



Buying a second property ■ Overcapitalising and how to avoid it ■ How your bank calculates a business risk ■ How redraw works



## Welcome

Welcome to our Autumn issue.

In this issue, we talk about the different ways in which you can help your children purchase their first property.

We share our top tips when considering that second property and shine the spotlight on overcapitalisation and how best to avoid it. Plus there's a detailed article on how your bank calculates its business risk and an explanation on how redraw works and why it's a useful feature.

## WANT TO HELP YOUR KIDS BUY PROPERTY? HERE'S HOW.

The real estate market can be tough for young adults, but as a parent you may be able to lend a helping hand. We tell you how.

### 1. Parent-to-child loan

A parent-to-child loan is when a parent lends their child money. This is a formal, legally binding arrangement, administered by an independent third party. At the start of the loan period, both parties agree to terms including repayment amounts, a schedule and a process to manage defaults.

**Benefits:** You can set generous terms for your child, but your assets, savings and credit rating are somewhat protected as you are not the borrower.

**Drawbacks:** There are legal implications for your child if they have a spouse and the relationship breaks down, in that the spouse could try to claim some of the loan proceeds as an asset of the relationship to which they are entitled. There are also tax considerations for both parties.

### 2. Family guarantee

If your child doesn't have enough security for a mortgage, you could provide a family guarantee. This is where you use some of the equity in your

own home as part of the security. For example, your equity might cover 20% of the security, and your child's new property would be the other 80%. It's also known as a guarantor loan.

This can be a temporary arrangement until your child has paid down the loan to an acceptable level.

**Benefits:** You have the option of guaranteeing only a portion of the loan.

**Drawbacks:** If your child defaults, your assets are at risk.

### 3. Becoming a co-applicant

You can help your child secure a loan if you sign on as a co-applicant. This means you're equally as responsible as your child for meeting repayments. The lender will consider your assets in its borrower's assessment.

**Benefits:** Your child can obtain a loan with a low income.

**Drawbacks:** If your child stops making repayments, you're responsible for making them. If you can't make the repayments, it will affect your credit rating.

### 4. Gift

When you give your child money but don't expect it to be repaid, it's considered a gift. You may need to sign a statement to say it's a gift, not a loan.

**Benefits:** You can provide financial help, possibly without the legal, tax or financial implications of a formal arrangement.

**Drawbacks:** If your child has a spouse and their relationship breaks down, the former partner could make a claim for the property.

### 5. Assistance in kind

If you're risk averse, consider providing assistance in kind; that is, covering some of the expenses that come along with buying a property. You could pay for services such as a property survey or conveyancing fees, or help with stamp duty.

**Benefits:** You can give practical financial assistance.

**Drawbacks:** The amount of money you provide may be more than what your child ends up spending. For example, you might want to contribute \$20,000 but the services cost \$15,000. In this case, the rest of the amount is subject to the terms of a gift or loan.

Make sure you're well informed about your options when giving or lending money so you can remain in the best position to help your child become a home owner. You can contact your mortgage broker to discuss the right financial arrangement for your family.

## What to consider when buying a second property

Buying your own home remains the great Australian dream – and purchasing a second property may help you take your wealth further.

Whether you're building your property investment portfolio, buying a holiday house or supporting a family member, there are plenty of things to think about before you take that next step.

### Consider your cash flow

Property tends to be a long-term investment, so do your sums to make sure you can afford the ongoing repayments on two mortgages. Also think about any major life changes on the horizon. For example, you may be planning to expand your family, or you might need to support a parent in the coming years.

### Get to know the market and location

Research what's happening in the current market and whether it's the right time for you to buy. Get to know the area you're considering by speaking to local residents and real estate agents. It's also wise to look into the short and long-term planning for the area. For example, nearby construction may affect your ability to find a tenant.

### Investigate before you invest

If you're buying a property as an investment, carefully consider its location. Buying in a high-demand area is likely to see you enjoy a constant flow of income from the rent.

You'll need to provide your lender with a rental estimate letter, which you can get from the agent managing the property. Keep in mind that generally lenders only take 50–80% of the rental income into account when calculating whether you can afford the loan.

### Choose the right mortgage

The amount you can borrow and the type of loan you choose will depend on various factors, including the equity in your current home, your income and expenses, and your property valuation. It helps to get quality advice on the right mortgage for you, along with other considerations such as negative gearing, and how to structure your loan to maximise tax effectiveness.

Whatever your reason for considering a second property, being well-informed will ensure a smoother purchasing process and a financially secure future.



## OVERCAPITALISING: WHAT IT IS AND HOW TO AVOID IT

As a home owner or property investor, you may have heard the term 'overcapitalising'. But what exactly is it and why is it considered bad?

While adding a new deck or kitchen can increase the value and enjoyment of your property, overcapitalising can end up costing you more than you planned. Here's a closer look at what overcapitalisation is, why it's bad, and how you can avoid it and still increase the value of your property.

### What is overcapitalising?

Simply put, overcapitalisation is when the cost of a home improvement is more than the value it adds to your property.

For example, if you buy a property for \$500,000 and spend \$100,000 on a new outdoor kitchen area with timber decking and fancy landscaping, it doesn't automatically increase the property's value to \$600,000. If similar properties in your neighbourhood are selling for a maximum of \$525,000, your eye-popping improvements are unlikely to increase the selling price beyond this – meaning you have overcapitalised.

### Why should overcapitalisation be avoided?

Aussies love investing in their homes. However, keep in mind that while certain renovations can increase the value of your home, there is an upper limit on what properties are worth at any given time. If you find yourself in a situation where you have to sell an overcapitalised property on short notice, you could find yourself losing out on your investment.

### Increase the value of your property without overcapitalising

While overcapitalising is never a good idea, there's no question that the right renovations

can significantly add value to a property. Some areas where home improvements can make a big difference include:

- new curtains or blinds
- a fresh coat of paint inside and out
- updating light fittings with modern fixtures
- renovating an old kitchen or bathroom
- refinishing floors and replacing carpets
- adding a carport or garage.

When it comes to renovations, the key is to increase the kerb appeal without exceeding your budget.

Consider your neighbourhood and the types of features that buyers or renters are likely to be looking for, and be willing to set your personal preferences aside. While you may enjoy having a beautifully landscaped yard or pool, the next person living in the house may not. In other words, it pays to be practical.

### A good rule of thumb

In general terms, you'll probably avoid overcapitalising if you keep the cost of your renovations to less than 10% of the value of your home. The less you need to invest in your home to give it that wow factor, the more you can expect to get back when it's time to sell. And always keep a close eye on the sale price of similar properties in your area.

With many people continuing to depend on property investments to meet their financial goals, it's important to make sure you have the right information and tools on your side. Talk to your mortgage broker about how to unlock the full potential of your home or investment property with a renovation.

# HOW YOUR BANK CALCULATES A BUSINESS RISK

Just like you, banks are in business – and they don't succeed by making bad deals. When they consider your loan application, they're calculating the financial risk of entering into an arrangement with you.

## What the bank considers

For the bank, financial risk comes down to whether you can repay your commercial loan and the interest in the agreed time.

According to the Australian Bureau of Statistics, as of June 2016, the exit rate across all Australian businesses was 12.3% (percentage of businesses that ceased trading)<sup>1</sup>. To protect itself, the bank is looking for evidence that your business won't fail among these statistics and fail to repay the principal amount.

When assessing financial risk, one of the main factors the bank looks at is you, the business owner. What skills and experience do you have? Do you understand your business and have a clear and realistic plan for developing it? Importantly, they'll also be looking at your credit history, and any debt you may have.

Banks also consider:

- **Security:** The bank will evaluate what you're offering as security against your loan – this might be a family home or other assets such as stocks and shares.
- **Industry:** Lenders view some industries as riskier than others, because of conditions such as competition, profitability and the economic climate. If your industry is seasonal, such as tourism or agriculture, they'll want to know how you'll manage repayments in the off season.
- **Cash flow:** ASIC reports<sup>2</sup> inadequate cash flow among the top reasons why companies become unable to repay debt. The bank will want to see what revenue you have coming in, and be assured you can pay wages, keep the business ticking and make your loan payments on time – even if something unexpected happens.

## Show the bank you're managing risk

Having higher risk doesn't mean you won't get a loan. But you need to show the bank you're aware of the risks and are taking the necessary steps to manage them.



Start by making a risk management plan that documents your business's specific (financial and other) risks and identifies the steps needed to reduce or manage them. See [business.gov.au](http://business.gov.au)<sup>3</sup> for useful tips on risk management and tools to plan for it. Regularly review and act on your plan. No matter the size of your business, that's an essential part of good business management. Next, when preparing your loan application, think about what will convince the bank you're on top of your business risks. Here are some ways to do just that:

- Provide all the documentation the bank asks for.
- Use a business plan to succinctly explain what your goals, objectives and target markets are with any forecasts that might help.
- Supply solid evidence of your personal experience and credentials.
- Make sure your financial records and forecasts are in good order (poor financial control and lack of financial records also rate highly among ASIC's top reasons for company insolvencies<sup>4</sup>).

Convincing the bank that you're on top of risk management doesn't involve smoke and mirrors. It's about understanding your business, having robust practices, planning for the future and demonstrating you're on top of any present or potential risk.

Sources:

- 1 [www.abs.gov.au/ausstats/abs@.nsw/mf/8165.0](http://www.abs.gov.au/ausstats/abs@.nsw/mf/8165.0)
- 2 <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-436mr-asic-reports-on-corporate-insolvencies-2015-16/>
- 3 [www.business.gov.au/Info/Run/Risk-management/Risk-management-strategies](http://www.business.gov.au/Info/Run/Risk-management/Risk-management-strategies)
- 4 <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-436mr-asic-reports-on-corporate-insolvencies-2015-16/>

## *How redraw works and why it's a handy loan feature*

It's one of the less glamorous home loan features, but the redraw facility deserves a second look. Here's why:

### The redraw facility explained

A redraw facility lets you make additional repayments to reduce your variable rate home loan balance and save on interest. If you pay more than your minimum scheduled repayments, then you'll have money available to redraw from your home loan.

The redraw facility is a common feature of many home loans. It's not available, though, on construction loans and only some lenders allow it for fixed rate loans.

You can redraw funds if, and when, they are needed, or you can keep the funds in your home loan to pay off your principal faster. The amount available for redraw is the difference between what you have paid and how much you were required to pay, less one month's scheduled repayment.

### Accessing redraw

You can check your loan account online to view your available redraw amount at any time. Alternatively, you can call your home loan customer care team and ask them to check for you.

You can withdraw your funds from certain ATMs depending on your lending provider, but this may attract certain fees and come with restrictions on minimum amounts.

### What happens after using redraw?

After you redraw money from your home loan, you continue to make your regular repayments as normal. However, be aware the interest component of the repayments you make will increase since you're now paying interest on a higher loan principal amount.

### What are the benefits?

Like an offset account, a redraw facility can help reduce the total interest paid on your loan and shorten the life of the loan. And, of course, when you need some cash it's easily accessible.

Depending on your lender, additional payments can be made at no extra cost and redraw funds can be accessed at any time.

When comparing loans and choosing the option that best suits your financial needs, remember to consider the redraw facility.