PART 8

REAL ESTATE LENDING - BALLOON LOANS

A significant part of HFC's lending business consists of loans secured by mortgages over residential property. HFC refers to these loans as real estate loans. It will be recalled that real estate loans constitute the most profitable part of HFC's lending business. It should be understood that HFC's real estate loans are not loans for the purposes of acquiring the property to be mortgaged, but are loans for other purposes such as debt consolidation and home improvements, to persons who already own their homes.

Real estate loans are solicited by and principally dealt with at HFC branch offices. An important element of HFC's business strategy is the marketing of real estate loans to customers who currently have, or in the past have had, personal loans from HFC.

All of HFC's personal loans, whether unsecured or secured by goods mortgages, are for fixed terms, normally three years or less. The structure of the personal loans is conventional, that is to say the loans are repaid by regular instalments which are sufficient to repay the principal plus interest in full by the time the last instalment is made.

HFC's real estate loans are structured entirely differently. Each real estate loan envisages a series of five loans, each for a term of three years, at the end of each of which (other than the last) an amount of principal "the balloon payment" remains unpaid. That amount becomes the amount financed in the next loan in the series.

The following table illustrates how a real estate loan of $20,000 at 18% p.a. would be repaid.

	Amount Financed	Monthly Instalments	Principal Outstanding at end of loan (balloon payment)
Loan No. 1	$20,000	36 of $322.08	$18,956.12
Loan No. 2	$18,956.12	36 of $322.08	$17,172.01
Loan No. 3	$17,172.01	36 of $322.08	$14,122.70
Loan No. 4	$14,122.70	36 of $322.08	$8,911.04
Loan No. 5	$8,911.04	35 of $322.08 1 of $325.64	Nil

In mathematical terms the above gives the same result as a single loan of $20,000 at 18% repayable by 179 instalments of $322.08 and a final instalment of $325.64, but that will remain true only if the interest rate remains constant throughout. In more recent times, HFC has altered the structure of the loans to a series of three loans, each of five years, but the same principles are applicable.

However, HFC does not contract to retain the initial interest rate for the subsequent loans which refinance the balloon payments. Indeed that is said to be the purpose behind the structuring of real estate loans as balloon payment loans. HFC says that it is unable to borrow funds at fixed rates of interest for terms of anything like 15 years and accordingly cannot lend at fixed rates of interest over such terms. Its solution to that problem is to use balloon loans under which it has the opportunity on each refinancing to adjust the interest rate to a rate which reflects the then current cost of funds to it.

It will be readily appreciated that by comparison with a normal personal loan which is for a single fixed term where the interest rate is fixed for the whole of the contract, a real estate loan involves a number of uncertainties from the point of view of the borrower. The original sum lent will not be repaid unless the borrower is able to obtain four successive further loans from HFC to finance the balloon payments. HFC does not, at the time of the making of the initial loan, undertake to refinance any of the balloon payments nor, for the reasons already given, does it contract that the interest rate which applies to the first loan will also apply to any of the subsequent loans.

There is nothing in the Credit Act which prohibits, or even imposes additional conditions or disclosure requirements for, balloon loans. Nonetheless such loans are a far from common form of lending in the Australian consumer credit market and further such loans are fundamentally different in structure from HFC's other main form of fixed term lending.

Accordingly, the Authority sought to examine what steps HFC took to ensure that borrowers understood the important differences between its balloon loans and conventional loans.

It has at all times been HFC's practice, before a real estate loan and the related mortgage are signed by a borrower, to give to the borrower documents called a letter of offer and a proforma letter of acceptance and to require that the borrower sign and give back to it the letter of acceptance. It is HFC's case that the letter of offer adequately informed the borrower of the important variables, namely the need to obtain refinancing of each balloon payment and the possibility that the interest rate may vary.

The letter of offer and the proforma letter of acceptance were prepared in the Sydney head office and sent to the branch office with which the borrower was dealing. It has been for the branch to send the letters to the borrower. The Authority was interested to ascertain at what stage the borrowers received their letters of offer. However, the evidence is such that it is not possible to determine how long prior to the execution of the loan and mortgage, borrowers usually received the letters of offer and proforma letters of acceptance.

All of the letters of offer which the Authority has seen appear to have been dated by HFC's head office before the letters were sent to the branches for transmission to the borrowers. Moreover, each proforma letter of acceptance which the Authority saw bore the same date as the related letter of offer. Thus the dates which the letters bear do not reveal when the letters were actually delivered or sent on by the branches concerned to the borrowers.

HFC's Real Estate Lending Manual (A156, Vol. 6 Tab 33) instructed branch managers to deliver the letters of offer and pro forma letters of acceptance either personally or by post <u>after</u> the loan application had been investigated and approval for the loan granted but <u>before</u> instructions were given to the solicitors to investigate title and draw up the necessary mortgage.

Evidence was given by a former branch manager, Mr. Downs, of a practice which he adopted by which the giving of the letter of offer to the borrower was delayed until the solicitors were ready for settlement. His explanation for this practice was "The situation was to try and make the customer feel that he was committed to the loan as early as possible ...(W)e didn't want to frighten the customer with a letter of offer showing them 35 consecutive monthly instalments and a balloon payment of such a large amount of money, when they were first led to believe that it was a 5 year loan or a 10 year loan" (3951-52).

As to the practice spoken of by Mr. Downs, it must be said that that practice was clearly contrary to HFC's instructions as set out in its Real Estate Manual. It should also be noted that Mr. Downs said that he was sure that consumers understood the essential features of the loans from his explanations and that if the consumers then demurred, they were free not to proceed.

The evidence of particular balloon loan transactions given before the Authority is of no real assistance in determining whether in the majority of cases borrowers received the letter of offer at the time instructed by the Real Estate Manual or whether, as Mr. Downs' evidence might suggest, it was at a later stage. Accordingly, it is not appropriate to conclude that the practice spoken of by Mr. Downs was typical. On the other hand the Authority is not prepared to assume that in all cases other than those in which Mr. Downs was involved, the instructions set out in the manual were followed. The practice of dating the letter of offer and the proforma letter of acceptance at HFC's head office in Sydney prior to those documents being forwarded to branches for delivery to the borrowers created the opportunity for the practice spoken of by Mr. Downs to be employed with little chance of detection by HFC's supervisory or auditing processes.

In any event, the issue of whether the borrowers received their letter of offer in accordance with the instructions in the manual or whether they got them at a later stage in accordance with the practice spoken of by Mr. Downs is not the most important issue. The Authority considers that it was HFC's duty in fairness to tell prospective borrowers of the balloon payment nature of any proposed loan and of the possibility of interest variations at a much earlier stage.

It is plain from the procedures set down in the Real Estate Lending Manual referred to earlier that there must have been considerable contact between HFC branch staff and any prospective borrower before the stage was reached where approval was given for the loan and the letter of offer delivered to the borrower. There must have been -

(i) initial contact by the consumer enquiring about a loan or alternatively by HFC attempting to solicit a loan;

(ii) a loan application interview at which HFC staff obtained and recorded on the loan application form personal, employment, financial and property details relating to the borrower and at which the borrower's signature to the completed loan application form was obtained; and

(iii) an inspection of the exterior and interior of the borrower's property made by the manager or other senior branch staff member, except where the borrower's property had been security for an earlier real estate loan.

In the Authority's opinion, it is obvious that the proper time at which the borrower should have been informed of the special features of any loan that might be offered in response to the application, namely the balloon payment structure and the possibility of the interest rate changing upon refinancing, was at the loan interview stage. The Authority also considers that the withholding of that information until the borrower was advised that the loan was granted (subject only to satisfactory title for security purposes) was a conscious and unfair strategy designed to reduce the possibility of the borrower looking elsewhere for finance on terms not subject to those features.

Apart from the issue of the time at which HFC intended borrowers to be made aware of the variable features of its real estate loans, the Authority had some concern about the terminology of the standard form letter of offer.

The relevant part of the typical Letter of Offer (e.g. see Exhibits 0121 and 0128) contains the following:

> "Dear Borrower,
> Your application for a loan on mortgage has been considered and HFC Financial Services Limited (hereinafter called "the Company") is now prepared to negotiate with you, a facility on the terms and conditions set out below. Nothing contained in this letter or in any acceptance thereof shall be deemed to constitute a contract for loan.

1.	PRINCIPAL	:	"A" Dollars ($A)
2.	PRINCIPAL REPAYABLE	:	Together with interest by "B" equal consecutive monthly instalments of $"C" plus a final payment of $"D", the first of such instalments to commence one month from the date of making the loan. We will be happy to consider negotiating a new loan at that time subject to the market rates and conditions then in force. Factors to be taken into consideration in determining whether a new loan will be negotiated at the expiration of the present term will include a review of your performance and observance of the terms and conditions contained in the Mortgage and also the value of the property at the time the application is made to renegotiate the loan, to ensure that any equity in the land is sufficient to support the loan.
3.	INTEREST	:	a) Payable with principal as shown above b) Rate "E" per centum per annum".

The remaining portions of each letter deal with matters of security, documents of title, solicitor's approval, etc.

The proforma Letter of Acceptance merely informs HFC that the borrower accepts HFC's offer of a loan on the terms and conditions of the loan set out in HFC's letter.

In the Authority's view, the terms of the Letter of Offer are less than ideal. To the average borrower used to HFC's conventional personal loans and unfamiliar with more sophisticated lending practices, the letter does not indicate that the interest rate at which any refinancing of the balloon loan will be offered may well differ from the interest rate offered for the start of the loan. In fact there is no specific reference to interest rates in the critical sentence which commences "We will be happy to consider negotiating..."; the reference is to market rates and conditions.

Conclusions

The Authority considers that HFC acted unfairly in not revealing to prospective borrowers at the loan application stage the critical features of real estate loans.

As to the terminology of the letters of offer, the Authority considers it unsatisfactory, but regards this as a matter of less importance.