Why calculating your living expenses before applying for a home loan is so important

home loans made clear

Are your spending habits an arcane mystery or an open book? If you answered the former, you're not alone. Most Australians don't know how much money they spend each month - much less what they spend it on.

If you're applying for a home loan, you'll need to get intimate with your bank statements. Over the past few years, the ways in which lenders assess your ability to repay a home loan have changed. This means that even if you've successfully obtained a home loan in the past, it's worth understanding how these changes have impacted the loan approval process and why they could affect your ability to secure a home loan.

Whether you're a first home buyer, looking for an investment loan or just wanting to refinance and consolidate your existing debts, lenders are going to put your spending habits under scrutiny. Banks used to use standard measures to estimate your living expenses. Today, they look at your actual expenses and spending history. That makes it vitally important that you understand your spending habits and take control of your outgoings ahead of time to help make the loan application process as painless as possible.

Why do banks measure your living expenses?

Current legislation dictates the way credit providers assess your ability to meet your mortgage repayments, so these methods are relatively consistent from lender to lender. The lender first determines your net monthly income from all sources, e.g. salary, rental, Family Tax A/B and then deducts from that amount your monthly outgoings or living expenses. The remaining funds are deemed surplus funds available to meet loan repayments.

So, whilst your income is generally assessed based on consistent, regular payments, the living expenses component of this calculation is different for everyone, and this is the area that lenders now require a detailed analysis of.

Home loans in a simpler time

If you applied for a home loan before the Banking Royal Commission (BRC), your lender would have used one of two standard measures when assessing your borrowing capacity. Before 2011, it would have been the Henderson Poverty Index (HPI). From 2011 onwards, the Household Expenditure Measure (HEM) was used, a standard benchmark developed by the Melbourne Institute which estimates your living expenses based on a number of variables including income, family size, location and lifestyle.

What lenders look at today

Following the BRC, banks came under criticism for using the HEM to determine borrowers' living expenses. It has been called a crude measure, that almost always underestimates real living expenses. As a result, the Australian Prudential and Regulation Authority (APRA) became worried banks were lending people more money than they could comfortably repay, and APRA now requires lenders to complete a full assessment of borrowers' actual ongoing living expenses.

This means that every borrower, from seasoned property investors to first home buyers, can expect their bank statements to become objects of fascination. Lenders are looking at more categories than ever before. If you have a Netflix subscription, an Afterpay bill, or a penchant for Friday night pizza, your lender is now required to take that into account. And if your statements don't match your declared living expenses, you need to be prepared to justify why.

While the new process can feel intrusive, it's important to understand that it's not the lenders' fault. They don't want to know how many times you've ordered Uber Eats any more than you want to tell them. It's a regulatory requirement, and it applies to all loan applicants.

What if your spending history is crazy?

Be warned, the exercise of analysing where your money goes can be extremely confronting and for some, almost embarrassing.

The good news is, you don't need to stress too much about it. As part of our pre-application interview, we will help you work out which items can be categorized as "discretionary" expenditure. We can then help you make a plan to reduce some of these discretionary spending items, thereby reducing the total declared living expenses required to be assessed by your lender.

Self-Assessed Living Expenses

When applying for a home loan you will be asked to review your bank statements and provide the lender with a detailed summary of where your money goes each month. It's important to remember that many lenders will cross-check your estimates against your savings account and credit card statements so it's best to be diligent with your figures.

Some common areas that people underestimate or forget to include are:

- Large irregular expenses, like private school fees or annual memberships
- Discretionary spending on eating out, travel and leisure
- Loan repayments, especially novated leases where the money is deducted straight from a salary

When working out your living expenses you will be asked to split your outgoings into 16 categories:

- Clothing & Personal Care
- Childcare
- Phone/Internet/PayTV
- Medical & Healthcare
- Insurance (Health)
- Insurance (Home/Car)
- Insurance (Life/Trauma/Accident)
- Food & Groceries
- Transport (Rego/Servicing/Fuel/Public Transport)
- Ongoing Rent/Board
- Utilities & Rates (Home)
- Utilities & Rates (Investment property)
- Child Education
- Higher Education/Vocational Training
- Private School Fees
- Recreation & Entertainment

Our 3-step financial makeover

Lenders aren't just looking for more detail. They're also looking at spending behaviours—both how you spend and what you spend your money on.

The sooner you speak to us when planning to take out a loan, the more scope we have to help put you in a stronger position to secure an approval when it comes time to lodge an application.

Here is a step-by-step guide to becoming the perfect home loan candidate:

1

Track everything

Start by downloading your last six months' worth of bank statements, including any credit cards and savings accounts. Don't forget to include annual or bi-annual expenses outside of this time period, like private school fees or car registration.

Enter all of your expenses into our Clarity Budget Calculator along with your income and any other obligations and repayments you currently have. The calculator is broken down into the 16 categories mandated by APRA to reflect the lender's process. In the digital age, there are also numerous phone apps that link directly to your bank accounts and can do all the hard work for you.

We understand it's a hard task and it can be the part of the lending process our clients most frequently refer to as 'painful'. It can be uncomfortable seeing what you spend written down in black and white. But it is, without a doubt, the most powerful tool out there to help you control spending, master financial discipline and achieve your savings goals.

2

Adjust your spending now, not later

Start getting your ducks in a row early. It's far easier to apply for a loan with the right spending history than it is to justify a bad one. Ideally, you want to show the bank at least three months' worth of good spending habits to prove that you're financially responsible.

We recommend that people come and see us as soon as they start thinking about applying for a loan. Often, we can find simple ways to cut back. Just bringing your lunch from home instead of buying it each day can save you $50 a week and give you an extra $200 per month to repay your loan.

We can also give you some advice around savings. For some people, paying off a personal loan or credit card might be the best approach. For others, stashing that money into the savings account for a larger deposit is a smarter strategy. We take a tailored approach to each client's unique situation to help them reach their goals.

3

Watch your behaviour as well as your bank balance

It's not enough to show that you have money left over at the end of the month. What you spend money on can count against you as well, so too can certain spending behaviours including:

> **Consumer credit:** Afterpay/Zip Pay, 'interest free periods' and novated car leases are all forms of credit. Lenders will see their use as an indication that possibly you aren't managing your finances well.

> **Risky behaviours.** Gambling apps or regular visits to the TAB are a red flag even if you're not using credit to fund your habit.

> **Late fees and penalties.** Even if you don't have defaults showing on your credit history, too many late fees or bounced direct debits might sound an alarm.

Lenders used to have limited access to this information, but the advent of Comprehensive Credit Reporting (CCR) has meant increased sharing of repayment conduct and financial history across institutions. That missed credit card payment a year ago? Even if you go to a different bank to apply for a loan, they'll know about it. Check out our Guide to understanding your credit score for more information.

If that sounds complicated, well, it is. That's why we recommend talking to a broker before you scope out lenders, not just any broker of course, speak to Canberra's most highly trained and professional mortgage brokers at Clarity Home Loans. It doesn't cost a thing and is obligation free. Give us a call now to set up a consultation.

Speak to the experts

Unlike many of our competitors, the Mortgage Brokers at Clarity Home Loans are all paid a salary and don't earn any commissions from the banks, so we'll never try and talk you into a lender or product that isn't the right match for you. With over 2,500 loan products to choose from, we can offer you a range of options to suit your specific goals.

If you're thinking of applying for a home loan at some point in the next twelve months, why not come in for a consultation so we can help educate you on the finer points of credit assessment across a wide range of different lenders and their policies.