HOW TO FINANCE ASSETS: PART TWO OF A SIX-PART SERIES

Structuring and insurance issues on your home loan

After securing a home loan comes the difficult task of servicing it. In the second article in a six-part series on how to finance assets, by Personal Finance in association with First National Bank (FNB), **Angelique Ardé** finds out how savvy consumers manage their loans.

Once your home loan has been approved, you'll be faced with some important decisions, such as choosing the term of the loan, choosing insurance over your life and your property, and deciding whether to opt for a variable or a fixed interest rate. These decisions have major cost implications.

Arguably, your biggest decision is in respect of the term of your home loan.

Most people assume that a 20-year term is their only option, but some banks let you choose a term of less than 20 years. Other banks don't, but will give you a loan for 25 or 30 years. It's important to find out what options are available to you when you apply for a home loan.

Praven Subbramoney, head of product and sales at First National Bank (FNB), says FNB gives customers the option to choose "any term shorter than 20 years" – although the demand for short terms is very low, he says.

FNB does not offer customers 30-year bonds, Subbramoney says. "The instalment on a 30-year loan is 10.6 percent smaller than the instalment on a 20-year loan, but it will cost you 50 percent more in fees and 63.6 percent more interest over the life of the loan." (See the table on the right for cost differences between a 20-year and a 30-year home loan.)

Standard Bank offers a 30-year home loan but does not offer terms of less than 20 years.

Steven Barker, head of home loans at Standard Bank, says a 30-year loan means you're in debt for longer and results in you paying more for your loan than a customer with a 20-year loan term.

He says "most customers" opt for a longer loan term to ease their affordability pressures when taking out the loan. "However, they quickly begin to pay additional funds into their loan to reduce the term and finance charges."

Barker says that it's best to opt for 20 years: "Once a bond is registered, the term is fully flexible and can easily be changed."

Peter Swartz, head of business development at Absa Home Loans, says that, depending on the client's ability to afford increased monthly instalments, Absa will give home loans over less than 20 years. Most of the home loans granted by the bank are for 20 years.

Nedbank also offers terms of less than 20 years, subject to credit approval. The bank's maximum loan term is 25 years.

VARIABLE AND FIXED

When you enter into a home loan agreement with a bank or mortgage lender, you pay the bank according to a variable interest rate. In other words, the interest rate varies in line with movements of the prime lending rate.

The prime lending rate is fixed at 3.5 percentage points above the repurchase (or repo) rate, the interest rate at which commercial banks can borrow money from the Reserve Bank. The prime rate is currently nine percent.

Banks usually charge their "best" customers prime less one or even two percent on home loan agreements. Most home loan clients will pay prime or prime plus one or two percent.

A variable interest rate is the standard interest rate option.

Another option is a "fixed" rate.

Subbramoney explains: "A fixed interest rate is an agreement between the bank and a bond holder for the outstanding balance at a specific point in time at an agreed interest rate for an agreed term."

Fixing is attractive when interest rates are on an upward trend, because it offers you a measure of stability. Depending on your bank, you can select a contract period of 12, 18, 24, 36, 48 or 60 months, and in that term your bond repayment won't go up or down, irrespective of charges in the prime lending rate.

FNB is offering fixed rates over 12, 18, 24, 36, 48 and 60 months. The rates range from prime plus 1.1 percent for 12 months to prime plus 2.55 percent for 60 months.

Nedbank is also offering fixed rates over 12, 24, 36, 48 and 60 months. The rates range from prime plus 2.2 percent and prime plus 3.6 percent.

Standard Bank is offering a fixed rate, but for only 36 months. Barker says the bank's current fixed rate offer is "in the region of 11 to 13 percent (or between two and four points above prime)".

The National Credit Act regulates the maximum interest rate that you can be charged on any credit agreement. On mortgage agreements, the maximum the bank can charge you is the repo rate multiplied by 2.2 plus five percent a year. So, with the repo rate at 5.5 percent, you can't be charged more than 17.1 percent a year.

Subbramoney says interest on a home loan is charged from the date of registration of a new home loan and is calculated on the outstanding balance of the bond "multiplied by the interest rate applicable divided by 365 days multiplied by the number of days in the month". He says amortisation is making payments that include the amount registered (capital) and the interest of the loan for a specified period.

Mortgage originator ooba has an amortisation calculator that shows you how much of your bond instalment goes towards interest and how much goes towards reducing the actual capital amount. (Go to www.ooba.co.za/calculators/home-loan-amortisation-calculator)

For example, on a loan of R1 million over 20 years at an interest rate of nine percent for the entire term, the calculator shows that, initially, the lion's share of your instalment goes toward interest. Only in month 149 (after paying your bond for 12 years and five months) do you start paying more towards your capital than towards interest.

◆ *Next week's article will cover other aspects of servicing a home loan, such as the benefits of paying extra into your home loan and of using your home loan as a savings vehicle.*

You must take out cover, but you can choose where

When you take out a home loan, the lender has the right to insist that you also take out adequate life assurance and homeowner's insurance. This is to protect both the lender and you, the borrower. But you have the right to choose your insurer.

The purpose of life assurance is to cover your outstanding debt in the event of your death, whereas homeowner's insurance is short-term insurance that pays out in the event of damage to your property caused by natural disasters, such as flooding, and accidental damage, such as a burst geyser.

The banks offer credit life cover and homeowner's insurance from a preferred supplier, but it's advisable to compare the cover offered by this supplier with the cover you already have or could buy elsewhere.

If you choose to use your insurer or already have life cover, the bank will insist on the cover being sufficient – in other words, equal to the outstanding amount due on the home loan – and on you ceding your policy to the bank. This is an outright cession and means that the cessionary (the bank) takes precedent and will be paid before any payments to nominated beneficiaries. This means the bank gets first bite at your life assurance proceeds.

Praven Subbramoney, head of product and sales at First National Bank (FNB), says policies that the bank will not accept (for ceding) include retirement annuities, endowment plans, pension plans, provident funds, retrenchment- and/or disability-only policies, and group life assurance cover.

When choosing life cover, you need the best cover that you can afford and should consider insurance that will cover your loan in the event of not only your death, but also disability, dread disease or retrenchment.

Subbramoney says that one of the benefits of taking out cover from your bank's preferred insurer is that the sum insured is based on the outstanding balance, which only your bank has sight of. There's nothing stopping you from notifying your own insurer of your outstanding balance, but you can easily forget to do this and find that are under-insured if you have dipped into your home loan, for example.

With homeowner's insurance, Subbramoney says you may use an insurer of your choice, as long as the bank's minimum requirements are met. In FNB's case, this means that FNB's "interest" must be noted; meaning that if your policy lapses your insurer must notify FNB and if you have a big claim for something like subsidence, FNB must be notified. FNB also insists on you having Sasria cover and personal liability cover, as well as the prescribed sum insured as per your home loan agreement.

If you use an insurer other than the one recommended by the bank, he says you will be required to provide the bank with an updated policy following the renewal month of the policy on an annual basis.

FNB does not charge you a fee to check your policy if it is not with FNB's preferred insurer.

Subbramoney says it's important to remember that the bank has no influence over the insurer in the event of a claim.

Steven Barker, head of home loans at Standard Bank, says that a claim will fail if the damage was the result of inadequate maintenance. "When buying a property, look out for potential problems with regards to roofs, drainage systems, pipes and geysers, and cracks," he says.

TIME TO GET YOUR FIX?

If you recently obtained a home loan for the first time and are in the "affordable housing" range of up R600 000, you should consider fixing your interest rate. This is the advice of Marius Marais, chief executive of housing finance at First National Bank (FNB).

"Fixing interest rates is one way of creating a more stable monthly cash flow and is ideal for people entering the market for the first time and for those buying in the 'affordable housing' range, which is up to R600 000," he says.

First-time homeowners constitute 96 percent of the home loan market. "Due to affordability issues, these customers generally gear their loan to the maximum in order to purchase an entry-level house, which makes them the most vulnerable to changes in the interest rate," Marais says.

Until last month, when the Reserve Bank hiked its lending rate by 50 basis points to 5.5 percent, the prime rate of 8.5 percent was at its lowest in 20 years. The highest it has been is 25.5 percent, which was in 1996.

"It seems that we have entered an upward rate cycle. What we can't tell is how high rates will go or how quickly they will go up," Marais says.

Fixed rates are generally a few percentage points above the customer's variable rate.

"Initially, the customer will pay a higher rate. However, this will most likely be offset over time as rates increase," Marais says.

On a R500 000 loan, at prime plus one percent (10 percent), your instalment is R4 825. At a fixed rate, assuming two percent above this, the instalment is R5 505, which is R680 more. However, as the interest rate goes up, this gap will close by R335 for every percentage point increase, Marais says.

When you fix, there is the risk of the interest rate not moving higher than two percentage points, he says.

There are no extra fees if you fix your rate, but if you want to exit the fixed rate period early, it will cost you, because the bank has committed to the fixed rate for the full period, Marais says.

Close to the end of the fixed rate period the bank will contact you and offer you the option to either re-fix at the prevailing rate or move to a variable interest rate.

"Forty percent of our new loans are on a fixed-rate basis. We would like to see the whole market moving to a fixed-rate mechanism, which will protect the customer from rate increases in the future," Marais says.

Differences in interest and fees on a R1-million mortgage bond taken out over 20 years and 30 years

INTEREST RATE: 9%

	240 months	360 months	Difference
Monthly repayment	R9 054	R8 103	-10.5%
Total fees (R57 a month)	R13 680	R20 520	50.0%
Total interest	R1 159 342	R1 896 641	63.6%

SOURCE: FIRST NATIONAL BANK