ASIC

Australian Securities & Investments Commission

REPORT 119

Protecting wealth in the family home:

An examination of refinancing in response to mortgage stress

March 2008

About this report

This report draws on a qualitative examination of a small number of transactions, where brokers arranged refinances of home loans for borrowers in financial difficulties. It analyses the conduct of the parties involved, with a view to drawing lessons which may help consumers, brokers and lenders in similar circumstances make better decisions.

This report also analyses the practice of 'equity stripping', where fringe brokers refinance vulnerable borrowers in financial stress into loans they cannot afford, in order to earn substantial fees. We analysed 3 refinances in detail. For these 3 borrowers, the refinance cost them on average 27% of the equity they had accumulated in their home, and a minimum of $20,120 in fees and charges.

While it may only examine a small number of transactions on the margins, the report demonstrates that there are problems with consumer decision-making, in some cases contributed to by broker advice that is motivated by self-interest, and lender's procedures.

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Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

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Executive summary

What is 'equity stripping'?

1 Since 11 March 2002 ASIC has had a consumer protection role for credit facilities under the *ASIC Act 2001* (ASIC Act), which covers broad standards of conduct, including conduct that is unconscionable and misleading or deceptive. In March 2003 ASIC released a report into mortgage brokers, which identified some unfair practices occurring on the fringe of the industry.[1]

2 One of the marginal practices identified in that report was 'equity stripping'. 'Equity stripping' is when fringe brokers take advantage of the desire of mortgage borrowers in default to save their home by:

- charging them high fees (in some cases consuming up to 20% of the borrowers' equity in their home prior to the refinance); and
- refinancing them into loans where they are at extreme risk of being unable to afford the repayments on the loan.

3 This report examines case studies of consumers refinancing their mortgage under financial stress. Our review found that these borrowers had a strong attachment to their home and were centrally motivated by a desire to avoid its sale. This meant they were predisposed to ignore options that, while financially more rational, would involve its sale. In particular:

- They were readily inclined to trust brokers who told them that they could arrange a loan that would save their home. Fringe brokers were able to arrange credit with lenders who determined eligibility solely on the equity held in the home, whereas borrowers relied on brokers to put them into loans they could afford.
- Borrowers did not make inquiries into the total costs of the refinance, and some brokers did not disclose their fees or total costs in sufficient time for the borrower to make a considered decision. 6 of the 12 borrowers surveyed said that if they had been fully advised of the costs of refinancing they would either not have proceeded with the transaction or they would have investigated alternatives.

Options for borrowers in financial difficulties

4 Borrowers in financial stress can address their situation by focusing on concrete issues:

- whether their financial difficulties are temporary or continuing (and therefore whether they need a short or long-term change in their repayments);

[1] *A report to ASIC on the finance and mortgage broking industry* (REP 19) by the Consumer Credit Legal Centre NSW (CCLC).

- whether they need a significant reduction in repayments from their existing level.

5 Borrowers need to recognise they have options, even if some of them are unpalatable. These options may include:

- negotiating with their existing lender for temporary relief;
- examining all alternative loan options available, and the merits and disadvantages of each option;
- 'downsizing' by moving to a less expensive property; or
- selling the home, to realise as large a lump sum as possible and investing that sum, in the hope that they will be able to buy another home in the future.

6 Borrowers should also:

- approach their existing lender as early as possible, before the arrears accumulate to levels that make it harder to arrange a variation;
- use available resources like financial counselors, legal aid or community legal centres;
- make informed decisions, which may mean deciding to sell their home or downsize rather than erode their equity through a fruitless attempt to keep their home; and
- understand there are no easy solutions and therefore be better able to avoid brokers who make unrealistic promises about getting them out of debt or who advertise that they can help no matter how desperate a person's financial situation is.

7 Borrowers can also avoid fringe brokers and lenders by:

- only using brokers who are members of an External Dispute Resolution scheme approved by ASIC (e.g. Credit Ombudsman Service Ltd or Banking and Financial Services Ombudsman), as this will make it easier to obtain a remedy.
- recognising triggers in broker behaviour that suggest the transaction is risky, such as the broker asking them to sign blank documents or application forms with information that is false, refusing to discuss repayments with them before asking them to sign up or arranging a loan without discussing the borrower's financial situation in detail, or what repayments they can afford.

8 ASIC has resources available to assist consumers, including a checklist in Appendix A that enables borrowers to weigh up their options, and information on the FIDO website (www.fido.gov.au), including budgeting and repayment calculators that enables them to test whether refinancing is in their interests.

Nature, extent and consequences of 'equity stripping'

9 The sources for this report's examination of equity stripping are:

- a review of fees charged by 2 brokers who marketed themselves as 'refinancing experts';
- a survey of the experiences of 14 borrowers who refinanced their home loan through a broker at a time when they were in financial difficulties;[2]
- a detailed analysis of 3 of these borrowers to assess the overall financial impact of refinancing, including changes in the value of their equity; and
- other information highlighting current practices and borrower experiences (including government reviews and recent litigation).

10 It should be noted that this report is not, and was not intended to be, an examination of broker practices generally. By definition the borrowers involved refinanced as they were in financial difficulties, and most had problems meeting their new obligations and so sought assistance.

11 The 2 brokers reviewed in detail charged fees to borrowers:

- of more than 20% of the existing equity in their homes; and
- at a rate up to 22 times higher than industry standards, while the highest fee charged in dollar terms was $24,320.[3]

12 We analysed in detail the financial position of 3 borrowers who refinanced. We found that:

- the refinance cost them on average 27% of the equity they had accumulated in their home;
- they incurred a minimum of $20,120 in fees and charges; and
- in all 3 cases the brokers arranged loans with higher repayments; the refinances therefore did not address, even in the short term, the underlying problem of the borrowers' lack of capacity and their need for a significant reduction in repayments.

As a result, within 12 months of the refinance these borrowers had lost their home or defaulted to such an extent that the loan was irretrievable. At significant cost, the refinance only purchased them a very limited reprieve from the need to sell their home.

13 Borrowers who were placed into unaffordable loans could only extract themselves at a loss, as they defaulted and became liable for arrears and

[2] The survey was arranged through the Consumer Credit Legal Centre NSW. A summary of the methodology is in Section B.
[3] The figure for industry standards is based on *Report on Broker-Originated Lending* published by the Australian Prudential Regulation Authority (APRA) in 2003, and confirmed by recent ASIC inquiries. The fee of $24,320 was charged for arranging a loan of $220,000 on a property valued at $310,000.

enforcement expenses (secured against their equity). Borrowers in this position had two options, both potentially costly:

- *Refinance the increased debt to another loan.* The refinance may only defer the sale of the home, as the borrower will have a larger loan, with, in all likelihood, higher repayments. The amount borrowed will increase due to refinancing costs, such as further broker fees, early termination charges on the old loan and establishment fees for the new loan.
- *Sell the home to pay their debt.* An early sale, controlled by the borrower, may have been the most realistic and financially beneficial option even at the time of the initial refinance.[4]

14 Some fringe lenders will allow borrowers to enter into a cycle of unaffordable loans in which they default and refinance several times until the equity in their home has been exhausted.

15 Once placed in an unaffordable loan the borrowers had great difficulty in obtaining redress from their broker. The majority of the brokers in the transactions reviewed in this report were not members of an external dispute resolution (EDR) scheme. This meant that borrowers could only pursue compensation through court action, where they had legal support. This made it impracticable for these borrowers to recover money from the broker for the damage they had suffered, except in a handful of cases.

16 Equity stripping can have disastrous consequences for individual borrowers, apart from the financial impact. The personal costs can be high, and can include social dislocation, depression and great difficulty in re-entering the housing market in the future (depending on their age and overall circumstances).

17 There is no reliable data available as to the extent of fringe lending activities, as typically the loan funds are raised privately. Research suggests that up to 188,000 households are experiencing severe mortgage stress and at high risk of defaulting. This pool of borrowers reflects the target market for fringe brokers.[5]

18 The problem of equity stripping is sufficiently prevalent for it to have come to the attention of the recent Inquiry into Home Lending Practices and Procedures by the House of Representatives Standing Committee on Economics, Finance and Public Administration. The Committee's report found:

'There are, however, cases where lending has clearly been inappropriate. These loans occur within a small segment of the non-ADI sector that preys on vulnerable people through the practice of "predatory lending". This

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[4] Inquiries by the Reserve Bank of Australia suggest that '*voluntary sales often achieve a 15 to 20 per cent higher price than mortgagee-possession sales*', Financial Stability Review, September 2007, p 54.
[5] Fujitsu Consulting Australia, Press Release 5 February 2008.The basis for this estimate is set out in more detail in Section A.

practice involves lenders providing loans to borrowers with no capacity to repay. The lenders charge excessive fees and commissions to establish the loan, and foreclose on the mortgage at the first sign of default. The borrower is either forced to refinance with another lender or to sell their home. In both cases the predatory lender will have stripped a significant proportion of the equity the borrower previously held'.[6]

Fringe brokers and lenders

19 Equity stripping can be very lucrative for both fringe brokers and predatory lenders, as it allows them to generate significant profits with minimal risk. Some fringe lenders regularly charge borrowers interest at 50% per annum or more, and higher rates on default. In the cases identified in this report these lenders were protected against loss because there was sufficient equity available in the property to cover any default in repayments.

20 While increased disclosure and access to better information may assist some of these borrowers a small percentage are still likely to use fringe brokers and are therefore at risk of being refinanced into unaffordable loans.

21 The need of these borrowers for enhanced and effective protection has been recognised by the States and Territories in the proposed draft broker legislation. The draft bill will address this situation through:

- a licensing regime that allows fringe operators to be excluded;
- a requirement to ensure that the refinancing has benefits for the borrower;
- a requirement that brokers must assess the capacity of borrowers to meet repayments;
- changes that mean home loans cannot be falsely documented as being for business or investment purposes so that fringe lenders cannot exclude the operation of the Uniform Consumer Credit Code;
- more straightforward access to remedies against brokers for breaches of the legislation, in particular through compulsory membership of an EDR scheme as a licensing condition.

[6] *Inquiry into home loan lending practices and the processes used to deal with financial difficulty*, House of Representatives Standing Committee on Economics, Finance and Public Administration, September 2007, paragraph 4.7 ADI lenders are approved deposit-taking institutions under the *Banking Act 1959*, principally banks and credit unions.

Improving practices for brokers and lenders

22 Only a very small number of brokers engage in equity stripping conduct. Other brokers can avoid the risk of arranging refinances that are of no benefit to borrowers by:

- providing realistic information to borrowers in financial stress, including advice that, in appropriate circumstances, their best option is to sell their home rather than refinance;
- only recommending a refinance where that transaction has appropriate long-term benefits for the borrower;
- making sufficient enquiries to ensure that the consumer can repay the loan, including an assessment of their income and expenditure; and
- disclosing the likely repayments, their fees and the total cost of refinancing in advance of the transaction, so that the borrower can make an informed decision.

23 ASIC is aware that some, but not all, brokers already have appropriate procedures in place to address these issues, and would encourage all brokers to regularly review their approach to clients in difficult financial positions.

24 Lenders can reduce the risk of approving applications forwarded by brokers for borrowers who cannot afford loans by:

- regularly reviewing their risk management practices;
- identifying ‘high risk’ applications and patterns of conduct, and monitoring them more stringently (‘high risk’ applications can include refinances where the borrower is in arrears, and, for non-bank lenders providing low doc or no doc loans, refinances of home loans from another lender where the circumstances suggest the borrower may be in default);
- using their internal complaints handling procedures as part of this monitoring process;
- assessing the extent to which channelling all communication with the borrower through the broker increases the risk of fraudulent applications (and adopting appropriate risk management practices);
- if the broker arranges valuations for the lender, considering whether the broker is valuation-shopping to ensure the estimate of the property value is sufficient to allow the loan to be approved.

25 Lenders can also assist existing customers by ensuring that their procedures to deal with borrower hardship are workable, practical, and communicated to their customers so that short-term financial difficulties are managed in a way that reduces the need for the borrower to look to refinance elsewhere. ASIC will be looking to work with mainstream lenders on their procedures for hardship variations generally following the release of this report.

Lessons for investors

26 Some fringe lenders raise capital from private investors to on-lend. These investors need to be aware that this type of lending has risks attached to it. Investors therefore need to make their own inquiries and obtain their own advice before deciding whether or not to invest.

27 For example, in November 2007 ASIC obtained orders in the Federal Court to wind up Caveat Finance Pty Ltd (Caveat) on the grounds of insolvency. Caveat had raised funds from private investors to lend out at 60% per annum. ASIC's proceedings alleged that Caveat had contravened the *Corporations Act 2001* (Corporations Act) in the way in which it had issued debentures. Evidence before the Court indicated that in excess of $3.7 million was outstanding to debenture holders, and at serious risk of not being repaid.[7]

[7] See Media Release 07-308 *ASIC acts to wind up Geelong finance company* of 22 November 2007.

A The impact of equity stripping

Key points

Borrowers can lose significant amounts of equity in a very short period of time. The borrowers involved in our detailed case studies lost an average of 27% of their existing equity at a minimum cost of $20,120 within 12 months of refinancing.

Borrowers may enter into a series of refinances until the equity in their home has been exhausted and is insufficient to support a further loan.

Some brokers arranged refinances for borrowers who were in arrears where the new loans had higher repayments than those the borrowers were already failing to meet.

2 brokers reviewed in detail by ASIC charged borrowers fees of more than 20% of the equity they held in their property.

'Interest-only' loans arranged by some fringe brokers through private investors may not assist borrowers as they can have repayments that are similar or higher than repayments under a conventional home loan.

Experiences of 3 homeowners

28 We reviewed the financial impact of the refinances arranged for 3 borrowers where the amount borrowed ranged from $122,000 to $502,000. The situation of each borrower before refinancing is summarised below.

Borrower 1	Borrower 2	Borrower 3
These borrowers were a young couple with 3 children. The male partner stopped working in June 2004. A month later the couple were falling behind in home repayments. In September 2004 the male partner found casual work but still could not meet these repayments. Having trouble with other debts they decided to refinance in January 2005.	These borrowers purchased their home in 2000. In mid-2004 the male partner was made redundant and by the time the couple refinanced they were over 3 months and more than $5,000 in arrears.	This couple bought their home in 2000. The husband was self-employed and in mid-2005 the couple had insufficient income to pay their home loan and numerous credit card debts. They were 4 months in arrears on their home loan when they decided to refinance.

29 Our analysis of these transactions focussed on the following factors:

- the cost to the borrowers of refinancing; and
- the suitability of the new loans arranged by the brokers.

Cost to borrowers

30 When borrowers elect to refinance voluntarily they do so because the perceived long-term financial advantages (e.g. a lower interest rate) outweigh the transaction costs involved in refinancing. In these cases the borrower refinances to save money over time.

31 These considerations do not apply where the borrower is refinancing because of financial pressures and the purpose of the transaction is to save their home. In such circumstances the level of costs charged will only be a secondary consideration, allowing fringe brokers and lenders to charge fees that would not be accepted if the borrower was not under financial pressure.

32 Table 1:

- sets out the fees and costs charged to each of these 3 borrowers on refinancing; and
- compares it to typical costs of $670 that each borrower could reasonably expect to have paid if the broker had refinanced them into a loan with a mainstream lender.[8]

Table 1: Cost of refinancing through a fringe broker

	Borrower 1	Borrower 2	Borrower 3
Property value	$150,000	$380,000	$530,000
Refinancing costs			
Broker fees	$19,615	$19,885	$16,000
Lender fees	$9,234	$8,940	$3,500
Other costs (eg valuation and settlement fees)	$2,131	$1,706	$620
Total costs	**$30,980**	**$30,531**	**$20,120**
Average cost to refinance with a mainstream lender	($670)	($670)	($670)
Difference in refinancing costs	*$30,310*	*$26,861*	*$19,450*

33 This data shows:

- lenders charged fees of between $3,500 and $9,234, between 5 and 13 time greater than the average fees charged by mainstream lenders.
- the brokers charged fees ranging from $16,000 to $19,885, when borrowers would not have been liable for these fees if they had refinanced with a mainstream lender, as the broker would have been remunerated by commission only.

[8] Based on average costs over 157 standard variable rate loans on the database at infochoice.com.au in November 2007.

34 In all cases, these high fees were paid by drawing down the equity in the family home. Table 2 shows the impact of these fees on the equity position of each borrower immediately after refinancing.

Table 2: Loss of equity in home

	Borrower 1	Borrower 2	Borrower 3
% Equity held by consumer before refinance	46%	47.4%	15.1%
% Equity held by consumer after refinance	25.8%	39.5%	11.4%
% Loss in equity due to refinancing	43.9%	16.6%	24.3%

35 These three borrowers lost, on average, 28% of their equity as a result of the refinance. It is an indication of the price some borrowers may end up paying as they seek to retain possession of their home.

36 Table 2 only takes into account the fees charged. Each borrower also lost further equity over time as they were paying additional interest relative to their previous loan, both because of the higher interest rate and a larger loan amount (due principally to the fees and costs charged).

37 Deciding whether or not to 'sell or save' the family home is therefore a complex question, and one requiring considered examination of competing options, and short-term benefits against medium–term losses.

Loans did not meet borrowers' needs

38 In all 3 cases, the brokers advised the borrowers to refinance into a loan with higher repayments and a higher interest rate than their existing loan. Details of each loan are set out in the Table 3.

Table 3: Comparison of terms on existing and refinanced loans

	Amount borrowed		Interest rate		Monthly repayments	
	Old loan	New loan	Old loan	New loan	Old loan	New loan
Borrower 1	$450,000	$502,000	7%	10.6%	$3,183	$4,633
Borrower 2	$200,000	$250,000	7%	9.95%	$1,600	$2,114
Borrower 3	$81,000	$122,000	9.44%	9.95%	$800	$1,011

39 These new loans did not meet the needs of the borrowers:

- Each borrower was refinanced into a loan with significantly higher monthly repayments than their existing loan. The brokers arranged loans with these terms, even though these borrowers had defaulted and needed a loan with repayments lower than their existing loan.

- In 2 of the 3 cases, unemployment was the catalyst for a change in financial circumstances, prompting a need to refinance. This meant the borrowers' capacity had significantly reduced since the first loan, and that they needed a substantial reduction in repayments, rather than a marginal change. Even a cursory review of their financial situation would suggest they could no longer meet their existing repayments.
- The refinances did not allow the borrowers to save their homes. Borrower 1 and Borrower 2, who lost most equity in their home, were forced to sell their homes approximately 12 months after the refinance. Borrower 3 remained in their home a little longer but at considerable personal stress, including leaving the house and returning to it at one point. They ended up selling the house and paying the entire sale proceeds to the lender to finalise their debt.
- The high broker fees and further charges by the lender increased the amount that had to be borrowed which in turn increased the repayments to the lender.

40 These results suggest that refinancing when already in default is a high-risk strategy. Borrowers in this position are susceptible to agreeing to enter into expensive loans with high set-up costs, when these loans can erode their equity and may not enable them to remain in the family home beyond the short term. As one borrower said:

'If we hadn't gone to a broker, we may have waited and looked at refinancing later on or just tried to find a buyer for the house. Now we have no equity and no choices, and it cost us $40,000 to get here.'

Effect of serial refinancing

41 If a borrower has entered into an unaffordable loan then they are at risk of entering into a cycle in which they default and refinance again. Each time they refinance the amount they borrow increases, due to:

- establishment costs charged by the new lender and a new set of brokerage fees (if applicable);
- costs charged by the existing lender arising from their default, such as enforcement costs or penalty interest (which can be charged at a significantly higher rate); and
- any early termination fee charged by the existing lender, given that the loan is being refinanced within a short period of time.

42 This pattern of refinancing is likely to have the following results:

- the equity they hold in their home will significantly reduce;
- the size of their loan repayments will increase;
- they will be at an even greater risk of defaulting under the loan; and

- the loan can only be repaid in full by the borrower either taking out a larger subsequent loan or selling the asset secured by the loan.[9]

43 A recent decision of the Supreme Court of NSW, *Permanent Mortgages Pty Ltd v Cook*,[10] is an example of this process. In this case the borrowers had refinanced their home loan 4 times when they were in default.[11] The details of the refinances are set out in Table 4.

Table 4: Summary of loans in *Permanent Mortgages Pty Ltd v Cook*

Lender	Date of loan	Amount borrowed	Amount from advance directed to earlier loan	Date of 1st default
CBA	1997	$110,000	N/A	Sept–Oct 2000
Private Mortgage Fund	Dec 2000	$120,000	$110,000	April 2001
Private Mortgage Fund	June 2001	$138,000	$133,000	Sept 2001
Liberty Finance	July 2002	$182,000	$147,490	Sept 2002
Permanent Mortgages Pty Ltd and Private Mortgage Fund	May 2003	$240,000	$229,778 ($191,000 and $38,778)	June 2003

44 This data shows that:

- the size of the borrowers' debt doubled from $120,000 to $240,000 in just under 2½ years (between December 2000 and May 2003); and
- the period of time it took for the borrower to default on repayments reduced with each refinance (from 4 months after the December 2000 refinance to missing the first payment on the May 2003 loan).

45 In finding that the loan contract was unjust Patten AJ provided the following comment on the transaction, highlighting the risk for consumers from multiple refinances:

'Given the means of the Defendants and their credit history, the Plaintiff, in my view, was aware, or would have been aware, had it made the most perfunctory of enquiries, that the Defendants were not capable of servicing the loan even at the lower rate of interest and could only satisfy their obligations by selling the mortgaged property for a sum sufficient to cover the principal and interest. It was likely that they would thus become obligated to pay interest on the amount of the credit, not at 8.8% p.a., but at the much higher rate of 13.8%.' [12]

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[9] These loans have been described as 'Ponzi' loans; see the expert's report by Steve Keen, Associate Professor of Economics and Finance at the University of Western Sydney, tendered in evidence in *Permanent Mortgages v Cook* [2006] NSWSC 1104.

[10] [2006] NSWSC 1104.

[11] The Court found that the final refinance was unjust within the meaning of the *Contracts Review Act 1980* (NSW), and reduced the borrowers' liability under that contract.

[12] At [88].

Broker conduct

46 The refinances reviewed for this report show a range of conduct by the brokers involved:

- At one end of the spectrum, brokers provided responsible advice to borrowers that their best option would be to sell their home, even though the brokers would not earn fees or commissions for this advice.
- In one case, the broker did not charge a fee and, in fact, paid some of the refinancing costs out of their own pocket, as the borrower could not afford them. This suggests the refinance was an attempt by the broker to meet the borrowers' unrealistic expectations that they could keep their home.
- Other brokers charged high fees to arrange refinances where there was no reasonable prospect the borrower could meet the repayments.

47 Transactions in this last category are those where the broker's conduct could be characterised as equity stripping and unfair. We analysed the conduct of 2 brokers who marketed themselves to borrowers in financial difficulties, with a view to identifying criteria to assess their conduct. The analysis considers:

- the amount and method of calculation of the fee; and
- the suitability of the loans, particularly taking into account the level of inquiry into the borrowers' capacity to meet repayments.

Level of fees

48 We reviewed 2 brokers who promoted themselves in advertisements as providing refinancing solutions for borrowers in arrears, examining in detail 5 files from each broker. The advertisements were likely to attract borrowers already in default and consequently with minimal bargaining power.

49 In each case the broker arranged for the borrower to refinance into an interest-only loan for 12 months, with the broker's fee paid from the borrowers' equity through an increase in the amount borrowed. Table 5 and Table 6 analyse the transactions and the fees charged.

50 This data shows that:

- Broker A charged borrowers fees of between 5.1% and 30.0% of the equity in the home;
- Broker B charged borrowers fees ranging from 4.4% to 21.0% of the equity in the home;
- Broker A charged an average fee of 12.2% of the amount borrowed, and Broker B an average fee of 4.4%.[13]

[13] In addition Broker B also received a commission from the lender, although the files did not disclose the amount received.

Table 5: Fees charged by Broker A

	File 1	File 2	File 3	File 4	File 5
Property value	$175,000	$470,000	$310,000	$275,000	$260,000
Loan amount	$125,000	$130,000	$220,000	$220,000	$195,000
Fee ($ value)	$21,150	$18,350	$24,320	$23,570	$15,220
Equity (before deducting broker fee)	$71,150	$358,350	$114,320	$78,570	$80,220
Fee (as % of equity)	29.7%	5.1%	21.3%	30.0%	19.0%
Fee (% of loan amount)	17%	14%	11%	11%	8%

Table 6: Fees charged by Broker B

	File 1	File 2	File 3	File 4	File 5
Property value	$405,000	$520,000	$425,000	$340,000	$460,000
Loan amount	$324,000	$297,000	$327,000	$270,000	$260,000
Fee ($ value)	$21,560	$15,180	$15,180	$8,910	$5,240
Equity (before deducting broker fee)	$102,560	$238,180	$113,180	$107,780	$198,910
Fee (as % of equity)	21.0%	6.3%	13.4%	9.9%	4.4%
Fee (% of loan amount)	6.6%	5.1%	4.6%	3.3%	2.0%

51 We compared the fees on these loans against standard industry remuneration. We used the fee levels in a 2003 report by the Australian Prudential Regulation Authority (APRA) as our inquiries suggest there have been no significant changes to commission levels since that report. The APRA report found that banks, credit unions and building societies were paid, on average, for housing loans:[14]

- an upfront commission of 0.57% of the initial loan amount; and
- an average trail commission of 0.23% of the outstanding monthly balance.

[14] APRA *Report on Broker-Originated Lending*, pages 10–11.

52 On a loan of $300,000 commissions at this rate level amount to approximately $2,300 during the first 12 months of the loan (or 0.76% of the amount borrowed). A comparison with the remuneration earned by Brokers A and B during the first year of the loans we reviewed demonstrates that:

- the *average fee* charged by Broker A was 16 times higher than standard industry remuneration, and that charged by Broker B was 5 times higher;[15]
- the *highest fee* charged by Broker A was 22 times higher than standard industry remuneration, and that charged by Broker B was 8 times higher.

53 A review of the files of Broker A and Broker B found:

- no correlation between the fees and the amount of loan; and
- no apparent relationship between the fees and the amount of work undertaken.

Suitability of the loan

54 In situations where the borrower is unlikely to be able to afford the loan, the broker will need to use lenders who are prepared to approve the loan according to the borrowers' level of equity rather than their overall financial position.

55 Our review of the 10 files found that:

- in all 5 cases Broker A arranged the refinance without finding out details of the borrowers' existing loans (including repayments);
- Broker B obtained details of the existing loan for only one of the 5 borrowers;
- in 2 cases, Broker B arranged refinancing for borrowers who were in default on their existing loan without establishing what level of repayments the borrower had already failed to meet, even though this gives a benchmark figure for the amount the borrower cannot afford; and
- in all 10 cases the brokers only approached a lender who provided interest-only loans, and did not investigate alternatives.

56 The outcomes for the borrowers involved are set out in Table 7.

Table 7: Outcomes for borrowers

	File 1	File 2	File 3	File 4	File 5
Broker A: Outcome of refinancing for borrower	Property sold after 12 months	Property sold before loan finished	Property sold by mortgagee	Property sold by mortgagee	Refinanced with bank
Broker B: Outcome of refinancing for borrower	Property sold before loan finished	Paying loan	Paying loan	Paying loan	Property sold after loan finished

[15] The remuneration earnt by Broker B is however further increased by the amount of the undisclosed commissions received from the lender.

57 This data indicates that the appropriateness of the majority of these loans was questionable in that:

- 4 of the borrowers who approached Broker A failed to keep their homes;
- 2 borrowers with loans arranged by Broker B lost their homes; and
- the borrowers who lost their homes received significantly smaller lump sums after the sale than if they had sold the property rather than refinancing. This limits their future options, including their capacity to trade down to a less expensive home.

Use of 'interest-only' loans by fringe brokers

58 As seen with Brokers A and B above, one strategy used by fringe brokers is to arrange the refinance by utilising an 'interest-only' loan through private lenders. These loans have the following features:

- The lender will approve the loan based on the equity available in the borrowers' home to provide security (and without assessing in detail the capacity of the borrowers to meet repayments under the loan).
- The interest rate will usually be higher than for a traditional home loan. For example, the interest rate charged in the 10 files we reviewed was 9% or more for a first mortgage and up to 21% for advances secured by a second mortgage.
- There is little scope to significantly reduce the level of repayments to meet the borrowers' needs. A loan term of 12 months does not allow for the flexibility available with a traditional home loans (e.g. by varying the term of the loan or staggering repayments in the early part of the loan). The repayments are determined by the interest rate, and in most cases the broker is not able to influence this figure.

59 These factors mean that refinancing from a conventional home loan to an interest-only loan does not necessarily result in the borrower having significantly lower repayments, even though the borrower is only meeting the interest on the loan.

60 Table 8 compares repayments on:

- a traditional loan with an interest rate of 7.5% (a typical interest rate on a mainstream home loan during the period of refinancing reviewed);
- an interest-only loan for a term of 1 year at 9% (the lowest interest rate charged to borrowers in the 10 files we reviewed)

61 These loans are compared for scenarios where the amount financed:

- is the same for each loan; and
- where it is increased by $20,000 for the interest-only loan (to cover assumed transaction costs).[16]

[16] Transaction costs for some refinances we examined ere higher than $20,000: see Table 2.

Table 8: Repayments on interest-only and principal and interest loans

Loan details	Monthly repayments	Increase in repayment
$200,000 at 7.5% over 25 years (P and I)	**$1,477**	
$200,000 at 9% over 1 year (interest only)	$1,500	$23
$220,000 at 9% over 1 year (interest only)	$1,650	$173
$300,000 at 7.5% over 25 years (P and I)	**$2,216**	
$300,000 at 9% over 1 year (interest only)	$2,250	$34
$320,000 at 9% over 1 year (interest only)	$2,400	$184

62 This data suggests that there will be:

- a *minor increase in repayments* using an interest-only loan, where the amount financed is the same; and
- *a significant increase in repayments* using an interest-only loan for financially stressed borrowers, where the amount financed is increased by $20,000 to cover broker and lender fees and charges .

63 Short-term interest-only loans are a high-risk strategy as they may not give the borrower ‘breathing space’ through lower repayments. The risk of detriment increases where the broker has recommended a loan of this type only because the borrower can meet the eligibility criteria based on their equity in their home (the loan-to-equity ratio) rather than on an assessment of the level of repayments they can reasonably afford.

64 In some cases, the broker arranged for the borrower to meet repayments by including an allowance for prepaid interest in the amount borrowed, for some or all of the loan term. The use of prepaid interest in this way suggests that the broker knew there was a significant risk the borrower would not be able to afford the payments on the loan, and that the borrower would be unable to repay the principal in the future without selling the house (barring a dramatic change in their situation). If the borrower is likely to have to sell the property then there is a risk that delaying the decision to do so will reduce their equity.

65 The inclusion in the loan amount of prepaid interest can simply be an artificial means of allowing a loan to be approved, despite a lack of capacity to repay by the borrower. As long as there is sufficient equity available, advancing the repayments upfront in the amount financed maximises the return to the lender at no risk.

66 Including prepaid interest in the amount borrowed in this way inevitably has a significant impact on the level of equity held by the borrower. Depending on the amount of the loan and the interest rate it can result in an immediate reduction of equity of at least $10,000 and up to $30,000 or more.

Scale of the problem

67 There is no reliable data available as to the extent of fringe lending activities. Typically the loan funds are raised privately and therefore are not tracked through reporting to APRA. It is clear that it is only a small percentage of the overall housing market, given that as at July 2007 there were an estimated 5,500,000 home loans with a value of $850 billion.

68 However, it is possible to estimate the number of borrowers at risk of using predatory brokers and lenders because they are in mortgage stress.

69 The *Wizard-Fujitsu Report on Predatory Home Loan Lending* (Sept 2007) contains an estimate of the number of borrowers at risk of needing to refinance due to financial difficulties. The estimate is based on research with 26,000 consumers across Australia and uses a combination of demographic, psychographic and other factors (rather than, for example, simply considering the percentage of household income attributed to repayments). The report estimates that, as at September 2007, 70,000 households were experiencing severe mortgage stress, with this defined as *'households who are in significant risk of default, are having difficulty in making regular mortgage repayments, have defaulted or have commenced forced sales'*.[17] In February 2008 this figure was updated to 188,000 households under severe mortgage stress.[18]

70 This pool of borrowers is at risk of being attracted to predatory brokers and lenders in an attempt to retain possession of the family home.

[17] *Wizard-Fujitsu Report on Predatory Home Loan Lending Report*, September 2007, p 10. The estimate is based on research with 26,000 consumers across Australia and uses a combination of demographic, psychographic and other factors (rather than, for example, simply considering the percentage of household income attributed to repayments).
[18] Fujitsu Consulting Australia, Press Release, 5 February 2008.

B Why surveyed borrowers refinanced

Key points

Section A demonstrates how some fringe brokers can engage in equity stripping by placing borrowers in loans they cannot afford, and where the borrowers stand to lose significant amounts of money.

This raises some questions:

- Why would borrowers enter into loan contracts that are high risk and economically irrational?
- Why would lenders provide credit in these circumstances?

This section reviews the conduct of borrowers entering into unaffordable loan contracts in more detail. Section C analyses the reasons lenders provided finance.

No borrower wanted to sell the family home. As a result, social and emotional considerations overrode financially prudent decision-making, and made borrowers susceptible to fringe brokers. Some borrowers made poor choices as they asked themselves '*What can I do to stop my current lender selling me up?'* rather than *'Can I afford this refinance if I cannot afford my current loan?'*

Our survey of borrowers

71 A borrower seeking finance to try and avoid the sale of the family home is extremely vulnerable. In *Brendan King Pty Ltd v Toseska* [2006] NSWSC 487 Hulme J described the position of one such borrower:

'I am also satisfied that the Plaintiff had knowledge of the Defendant's disability … It knew of her financial situation. It knew she was borrowing to pay off debts on an investment loan or investment properties and that a mortgagee was threatening to take action—events strongly suggestive of an excess of expenses over income. It knew of the urgency of the Defendant's needs. In short it knew she was desperate.' [19]

72 One commentator in the United States has observed that equity stripping is based on the vulnerable situation of the borrowers:

'[It] is particularly devastating because sub-prime borrowers typically seek home equity loans at a time of great financial need, when they are in the weakest bargaining position and most susceptible to practices that can strip them of substantial sums of money, and ultimately, their homes.' [20]

[19] At [168].
[20] Centre for Responsible Lending (USA), 'The Case for Predatory Lending Reform', p 3.

73 Our examination of the experiences of 14 borrowers suggests that the desire of borrowers to save their home, despite being in a desperate financial position, can make them dependant on brokers in a way that inhibits sensible decision-making.

74 The borrower review was conducted by the Consumer Credit Legal Centre NSW (CCLC), and sponsored by ASIC's Consumer Advisory Panel. It examined the experiences of this group of borrowers in a qualitative way through detailed interviews.

75 The CCLC spoke to 14 borrowers[21] who had refinanced and subsequently sought help from financial counsellors, community legal centres or legal aid solicitors. Borrowers completed the questionnaire with help from their caseworkers.

76 Each transaction met these criteria:

- the primary loan being refinanced was secured by a mortgage over the borrowers' home;
- the refinance occurred in the last 5 years;
- the borrowers experienced financial difficulties at the time they refinanced;
- the initial refinance was arranged by a broker.

77 The 14 borrowers had a total of 23 transactions, as some borrowers refinanced a number of times. In broad terms, 18 of the refinances did not assist the borrower, while in 5 cases the refinance resolved or stabilised the borrower's financial position.

78 In addition, ASIC undertook:

- a detailed analysis of 3 of these transactions, based on the information provided by CCLC, to assess the overall financial impact of refinancing, including changes in the value of the borrowers' equity;
- a review of files by 2 brokers who marketed themselves as 'refinancing experts'.

Borrowers' situation before refinancing

79 The 14 borrowers consisted of 7 couples, 6 sole borrowers, and an adult and elderly parent as co-borrowers. Their ages ranged from early 20s to 60s.

80 In terms of income, 7 received Centrelink payments: 3 received disability support pensions, 2 received age pensions, one a carer's pension and one parenting payments and family tax benefits. A number of the borrowers were temporarily unemployed. All the borrowers used brokers and most of the

[21] Some of the transactions involved joint borrowers so there were 21 borrowers altogether.

brokers involved specialised in arranging home loans, rather than personal loans or other types of finance.

81 Each of the borrowers was under financial pressure in that:

- 7 borrowers were in default on their existing home loan, while a further borrower faced default in the near future;
- 6 borrowers were under pressure from other creditors. In one case the creditor had a caveat over the house, and in another instance the creditor had commenced legal action.

82 The financial pressure had a number of different causes. In some instances it arose out of a change of circumstances, such as loss of employment or failure of a business. In other cases the borrowers simply did not have enough income to meet their loan commitments.

Outcomes of refinancing

83 The outcomes for the 14 borrowers after refinancing was:

- 3 borrowers were 'back on track' as they had been able to refinance to a loan with affordable repayments;
- 6 borrowers had lost their homes (4 of these borrowers had been refinanced with fringe lenders, and had defaulted within a few months of taking out the loan);
- 5 borrowers were treading water, in that they were meeting the repayments on their loan with considerable difficulty and still at risk of defaulting.

84 The comments of the surveyed borrowers provide valuable insights into how these consumers made decisions under financial stress.

Borrowers wanted to save the family home

85 All the borrowers surveyed were at some risk of losing their home. This varied from minimal risk (they were not yet in arrears on mortgage repayments) to high risk (enforcement action had begun or was imminent).

86 The survey highlighted that in deciding whether to try and save the home or sell it, social and emotional considerations overrode financially prudent decision-making. Borrowers were influenced by factors such as fear of family break-up, loss of self-esteem, and dislocation from their neighbourhood and amenities. This finding is not surprising given that most people have a strong emotional and financial investment in their home.

87 As a result the priority of surveyed borrowers was to take action to prevent the existing lender selling their home, rather than taking a long term view

and assessing whether they would also be in a better position because of the refinance.

88 This in turn made the borrowers dependant on brokers who would offer to help them achieve this objective, where they did not think they would be able to do so on their own (particularly where their existing lender refused to negotiate or other lenders had rejected applications to refinance). In this situation the relationship can become personal rather than commercial, because the borrower perceives that the broker shares their commitment to saving the family home, when other players had rejected the borrower.

89 Where the borrowers believed the broker is acting in their interests they are more susceptible to fringe brokers as:

- they relied on the brokers in a very uncritical way;
- they were not presented with options apart from refinancing into a high risk loan;
- the brokers failed to fully disclose their fees and the overall cost of refinancing;
- the level of repayments the borrowers could afford was not discussed;
- where the Uniform Consumer Credit Code was excluded as a result of the loan being documented as 'for business purposes', the interest rate on the new loan was understated in that it did not take into account fees charged by the lender.

Borrowers relied on brokers' assurances

90 All 14 borrowers arranged their refinance through a mortgage broker. 5 borrowers responded to advertisements which suggested the broker could help the borrowers no matter what state their finances were in. One borrower commented that the advertisement *'felt like it had been written just for us'*.

91 Borrowers relied on promises by fringe brokers to help them, and as a result believed the refinancing had resolved their financial problems:

'We thought it was a relief to have our creditors sorted out at first but the trouble [with the new loan] started within a couple of weeks.'

92 This feeling of relief created a sense of trust in the broker. The broker reinforced this trust by arranging the refinance quickly and with minimal effort, as this relieved the stress created by the borrower's uncertain financial position. One borrower said:

'The broker organised the finance and documents. I just received them and signed. It was very, very easy.'

93 This in turn inhibited some borrowers from undertaking a detailed analysis of the loan terms, even in relation to the most important terms, particularly the size of the repayments and their capacity to afford them.

94 Despite their ongoing financial difficulties in nearly all cases borrowers stated that there was little or no discussion about the level of repayments they could afford. One borrower said:

'The refinance made my situation worse because it took a bunch of unsecured debts and made them secured against my home. I went from a small mortgage I could afford, to one beyond what the pension can cover.'

95 The failure to discuss repayments also led borrowers to assume that they could afford the repayments because of their perception that:

- the broker was acting on their behalf; and
- the lender would not approve the loan unless it was satisfied the borrower could meet the repayments. This assumption was reinforced where the loan was arranged in a short period of time with minimal fuss.

The brokers did not present alternatives

96 Most of these borrowers used a broker because they believed they could not obtain a loan themselves. In 3 cases, the borrower had attempted to negotiate a refinance or variation with their existing lender, which had failed. Some borrowers had contacted other lenders and been told they did not qualify for a loan.

97 The borrowers consistently stated that their brokers failed to advise them of options such as:

- negotiating with their existing lender;
- alternative loan options (if available), and the merits and disadvantages of each option;
- 'downsizing' by moving to a less expensive property; or
- selling the home immediately to realise a larger lump sum from their equity.

98 Only one broker came close to discussing options with the borrowers by raising the possibility of refinancing to a 25-year loan. However the borrowers involved said that he then told them it would take too long to process and, on that basis, he instead recommended a short-term interest only loan.

99 The failure to discuss alternatives meant that these borrowers did not receive the considered advice necessary to make an informed choice in resolving whether to 'sell or save' their homes. The majority of borrowers were channelled into loans that they had little or no prospect of repaying and which did not address their underlying financial stress. The lack of

discussion of other options by the brokers reinforced the borrowers' belief that they had no alternative but to accept the proposal offered by the broker.

100 In 4 instances the broker moved the borrowers from long-term principal and interest loans to an interest-only loan for a 12-month period. At the end of this time these borrowers would either have to refinance again or sell their house. Only one of these 4 sets of borrowers properly understood the implications of the loan, and was therefore prepared for the fact that they may have to sell their house in 12 months time.[22]

Misleading or inadequate disclosure of brokers' fees

101 In most cases borrowers in financial difficulties will not have surplus cash on hand to pay an upfront fee to a broker. Any upfront fee will therefore be deducted from the loan proceeds on settlement.

102 Of the 14 borrowers, 12 advised that, at the time of deciding to proceed with the refinance, the broker failed to fully disclose their fees and the overall cost of refinancing:

- 8 borrowers said they were not informed *at all* of the costs involved; and
- 4 borrowers said they were advised of *some*, but not all, of the costs they would incur.

103 Of these 12 borrowers, 6 said that if they had been fully advised of the costs they would either not have proceeded with the transaction or they would have investigated alternatives. One borrower said that it would not have changed their decision, as they were facing Supreme Court repossession proceedings. The other 5 borrowers were uncertain whether it would have made any difference. With the benefit of hindsight one borrower commented, '*We may as well have given the broker half our house*'.

104 One borrower disputed the fee the broker proposed to charge. They were told that if they did not agree to pay it, the refinance of their home would not proceed. The borrower withdrew their objection, reflecting their lack of bargaining power.

105 The 12 borrowers reported that the fringe brokers they dealt with concealed costs in a number of different ways:

- Some borrowers were asked to sign blank documents at the broker's instigation: 'It will be much easier for you if we just sign all these now'.
- Other borrowers reported having piles of pages put before them and being asked to 'just sign' where indicated. Several reported being given no copies of the documents they had signed.

[22] This couple had an exit strategy in that they intended to borrow enough money to renovate the house prior to selling it. The strategy failed as the cash surplus was eroded by transaction costs.

- Fees were only disclosed when the borrower was asked to sign the loan documents (i.e. they were at a point in the transaction where they were emotionally committed to it, and would not readily change their mind).
- In 2 instances, the broker encouraged a borrower to borrow an additional lump sum as a cash advance when refinancing their loan. On settlement, the lender and the broker both charged higher fees than earlier advised, taking most of the money earmarked for the advance and leaving the borrowers with little or no additional funds.
- One of these brokers represented to borrowers that the fees charged were payable to 4 different entities, each apparently performing different roles—advisory, processing and brokerage functions. In fact, the fees ended up with 2 related parties. This misled borrowers, both about the fees being charged and the services being provided by the broker. In one case the borrowers said that they were told that the broker's fee would be $3,000, but on settlement they were charged another $13,000 by a related entity.

106 Our inquiries show that in some cases the broker charged an upfront fee and also received a commission from the lender, which was not disclosed to the borrower. This conduct had the following consequences:

- The borrower was at a disadvantage because they had to decide whether to agree to the fee charged by the broker unaware of the total remuneration the broker would receive as a result of the transaction.
- The broker's commission would need to be recovered through fees or interest, and thus would tend to push up the borrower's overall liability under the loan.

Terms of refinance were not made clear

107 Some borrowers alleged that their lending decisions were influenced by inaccurate information from the broker about the cost of the transaction, including:

- the overall level of fees;
- the size of the repayments; and
- interest rates (e.g. quoting a lower rate than that charged by the lender).

108 As a result these borrowers stated that they were led to believe that refinancing would save their home. One borrower said:

'The broker told us the interest rate would be one thing, but when the contract arrived it was a different story, it was higher. This meant the payments were too high. By that time, it was too late to pull out of the contract.'

109 In another case a borrower had defaulted on his home loan (with an interest rate of 8.5%), and was facing Supreme Court possession proceedings. The

borrower maintained that the broker told him that he could refinance his loan to a loan with a 6% or 7% per annum interest rate and that until this loan came through he would arrange a short-term loan for the borrower to pay his arrears. After several months the broker had still not arranged a loan at a lower rate, and the borrower had 2 short-term loans at 10% per month.

110 Another borrower said:

'The second refinance made things much worse as it was like the point of no return. The repayments were much higher than the broker said they would be and we had used up all the equity in the house. I wish a bank had given us a loan in the first place at bank rates. We are working towards this now.'

111 Where the Uniform Consumer Credit Code (Code) does not apply to the loan, the lender does not have to meet the Code's disclosure requirements in relation to the cost of the loan including the comparison rate.[23]

112 Where the Code has been excluded lenders can state an interest rate that excludes the impact of upfront fees. This makes any comparison with interest rates where the Code applies confusing because the calculation is not made on the same basis, and includes upfront fees. As a result brokers can quote an interest rate to borrowers that does not seem unduly high, relative to rates offered by mainstream lenders where the Code applies.

113 We reviewed 3 loans to compare the stated interest rate for these loans, and to calculate the interest rate that would need to be stated if the Code applied and a comparison rate was used. The results are set out in Table 9 and show a difference of between 2.2 and 5.8 percentage points.

Table 9: Stated and comparison interest rates on selected loans

	Loan amount	Upfront fees	Stated interest rate	Comparison rate (not disclosed)
Loan 1	$122,000	$4,403	9.95%	14.3%
Loan 2	$220,000	$4,486	9.5%	11.7%
Loan 3	$195,000	$4,772	9.5%	15.3%

114 4 of the surveyed borrowers stated that the broker actively misdescribed the purpose of the loan, either by stating in the loan application that the credit was for business purposes or by asking the borrower to sign a declaration that the loan was for business purposes.[24] As loans for business purposes fall outside the Code, this conduct meant that these 4 borrowers did not get the

[23] A single figure rate which incorporates interest and other fees into a single percentage figure.
[24] The involvement of some fringe brokers in this practice was highlighted as a problem in both REP 19 (ASIC's 2003 broker report) and the NSW Office of Fair Trading's *Regulatory Impact Statement—Discussion Paper*, February 2005.

benefit of the single figure comparison rate and were at greater risk of misperceiving the cost of the loan on offer relative to others in the market.

115 The exclusion of the Code through the incorrect characterisation of the purpose of the loan also means that lenders can take enforcement action without complying with the Code, and that caps on fees or interest rates do not apply.

Conclusion

116 Survey responses suggest that borrowers elected to refinance because they did not properly understand the transaction or the options available to them. This was for a variety of reasons including:

- a reluctance to test or evaluate assertions by the broker that the refinance would save the home;
- a failure to consider alternatives, particularly the advantages and disadvantages of selling the home now rather than in the future; and
- inadequate or misleading disclosure of the costs of the transaction and the size of the repayments under the proposed loan.

117 The extent to which borrowers approach fringe brokers is therefore likely to be reduced if they have increased access to alternatives and a better understanding of the options available to them. In this respect, recent changes by the Mortgage and Finance Association of Australia (MFAA) to its Code of Practice are relevant.[25] The changes mean that lenders who are MFAA members, once they become aware a borrower is in financial difficulties, must actively consider whether or not to lower or vary repayments, irrespective of whether or not the borrower has approached them with such a request. These enhanced obligations may assist borrowers to avoid refinancing where they are in a position to meet the repayments through a variation in their loan, for example, a short-term reduction in payments or an extension of the loan term.

118 The need for borrowers to have protection from predatory brokers has been addressed in the proposed draft broker legislation. The current draft:

- allows fringe operators to be excluded from the market where they do not meet licensing criteria;
- reduces the risk of asset-lending in that brokers must only recommend a loan where they have assessed the capacity of borrowers to meet repayments (and a remedy is specifically available where the borrower is overcommitted);

[25] The MFAA is the main industry body for lenders that are not banks or credit unions. As at July 2007 approximately 2,500 lenders were members of the MFAA.

- requires brokers to compare a borrower's existing loan with a proposed refinance, and to set out in writing why the refinance will benefit the borrower;
- places obligations on brokers to adequately disclose their fees, and allows for excessive fees to be recouped from the broker;
- requires brokers to verify the purpose of the loan, reducing the extent to which brokers assist in incorrectly documenting home loans as being for business or investment purposes.

119 The draft bill will also require brokers, as a condition of being licensed, to join an External Dispute Resolution scheme. This will assist borrowers to obtain access to a forum to resolve complaints without litigation. At present, membership of such schemes is voluntary, and fringe brokers can either not join a scheme or revoke their membership at any time.

C Why lenders approve loans

Key points

Lenders may take on high-risk loans for a range of different reasons, depending on their business model:

- In some cases, fringe lenders may be deliberately engaging in equity stripping.
- In other cases, brokers exploit weaknesses in the application process, either because the lender's eligibility and verification procedures are not stringent enough, or because their staff fail to rigorously follow these procedures.

Fringe lenders provided expensive credit

120 Some fringe lenders charge borrowers interest rates that are extremely high. For example, the NSW Supreme Court decision in *Brendan King Pty Ltd v Toseska* involved a case where the lender charged a borrower (found by the Court to be *'financially desperate'*) normal interest at 72% per annum and default interest at 114% per annum.[26]

121 Borrowers who can only obtain loans at these high interest rates are likely to be in a marginal financial position, and to have already exhausted any buffer of cash. They are therefore at significant risk of defaulting.

122 As long as the borrower has sufficient equity in their home, the fringe lender can earn more where the borrowers defaults than if they meet the repayments, as:

- the borrower has to pay a higher interest rate on default; and
- the borrower will become liable for other charges and enforcement expenses.[27] Some lenders charge these costs in-house on a basis that includes an element of profit.

123 The lending decisions of some fringe lenders make it evident they are aware of these economic drivers. As Hulme J said in *Brendan King Pty Ltd v Toseska*:

'I have not the slightest shadow of doubt that … the Plaintiff also knew of the benefits potentially available if the Defendant did fall into default.' [28]

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[26] [2006] NSWSC 487.
[27] In *Guardian Mortgages v Miller* [2004] NSWSC 1236 the lender charged the borrower the sum of $15,000 as damages for late payment, in addition to default interest at 14.5% per month on a 1-month loan. Wood CJ at Common Law found that the imposition of the $15,000 payment was a penalty and therefore unenforceable.
[28] [2006] NSWSC 487 at [174].

124 Some fringe lenders also act quickly to take enforcement action if the borrower defaults, particularly where they are concerned about the equity eroding or because they consider it unlikely that the borrower will be able to remedy any such default without refinancing.

125 One borrower we surveyed said:

'I didn't realise home lenders were so different from each other. I was only behind by one-and-a-half payments and the lender took court action. A bank would not have done that'

Fringe lenders not accountable for poor lending practices

126 Fringe lenders face little risk of the borrower seeking redress:

- The Corporations Act requires other financial service providers to be members of an ASIC-approved external dispute resolution (EDR) scheme. These EDR schemes can hear complaints without any cost to the borrower. This requirement does not extend to finance brokers or lenders, and nearly all fringe brokers and lenders are not members of an EDR scheme. Where this is the case borrowers have no alternative to court action for redress.[29]
- Except in rare instances, borrowers in financial difficulties have no access to funds to seek redress or compensation through court action.
- The lender will ordinarily not be responsible for the conduct of the broker because the law usually deems brokers to be agents of the borrower. Where this is the case, misleading conduct by the broker will not be a defence against a claim by the lender for the borrower's home after default. The borrower will have to take a separate action against the broker for compensation, and this potential claim will not prevent the lender selling their home.
- If the borrower has signed a business purpose declaration, the Uniform Consumer Credit Code does not apply. These borrowers do not have the Code's protections during the life of the loan and cannot access its remedies. This makes it more straightforward for the lender to take court action for possession of the family home.

127 State and Territory Governments are considering amendments to the way in which the business purpose declaration operates. Changes to the Code which provide for an accurate documentation of the purposes of the loan and appropriate application of the Code will restrict the extent to which fringe lenders can take advantage of borrowers in financial stress.

[29] Most mainstream brokers have voluntarily chosen to be members of an ASIC-approved EDR scheme. As at July 2007, approximately 7,500 brokers were members of the Credit Ombudsman Services Limited (COSL).

Use of certificates from accountants

128 In 4 cases these fringe lenders assessed the capacity of the borrower by relying on a certificate provided by an accountant. In the certificate the accountant stated that it was their opinion the borrower could meet the repayments under the loan.

129 Based on our interviews with borrowers in these cases:

- None of the borrowers had ever physically met the accountants, or had previously used them in a professional capacity.
- In 2 cases, the borrowers said that they never spoke to the accountant, and were unaware of what information the broker forwarded to them.
- In the other 2 cases, the accountants relied on information about the borrowers' financial position provided by the borrowers, by phone. In one case the borrower said that he started to tell the accountant the truth about their financial position when the broker interrupted and told him to repeat false information to the accountant (by phone). In the other case the borrower said he had a brief conversation with the accountant who then wrote a letter stating that he had been the borrower's accountant for 2 years and confirming that the borrower could pay the loan.

130 Certificates of this type were also the subject of judicial scrutiny in the case of *Small v Gray*.[30] McDougall J stated:

'The role of Mr Michael [the accountant] is very troubling. On any view, his certification was important … But it was lamentably defective …

The clear implication was that Mr Michael was satisfied, from the information that he had been given by Rodney and Kristine [the borrowers], that they had the capacity to meet their obligations under the mortgage. Even leaving aside the falsity of the certificate in so far as it relates to Rodney, I find that Kristine said nothing to him that could have conveyed to him this impression.' [31]

131 The value of accountants' certificates in verifying capacity to meet repayments is questionable, even where completed accurately, and more so where the accountant has had no previous relationship with the borrower. They are not a substitute for proper credit assessment procedures.

[30] [2004] NSWSC 97.
[31] Paragraphs [53] and [54]. McDougall J found that Kristine Gray in fact had no capacity to make a single repayment as she was unemployed, and granted relief as the loan was unconscionable.

Brokers presented false information in loan applications

132 7 of the 14 borrowers said that their broker either included false information in the loan application or prompted them to provide incorrect details such as:

- false statements of income or capacity, including that the borrower was employed in a remunerative position or occupation when this was not the case;
- incomplete records of liabilities, particularly credit card accounts; or
- encouraging them to lie to third parties during telephone conversations or in written communications.

133 Some borrowers stated that they expressed concern about the fabricated information, and their broker responded with comments such as 'this was perfectly normal' or 'I know what I'm doing, I've been in business for a long time'. The brokers' endorsement of this practice made it easier for borrowers to acquiesce in signing documents containing false information. Nearly all of the borrowers aware of false information in the application process were those facing or on the brink of enforcement action, suggesting that the greater the risk of losing their home the more susceptible borrowers may be to becoming parties to this type of dishonesty.

Low doc loans

134 3 of the 7 cases where the application included false information involved low doc loans. In one case the broker submitted an application giving an income figure for the borrower that was both false and inherently improbable given the borrowers' age and the nature of their occupation. In 2 cases brokers advised the borrowers to leave out some of their credit card debts; one borrower was told to only include 2 of their 3 credit card accounts 'or the loan would not be approved', while in the other case 14 credit card debts were excluded, again on prompting by the broker.

135 Low doc loans increase the opportunity for intermediaries to engage in misleading or fraudulent conduct because the limited checks and verifications by the lender are less likely to detect anomalies in the loan application.

Weaknesses in risk management systems

136 Some non-ADI lenders finance their lending through securitising loans. Securitisation is a process in which the loans are converted into tradeable products, with the lender selling the income stream under the loan (the repayments) for a lump sum (to obtain money to continue its lending). One consequence of securitisation is that there may now be a number of different entities involved in arranging and handling the loan, including mortgage managers and originators.

137 Genworth Financial, a major Australian provider of lenders mortgage insurance, described the consequences of these structural changes in its submission to the recent Home Lending Inquiry by the House of Representatives:

'The increased reliance on third party mortgage originators and brokers to originate and, in some cases, perform the credit underwrite on a loan application has led to increased risk associated with residential mortgage lending. These parties' interests are often misaligned with the ultimate credit provider and LMI [Lenders Mortgage Insurer] provider in the sense that they are remunerated on a commission basis and bear no real risk associated with the loan defaulting.'[32]

138 The Reserve Bank of Australia, in recent commentary on the US sub-prime lending market, stated:

'If the institution originating a loan does not ultimately bear the credit risk associated with the loan, its incentives to assess and monitor the credit worthiness of the end borrower may be weakened.'[33]

139 A judge of the NSW District Court has also noted the potential weaknesses resulting from these arrangements. In a recent case involving a refinance Rolfe DCJ said: *'the system of securitised loans is rife with the possibility of fraud or misrepresentation'*.[34]

140 The Australian Property Institute identified a specific practice arising from the different interests of the parties. It gave evidence to the House of Representatives Inquiry that:

'We have had a number of issues with some brokers whereby they will shop around from valuer to valuer until they get someone to give them the right price for whatever the right amount of money is.'[35]

Lenders ignore their own guidelines

141 Lenders may also approve loans because of failures in their internal procedures, which means staff breach lending guidelines. The extent of this practice is not readily measurable and could not be identified through our case studies.

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[32] Submission by Genworth Financial to *Inquiry into home loan lending practices and the processes used to deal with financial difficulty*, 20 July 2007, p 4.
[33] Financial Stability Review, September 2007, p 11.
[34] *Khoshaba v Perpetual Trustee Company Ltd* (unreported, District Court of NSW, 3639/2003) cited on appeal in *Perpetual Trustee Company Ltd v Khoshaba* [2006] NSWCA 41 at paragraph [20].
[35] *Inquiry into home loan lending practices and the processes used to deal with financial difficulty*, House of Representatives Standing Committee on Economics, Finance and Public Administration, public hearing, 10 August 2007, transcript, p 35.

142 However, the Supreme Court of New South Wales has recently considered 2 transactions where a loan was approved contrary to stipulated approval procedures.[36] These cases were:

- In *Perpetual Trustee Company Ltd v Khoshaba*,[37] the lender advanced $120,000 to 2 pensioners to invest in the trolley collecting business operated by Karl Suleman Enterprizes Pty Ltd. The Court found that there had been breaches of internal lending guidelines including a failure to verify the employment and income of the borrowers, and to ascertain the purpose of the loan.
- In *Permanent Mortgages Pty Ltd v Cook*,[38] the lender advanced the sum of $240,000 on a one year, interest-only basis. This was the fourth refinance by the borrowers in 2½ years, as they had been unable to meet repayments on the previous 3 loans. The Court found that the lender had failed to ascertain the source and nature of Mr Cook's income, as required by its own lending guidelines.

143 In both cases the Court held that the failure to follow internal procedures meant the lenders had engaged in asset-based lending and this rendered the loan contracts unjust under the *Contracts Review Act 1980* (NSW). As Basten JA said in *Khoshaba*:

'To engage in pure asset lending, namely to lend money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default, is to engage in a potentially fruitless enterprise, simply because there is no risk of loss. At least where the security is the sole residence of the borrower, there is a public interest in treating such contracts as unjust, at least in circumstances where the borrowers can be said to have demonstrated an inability reasonably to protect their own interests ...'[39]

[36] In both cases responsibility for approving the loan applications was handled by a third party rather than the lender directly. However, the court held that the lender was fixed with responsibility for the failures of the party conducting the credit underwrite to comply with lending application guidelines.
[37] [2006] NSWCA 41.
[38] [2006] NSWSC 1104.
[39] [2006] NSWCA 41 at [128].

D Taking action

Key points

This report has highlighted risks for borrowers under financial stress and some unfair practices by a small number of fringe brokers and lenders that can cost borrowers significant amounts of money, and, in some cases, their homes.

In this section, we look at ways to address these problems. We also look at what consumers need to consider when deciding whether or not to refinance their homes, and how brokers and lenders can improve the outcomes for borrowers under financial stress.

ASIC's regulatory role

144 Since 11 March 2002, ASIC has had a federal regulatory role over brokers and lenders. However, under the ASIC Act, our jurisdiction only covers broad standards of conduct, including:

- prohibitions on unconscionable conduct, and on conduct that is misleading or deceptive; and
- prohibitions on false and misleading representations.

145 ASIC does not have power to regulate fees charged by brokers or interest rates charged by fringe lenders, or exclude unscrupulous operators from the market.

146 Within the scope of our jurisdiction, we have taken action against several intermediaries under this legislation[40], and will continue to do so as appropriate. We will also continue to:

- undertake further research to inform our priorities in this area;
- refine consumer education materials and tools on the FIDO website (www.fido.gov.au), including the budgeting and repayment calculators;
- work with industry to develop best practice; and
- work with state and territory governments.

[40] For recent examples, see Media Release 07-266 *ASIC obtains orders against Canberra mortgage broker over 'low doc' loans* (declarations that a broker engaged in misleading or deceptive conduct in misrepresenting the borrowers' financial position in 'low doc' loan applications) issued on 9 October 2007, Media Release 07-268 *'Former director of Newcastle-based investment company found guilty'* (criminal action against a director for falsifying a borrower's income on a 'low doc' loan application) issued on 12 October 2007, and Media Release 08-24 *'Former Coffs Harbour mortgage broker jailed'* (criminal action against a broker director for appropriating client funds that he had represented would be invested) issued on 18 February 2008.

National legislation

147 The states and territories have recently released a draft bill for the uniform regulation of brokers that includes:

- compulsory membership of an external dispute resolution scheme for brokers;
- responsible lending obligations on brokers; and
- a licensing scheme for brokers that would exclude industry participants failing to meet specified standards of conduct.[41]

148 Other measures included in the draft bill are detailed at 118 to 119 above.

[41] The Exposure Draft of the proposed bill was released for public comment on 28 November 2007.

What borrowers can do

If you are in financial difficulty with your home loan

1. Seriously consider making the tough decision to sell your home now—it may be the best option for you. If you don't you could find yourself still having to sell it in 6 or 12 months time but getting less money in your hand after the sale because of an expensive refinance.
2. Be realistic about whether you can afford repayments if you are already in default or under financial stress.
3. If you are behind on your home loan seek help as soon as possible—the sooner you act the easier it will be to try and come to some arrangement with your existing lender. Don't be afraid to ask your lender if the repayments can be lowered. If they say no, ask for the decision to be reviewed by someone senior.
4. Consider approaching a financial counsellor, community legal centre or legal aid to negotiate with your lenders or get legal advice.
5. Use the FIDO website (www.fido.gov.au) and budgeting and repayment calculators to test whether refinancing is in your interests.
6. If you have a complaint about the broker and the broker is a member of the Credit Ombudsman Service Ltd then that service may be able to hear your complaint.
7. Use the checklist in Appendix A to weigh up your options.

How to avoid fringe brokers and lenders

1. Check that the broker and the lender are members of an External Dispute Resolution scheme approved by ASIC (e.g. Credit Ombudsman Service Ltd or Banking and Financial Services Ombudsman), as this will make it easier to obtain a remedy. Check with the EDR scheme itself rather than relying on oral statements by a broker or lender.
2. Be wary of advertisements or statements by the broker that say they can help no matter how desperate your financial situation is.
3. Walk away if the broker:
   - asks you to sign blank documents
   - asks you to sign application forms with information that is false
   - refuses to discuss repayments with you before asking you to sign up
   - arranges a loan without discussing your financial situation in detail, or what repayments you can afford
   - says the loan must be recorded as being for business purposes, when this is not true.
   - asks you to obtain an Australian Business Number for the loan when you are not self-employed or do not need one
   - rushes the transaction
   - refuses to put all loan costs and the interest rate in writing before you sign up
   - refuses to give you copies of documents you have signed.

What brokers and lenders can do

If you are a broker arranging for borrowers to refinance

1. Do not compromise your advice on what can be achieved by refinancing, just because the borrower is desperate. Borrowers in financial stress need realistic information and advice.
2. Ensure that the borrower is better off as a result of refinancing, and only recommend a loan that is appropriate with long-term benefits for the borrower.
3. Make all necessary enquiries to ensure that the consumer can repay the loan, including a detailed assessment of their income, assets and expenditure.
4. Disclose all the costs of refinancing, and all fees and commissions in writing, so that the borrower can make an informed decision.

If you are a lender relying on information from brokers

1. Regularly review your risk management practices.
2. Identify ‘high risk’ applications and patterns of conduct, and monitor them more stringently. ‘High risk’ applications include refinances where the borrower is in arrears, and, for non-bank lenders providing low doc or no doc loans, can include refinances of home loans from a bank where the circumstances suggest the borrower may be in default.
3. Use your internal complaints handling procedures as part of this monitoring process.
4. If all communication with the borrower is channelled through the broker, consider whether this increases the risk of fraudulent applications, and adopt appropriate risk management practices.
5. If the broker arranges valuations for you, consider whether steps are necessary to monitor if the broker is valuation-shopping to ensure the estimate of the property value is sufficient to allow the loan to be approved.

Appendix 1: Checklist for borrowers

Estimating the cost of refinancing on equity	
How much equity do I have in my home now?	$
How much will I be charged to refinance?	
By the lender	$
By the broker	$
Are there any other costs?	$
Total cost of refinancing	
Outcome 1—Sell after 12 month loan finishes	
If I sell after 12 months how much equity will I have left?	
If property values stay the same	$
If property values go up by 5%	$
If property values go down by 5%	$
Outcome 2—Default and the lender sells up	
If I default and the lender sells me up after 3 months how much equity will I have left after legal and court costs of $5,000?	
If my home is sold for current value?	$
If my home is sold for 10% less than market value?	$
Questions to ask the broker	

- What will my repayments be under the new loan? Will they be less than my current repayments?
- What are your brokerage fees?
- What is the total amount in fees and costs I will have to pay to refinance? If you are not sure, what is the maximum amount?
- How long is the loan for? If it is only for 1 or 2 years what will happen when the loan ends? Will I have to sell my house anyway? If I have to sell my house, what extra costs will I have to pay?
- Will I be protected by the Consumer Credit Code? Why do I have to tell the lender the loan is for business or investment purposes when this is not right?
- Are you a member of an ASIC-approved External Dispute Resolution scheme? Which scheme is it, and how do I contact it?

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Key terms

Term	Meaning in this document
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investment Commission
ASIC Act	*Australian Securities and Investment Commission Act 2001* (Cth)
CCLC	Consumer Credit Legal Centre (NSW)
Code	Uniform Consumer Credit Code
Corporations Act	*Corporations Act 2001* (Cth)
EDR scheme	An external dispute resolution scheme approved by ASIC
equity stripping	Loans in which brokers and lenders take advantage of the desire of borrowers in default to save their family home by charging them high fees and charges to refinance

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Related information

Headnotes

Finance and mortgage brokers, lenders, unconscionability and unfair conduct, equity stripping, consumer protection, consumer education

Legislation

Australian Securities Investment Commission Act 2001 (Cth)

Contracts Review Act 1980 (NSW)

Cases

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Reports and speeches

A report to ASIC on the finance and mortgage broking industry (REP 19)

Report on broker-originated lending (APRA, 2003)

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