VARIABLE RATE LOANS

Variable rate home loans are popular and offered by most lenders. With a variable rate loan, the interest rate you are charged can fluctuate in line with market interest rate changes. Because of this, your home loan repayments may also vary. Generally, the variable interest rate on your loan will move in line with the market rate set by the RBA, but banks can set their own interest rates and change them at any time.

What's good about a variable interest rate loan?

- You can make **extra repayments** to pay off your home loan sooner. Making additional repayments above your minimum repayment amount can reduce the term of your loan and save you money on interest. Visit our website and use our repayment calculators to see the difference that extra repayments can make to the term of your loan and to find out how much you could save.
- You get a **redraw facility** that allows you to withdraw your extra loan repayments if you need to access the money. (Some lenders do have minimum amounts you can redraw, see our Redraw & Offset Information fact sheet for more information.)
- You can use an **offset account** to reduce the interest you pay. That's a transaction account linked to your home loan where the balance is 'offset' daily against your loan balance before interest is calculated. This reduces the principal amount the interest due is calculated on. (See our Redraw & Offset Information fact sheet for more details).
- **Flexible repayment options** so you can make your loan repayments weekly, fortnightly or monthly—whenever is most convenient to you. This can help maintain your budget requirements and align with your pay cycle to make it easier to manage your loan repayments.
- You can choose to **split** the loan to gain more control of the **interest rate**. That means you can have a fixed interest rate on a portion of the loan for up to five years, and a variable interest rate on the other portion of the loan. This allows you to gain some protection from potential interest rate rises.
- You can **switch loans and lenders** more easily if you have a variable rate loan. All variable mortgages advanced on or after 1st July 2011 have no early repayment penalties or exit fees. (However, lenders can charge discharge fees to cover the administrative costs and there are other Government charges which may apply.)

Things to consider

- With a variable rate loan, your repayments will increase with interest rate rises. You should consider how interest rate rises may impact your future financial situation and goals. Use our handy online calculators to help you plan and budget for possible rate rises.
- A basic or 'no frills' variable rate loan is one which lacks additional features such as an offset account and as a result, attracts a lower interest rate and fees. This type of home loan is useful for first home buyers who want to keep costs down and those who prefer a simple loan product without all the bells and whistles.
- A standard variable rate loan is suited to borrowers who prefer more flexibility and want the ability to redraw from the loan or place any extra funds in an offset account. These extra features are usually part of a Package Home Loan that includes offset accounts, a credit card and other associated facilities and discounts, for an annual fee.

What's a Home Loan Package?

- A Home Loan Package is an all-inclusive suite of products attached to a home loan. For an annual fee, you can get benefits such a discount on the variable interest rate, fee waivers for transaction or offset accounts, a credit card with an annual fee waiver and discounts on insurance products.

Things to consider

- To be eligible for a Home Loan Package, a minimum loan amount will be required (usually $250,000 or more).
- An **annual** package fee will apply and can range from $350 to $750 depending on the type of package and the lender.
- A credit card (with no annual fee) is usually part of the package. You may not require this card and the credit card limit may impact your borrowing capacity. It could also result in you incurring more debt at credit card interest rates.
- Talk with us and we'll help you consider the pros and cons of each product, as well as the overall costs and savings, before choosing the option that suits your needs.

REDRAW FACILITIES

A redraw facility is a loan feature that is usually available with variable rate home loans and some fixed rate loans. A redraw facility lets you access any extra repayments you've made on your home loan.

To use a redraw facility, you first need to make extra repayments, or regularly pay more money on top of your minimum loan repayment amount. Use our handy online calculators to find out how much interest you could save by making extra or larger than minimum repayments.

How a redraw facility works

If your minimum monthly repayments are $700 per month and you pay $900 for a period of 12 months, you will have paid an extra $2,400. A redraw facility would allow you to access the extra $2,400 you have paid.

Benefits of a redraw facility

- A redraw facility is a useful feature for those who want an emergency fund for unexpected situations or expenses and who don't require regular or immediate access to their extra funds.
- A redraw facility can be an excellent savings tool. Any excess funds put into your home loan are earning the same interest rate being charged on your home loan. By comparison, savings accounts generally pay much lower interest rates.
- There may potentially be tax advantages when using a redraw facility. Interest earned on your savings account is considered income and may be taxable, whereas any interest that is saved on your home loan by having money in a redraw facility will not be subject to tax.

Things to consider

- Some lenders may charge a flat fee for having a redraw facility. This is known as an activation fee. Once the redraw facility is activated, you can use the redraw facility as often as you like.
- Some lenders may impose a fee for each redraw. This fee will vary between lenders and loans.
- Some lenders may offer unlimited free redraws while some lenders may only offer a few free redraws per year. Once the limit of free redraws is exceeded the lender might charge a fee for each additional redraw.
- Redraw facilities can have a minimum and maximum amount which can be withdrawn at any one time. While some will have no minimum set amounts, others may set the minimum redraw amount as high as $5,000.

Redraw verses offset

- Choosing between an offset account and a redraw facility on your home loan will depend on how accessible you need your money to be. You should also consider any associated bank fees with each facility.
- An offset account is a separate deposit account, whereas a redraw facility is not a separate account, but a feature attached to your loan.

OFFSET ACCOUNTS

A mortgage offset account is a savings or transaction account that can be linked to your home loan. The balance in this account 'offsets' daily against the balance of your home loan before interest is calculated. An offset account can help you cut years off your home loan term and save money on interest.

For example, if you have a home loan balance of $250,000 and have $10,000 in your 100% offset account, you'll only pay interest on a home loan balance of $240,000. Because your home loan interest is calculated daily, every dollar in your offset account can save you money in interest. That means more of your repayment goes towards paying down the principal, helping you to repay your home loan faster.

Types of offset accounts available

- **100% offset account:** 100% of the funds in your offset account are applied against your home loan balance before interest is calculated
- **Partial offset account:** A partial offset gives you a reduced interest rate on the part of your home loan equal to the balance of your offset account. This can be far less effective than a 100% offset account.

Benefits of an offset account

- **An offset account is easy to manage.** Simply have your salary and any other income deposited into your account to have an immediate impact on the amount of interest you pay, as the interest on your home loan is calculated daily.
- **An offset account offers convenience and flexibility** should you need it, as the account allows transactions and transfers giving you the same accessibility as an everyday transaction account.
- **Some lenders offer multiple offset accounts** linked to your home loan, so you can manage your finances while still benefiting from the interest saved on your home loan. This can be a great way to save for big expenses such as a holiday or a new car while still saving on home loan interest.
- **Offset accounts are usually part of a home loan package** that incur an annual fee, lower interest rate and other product discounts could still help you save money.
- An offset account can be **more beneficial than a savings account** as the interest you may earn on a savings account is less than the interest incurred on a home loan. There will be no tax on the interest you earn and you'll be building valuable equity on your property

Things to consider

- There are many kinds of offset accounts, and the features will differ depending on the loan type and lender. For example, not all offset accounts are 100%, some may only be partial. Fixed rate home loans may only allow 100% offset for a set period, or other conditions may apply.
- You may incur monthly fees for having an offset account. It pays to look at the total charges associated with your home loan package to determine if having this product leaves you better off financially.
- Some lenders may require a minimum balance in the offset account.
- Weigh up the pros and cons carefully to decide if an offset account is the right product for your situation.

FIXED RATE HOME LOANS

A fixed rate home loan allows you to set your interest rate for a period of one, three or five years. Sometimes, you can arrange to secure your interest rate for longer.

Fixing your interest rate can be a suitable option for some people, however you need to be aware of the following:

- Fixed rate home loans often have higher interest rates than variable rate home loans. The longer the fixed rate term, the higher the interest rate is likely to be. For example, a five-year fixed loan will usually have a higher rate than a three-year fixed loan.
- If interest rates do not rise, or if they fall during your fixed rate period, you will pay more interest than you would if you had a variable rate home loan.

What's good about fixed rate home loans?

- During times of very low interest rates, fixing your loan can work to your advantage, because you can retain a low rate for a fixed term even if the rates rise steeply. Depending on the lender and the current interest rate, this could potentially lower your repayments and the total interest paid over the loan term.
- You know exactly how much your repayments will be during your fixed rate term, which can make budgeting easier.

Things to consider

- **Less Flexibility.** Fixed rate loans usually do not have the same flexibility that a variable rate loan provides. For example, you may not be able to make extra repayments and redraw them. Some lenders do allow extra repayments to be made, but will restrict the amount that can be paid during the fixed term or on an annual basis.
- **No offset facilities.** Most lenders will not allow you to have an offset account with a fixed rate loan so there is no opportunity to save on interest. Where offset facilities are available, they will usually only be available on a partial basis, with a 100% offset account being available through some lenders only.
- **Break costs.** You can expect to pay significant penalties if you want to exit before the end of the fixed term. Your reason for wanting to end the loan is not considered, and break costs also apply if you want to end the loan as part of selling the property.
- **The rate is usually not set until settlement.** Some lenders will apply the fixed rate at the loan settlement date or the date the fixed rate period commences while others will apply the fixed rate available at the time you sign your letter of offer. This may or may not work in your favour.
- Your decision whether to fix the interest rate on your loan should be based on your own circumstances, with your future in mind. Certainty of repayments is the best reason to fix your rate—they seldom help to beat rate rises over time.

Remember:

If variable rates increase, you may pay **more** interest than if you fix your rate. It will depend on the size of the increase(s), how far into the term the increase(s) occur, and how long you hold the loan after the increase(s) occur.

If variable rates stay flat or decrease, you will pay **less** interest than if you fix your rate. This is on the basis that your fixed rate is higher than the variable rate over the same period.

Rate Lock

Some lenders will provide you with the option of locking in the fixed rate prior to settlement occurring. This is referred to as "Rate Lock" and will involve paying a rate lock fee which will usually be calculated as a percentage of the loan amount.

This fee can be a significant amount, although some lenders will not charge a fee or may waive it. If you choose this option, then you can proceed with certainty and complete peace of mind that the decision to fix your interest rate will not move between when the rate lock is effective and the rate that would be applicable on the day of settlement.

Most people who elect to Rate Lock do so at the time the application is submitted. It can be done later in the process—however, the lender can announce a rate increase at any time before settlement and once announced the opportunity to lock in the previous rate passes. A "wait and see" approach carries with it the risk of missing out on the lowest fixed rate that could have been obtained.

If you decide to Rate Lock, make a note of the expiry date, as it will usually be in place for 90 days. If your settlement still hasn't occurred when it expires, it will need to be renewed (including paying another fee) for it to remain in place. This can be an important consideration if you have negotiated a long settlement.

SPLIT LOANS

A split rate home loan is a loan that allows you to split your home loan into multiple loan accounts that attract different interest rates.

A common example is to split your home loan to obtain a variable interest rate on one portion of the loan and a fixed rate on the other.

For example, if you require a loan amount of $350,000, you can decide to split your loan with $250,000 at a variable interest rate and the remaining $100,000 at a fixed interest rate. You will have the flexibility a variable rate loan offers, while still enjoying the interest rate certainty of a fixed rate on a portion of the loan.

Benefits of a split loan

- Split loans are a comfortable compromise that allows you to enjoy the benefits of both types of mortgages—variable and fixed—at the same time.
- The fixed rate portion of a split loan offers you some security and protection against sudden interest rate rises.
- The variable rate portion of a split loan provides flexibility and allows you to take advantage of decreases in interest rates.
- You can often make extra repayments on the variable portion of the home loan, which could help you pay it off sooner.
- If you choose a variable and fixed portion split, your variable portion can have additional benefits such as an offset account or a redraw facility.
- There are no restrictions on how you split your home loan. For example, you can split your home loan down the middle 50/50, or you can split it 30% variable and 70% fixed. However, most lenders only allow two splits.

Things to consider

- You may miss out on potential savings on the fixed portion of your loan if interest rates should fall.
- You will pay more on the variable portion of your loan if interest rates rise.
- There may be additional costs associated with this type of loan.
- If you need to pay out the loan early within the fixed term, early repayment costs will be charged.
- Consider where you want to be in the next five years. This will help you choose a loan with features suitable to your goals and objectives.

INTEREST ONLY LOANS & REPAYMENT TYPES

The repayment on your mortgage will always include the interest payable on the amount borrowed, no matter what kind of loan you have. If you have a Principal & Interest loan (P&I), part of your repayment will also be allocated to reducing the balance of the loan.

With an Interest Only loan (IO), your repayments only pay the interest that is due and do not reduce the balance (or the amount you borrowed). As a result, an IO loan can only be obtained for a limited period (usually up to five years). At the end of the IO period, the loan will automatically convert to a P&I loan unless you make an application to extend the IO period.

Who should use an Interest Only loan?

IO home loans are not designed for every type of borrower. For example, they are not recommended for standard owner-occupied home buyers. In this scenario, the less you pay off the principal amount, the more you end up paying in interest over the life of your loan. Your repayments are likely to be a lot higher as well, so there are very little benefits to an IO loan for owner-occupier home buyers.

However, IO loans can be very useful for property investors—that's because the interest on a loan for a property investment is usually tax deductible. In this scenario, an IO loan can help an investor to arrange their finances to maximise their investment strategy, tax advantages and cash-flow.

How do IO repayments differ?

You can expect your repayments to be lower initially if you commence your loan with an IO period. However, while the IO period is in place, you can also expect to be paying a higher rate of interest than if you started with P&I repayments from the outset.

At the end of the IO period, your repayments will increase to cover repayments on both the principal and the interest—so you can expect this increase to be significant. You also need to consider the period left to pay off the principal is reduced, which could drive up your repayment amount even further.

Because IO repayments will result in you paying more interest over the term of the loan, this option should only be chosen to fill a requirement that you have—such as maximising your tax advantages with a property investment. They are usually not a wise choice just to make loan repayments more affordable.

Even with an IO period in place, you may be able to reduce the principal during this time by making voluntary extra payments, or by depositing funds into an offset account. Flexibility to do this may be restricted with some lenders, and some additional fees may apply.

What are the benefits of IO loans?

- **Smaller repayments.** During the IO period of the home loan, your monthly repayments will be lower than with a P&I loan.
- **Improved cash-flow.** Lower repayments mean you could use your cash for other purposes that may be financially beneficial - pay off debts, make other investments, fund a loan to purchase another property, or pay the cost of additional educational qualifications that may increase your earning potential.
- **Maximise tax benefits for property investors.** The interest on an investment property debt is usually tax deductible for property investors, as long as you follow the ATO rules. It should be noted, however, that owner-occupiers will not receive any tax deduction for interest if you take out an IO loan. Please speak to your accountant or financial planner to discuss if an IO loan is the right option for you.
- **Benefits are ongoing for the life of the IO term.** You can often choose an IO term of one, three, five or 10 years. This can be very beneficial for tax minimisation strategies and financial planning purposes, so please speak to your accountant or financial adviser to find out how to make it work for you.

Things to consider

- **You may not build any equity.** IO loan repayments do not help you to pay off the principal and build equity in your property. If property prices do not rise during the IO period of the loan, you will not have improved your financial situation. You may also be at financial risk if property prices should fall during the IO period.
- **The loan reverts to P&I as soon as the IO period ends.** If you take out an IO loan, you should plan for the end of your IO period. At that time, some lenders may allow you to renegotiate another IO term. Otherwise,

you can plan for increased repayments, consider refinancing the loan, or selling the property.

- **Not all lenders allow extra repayments** during the IO period and the availability of additional features such as an offset account will vary between lenders and loan products.
- **A loan with an IO period will cost more** in interest over the life of the loan, than a loan that has P&I repayments from the outset. The cost differentials can be quite significant and should be clearly understood.

For example:
With a normal P&I Loan for $500,000 at 4.78% p.a. based on an LVR of 80% over 25 years, the total cost of interest on the loan would be $357,766 over the 25-year period.

For the same loan with an IO period of 10 years, the total cost of interest on the loan would be $440,443 over the 25-year period and therefore would cost you an additional $82,676 in interest compared to a loan that had P&I repayments over the full 25-year term.

- You could miss the opportunity to pay down the principal while interest rates are low. Paying as much as you can off the principal while rates are low could mean that when interest rates rise, you will be paying those higher rates on a reduced loan balance. This could mean lower loan repayments and/or paying less interest in the long-term.

DEBT CONSOLIDATION

Debt consolidation involves bringing your existing debts together into one new loan. The objective is to reduce the number of individual payments you make and reduce the interest rate you are paying on your more expensive debts.

This may be something to consider if you are:

- Managing multiple debt repayments and struggling to keep track of what is due and when.
- Getting into a credit trap where all your spare income is used to pay interest, but you don't have enough left over to reduce your debt balances.
- You're paying a very high interest rate on your debts—perhaps you have credit card or cash advance debts, or store credit purchases.

There are several possible strategies to consolidate debts, which can include:

- Moving debts to a new credit facility (e.g. a personal loan or mortgage) with a lower rate of interest, or lower fees.
- Lengthening the term of existing loans (e.g. taking a mortgage debt back out to the 30-year loan term).
- Changing the repayment terms on an existing loan to interest only, or
- A combination of these strategies.

Usually a debt consolidation strategy is implemented to make it easier for you to pay back your debts. However, in some instances, the objective of a debt consolidation may be to improve your cash-flow.

If you implement a debt consolidation strategy, it's important to understand that it doesn't reduce your debts—it just makes your repayments more manageable. A debt consolidation strategy should be implemented in combination with a change to your spending behaviour, so you can work to reduce your overall debt level over time. This should include creating a budget to ensure the debt consolidation measures work effectively and using a budgeting template such as the one available on ASIC's MoneySmart website (www.moneysmart.gov.au).

What's good about debt consolidation?

Simplicity: One loan repayment is a lot easier to manage and more convenient than juggling several different repayments.

Savings on interest and fees: Debt consolidation could potentially reduce the amount of interest you pay on high-interest facilities like credit cards and save you money on fees for multiple credit facilities. This may make it easier to pay back your debts.

Potential cash savings: This is potentially the biggest benefit of debt consolidation. By consolidating your debt into a loan charging a lower interest rate, you have the potential to save interest on monthly repayments and reduce your overall interest.

Lower repayments: Reducing the interest rate and spreading out repayments over time could potentially reduce the monthly repayment amount due.

Stress relief: Specialist lenders are available that may lend to you if you have missed repayments on your current debts, or if you have a poor credit history.

Things to consider

For example:
If you have a $30,000 personal loan over a five-year term at 15% p.a. then this will cost you $12,822 in interest.

If you add this $30,000 debt to the balance of your mortgage instead, the same $30,000 at 5% over 30 years will cost you $27,977 in interest.

Higher costs: Long-term interest costs could be higher if you extend the loan term during a debt consolidation program. While it may reduce the size of the repayments in the short term, the overall amount repaid is far greater—particularly if you are consolidating your debts into a home loan which may have a 30-year term.

Increased credit access: If you're not careful when consolidating your debts, you could make your financial situation worse. Remember to close your cleared credit facilities. For example, if you roll your credit card balances into your home loan to consolidate your debts, you might be tempted to continue using your credit cards and run up even more debt if you don't close them.

Concentration of risk: Consolidating all your debt into your mortgage means that you have a lot at stake if interest rates rise. We recommend that you take advantage of all available cash to make additional repayments to pay off the refinanced debt as quickly as possible, or to start a savings account to build up a safety net.

Using up equity: Consolidating debts into your mortgage can also mean you are using up equity gained through paying down the balance or through an increase in value of the property. This means your returns will be reduced when you sell. Furthermore, consolidating your debts into your home loan can increase your loan-to-value ratio (LVR) above 80 percent. If this occurs, you will be required to pay Lenders Mortgages Insurance (or LMI). LMI can be expensive, so this may affect the savings you receive from refinancing your home loan to consolidate your debts.

Lenders Mortgage Insurance

Lenders Mortgage Insurance is often referred to as LMI. It is insurance that a lender takes out to insure itself against the risk of not recovering the full loan balance if the borrower (you) were unable to meet loan repayments.

LMI is a one-off fee charged by the Lender to you when you need to borrow more than 80% of the value of the property.

Benefits of LMI

- The benefit of LMI is it allows lenders to provide home loans to customers who do not have a substantial deposit but would otherwise meet the lenders credit requirements.
- LMI covers the outstanding balance of the loan owing to the lender if the sale of the property does not cover the total loan amount.

What is the cost of LMI?

- The LMI premium payable can either be included into the loan amount (called capitalisation of LMI) or paid upfront on settlement. The lender will be able to provide you the applicable costs of LMI.
- It is important to note, if you choose to capitalise the LMI, your loan repayments are based on the higher loan amount which includes the LMI premium.
- The cost of LMI will vary and it will depend on the lender, how much is borrowed and the size of the deposit.

Is LMI refundable?

- LMI may be partially refundable if the loan is terminated early, usually within the first two years.
- Each lender will have their own refund arrangements.

What happens if a borrower defaults and the property is sold?

- If the borrower is unable to meet their loan repayments and there is no other resolution, the property may need to be sold to cover any outstanding loan amount.
- The LMI insurer will pay the lender in accordance with their LMI policy and could then ask the borrower to repay this sum directly to them.
- LMI does not protect you or cover your loan repayments in the event you are unable to make the repayments on your mortgage. You should discuss personal insurance options such as Mortgage Protection Insurance with your broker to cover any unforeseen circumstances.

What happens when the loan is refinanced?

- LMI is lender specific, which means if you refinance your home loan to a different lender and you borrow more than 80% of the value of the property, you will have to pay LMI again.
- Do your research, as this may outweigh the benefits of refinancing to a lower interest rate.
- If the equity in your home has increased or you have paid down the principal on your loan, you may not need to borrow more than 80% with the new lender and therefore avoid paying LMI again.

Case study

Bob and Jill have found a home they want to buy for $500,000. Typically, they would need a 20% deposit ($100,000) to secure a loan from their lender. By taking out Lenders Mortgage Insurance, their lender is prepared to provide a loan up to 95% of the value of the home.

This means that Jenny and Tom can secure a home loan sooner with a 5% deposit ($25,000) and stop paying rent. Their lender passes on the Lenders Mortgage Insurance premium cost to Bob and Jill by way of a fee called a “premium”.

The Lenders Mortgage Insurance protects the lender if Bob and Jill default on their loan repayments
– it does not protect Jenny and Tom.

Important: If you experience problems in meeting your loan repayments, you should contact your lender as soon as possible as you may be able to arrange a payment variation on the grounds of financial hardship. More information about LMI can be found at www.moneysmart.gov.au or www.asic.goc.au