another that has grown. In this instance, your net gains may be zero as the property values may offset each other. In an uncrossed structure, you could increase the loan balance on the property that has grown in value without the lender considering the other properties.

This happened to one of our clients:
They owned an investment property and the local fruit bats decided to roost in their back yard. They were in the middle of revaluing their properties to obtain equity and this investment property was linked to another with significant growth.

However, because of the bat problem, the property's value was reduced because the valuer considered the property difficult to sell. This in turn reduced the net equity available to our clients by the bank.

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reason 7

Equity lock up

This is a situation you may encounter when you have a fairly low Loan to Value Ratio and you go to the bank looking to release equity, only to find they don't want to help you.
It's often because the bank policy has changed.

(Post Global Financial Crisis many have lost their appetite for risk and in turn changed policy to reflect this)

For example:

- Stricter lending criteria and a lack of appetite for the security you're offering (eg: Student accommodation, serviced apartment, units <50m, 3 townhouses on one site)
- You're at the upper limits of allowable debt exposure levels - Usually seen above $1.5m
- You're ability to service your loans has been reduced by rising interest rates or reduced income.

There are many reasons why the bank won't lend you any more money, even in cases where your debt levels are not particularly high. If you have all of your properties interlocked with them, you usually have to move the entire portfolio to get the outcome you want. This can be time consuming and expensive - especially if you have fixed - rate loans.

CONCLUSION

Now you have an understanding of what 'crossing; is and why it's sometimes unsustainable. In the next instalment of this report, you'll learn how to structure a new loan so you aren't crossed.

In the meantime, for a professional take on your situation, including how to structure your portfolio for grater sustainability, flexibility and control, why not take advantage of our complimentary
Investment Property Finance Consultation?

With one 10 minute chat we can usually tell you whether or not we can help. The consultation is free of cost and obligation - simply call 02 6188 4555 or make an appointment online.

We can be found at:

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Deakin, ACT 2600

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