Deposits - Which is the best option?

Thoughts and Opinions by Dr. Tony Hayek

When purchasing property, there are a number of deposit options available to buyers. In most cases, a standard contract will require 10% of the purchase price as a deposit to exchange a contract. The three most commonly used deposit types are cash, deposit bonds or bank guarantees.

An exchange occurs when both the vendor's and purchaser's solicitors agree on the terms of a property transaction and exchange signed copies of a contact.

Cash is the easiest deposit method, where, you simply provide a bank cheque for the required amount.

The second option is a bank guarantee. A bank guarantee (as the name suggests) is a "guarantee" from your bank to the vendor that upon settlement, the deposit amount will be available. The process does involve a lot more effort, as a bank guarantee normally undergoes a full credit application with a bank. In almost all cases, a bank issued bank guarantee will be secured either against cash or some form of real estate. There are often annual fees and maintenance fees associated with a bank guarantee. If, for some reason, you don't have the funds available at settlement, the vendor can call in the bank guarantee and your bank will pay the vendor the deposit. The bank will then require you to pay the amount back.

The last option is a deposit bond. A deposit is an unsecured note issued by a Deposit Bond company. Like a bank guarantee, you are required to undergo a credit application. The Deposit Bond company will issue you a bond in return for a premium. Premiums are calculated by considering time until settlement and the amount of the deposit. Again, if you are unable to settle a property transaction, the vendor can then call on the deposit bond, the Deposit Bond company will pay the vendor. The Deposit bond company will require you to pay the amount back.

The Pros and Cons of the three deposit methods can be summarized as follows:

Deposit Type	Advantages	Disadvantage
Cash Deposit	• No credit application required • At settlement you have already funded 10% of the purchase amount	• Unless vendors offer an incentive, you will forgo interest income on deposit • You need to part with the cash until settlement. Potentially affecting your cash flow
Bank Guarantee	• No need to tie up funds • Gives you an option if you have equity and cash isn't available • Cheaper than Deposit Bonds • Developers prefer them over Deposit Bonds as banks are seen as less risk than deposit bond companies	• Banks take security over assets and can call upon them if they need to recover costs • Full credit application required
Deposit Bond	• No need to tie up funds • Gives you an option if you have equity and cash isn't available Unsecured facility	• Can be costly • Can be difficult to get approval • Full credit application required • You need to pay the premium up until the sunset date, so if construction finishes before that date, you will have paid the full premium unnecessarily.

September 2009

BLUEWEALTH PROPERTY

Deposits - Which is the best option?

Thoughts and Opinions by Dr. Tony Hayek

To illustrate the how each facility compare in terms of costs, consider the following example. The example assumes your client is buying a property off the plan and settlement is 18 months away, the purchase price was $500,000 and the client has the full deposit available in cash. Further, the sunset date is 27 months away.

A sunset clause is a provision in a contract of sale that sets a date after which the contract is no longer in effect. So in this example, after 27 months, the contract is no longer valid, and either party can rescind the contract. However, if both parties agree the agreement can be extended.

Deposit Type	Cash Available	Costs to Set-Up	Interest Income
Cash Deposit	$50,000	$0	$0
Bank Guarantee	$50,000	($2,000)	$3,375
Deposit Bond	$50,000	($3910)	$3,375

In the cash example, the Client will simply make the funds available before the exchange of contracts.

If a bank guarantee were used, the client will exchange contracts with a bank guarantee and pay $2,000 in establishment and ongoing costs. The client will then invest the $50,000 in cash for the 18-month period and receive $3,375 in interest income. The net profit from the strategy is $1,375.

If a deposit bond were used, the client will exchange contracts with a deposit bond and pay a one-off premium of $3,910. The client will invest the $50,000 in cash for the 18-month period and receive $3,375 in interest income. The net loss from this strategy is $535.

Depending on your client's position and their perception of the advantages and disadvantages of each deposit method will determine which deposit works best for them.

For more information on deposit bonds, you can visit Deposit Access's website at http://www.depositaccess.com.au

Dr. Tony Hayek B.A. (Hons.) PhD

September 2009

BLUEWEALTH PROPERTY