

February 2008 Newsletter

Leverage one of your greatest assets... Superannuation.

Previously, superannuation funds were not allowed to borrow money as it contravened the sole purpose test (being to create retirement benefits for its members) and therefore the legislation specifically prohibited it. However, an amendment to the Superannuation Industry (Supervision) Act 1993 (SIS Act) which received Royal Assent on 24 September 2007 means super funds can now borrow in certain circumstances. This is particularly relevant to people that operate their own Self Managed Super Fund (SMSF). You can now use cash in your SMSF as a deposit to purchase an investment property.

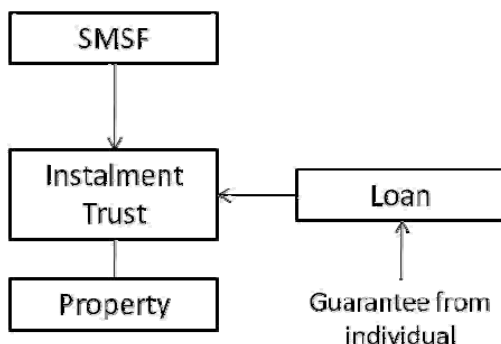
What has changed?

Section 67(4A) of the SIS Act now provides an exemption to the general prohibition that super funds cannot borrow. This exemption relates to instalment warrants. Instalment warrants normally relate to share purchases, but they can be applied to the purchase of real estate property.

How does it work?

The property must be purchased using an instalment trust. This trust allows the super fund to have a beneficial interest in the property. This trust also needs to provide the super fund the right (not obligation) to acquire the asset (property) through the payment of instalments.

The super fund contributes its cash deposit into the instalment trust. The instalment trust purchases the investment property with the cash from the super fund and obtains a limited recourse loan for the remainder of the purchase price.



The instalment trust must be carefully worded to ensure that a stamp duty liability does not arise when the property transfers to the super fund (on payment of the final instalment). It is very important that the trust is in existence prior to signing a Contract of Sale for the purchase of an investment property. Some legal firms have developed special trust deeds for this purpose.

Lending restrictions

There are some important lending restrictions that must be complied with. The lender (that provides the loan to the instalment trust) must provide a limited recourse loan so that the assets of the super fund are not put at risk. As such, the bank may only take the following security:

- Registered first mortgage over the subject property.
- Personal guarantee from the directors of the trustee company (or individual trustees).
- Registered mortgage debenture over the trustee company (if corporate trustee exists). This would not be commonly requested by the lenders.

These lending restrictions should not pose many problems with most lenders, as most (but not all) lenders would only ask for a registered first mortgage and guarantees from the directors of the corporate trustee. Some lenders have released specific mortgage products, but these are relatively expensive. It is expected that these products will become more competitive in the coming months.

Asset protection

Investing in property through your super fund provides you with additional level of asset protection, particularly in relation to bankruptcy.

Contributions threshold

Borrowing money will help manage the superannuation contributions threshold. Personal contributions are limited to \$150,000 per year (or \$450,000 over 3 years). However, the tax deduction is limited to \$50,000 p.a. Therefore, you could borrow the required funds to purchase a property and then contribute \$50,000 p.a. and use this \$50,000 to pay down your debt. Borrowing essentially allows you to invest tomorrow's contributions today.

Tax savings

Obviously, one of the biggest benefits of investing via a super fund is the tax savings. Once the super fund's members are over 55 and retired, the fund's income and capital gains tax rate is zero. During the super fund's accumulation phase (i.e. before members are retired), the income tax rate is 15% and capital gains tax rate is 10%, which is a huge saving compared to assets held outside of a super environment.

Tax benefits

Many people are attracted to the tax benefits that investing in property creates. Essentially, because the interest on a loan used to finance an investment property is tax deductible, investors end up reducing the amount of tax they pay. Sure, instead of paying tax they need to meet an interest bill. However, they get something in return – finance to invest in property. A similar outcome can be derived with this structure, because you can

salary sacrifice super contributions which will assist in paying the interest (and perhaps principal) loan. This results in lowering your overall tax rate, as super contributions are taxed at the concessional rate of 15%. Therefore, this will yield similar tax saving benefits as negative gearing into property in your personal name.

Better asset allocation

A recent article published in the US version of Money Magazine profiled the top 20 timeless rules of money from the smartest investors that ever lived (it was a great article by the way). Number 5 (in the article) was all about asset allocation (spreading your investment dollar in different assets like direct property, shares, fixed interest, etc). Consider someone that has \$400,000 in a SMSF. In the past they would have been able to either purchase a \$400,000 investment property or put all the

money into shares. Now they can do both. They could use \$200,000 as a deposit for an investment property (and borrow the remaining \$200,000 plus costs) and put the remaining \$200,000 into shares. This provides investors with more flexibility around asset allocation.

What do you need to do?

Firstly, you need to speak with your accountant or financial planner to ascertain if gearing into property is an appropriate investment strategy for you. If it is, you will need to establish the instalment trust which will own the investment property (there are a few legal firms which sell these 'off-the-shelf'). Secondly, you will need to arrange a pre-approval with your chosen lender ensuring that they do not contravene the strict lending rules (i.e. exposing the super funds assets).

Australian Interest Rates - What's Happening?

Since the beginning of 2008, many banks have increased their variable interest rates independently from any movements by the RBA. Just to refresh your mind, the majors have increase rates by the following margin:

- CBA: 0.15% + RBA rate increase of 0.25%
- Westpac: 0.15% + RBA rate increase of 0.25%
- NAB: 0.16% + RBA rate increase of 0.25%
- ANZ: 0.20% + RBA rate increase of 0.25%
- St George: 0.20% + RBA rate increase of 0.25%

What has caused these rate increases?

Lenders fund some of their mortgage using securitisation. This involves bundling a group of home loans together and selling them to institutional investors. These investors are now demanding higher returns (interest rates) so it's costing the banks more to fund these loans.

What caused investors to demand more?

The US sub-prime melt down has caused investors to be very wary. Some bullish lending practices emerged in the US like lending a high percentage of a property's value (sometimes over 100%), while offering a 1 or 2 year low introductory rate to people that had poor credit histories. Lenders measured borrowing capacity using the introductory rate, not the higher rate that the borrower would end up paying for the majority of the term. Therefore, the borrowers introductory term expired and then they struggled to meet the repayments at the higher interest rate. Of course they had little equity in the property, (because they borrowed a high percentage) so some borrowers are now walking away from their homes. As there are more potential home sellers than purchasers, house prices have plummeted in some areas. The lenders are left holding the bag - or more correctly, the investors that funded the lenders!

These events in the US have caused investors to be extremely careful with what bonds or commercial paper they invest in.

How long will this go on?

Fundamentally, nothing has changed in the Australian market. The creditworthiness of the Australian borrower has not changed. Our overall loan to value ratios are comparably low. Our property market is in a stable to strong position (depending on which State you look at). Our economy is booming (just ask the RBA!). Our sub-prime market (or non-confirming as its called here) is tiny in percentage terms compared to the US (less than 2% of Australian borrowers are non-confirming). Overall, the risk profile has not changed and therefore the 'cost of funds' should not change. Therefore, the increase in costs is likely to be temporary. The question then becomes, how long will it take for pricing to return to normal? That's a million dollar question. I think financial markets need to be assured that all losses from the sub-prime fallout have been realised and reported, before confidence can be re-built. Therefore, I suspect we'll have to wait for March 2008 quarter earning results to be released by the big US banks. Until then, we will just have to hang on for the ride! Be assured. Once pricing has returned to normalised levels, we'll be keeping pressure on the banks to reduce their rates.

Our Best Rates

Basic variable	8.23%
Offset (> \$700k)	8.17% (0.80% ongoing disc.)
Offset (> \$1 million)	8.13% (0.85% ongoing disc.)
Offset (> \$1.25 million)	8.08% (0.90% ongoing disc.)
3 years fixed	8.24%
5 years fixed	8.20%
10 Years	8.25%

Rates current as at 15/2/08 and are subject to change without notice. Standard lenders terms and conditions apply. Comparison rates are available upon request.

Investment Property Seminar

Our next joint investment property seminar with Wakelin Property Advisory will be held on Saturday 15 March at 2pm. Call Wakelin on (03) 9859 9595 to book (Melbourne only).