Types of Home Loans

A home loan is a type of debt, it is a redistribution of assets over time between a lender and a borrower. The borrower receives money (principal) from the lender and is obligated to pay this equal amount back to the lender at a later date. In many cases this is paid back in equal amounts over time.

The lender provides the money at a cost, being the interest cost, which is also required to be paid to the lender to use their funds.

We borrow money to enable us to purchase an asset (a house, a car, an investment property, etc.) earlier than we would otherwise have been able to as we may not have the capacity to save the money ourselves to buy the asset outright.

The two main components of a loan are the principal and the interest and this is where most loan types vary according to our preferences for repayments.

Principal and Interest Loans (P&I): These loans are where a combined principal and interest amount is repaid regularly over the life of the loan. On a $300,000 loan over 30 years at a 7% interest rate, the repayments would be $1,996 per month.

A home owner should consider taking a P&I loan to reduce the overall debt or mortgage owed over time.

Interest Only Loan (IO): This is where interest only is paid for a specified period and then the loan reverts back to a P&I after that period. The IO period can vary between lenders, some as little as 1 year with others going to 15 years for an investment property but the calculation for serviceability will decrease dramatically as it is calculated as being able to repay the full loan over the remaining period of the loan. Using the example above, an IO repayment would be $1,750 per month.

An investor will consider an IO loan to minimise cash outflow and maximise tax deductions for interest expense.

Variable Interest Loans: This is where the interest rate will vary during the life of the loan. For many lenders it has been traditionally tied with the Reserve Bank of Australia (RBA) cash rate but lenders have moved away from a direct correlation and are setting their own interest rates independent of the RBA. Lenders are very quick to pass on any rate increases but take some weeks to pass down any decreases.

These loans can be either P&I or IO.

Fixed Interest Loans: This is where the borrower chooses to lock in an interest rate for a period, irrespective of what the RBA does or the lender does. The periods can be from 1 year to 15 years but most lenders will only offer up to 5 years.

These loans can be either P&I or IO. Borrowers may choose a fixed rate to provide some certainty as to their repayments. Caution needs to be taken if the loan contract needs to be broken or paid out prior to the end of the fixed period. Lenders lock in the funds and they will charge a break fee (if applicable) for early repayments. Fixed rates are generally higher than variable rates as they include a premium to protect against the risk of rates rising but at certain periods of time, some fixed rates are lower than the variable rate.

Split Loans: These are simply of mix of the above, perhaps 50% of the loan is fixed P&I and 50% is a variable IO. It provides flexibility for the borrower.

Line of Credit (LOC): This is an "all in one" account, almost like a credit card where you have a limit and use the funds and make repayments as required. They provide flexibility as there are no set amounts needed to be repaid and salaries and other income can be directed into this account but great caution is needed as the tendency is not to pay it down. The interest rate tends to be higher for a LOC than a normal loan account.

Honeymoon Loan: This is where a discounted introductory rate is offered for the first few months or years. This is a product aimed squarely at first homebuyers.

Most of these loans will 'roll over' (revert) to the standard variable rate after the introductory period. This means that any benefit you may have had by way of a cheap rate may be negated by the fact that you might now be paying what is generally the most expensive rate in the lender's variable suite.

Construction Loans: When building a new home, you will not need the entire amount of the loan drawn down all at once. If you did this, you would be making interest repayments on the entire amount right from the start and not just on the amount needed at the time. Construction of a dwelling is generally divided into five stages. These are as follows:

- Purchase of the land
- The pad (floor – also known as 'bearers and joists' for wooden floors)
- Roof (usually including frames)
- Lock up
- Final

With a construction loan, you can break up the drawdown of the loan amount into five progressive draws, which parallel the construction phases. As one phase of the construction is complete, you are able to draw down the next portion of the loan.

This means that interest is only being calculated on that amount which has been physically drawn down, and you are only making repayments on the portion you have used. When construction is complete, you can nominate which product or loan type your loan reverts to.

When you decide to build and apply for a construction loan, the lenders will need to see, at minimum, council approved plans and a fixed-price building contract, before they will unconditionally approve a construction loan.

After each phase is finished, a valuer will normally go out to inspect it to make sure that the phase is complete according to the requirements set out in the fixed price building contract. Once the valuer is satisfied, they will contact the lender and authorise the next payment.

To ease the financial burden during the construction phase, construction loans are usually interest-only. The interest rate may be slightly higher than that charged on normal residential loans, but should be less than that of a line of credit/equity rate.

Bridging Loans: This is a short term loan (up to 6 months) that covers the gap period between purchasing your new property and selling your old one. Bridging finance allows you to obtain finance to 'bridge' the gap between having to pay for a new property and receiving the proceeds from the sale of your existing one.

The lender will take security over both properties until the sale of the existing one is complete. Usually the bridging amount or 'peak debt' will not be allowed to be above 80% of the value of both properties. Some lenders will allow you to capitalise the interest payments (add them onto the loan) for a period of time or until the 80% limit is reached, to ease the financial burden on the borrowers. The bridging loan is usually separate from the lender's normal products, and may be slightly more expensive, however the borrowers nominate which product their loan defaults to after the bridging period is over.

When you sell your existing property you just pay the proceeds from the sale off the balance on the bridging loan, and revert to your nominated loan product.

Reverse Mortgages: The reverse mortgage loan was introduced to the market to cater for retirees wanting to take advantage of the equity they have in their home and use it to supplement their retirement income or be able to make lifestyle decisions. Seniors can use this type of loan to borrow money against the equity they have in their property, and have it paid to them in either a lump sum or in instalments, depending on the lending institution involved.

Generally all repayments, fees and charges will be added to the loan balance each month so that the borrowers don't have to make any payments whatsoever. The lender recoups the repayments and fees when the borrowers pass away, the property is sold or the borrowers no longer live in the property. The borrowers may make payments at any stage if they wish to reduce the loan balance.

To qualify, the borrowers will generally need to be over 65 years of age

Accommodation Bonds: An Aged Care Accommodation Bond loan provides a flexible solution for senior clients who wish to retain the benefits of owning their own home and at the same time secure a place in a residential aged care facility of their choice.

It enables you to continue to own your own home, whilst renting it out to generate additional income, allow family members to move in, or simply arrange a more orderly sale of the property. It also enables you to retain your Centrelink entitlements for longer. There is no requirement to make loan repayments over the life of the loan unless you choose to do so.

Interest fees and charges are capitalised to the loan and repayment is deferred until the property is sold, the borrowers are no longer living in the house, or the borrower(s) has passed away.

Low Doc Loans: These are designed for borrowers who would not normally comply with the usual income verification policies for standard home loan products and lenders do not require traditional proof of income such as company financials or tax returns. Instead, borrowers generally complete a declaration that confirms they can afford the loan. This is known as self-certification. These loans are particularly attractive to self-employed or full-time investors who may have difficulty showing a high level of income, as a result of either writing off a number of expenses, reinvesting profits into a business, or being slow in lodging their tax returns. Many lenders post GFC require ABN and GST registration as well as BAS statements or bank trading statements to verify income to an extent. Some lenders may just require self certification and an accountant's declaration.