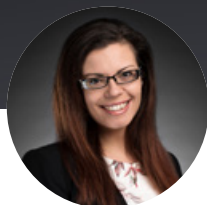




PRACTICE GUIDE FOR SECOND MORTGAGES

# DUE DILIGENCE FOR SECOND MORTGAGES



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**This is the first of a number of publications we will be issuing answering some frequently asked questions regarding second mortgages. This publication and our overall guide are designed to give lenders a more in-depth knowledge of second mortgages and some tips and traps to watch out for.**

Some of the comments in this publication also apply to first mortgages and, of course, apply to third and other subsequent securities for lenders with that risk appetite.

It is important to note that States and Territories have individual laws relating to mortgage securities, particularly registration and mortgagee rights on title. Although we will attempt to point out where differences may exist, it is always important to check the requirements of your individual jurisdiction.

*Disclaimer: The advice in this publication is general in nature and should be viewed in light of your specific circumstances and transaction requirements. We encourage you to contact us to discuss your needs.*



# UNDERTAKING DUE DILIGENCE IN SECOND MORTGAGE TRANSACTIONS

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## 1. SERVICEABILITY

The first matter to be decided when considering any loan application is the serviceability of the loan. It is important to understand that serviceability does not relate to the equity in the security but rather on the borrower's capacity to repay the loan without there being a need to resort to the security. A strong serviceability assessment is important irrespective of, but will be guided by, the method of repayment.

If the facility is to be repaid through the borrower's ordinary income, we recommend you undertake a standard debt servicing ratio calculation. There is more than one method for calculating a debt servicing ratio and unfortunately, most banks do not publicise their internal policies, but we can give you the following guidance:

- [APRA's Prudential Practice Guide APG 223](#) Residential Mortgage Lending outlining APRA's recommendations to formulating a prudent policy for serviceability of home loans can also be considered for other types of facilities that rely on repayment from the borrower's ordinary income.
- Most institutional lenders will only accept up to 80% of business income (eg. rental income).
- When considering existing debt, be sure to factor in the possible increase of interest rates. APRA recently updated its guidelines and recommends an increase factor of 2.5% above the current interest rate of the debt.

If the facility is fully capitalised and intended to be repaid from the outcome of the project being financed, serviceability will need to be determined on a combination of the project outcome, and the fall-back position of the borrower's ordinary income and value of the security, the project viability and outcome being the obvious primary factor.

When reviewing proposals for projects, you should consider obtaining or verifying matters such as:

- audited or at least accountant certified evidence of starting profit and loss, assets and liability of the borrower and any guarantors;
- independent assessment of the borrower's plans, proposal, and expected figures by a suitably qualified person in the relevant industry (if you do not have this expertise);
- evidence of pre-sales for property developments; and,
- review of other contractual arrangements with third parties on which the project relies and which you may be able to 'step-in' to in case of default, such as builders contracts and project management contract.

The terms of loan in facilities of this kind may then need to include:

- application of a suitable margin of error on the project outcomes;
- a step-in deed in respect of third party contracts allowing you to step-in and continue that contract;
- pre-requisites for subsequent drawdowns, which can range from quantity surveyor assessment to independent valuation and re-assessment; and,
- accountability measures to ensure things stay on track, which can range from as little as regular reporting to regular reviews, updated valuations, and the ability to vary the loan terms in certain cases.



# UNDERTAKING DUE DILIGENCE IN SECOND MORTGAGE TRANSACTIONS

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## 2. PROPERTY AND MARKET INVESTIGATIONS

Lenders will ordinarily obtain an independent valuation of the mortgaged property. Be aware of valuations conducted prior to certain improvements being demolished, or on the basis that certain improvements will have been made, as these are useful but do not necessarily confirm the present value of the security.



Lenders should also undertake an assessment of market and economic outlook that might cause increases or decreases in the value of the property and/or the borrower's proposed project. This is particularly relevant to second mortgage securities that tend to soak up the majority if not all of the remaining equity in the property.

Assessments of general economic outlook are difficult to make but there are things more close at hand that can impact on the value of a security. Be sure to consider, and or ensure the borrower or valuer have considered:

- if there are current or proposed developments nearby, or any such development is likely; and
- current or proposed Government infrastructure projects that may affect the property.

The borrower will have usually considered these matters to the extent that they may increase the value of the property, but be aware of a failure to consider adverse developments or projects that may arise.

# UNDERTAKING DUE DILIGENCE IN SECOND MORTGAGE TRANSACTIONS

## 3. DETAILS OF FIRST RANKING SECURITY

Whilst lenders are accustomed to obtaining a statement of the total outstanding on a first mortgage security, we routinely see a failure to obtain the full details of the first mortgage security. This is particularly relevant for first mortgages which are not bank loans.

Loans by non-bank lenders quite often contain unique terms and conditions. It is important to verify matters such as:

- the provision for further advances and in that case the facility limit;
- the interest rate, including default interest rate and methodology of calculation;
- the repayment date and repayment terms, including milestones and early repayment requirements; and
- other special terms including variation rights.

Do not assume that a mortgage registered against a residential property is a home loan, it could be given pursuant to a guarantee on a completely different type of facility.

Most of this information is able to be verified by requesting a full copy of the loan documents pertaining to the first mortgage, which lenders should insist upon.

**If you are requesting the first mortgagee's consent to a second mortgage, a confirmation of the key details of the facility and that no other agreements exist can usually be obtained from the first mortgagee directly and, ordinarily, the deed of priority will afford you some additional protections.**



# UNDERTAKING DUE DILIGENCE IN SECOND MORTGAGE TRANSACTIONS

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## 4. PUBLIC SEARCHES

Lastly, in conducting due diligence of a loan, it is important to carry out some legal searches.

There is some information that we recommend you obtain from the borrower before instructing solicitors, this includes:

- Borrower full name (ACN / ABN).
- Borrower (or principals) copies of ID (drivers licence and passport).
- Copy of trust deed and any variation documents pertaining to any trusts.
- If the borrower's ABN does not match the ACN it means the borrower is acting as trustee of a trust.
- Latest rates/water and land tax notices for the all mortgaged properties.

Lenders should be familiar with the capacity and pre-requisites of superannuation funds if the proposed borrower is a superannuation fund. In general:

- Super funds cannot acquire or own property in which the members reside, all property ownership must be for business purposes;
- The proposed project must be within the super fund's business strategy, highly speculative projects may not qualify; and
- Loans to super funds must be limited recourse that is, limited to the mortgaged asset and without the ability to claim the balance against superannuation. The balance payable is usually supported by other security, such as a guarantee.

Lenders should become familiar with the variety of legal searches that can be conducted or ask this question of their solicitor. This is particularly relevant for unique properties or where the facility is reliant upon some important matters, which the solicitor may simply not know.

Standard searches in loan facilities normally include:

- **Title search** – a search of the title of the property to verify the borrower's ownership and registration of caveats, mortgages and other encumbrances which may not have been disclosed.
- **Plans, maps and name searches** – if you are funding a development, information can be gathered from the relevant titles office to ensure all relevant parcels of land are included in the proposed security.
- **Land tax / rates and water (where information not provided)** – it is important to keep in mind that State revenue offices and local governments have the power to garnishee land and require payment of land tax, rates and other charges from a mortgagee or in priority to the mortgagee.
- **Borrower and guarantors company searches** – a search to verify the details of any company borrowers and guarantors including that they are not deregistered or under external administration.
- **Borrower and guarantors bankruptcy searches** – a search to verify that any individual borrowers or guarantors are not currently or have previously been bankrupt.
- **Personal property securities register search** – if the security includes a general security over the assets of the borrower or any guarantors, a search of the personal property register will confirm any pre-existing competing interests that will have priority.



# UNDERTAKING DUE DILIGENCE IN SECOND MORTGAGE TRANSACTIONS

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There are additional searches that can also be carried out which may ordinarily be conducted for conveyancing purposes and which may be advisable for particular properties or projects. These include:

- **Town planning and building searches** – confirming property approvals and restrictions.
- **Contaminated land search** – confirming presence of the property on the contaminated land register or the existence of prior environmental activities.
- **Transport, energy and infrastructure searches** – confirming any current or proposed resumptions and other infrastructure affecting the property.

If you are funding in connection with the purchase of a property, you should also request a copy of the contract of sale. This is important to confirm:

- if the borrower is the buyer or if the mortgage will need to be by guarantee and in that case the arrangements in place between borrower and buyer entities;
- the overall sum required by the borrower including rebates that may apply; and
- any other specific terms of the purchase that may affect your approval terms.

Some of this information may be able to be obtained directly from the borrower, including where you are funding in connection with the purchase of the mortgaged property. In this case the borrower will have hopefully conducted conveyancing searches for itself.



# YOUR CHECKLIST

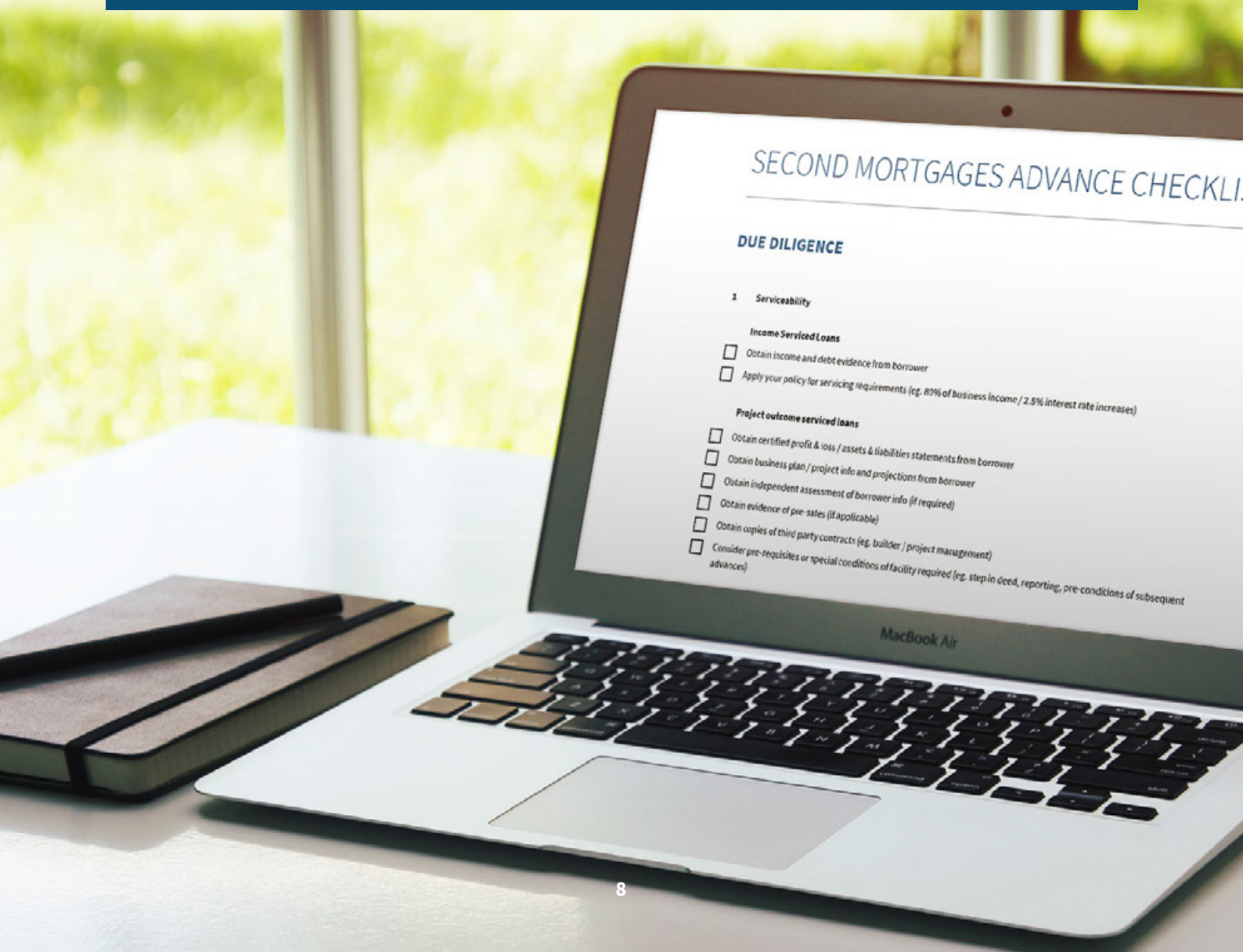
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**We have synthesised all the information in this publication in a Checklist for your use in connection with conducting due diligence in second mortgage transactions.**

If you have any questions regarding this publication or wish to discuss your policies and procedures with us, please don't hesitate to contact us.

Bennett & Philp provides practical, tailored and cost effective solutions for all mortgage transactions. Our clients enjoy regular advice, education and networking opportunities, which are included in your benefits as a client of Bennett & Philp. We provide all prospective clients with a free initial consultation, so call us now to discuss how we may be able to help.

**Contact us today and talk to us about how we can assist you in achieving your business goals and objectives.**





# SECOND MORTGAGES ADVANCE CHECKLIST

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## DUE DILIGENCE

### 1 Serviceability

#### Income Serviced Loans

- ☐ Obtain income and debt evidence from borrower
- ☐ Apply your policy for servicing requirements (eg. 80% of business income / 2.5% interest rate increases)

### 2 Project outcome serviced loans

- ☐ Obtain certified profit & loss / assets & liabilities statements from borrower
- ☐ Obtain business plan / project info and projections from borrower
- ☐ Obtain independent assessment of borrower info (if required)
- ☐ Obtain evidence of pre-sales (if applicable)
- ☐ Obtain copies of third party contracts (eg. builder / project management)
- ☐ Consider pre-requisites or special conditions of facility required (eg. step in deed, reporting, pre-conditions of subsequent advances)

### 3 Property and market investigations

- ☐ Obtain independent valuation
- ☐ Investigate current or proposed developments nearby
- ☐ Investigate current or proposed infrastructure projects
- ☐ Investigate other relevant market conditions

### 4 First mortgage security investigations

- ☐ Obtain statement of current balance on first mortgage security
- ☐ Obtain full copy of first mortgage security documents – consider:
  - a. further advances and facility limit
  - b. interest rate and method of calculation
  - c. default interest rate and method of calculation
  - d. repayment date including milestones or early repayment requirements
  - e. other conditions, special terms and requirements

### 5 Public searches

- ☐ Obtain borrower full name, ACN, ABN and ID (drivers licence / passport)
- ☐ Obtain guarantor full name, ACN and ABN
- ☐ Obtain copy of trust deeds and variations  
NB: if the Borrower's ABN does not match the ACN a trust is involved
- ☐ Check super fund compliance if super fund is borrowing. For example:
  - a. obtain certificate from super fund accountant that transaction is compliant; and
  - b. ensure loan is limited recourse.
- ☐ Obtain evidence of rates, water and land tax from borrower
- ☐ Conduct standard legal searches (per your policy with your solicitor)

# ABOUT BENNETT & PHILP

Established in 1984, Bennett & Philp is a mid-tier law firm based in the heart of Brisbane offering end-to-end legal solutions for both business and individual clients. Our team offers a broad range of services to support both Australian and international clients across every stage of business and life.

## AREAS OF PRACTICE

We provide personalised service across six core areas of specialisation:



Business Advisory  
Services



Disputes & Litigation



Intellectual  
Property



Property & Real  
Estate



Compensation  
Law

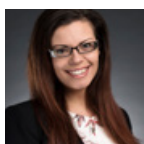


Wills & Estates

## MEET OUR TEAM

With 13 Directors and over 70 team members across six different service areas, you can rest assured that our experienced team can give you the practical and solutions-oriented legal advice you need for any occasion.

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Contact us today and talk to us about how we can assist you in achieving your business goals and objectives.

