

### **Case study: Switching mortgages who pays?**

This is a case study based on an actual transaction, which for privacy reasons has been edited. The facts outlined are based on an exit interview with the clients.

Clients Mary & Bill refinanced a five year old home loan in April 2007 in order to inject some capital into their business. They did this through an accredited finance advisor. The loan was with a conforming lender (lender A) and it was a standard variable loan split with an interest only portion which was the portion related to the business. Their accountant asked for this split as he was going to help them claim the interest only portion.

In January/ February 2008 Mary's family friend, a mortgage broker, approached the couple and suggested that given the rising market rates they should seriously consider refinancing to get a better rate. Especially given that he had access to some special deals via a top tier bank.

So in March 2008 the refinance took place and they moved to a single loan at standard variable rates with lender B. The loan was bundled into one single sum as they now no longer owned the business.

The transaction settled within month eleven of the first anniversary of the loan with lender A hence early termination fees applied. This is where the lesson begins. Mary & Bill were approached by their 2007 advisor and asked why they switched and they simply explained that the broker was a family friend and he had convinced them that it was a good option, the broker works for a well established broker brand. Mary & Bill went on to explain that they had saved 0.5% on the rate they had with lender A. by switching to lender B.

The maths then becomes a critical factor in the switch, because lender A applied an early termination fee of approximately \$3,800 on a loan amount of \$280,000 (approx). Plus lender B applied the usual establishment costs which we can assume to have been close to \$1,000 (including legals).

Total cost of refinancing estimated at \$4,800 in exchange for a rate improvement of 0.5%. Bill did comment that he thought it strange that their total loan balance had increased by some \$4,000 but was reassured that this was going to be rectified by the saving in interest rate level that they had gained.

The numbers tell us that over twelve months the interest rate saving would need to be greater than 1.0% to justify such costs. In fact Mary and Bill will be back to where they were before the refinancing with lender B by mid 2009 if rates do not move upwards, sooner if they decline. It goes without saying that knowing these facts Mary & Bill are now most annoyed at their family friend/broker and at themselves for not asking more questions.

### ***The questions that remain to be answered in this case study are as follows;***

Was the broker bothered to analyse the clients needs and best interests?

Was the broker aware of the costs involved in twisting the business from lender A to lender B? If so, what motivated his advice, commissions maybe? Need to make sales?

What responsibility does lender B have for underwriting this case in month eleven knowing full well that the maximum early termination fees would apply?

Who if anybody applied the "know your client" rule to this advice?

What financial qualifications if any did the Broker have if he could not do a cost benefit analysis on this case?

There are more questions and discussions to be had as this is probably only one of many cases of "twisting" that unfold out in the market under the current interest rate climate. Over to you.

The author Max Franchitto is a management advisor with over two decades of financial services industry experience with a focus in marketing & distribution channel management, customer service and Financial management. He does have a financial interest in a Finance advisory firm which is accredited by the FBAA.