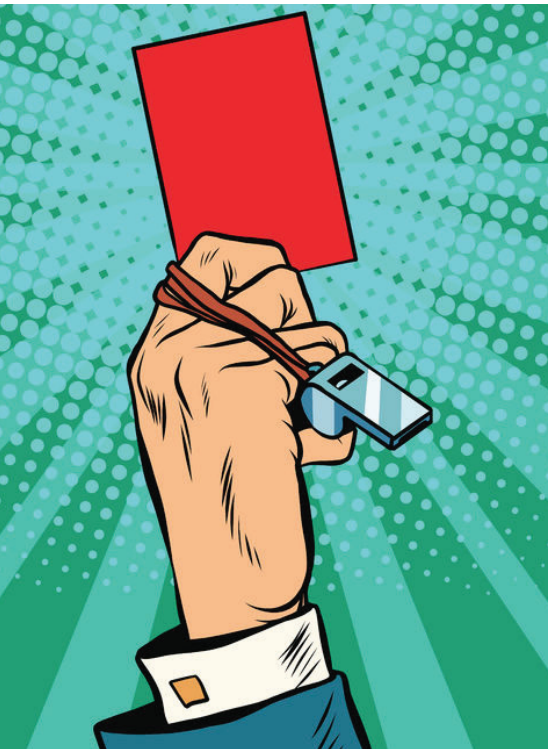
mikephippsfinance

The Rules Have Changed……
Game On….Maybe !



I was once told that the definition of a consultant is someone who steals your watch and then asks you the time. I have also heard that a good accountant, when asked the total of 2 + 2 will reply, "What would you like it to be ?"

Perhaps fortunately, in our world, things are a bit more cut and dried. We are certainly seeing a quantum shift in the banks' approach to loan assessment and obviously the various investigations and commissions currently under way are driving a far more conservative credit environment. Interestingly, this is leading to a refocus on lending fundamentals and, in my view, that's not necessarily a bad thing. However, here's a caveat. If the trend swings to far toward absolute compliance with credit policies we run the very real danger of a serious credit crunch, particularly impacting small business. There is no such thing as a perfect business credit application so there always needs to be some room for lenders to make reasoned decisions within a flexible policy framework..

When I was a young bloke, many moons ago, I had various old and wise credit managers attempt to beat credit theory into me and, in particular, the so called five Cs of credit. My view is that the fundamental rules still apply and are worth revisiting given the current banking environment.

Character

Some say that this is the test of a borrower's ability to pay back debt. I disagree. In my mind what we are talking about here is a desire to take responsibility for the debt and repay it. It's one thing to be able to meet your obligations, a whole different thing to wanting to meet them. That can sometimes mean that a borrower who has faced financial adversity and prevailed will be well regarded by lenders. This is as it should be. Obviously, credit history and full disclosure of all matters that form part of the assessment is essential. A strong CV and credible references carry a lot of weight as well.

Ultimately, if a bank is going to approve a deal outside policy, character is the most important attribute that a borrower needs to demonstrate.

Capacity

The empirical measurement of a borrower's financial ability to meet commitments coupled with a degree of income and interest rate risk assessment. Recent events have seen lenders tighten up on capacity assessments and it's important to understand the state of play. In order for a borrower to have finance approved we must be able to demonstrate that loan commitments can be met on a Principal and Interest basis with a 3% lift in current rates. Furthermore, we must be able to prove this capacity over the balance term of the loan after any interest only period and after reasonable allowances for living expenses and tax. As you can see this means that the longer the interest only period, the higher the post IO payments assuming a specific loan term. Some lenders do 3 year total loan terms but we still need to be able to show notional debt servicing over the long term.

The days of making a standard living expense allowance are gone and borrowers must provide a personal budget when applying for credit. We must be able to confirm all income sources and we must be able to demonstrate that there is a reasonable expectation that this income will continue. In the case of investment property rental income, we must discount the gross rent to allow for costs and a vacancy factor.

Income associated with employment that is subject to a short term contract or probation is extremely hard to rely on, as is income from some pension and retirement schemes such as public service pensions.

Mike Phipps. **0448 813 090**
mike@mikephippsfinance.com.au
Paul Grant. **0448 417 754**
paul@mikephippsfinance.com.au
Cameron Wicking. **0477 776 859**
cameron@mikephippsfinance.com.au

Head Office
4/31 Mary Street
NOOSAVILLE QLD 4566
Office. 07 5470 2194
Fax. 07 5455 6626
www.mikephippsfinance.com.au

MIKE PHIPPS FINANCE ACL (364 314)

The Rules Have Changed…….. Game On….Maybe !

We talk to many borrowers who, in their minds, have self-servicing property debt. That is, the rental income pays the interest. As we can see borrowers need to modify their thinking and take into account the sensitivity tests I have outlined.

In terms of taxation strategies lenders have a variety of views. It's important to understand that banks are fearful of any changes in tax law that may adversely impact borrower's capacity to service debt. Recent discussions regarding negative gearing being a case in point with some lenders not recognising the tax savings inherent in a negative gearing arrangement.

Capital

Also know as equity and fall-back capital this section refers to the amount of cash or value of supporting assets the borrower can, or is willing, to contribute to a transaction. Lenders quite rightly see a large equity contribution as both a positive impact on the transaction risk and also an indication of the borrower's commitment to the arrangements. In essence, the more the borrower has to lose, the harder they try and make sure they meet their commitments. Often referred to as the hurt in the deal or skin in the game. I like neither expression, but you get the picture.

It's important to note that having sufficient equity to carry a minimum deposit and costs is not enough, particularly for business finance. Lenders want to see that the borrower has enough money left over to cover any contingencies and general cash flow fluctuations. Often referred to as a working capital reserve.

Another important point here is that banks will also look at the borrower's capital reserve in terms of the applicants age and their historical spending habits. Trends that reflect a preference for lifestyle over prudent investment don't always go down well with credit departments.

Lenders are not favourably disposed to equity coming from inter family loans or indeed vendor finance. Family gifts are acceptable but need to be confirmed via statutory declaration.

Collateral

More commonly referred to in Australia as security. Obviously, the more security the better from a lenders point of view. The usual security mix for a business loan will be a charge over the asset being purchased combined with the personal guarantees of the people controlling and benefiting from the acquisition. If a company or trust is involved lenders will seek guarantees from directors, shareholders and beneficiaries.

Mortgages over any supporting security will be taken. Most lenders will not (and should not) contemplate taking security from a third party who is not receiving a commercial benefit from the transaction. Forget about having your 90- year old mum putting her house up, it simply won't be acceptable. Back in the day you might have got around this by making mum a beneficiary of your trust. Those days are over. The banks are not interested in being featured on A Current Affair as they throw mum out on the street.

Limited recourse lending refers to a loan with only the asset being purchased being offered as security. There may be perfectly valid reasons why a director does not want to offer a personal guarantee albeit the explanation of the strategy needs to be pretty compelling. We have had some success with this style of lending but always at reduced gearing and higher rates. It's a higher risk for the lender so no surprises there.

mikephippsfinance

Mike Phipps. **0448 813 090**
mike@mikephippsfinance.com.au
Paul Grant. **0448 417 754**
paul@mikephippsfinance.com.au
Cameron Wicking. **0477 776 859**
cameron@mikephippsfinance.com.au

Head Office
4/31 Mary Street
NOOSAVILLE QLD 4566
Office. 07 5470 2194
Fax. 07 5455 6626
www.mikephippsfinance.com.au

MIKE PHIPPS FINANCE ACL (364 314)

mikephippsfinance

The Rules Have Changed……
Game On….Maybe !

Limited guarantees , particularly for partnerships, are available and generally reflect personal guarantees limited to the partners percentage shareholding in the purchase entity.

Conditions

Generally referred to as Conditions Precedent and Conditions Subsequent. As the names suggest there will be loan approval conditions that need to be met prior to settlement. Confirmation of assignment approval for management rights is a prime example.

Conditions Subsequent to settlement can be a bit more interesting. A business loan will have a term, anything from 3 years to 15 years is the norm. In many cases there will be an interest only period during which the loan and therefore the lenders risk does not amortize. Banks will seek to keep an eye on the financial health of their client by regularly seeking information over the course of the loan. The obligations of the borrower to provide this information are outlined in the Conditions Subsequent section of the Letter of Offer. Some obligations are regular, such as annual financial statements while others are event driven. Reporting loss of units in a letting pool falls into this category.

There will also be default conditions and here's where things get a bit more complicated. There are monetary defaults and there are non-monetary defaults. Triggering either would once have led to anything from a warning letter to penalty interest being applied or, in extreme cases, formal debt recovery action commencing. I have never been a supporter of penalty interest in cases of monetary default. It's a bit like kicking someone when they are down and, in my mind, not a good look. However, a financial penalty for a borrower who simply refuses to supply reasonable information for an annual review seems like a good way to focus that borrower on meeting their reporting obligations.

Recent investigations into the banking sector have led to a discussion around loan conditions for business finance with the result that banks will not be allowed to include a raft of Conditions Subsequent in their finance offers. The Carnell Report into banking practices makes numerous recommendations and for business borrowers the report summary is well worth a read. Recommendations in regard to banks being unable to pursue borrowers on non-monetary default, reporting and adequate time for borrowers to roll expiring business facilities are of particular interest, as is a recommendation to cease the revaluation of security assets where there has been no monetary default.

You can read more about the Carnell Report at
http://kmo.ministers.treasury.gov.au/media-release/005-2017/

While all this sounds like a win for the borrower the downside of less stringent loan conditions and monitoring may well be a move to higher rates and shorter loan terms. Think about it. If a lender is limited in what they can monitor, revalue and enforce after settlement then that's a higher risk loan. That risk can be compensated for through a higher risk rated interest rate and a shorter loan term. I suspect this consequence may not have been completely considered or appreciated by the authors of the report.

Based on our current dealings with some banks I am working on a theory that there may be sixth C but let's not go there.

Get your mind out of the gutter……it's Confusion of course.

Mike Phipps F Fin
Director | Phippsfin Pty Ltd
ACN 139 124 673

Mike Phipps. **0448 813 090**
mike@mikephippsfinance.com.au
Paul Grant. **0448 417 754**
paul@mikephippsfinance.com.au
Cameron Wicking. **0477 776 859**
cameron@mikephippsfinance.com.au

Head Office
4/31 Mary Street
NOOSAVILLE QLD 4566
Office. 07 5470 2194
Fax. 07 5455 6626
www.mikephippsfinance.com.au

no surprises...