THE *facts*

Shining a light on the mortgage trust sector

What is a mortgage trust?

Mortgage trusts are one of the oldest examples of "unit trusts". They have existed in the form we know today since the early 1970's, although their real growth and prominence began in about 1982. Such unit trusts are today called managed investment schemes.

A unit trust "pools" the money of investors and then selects investments (which are funded out of the "pool") in accordance with the unit trust Constitution and details the Product Disclosure Statement (PDS) for the trust. The attraction of a unit trust is that it allows investors to do collectively what they otherwise generally cannot do individually, either because of lack of time, lack of expertise, lack of sufficient capital, or any combination of these factors.

Mortgage trusts essentially make loans in respect of commercial and residential properties. While it is true that mortgage trusts have historically offered better returns than bank term deposits, as an investment rather than a savings vehicle, they do have a different risk profile to bank term deposits.

This fact sheet seeks to explain how mortgage trusts work and the different types of mortgage trust available.

How popular are they?

Although growth in mortgage trusts has slowed over the past 18 months, the mortgage trust sector has been one of the fastest growing "unit trust categories" over the past 15 years. Total funds under management now exceed $17 billion and growth in the last 5 years was $10.5 billion (source: Standard & Poor's Market Share Reports). The sector is very competitive and increasingly diversified in terms of product offerings. Every mortgage trust has a risk profile that is different to another trust and this is important for investors to understand - mortgage trusts are not all the same and it is essential that you are fully informed and review the risk profile for the investment you are considering.

What are the main differences between the mortgage trusts?

In their recent Sector Report on mortgage trusts, Standard & Poor's separated the sector into three distinct subgroups: conservative, hybrid/multi sector, and high yield mortgage trusts. Standard & Poor's defined each subgroup as follows:

Conservative mortgage trusts are those funds investing in first registered mortgage assets secured by residential and commercial properties with less than 30% of the portfolio in construction, development or specialised property exposure, and with a stated maximum 'Loan to Value Ratio' (LVR) of 75%.

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High Yield mortgage trusts are those funds investing in first registered mortgage assets secured by residential and commercial properties, with more than 30% of the portfolio in construction, development or specialised property exposure, and with loans with a maximum LVR in excess of 75%.

Hybrid/Multisector mortgage trusts are funds investing in mortgages meeting the same criteria as the conservative trusts, but with a strategic allocation of between 30% and 50% to non-mortgage-backed, fixed interest assets. A major differentiating feature of hybrid/multisector trusts is the variable unit price, which is a result of strategic allocation to fixed interest securities.

While this is Standard & Poor's interpretation, other researchers, commentators and experts may have a different view.

Is there a label which would help make the differences obvious to consumers?

No, but the industry is working on improving disclosure and education so investors are better able to understand the products and identify the differences.

What risks are associated with an investment in a mortgage trust?

Like all investments there are risks associated with mortgage trusts. The degree of risk for each trust depends on, but is not limited to, factors such as:

- the lending experience of the mortgage trust's staff and the procedures in place;
- the robustness of the mortgage investment process;
- the extent of mortgage investment in construction loans and specialised properties after considering specific procedures in place for these security types;
- diversification of mortgage investments across states and locations (i.e. country, metropolitan or population parameters);
- diversification of mortgage investments across accepted property types (e.g. commercial, office, industrial, retail and residential);
- the quality of the valuation of the property (independence of valuers and valuations on an "as is" basis rather than on completion);
- an assessment of borrowers ability to make repayments;
- whether the security offered is a first registered mortgage or not;
- whether the trust makes development loans (if there are development loans, the risk to investors increases) and
- the level of the LVR

These factors should be able to be determined by looking at the PDS for each mortgage trust or through manager websites or monthly/quarterly updates. In determining the degree of risk, consideration should be given to the depth and breadth of disclosure.

As with any investment, a higher return is often a signal there is usually a higher risk. Care should be taken when considering the appropriateness of any investment.

What do the terms mean?

Registered first mortgage
A mortgage is the charge over the property securing the payment of the loan. A registered first mortgage is the first charge over the property and must be repaid before any subsequent charge (e.g. a second registered mortgage).

Loan to Value Ratio (LVR)
One of the factors lenders consider before they approve a mortgage is the 'Loan to Value Ratio'. This is the loan amount expressed as a percent of either the purchase price or the appraised value of the property.

Fixed interest securities
These are investments that give the holder the right to a fixed money income or contractually determined variable money income.

Residential and commercial properties
Residential properties are houses and apartment blocks. 'Commercial properties' is a more generic term and includes offices, retail shops, factories and warehouses.

Specialised properties
These are properties built for a specific and specialised purpose such as child care, aged care, hospitals, service stations, hotels, motels and conference centres. These properties generally require specialist management to run, have configurations which tend to make them unsuitable for alternative use (in their present state) and, if offered for sale or lease may have a restricted market.

Construction & development properties
These are properties on which buildings are being built. The full value of the property is only realisable upon successful completion of the project and will depend on the project being completed within budget and on time.

Mezzanine debt
Where funds are borrowed on a second or subsequent mortgage basis. Mezzanine debt attracts a higher interest rate due to higher risks and in the event of default, will rank behind prior mortgages.

What are the differences between mortgage trusts and mezzanine finance products?
Property construction and development can be financed in a number of different ways. Some mezzanine finance companies raise funds from investors and provide forms of unsecured or subordinated debt often in situations where traditional bank finance is not available.

Such financing arrangements may, for example, involve the issue of high yielding promissory notes. Funds raised may be used to help finance residential or commercial construction. The underlying security for such investment is generally a second or subsequent ranking mortgage over the development project.

Mortgage trusts usually have a registered first mortgage over commercial or residential properties which are the underlying security for the investment. It is important to note that the value of property may increase or fall over the period of the investment.

What are the difference between mortgage trusts and debentures?

Debentures are a type of fixed-interest security issued by companies (mainly finance companies and large industrial firms) in return for investment of funds. The security for the debenture-holder is usually in the form of a fixed and floating charge over the assets of the company issuing the debenture. A debenture company's assets can include registered first mortgage investments.

Mortgage trusts are unit trusts and investors have, as the underlying security for their investment, registered first mortgages over commercial and residential properties.

What would be the effect of an increase to the interest rate?

While the Australian economy has been relatively stable over the past 10 years, because interest rates are generally variable (NB: Official interest rates have risen three times in the past 18 months, on each occasion by 0.25%pa - the last rise being in May 2006), a large number of mortgage trusts write their loans at variable rates of interest. If interest rates rise, this is passed through immediately to investors - If the interest rates fall the opposite can be true.

How is the investor's money protected in a mortgage trust?

Firstly, the operator of a mortgage trust must hold an Australian Financial Services License (AFSL) issued by the Australian Securities and Investment Commission (ASIC). The manager must pass a number of rigorous tests including a demonstrable expertise in all aspects of commercial mortgages and in managing investor funds. ASIC also requires the holder of an AFSL to hold a certain amount in net tangible assets and have insurance coverage up to $5,000,000.

Secondly, before investment in a mortgage trust can be offered to investors, the mortgage trust scheme must be registered by ASIC. This involves a scheme constitution, a scheme compliance plan, and a statement signed by the directors of the Responsible Entity that the constitution and compliance plan comply with the requirements of the law, being lodged with ASIC. One of the requirements of the law is that all scheme property must be clearly identified and held separately from property of the Responsible Entity and any other scheme.

Thirdly, the manager can only make investments that are within the requirements of the constitution and the PDS for the particular mortgage trust.

Does the Law require mortgage trusts to have a liquidity strategy?

A liquidity strategy is the method by which the fund is able to meet the day to day withdrawal requirements. This is required under the Corporations Act for all managed investment schemes, including mortgage trusts, and should be part of the mandatory compliance plan of the scheme.

What fees are paid on a mortgage trust and how are they paid?

The Responsible Entity of a mortgage trust, as part of its AFSL licensing obligations, must disclose fees that are paid to it under the scheme constitution and in the PDS. These may include entry, exit and operating fees.

The operating fees are called the Management Expense Ratio (MER). The MER consists of two parts:

- a management fee and
- an expense recovery fee.

The MER will generally range between 1.1% - 1.5% of the value of the fund. From 1 July 2006, the MER measure for mortgage trusts will be replaced under the enhanced fee disclosure regulations by the Indirect Cost Ratio (ICR).

Do mortgage trusts pay adviser commissions?

Yes. Mortgage trust operators do pay financial advisers commissions for referring investments to their fund. Importantly it is the Responsible Entity, as the operator of the trust, and not the funds that pay these commissions. The Responsible Entity will generally pay the commission from the fees it receives for operating the mortgage trust. Fees and charges are disclosed by the mortgage trust provider within the PDS and the exact level of commission received by an adviser must be disclosed by that adviser. If you have any questions you should speak to your adviser.

What level of disclosure is the mortgage trust Sector obliged to give?

Current regulations oblige mortgage trusts to clearly identify in their PDS what type of mortgage investments they will seek to invest in. This can include LVR, geographic and sector profile and the nature of property they will classify as acceptable security. It is suggested that investors review this detail thoroughly, considering the impact these factors will have on the risk associated with their investment.

IFSA is currently updating its Guidance Note on mortgage trust disclosure, with a view to enhancing disclosure within this sector.

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