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Borrower Risk Guide

7 things that could go wrong with your mortgage (and how to fix it).

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You're about to borrow hundreds of thousands of dollars to buy a property. It's a big deal. Because we work with lots of Kiwis in the same situation, we've seen what can go wrong.

To help you be successful in property investment, we've prepared this document to let you know what could go wrong … and how to avoid these common problems.

While we've listed the 7 most common problems borrowers face when getting lending, there are some other more specific issues that crop up occasionally.

While we can't cover every single scenario here, it's important to recognise that this is why
you're working with a mortgage adviser. They can help you work through the problems so you
can become successful.

The quick read

All financial products have risks and disadvantages and obtaining a mortgage is no different. We want our clients to be fully informed, so we have published the *'Borrower Risk Guide (7 things that could go wrong with your mortgage (and how to fix it)'* This provides the high level risks and disadvantages. When the lender provides specific loan terms, then we will outline the specific benefits and key risks and disadvantages of those terms.

Below are the key risks and disadvantages with a summary. We have grouped the risks into four generic categories. Find out more by clicking each link or listening to our podcasts and other supporting documents on our website.

- **Interest rates can change:** Mortgages are typically long-term financial commitments, and over the period of your loan your mortgage interest rate may rise. This increases the total cost of your borrowing, and interest rates may rise to a level where you are unable to meet the repayments. This could result in a default on your mortgage repayments, leading to a potential situation where you may have to sell the property.
- **Property values may fall:** Property is a cyclical investment where values rise and fall. If values fall to a level where you hold less than the minimum equity in the property, then the lender may request that you contribute more capital. If you were unable to achieve this, then it could lead to a situation where you may have to sell the property.
- **Unable to restructure your loan:** The market may change, as could your financial situation. Therefore, you may want to restructure your loan to obtain more favourable terms. The lender does not have to agree to any restructuring, so you could find yourself with a less than ideal financial commitment.
- **All obligations guarantee:** In New Zealand, some mortgages may require a personal or a third-party guarantee, such as that provided by a parent. This means that if the loan repayments are not met, the lender can recover the outstanding debt by seizing assets from either the borrower or the guarantor, depending on the terms of the guarantee, to ensure the loan is repaid. In an extreme financial situation, you could end up losing your home and other assets.

#1

The build takes longer than the bank pre-approved you for

When the bank gives you a pre-approval, this confirms they'll lend you the money. However, the pre-approval doesn't last forever. It might be valid for 3-12 months (sometimes longer).

If the property takes a while to be built, your pre-approval might end before construction is finished. It's the same as looking for the right house but you haven't found the one yet.

If that happens, you'll need to do a new application to get the money.

But, over time the bank might change their policies, or something in your financial situation might change. For example, you might get a new job with a lower income.

If your pre-approval lapses, there is no guarantee that the bank will definitely say 'yes' when you reapply.

How do I fix it?

The best way to avoid this being a problem is by:

1. Getting a pre-approval for as long as possible. In some cases, you can get a pre-approval in place before you go unconditional.

   If you can, you might try to make your pre-approval longer than the expected construction timeframe.

   That way, even if the build takes longer, your pre-approval could still be in place.

2. Staying on top of your build updates. Every month you should receive an update from your developer showing the progress of the build.

   If it looks like the build is taking longer than expected, then you might start the process of getting a new pre-approval early.

   The more time you can give yourself (and your mortgage adviser), the better. This gives your adviser time to explore different lending options if your original bank says no.

#2

Your income goes down

(or your expenses go up) during the build

When your bank gives you the thumbs up (a pre-approval), it comes with some conditions. For instance, it will say that your financial situation “doesn’t materially change.”

For example, you can’t quit your job, have 5 kids, and expect the bank to still lend you the money.

Your financial situation will have “materially changed”, and you probably won’t be able to pay your mortgage. That’s why the bank wouldn’t lend you the money in this instance.

Basically, when the bank pre-approves you, they’re saying “yes, we’ll lend you the money as long as nothing big happens.”

Those are things like:

- You change jobs and take a lower income,
- You become self-employed,
- You take on large debts (like a car loan),
- Welcome a new-born into the family (since babies are expensive),
- Or anything else that the lender thinks will stop you from paying the mortgage.

How do I fix it?

Sometimes these changes in circumstances aren’t within your control. If you are made redundant and have to take on lower-paid work, that’s not entirely within your control.

Similarly, sometimes new arrivals in the family surprise us. That can mean that your family goes down to one income.

But, if you’ve bought a turnkey property, you’ve signed a contract. You legally need to pay for it. So what can you do if the bank pulls their pre-approval?

The best thing you can do – is not put yourself in the position where the bank pulls the pre-approval.

Sometimes, borrowers will take out massive new loans or voluntarily take a lower-paying job during construction.

If you are already in a position where the bank is willing to lend you a lot of money, doing these things might not be so bad.

But if your lending is tight. This is often not a good idea.

That’s why you want to speak openly with your mortgage adviser about taking on new debt (before you do).

If something happens outside your control, contact your mortgage adviser. If they have more time, they can explore different lending options.

If your adviser only finds out about your lower income 2 weeks before settlement (when you’re due to pay for the property), they can’t explore as many alternatives.

#3

Interest rates go up during construction

You won't be able to lock in a fixed interest rate until the property is built.

Over time interest rates will go up and down. And there is a chance that interest rates will increase between now and when the property is finished.

If interest rates go down, it can be beneficial to investors. But if they go up, it can impact cash flow substantially. Particularly if you take out a large mortgage.

Remember that banks will stress-test your mortgage application at a much higher interest rate. This gives them the confidence that you'll be able to afford your mortgage should interest rates increase.

This means you can likely afford your mortgage, even if interest rates go up while your property is being built.

While we can look at how much a mortgage would cost based on today's interest rates, this won't be confirmed until the code compliance certificate and title are issued (i.e. the property is built).

How do I fix it?

Unfortunately, there's nothing you or we can do about interest rates (if only). And while we can do our best to predict interest rates … no one has a crystal ball.

Forecasts are based on the most recent data, and data can change quickly.

Although you can't control interest rates, there are still some options around how to manage cashflow at settlement time, for instance:

- Working with your mortgage adviser to lock in the lowest interest rate possible
- Using a bank's cashback (if available) to help finance cashflow
- Increasing the term of your mortgages (where possible) to decrease your repayments
- Setting your mortgages (where possible) to interest-only
- Seeking to raise your income so you have more money

Financial commentators regularly discuss interest rates. Our sister company, Opes Partners, regularly update their interest rate predictions on their website and podcast: *The Property Academy* Podcast.

#4

The value of your property goes down

During construction, the value of your property can change. For instance, if you purchase a property for $600,000, it may increase or decrease while it's being built.

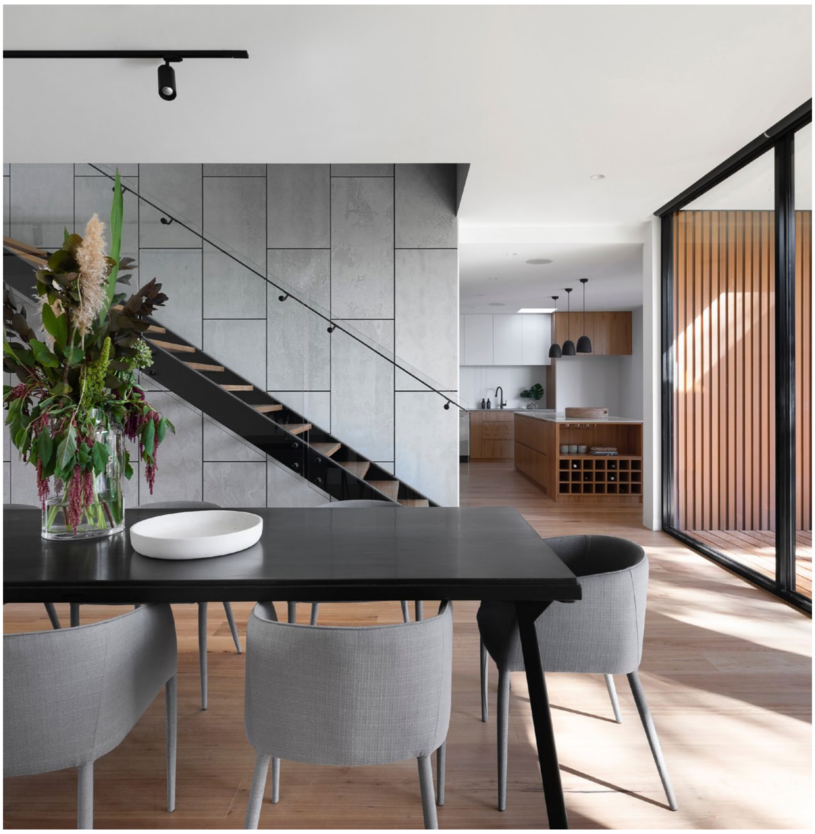
Obviously, an increase in value is good news for you because you've gained immediate equity.

But if it goes down in value, you still need to pay $600,000 for a property, even though it's only valued at $580,000 (for example) once it's built.

In this scenario, you will likely need to increase your deposit.

This is because LVRs (loan-to-value ratios) tell the bank it can only lend up to 80% of the property's value.

So, if the property value drops, the bank will lend you less money ... but you still need to pay the original price you agreed with the developer.



How do you fix this?

If property prices drop, a few options are available to cover the shortfall.

Talk to your mortgage adviser about the following:

- Using equity within your own home
- Switching to a bank that accepts purchase price as valuation (some do, some don't)
- Borrowing with a higher LVR from your bank (which may come with an additional fee)
- Seeing if a non-bank lender will lend to you at a higher LVR
- Using your own cash

You should also talk to your financial adviser about purchasing a property under your maximum ability to borrow.

For example, if the maximum amount you can borrow for an investment property is $700,000, perhaps you buy a property for $600,000.

This will give you some buffer if the market does change.

In this scenario, some property owners think: *"I'll just sell the property."* This is often not a good idea.

First, you'll lose money because the property has decreased in value. In addition, you'll also need to pay real estate and legal fees. So you will very likely lose money.

Remember, you purchased this property for the long haul. You wouldn't consider selling if your property had increased in value by $50k, so don't start panicking if it falls by $50k.

The best thing to do is hold your nerve and find a practical way to make up the difference.

#5

You struggle to get the deposit for your property

When you buy a new build property, there are two deposits to think about:

- The developer deposit
- The deposit for the bank

Together, these combined make up the 20% required for a new build.

You'll typically pay 10% to the developer when you can go unconditional.

Then you'll need another 10% once the property is finished. It's this second deposit where investors sometimes get caught out.

Here's why.

Let's say you're borrowing your deposit against your own home (or another property).

You borrow the initial 10% against this property when signing your contract with the developer.

You then wait for the property to be built and then approach the bank to borrow the other 10%.

But what happens if the value of your own home goes down? You might not be able to borrow the rest of the deposit for your new property.

This can put you in a tough position because you don't have the deposit required from the bank.

How do you fix this?

Often your mortgage adviser will set up a large revolving credit (or a similar loan) against your home. You'll use this money as the deposit for your investment property.

It's a very good idea to set up the entire 20% deposit right at the start.

When you go unconditional and commit to buying the property, you transfer 10% to the developer's solicitor. Then the other 10% is still available for when the property is built.

#6

You spend the deposit

(you weren't meant to)

You won't believe this … but sometimes investors spend the deposit money (the remaining 10% we mentioned on the previous page).

For example, if you follow the steps mentioned previously, your mortgage adviser will set up a large revolving credit against your home.

After your transfer some of the money to the developer, you will still have a lot of money available in that account.

This is where willpower comes into play.

You must not spend this money. Don't use it to buy a car. Don't use it to buy a boat or a new lounge suite. Use some of your other money if you want to go on holiday.

That money is already allocated for your new build investment property.

If you spend it, you may not be able to pay for your property. If that happens, you could lose the money you've already paid the developer (tens of thousands of dollars). And this process is often very stressful.

How do you fix this?

Simple. Don't spend your deposit money.

Talk to your mortgage adviser if you want funds for other things (renovations, cars, boats, holidays …). They may be able to get you the money for this.

#7

The bank doesn't keep giving you interest only

Many investors use interest-only loans to improve the cashflow of their properties.

That's because when you use an interest-only loan, you don't pay the loan down.

You just pay interest.

That means your mortgage repayment will be lower than if you were paying interest and also paying down the loan at the same time (that's called a principal and interest loan).

However, interest-only loans aren't what they sound like. Because the interest-only period doesn't last forever.

The bank will generally only give you an interest-only period of 2-5 years only, depending on the lender.

Let's say the bank approves you for a 30 year loan and a 5 year interest only-period.

This means for the first 5 years you'll pay interest-only. Then you have to pay interest and pay down the loan over the remaining 25 years.

If at the end of the first 5 years, you want to continue on interest only, you need to apply to the lender for an extension.

But what happens if the lender says no?

How do you fix this?

There's a quirk in how banks assess whether you can afford an interest-only loan.

They don't look at whether you can afford the interest-only repayments. Instead, they look at whether you can afford the repayments once the interest-only period ends.

Let's say you take out a 30 year loan with a 5 year interest-only period. They'll assess whether you can afford to pay off your loan over the remaining 25 years. That's both interest and principal.

After the first 5 years, you then decide to apply for another 5 year interest-only period. They'll assess whether you can afford to pay off your loan (principal) over the remaining 20 years.

That's why it gets harder to get your interest-only period approved over time.

There are a couple of tactics you can use:

- You might move your loan to another bank who is willing to give you interest only
- You might extend the term of your loan back out to 30 years (this makes the repayments look smaller)
- You might cancel some credit cards or pay off debt, so that the bank thinks you can now afford the loan.

If none of these options work, you will need to move to principal and interest payments. This means your repayments will increase.

How do you deal with the risk?

On a personal note, here at Opes Mortgages, most of us are property investors and mortgage borrowers. Collectively, we've seen most things go wrong when Kiwis take out a mortgage.

We've also learned what things tend to surprise property investors.

That's why – because we fully believe in transparency – it's vital that you fully understand the situation you are getting yourself into. Let's face it, to invest you'll often take on substantial debt, and a lot is at stake.

Yes, the returns from property investment can be enormous and life-changing.

But it comes with risk, and at some point, something will happen that causes you some concern. That's life.

If you want the returns, you've got to deal with these risks, which means dealing with these issues as they come towards you.

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Related Parties:
When you purchase a property, often you need help with some of these services that our related companies can offer. Within this guide we have recommended the following related businesses of which our shareholders also have interests in:

- Opes Property (real estate sales)
- Opes Partners (initial wealth planning based on property investment)
- Opes Property Management Limited
- Opes Accounting Limited (accountancy services).

There is no obligation to use our related companies but if you do, then Opes Mortgages will benefit. Please read our publicly available disclosure **HERE** to find out how we operate and look after your interests.