



MORTGAGE LENDERS BEWARE



BEN FISHER, Solicitor

Federal Government 'Green Paper' on financial services and credit reform – Treasury foreshadows Commonwealth regulation to stem 'Early Mortgage Termination Fees'

The Federal Government has released a 'Green Paper'* on financial services and credit reform to outline its response to a perceived rise in mortgage fees. The Government's policy aim is to make it easier for mortgagors to switch mortgage providers where they are unsatisfied. The purpose of the 'Green Paper' is to seek input from stakeholders about financial services and credit reform initiatives including:

1. the development of a national comprehensive approach to the regulation of mortgages and mortgage broking advice
2. the most appropriate regulation of a range of non-mortgage credit products, such as credit cards, personal loans and micro-lending

The Government has already commissioned the Australian Securities and Investments Commission (ASIC) and the Productivity Commission to review elements of the mortgage sector.

The State and Territory Governments under the Uniform Consumer Credit Code (UCCC), adopted in all states and territories, regulates consumer credit, including mortgages. The Productivity Commission, in its review into Australia's consumer policy framework, has suggested several inadequacies exist within the UCCC which it believes act to the detriment of borrowers. These include:

- lack of positive obligations on lenders to assist borrowers facing financial hardship
- lack of explicit requirements on lenders to provide credit only to people who can afford it
- lack of capacity to provide protection to small businesses seeking loans
- lack of regulation of advice in relation to credit given by both Authorised Deposit taking Institutions and non-deposit taking institutions
- lack of regulation over the conduct of and advice given by mortgage brokers
- inability to amend the UCCC due to its state-based nature



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In addition, ASIC has conducted an industry review of mortgagor loan account entry and exit fees. The review suggests that early mortgage termination fees have increased disproportionately against total fees taken by lenders since 2005. ASIC noted that comparison tables created for consumers to compare loans do not include contingent fees as they are a product of various factors which may render their exact cost unascertainable at the time of the loan product being offered, such as early termination fees, and asserted that this exclusion has been the instigator of the increases of early termination fees in Australian mortgage products. Further, ASIC compared early termination fees in Australia to those charged in the UK and USA, two jurisdictions where such fees are regulated and compared publicly, and found that Australian lenders charge amounts up to 4-times greater.

The 'Green Paper' contends that the increased fees which mortgagors are encountering in the mortgage sector are a nationwide concern. The Government proposes in the 'Green Paper' that the Federal Government should assume responsibility for the regulation of mortgages, the licensing of all credit providers and mortgage brokers and the creation and enforcing of standards. The Government hopes this will improve disclosure for mortgage products and halt rising fees in the belief that lenders will not charge

disproportionate early termination fees when such fees are regulated and compared publicly. The Green Paper also investigates the benefits of the Federal Government appropriating responsibility for the entire regulation of credit, however, it finds that smaller loans such as credit card facilities and 'payday' loans may be better governed by the States due to regional differences in these products.

Recommendations from stakeholders to the Federal Government in relation to the proposed legislation closed on July 1 2008.

Please contact Ben Fisher or Sebastian Saccuzzo of Russell Kennedy should you require any advice in relation to the proposed Financial Services Credit Reform.

The Commonwealth of Australian Governments (COAG), comprising of State and Territory Government representatives, has agreed in principle to the Commonwealth assuming responsibility for regulating mortgage credit and advice. We will provide you with updates for any further developments.

* A 'Green Paper' is a government document which discusses the government's initial viewpoint and proposals on issues providing a basis for consultation with interested parties. 'Green Papers' are often the first step taken in making amendments to the law and may result in the production of a 'White Paper'. A 'White Paper' formally enunciates government policy.

SEBASTIAN SACCUZZO,

Principal

Tel: 03 9609 1578

Email: ssaccuzzo@rk.com.au

BEN FISHER,

Solicitor

Tel: 03 9609 1636

Email: bfisher@rk.com.au

LENDING TO SELF MANAGED SUPER FUNDS

RODERICK TAN, Solicitor



Self Managed Super Funds (SMSF), under the *Superannuation Industry (Supervision) Act 1993* (SIS), are generally prohibited from borrowing. A SMSF trustee cannot borrow money or maintain an existing loan. There are some exceptions; namely if the borrowing is to make payment to a beneficiary for a statutory purpose or if the borrowing does not exceed 90 days and provided the borrowing does not exceed 10% of the value of the SMSF assets.

Recent amendments to the SIS, commencing on 24 September 2007 now allow limited recourse borrowings by SMSF if:

- (a) the borrowing is for the acquisition of an asset (original asset) or its replacement
- (b) the trustee, in its trust capacity, has a right to acquire legal ownership of the original asset or its replacement by making one or more payments
- (c) a lender's recourse against the trustee in the event of default are limited to rights relating to the original asset or its replacement

Borrowing for the acquisition of instalment warrants is also permitted under the above exceptions.

Applicable criteria for the acquisition of an asset

SMSF are permitted to invest in assets that generate a return on investment (eg. art collections, shares, vintage cars, real estate, etc) with the sole purpose of providing its members with retirement income.

Investments of a superannuation fund, deemed as in-house assets, are generally not permitted. An in house asset is described as an asset of the fund that is a loan to, or an investment in a related party, or is an asset of the fund

subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund.

Where the property is an asset of a related party of the fund, to be exempt from the in-house asset test, the following conditions must apply:

- the property must not be subject to a lease or lease arrangement between a trustee of the fund and a related party
- the property must be used exclusively for business purposes
- the property must be acquired on a willing buyer & willing seller basis

The recent SIS amendments do not set out any restrictions on the type of freehold properties that may be acquired by the SMSF nor on the amount a trustee may borrow.

Where the property is subject to a lease arrangement with a related party, the SMSF may risk its continued status as a complying fund. This may be the case where the rent paid is seen to be excessive or well below comparable market rate. Many lenders also consider this to be important as the investment in the property by the SMSF derives a direct income stream from the property rather than relying on sources of income of the borrower or a related party.

Loan Structure

Under the recent changes, the trustee acquires a beneficial interest in the original asset or its replacement. On repayment of a loan secured against the asset, ownership of the asset can then be transferred to the beneficial owner, the SMSF. The SIS does not specify who must hold legal title (for property investments). There are also no rules



as to who should act as a fund's trustee and/or a security trustee. Under these circumstances, even a member of the fund or a lender can act as a security trustee.

To supplement the non recourse nature of the security from a SMSF, a lender may obtain personal guarantees from key members of the SMSF and or other acceptable collateral security where available and held outside of an SMSF structure. The SIS does not limit a lender's ability to do this.

Apart from a corporate trustee borrower, a member of the fund can also act as a borrower (and on-lend to the SMSF) albeit a lender would have to be comfortable with such a structure due to its limited recourse and loan repayment issues.

As an alternative, individual 'unitholders' in the form of a corporate trustee acting for a super fund that owns the units in a Unit Trust (UT) may use this UT as a borrower (the trustee acting for the UT will be the borrowing vehicle).

Accordingly, loan structures are anticipated to be mainly influenced by tax considerations (eg. capital gains tax, stamp duty payable on transfer of an asset from a trustee to a SMSF, and negative gearing) whereas loan security will be influenced by the lender subject to its policies and procedures and taking into account the inherent credit risks. Due consideration will also be given where the SMSF is acquiring or selling property as any equity in the property must be paid into or out of SMSF funds.

Limited recourse to the borrower/SMSF

When lending to a SMSF, a lender cannot obtain recourse to other assets of the SMSF. The SIS gives the SMSF protection for its other assets in the fund despite any shortfall that may arise from redemption by a lender over the SMSF's mortgaged property or asset. If the trustee has a right relating to the security asset (eg. security trustee), the rights of the lender against the trustee's right are also limited to rights relating only to the security asset.

There is some uncertainty as to whether the SIS with the recent changes enables a lender to require an equity contribution to be made by the SMSF in the event of a shortfall. We do not think this would be possible.

Under the SIS, any provision in the trust deed of a SMSF is void if it purports to preclude a trustee of the entity from

being indemnified out of the fund's assets in respect of any liability incurred while acting as trustee of the entity.

Where a trustee breaches the terms of a SMSF, liability for breach of trust if the trustee fails to act honestly in a matter concerning the entity; or intentionally or recklessly, in these situations, the liability is personal to the trustee and cannot be discharged out of fund assets. Lenders to, and or taking security from, a trustee will not have a 'guaranteed' subrogation of rights and should factor these risks into as part of a loan approval.

Compliance Issues by SMSF

The Australian Tax Office (ATO) has outlined relevant compliance issues for SMSF on the ATO website. From 1 July 2007, all new trustees (and directors of corporate trustees) of SMSF are required to sign a trustee declaration, in the approved form, within 21 days of becoming a trustee or a director of the corporate trustee. The declaration aims to ensure that new trustees (or directors of corporate trustees) understand their obligations and responsibilities.

SMSF that do not comply are taxed at 45% (as a penalty tax rate) on their income and asset base compared with a complying SMSF which is taxed at 15% on their income. Hence non-compliance will impact on SMSF cash flows and is another risk factor for lenders' consideration.

Recommendation

There is scope for lenders/financiers to consider prudently lending to SMSF under a registered mortgage product. In doing so they will need to amend their loan and security documents to ensure that they are consistent with what is now permitted under the SIS, especially in relation to recourse and recovery, the SMSF's rights and liabilities and the role of the trustee and its statutory compliance requirements.

The above article is not an exhaustive view of the subject matter covered, for more information, please contact Sebastian Saccuzzo or Roderick Tan.

SEBASTIAN SACCUZZO,
Principal
Tel: 03 9609 1578
Email: ssaccuzzo@rk.com.au

RODERICK TAN,
Solicitor
Tel: 03 9609 1678
Email: rtan@rk.com.au



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MARIA JOCKEL, Principal
T: +61 3 **8602 7213**
F: +61 3 8602 7269
E: mjockel@rk.com.au



EMMA DUNLEVIE, Senior Associate
T: +61 3 **9609 1558**
F: +61 3 9609 6760
E: edunlevie@rk.com.au

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CONTACT DETAILS BANKING & FINANCE



Sebastian Saccuzzo, Principal
Email: ssaccuzzo@rk.com.au
Tel: 03 9609 1578



Paul McCarthy, Principal
Email: pmccarthy@rk.com.au
Tel: 03 9609 1623



Nathan Brunt, Senior Associate
Email: nbrunt@rk.com.au
Tel: 03 9609 1647



Adrian Kennedy, Solicitor
Email: akennedy@rk.com.au
Tel: 03 9609 1641



Kaajal Fox, Solicitor
Email: kfox@rk.com.au
Tel: 03 9609 1659



Helen Mastos, Solicitor
Email: hmastos@rk.com.au
Tel: 03 9609 1535



Roderick Tan, Solicitor
Email: rtan@rk.com.au
Tel: 03 9609 1678



Ben Fisher, Solicitor
Email: bfisher@rk.com.au
Tel: 9609 1636

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