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8 August 2007

Parliament of Australia
House of Representatives Standing Committee on
Economics, Finance and Public Administration
Parliament House
Canberra ACT 2600

Attention : MR ANDREW MCGOWAN

**RE: INQUIRY INTO HOME LOAN LENDING PRACTICES AND
PROCESSES**

Please find enclosed the Submission from Legal Aid NSW in relation to this Inquiry.

Yours sincerely

**John Moratelli
SOLICITOR**



Response to Inquiry into Home Lending Practices and Processes

**Submission on behalf of
The Legal Aid Commission of New South Wales
to the House of Representatives Standing Committee on Economics, Finance
and Public Administration**

The Legal Aid Commission of New South Wales (Legal Aid NSW) is an independent statutory body established under the *Legal Aid Commission Act 1979 (NSW)* to provide legal services and resources to the community, with a special focus on people who are economically or socially disadvantaged. The Commission also works in partnership with private lawyers in representing legally aided people.

As part of its civil law program Legal Aid NSW provides a free advice service in civil matters and grants aid, subject to its means and merit tests, in relation to a range of civil matters including loss of dwelling matters.

Legal Aid NSW has recently expanded its civil law program via the opening of new civil law units. Over the relevant period we have had a civil law unit in our head office and Wollongong, Liverpool, Fairfield, Parramatta, Dubbo, Newcastle, Coffs Harbour and Lismore regional offices.

Introduction

Over the past 5 or so years Legal Aid NSW has noticed a substantial increase in enquiries from people unable to meet their mortgage payments in respect of the house in which they reside.

Legal Aid NSW has granted aid in a significant number of these matters where we thought it strongly arguable that the loan was unjust.

Further, the large number of repossession matters recently undertaken by Legal Aid NSW has enabled us to identify a certain type of loan which appears to be becoming more common. The characteristics of these loans are:

- The borrowers are unable to obtain a loan from a mainstream lender such as a bank or credit union because of their impaired credit history and/or lack of income. The loans are, therefore, a sub-category of non-complying loans
- The borrowers are seeking the loan either because they are in default on their current mortgage or about to go into default; or because they have been persuaded by a friend or relative to raise money for the purposes of the friend or relative
- The loan is unable to be obtained from a mainstream lender so they seek the loan through a broker
- The broker obtains a “business loan” for them even though the purpose of the loan is manifestly personal in that they are seeking to assist a friend or relative or seeking to retain the house in which they live
- The borrowers sign a business purpose declaration under s 11 of the UCCC¹ which, if effective, is conclusive as to purpose. The UCCC doesn’t apply to business loans
- The effect of the loan being characterised as a “business loan” is that the borrower is deprived of the protections available under the UCCC such as the ability to make a hardship application, certain disclosure provisions, the right to apply to have the loan reopened if its unjust, the right to have the

¹ Uniform Consumer Credit Code

affordability of the loan considered as one of the factors going to unjustness, and the right to be served with a default notice prior to the institution of court proceedings seeking possession of the mortgaged property. These consequences are, in our experience, never explained to borrowers.

- As the loan is a “business loan” capacity to service isn’t really considered in the writing of the loan. The relevant issue for the lender is the loan to value ratio. To the extent that capacity to service is considered there is no meaningful enquiry undertaken to verify the borrower’s true financial position
- There is extensive use of intermediaries, such as accountants, who do not act as independent advisers of the borrowers or, in the case of solicitors, are not required to and almost invariably do not give financial advice. The result is that the borrower usually receives no independent advice about the financial wisdom of the transaction
- There is a move to enforcement action almost immediately the loan goes into default. As enforcement costs are recoverable from the borrower this increases the cost of the loan
- The loan is short term and interest only necessitating expensive refinancing
- The loan in default may be refinanced with a similar loan involving similar costs from the same lending organisation
- The fees, expenses, and default fees are such that it is difficult for the borrower to appreciate the true cost of the loan and result in a loan significantly more expensive than conforming loans
- Commonly, brokers use caveats over the borrower’s property to protect the broker’s fees, to pressure the borrower to proceed with the loan

We deal with the questions posed by the committee below:

- *To what extent have credit standards declined in Australia in recent years?*
 - *Market share of non-conforming lenders; increase in low-doc products across the board.*
- *Have declining credit standards caused an increase in the number of loans in arrears and the number of repossessions?*
 - *Lack of accurate data on repossessions; ‘agreed’ sales hiding true rate of defaults.*

Comment

We have dealt with these 2 questions together as we see them as closely interrelated.

Legal Aid NSW believes that the very existence of such loans is indicative of a decline in credit standards although we are not in a position to determine the prevalence of such lending. We are unaware of the basis on which APRA figures on the extent of non-conforming lending are compiled and would be concerned if “business loans” were excluded from the figures given the characteristics of the lending described.

In our view, the loans we have described by their nature would cause an increase in the number of loans in arrears and the number of repossessions. This could be tested by doing an analysis of the recent increase in NSW Supreme Court Possession List filings to ascertain whether the increase is due or likely to be due to the types of loans we have described. In the absence of any such analysis in NSW, we are aware of research in the ACT Supreme Court which suggests such loans may be responsible for the increase in filings². We also know that the amount of money currently available to fund such loans is substantial³.

² Kilpatrick, Amy “They want to take our house. An Investigation into House Repossessions in the ACT Supreme Court”. Care Inc. Financial Counselling Service 2006.

³ For example, Kremnizers website (www.Kremnizer.com.au) states “RL Kremnizer and Co Solicitors have access to over \$200 million worth of funds”.

Case studies

These types of loans are exemplified in three matters we have recently conducted in the Supreme Court of New South Wales – Cook⁴, Bahadori⁵, and Ashikian⁶. These cases are illustrative of the difficulties faced in discouraging this type of lending and the reasons why such loans have the potential to become widespread in the absence of appropriate regulatory responses.

In each case the borrower sought a loan via a broker. The broker approached a large private mortgage practice – RLKremnizer & Co (“Kremnizer”) – via its in-house broker Bleier Mortgage Corporation (Bleier). Once Bleier assessed that there was sufficient equity to support the loan it issued an “indicative” offer. Once the borrower accepted this “indicative” offer Bleier handed over its file to Kremnizer who selected the lenders from its list of potential lenders and sent a list of requirements to the solicitor the borrower was obliged to retain. These requirements included the signing of a business purpose declaration in the form of a statutory declaration which, if effective, would ensure that the UCCC wouldn’t apply to the transaction. There were also requirements that a certificate as to serviceability be obtained from an accountant and a certificate of independent legal advice be provided by the borrower’s solicitor. There was also a requirement that an application containing certain information relating to assets and income be completed. In each case the borrower was seeking a loan to pay out a loan secured over their home which was in default.

Problems with regulation revealed by case studies

At first blush one may think that, apart from the question of the validity of the business purpose declaration, the UCCC would apply as it applies to the provision of credit if the debtor is a natural person and the credit “is provided or intended to be

4 Permanent Mortgages v Michael & Karen Cook [2006] NSWSC 1104

5 Bahadori & 2 Ors v Permanent Mortgages & 3 Ors [2007] NSWSC 79

6 Benjamin v Ashikian [2007] NSWSC 735

provided wholly or predominantly for personal, domestic or household purposes”. However, there were two issues which arose in Cook in this regard:

1. the lenders argued, in relation to one of the loans, that the UCCC didn't apply because they didn't provide the credit in the course of a business of providing credit or incidentally to any other business of theirs⁷. This issue wasn't determined as this part of the case settled.
2. the lender argued that the purpose of the loan should be ascertained by looking at what a reasonable person standing in the shoes of the credit provider would have understood the predominant purpose for which the credit is to be provided following a line of authority commencing with the decision of Brabazon DCJ in Rafiqi⁸. This argument didn't need to be settled in Cook, nor did it need to be settled in Ashikian, but in Bahadori there was a finding that the Rafiqi test should not be followed. However, pending appellate pronouncement this is probably still a live issue. This is very worrying from a borrower's perspective because it enables the UCCC to be avoided if unscrupulous lenders establish structures enabling them to disavow any knowledge or reason to have knowledge of the borrower's true purpose.

As regards the business purpose declaration itself the Court found it to be ineffective in Cook and Ashikian but, in Bahadori, upheld the finding of the Consumer Trader

⁷ 6 Provision of credit to which this Code applies

(1) This Code applies to the provision of credit (and to the credit contract and related matters) if when the credit contract is entered into or (in the case of pre-contractual obligations) is proposed to be entered into—

(a) the debtor is a natural person ordinarily resident in this jurisdiction or a strata corporation formed in this jurisdiction; and

(b) the credit is provided or intended to be provided wholly or predominantly for personal, domestic or household purposes; and

(c) a charge is or may be made for providing the credit; and

(d) the credit provider provides the credit in the course of a business of providing credit or as part of or incidentally to any other business of the credit provider.

⁸ Rafiqi & Anor v Wacal Investments Pty Limited (1998) ASC 155 - 024

and Tenancy Tribunal that it was effective. Relevantly although in each case the lender knew, from the answers given by the borrowers in the assets and income document or other documents required by Kremnizers, that the loan was to be used “wholly or predominantly” to pay out a loan secured over the borrower’s home which was in default this was only held to invalidate the declaration in Cook and Ashikian. The decision in Bahadori is currently on appeal in this respect.

Although Legal Aid NSW succeeded in Cook in obtaining a finding that the loan contract was unjust and in having the contract varied to reduce the principal payable, the borrowers were still held liable to pay the reduced principal with interest at the rate specified in the contract for timely payment. As a result, we and other consumer advocates are now receiving offers to settle matters similar to Cook on the basis of payment of the principal plus interest at the rate specified for timely payment. The rate payable for timely payment in Cook, a contract entered into in 2003, was 8.8% pa. If lenders involved in unjust lending are able to settle on such terms (as is likely given the cost risks for the borrower involved in refusing an offer and failing to better the offer at trial) there is no real incentive for them to rectify their practices. This is particularly the case where the return lenders stand to gain from the borrower defaulting on an unaffordable loan is considerable⁹.

Lenders involved in this type of lending are also likely to be aware, given the inherent uncertainties of litigation and given that they can recover their enforcement costs under the mortgage, they will only be challenged rarely, e.g. by very confident borrowers or by those eligible for legal aid (as far as we know legal aid for these matters is only available in NSW). Once 3 years has passed since discharge of the mortgage they are safe from a claim to reopen under the UCCC or Contracts Review Act.

9 In Cook the rate payable when timely payment wasn’t made was 13.8% pa on the first mortgage and 19.5% on the second.

It should also be noted that it is difficult to challenge such differences as constituting a penalty as the current state of the law, at least in NSW, is that if a higher rate is expressed as “the interest rate payable on the principal is 10% pa but should the payment not be made on time the rate will be 20%” this may be able to be challenged as constituting a penalty, but if expressed as “the interest rate payable on the principal is 20% but should payment be made on time the rate will be 10%” the higher rate can’t be challenged as a penalty- case reference

It is also likely that lenders can claim their losses as a tax deduction even if the loan is found to be unjust.

Role of intermediaries

It should be noted that, in *Cook*, the judge accepted the borrower's evidence that he had never spoken to the accountant who provided the certificate as to affordability of the loan and that the provision of this certificate was organised by the broker.¹⁰ We and other consumer advocates are often given similar accounts by borrowers who seek our assistance in these types of matters. The fact that we and other consumer advocates see the same brokers, the same solicitors and the same accountants involved in many of these transactions tends to give some credence to these claims¹¹.

In relation to solicitors acting for the borrowers providing protection for borrowers in this situation this doesn't occur in our experience for two reasons:

1. the solicitor often appears to have an existing relationship with the broker under which the solicitor receives a regular stream of referrals¹²; and
2. the solicitor's role at law in these situations is a very limited one, not normally extending to the provision of financial advice¹³

Finally, on the issue of intermediaries, it is appropriate to make some observations on the character of some of the brokers involved in this type of lending. In *Cook*, the

¹⁰ Similar evidence from the borrower was accepted in *Ginnelle Finance Pty Ltd v Diakakis & Ors* [2007] NSWSC 60

¹¹ The cases of *Lawteal Pty. Limited v. Ofo*; *10 Conway Ave, Rose Bay Pty. Limited v. Ofo* [2006] NSWSC 365 (4 May 2006) and *Motuzyshyn v Bissell* [2005] NSWSC 1134 both involved Kremnizer loans in which the solicitor and accountant were Stanley Price and Dennis Biggs respectively. Dennis Biggs was also the accountant in *Ginnelle Finance Pty Ltd v Diakakis & Ors* [2007] NSW SCTO another Kremnizer loan.

¹² In *King Mortgages v Satchithanatham*; *Cash King v Satchithanatham* [2006] NSWSC 1303 (at paragraph 6) the Court found that "King Mortgages and Cash King had a business relationship with Mel Ciampa [licensed conveyancer]... It was common for King Mortgages and Cash King to refer prospective borrowers to Mr Ciampa for him to provide them with legal advice relating to the proposed loan and security transaction. He received two or three such referrals per week."

¹³ *Citicorp Australia Ltd v O'Brien* (1996) 40 NSWLR 398

broker, Cash King, refunded money to the Cooks as a result of Federal Court Proceedings brought against it by the Australian Securities and Investments Commission (ASIC)¹⁴.

As part of the settlement Cash King made refunds to many other borrowers. Many of the refunds arose from Kremnizer loans brokered by Cash King in which Cash King altered the 'indicative' letter of offer sent out by Bleier to overstate the establishment fee payable to Bleier by the borrower. Cash King had an agreement with Bleier whereby Bleier would retain 35% of the increased portion of the establishment fee and pay back to Cash King the remaining 65% of the increased portion of the establishment fee¹⁵. As far as we are aware Cash King still operates as a broker in NSW.

Current proposals for reform

The proposals for national regulation of finance brokers announced by the NSW Government in December 2006 (see Attachment 1) should go some way to addressing the problem identified by providing for licensing and probity checks for brokers and redress where a borrower enters into an inappropriate loan on the broker's recommendation. Legal Aid NSW does have some concerns, however, about the time it might take to implement the reforms given the inherent difficulties of negotiating a national system via six states and two territories.

In relation to the UCCC, we understand that a consultation bill containing provisions to close the business purposes declaration has been prepared, but we are unable to comment on the proposed provisions not having seen them.

- *Are borrowers in financial difficulty being treated appropriately by lenders?*
 - *Obligations under CBP and/or UCCC; access to superannuation for repayments.*

¹⁴ [2005]FCA 1429

¹⁵ [2005] FCA 1429, Schedule to Orders, Enforceable Undertaking 1.6 (c).

Comment

The types of loans we describe are designed to avoid the UCCC and are not, in our experience, generally made by banks or other ADIs.

- *Are declining credit standards likely to have any long-term implications for the Australian financial system?*
- *Lessons from the current situation in the United States.*

Comment

In Cook, Associate Professor Steve Keen gave expert evidence. He summarised that evidence as follows:

1. I have been asked to provide my expert opinion “as to the consequences or potential impact of the lending typified in Loan 5¹⁶ on the economy generally.” In summary my opinion is:

(a) Standard home loans are limited in size by the need for the borrower to establish that he/she can repay the loan out of income.

(b) Legitimate “Low Doc Loans” are a necessary development of income based loans in light of the changing composition of the Australian workforce.

(c) Ponzi Loans are loans that can only be repaid by either taking out a larger subsequent loan, or by selling the asset that was financed using the loan.

(d) Ponzi Lending can occur in Low Doc Loans because the loosening of

¹⁶ This was the loan the subject of the proceedings in Cook.

income-verification standards enables loans to substantially exceed the size that could be met out of borrower's actual income.

- (e) Loan 5 to the Cooks was a Ponzi Loan.*

- (f) The financial system is, on the evidence, unstable enough in the absence of widespread Ponzi lending to warrant serious concern by the relevant government authorities.*

- (g) Were the practice of Ponzi Lending to become widespread, it would substantially increase the tendency of the Australian financial system to asset bubbles and subsequent financial crises, by:*
 - i. accelerating the accumulation of excessive debt during the upswing to an asset bubble;*
 - ii. accelerating the rate of decline during the bursting of the bubble; and*
 - iii. causing the recovery to take much longer.*

- (h) Ponzi Loans thus have adverse social and economic consequences that extend well beyond the immediate parties to the loan agreement.*

- (i) A Ponzi Loan is arguably an economically illegitimate contract, in that it may be entered into with the expectation by one party that the other:*
 - i. will not benefit from the contract; and*
 - ii. will not live up to its contractual obligations”.*

For the reasons stated above we have concerns that the type of lending we have described does have the potential to become widespread in the absence of appropriate regulatory response.

Conclusion

The particular sub-category of non-complying loan we describe has become common and has, in our view, led to a decline in credit standards.

There are significant difficulties in successfully challenging the efforts of unscrupulous lenders and brokers to avoid the UCCC via the use of business purpose declarations and the use of intermediaries so as to engage in such lending. Even when there are good prospects of doing so the opportunity to run a matter to completion to obtain a decision to achieve systemic change in this area is likely to be rare.

Such lending is socially undesirable and, should it become prevalent, is likely to have adverse effects on the broader economy.

It follows that there is a need for regulatory intervention to address such conduct by lenders and brokers both by way of appropriate national regulation of brokers and by way of strengthening the provisions of the UCCC to prevent its avoidance.

The proposals announced by the NSW Government have the potential to significantly reduce the type of lending we have identified, but we have concerns regarding the length of time they may take to be implemented.

Legal Aid NSW believes the UCCC needs to be strengthened in a number of respects including:

- Overriding the approach in Rafiqi
- Making it illegal to obtain business purpose declarations in the form of a statutory declaration

- Implementing recommendation 2.11 of the UCCC Post Implementation Review to ensure that the required default notice contains information regarding the borrowers' right to make applications for hardship and postponement. This should reduce the extent to which desperate borrower end up with the types of loans described
- Amending s 11 of the UCCC to provide that any information received by the lender or its agent, before settlement, giving reason to believe that the business purpose declaration is false will invalidate the declaration
- Requiring lenders to undertake reasonable verification of a borrower's income and expenses.

Legal Aid NSW also believes that provisions such as s. 730 A of the Legal Profession Act which requires that complainants be reported to the appropriate investigating authorities if suspected of committing an offence should be repealed. Such provisions have the effect of discouraging complaints against lawyers where the complainant has e.g. signed an inaccurate statutory declaration as to purpose.

Legal Aid NSW also calls for urgent amendment of taxation law to prevent tax deductibility of costs associated with unjust conduct.

Lastly, Legal Aid NSW believes that all credit providers should be required to be in External Dispute Resolution.

For further information or discussion of any of the issues raised in this paper, please contact John Moratelli, on (02) 9219 5000 or via email at john.moratelli@legalaid.nsw.gov.au.

National legislation ahead for finance brokers

13 December 2006

"The majority of finance and mortgage brokers do the right thing, however there are cases of operators using heavy handed tactics to get consumers to enter into re-financing deals that result in the loss of their homes," Ms Beamer said.

"Unscrupulous operators charge upfront fees and steer consumers toward inappropriate financial products that bring big commissions for the so-called brokers.

"In 2004, the NSW Government introduced laws to better protect consumers from unfair practices. The laws were designed to ensure brokers provide the loan that best suits a consumer's circumstances and ensure consumers are treated fairly," Ms Beamer said.

"However, the rapid growth of the industry saw an increase in the number of operators who called themselves finance or mortgage brokers but were in fact only in the business to defraud consumers."

"Widespread consultation with industry and consumer groups resulted in a package of reforms that has been approved by Cabinet.

"The Iemma Government has secured the support of all states and territories and the package has been approved by the Commonwealth's Office of Regulatory Review," Ms Beamer said.

The reforms include:

- Licensing and probity checks for brokers
- Mandatory skills and ongoing professional development
- Prohibiting charging upfront fees and lodging caveats over property to secure fees;
- Redress for losses when a consumer enters into an inappropriate credit product on the broker's recommendation;
- Provision for a stay of home repossession where damages are being claimed from the broker;
- A requirement that brokers take out professional indemnity insurance
- A requirement that the broker provide specified disclosures about costs and services before negotiating a broking agreement with the client
- A broking agreement that contain details of the client's needs and why the product recommended satisfies those needs
- A requirement that a broker has a reasonable basis for recommending a particular product.

"These reforms will ensure that brokers recommend appropriate financial products and will give consumers greater confidence in the finance broking industry," Ms Beamer said.

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