Banks offer risky home loans

Banks are approving home loans that can get you into serious trouble when interest rates go up.

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01.Loans that get first-home buyers into trouble

You would've been hard pressed to get a home loan approved by your bank during the GFC, unless you had a hefty chunk of savings on hand. Lending standards were tightening in the wake of the financial crisis that just happened to be set off by home loan defaults.

Now three types of **high-risk home loans** are back on the market for those who have little or nothing in the way of a deposit. The loans leave very little margin for comfort if there's a change in circumstances, such as an interest rate hike or a decrease in income.

- No deposit and low deposit home loans – currently used by a third of all new borrowers.
- Family guarantees – offered by a raft of lenders including the big four banks.
- 40-year mortgages – available for borrowers who can't afford the repayments for standard 30-year home loans. (This one is about as risky as it gets.)

These types of home loan allow you to take the leap from renting to home ownership sooner, but they can also ruin your financial life. If you lose your job, get sick or are otherwise unable to keep up with the repayments, it may not take long until the bank asks you to sell your house or even repossesses it.

And if your parents or siblings guarantee your mortgage they may lose their house as well. As Katherine Lane, principal solicitor of the Consumer Credit Legal Centre, told us, “the lenders always give themselves the option to sell either property, so it’s possible the guarantor may lose their home first.”

The Australian Prudential Regulation Authority is also concerned and has warned that lenders need to ensure borrowers can afford higher repayments when interest rates rise from today’s historically low levels. Overseas regulators have similar concerns and have acted on them. In New Zealand, loans to buyers with less than a 20% deposit have been limited to 10% of new loans since October 2013.

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The combination of high-risk loans and a housing bubble is especially dangerous – and the RBA recently warned that a fall in house prices is a real possibility. Borrowers with little equity could end up making mortgage payments they can barely afford, based on more than the house is worth.

How to protect yourself

Take these steps to protect yourself from getting into trouble with risky loans. Before going house hunting:

- check if you can afford the repayments if interest rates increase by three per cent.
- set up a high-interest savings account and transfer your expected mortgage payment with a three per cent hike factored in every week. This will accelerate your deposit savings and show you if you can afford the mortgage.
- consider taking out a First Home Saver account.

Once you’ve got the loan:

- try to make regular extra repayments to get a buffer.
- make lump sum extra repayments such as the refund from your tax return.
- if your parents gave a guarantee, pay enough to make sure that they can get released from it as soon as possible.
- consider taking out a fixed loan or split your home loan between a fixed and a variable rate.

The riskiest of the three strategies is taking out a 40-year mortgage. Just as with any loan, always ensure you repay your home loan as quickly as possible. Extending a mortgage to 40 years doesn’t help much with affordability, as the minimum repayment amounts aren’t much lower. Instead, it can cost you thousands more in interest over the time of the loan.

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