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RULES OF THE LENDING GAME

HOW TO MASTER THE GAME OF LENDING TO INVEST IN PROPERTY

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First published in 2020 by Major Street Publishing Pty Ltd
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A catalogue record for this book is available from the National Library of Australia

ISBN: 978 0 6486626 5 5

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Cover design by Simone Geary
Internal design by Production Works
Printed in Australia by Ovato, an Accredited ISO AS/NZS 14001:2004 Environmental Management System Printer.

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ABOUT THE AUTHOR

Stuart Wemyss is a licensed independent financial adviser, registered tax agent, chartered accountant and licensed mortgage broker. He has over 20 years of financial advisory experience and founded his Melbourne-based practice (ProSolution Private Clients) in 2002.

Stuart's goal is to inspire people to take action to achieve their lifestyle and financial goals through advocating the benefits of holistic and independent advice. Many important financial decisions involve numerous financial disciplines such as taxation, financial planning, risk management and borrowing; he therefore believes people will maximise their wealth if they receive holistic and honest advice.

Stuart writes a weekly blog which he also records as a podcast called *Investopoly*. He regularly contributes articles to the Wealth section of national newspaper *The Australian*.

He is married and has two teenage sons, whose only advice to him is 'Dad, put the pen down'. Suffice to say that his sons aren't avid readers of his books (yet)! Stuart's passions include travelling to new destinations with his wife, all things French, red wine, enthusiastically supporting the Geelong Football Club and spending time with his family.

You can follow Stuart's musings on LinkedIn (linkedin.com/in/stuartwemyss) and Twitter (twitter.com/StuartWemyss).

ACKNOWLEDGEMENTS

I would like to thank my beautiful wife for her unwavering love and support. She does so much to support me at work and at home: everything from bringing me coffees while I wrote this book to helping me navigate important life and business decisions. She looks after me so amazingly that everything I achieve personally (such as writing this book) is the result of her contribution. I couldn't do it without you. I love you very much.

My personal goal is to inspire people to achieve their lifestyle and financial goals through advocating the benefits of holistic and independent (honest) advice. It's why I write books like this one, record podcasts, publish blogs and choose to do the work I do. The team at ProSolution Private Clients has been helping me work towards this goal now for nearly 18 years. Thank you to all the staff for your dedication to doing work that you're proud of. I'd especially like to thank the two longest-serving members, Jodi McKeown and Kristy Dishon, who've been working with me for well over a decade. Thank you, ladies.

WHY YOU NEED THIS BOOK

When I applied for a mortgage to buy my first property at the age of 24 (many, many years ago!), I had no idea what I was doing... with the mortgage and with life in general! There were so many mortgage options and so much different terminology that I couldn't make head or tail of it, even though I was an accountant at the time.

I was more excited about buying a property and building wealth than about the boring mortgage. I just wanted to know that the bank would give (lend) me the money and that was pretty much it. The mortgage was a mere distraction.

I ended up putting my trust in a mobile banker from one of the 'Big Four' banks (the Big Four are the Commonwealth Bank, ANZ, NAB and Westpac, and we'll discuss these further throughout the book). The mobile lender came out to see me at home. I didn't speak to anyone else for comparison purposes, and there were no online mortgage comparison websites or access to the enormous volume of information that is available online today. I didn't spend much time considering cash flow and affordability. I didn't think about my future needs or the future use of the property. I probably didn't even ask about the interest rate! I pretty much just said, 'Show me the money' and went on my merry way.

I think my experience would be similar to that of a lot of people. A mortgage is a means to an end; it's really nothing to get excited about... or is it? Well, I'm going to propose that it is something to get excited about. I believe that building wealth and getting ahead financially is a game of finance. And those who know how to play

the game get ahead. Most people consider mortgages to be liabilities. However, if used correctly (and I'm going to show you how), a mortgage can be an asset – a very powerful and effective asset.

The rules have changed

Prior to 2016, getting a mortgage approved was easy-peasy! You would just walk into a bank and tell them what you earned, and they would typically be prepared to lend you way more than you would ever feel comfortable borrowing. You'd hardly have to provide any documentation, sometimes you wouldn't even have to sign an application form, and the lender certainly would not ask you what you spent your money on and how much cash you had left over. Lending policies and processes were very loose – definitely too loose.

That all changed after 2016 – and dramatically so. The process of applying for a mortgage these days is like a criminal forensic financial investigation. It's intrusive. It's laborious, and often pedantic. But you can make it easier by becoming 'borrowing ready'. I'll tell you how.

Why read a whole book about mortgages?

If you find it hard to get motivated to ensure you're structuring your loans correctly, then imagine how hard it is to write a whole book on the subject! I completely understand that people generally fall in love with the idea of buying property, not with taking out a mortgage. I get it.

Think about it this way, though: every person in the world has a borrowing limit. There's only so much money a lender will be prepared to lend you, so it's a scarce asset. Therefore, you must think very carefully about how you use that scarce asset. Use it wisely and it's more likely that you'll achieve your financial and lifestyle goals.

The three main things that determine your personal borrowing capacity are:

1. cash flow
2. equity
3. risk tolerance and financial stability.

The way you go about structuring your mortgage can dramatically affect your maximum borrowing capacity. A poorly structured loan portfolio will choke cash flow, waste equity and expose you to higher risk. This means you borrow less... and guess what? For those property-lovers but mortgage-haters out there, it means you buy less property, invest less and/or don't reduce non-tax-deductible debt at the fastest possible rate. This probably means you create less wealth and you're further away from financial freedom.

So, my advice to you, if you're turned off by the topic of mortgages, is to read this book once and once only. Then, immediately go out and find yourself a trusted credit adviser. This book will give you knowledge to select the right adviser – someone who's an expert, not an amateur or just a good salesperson. Once you have the best adviser you can find, hang onto them throughout your investment journey. This approach will allow you to focus on the sexier side of the undertaking – investing in the property, shares and the like – and means you'll be able to maximise and optimise your borrowings throughout your life.

What you don't know will hurt you

Boy, do I have a surprise for you. I guess you've probably heard the saying. 'You don't know what you don't know until you know it'? Well, it couldn't be more apt when it comes to structuring loans. I founded my financial advisory business in 2002. Prior to this, I was working at one of the international accounting firms, Deloitte, but a moment of insanity led me to think that

building a successful business would be an enjoyable challenge. I resigned from Deloitte and literally two weeks later I was sitting in my apartment feeling pretty confident about starting a mortgage-broking business because ‘How complex can mortgages really be?’ Remember, by that time, I already had a mortgage, which had been nice and simple to arrange and hadn’t taken up much of my time.

What I learned (very quickly) was that a mortgage can in fact be easy. However, it’s as easy to establish an incorrect loan structure as it is to establish a perfect loan structure – that’s the problem. You often don’t realise you have the wrong structure in place until afterward – sometimes many years later. Frustratingly, you may have to live with your mistakes, because often they can be too costly or difficult to correct. Therein lies the problem. Mortgage structuring can be insidious, and it’s deceptively easy to make a mistake.

It’s not often that I meet a new client who hasn’t made a costly mistake with a mortgage in the past. Many people make the same mistakes. They go it alone, thinking it’s a simple process, and learn through error that in fact they should have paid more attention to their financing. That’s generally when they come to see me. Frankly, it makes my job a lot easier, because they immediately value my advice. Other people’s mistakes have also provided me with heaps of ideas for the many articles I have written over the years, which have resulted in this book.

Get it right but keep it simple

I don’t want to make things any more complex than they need to be. I like simplicity: it’s easier to understand, easier to manage and typically lower cost. Often, it’s possible to keep things simple and yet still get things right.

This book will teach you everything you need to know about borrowing that I've learned over the past 17-plus years. I've tried to take what can be complex concepts and make them as simple as possible, and have endeavoured to ensure that the information in the book is communicated in a way that allows you to implement the ideas which are relevant to you straight away, so you get immediate value from my strategies.

I cover basic topics such as:

- the best products to use and when to use them
- how to manage your cash flow effectively and maximise your borrowing capacity
- how to maximise current and future borrowing tax deductions, and
- how to develop a good financial strategy so that you can safely and effectively build wealth.

I then delve a little deeper and give you a step-by-step description of how and why you should structure loans in a certain way. Importantly, due to my background (being a chartered accountant, tax agent and financial adviser) – and because tax and lending are heavily interrelated – I cover the tax considerations. My aim is that, by the time you've finished reading this book, you'll know more about mortgages than your average mortgage broker or lender.

In chapter 14, I've provided a summary of the key takeaways from each chapter. This will help you avoid making mistakes when you're in the throes of arranging and reorganising your loans, as it serves as a quick and easy reminder.

A WORD ABOUT JARGON

All industries have their own language and the mortgage industry is no different. Don't be put off by the jargon: 'borrowing', 'gearing' and 'leverage', for example, are one and the same thing – using other people's money. For your convenience, I've included a glossary at the back of the book.

It's not just about property

Although the majority of mortgages are used to fund property investments, the principles explained throughout this book can be applied to all forms of borrowing – for example to purchase a business or to invest in shares or managed funds or real estate investment trusts.

This book is guaranteed to save you money – every year!

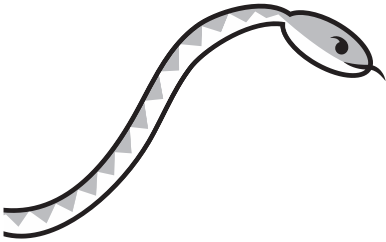
Interest is the single largest lifetime expense for an investor. The amount of debt investors carry affects their net worth and their cash flow, and can make or break their retirement goals. I guarantee that getting your borrowing right will save you a considerable amount of money in the short term and over the years. It's not uncommon, in fact, for the advice I give my clients on structuring their investments to save them well over $10,000 per year.

This is not a sales pitch for my business; it's a sales pitch for this book. Never underestimate the value of the right structural advice! It's a gift that keeps on giving, as good advice results in recurring savings. On the other side, beware: a poor structure will continue to cost you money each and every year. The cost of this book, plus the few hours of your life you'll invest in reading it, is a very small price to pay compared to what you'll gain from it.

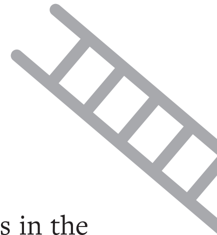
Good luck! I'd love to receive your feedback. You can connect with me in a few ways:

- I have a weekly blog which is also a podcast – www.prosolution.com.au/blog
- I frequent Twitter – @StuartWemyss
- I spend a bit of time on LinkedIn, too – www.linkedin.com/in/stuartwemyss

Most importantly, if you like this book, please share it. Tell your friends and family, and if you're willing to do so, post a review or recommendation of it somewhere online. The more people that read it, the more people will, hopefully, benefit.



1.
THE PLAYERS



Smart borrowers have an understanding of all the lenders in the marketplace, and of their individual pros and cons and when to use each one. I call them the 'players'. You need to know the players in any game; how else can you back the winning team? New players come in and out of the market, so it's useful to have an understanding of where the game is currently at in an historical context. A quick history lesson will give you a deeper insight into the workings of the mortgage market and, in turn, greater confidence when approaching lenders.

A history lesson

The finance industry has changed dramatically over the past 25 years. Once upon a time, hopeful home buyers had to dress up in their 'Sunday best' and approach their local bank manager in an attempt to secure a loan.

Prior to 1980, the finance industry was heavily regulated. This prevented smaller players from getting a foot in the door and

offering alternative products to those offered by the major banks, who held a definitive market monopoly. In the early '80s, however, the federal government realised that competition in the banking industry was desperately needed in order to expand the options available to consumers and keep the 'Great Australian Dream' of home ownership attainable.

So, a decade of systematic deregulation of the finance industry began in 1981, breaking down some of the barriers that had kept the power players in control for so long. Although this marked the beginning of a somewhat easier ride for new lenders, it was still slow going due to the regulatory red tape involved in getting a banking licence.

However, as the 1990s and early 2000s progressed, more and more lenders entered the marketplace, all vying for borrowers' business and offering hundreds of loan products with far less stringent approval criteria than previous generations of borrowers had had to meet.

Perhaps the most significant change during this deregulatory phase – and the biggest thing to hit the finance industry – occurred in 1992, when Aussie Home Loans was launched by John Symond, AM. Anyone born in the 1970s or earlier will probably remember Aussie's 'We'll save you' TV commercials. Before 'Aussie John' broke into the finance arena, the banks were making a profit margin of more than 4 per cent! Aussie John saw this profiteering, recognised the opportunity it presented and approached Adelaide Bank for wholesale money – to become a lender himself through a process called 'securitisation', which we'll discuss later in the book. He was able to make some serious waves by undercutting the banks' margin by about 2 per cent; this bold move encouraged other smaller competitors to enter the market and brought the bigger banks into line.

It changed the market forever. Credit unions, smaller mortgage managers and other wholesale lenders such as RAMS (who are

now owned by Westpac) progressively opened their doors to more and more home buyers seeking finance, once they could see a more level playing field.

Now, the major banks' profit margins (called 'net interest margins') are around 2 per cent, according to the Reserve Bank of Australia, and even lower for some of the smaller lenders trying to keep up in an increasingly cut-throat area. Essentially, Aussie John was the catalyst that forced the banks to halve the margin they'd been enjoying for so many years. Although we all gripe about current bank fees, if you add up the total revenue made from mortgages 20 years ago – including fees and the net interest rate margin – and compared it to what we pay today, in percentage terms consumers are now much better off.

That was really what the federal government hoped to achieve when it decided to deregulate. Deregulation opened up the banking industry and made it a lot more competitive, which benefited the consumer and encouraged more people into the housing market. Previously, there was really nothing driving or incentivising the banks to offer better deals to customers. They were naturally more concerned about their shareholders and the bottom line.

The global financial crisis in 2008

The global financial crisis (GFC) has largely been blamed on the bad lending practices of banks worldwide – particularly in the US and Europe. When the credit-crunch came (i.e. when it came time to pay back these loans), defaults on a monumental scale caused banks to go under.

In Australia, due to our stricter regulation and tougher lending criteria, our banking industry held firm. The government played a part in this by underwriting the banks during this difficult time, which meant that customers were guaranteed that their deposit funds would be safe, come what may. The government also lent its AAA rating to the banks to help them access funds from overseas.

These measures were criticised by many, because the fee charged for the lending guarantee was too high for the smaller lenders and so damaged competition, feeding the Big Four's dominance.

During the GFC, many smaller and second-tier players were acquired by the Big Four, giving them even more power in the marketplace. The government just sat on the sidelines and didn't object. Aussie Home Loans, Wizard and Bankwest were bought by the Commonwealth Bank of Australia, and Westpac purchased St. George and RAMS. Suncorp nearly went bust but managed to remain on its feet, mainly because no-one wanted to buy it and it had to find its own solutions.

Essentially, there aren't many lenders now, post-GFC, that are independent of the Big Four. This has given the Big Four even more market power and reduced competition, in my view.

Credit tightening from 2017

The banks' regulator, the Australian Prudential Regulatory Authority (APRA), started talking about tightening credit policy in late 2016. In early 2017, it released an updated regulatory guide (APG 223) which, among other things, required banks to make more enquiries into a borrower's living expenses. The banks made some significant and severe changes to their own policies as a result. The upshot is that, when you apply for a loan, banks will typically trawl through the most recent three months of your bank statements in order to determine how much you spend. They don't distinguish between discretionary and non-discretionary expenditure; as I said earlier, it's tantamount to a forensic investigation.

In March 2017, APRA became concerned about the volume of interest-only mortgages – that is, mortgages for which the repayments comprised only interest, and the borrower was not obligated to repay any of the loan's principal. At the time, over 40 per cent of all new mortgages were interest-only. APRA's

response was to demand that the banks reduce new interest-only loans to less than 30 per cent; when the banks well and truly achieved this target by late 2018, APRA removed the benchmark.

The consequence of these two changes (living-expense checks and reduced interest-only lending) is that the loan-application process has become significantly more difficult, onerous and time-consuming than it has been in the past.

The Royal Commission in 2019

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was established in December 2017 and conducted its hearings throughout 2018. It handed its final report to the Governor-General on 1 February 2019.

The Royal Commission didn't make any recommendations that would materially impact the mortgage market, other than recommending that mortgage-broker commissions be banned. The government has shelved that recommendation, as it recognised that it would be a disaster for the mortgage-broking industry and probably result in its demise – ultimately handing more market power to the big banks. The banks pay mortgage brokers a commission, which I view as a 'tax' that the banks must pay due to the otherwise low level of competition in the marketplace. In other words, mortgage brokers facilitate increased competition between banks, so the banks must pay for their existence to ensure that there's a good level of competition.

It's all about the margin

The banks might incessantly grumble about the low margins they make from home-loan lending, but it's unlikely they'll ever enjoy the levels these rates were at prior to deregulation. In fact, I think there may even be further margin contraction. In the UK and US, lenders are making less than 1 per cent on their home loan rates; although they're very different markets, I believe that we'll see

further erosion of the banks' margins here in Australia. However, the US and UK finance industries are more fragmented than ours – their largest banks don't hold anywhere near the 80 per cent market share enjoyed by the Australian Big Four.

Of course, a loss of revenue due to margin contraction has meant the banks have tried to counteract that dip in profits – primarily by focusing on bank fees. Consumers have reacted angrily to more and more fees and charges being introduced; however, they perhaps don't realise that they're still better off paying these costs than returning to the days when the banks had larger margins.

So, while the Australian market has made some progress, I think something dramatic has to happen before there's another large shift in terms of competition. I just can't see it happening anytime soon.

The Big Four

So, who's competing for your business today? Most of you will be familiar with the Big Four players: National Australia Bank (NAB), ANZ (Australia and New Zealand Banking Group Limited), Commonwealth Bank of Australia (CBA) and Westpac Banking Corporation. As I noted earlier, the Big Four's market share increased greatly during the GFC – peaking at over 90 per cent after their acquisition of many of the smaller lenders. Today, some smaller lenders have been successful at winning customers back, and the Big Four's market share hovers around 80 per cent (according to KPMG).

St. George, BankSA, Bank of Melbourne, Bankwest, Wizard and Aussie Home Loans are all owned and controlled by the Big Four, despite many of them still operating under their previous branding.

The four big banks are obviously very powerful financial institutions with large balance sheets. They offer a full range of products to clients, meaning that if a borrower establishes a relationship

with one of the big banks (as opposed to a smaller lender), they can cover off all their product needs – financial advice, property loans, share broking, the works.

> *A bank is a place that will lend you money if you can prove that you don't need it.* —Bob Hope

Second-tier lenders

What about some of the smaller lenders that have made the industry more affordable for us over the years? Let's take a look at how the finance-industry lightweights stack up against the heavyweights.

The Big Four are well known and recognised brands; however, some second-tier lenders have spent a lot of marketing dollars to get noticed. You're probably familiar with the likes of ING, Suncorp, Bank of Queensland, Members Equity (ME) and Bendigo Bank. They do their best to compete with the Big Four, but there are some differences. For example, sometimes their credit policies are more restrictive and conservative, particularly for investors and people with a lot of lending.

Credit unions and building societies

Credit unions and building societies are generally cooperatives, with many operating as not-for-profit organisations. They are usually formed by the aggregation of their 'members', who typically all work together in a specific industry, business or organisation; for example, Woolworths Employees' Credit Union and Police Credit Union Limited.

Rather than aiming to make profits for shareholders, traditionally, credit unions and building societies offer a service to their members. They take deposits from members and use that deposit base to lend money to customers. (They're now becoming a little more

competitive in how they finance their mortgage books, but that's beyond the scope of this book.)

Many credit unions applied for banking licences after the GFC because they wanted to start calling themselves 'banks' (which you can only do if you have a licence), to convey stability to existing and new members. For example, Ford Co-operative Credit Society now trades as Geelong Bank and Victoria Teachers Credit Union now trades as Bank First. They're still owned by their customers.

Working with a customer-owned cooperative that isn't driven to generate profit might sound like an attractive alternative to banking with the Big Four. However, credit unions and building societies have problems keeping up with the banks in terms of providing the full range of services. They might offer products such as personal loans and home loans, but they don't generally offer services such as financial planning, share trading or funds management, which is a potential disadvantage.

Also, these institutions don't have the scale that the big banks do, so their costs are typically higher. They might not make a profit, but that doesn't always mean they can deliver products at a lower cost.

Mortgage managers

Mortgage managers act as intermediaries, rather than actual product manufacturers or market makers. A mortgage manager will approach a wholesale funder such as Advantedge (NAB) or the Adelaide Bank (a lot of the larger banks sell wholesale mortgage funds) and ask for a lump sum of money to re-lend to their clients at a higher margin. For example, if I were a mortgage manager, I might approach Adelaide Bank and request a wholesale facility of, say, $20 million. I would then on-lend these monies to my clients. I might pay Adelaide Bank 3 per cent and charge my clients 4.5 per cent, thereby making a gross profit of 1.5 per cent.

As they're merely intermediaries, mortgage managers are not required to have banking licences. Their funder or funders take care of all the red-tape requirements on their behalf. Larger mortgage managers may have two sources of funding, whereas smaller players might only have a single source. They can have their own delegated lending authority, so they can approve loans on behalf of the bank that funds them, but they still have to comply with that bank's credit policies. In this respect, they almost work like a sub-branch of a larger lender.

During the GFC, many mortgage managers saw their sources of funding dry up or the funding costs spiral out of control, which permanently damaged a lot of these businesses – RAMS, for example, which is now owned and funded by Westpac.

These days, many mortgage managers attempt to create their own brand in the industry by targeting a specific market segment, so they don't have to compete with the banks; for example, offering only small commercial loans, self-managed super fund (SMSF) loans, non-conforming loans or 'low-doc' loans.

Generally speaking, they don't offer any products or services apart from mortgages, and therefore can't take deposits or operate like banks. They might have a branded credit card associated with their wholesaler but, ultimately, if you choose to establish a lending relationship with a mortgage manager, all you'll probably get is a mortgage.

Neobanks and online lenders

Online lenders have been around for more than ten years, with the highest-profile lender being UBank, owned by NAB. Online lenders can be a good solution for borrowers with very simple needs who don't need advice or assistance from a human; however, most of the customers I've spoken with tell me that setting up a mortgage online can be very 'clunky', especially if something

doesn't go to plan. That's when you need a human to call upon. So, they won't suit some borrowers, such as first home buyers and investors.

A neobank is a bank that is totally digital: that is, it doesn't have any branches or large call centres. Instead, it uses technology, artificial intelligence and machine learning to interact with its customers via apps and online services. There are currently five neobanks in Australia (being 86 400 Ltd, Volt Bank Limited, Xinja Bank Limited, Archa Pty Ltd and Judo Bank Pty Ltd), all at different stages of evolution, and only one, 86 400 Ltd, offers mortgages so far – although I expect the others to follow soon. It will be interesting to see if they're able to compete with the Big Four, and to what degree.

Non-conforming lenders

Non-conforming lenders, such as Liberty Financial and Pepper Money, target borrowers who don't conform to mainstream credit policies. These may include, for example, borrowers with defaults listed on their credit file, ex-bankrupt persons, and people who have been self-employed for only a short time. In an environment where credit is very tight, more borrowers are being classified as non-conforming.

Of course, non-conforming loans typically attract higher interest rates.

Private lenders or private funds

Private lenders or private funds are something of a dying breed. They generally consist of wealthy private individuals or businesses which have money available to lend out as mortgages. In the past, much of this lending was conducted through solicitors' funds, where the solicitor might have a number of wealthy clients

whose money was pooled together and then re-lent to private clients – acting in much the same way as a mortgage manager.

Again, these private lenders generally selected a niche to work within. For instance, in the late 1990s and early 2000s, if you had a bad credit rating due to a default or bankruptcy, the only lenders that might consider providing you finance would be private lenders.

However, the arrival of non-conforming lenders such as Liberty has substantially reduced the very specific pool of people that these solicitors or private funds lend to. These days, the only way private lenders can get any money out there in the market is if they offer short-term lending solutions or 'mezzanine finance' (typically a loan secured by a second mortgage or caveat) to property developers. If people need fast cash for a deposit to purchase a property or something of that nature, a private lender may perhaps loan them $50,000; they charge a very high rate of interest in most cases.

Where do lenders get their money?

When you're considering which type of lender to approach, it's important to have an understanding of how they fund their mortgages, as this could impact on your application being accepted, rejected or subject to the additional cost of lenders mortgage insurance (LMI).

There are three main ways a lender can fund mortgages:

1. through a deposit base
2. via domestic and/or international money markets (through bonds and similar instruments)
3. by securitisation.

We look at all three of these in detail.

PLAYING TO WIN

Astute borrowers know that not all lenders are equal. Dealing with a deposit-base lender, a securitised lender that must insure its loans or a small credit union that has customer limits can be very different. Selecting the wrong type of lender will hamper success.

Deposit base

Deposit-base lenders are quite literally lenders who take deposits, such as banks and, in some cases, credit unions and building societies. Depending on their capital adequacy requirements (that is, the required ratio of equity to deposits and mortgages held at any given time, which is set by government agency APRA), they can take a portion of their money and re-lend it as mortgages.

Keep in mind that there are still many traditionalists out there who have a lot of money tied up in their bank accounts. While this might not earn them a great deal of interest, their loyalty does provide the banks with a very cheap and flexible source of funding. The Commonwealth Bank has the biggest deposit book in Australia, which means that, mathematically, it could also offer the cheapest cost of funds in this country (depending on the make-up of its funding).

Money markets

Money markets have been used by lenders as a source of funding a lot more since the GFC. A bank or lender borrows money from ‘the market’ – which includes investors and institutions such as superannuation funds and insurance companies – by issuing bonds. The higher rated the lender is (i.e. the safer they are), the more cheaply they can access funds. An AA-rated bank, for example, will be seen as a low-risk borrower (issuer of bonds) and therefore will be able to source more money at a lower rate

than smaller, 'more risky' banks. This is where the Big Four have a major advantage over second-tier lenders with lower grade credit ratings, and (after the GFC) lenders that couldn't afford the government lending guarantee fee.

Securitisation

Securitisation isn't a new concept; however, it only came to the fore in the finance industry in the early 1990s. It's essentially a process of pooling a large number of individual mortgages and then reselling them back to the wholesale market. These are typically called 'mortgage-backed securities' (MBSes).

Normally, lenders will aggregate mortgages with similar credit strength. So, they might have $100 million worth of mortgages at an average charge rate of 4 per cent which they will then sell back to the market at perhaps 4.5 per cent or 5 per cent.

Institutional investors such as superannuation funds and large corporations traditionally bought these mortgages, secure in the knowledge that the capital they put in was backed by residential properties. This gave them peace of mind in terms of the creditworthiness of the finance, and they benefited from a higher rate of interest than they might receive on deposit or investing in bonds.

When the GFC began, the securitisation market all but closed overnight, with only a couple of transactions completed over the following 18-month period. This meant that some lenders no longer had access to any funding, nor did they have the ability to roll over old funding. No-one in the world wanted to buy mortgage-backed securities, because no-one knew which mortgages were toxic (i.e. at risk of default or already defaulted on). In 2009, the Australian government started buying MBSes in an effort to get the market moving again, but the securitisation market remains a shadow of its former self.

Everything moves in cycles, so I'm sure securitisation will be back. However, lenders have probably learned not to rely so heavily on

a single source of funding, and are aware that property values can drop dramatically, as was seen in the US during the GFC.

The primary benefit of securitisation is that the lender can shift its lending off its balance sheet; for example, mortgage managers can repay their wholesale facility and start again. I mentioned capital adequacy earlier – lenders can only take a certain amount of deposits to disperse for loans, because they must make sure they always have enough money available if people want to make withdrawals from their accounts. Capital adequacy requirements ensure banks maintain a safe amount of liquid assets and equity, keeping them financially strong. Securitisation, however, allows banks to move mortgages off their balance sheet so they can reallocate capital (or need less capital).

One of the potential drawbacks for customers of some of these securitised lenders is that they often require their mortgages to be insured, so that the subsequent mortgage-backed securities receive a lower risk rating. Normally, the bigger lenders who fund their mortgages from their balance sheet will only insure loans with a loan-to-valuation ratio (LVR) of more than 80 per cent. This means that if you want to purchase a property valued at $800,000, for example, you'd need to have a deposit of 20 per cent, or $160,000.

On the other hand, securitised lenders have a policy of insuring all loans, regardless of the LVR. Whether they then on-charge the expense of mortgage insurance to the borrower often depends on the LVR in consideration. Most lenders pay the cost of insuring the mortgage themselves if the borrower is seeking a mortgage below an LVR of 80 per cent, but charge the cost to clients who are borrowing above 80 per cent, in order to stay competitive with balance sheet lenders.

The downside of securitised lenders

The requirement for mortgage insurance on a loan from a securitised lender – under all circumstances and at any LVR – can constrain serviceability or the types of securities that mortgage insurers will accept. For example, if you wanted to buy an apartment with a small living area, even if you intended to borrow less than the 80 per cent threshold, you could be knocked back due to the insurer's policies. You're more likely to get a thumbs-up on your application for the purchase from a Big Four or larger second-tier lender which can fund your loan via means other than securitisation.

There's simply less flexibility in using lenders who purely securitise.

Let's take another example of the more rigid requirements of a securitised lender. In this scenario, you approach the CBA seeking 82 per cent borrowings and ask them to waive lenders mortgage insurance because you have a strong application. They can analyse applications on a case-by-case basis and may agree to your request, potentially saving you thousands in insurance fees. If you approached a lender like Resimac with the same request, by contrast, they wouldn't even consider it. They always have to pay mortgage insurance, and for any borrowings above 80 per cent, they will always on-charge this cost to the customer.

Investors who intend to borrow large amounts, perhaps spread across multiple loans, should give this point further consideration. Most mortgage insurers have an individual borrower exposure limit and will only insure loans up to $1.5 and $2 million per client. If you use a securitised lender, therefore, they might cap your total lending at $2 million, even if your LVR is less than 80 per cent. You need to take this into account for future borrowing ability, too – for example, if you want to increase the loan in future to access equity.

Mortgage insurers: the puppeteers

All of us are aware of the role lenders play when it comes to making or breaking our chances of getting into the real estate game. In fact, one of the first things we think about when buying a home is generally who we'll approach for a loan.

Most people give very little thought to the puppeteers behind the lenders – the lenders mortgage insurers that in many instances pull the strings and make the ultimate decision as to whether or not we obtain a mortgage. More and more borrowers are seeking to borrow more than 80 per cent of a property's value, which will subject them to a mortgage insurer's scrutiny, so it's important to understand what these faceless entities are and how they operate.

Mortgage insurers are third parties to the banks. The two largest mortgage insurers in Australia, QBE and Genworth Financial, effectively form a duopoly, controlling 97 per cent or thereabouts of the market share. In early 2019, APRA approved another mortgage insurer, Arch (listed on the US Nasdaq) to operate in Australia: this may generate some welcome competition.

Mortgage insurers sell their products to lenders, insuring them for any loss should they need to sell the insured security (property) due to loan default by their customers. The larger the percentage of a property's value that an institution is lending to a client, the greater the risk to the lender that they will make a loss if things go wrong and they have to sell the property to recover funds.

Let's look at an example, in which a bank lends a client 95 per cent to buy a home, but shortly after this, the market dips a little and the client can no longer afford to make the loan repayments. The bank might only realise 90 per cent of the property's value, should it take possession of the property and sell it (known as a 'mortgagee sale'). This leaves a shortfall of 5 per cent of the initial borrowings. In this case, the mortgage insurer pays the difference and the bank breaks even.

Recently, mortgage insurers have come under fire, accused of adding to the problem of the ongoing housing affordability crisis in this country, as theirs is just another expense to add to the overall cost of purchasing a property. According to Genworth's *FY19 Financial Results Presentation* of 5 February 2020, only around half of one per cent of mortgage insurers' contracts are ever acted upon – in other words, they're rarely forced to pay up on the loans they insure and are arguably making an enormous amount of money for doing nothing. This is particularly the case in a rising market, because as property values increase, the insurers' exposure is reduced, as lenders are more likely to realise the full amount of any loans they're forced to recoup through mortgagee sales.

Lenders mortgage insurance premiums have increased significantly since the GFC. Both LMI companies in Australia used to be owned by American companies and were thus exposed to the epicentre of the GFC. (Australian company QBE purchased US-owned insurer PMI during the GFC; Genworth is still American-owned.) However, large losses were not experienced in the Australian market, so there was no reason for such large premium increases.

In fact, it's probably only over the first two to three years of a loan that lenders are exposed to any potential loss. Further down the track, more breathing space is created between the value the property will realise on the open market and the loan amount, which is being reduced via repayments.

The issue of mortgage insurance is generating fierce debate within the real estate and finance industries, but I believe only a major catalyst – such as an increase in competition – will stir things up and change the situation. It's long overdue in the eyes of many, and would be most welcome.

> *Creditors have better memories than debtors.*
> —Benjamin Franklin

What does lenders mortgage insurance cost?

Mortgage insurance rates are generally charged as a percentage of the loan amount plus stamp duty. The percentage rate depends on two factors: the dollar amount borrowed and the loan-to-valuation ratio (LVR). The table following sets out some indicative rates, to demonstrate how the percentage charged increases with an increase in loan amount and/or LVR. For example, if you purchased a property for $570,000 and borrowed 90 per cent of its value (or $513,000), the mortgage insurance premiums could be 2.50 per cent of this loan amount (or $12,825).

	Loan amount		
LVR	**$500,000**	**$750,000**	**$1,000,000**
85%	1.00–1.20%	1.15–1.40%	1.20–1.40%
90%	2.40–2.80%	2.15–2.70%	2.15–2.60%
95%	2.96–3.40%	4.00–4.70%	4.00–4.70%

The cost of mortgage insurance varies significantly between lenders, so it's something you need to speak with them about directly. Often, borrowers don't even think to ask what the going rate of mortgage insurance is. They focus solely on the interest and fees applicable to a loan, even though the cost of mortgage insurance can vary by thousands of dollars, which is quite significant in the scheme of things.

Note that most lenders cannot vary the cost of mortgage insurance (i.e. it's a non-negotiable cost), as it's normally paid to a third-party. Insurance usually kicks in at an LVR of anything above 80 per cent; however, some lenders will consider lending up to 85 per cent without mortgage insurance, so the lines are somewhat blurred in this regard.

Picking who you'll play the game with

Each type of lender has various pros and cons and, in order to make sure you get the best deal possible, it's important that you weigh up their overall merits. Consider what they can offer you, not simply the rates they charge.

Here's a summary of some of the differences we've discussed in this chapter:

- Balance-sheet, 'deposit-base' lenders can provide more flexibility in loan approvals, as they're the sole decision-makers.
- Larger lenders can offer more bundled banking products to their clients. You may be able to negotiate a free banking and transaction account, for example, a lower rate on your mortgage and/or a free credit card.
- Mortgage managers who work within a niche sector of the market can be of benefit to relevant borrowers in that niche.
- Credit unions can be attractive to people who like to feel as though they're part of a family or dealing with a smaller, more personal business, rather than simply being another faceless number among the big banks' 10 million customers.

It's rare that a one-size-fits-all approach is appropriate. For investors, using a combination of different types of lenders can sometimes yield the best results, as it evens out all their differing pros and cons at a portfolio level.

Mortgage broker or direct to the lender?

The final consideration, when examining the evolution of the finance industry and how it currently works, is the emergence of mortgage brokers in the late 1990s and early 2000s. Mortgage brokers were once a rare commodity and borrowers were forced to sweat out the loan-application process in front of their

bank manager, but now, according to the Mortgage & Finance Association of Australia (MFAA), approximately 55 per cent of new loans are taken out via mortgage brokers. This market share continues to grow each year.

Establishing a relationship with a mortgage broker can bring significant benefits. Brokers represent a number of different lenders (often more than 30) and therefore can advise which lender offers the best product for your situation. This can save you a lot of time shopping around. However, you could simply create your own spreadsheet to compare these costs.

I think the real 'value add' is a broker's advice on things like loan structure and credit policy. A good broker will have all the knowledge this book contains, and probably more! For example, if you wanted to purchase a property with a living area of 40 square metres, a mortgage broker should be able to advise you which lenders will lend against that type of security. Also, and perhaps more importantly, if you plan to invest in several properties to create wealth, then a good mortgage broker can develop a longer-term credit strategy to allow you to make your investing goals a reality. Helping you achieve your financial goals sooner is a very valuable service.

As with most things, it's the quality of the person you deal with that will determine the success of the relationship. There are some excellent bankers and brokers in Australia; an excellent banker will probably offer more value than an average broker and vice versa. However, the most fundamental difference between a broker and a lender is that the broker offers choice (i.e. products from a number of different lenders) and isn't employed by or tied to one particular lender. Therefore, they're more likely to tell you the good, the bad and the ugly. They don't necessarily care which lender you use, as long as they win your business.

When was the last time your bank proactively called you up and told you that because their competitors are offering a lower rate,

they've decided to match it and reduce your current interest rate? Never, right? And it's probably never going to happen. However, good mortgage brokers do this all the time, because they need to retain your business and want to earn referrals.

Establishing a relationship with a banker (i.e. an employee of a lending institution) can be beneficial too, particularly if you run your own business and have extensive needs. However, even then, I typically advise clients to separate their transactional business banking and their borrowings and have these with two different lenders, so you have full control over access to information.

PLAYING TO WIN

Finance is a game which is ultimately played to help you achieve lifestyle and financial goals. Building a relationship with a good banker or mortgage broker is paramount to winning this game. Professional advice will save and make you a lot more money in the long run than a slightly cheaper interest rate. So, maintain perspective about this. You need a good banker or broker on your team if you're going to be successful.

Make sure your advisers are licensed

In 2011, the government introduced a requirement that all lenders, banks and mortgage brokers – anyone giving credit advice – had to hold an Australian credit licence, under the *National Consumer Credit Protection Act 2009*. The aim was to ensure tighter regulation of the people providing credit advice and to legally require them to ensure that any credit advice they give is appropriate. Perhaps the most significant advancement was the introduction of a requirement for the credit adviser to investigate and document why they feel that the product or products they're

recommending are 'not unsuitable' for the borrower – a pretty low burden of proof in my opinion.

One of the recommendations made by the banking Royal Commission in 2019 was to include a 'best interest' duty in the law – a provision that credit advisers must act in the borrower's best interest – which seems like a pretty obvious and basic requirement. At the time of writing, this Bill* was before the Australian Parliament but had not yet been enacted into law.

In any event, if someone offers you mortgage advice, make sure they're licensed to provide it.

* The not so succinctly named Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2019 Measures)) Bill 2019.