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Report: Mortgage strategies 7-Feb-2007

Chasing the lowest interest rate may not be the right strategy to pay your mortgage off quickly.

The type of mortgage you have, and the way you handle your finances, make a surprising difference.

Our five case studies have the same-sized mortgage and the same family income. One of them saved over $50,000.

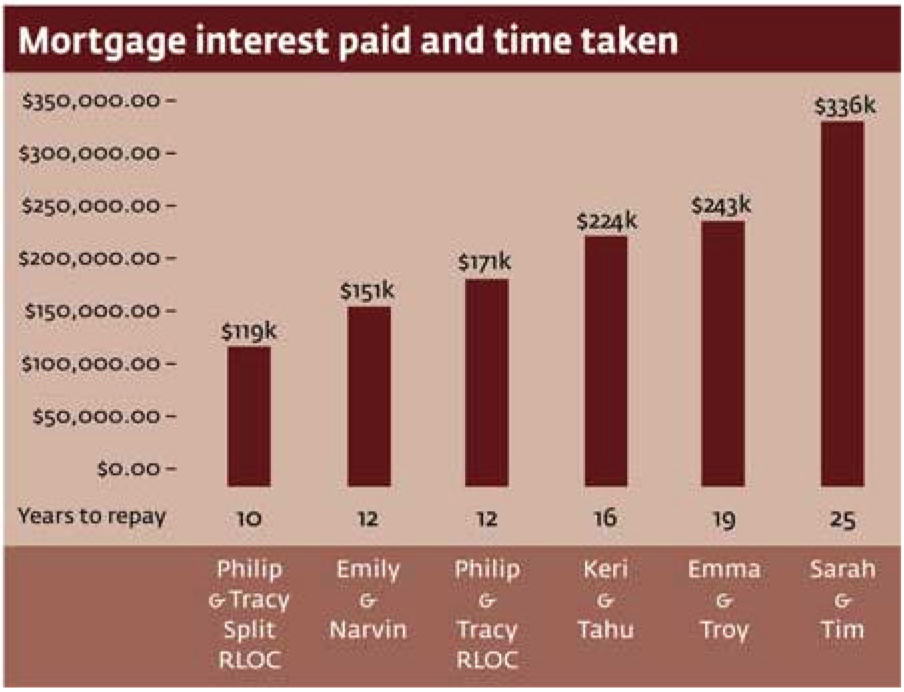
Plus, check out our mortgage guide for the latest rates, calculators and more.

The five mortgage strategies

With the help of the independent financial-services firm Cannex, we show you how five different couples and families with the same-sized income and mortgage decided to handle their finances.

We haven't just compared interest rates and terms: we've looked at the total financial situation of our fictional families.

The graph below illustrates the mortgage interest paid and the time taken to pay off the mortgage for each of the families (with two options for one of the families).



The five strategies that we've compared use the following types of mortgage as the cornerstones of their finances:

- Tracy and Philip opted for a revolving line of credit mortgage at the floating rate (we show two options for this mortgage).

- Tim and Sarah have a two-year fixed-rate mortgage. With their two young kids, Henry and Buddy, they have extra outgoings and so make only minimum repayments.

- Emma and Troy also settled for a two-year fixed-rate mortgage but their strategy is to increase their monthly repayments as much as they can.

- Narvin and Emily have a two-year fixed-rate mortgage. They've decided to save up and make regular lump-sum repayments.

- Keri and Tahu took on a split 80/20 mortgage - 80 percent is on a two-year fixed rate and the remaining 20 percent is floating. Their first child Sam has just arrived and they wanted the security of most of their mortgage being fixed.

All of our families have a $250,000 mortgage and a combined after-tax income of $63,455.

Their savings account is taxed at the same rate as their income. Most of our families are savvy credit-card users, so won't be paying any interest on their card as they pay off their balance every month. Some of our families have an online savings account earning 7 percent interest.

The interest rate for our mortgages is the average rate for five major lenders, and we've kept the same interest rate over the life of the mortgages.

The four families with fixed-rate mortgages re-fix for two years at each renewal. The life of all mortgages is 25 years.

Profile families	
Combined pre-tax income	$80,000
Loan amount	$250,000
Net annual income	$63,455
Net monthly income	$5,287.92
Average monthly expenses	$2,400.00
Disposable income	$2,887.92

Make your money work smarter and harder

The bank may be your friend when it comes to signing up for the mortgage, but it's an expensive friendship. The longer you're friends, the bigger the mortgage-monkey on your back.

The bank always wins. You can chase low mortgage-interest rates, but is it the right strategy? Your overall aim is to pay the least amount of interest over the life of your mortgage. So you need to make your finances work smarter and harder.

Your mortgage is just another financial tool like your savings account, current account or credit card. You need to work them together, to minimise the mortgage interest you pay. That way you'll own your home sooner.

1 Revolving line of credit

Our first case study couple, Tracy and Philip, have a revolving line of credit (RLOC) mortgage.

A revolving line of credit mortgage works like a huge overdraft account.

You have to be a disciplined saver to make this type of loan work, as it's very easy (and tempting) to continue to borrow up to your credit limit as your mortgage reduces. "We need a better car." "No problem, we'll just put it on the revolving credit."

To make their RLOC mortgage work for them, Tracy and Philip must use it as their only account. All of their salary and any other income are paid into the account.

They pay their household expenditure by using the interest-free period on their credit card. This allows them to keep money in their RLOC for as long as possible - money otherwise used to pay bills and retailers. Interest on their RLOC is calculated daily, and keeping their money in their mortgage account for as long as possible reduces the amount of interest they pay.

Our calculations assume Tracy and Philip put 80 percent of their expenditure on their credit card (paid off monthly). This alone can save them over $4000 in interest over the life of the mortgage - and that's tax-free savings because they haven't had to earn it from income or interest on their savings that has been taxed.

Any extra money goes into the RLOC to reduce the interest they pay and help repay the mortgage faster.

Using their RLOC in this way reduces the time Tracy and Philip are paying their mortgage from 25 years to just over 12 years (see table below).

What if they have a split loan?

The figures for Tracy and Philip change dramatically for the better if they use the RLOC strategy to manage a split mortgage.

In this case, they put $50,000 on the RLOC and $200,000 on the two-year fixed portion. Tracy and Philip can be mortgage-free in an amazing ten years - and save over $50,000 compared with their first option. They do this by keeping the repayments to the fixed portion at the minimum level, using the RLOC as their only account, and being savvy spenders with their credit card.

Concentrating all their resources in the RLOC part of their loan reduces the interest they pay, and so they can pay off the RLOC faster.

Every time the fixed portion of their loan is up for renewal, they increase the RLOC again to the full $50,000 limit and use the money to make a lump-sum payment that reduces the principal on their fixed mortgage.

They just have to repeat this strategy five times and their mortgage is paid.

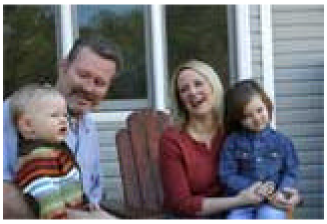
Revolving line of credit (RLOC)	
Interest rate	9.56%
Minimum monthly repayment	$2887.92 ($1,991.67 interest only)
Extra repayment	$896.25
Total monthly repayment	$2,887.92
Contribution to savings account	n/a
80% expenses by credit card	$1,920.00
Total interest paid on loan	$171,593.96
Loan will be repaid in	12 years 1 month

Split loan	
$200k on 2-year fixed rate loan	8.15%
$50k on RLOC	9.56%
Minimum payment to 2-year fixed loan	$1,563.56
Payment to RLOC	$1,324.36
Total repayment to both loans (100% disposable income)	$2,887.92
Assuming the borrower will use credit card for 80% of their monthly expenses	$1920
Total interest paid on loan	$119,216.58
Loan will be repaid in	10 years

Notes:
(1) Total repayments are kept constant at $2,887.92
(2) Every 2 years, RLOC balance returns to $50k and the principal reduced on the fixed-rate portion.

2 Fixed rate, minimum payments

Two-year fixed rate with minimum monthly repayments



Sarah and Tim (and our other fixed-rate families) are very popular at the moment. The banks are chasing two-year fixed-rate mortgage holders like they're an endangered species - it's big business.

Sarah and Tim find it hard to make ends meet because there's also Henry and Buddy (both under 5).

They can't make use of the fastest way to pay off a fixed-rate mortgage - either by increasing their monthly repayments or saving up in a separate account and making lump sum payments when they re-fix the loan every two years.

Making only the minimum monthly repayments gives Sarah and Tim the extra cash they need for daily living - but they have no savings. And because they're worried about getting into debt, they don't use their credit card to pay their everyday expenses.

This is the worst way for Sarah and Tim to manage their finances.

They'll pay a huge $336,000 interest bill and their mortgage will last the full 25 years. While having two kids limits their options, they can still pick up some tips from our other families.

Two-year fixed rate - minimum monthly payments	
Interest rate	8.15%
Monthly repayment	$1,954.45
Extra repayment	n/a
Contribution to savings account	n/a
Total monthly repayment	$1,954.45
Expenses by credit card	n/a
Total interest paid on loan	$336,334.41
Loan will be repaid in	25 years

3 Fixed rate, higher payments

Two-year fixed rate with increased monthly repayments

Emma and Troy want to get their mortgage down as quickly as possible before they have children, so they've decided to increase their monthly repayments by $200 a month.

Because of these extra mortgage payments, Emma and Troy don't bother with a savings account. They spend any remaining disposable income and don't put their living expenses on a credit card.

They'll need to be careful if they want use their spare cash to make extra repayments - usually you can't do this more than once a year. And if you up the payments you may not be able to change them back.

As well, banks often have a limit on the amount you can repay on fixed-rate mortgages before penalty fees kick in.

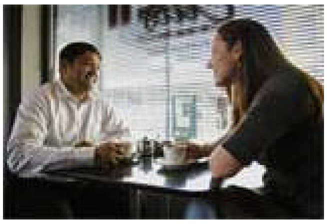
Westpac, for example, limits any increase in monthly repayment to 20 percent of the original monthly payment and any lump-sum may attract an early repayment fee. ANZ limits extra payments to an annual lump sum that's either $10,000 or five percent of the principal (whichever's the smaller).

Simply increasing their repayment by $200 per month takes nearly six years off Emma and Troy's mortgage. This is good, but not as good as the RLOC strategy.

Two-year fixed rate - $200 extra monthly repayment	
Interest rate	8.15%
Monthly repayment	$1,954.45
Extra repayment	$200.00
Contribution to savings account	n/a
Total monthly repayment	$2,154.45
Expenses by credit card	n/a
Total interest paid on loan	$243,878.71
Loan will be repaid in	19 years 2 months
Note: Because the rules for extra payments are different across banks, we've used a fixed amount of $200 per month extra.	

4 Fixed rate, lump sum payments

Two-year fixed rate with extra lump sum payments



Narvin and Emily know a thing or two about saving.

Their plan is to save a lump sum in their online savings account to reduce their principal each time they renew their mortgage (every two years).

Using their savings in this way means Narvin and Emily don't have to worry about meeting their bank's maximum monthly or lump-sum repayment restrictions. Nor do they get hit with early repayment penalties.

Narvin and Emily put 80 percent of their household expenses on their credit card.

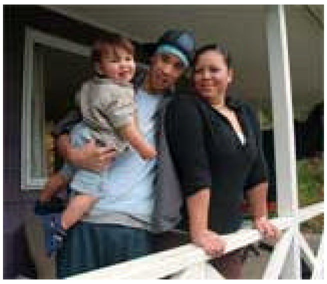
Being savvy, they pay off their card monthly and always within the interest-free period. This keeps their money working longer for them, by earning 7 percent interest in their savings account.

After paying for their household expenses, Narvin and Emily put all of their remaining income into their savings account.

After just over 12 years, Narvin and Emily have not only paid off their mortgage but also have nearly $40,000 in savings (after tax on their interest).

Two-year fixed rate – lump-sum payment on renewal	
Interest rate	8.15%
Monthly repayment	$1,954.45
Contribution to savings account	$933.47
80% expenses by credit card	$1,920.00
Maximum lump sum payment on renewal	$20,000.00
Savings account balance end of loan	$39,676.15
Tax paid on interest from savings	$6,180.14
Total interest paid on loan	$151,980.19
Loan will be repaid in	12 years 1 month

5 Fixed and floating



Keri and Tahu want the best of both worlds - a combination mortgage where they have a portion of their mortgage on a flexible floating rate and the remainder on a fixed rate.

They want to keep most of it on a fixed rate now that they have baby Sam.

The fixed portion of their loan allows them to take advantage of a lower interest rate, and they have the certainty of knowing what their repayments are.

Keri and Tahu can make extra payments to the floating-rate portion of their mortgage at any time without penalty. This could be handy if they inherit some money or one of them gets a more highly paid job, but, unlike the revolving line of credit mortgage, they can't re-draw the money back.

The extra flexibility means they don't have to worry about rising interest rates on the fixed portion of the loan. And if interest rates go down, the repayments on the floating portion of their loan will decrease.

Keri and Tahu have decided on a split of $50,000 on floating and $200,000 on a two-year fixed rate.

They continue to keep $50,000 on a floating rate each time they renew. They also keep their repayments at $200 a month more than the minimum.

Managing their mortgage in this way should see it completely paid off in less than 16 years.

80% two-year fixed and 20% floating with extra repayment	
Interest rate fixed	8.15%
Interest rate floating	9.56%
Monthly repayment	$2,002.15
Extra repayment	$200.00
Contribution to savings account	n/a
Total monthly repayment	$2,202.15
Expenses by credit card	n/a
Total interest paid on loan	$224,610.56
Loan will be repaid in	15 years 10 months

Revolving credit pros and cons

- Although revolving line of credit (RLOC) mortgages have a higher floating interest rate, we've calculated this has little effect on your financial situation because you're able to pay the mortgage off well ahead of time. (See our revolving line of credit case study.)
- You have the extra flexibility of being able to re-borrow at any time against the growing equity in your home, as your mortgage reduces.
- Any pay rises or unexpected lump sums can be put to work immediately on reducing your mortgage without paying any penalty fees.
- By concentrating all your money in one account, and not having a separate savings account, you don't pay any tax on the interest from your savings. All the savings kept in your RLOC account are effectively tax-free.
- As your mortgage is tied to the floating rate, the lower it goes the more you save. You aren't locked in to a fixed rate. But this goes both ways: you must make sure you have enough income to cover your repayments if the floating-rate rises. You also have to avoid the temptation to put more borrowing on your RLOC, or make only minimum repayments, if your circumstances change.

Fixed-rate pros and cons

- With a 100 percent fixed-rate mortgage, you know exactly what your repayments are. This makes it easier to budget, especially for families with children.
- When your mortgage is fixed, you are locked in until the end of the fixed term - unless you are willing to pay to get out of it. If you have an increase in income, come into some unexpected money, or just want to get rid of the mortgage-monkey then you may have to wait until your next renewal. That's why having part of the mortgage on a floating rate can make sense.
- Being tied to the bank for the term of the mortgage also makes it easier for the bank to sell other products, such as credit cards and personal loans. This is just what the bank wants.
- There's no flexibility to deal with unexpected events - having a baby, house maintenance or repairs, replacing

essential goods. The built-up equity in your home is locked away until the fixed term is up. Having a savings account may partly overcome this - but those savings are taxed at the same rate as your income tax.

- You need to be careful with the maximum percentage or dollar amount of any increased payments that can be made during the term of the mortgage - the rules for this vary from bank to bank.

Make your money work for you

Credit cards

Our credit cards report highlights just how much you can save if you use your credit card like a "savvy spender".

Being savvy means putting all your day-to-day household expenses and discretionary spending on your credit card. You can then make the most of your card's up-to-55 days-interest-free period. Your money is better off working for you in your mortgage or savings account than in a retailer's bank.

But you do have to pay the whole card off each month.

Savings

Any money that you have in a separate savings account will be taxed at the same rate as your income is taxed.

That means even if you have a high-interest-earning online account (paying around 7 percent), your after-tax return is much less - more like 4.5 percent.

If you keep all of your savings in your revolving line of credit mortgage account they are reducing interest on your mortgage and they are tax free. Better to have your money working to minimise the interest paid on your mortgage than earning taxable lower interest elsewhere.

Debt consolidation

If you have separate hire purchase, credit-card debt or personal loans, you're probably paying a much higher rate of interest than on your mortgage.

By adding these debts to your mortgage you deal with your short-term cash flow problems. But you must try to repay the extra debt as fast as possible - or, over the lifetime of a mortgage, you'll end up paying a lot more in interest.

A revolving line of credit (RLOC) mortgage is probably the best way of doing this because you can make extra payments at any time without extra fees.

See our report on Debt consolidation for more information.

Floating interest rate

If more people went floating, then banks would have an incentive to lower the current 9.56 percent rate.

The two-year fixed rate is currently around one percent lower than the floating rate. This may not hold in the future.

In most countries the floating rate is usually lower than the fixed rate.

Our advice

- Look at all the available mortgage options and see how well they fit in with your lifestyle and your future plans.
- Factor in the normal bank products that you also use - such as your credit card and savings account - and identify how they can work for you in paying off your mortgage. This could save you a considerable amount of money and time.

- Revolving line of credit (RLOC) mortgages may be worth a closer look if you're disciplined enough. Their extra flexibility means you can use the built-up equity in your house, make lump-sum repayments without penalty, and have tax-free savings. And these benefits are working all the time to reduce the total interest you pay. Despite its higher floating interest rate, the RLOC mortgage performed as well in our case studies as the traditional and more rigid two-year fixed-rate mortgages.

- Another good option is a two-year fixed-rate mortgage combined with some serious saving in an online account. This allows you to take maximum lump sums off your principal each time you renew your mortgage. But remember that these savings are taxed and you'll have no access to your built-up equity should you need it.

- Check out the time taken to repay each mortgage compared with the amount of interest paid, on our Five mortgage strategies page.

More information

- Cannex: www.cannex.co.nz

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