

Super facts on stretching your mortgage

TelstraSuper
Financial Planning

This factsheet explains the risks and rewards of extending your mortgage to renovate your home or to purchase goods.

The risks and rewards of extending mortgages

If you have a reasonable level of equity in your home, you may have access to relatively low-interest credit by extending your mortgage or redrawing from it. Using that facility strategically has the potential to enhance your lifestyle and the value of your home, but there are also traps to be avoided. Before you add any debt to your mortgage, you need to consider what it means for your future financial situation.

Evidence shows that many Australians are becoming dangerously comfortable with debt, and borrowing more freely than they can afford to.

Deeper in debt: Australia's addiction to borrowed money¹, a report by Dr Steve Keen of the Centre for Policy Development, shows that - on average and allowing for inflation - householders now owe six times as much as they did in 1964. Dr Keen also demonstrates that the situation has become dramatically worse in the last few years and he predicts that this trend may lead to a severe economic downturn.

How mortgages build wealth

Mortgages can have a valuable role as a tool for building personal wealth in the long term. They make it possible for individuals and couples to acquire property - a substantial asset that, in most cases, will increase in value over the years it takes to pay off the loan. That increase in value should offset the large interest payments you make over the life of the loan.

You can accelerate the wealth-creation effect of a mortgage by:

- making extra payments to clear the debt ahead of schedule and minimise the interest payable.
- paying your salary into your mortgage account, then re-drawing from it to pay bills. This reduces the balance (and therefore the interest payable) for some days or weeks in each month.
- making improvements to the home that will increase its future sale price.

Mortgages become less financially productive if you:

- only make the minimum payments.
- extend the life of the mortgage without adding re-sale value to your home.

Before you decide to solve short term financial problems or upgrade lifestyle accessories by extending your mortgage, it is essential to think through the long term consequences.

A big bill for little changes to your lifestyle

Through the last few years of exceptionally low interest rates, many people have been extending their mortgages to buy goods such as new cars or plasma screens. Some have consolidated credit card debt into their mortgage.

Example

6 years ago you added \$40,000 to your mortgage for the purchase of a new car. Based on a 25 year mortgage of \$250,000, with a fixed interest rate of 7.75% pa for the life of the mortgage, if the \$40,000 is added 5 years into your mortgage and you continue to fund only minimum monthly repayments (set at the start of the mortgage), the period of your loan is extended by 13 years and costs you \$257,233 in extra interest payments. One reason for this increase is that the \$40,000 is withdrawn before \$40,000 has been paid off the principal of your loan.

With new cars generally depreciating at a rate of 14% per year for the first three years and 6-8% each year thereafter², the resale value of your car is now around \$21,000 and you haven't paid anything off the purchase price of the car.

Although you paid 7.75% pa for vehicle finance, the car has now cost \$297,233 over the life of the mortgage (purchase cost and additional interest on your mortgage) and 6 years later is worth just over half the purchase price.

It can be tempting to extend your mortgage or re-draw from it because mortgage interest rates are generally much lower than the rates for other forms of credit. However, repaying a loan at low interest rates over a very long time will usually cost a lot more in total interest than repaying the same amount at a higher interest rate over a much shorter time span. Using the car example again, if car finance was used to pay for the \$40,000 at 10% pa fixed interest over a term of 5 years, with a repayment of \$861 each month you would have only paid \$10,815 in interest.

How extending your mortgage effects repayments

The following example compares a \$300,000 mortgage with a 25 year term. The interest throughout the duration of the term is 7.75% pa.

Rob & Di

Pay the minimum monthly repayments of \$2,270, and extend their mortgage by \$5,000 after 5 years. 10 years into their mortgage, they borrow an additional \$50,000 (in today's dollars) for a kitchen and bathroom upgrade.

Result: \$999,914 over 39.4 years

Rick & Bec

Keep up the minimum monthly repayments of \$2,270 without any refinancing and pay off the mortgage over 25 years.

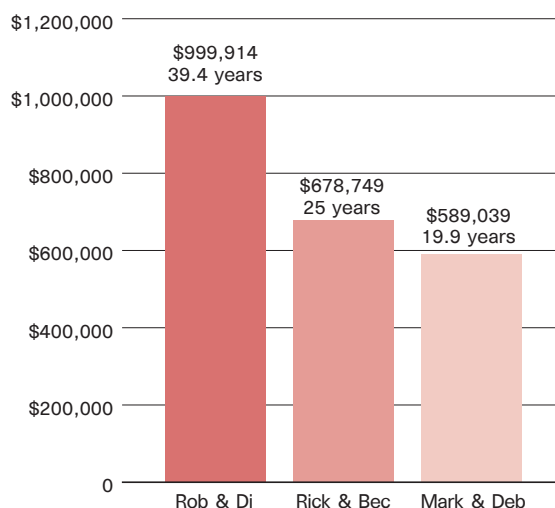
Result: \$678,749 over 25 years

Mark & Deb

Choose to make fortnightly repayments of \$1,135, adding an extra \$100 more than the minimum each fortnight and do not redraw throughout the term of their loan.

Result: \$589,039 over 19.9 years

\$300,000 mortgage comparison



As these comparisons confirm, re-drawing from your mortgage means making repayments for longer. The extra interest bill also means you have less money to invest in other diversified financial products like super and shares. Over the longer term, you also have less income to spend on leisure activities as the mortgage repayments continue.

Adding re-sale value to your home

While renovations will extend your mortgage, the right renovation, handled correctly, can increase the re-sale value of your home. When considering a renovation, it is important to:

- **Consider your location.**

Location is the key to a property's value. To recoup the money spent on a renovation, you need to compare your home with its neighbours and how much they are worth.

If your home's value is well below the area's average, adding features that are standard around the locality will probably be money well spent.

Renovating a home in bad condition in a good street can be rewarding, but spending heavily on renovations to your home when it is surrounded by houses in poor condition is unlikely to pay off. The less attractive homes around it may deter anyone from paying a good price for yours.

- **Have a clear understanding of what adds to and detracts from a residential property's value.**

Watch the local real estate market or ask a local real estate agent to value your home and find out their opinion of the value your planned works will add. If you are adding a third bedroom, pay attention to what three bedroom homes are selling for in your area.

This will give you a guide as to whether or not you are overcapitalising for your location.

- **Stick to a budget.**

When determining your budget, you should first look at what you can afford, and how much you can comfortably pay back if interest rates were another 2 or 3% higher.

The real costs of renovation

The average cost of a ground floor extension is around \$109,000.* If you own your home for 5 years before renovating and have a current mortgage of \$255,000 you may decide to add \$109,000 for the extension to your existing mortgage increasing the balance to \$364,000. This increase would potentially have the following impact on your mortgage repayments:

- your minimum repayment for the next 25 years would increase from \$890 per fortnight to \$1,265 per fortnight.
- the interest on the remaining loan term would increase from \$317,263 to \$460,533 - an increase which effectively doubles your renovation cost.

*Average cost of major renovation projects, HIA Renovations monitor, last quarter 2006.

How much it costs*

Second storey extensions	\$115,023
Ground floor extensions	\$109,546
Roofing and cladding	\$33,358
Kitchens	\$21,929
Bathrooms	\$20,681
Garages and carports	\$18,591

*Average cost of major renovation projects, HIA Renovations monitor, last quarter 2006.

What if something goes wrong?

Adding to your mortgage always carries a potential risk. The biggest risk is the danger that the mortgage debt will exceed the value of the house.

- Extensive renovations can make you financially vulnerable in the short term if you don't already have substantial equity in your home. If you renovate a house you have only recently bought, you may owe more than the house is worth. An unexpected event - such as unemployment - that forces the sale of the house before the market catches up in value can create major difficulties. In general, it is important to live in a house for some time before starting renovations.
- When you use your mortgage for more transient lifestyle purchases or depreciating assets, you have little chance to recoup what you have spent (and paid interest on) as you have not added value to your home.
- While you are putting the bulk of your income into your mortgage for upwards of thirty years, it is unlikely that any income is being channelled into other investments such as superannuation, shares or even savings. This means a key principle of investing - diversification - is ignored.

How to get back on track

No matter what your situation, it is never too late to get back on track with your mortgage.

- Small amounts contributed to your mortgage regularly can have a big impact.
- If you have recently renovated to sell, get expert advice as to whether or not enough time has passed for housing prices to increase enough in value.
- If you put little extra money into your mortgage, work out the real cost to your future financial security before spending on non-essential goods. You may decide you can wait. In the case of technology such as plasma and LCD screens, waiting even a couple of years means the technology is much more affordable.
- If you do have a large credit card debt you may be advised to consolidate this debt into your mortgage to pay less interest – a useful tactic if you pay more off your mortgage (at least what you were paying off your credit card) and if you don't keep repeating the pattern.

Be careful how you use your mortgage

Mortgages are designed to make it financially practical for us to own the houses we live in. Using them to purchase lifestyle items means you can spend thirty years paying off a plasma screen when you could have waited a few years to acquire it at a fraction of the cost.

And while a well-considered investment in strategic renovations can pay off in the long run, you should carefully plan out the work and ensure that you will stay in your home long enough to enjoy your renovation and recoup the cost when you do come to sell.

1. Deeper in debt, Australia's addiction to borrowed money, September 2007, Centre for Policy Development, www.cpd.org.au
2. Car depreciation, Choice, www.choice.com.au/viewArticleAsOnePage.aspx?id=103317

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