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Rates too high? Here's how to cut your borrowing costs

By **STUART WEMYSS**
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Borrowing capacity has never been as tight as it is today, primarily due to the occurrence of two factors.

First, while interest rates have been higher in previous periods, such as the early 1990s and 2008, they are currently elevated and closer to the upper range.

Second, in 2014, the banking regulator initiated a tightening of lending standards, particularly emphasising a shift from reliance on benchmarks for borrowers' living expenses, which were unreasonably low, to a verification process based on the actual spending reported by borrowers.

This involves borrowers detailing their expenditures across various categories, with banks subsequently verifying this information through a thorough examination of bank statements.

These two conditions occurring simultaneously has resulted in reducing borrowing capacity even compared to higher interest rate periods.

However, there are some opportunities available to borrowers to navigate this tight borrowing market.

Typically, banks assess a borrower's ability to afford a new loan by adding an interest rate buffer of 3 per cent to the current rate. This buffer is designed to account for potential future increases in interest rates. Consequently, borrowers are evaluated at a benchmark interest rate ranging from between 9 to 10 per cent, even though it's improbable that home loan interest rates will now reach such levels in the current cycle.

Notably, some lenders have specific policies for refinancing customers, wherein they reduce the buffer to 1 per cent. This adjustment facilitates borrowers in refinancing with new lenders to capitalise on more favourable offers.

You could argue that a borrower's impeccable repayment history is the best evidence of loan affordability: It would make these buffers unnecessary when refinancing on a dollar-for-dollar basis. Nevertheless, investors should consider lenders with credit policies that better accommodate refinancing.

Banks are increasingly relying on desktop valuations to streamline approval processes and cut costs. These valuations are based on data-driven models that compare the attributes and imagery of a subject property with sales data from comparable properties to estimate its value. This avoids the cost and time associated with a valuer conducting a physical inspection of the property. Typically, banks use desktop valuations for properties valued at less than $2m and with a loan-to-value ratio below 80 per cent.

Based on my recent experience, desktop valuations have yielded favourable results for clients, probably influenced by the buoyant property sales market in recent years. Consequently, investors might find it beneficial to revalue their property holdings. This can help secure access to additional equity, serving either as a protective financial buffer or to prepare for future acquisitions or additional investments.

It is advisable to proactively reassess the value of your property strategically, rather than waiting until the necessity for additional funds arises. This approach ensures that you revalue your assets at the most favourable time.

Here's some ideas.

When seeking finance, lenders take into account existing loan commitments to determine your borrowing capacity. This involves calculating repayments using a benchmark interest rate, referred to above, over the loan's remaining term.

For instance, if an investor has already used two 5-year interest-only terms, the remaining loan term will be 20 years. This increases their repayment commitment because the loan is amortised over only 20 years instead of the usual 30 years. As such, it reduces their borrowing capacity.

To enhance borrowing capacity, investors are advised to consider resetting loan terms on existing loans back to 30 years. Increasing a loan term from 20 to 30 years reduces annual repayment commitments by more than 16 per cent. Maximising loan terms on existing loans minimises repayments thereby increasing one's additional borrowing capacity.

More investors opt to make principal-and-interest repayments on investment loans to secure the lowest interest rate, as lenders often impose an interest rate premium of half a per cent on interest-only loans. Resetting the loan term at the same time as switching to principal-and-interest repayments helps minimise both the interest rate and overall repayments.

Similarly, you can maximise your borrowing capacity by reducing or eliminating other financial commitments, particularly those with shorter loan terms.

Examples of such commitments include car loans or leases, which typically have loan terms of only two to five years. Clearing these loans using cash savings or consolidating the debt into a mortgage can extend your borrowing capacity.

Repaying HECS-HELP debt can significantly impact borrowing capacity, especially for first-time buyers. Individuals earning more than $151,201 per annum are obliged to allocate 10 per cent of their pre-tax income to repay any HECS-HELP debt, leading to a substantial reduction in their borrowing capacity.

Despite recent reductions in fixed interest rates by lenders, these rates are not attractive enough yet, particularly for terms exceeding three years. Consequently, when fixed-rate loans reach their expiration, clients might do well to rollover onto a variable interest rate.

Investors should always aim to proactively maximise their borrowing capacity. Doing so allows them to maintain robust financial buffers and positions them to seize any investment opportunities that may arise.

Stuart Wemyss is host of the weekly podcast Investopoly.