i.e. financial services

THINGS YOU SHOULD KNOW ABOUT HOME LOANS

Types of home loans

There are generally five different types of home loans available, featuring variants on interest rates. These are:

- introductory or ‘honeymoon’ rate
- variable rate
- fixed rate
- split loans (a mix of fixed and variable rates)
- interest-only

What is a variable rate?

A variable rate, as the name suggests, is one which fluctuates according the official cash rate set down by the Reserve Bank of Australia. During the contracted term of your home loan, a variable rate can go up, as well as down at any time, altering your set repayments.

Variable loans include basic, standard or revolving line of credit products and are traditionally the most flexible. These days, standard variable loans can offer a wealth of features. If used properly, these features can help to pay off a home loan quickly. Variable loans may allow you to offset your mortgage, make extra repayments and redraw. They also allow you to pay your loan out early. Many institutions offer basic or “no-frills” variable loans with a lower interest rate. In the past, these loans were rate based with little or no extras. Recent mortgage competition has seen these loans offering features as a way to distinguish them from other basic products. Make sure you find out if your institution has a basic product with the features you require as it could meet your needs at a lower rate.

What is a fixed rate?

Fixed loans generally allow a borrower to lock in an interest rate for a particular period of time, normally 1-5 years. Borrowers who choose a fixed rate are assured their repayments will be set for the fixed period and that if interest rates rise, their rate will remain the same. However if interest rates drop, a fixed loan will keep a borrower at the higher rate.

What is a 'honeymoon' rate?

A home loan with an introductory, or honeymoon, rate simply means you pay a lower rate of interest for the first couple of years before the repayments revert back to the original interest rate. This gives you a little more time to get on your feet and perhaps buy some new furniture for your home before settling down into paying off the home loan.

What is a split loan?

A split loan is a pre-determined portion at a fixed interest rate and the rest at a variable rate of interest. If you want the assurance of a fixed rate but want to take advantage of rate drops, you could consider splitting your loan. Fixing a portion of a loan gives a flexibility trade off. The fixed rate portion of a loan generally has more restrictions than a standard variable. Most fixed rate loans do not let you make extra repayments or pay out the loan (refinance) during the fixed period. Features such as redraw or mortgage offset are usually not allowed during the fixed period of a loan.

What is an interest-only loan?

Interest only means simply that no principle repayments are required. You only have to pay the interest portion. Borrowers can't have more of their loan outstanding then they originally borrowed so interest repayments are required to keep the loan balance below that amount. Theoretically, the loan need never be paid out as long as interest payments are made. Some loans can be split with an interest-only portion to reduce the repayments necessary in the early years of a loan. However, most people expect to build equity in their property and paying interest only, instead of normal repayments, will not do this. Interest only is common in fixed rate loans where the ability to calculate future interest means interest can be paid in advance. It is also used by property investors to keep cash flow on an even keel.

Doing your own home loan analysis

When analysing your requirements, remember it all boils down to whether your finances can cope with the variances of interest rate movements during the period of your loan. The main reason you fix your interest is because you are confident the rate will go up in the next few years and, in theory, you should actually save money by committing to the fixed interest. For some borrowers, it is important to know exactly how much of their income they must pay towards their loan. These borrowers don't like 'surprises' such as rate rises that throw their budgets into disarray. On the other hand, a popular way to go is to fix part of the loan and leave the rest as variable. So you get the best of both worlds – a partial hedge against rate rises and a benefit if rates go down. Be mindful that there are usually costs involved with fixing or unfixing the rate of your loan and in switching from one lender to another, so make sure the benefits outweighs the costs.

Selecting home loan features

It is imperative to clearly understand your immediate needs and anticipate future needs, as some product features you may want come at a cost. You also need to understand the term of your loan, if the home loan has a redraw or offset facility and if it does, how much does it cost to use. Another important question to ask is can you make additional repayments without penalty?