

The Lender's Secret Weapon

Property investors Gordon and Sally Jones are about to lose everything, their home, their three investment properties, and potentially their marriage; if only they'd been advised on how to protect their home from the bank when they set their loan up.

You see, their bank, like all lenders, has an insidious secret weapon, it's called the "All Monies Mortgage Clause" (AMMC) embedded in their legal documents and it puts them in a commanding position.

So how did Gordon and Sally get themselves into this position?

Years ago Gordon got a loan from his local bank manager to buy his own home. About five years ago, after marrying Sally, they decided to buy some investment properties. So, like most property investors, they went back to their bank manager who happily arranged a loan for "106% of the purchase price" for each of the properties to cover costs and deposits.

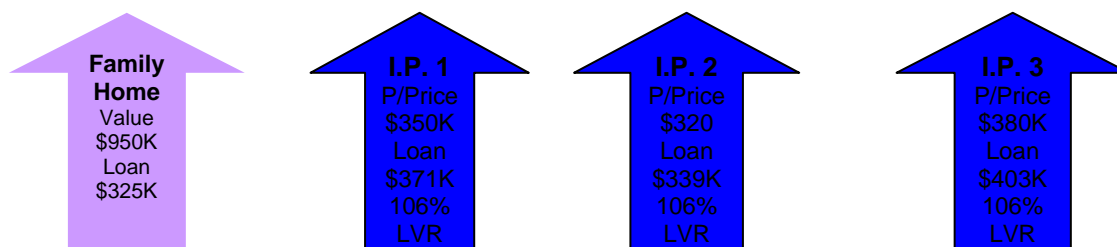
"Fantastic", they thought, "Just like we heard at all those seminars - build a property empire using none of your own money!"

After hearing about the dangers of cross collateralisation from a mate, Gordon insisted on each loan being "stand-alone" and his bank manager happily obliged.

What Gordon didn't know was that cross collateralisation was to be the least of his worries. It was the AMMC that was to be his downfall. His unawareness sowed the seed for today's catastrophe.

Let's look at how his bank manager explained the set up of his loans.

Typical Finance Structure



You might be thinking that this all looks fine - so where is the problem?

The AMMC threat is subtle and poses no immediate threat; and the menace can lay dormant for years, but it does give the bank the means to foreclose almost at will.

Real finance structuring tactics

The way in which their bank structured their loans is actually quite different from the structure illustrated in the first diagram above.

In reality, the bank, which already held the title for Gordon's home, has simply thrown a net around his home and their investment properties to 'jointly and severally' secure the total debt. That's right; the bank now has the right under the AMMC to foreclose on **any or all** of the properties to repay all loans.

The bank has actually 'stripped' equity from their family home and applied it to the purchase of their investment properties in what is known as an 'equity transfer'.

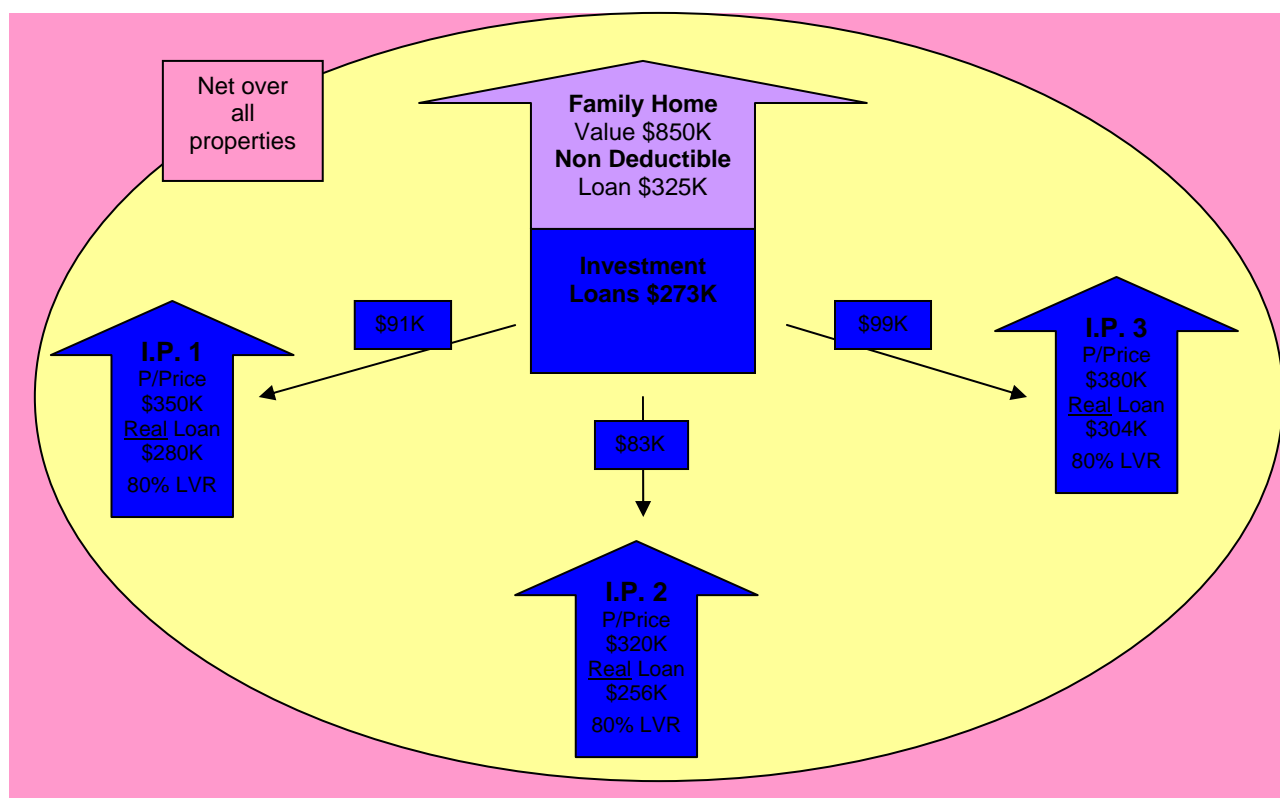
Equity transfers are standard banking practice and has enabled mum and dad investors across the country to build a property portfolio, but it has also exposed them to unnecessary dangers. More about that and how to avoid the traps later...

Banks won't lend 106% of the purchase price against a property without a much higher interest rate and a huge mortgage insurance fee (which, by the way, only covers the lender... not you - you pay the premium for their peace of mind!)

As you can see in the diagram below, the bank has actually stripped a whopping \$273,000 from Gordon's home to secure the loans used to fund the purchases of their investment properties.

Unbeknown to Gordon and Sally, the loans on their investment properties are actually limited to 80% of the value of each property, (80% LVR), a comfortable 1.25 security for every \$1 borrowed.

To meet Gordon's demand for stand-alone loans, the bank simply split the loans into deductible and non-deductible sub accounts.



Their bank stripped \$273,000 from the equity Gordon had in his home to cover his 20% 'hurt money' he and Sally were (unwittingly) required to contribute, plus purchase costs. They were totally mis-led into believing the bank was actually lending 106% against the investment properties.

But it gets worse for Gordon and Sally, much worse.

Under the AMMC, the family home's 'exposure to debt' (that is the debt their home is liable for), rocketed from \$325,000 to a massive \$1.438M, nearly 60% higher than the value of his home.

And Gordon had no awareness of what the bank had done, and neither do most investors who borrow money for investments with the same lender as they have for their home.

Suddenly their home is at the mercy of the bank. And, they had no idea as the bank manager had never explained the effect AMMC could have on their own home. Little wonder – a recent survey of bank managers found that less than 25% understood the implications of the AMMC.

What triggered Gordon and Sally's catastrophe?

Life had been pretty good for Gordon and Sally. Gordon and they decided he would take his long service leave so they could travel for three months.

Gordon arranged direct debits from their savings account to cover the repayment shortfall after rent.

It was while Gordon and Sally were overseas that disaster struck. One of their tenants lost his job and missed a rental payment creating a shortfall in the repayment of \$1170. The bank automatically issued a default notice demanding immediate payment.

Unaware of the events that were unfolding at home, Gordon and Sally were trekking towards "Base Camp" in the Himalayas.

Six weeks later they arrived home, exhausted, but exhilarated from their epic journey. The next day they started to wade through the mountain of mail that had accumulated over the two months they'd been away.

Upon tearing open the first of a number of letters from Gordon's bank, his blood ran cold as he scanned the headline "Notice of Default". He scrambled to rip open a second letter from his bank as beads of sweat appeared on his forehead. This time the headline in red screamed "Letter of Demand – immediate payment required."

By now their loan was two months in default and the third repayment was due in just 5 days.

Terror set in as Gordon scrambled to find the statement for their savings account. He found it was overdrawn by \$2,751.28. He then fumbled for to find their credit card statement, it was just shy of its limit.

Including default interest, they were now nearly \$4,500 behind in his payments. Their savings account was overdrawn and their credit card was nearly 'maxed out'. They needed over \$7000 immediately. Where were they going to find that sort of money?

Their loans were now in default. If all requirements of the order were not met within 28 days, the provisions of the All Monies Mortgage Clause provided that **ALL** loans would be 'deemed' to be in default and would be called up or action taken to sell any or all of the securities, (properties), including their home to recover any outstanding loans. Remember, the bank is exposed to a single client for in excess of \$1.4M, so alarm bells were ringing... and loudly.

Gordon and Sally's predicament was now dire. It proved impossible to liquidate these investment properties within 28 days and equally impossible to secure new finance while in default.

One tenant losing his job had cost Gordon and Sally their \$1.9M portfolio, including the family home in just a few short months.

The worst was to come... their relationship was at breaking point as they faced their financial ruin.

Gordon and Sally's Grave Mistakes

None of this had to happen.

This whole tragic scenario could have been avoided if only Gordon and Sally had sat down with a financier who was skilled in correctly structuring finance for property investors.

They had made many financing errors, but it was three key mistakes that lead to this disaster:

1. They gave the bank financing their investments access to their home as joint security – albeit, they had no idea they had done so.
2. They had not allowed for a safety net for this instance, to cover an interruption of income.
3. Their exposure to a single lender was way too high leading to fast action by their bank to recover the debt, An “A” class client can very quickly plummet to “D” class.

A skilled “Financial Architect” would have structured his finance to ensure maximum asset protection, particularly for the family home.

Structuring for Protection

A Financial Architect would have structured Gordon and Sally's finance to achieve four key objectives:

1. Provide maximum protection for the family home and key assets
2. Protect and maximise cashflow to prevent a repayment default
3. Preserve and protect tax benefits for the future
4. Maximise returns leading to passive income

Now let's have a look at how a Financial Architect would have structured Gordon and Sally's finance.

Protecting the Home

First and foremost, the home would have been protected. This is achieved by isolating it from the banks providing the investment loans, virtually negating the dreaded All Monies Mortgage provisions.

This is done by using a separate lender. The Financial Architect then arranges a “cash transfer” to fund the “hurt money” and costs. This would have reduced the home's exposure to debt by about 76% or \$840,000.

Under a “cash transfer” the home would be exposed to just \$598,000 instead of \$1.438M.

Guarding against Default

Secondly, Gordon and Sally would have been provided with a safety net to negate the effect of the rental default which caused them to default on their loans, putting their home in jeopardy.

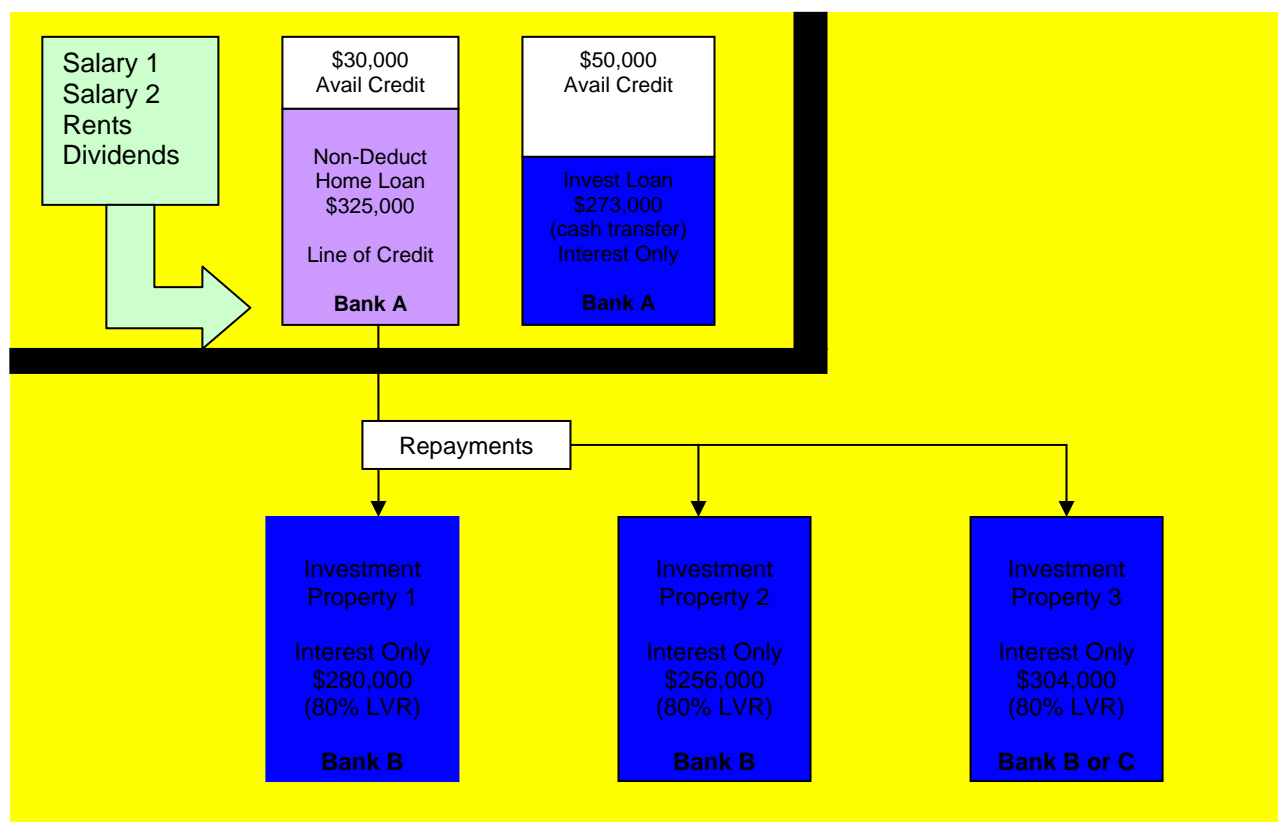
If the rent doesn't come in or there is some other interruption to your income (or you over-spend on your holidays), you can ride it out until things return to normal. We recommend your buffer covers you at least 6 months.

Optimising your Returns

Thirdly, there's only one reason to invest in property,- to make money. Everything you do should revolve around maximising your position, because while you making money you can't go broke.

“Washing” all appropriate income through your non-deductible home loan can eliminate your home loan very quickly, slashing the cost of your interest and boosting returns.

Let’s have a look at how this structure would look.



Why Gordon and Sally’s finance wasn’t structured correctly

1. A lender will always optimise its position, by obtaining and retaining all available properties to secure the loan. The lender is in a powerful position, while Gordon and Sally are in a weak position.
2. A bank cannot achieve the best possible position for the borrower, because it requires a second lender to counter the AMMC.
3. Bank Managers don’t understand the AMMC and the danger it exposes the investor to.
4. A mortgage broker typically won’t structure the finance to give you the safest position there is a lot more work for the broker (not you) to deal with two banks and, like most bank managers, most mortgage brokers do not understand the AMMC and the risk it poses to borrowers.

How do you know if you are at risk?

For some, you will have experienced an uneasy twitch as you read through the scenario. For others, you will simply know you are at risk. A simple question to ask yourself:

Are any of your investment loans with the same lender as your home loan?

If you so, you could face the same risks Gordon and Sally encountered

What course of action should you take?

- a) Make arrangements to review your finance structure with a financier specialising in structuring investment finance for property investors.
 - b) Go to www.investorsedgefinance.com.au and complete the "Self Audit" questionnaire and study the three reports which will be emailed to you.
 - c) Contact us at Investors Edge Finance and a Senior Financial Architect will conduct a wide ranging review of all aspects of your property investing structures, strategies, portfolio, goals and objectives. There is no charge for this consultation. Call us on 03 9509 8911 to arrange an appointment.
-