



Cross Collateralisation – who is in control of your financial future?

Similar to building a house, building a vibrant property portfolio requires strong foundations. When it comes to mortgages the ‘right’ foundation is the most appropriate loan structure for each investor. Spending time initially to work out an appropriate loan structure can literally mean the difference between achieving your long term financial goals or not. As many of my clients will attest to taking the time to get it right is something Investors Choice Mortgages specialises in as it is a passion for me as I understand how it can either enable you to achieve your financial goals or hobble your attempts. With this in mind let’s discuss the cross collateralisation structure.

So what is cross collateralisation? Simply put it’s when the bank uses equity in existing property to secure new purchases.

Let’s say you decided to buy an investment property with the equity in your home as opposed to your savings. Traditionally, if you went to a bank to organise a loan they would look at the equity in your existing home, take into account the value of the investment property and your ability to service the new loan. Assuming the bank approves the loan, the loan is usually structured in one of two ways.

1. Firstly a small loan can be added to your existing home loan, this is just to cover the deposit for the purchase and other purchase costs. Once this is done a separate loan to cover the balance is setup, even with another lender. This second loan is secured just against the new property.
2. Alternatively one large loan is setup and the lender uses your current property and the new property as security to cover the purchase price and all purchase costs.

More often than not lenders will opt for the latter option above, that is, cross-collateralise your existing home and the new investment property. That means the bank uses both properties to secure the new loan. It’s easy to find out if this has happened to you. The best indicator is if your new loan is greater than the value of the property you are purchasing. In the majority of cases there is no need for banks to use both properties as security. Even worse, many people are unaware that the bank has cross-collateralised their properties and it can prevent them accessing further equity in the future.

So what? Well if you wish to continue investing in the future, if you cross-collateralise your properties, you have dramatically reduced your flexibility to do just this.

No doubt you have gathered that I am not a fan of cross-collateralisation. There are three reasons for this.

Firstly it’s a ‘quick and dirty’ loan structure with no consideration of future requirements. Often people are rushed into it by a lender when there is a settlement deadline looming.

Secondly, nearly every month I meet new clients who believe they are ready to purchase an investment property. However once we start reviewing their financial position and existing loans, I find it either won't be as easy as it should be, or they are not in a position to purchase. Why? Because their existing properties have been cross-collateralised without them understanding the implications, sometimes without them realising that they even have this structure.

Thirdly - and most importantly for me personally as an investor – cross collateralising investment properties effectively means you are allowing the bank to restrict your future portfolio growth. By cross-collateralising your properties the bank calls the shots, not you. I prefer to be in control of my financial future. By cross-collateralising you effectively hand control over to your bank, and I definitely prefer my clients to be in control of their own financial destiny.

I'm finding particularly during the current credit crunch, more and more lenders are trying to cross collateralise properties. Simply put this is one way they can reduce their risk. Many successful investors started out with this structure without realising the implications. So on a practical level, what does it mean if your properties are cross collateralised?

Over time you may find that the lender will start dictating terms which you may not be comfortable with. For example they will only lend you new funds on a Principal and Interest basis, rather than the preferred basis for investors, which is Interest Only. The worst case scenario is when the bank will not lend any more funds. One of the main issues is that your potential portfolio growth may be restricted. Conversely by not cross collateralising, if you had your properties with separate loans it might be an option to move one loan to another lender who assesses your borrowing capacity differently and allows you to borrow more.

It can be messy separating the properties however it is possible to do so, providing greater flexibility to access equity and continue to build their portfolio. We are often told when buying property 'buyer beware'. It's just as important to remember this when buying money (ie getting a loan).

It's important to note – there are obviously exceptions where this loan structure can be a positive. One of the benefits of cross collateralisation is that you do not have to pay mortgage insurance if using less than a 20% deposit to buy the new property (ie the deposit coming from the equity in your home). The benefit for the lender is that they have made it very difficult for you to separate your properties and hence harder for you to shop around and find a more competitive lender in the future. This is compounded further if the lender fixes your loans for a long term. Often they are using all your surplus equity to reduce their risk when only a portion of your equity may have been needed.

The following example explains cross collateralisation.

You have a property worth \$600,000, with \$200,000 remaining on the mortgage. You plan on using some of the equity in your home, rather than your savings, to purchase an investment property. You have found a property for \$400,000.

Scenario 1: The lender cross-collateralises the properties. The bank will loan you \$420,000 to cover the new purchase and costs. (The loan is worth more than the purchase price so you know immediately the bank is planning to cross-collateralise your properties.) In doing this, essentially the bank has taken \$1,000,000 worth of security (ie both properties) for a \$620,000 loan (the balance of existing loan plus new property). The loan to value ratio (LVR) is 62%. The lender has now tied up your additional available equity unnecessarily and prevented you from using that equity for another purchase.

Alternatively let's assume you decide to make a 20% deposit (ie \$80,000) for the new purchase, thereby avoiding the need for mortgage insurance. You also require a further \$20,000 to cover stamp duty and other purchase costs. Therefore you establish a new loan against your home for \$100,000 to cover these costs, taking the total loan against your existing home to \$300,000. These loans would remain separate for tax reasons as the interest on the \$100,000 loan is tax deductible as the purpose is for investment.. Then a new loan of \$320,000 (ie the remaining 80% of the \$400,000 purchase price) required is sourced through either the same lender or a new lender.

*In this scenario you have used or tied up only \$300,000 of the value of your existing home, compared to using the entire value (ie \$600,000) in the earlier scenario. Allowing you to access the remaining equity for further investment at a later stage. * Keeping your loans separate – and even using a different lender for the remaining 80% loan - keeps your portfolio separate and you in control. You have the flexibility to do what you want, and even access that additional equity for the next purchase.*

So in the first structure if your borrowing capacity with that lender is maxed out then although you have more equity your portfolio growth ceases until you earn more or pay more off your home. With the second structure you could move to a new lender with a better servicing calculator and borrow more for your next purchase. In reality most of my clients plan how many properties they would like to buy in a 3 – 5 year period and they make the initial topup loan on their home large enough to provide the deposits and costs for each of these purchases. Many initially use the least deposit they can ie a 5% deposit and opt to pay the once off mortgage insurance fee, and reserve their unspent equity to have as a buffer or as to provide a 20% deposit when needed in the future for the next purchase.

Cross collateralisation is a strategy that many use without really understanding how they got into it. In some instances it allows investors a time saving way of quickly organising finance through one lender to complete a purchase. The fact is if they had used a mortgage broker, the broker would have done all the work for them, made sure the loan structure was appropriate, saving the borrower time, while also ensuring they would

have the flexibility to choose when they want to access equity in the future and not remain beholden to the lender.

Bank and media articles often suggest that mortgage brokers are against cross collateralisation because they make more commissions out of creating two loans. Brokers get paid based on the loan amount not the number of loans so structuring two loans for \$420,000 in total or one loan for \$420,000 makes no difference to them – don't fall for the hype.

Over the past ten years home values throughout Australia have increased, and in some instances doubled. This increased equity provides homeowners with a source of funds they can use. Some use these funds to renovate their homes, buy new cars, go on an overseas holiday. Others invest this equity, be it in superannuation, shares or property. It is up to you on how you use these funds. Importantly it is your choice and you should not relinquish your ability to stay in control of your own financial future.

* Note your ability to service the loan could restrict how much you can access of this equity