

# Cross Collateralisation

So what is cross collateralisation? Let's say you decided to buy an investment property with none of your savings just the equity in your home. Traditionally, if you went to a bank to organise a loan, they would look at the equity you have in your existing home, take into account the value of the investment property and your ability to service the new loan. Assuming they agree that you can afford the loan, the structure can usually go one of two ways. Firstly an additional loan could be added to your home loan secured by your home to provide the deposit and cover the costs of the purchase and then a completely separate loan is taken out secured only by the new property.

However more often than not lenders cross-collateralise your existing home and the new investment property. That means the bank uses both two properties to secure the new loan. You know you have this structure if your loan to buy a new property is larger than the value of the property being purchased. In the majority of cases there is no need for banks to take two 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.

Especially during the current credit crunch I'm finding more and more lenders are trying to cross collateralise properties. Simply this is one way they can reduce their risk. Many a successful investor started out with this structure, it can be messy separating the properties however it is possible to do so to give the investor the 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).

So what? Well if you wish to continue investing in the future, if you do 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'm not sure about you, but 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.

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. Hence one of the main issues is that your only portfolio growth may be restricted. 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's important to note – there are obviously exceptions. 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. Say you have a property worth \$600,000, with \$200,000 remaining on the mortgage. You plan on using the equity in your home 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 old 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 lets assume you decide to use a 20% deposit for the new purchase, so as not to pay mortgage insurance, ie you require \$80,000 and a further \$20,000 to cover stampduty and buying costs. So you setup a new \$100,000 against your home, ie the total loan against your home is now \$300,000. These 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% required is sourced through either the same lender or a new lender. Hence you have used only \$300,000 or the value of your home ie \$600,000. In keeping with the 80% LVR this leaves you access to a future \$180,000 for further investment.\* 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 model 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 organizing finance to complete the next 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 right, have taken the borrower less 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.

Banks 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 2 loans for \$420,000 in total or one loan for \$420,000 makes no difference to them – don't fall for the hype.

Traditionally 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, or if indeed you do. 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