

THE BIGGEST MISTAKE MADE IN FINANCE:

Cross Collateralisation

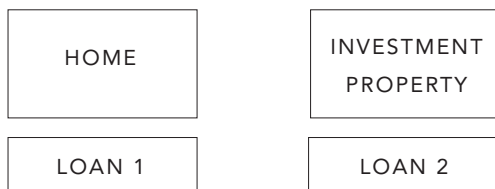
What is cross collateralisation?

Cross collateralisation occurs when a lender links two or more properties together for lending purposes. This is also called cross securitising. Cross collateralisation happens when a person goes to the same lender that they have for their home loan (or investment property) to get a second loan to purchase another property. In most cases the other property is usually an investment property.

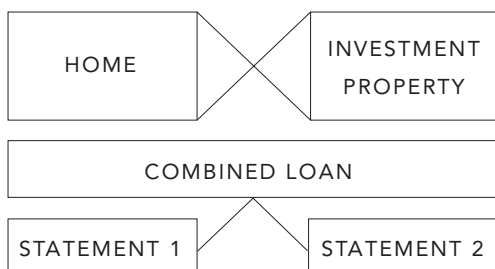
Generally when a homeowner wants to buy an investment property, they seek to get an investment loan to cover the purchase price. Most homeowners will go back to the same lender that they have their home loan with, to get the loan for the investment property. The homeowner puts in a loan application and their lender then approves them for a loan to purchase a separate investment property.

Once they settle on their new investment property, the homeowner believes they have two individual loans; one for their home and another loan for their investment property. They are usually given a separate loan statement for each property to reinforce this belief. In actual fact they will have one loan for all properties combined,

What the Homeowner thinks their structure is:



What the Homeowner's structure really is:



Why do lenders (Banks, Credit Unions etc) cross collateralise properties?

Lenders cross collateralise the borrowers properties for their own (the lenders) protection. They also do this to save money, to save time and to grab as much security as they can to limit their lending exposure or risk. They also know that this makes it harder for borrower to take their loan elsewhere and hence the lender can lock the borrower in as their customer. The bank saves money by not paying for an independent valuation on the investment property, as there is enough equity in the home to cover both loans.

How does cross collateralisation affect the borrower?

When a lender cross collateralises a borrowers properties, it has four negative effects on the borrower:

1. Cross collateralisation reduces the amount of funds a borrower can qualify to borrow,
2. It then also reduces the number of investment properties a borrower can buy,
3. When the initial property is the borrowers home, it places the borrowers home at risk, and
4. It also opens the borrower up to purchasing an overpriced investment property by not having an independent valuation carried out on the investment property.

How can a borrower avoid cross collateralisation?

Cross collateralisation of properties is avoided by simply using different lenders for the finance for each property. In the case of investment properties, the same lender may be utilised for multiple properties, provided that different mortgage insurers are used and you have the right finance team to ensure the lender has separate securities.

A borrower should never use the same lender that they have used for their home loan to purchase an investment property. This will definitely put their home at risk.

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How does cross collateralisation reduce the amount of funds a borrower can qualify for per loan?

When a lender is approached for finance by a borrower, they conduct a capacity test. Capacity tests allow lenders to ensure that the borrower, with their current income, assets and liabilities, is a good risk to lend money to.

When the lender conducts the capacity test, they build in a margin. This enables them to be absolutely sure that the borrower can repay the loan even if interest rates rise. So the lender will test the loan with an extra 2 – 3% interest on top of the current rate and also they test their own loans at Principal and Interest repayments.

If the borrower has gone to Lender A for their home and investment property they will then have a double margin built into their capacity test, because each loan will have had the margin built in. This double margin may cause the borrower to fail the capacity test and not be able to borrow as much as they want (or need), even though in reality they may be able to afford the new loan.

However, when the borrower applies to different lenders for their loans, the lender only builds in a margin on the money that they are lending. The lender doesn't build in a margin on the other lenders repayments, so they only test the other lenders finance at the current rate. Therefore, there is a smaller margin on the total borrowed. This increases the borrowers potential to pass the capacity test. The Homeowner will therefore qualify to borrow the amount of money that is required for their loans.

How does cross collateralisation reduce the number of investment properties that a borrower can finance?

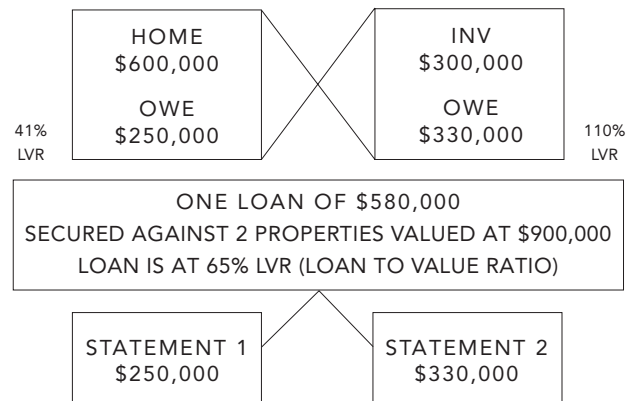
If a borrower continues to apply for loans with the same lender for all of their finance needs, they will eventually be unable to borrow any more money. The lender will have built in such big margins to protect themselves that the borrowers subsequent applications fail because they cannot pass the capacity test, no matter how much equity you may have in your portfolio. If the borrower goes to another lender for the funds, they may qualify because the same large margin is not built in and therefore the capacity test is passed.

How does cross collateralisation put a borrowers home at risk?

To explain how the borrowers home can be placed at risk by cross collateralisation, let's use the example of a couple

who have a home valued at \$650,000 that has \$250,000 of personal debt owing with lender A. They also have an investment property worth \$300,000. They borrowed 110% of the purchase price to cover all costs, as they put no cash into the purchase. They owe \$330,000 with Lender A for the investment property.

As we discussed earlier, the couple think they have two loans, but they actually have one loan with two statements.



Let's assume that due to retrenchment, the couple's income reduces to the point that they cannot afford the repayments on their home mortgage -they have a standard Principal and Interest loan. They ask their bank for help?

The bank takes stock of the situation:

1. There are two properties secured against this loan; one is the home and one is the investment property,
2. There are tenants in the investment property who are paying rent – this portion of the mortgage is not completely covered by the rental income,
3. The home is worth \$600,000, but only \$250,000 is owed. The owners cannot afford to make repayments.
4. There is 110% borrowing on the investment property so if it were to be sold the bank wouldn't get back what is owed.
5. Because the borrowers took an investment loan that is higher in value than their personal home loan (and it is secured to their home) under the consumer credit code the majority of the loan is considered to be for investment purposes. As such the whole loan is considered to be an investment loan. Investment loans are not protected by the consumer credit code as home loans are. This means the bank is not obligated to show leniency in the case of loss of employment.

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The bank decides that the only option is to repossess the home and sell it. This is because the sale will mean the home loan is paid off and the surplus equity can pay down the investment property loan to an acceptable LVR, usually 65% as the couple have a limited income. The couple are forced to sell their home. The bank quickly sells the property at a mortgagee in possession auction. In a fast sale the home is sold for \$540,000 or 10% below normal market value.

The bank then discharges (pays out) the current home loan of \$250,000. Pays selling costs to the real estate agent of \$15,000 and reduces the mortgage on the investment property to 65% LVR by paying down the loan by \$135,000. This then leaves the borrowers with \$140,000 cash, no home and an investment property that the rent covers most of the mortgage. They will then need to go back into the market (when they return to work) and borrow \$480,000 to buy their home back at the market price.

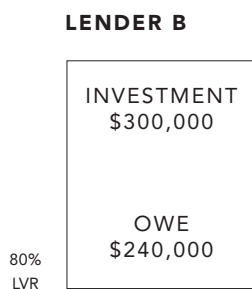
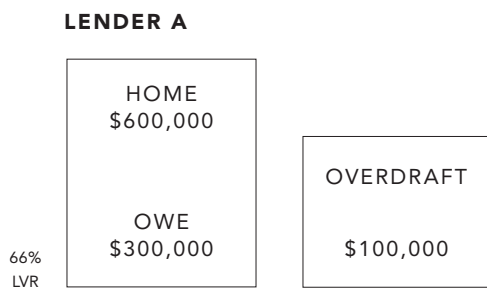
How does the Deden finance structure protect Homeowners from losing their home?

Deden structures Homeowners so that their properties are not cross collateralised, thus protecting them from losing their home if a situation should arise where their income is reduced to the point whereby they cannot meet their mortgage repayments.

The home is refinanced with Lender A. The property is worth \$600,000. Using a line of credit of 66% of the value of the home, a loan to the value of \$400,000 is taken and the structure above is created; \$300,000 (Includes a spare \$50,000 of equity) for the home loan is placed into one account, \$100,000 equity is then placed in a second account for the investment purchase (\$80,000 deposit and costs) with a spare \$20,000 to pay for further investment costs or loss of rental income.

The investment property is financed with Lender B at 80% LVR. This loan is separate from the home loan and is not linked in any way.

If the couple were to face income loss through retrenchment, they would be able to continue paying the mortgage by withdrawing funds from the spare \$50,000 in equity making a payment into the first account. The bank would not even know that the couple had a temporary loss of income. They would not lose their home, they would maintain their lifestyle and they would only increase their debt until they returned to work.



If you require further assistance with your current investment portfolio call us at Deden on 02 9955 1444.