Solicitor lending to consumers: a study of interest only loans and asset-based lending practices in Victoria

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for

Consumer Credit Legal Service Inc (Vic)

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About Consumer Credit Legal Service

Consumer Credit Legal Service Inc ("CCLS") is a community legal centre that provides advice, and legal representation to consumers in relation to consumer credit matters.

CCLS also aims to influence industry practices and Government policy through policy work, research and advocacy.

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Executive summary

Introduction

This report is a study of the experience of consumer borrowers, where finance has been provided by, or through, a legal practice ("solicitor lending"). The experiences of the borrowers illustrate some weaknesses in the current consumer protection for consumer borrowers.

What Is "Solicitor Lending"?

Most consumer credit is provided by banks and finance companies. However, there are other types of lenders in this market. Solicitors (or investment schemes operated by law firms) provide a small proportion of consumer loans. The loans provided through legal firms are, as far as we know, all provided on a fixed-term, "interest only" basis. While solicitors are a minor source of consumer loans, they appear to be the major source of interest-only loans to consumers. These types of loans can cause severe problems for consumer borrowers.

Fixed-term Interest Only Loans

Fixed term, interest only loans usually involve:

- Regular payments of interest;
- Repayment of the total amount borrowed as a lump sum at the end of the loan period (usually two or three years); and
- A mortgage over the borrower's house as security for the loan.

If the borrower fails to make one or more payments of interest, or is unable to pay the lump sum at the end, the lender can sell the borrower's home.

This type of loan may suit some business borrowers – for example, a builder may wish to borrow funds to build a block of units, and repay the full amount once the units are sold. However, as this report shows, these loans are unsuitable – and often dangerous - for consumer borrowers.

We are aware of a few other lenders providing these types of loans to consumers, however we believe that solicitors (acting on behalf of a client who is providing the finance, or managing a mortgage investment scheme) are the predominant providers of these loans.

Research

The research aimed to identify problems experienced with, and reasons for accessing, this type of lending, as well as reforms that may be required to address the problems.

The research was primarily qualitative, as we felt that qualitative research would be the most effective way of obtaining an in-depth understanding of consumer experiences.

The sample was not large, nor was it representative of all consumers who borrow from or through law firms. Instead, the sample group was comprised of consumers who had experienced some problems with solicitor loans. Despite this, the experiences of the consumers who participated in this research provides valuable information about the problems some consumers experience with these types of loans.

Sources used to contact consumers were:

- Supreme Court files where a writ of possession was sought by the lender. From these files, we identified solicitor lending matters and defendant borrower contact details;
- Credit Helpline contacted consumers who had sought telephone advice on solicitor loans;
- Financial counsellors, Consumer Credit Legal Service and other caseworkers provided referrals to the project.

We obtained information about consumer experiences through:

- Personal interviews;
- Questionnaires; and
- Case studies provided by casework services.

Responses from interviews and surveys covered:

- 35 borrowers;
- 28 households; and
- 32 loans.

Research Results – Borrower characteristics

The borrowers surveyed or interviewed were generally of an older age group, and most had relatively low incomes. Almost two-thirds of the borrowers (22 of 35) were over 55 years of age, with nearly one-third (10 of 35) being over 65 years.

Only a small proportion of the sample group was in full time employment (4 of 35), and nearly half (15 of 35) was in receipt of a pension. Consistent with this finding, about half of the households (15 of 28) reported a household income of less than $20,000.

Three-quarters of the loans obtained were for less than $100,000 (25 of 35) with only a small number (5 of 35) of loans being for more than $150,000.

Of the 20 households that were represented in the interviews, 6 borrowed funds for the benefit of a person other than the borrower/s.

Borrowers interviewed appeared to fall into three broad groups:

- "Elderly, quasi guarantors", who tended to be older borrowers who borrowed money for the benefit of a third party;
- Borrowers who understood the loans, but experienced problems; and
- Borrowers seeking finance of last resort (who were in financial difficulty already).

Out of the 32 loans identified through the research, enforcement action was taken by the lender in relation to 23. In 7 of these cases, the borrower(s) sold their home to prevent a mortgagee sale, and in 6 cases, the borrower(s) refinanced the loan through other lenders.

Key Problems

The research found that the main problem for borrowers with this type of loan is that the family home is at serious risk if the borrower is unable to meet monthly interest payments, or unable to pay the principal when it is due (in a lump sum). This problem is caused, or exacerbated by:

- Failure of lenders to assess borrower income, or capacity to pay;
- Excessive fees;
- Lack of flexibility in response to defaults;
- Little understanding by some borrowers of the key terms of the loan;
- The role of mortgage brokers in suggesting inappropriate loans to borrowers; and
- Lender avoidance of consumer credit legislation by use of false business purposes declarations.

The experiences of the respondents to this research, suggest that the law fails to provide adequate protection to consumers in relation to both the provision of adequate redress for individual consumers and discouraging unfair industry conduct.

Recommendations

Recommendation 1: Credit laws should cover loans for business, as well as personal purposes, in line with recent legislation (such as the Financial Services Reform Act 2001). This would ensure that business purposes declaration could not be used to avoid Code coverage in circumstances where the loan is for personal, domestic or household purposes.

*Recommendation 2***:** Consumer credit legislation should provide additional protections to consumers who enter into a credit contract where they receive no personal benefit – regardless of whether they are documented as a guarantor, co-borrower or borrower. Such provisions should include a cooling off period, in addition to a requirement that the consumer receives advice, and signs the documents, in the absence of the person who is to benefit from the loan.

*Recommendation 3. A*mend the CCC by adding an additional sub-clause to Section 6 to ensure coverage of loans by individuals if commercially arranged. Section 6(e) would read:

> "the person arranging the credit arranges the credit in the course of a business of arranging credit or as part of, or incidentally to, any other business of the person arranging the credit".

Recommendation 4: The UCCC should be amended to incorporate a positive obligation on credit providers to assess capacity to pay before consumer credit is offered or accepted for personal, domestic or household purposes. This should include:

- a prohibition against making loan decisions on the basis only of the value of the security property;
- for an interest only loan, a requirement to obtain written advice from the borrower as to how the principal is to be repaid; and
- an assumption that an interest only loan that requires payment of the principal in a lump sum is unjust unless the lender has made adequate enquiries and reasonably believes that the borrower will have the means to pay.

The UCCC should specify how remedies should be determined in such cases, so that it is clear that the principal (as well as interest and fees) can be reduced if payment would cause undue hardship.

Recommendation 5: Section 31(3)(a) of the UCCC should be deleted, so that consumers with amounts outstanding on fixed interest loans receive regular statements.

Recommendation 6: Federal and State Governments should immediately instigate a review of the effectiveness of the UCCC, and the mechanism for reviewing and amending the UCCC, in achieving outcomes for consumers with a view to an overhaul of credit regulation in Australia.

Recommendation 7: All businesses providing consumer credit should be required to meet similar requirements to other financial services (including belonging to an approved alternative dispute resolution scheme) in addition to complying with specific consumer credit regulation.

Recommendation 8: Introduce legislation that would deem a broker to be the agent of the lender. In the short term, urgently pursue the proposed national approach to regulation of finance brokers (including a requirement that all brokers arranging credit to be licensed, to obtain an appropriate loan for the borrower's circumstances and to belong to an approved industry external dispute resolution scheme).

Recommendation 9: Research should be undertaken to identify the role that independent legal and/or financial advice plays in consumer credit transactions, and what factors influence the quality of the advice – including whether the quality of legal advice differs depending on whether the consumer chooses the source of the advice or whether the source is recommended by the lender or broker.

Recommendation 10: The Law Institute of Victoria should review the extent to which members of the Managed Mortgages Section are complying with MMS rules, including the obligation to assess the borrower's capacity to repay the loan.

Table of contents

PART A: INTRODUCTION AND BACKGROUND

1. Introduction

In 2001 and 2002, financial counsellors and consumer credit lawyers in Victoria began noticing an increase in clients reporting problems with interest-only loans that had been provided by or through solicitors' mortgage practices. In response to concerns about the impact of this form of lending on consumers, Consumer Credit Legal Service ("CCLS") successfully sought funding from the Victorian Consumer Credit Fund for a research project on solicitor lending.

The research focused on lending where the funds were used for personal, domestic or household purposes.[1] Solicitors' mortgage practices also provide or facilitate finance to farmers, developers, builders and others for business and investment purposes. However, this type of lending was not within the scope of the research.

This report sets out the key findings of our research, and makes recommendations for further work and for change to industry practices, as well as regulatory and legislative reform.

1.1 Background

Loans provided by solicitors' mortgage practices are commonly short-term, provided on an interest only basis, and secured by real property. Regular payments during the life of the loan merely cover the interest accrued, and do not reduce the outstanding principal. At the end of the loan term, the borrower must either repay the principal amount borrowed, or refinance the loan.

In existence for many years, these loans have normally been used as a source of funds for property developers, investors, and other businesses. They seem to be particularly suited for this type of step, where the intention often is to sell the secured property at the end of the loan term.

More recently, some solicitors appear to have begun providing finance for personal, domestic or household purposes, for example, to finance renovations, home purchases, and to enable the borrower to meet bills and repay other debts.

On the face of it, the use of this form of finance for consumer purposes appears to be more problematic. Where the loan is secured by the borrower's family home, as is often the case, the borrower may not have any intention of selling the property at the end of the loan term. (Indeed, as this study found, many borrowers do not realise that this was a likely outcome of securing finance through an interest only loan.)

However, for borrowers without other assets or significant income, the sale of the house may be the only option. This has particular consequences for borrowers on low or fixed incomes who may have limited alternative housing options. And, of course, the forced sale of a family home often causes great distress for those involved.

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[1] This is the definition used in Uniform Consumer Credit Code s 6(1)(b).

Another issue that is raised by providing interest only loans for consumer purposes is that of asset-based lending. With asset-based lending, loans are provided on the basis of the value of the security property. Less attention is given to the ability of the borrower to meet the loan repayments with their income, and their capacity to repay the loan *without* selling the security. Asset-based lending has long been considered inappropriate where the borrower is a consumer and the security is a family home.

Additional problems reported by financial counsellors and other caseworkers included:

- Consumers not having a full appreciation of the interest only nature of the loan, and the requirement to repay the principal at the end of the loan term;
- Loss of the protections provided by the Uniform *Consumer Credit Code* ("UCCC") because the finance is not provided by someone "who is in the business of lending", and/or because a false declaration that the loan is for business or investment purposes has been obtained;
- The role of mortgage brokers in suggesting inappropriate loans, and/or misrepresenting the nature of the loans to vulnerable consumers; and
- High interest rates and high fees compared to finance from mainstream lenders.

The project aimed to explore these issues in more detail.

Of course, solicitors' mortgage practices are not the only financiers who provide interest-only loans for consumer purposes. However, to date, the cases that financial counsellors have observed have primarily involved loans provided by solicitors' mortgage practices, and it is for this reason that this project focused specifically on lending by solicitors' mortgage practices.

In addition, there are extra regulatory requirements that are imposed on solicitors' mortgage practices, but not other lenders providing interest only loans. These make it worth exploring the issues of interest only loans and asset-based lending through the lens of solicitor lending.

1.2 Research Objectives

The project aimed to:

- Identify the problems experienced by consumers who borrow from solicitors' mortgage practices;
- Identify the reasons that consumers have accessed this type of lending;
- Identify the practices of solicitors' mortgage practices in relation to disclosure, sales techniques, fees and charges, fairness of contract terms and collection practices;
- Identify regulatory reforms that could address some of the problems identified;
- Raise the problems and regulatory issues to government and regulators; and
- Bring the issues to the attention of the public.

We also asked whether existing regulation and industry practices provide adequate protection for consumers who borrow from solicitors' mortgage practices.

1.3 Conducting the Research

The research project was conducted by Nicola Howell (Project Manager/Researcher) and Elena Mogilevski (Researcher), and the primary research activities were carried out between June 2003 and February 2004.

The project was overseen by Carolyn Bond, Manager, CCLS, and a Steering Committee of community workers with a particular interest in, and experience of, this issue:

- Brian Harvey, Financial Counsellor;
- Peter Gartlan, Financial Counsellor;
- Donna Letchford, Financial Counsellor;
- Eloise Curry and Darren Ferrari, Secondee Solicitors, Public Interest Law Clearing House;
- Paul Gillett and Kate Allan, Solicitors, CCLS.

The following people also provided valuable assistance and/or advice during the course of the research and/or drafting of the report:

- Tim Gough, Solicitor, Consumer Law Centre of the ACT (whose assistance with much of chapter 4 should be acknowledged);
- Penelope Hill, Manager, Credit Helpline;
- Dean Wilson, Lecturer, Monash University.
- Christian Groves, Locum Solicitor, CCLS.
- Roslyn Hunter, Volunteer, CCLS.
- Anna Stewart, Principal Solicitor, Consumer Law Centre (Victoria).

Thanks are due to all for their assistance, however, any errors are the author's responsibility alone. Special thanks are also due to the borrowers, solicitors and financial counsellors who took the time to complete a survey or participate in an interview for this research.

1.4 Structure of this Report

In the first part of this report, we summarise the research method used.

The second part of this report sets out background information that is essential to understanding the results of the research. Here, we provide some definitions, briefly review the recent regulatory history of solicitor lending, and explain the regulatory framework governing solicitor lending.

The third part of this report describes the key findings of our research. Initially, we summarise some of the key features of the sample group and their loans – for example, their age, income, loan size, and source of referral to this form of finance.

We also use the loan contracts provided by borrowers to get a further understanding of contract terms and conditions, and information from Supreme Court writs to further understand the way in which creditors use the legal process.

We then describe the experiences of the borrowers interviewed in detail, and tease out some key themes and issues that are common to all of those interviewed, or to a subgroup of those interviewed.

Finally, to complement the information gained from borrowers and their documents, we include the perspectives of solicitors and caseworkers.

The last section of the report summarises the key themes and issues arising from the report, and sets out some recommendations for action and further research.

2. Research Method

The primary focus of this research was to collect information about the experiences of borrowers who have used solicitor lending for personal, domestic or household purposes. Borrower surveys and interviews were the key methods used. A copy of the survey used is at Appendix A and a copy of the interview questions is at Appendix B.

However, to put those experiences in a wider context, we also sought information and comments from financial counsellors and other caseworkers and solicitors. We also reviewed relevant literature, websites, legislation, reported cases, contracts, and a sample of Supreme Court files involving solicitors' mortgage practices.

2.1 Borrowers

In undertaking this research, we wanted to get a clearer picture of the problems faced by consumers who had borrowed funds from or through a solicitors' mortgage practice. Given the small scale of the project and the small size of the market for solicitor lending, it was not feasible to undertake any form of random sampling to identify potential survey or interview participants.

We also were aware that neither the borrowers, nor the lenders, would be an easily identifiable group.

We therefore focused on identifying those borrowers who had been in contact with an advice service or the legal system in relation to their loan. We:

- searched Supreme Court files where a writ of possession was sought to identify solicitor lending matters and defendant borrower contact details;[2]
- asked Credit Helpline[3] to review their files and identify consumers who had sought telephone advice on a solicitor loan;
- promoted the project to financial counsellors and other caseworkers and asked them to contact relevant clients on our behalf; and
- contacted relevant clients of CCLS.

After identifying possible research participants, we wrote to them seeking participation in the project. We sent letters to 74 borrowers identified through the Supreme Court files,

[2] Supreme Court records between September 2002 and July 2003 were searched to identify potential borrowers for the research. In order to increase the chances that the borrowers contacted would have borrowed for personal, household or domestic purposes, the following criteria for selecting borrowers to contact were used: the lender appeared to be a solicitor lender, private investor, or nominee company; the borrower was a natural person; the mortgage was over residential property; and the address of the defendant was the same as that of the mortgaged property (i.e. the property was not an investment property). In all, 74 files were identified as possibly being relevant for this project.

[3] Credit Helpline (Victoria) Limited operates a telephone advice service that provides information and advice on credit and debt matters. Credit Helpline is co-located and works closely with CCLS. Credit Helpline records details of all calls received and advice given in an electronic searchable database.

and Credit Helpline, on our behalf, sent letters to 7 borrowers from their files, and spoke to a number of other clients.

Letters or contacts to borrowers explained who CCLS was and the nature of our research; explained how we had obtained their details; and offered borrowers the opportunity to participate in the research by completing a survey or attending an interview. Borrowers were advised that interview participants would be paid $30 to compensate them for their time and effort.

Consumers were also directly approached through a notice on the Choice website, however, no contacts were made as a result of this notice.

In total, we conducted 18 interviews[4] and received 10 completed surveys[5] for this project.

2.2 Comments on Borrower Sample

Although the response rate to our requests for surveys in particular appears to be low, the size is perhaps not surprising, given the factors that might dissuade borrowers from responding to our request for participation. These include:

- the sensitivity of the issues involved – difficulties with personal finances are often a matter that consumers are quite embarrassed or ashamed about;
- the fact that many of the borrowers contacted may no longer reside at the address used – particularly given that many had been the subject of proceedings by the lender to gain possession of their property;
- responding to surveys is likely to be a low priority for many consumers, particularly as the research project was not able to offer any legal advice or assistance.

Time and other constraints prevented us from undertaking another survey distribution exercise.

However, the willingness of 19 borrowers to be interviewed for the project was very pleasing, and attests to the importance of this issue for many of the consumers affected.

Obviously these borrowers are not a representative sample of the Victorian population as a whole. Nor is it possible to know whether they are representative of borrowers who borrow from or through solicitors' mortgage practices.

However, this research aimed to be an introductory study into the market for solicitor lending, and into consumer experiences. The experiences reported by the sample group illustrate a number of the concerns that caseworkers had previously identified, and enable us to draw some initial conclusions about the suitability of this type of lending for

[4] Another borrower was willing to be interviewed, but subsequently was not able to do so because of time constraints. The loan in this case was also for business purposes.
[5] In two cases, the borrowers referred to in the survey were subsequently interviewed for the project. The information from these surveys was therefore excluded from the results in Chapter 5.

consumer borrowers. The research also has wider implications for asset-based lending and the use of interest only loans for personal, domestic or household purposes.

2.3 Interview Process

Depending on the interviewee's preferences, interviews were conducted at the interviewee's home, the CCLS office, or the office of the financial counsellor assisting the borrower. All interviews were conducted by one interviewer, and took place between November and December 2003.

At the commencement of each interview, the interviewer explained the nature of the project and the intended use of the information provided in the interview. The interviewer emphasised that the interviewees would not be identifiable in the final report or any other material arising from the project. The interviewees were also advised that they could stop the interview at any time. Each interviewee signed a consent form, retained by CCLS.

Interviews lasted between 30 and 60 minutes and were semi-structured, in that the interviewer roughly followed a series of questions, but allowing for further discussion around those issues.

Interviews were taped (with the permission of the interviewee) and later transcribed by CCLS staff and external consultants.[6] The interviewer also copied relevant documents for later review (for example, contracts[7]) where these were made available by the interviewee.

2.4 Financial Counsellors and Other Caseworkers

We received comments, case studies and other input from financial counsellors and other caseworkers through the Project Steering Committee, which met in person a number of times and also communicated frequently by email.

We also sought caseworker input through:

- Regular notices in Devil's Advocate, the newsletter of the Financial and Consumer Rights Council ("FCRC");
- An email survey (sent to all members of FCRC) and follow-up phone calls (in all, 20 responses were received); and
- Discussions at the annual FCRC conference and other forums.

[6] In three interviews however, the tape recorder was faulty and the interview was not fully taped. In these cases, the interviewer took detailed notes, including key quotes and transcribed these for the purpose of analysis.
[7] Copies of contracts or other documents were provided by 11 of the interviewees.

2.5 Solicitors

To obtain input from solicitors involved in mortgage lending, we held discussions with the Law Institute of Victoria ("LIV"), and two members of the Law Institute's Managed Mortgages Section ("MMS").

In addition, we wrote directly to the four firms that were most frequently mentioned in calls about solicitor lending to Credit Helpline. These letters described the project, and offered the firm the opportunity of a meeting to provide information and their perspective.

CCLS guaranteed that the report would not name individual firms, either in the context of general discussions in the report, or in relation to particular surveys or interviews. It was felt that this was the most appropriate course given the small-scale nature of the research and the limitations of the borrower sample described above. In addition, it was hoped that this guarantee of anonymity would facilitate input by solicitors.

Two firms responded to this letter and agreed to meet with CCLS. However, in the case of the second firm, the initial interest was not sustained, and later calls to arrange a meeting were not returned.

PART B – SOLICITOR LENDING IN CONTEXT

3. Solicitor Lending – an Introduction

3.1 Definitions

Lending has formed a part of some legal practices for many years. Different forms of lending are used. For example, some solicitors provide finance through a "mortgage investment scheme". As explained by the Australian Securities and Investments Commission ("ASIC"):

> "a mortgage investment scheme differs from a simple loan secured by a mortgage in three ways:
>
> - More than one person contributes money to buy an interest in the benefits produced by a scheme (in some instances the scheme may include single investor loans)
> - The money people contribute is pooled or used in a common enterprise for scheme members
> - Members of the scheme do not have day to day control over the scheme's operation."[8]

Solicitors are not the only businesses that operate mortgage investment schemes. For example, mortgage investment schemes are also operated by trustee companies, finance brokers and investment companies that have no formal or informal relationship with a law firm.

In theory, mortgage investment schemes are regulated in the same manner whether they are operated by law firms or by other businesses. In practice, however, the option of running a small mortgage investment scheme that is supervised by an industry association (rather than ASIC) is currently an option that is only available to solicitors (see Chapter 4).

Solicitors can also provide finance directly by or through their legal practice – for example, where a solicitor facilitates a loan from one client to a borrower.

There is some variation and overlap in terminology used in this area. For our purposes, we have used the term 'solicitor lending' to mean a form of finance that is provided by or through a legal practice. Thus, in our definition, solicitor lending includes the following situations:

- A solicitor facilitates or brokers a loan between an individual client (or a client's company) and a borrower. (This is distinguished from the situation where the

[8] *Types of Mortgage Investment Schemes,* (2001, February 25), Australian Securities and Investments Commission (ASIC) Information Sheet, Available: www.fido.asic.gov.au (Accessed: 2004, June 10)

solicitor merely provides advice and/or draws up documentation for a loan that has already been agreed in principle between the parties.)

- A legal practice pools funds from a number of clients, holds those funds on trust, and establishes loans between the borrower and investor clients, with the clients recorded on the documents as the mortgagees and credit providers.

- A legal practice pools investor funds for lending, again holding those funds on trust, and the solicitor's nominee company is the mortgagee and credit provider.

- A legal practice is very closely associated with a 'responsible entity' (see Chapter 4) that operates a mortgage investment scheme, seeking and pooling investor funds and managing the loans that are provided by the scheme. (This situation occurs in a number of firms that had large mortgage practices and then transferred the mortgage management to a separate company when the *Managed Investments Act 1998 (Cth)* came into effect.)

- A lawyer or legal practice lends funds directly to individuals or businesses.

As shown later, funds provided by or through law firms are typically interest only loans, for a fixed term (normally 1 – 5 years). The loans are usually secured by a first mortgage.

3.2 History

It is likely that solicitors' mortgage practices were originally developed to provide an additional service to clients who had money to invest and wanted to invest in first mortgage securities. However, over time, solicitor lending has developed into a sub-industry in its own right. One commentator recently noted that this type of business:

> 'grew substantially during the past decade to a point where the intermediaries (solicitors) began pursuing borrowers and lenders outside their client base.'[9]

Originally solicitor lending was regulated as part of the normal regulation of legal practices, with the focus being on trust account regulation and inspection. In part, the rationale for this approach was based on the ancillary nature of the mortgage practices.

However, in recent years solicitor lending has come increasingly under the spotlight, as a result of investors losing money through poor lending practices. There have been a number of public and high profile enquiries that have, in turn, led to calls for the stricter regulation of solicitors' mortgage practices.

For example, a 2001 report by the Senate Committee on Superannuation and Financial Services concluded, in relation to solicitors' mortgage schemes in Tasmania, that:

> "much of the financial and emotional distress caused by the failure of some prominent solicitors' mortgage schemes could have been alleviated had there been a more effective regulatory framework, and improved access to consumer information and support."[10]

[9] A.G. Hodgson, *Run-Out Mortgage Investment Schemes - A Report to ASIC,* 7 March 2002, para 3.1

Similar concerns, including:

- Poor disclosure of the extent to which the scheme operators checked borrowers' credit history;
- Failing to take recovery action in relation to defaults;
- Failing to obtain independent valuations of the properties securing loans, or accepting inadequate valuations; and
- Inadequate borrower assessment practices;

were raised in an ASIC surveillance of responsible entities, including those operating mortgage investment schemes.[11]

ASIC noted:

> "We were particularly disappointed with the lack of compliance and other breaches by responsible entities of smaller mortgage schemes and will continue to focus on them as part of our wider review of the operation of mortgage schemes."[12]

Chapter 4 describes the regulatory changes that were introduced, in part, to overcome these problems. However, even after changes to the legislation were introduced, problems from an investor perspective were identified, particularly in the case of those schemes that were being operated as 'run-out schemes' during the transition to the new regulatory arrangements.

In 2001, ASIC commissioned a report on the operation of these 'run-out schemes' ("the Hodgson report"). In reviewing the schemes, the consultant identified a number of practices that had led, or could lead, to investors suffering loss. These included:

- Little evidence of pre-loan assessment due diligence - assessment of the financial standing of the borrower and guarantors (where they existed), or of the borrower's ability to service and repay the loan.
- Little evidence of regular post loan assessment of the borrower's ability to continue to service the loan.
- Reliance on valuations provided by the borrower, sometimes obtained months before the loan application.
- Overstated, improper, negligent and sometimes fraudulent valuations.
- Lending on inappropriate loan to valuation ratios.
- Misleading and inaccurate comments in the promotional material to investors.
- Failure to act on defaults in a timely and efficient manner.
- Delay in pursuing borrowers and guarantors, with the result that they cannot be located or have dissipated their assets and/or become insolvent.[13]

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[10] Australia, Parliament. Senate Select Committee on Superannuation and Financial Services, *Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services - Second Report - Some Case Studies* (John Watson, Chairperson) (Canberra: The Senate, Tabled 2001, August 20) p 72

[11] *2000-2001 Surveillance Outcomes for Responsible Entities,* ASIC Information Release IR 01/09 (2001, August) p 4.

[12] Ibid.., p. 1.

[13] Hodgson, *Run-Out Mortgage Schemes* para 6.20.

Mr Hodgson observed that:

> It appears that mortgage lending for many firms has grown from a small part of their legal practice to an entire operation where firms are acting, inter alia, as banks, financial advisors, project managers and property developers.[14]

In light of this expansion, Mr Hodgson also commented that some operators did not exhibit and have not demonstrated the appropriate level and skill to carry out some of the functions associated with their business[15] and in fact, that some of the operators should have their entire operation shut down 'so high was the level of long term loan defaults together with their failure to take steps to realise security properties and actively pursue recovery from borrowers and guarantors'.[16]

The extent to which lending has become a major component of some law practices has reinforced the fact that the previous rationale for light-touch regulation of solicitors' mortgage schemes – that such ancillary activities could be regulated through regulation of the legal practice – had become increasingly irrelevant.

3.3 Size of the Solicitor Lending Market

Given the disparate regulatory requirements (see chapter 4), it is difficult to assess the size of the solicitor lending market, either overall, or specifically in relation to consumer lending.

Law firms operating under industry supervision are required to join the Managed Mortgages Section (MMS) of the LIV. As at December 2003, the MMS had 34 firms as members,[17] and had aggregate funds of around $80 million in investments.[18] The largest of the group manages approximately $7 million in investments and a number of firms have around $3-$4 million in investments.[19]

We were unable to unable to obtain any estimates on the extent of solicitor lending by responsible entities, regulated under the *Corporations Act 2001 (Cth)*, as the regulator (ASIC), does not separately identify responsible entities that had their history in legal practices and/or are closely associated with legal practices.

Similarly, we were not able to assess the size of the unregulated solicitor lending market (that is, those mortgage investment schemes that have less than 20 members but more than $7.5 million in funds on loan).

Whatever the size of the solicitor lending market, it is likely to be dwarfed by the market shares of more mainstream lenders. For example, figures from the Reserve Bank of

[14] Ibid., para 6.1.
[15] Ibid., para 6.2
[16] Ibid., para 6.25
[17] Chairperson of the Managed Mortgages Section, Law Institute of Victoria, Letter to CCLS 2003, (December 17)
[18] Interview with Chairperson, Managed Mortgages Section, 26 November 2003.
[19] Ibid.

Australia show that in July 2004, the following amounts were outstanding on *bank* loans to persons:

Loans for housing, owner-occupier:	$291,236 million;
Loans for investment housing:	$153,668 million;
Other personal loans – fixed:	$31,742 million;
Other personal loans – revolving:	$47,128 million.[20]

Comment [u1]: It would be good to update these figures. Done

Despite the small size of the market, the impact on the individuals that are affected by poor lending practices in relation to solicitor loans can be significant. The issues raised in this research are also highly relevant to other forms of non-mainstream lending.

In addition, it is likely that the number of players in the consumer credit market will continue to increase. In these circumstances, it is the non-mainstream players like solicitor lenders, who may be the only option for those borrowers that are the most at risk of default, because of inadequate incomes, credit overcommitment, and/or other factors.

[20] Australia. Reserve Bank of Australia. *BANK LENDING CLASSIFIED BY SECTOR, Table D05,* <http://www.rba.gov.au/Statistics/Bulletin/D05hist.xls> (Accessed: 2004, October13).

4. Regulatory Framework

The regulatory framework that governs solicitor lending has changed dramatically in recent years – particularly in respect of regulation designed to protect investors. The key areas of regulatory oversight that impact on solicitor lending are as follows:

- Regulation to protect borrowers (primarily State/Territory level);
- General consumer protection regulation (benefits both investors and borrowers - Commonwealth and State/Territory level);
- Regulation to protect investors (Commonwealth and State/Territory level); and
- Regulation to protect solicitors' clients (State/Territory level).

These various strands are summarised below.

4.1 Borrower protection – the Uniform Consumer Credit Code

The UCCC offers the main, industry-specific protection for borrowers. All States and Territories have now adopted the UCCC as part of a nationally uniform scheme. The template legislation was enacted in Queensland, and was made law in Victoria by the *Consumer Credit (Victoria) Act* 1995. It commenced operation on 1 November 1996.

<u>Application of the UCCC</u>

Where individual borrowers obtain finance for "personal, domestic or household purposes" the UCCC should normally apply. However, where a transaction should otherwise fall within the ambit of the UCCC, there are a number of ways in which to avoid regulation.[21]

Section 6(1) of the UCCC provides that:

> This Code applies to the provision of credit (and to the credit contract and related matters) if when the credit contract is 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.

[21] It seems that some solicitor lenders choose not to enter mortgages that are regulated by the UCCC. See for example the evidence presented on behalf of the First Respondent in *Neuendorf v Rengay Nominees P/L & Anor*, unreported: Victorian Civil and Administrative Tribunal, 3 September 2002. Also, an article in relation to the implications of the former Credit Act 1984 for solicitors' nominee mortgages suggested that "It does not seem worthwhile for a solicitor-nominee or a solicitor's nominee company to undertake the additional licensing, documentation and procedures of the Credit Act and therefore it may desirable to confine loans to [loans that are not covered by the Credit Act]": Wilkin, J "The Credit Act and solicitors' nominee mortgages", *Law Institute Journal,* July 1985, 662-663.

Of these four requirements, the first is rarely problematic in the solicitor lending examples we have seen.

The third, which requires that there be a cost over and above the amount lent, is susceptible to abuse. However, this is more likely to occur where the transaction involves both the sale of goods or services and the provision of finance. It is therefore less relevant to the type of finance discussed in this report.

The final two requirements (paragraphs (b) and (d)), however, can be utilised by solicitor lenders to avoid the application of the UCCC. These are discussed further below.

Type of lender

The UCCC will apply if the lender is in the business of providing credit or otherwise provides credit incidentally to any other business.[22] As noted above, the actual lender in a solicitor lending transaction may be either an individual lender or a lending company. A lending company will inevitably fulfil this requirement.

An individual lender, however, is most likely *not* to fulfil this requirement, in which case the transaction will fall outside the operation of the UCCC.

It is possible for an individual lender to be involved in a number of transactions. The courts have held that the concept of "business" involves the notion of system, repetition and continuity.[23] Arguably, an individual lender involved in multiple transactions would fall within such a definition, and so would fall within the ambit of the UCCC. Needless to say, from a practical perspective this would be a very difficult matter to prove.

One problem that arises with solicitor lending is that it is often the individual who is recorded on the contract as the credit provider, even though it is a solicitor who has effectively facilitated the finance, and may indeed be "in the business" of facilitating finance.

This problem was identified in the Post-Implementation Review of the UCCC ("the PIR") in 1999. The final report of the PIR noted, in relation to solicitor lending that:

> "Where the 'investor' is the credit provider on record (as distinct from the solicitor) the resulting credit transactions … may not be regulated in so far as the investor cannot always be said to be in the business of providing credit or in any other business."[24]

The project team preparing the report agreed with consumer advocates that this was a problem, and the final report included the following recommendation:

> "**Recommendation 2.4**: Amend the Code so that the solicitor is the credit provider where consumer lending is organised by a solicitor on behalf of investors or from investment funds."[25]

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22 *Consumer Credit Code* s 6(1)(d)
23 see for example *Federal Commissioner of Taxation v Whitfords Beach Pty Ltd* (1982) 150 CLR 355
24 Ministerial Council on Consumer Affairs, *Uniform Consumer Credit Code Post Implementation Review Final Report,* December 1999, p. 58.
25 Id, p 60.

The Final Report of the National Competition Policy Review of the UCCC also appeared to support the amendment of the UCCC along the lines suggested by the PIR report.[26]

As at the time of preparing this report, recommendation 2.4 of the PIR had not been implemented.

Purpose for which the credit is provided

It is this element of a credit transaction that is most susceptible to abuse, and is most utilised as a means of avoidance by lenders across the spectrum – both some solicitor lenders, but also many other types of fringe lenders

Evidence given on behalf of the First Respondent in *Neuendorf*[27] illustrates the problems. The Victorian Civil and Administrative Tribunal ("VCAT") accepted that the lender's usual lending practice was "to provide short term, interest only loans which were not regulated by the UCCC, that is, which were for business or investment purposes". The Tribunal further accepted that the lender "would not lend if credit were requested for personal domestic or household purposes".

Although the UCCC itself is unclear on the point, it is now accepted that "the intention for which credit was sought is to be determined by an objective test - that is what a reasonable person standing in the shoes of the credit provider would have understood the predominant purpose for which the credit is provided".[28]

While this in itself provides an important protection to lenders, the UCCC allows for additional protection in the form of a business purpose declaration. Section 11 of the UCCC provides that:

> In any proceedings (whether brought under this Code or not) in which a party claims that a credit contract, mortgage or guarantee is one to which this Code applies, it is presumed to be such unless the contrary is established.
>
> Credit is presumed conclusively, for the purposes of this Code not to be provided wholly or predominantly for personal, domestic or household purposes if the debtor declares, before entering into the credit contract, that the credit is to be applied wholly or predominantly for business or investment purposes (or for both purposes).
>
> However, such a declaration is ineffective for the purposes of this section if the credit provider (or any other relevant person who obtained the declaration from the debtor) knew or had reason to believe, at the time the declaration was made that the credit was in fact to be applied wholly or predominantly for personal, domestic or household purposes. For the purposes of this subsection, a relevant person is a person associated with the credit provider or a finance broker (or a person acting for a finance broker) through whom the credit was obtained.

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[26] KPMG Consulting, *NCP Review of the Consumer Credit Code, Final Report,* December 2000, p. 76.

[27] *Neuendorf v Rengay Nominees P/L & Anor*, unreported; Victorian Civil and Administrative Tribunal, 3 September 2002.

[28] *Park Avenue Nominees Pty Ltd v Boon (on behalf of Weir) & Anor* [2001] NSWSC 700.

> A declaration under this section is to be substantially in the form (if any) required by the regulations and is ineffective for the purposes of this section if it is not.

A business purpose declaration can clearly provide certainty to a credit provider, but it has increasingly become popular as an avoidance mechanism. Those lenders which prefer to lend outside the UCCC, or who refuse to offer regulated credit, often rely on a business purpose declaration without making any further enquiry as to purpose. Where the debtor fails to comprehend the declaration, or is mislead as to its effect, the act of signing the declaration can prevent the debtor's reliance on the rights and remedies otherwise available under the UCCC.

Is the declaration effective?

A business purpose declaration will be ineffective for the purposes of section 11 if it is not substantially in the form required by the regulations. The courts have been careful to protect the interests of borrowers when deciding what constitutes "substantial" compliance.[29]

A business purpose declaration will also be ineffective for the purposes of section 11 of the UCCC if the credit provider (or any other relevant person who obtained the declaration from the debtor) knew or had reason to believe, at the time the declaration was made that the credit was in fact to be applied wholly or predominantly for personal, domestic or household purposes. This raises two issues.

Firstly, it encourages lenders or their agents to ask as few questions as possible regarding the purpose for which the prospective debtor is seeking the credit. The less information obtained that might contradict the declaration, the more difficult it will be for the debtor to subsequently prove that the declaration is ineffective.

Secondly, it has encouraged some lenders to place as much distance as possible between themselves and the person who obtains the declaration. The greatest protection will be afforded to the lender if the debtor's solicitor obtains the declaration. Caseworkers report that some solicitor lenders regularly refer prospective borrowers to the same "independent" solicitor for the purposes of obtaining advice prior to signing relevant documentation, including a business purpose declaration.[30] Where this occurs, the debtor will have almost no ability to rely on s.11 (3) to have the declaration declared ineffective. This is even the case if the broker knows of the true purpose, as long as the broker did not obtain the declaration.

The decision of the VCAT in the *Neuendorf* matter highlights an additional problem. Sections 11(3) and (4) of the UCCC operate to render a business purposes declaration ineffective *only* for the purposes of section 11. That is, the declaration will be ineffective for the purposes of forming the conclusive presumption provided for in s.11 (2). The declaration may, however, be effective for other purposes.

In *Neuendorf*, the Tribunal held that in the absence of information to the contrary, the lender was entitled to rely on the declaration, albeit ineffective for the purposes of

[29] eg. *Park Avenue Nominees Pty Ltd v Boon* (2001) ASC 155-052

[30] This experience has been recognised by case workers at CCLS, Consumer Credit Legal Centre (N.S.W) and Consumer Law Centre (ACT).

section 11, to create the belief that the credit was provided for business or investment purposes. Further, a reasonable person standing in the shoes of the lender would also, having regard to the declaration, form such an opinion.

This interpretation gives a business purpose declaration even greater weight than might otherwise appear from a reading only of section 11. It also means that the likelihood of a borrower being able to assert any rights under the UCCC once a business purpose declaration has been provided is minimal at best.

Rights and remedies under the UCCC

If the UCCC does apply to a particular transaction, the regulation relevantly involves mandated disclosure requirements and additional rights and remedies. These are discussed below.

Disclosure

The UCCC prescribes a range of information that must be provided to borrowers at specified points in the transaction or life of the contract. This includes:

- A pre-contractual statement that includes information about fees and charges, interest rate, and other terms and conditions;[31]
- An information statement in the form required by the regulations of the debtor's statutory rights and statutory obligations;[32]
- A copy of the contract;[33]
- Regular statements of account;[34]
- Statements of amount owing and the pay-out figure.[35]

Since 1 July 2003, credit providers have also been required to disclose a comparison rate in certain circumstances.[36]

The research suggests that those solicitor lenders that do operate within the ambit of the UCCC tend to comply with the disclosure requirements. In some cases, this results in contracts that disclose a very wide range of fees and charges, payable in respect of almost any action that will or might possibly be taken by the lender, whether at the lender's discretion or at the request of a borrower (see Chapter 5).

As discussed later, there are many reasons why consumers enter into loans of this type, notwithstanding complete disclosure of the costs involved. These include reliance on

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[31] *Consumer Credit Code* s 14(1)(a).
[32] *Consumer Credit Code* s 14(1)(b).
[33] *Consumer Credit Code* s 18.
[34] *Consumer Credit Code* s 31. One relevant exception here is that there is no requirement to provide statements if "the credit is provided under a credit contract for which the annual percentage rate is fixed for the whole term of the contract and under which there is no provision for varying the rate: section 31(3)(a).
[35] *Consumer Credit Code* ss 34, 76.
[36] *Consumer Credit Code* ss113A, 140, Part 9A, Part 12 as amended by *Consumer Credit (Queensland) Amendment Act 2002.*

misleading oral representations, failure to read the documentation and desperation to proceed regardless of the terms of the transaction. Most significantly, however, is that despite disclosure of costs, what many consumers suggest is that they were unaware of the nature of the transaction – short term and interest only – or had limited appreciation that their home was at risk. (Borrower understanding of the key terms and conditions is explored further in Chapter 5)

The UCCC provides that a failure to comply with disclosure requirements can lead to the imposition of a penalty on the credit provider.[37] In addition, where a credit provider has contravened a "key requirement" in connection with one or more credit contracts, a party to the contract or a Government Consumer Agency may apply to the Court for a civil penalty order.[38]

Unjust contracts

Section 70 of the UCCC allows a borrower to reopen a transaction giving rise to a loan contract, mortgage or guarantee if, at the time the loan contract, mortgage or guarantee was entered into or changed it was unjust. The section also prescribes an inclusive list of matters to which the Court or Tribunal may have regard in determining whether the transaction should be reopened. Of particular interest is section 70(2)(l), which provides as a matter to which the Court may have regard:

> whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider knew, or could have ascertained by reasonable enquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship.

This represents a fundamental change in the law. Prior to the introduction of the UCCC, the courts had held that the lender was not responsible for ensuring that a prospective debtor could afford repayments, and even where it was clear that a debtor would not be able to do so, a loan would not be considered unjust.[39]

The UCCC overturns this principle, and allows a contract to be reopened as unjust if the lender knew, or should reasonably have known, that the debtor could not reasonably afford to make payments in accordance with the contract.

Arguably, an interest only loan that requires payment of the principal at the expiration of the loan term will be unjust if the debtor has no means of making that payment except by way of selling their home (or deferring the inevitable by refinancing the loan and incurring substantial costs in the process).

This issue has not come up for decision in matters argued under the UCCC, although similar issues have come up in matters argued under other legislation, and the outcomes in those cases may be relevant for future decisions under section 70 (see discussion below).

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[37] See for example, *Consumer Credit Code* s 20.
[38] *Consumer Credit Code* s 101.
[39] for example: *Custom Credit Corporation Limited v Lynch* [1993] 2 VR 469

However, even if an interest only loan was determined to be unjust under s. 70, the fundamental question is whether the UCCC will deliver effective remedies to borrowers who have entered into an unjust transaction of this type.

If a transaction is reopened as unjust, section 71 of the UCCC provides that the court may make one or more of a wide range of orders, including setting aside the transaction either wholly or in part, and relieving the debtor from payment of any amount in excess of that considered reasonably payable.

The approach of courts prior to the introduction of the UCCC does not inspire confidence that borrowers will be able to access effective remedies. In making orders in relation to unjust contracts under earlier fair trading legislation, there has been a consistent reluctance to relieve debtors from the obligation to repay at least the amount borrowed.[40] Given that the primary injustice of this form of lending is the loss of the debtor's home, a continued obligation to repay the principal will not avoid injustice, as it will inevitably result in the loss of the home or, in some cases, some other form of protracted financial hardship.

This issue has yet to be tested under the UCCC. There is a strong argument to say that with the inclusion of the over-commitment provision in the factors to which the court may have regard, relief from payment of the principal becomes a far more appropriate remedy than may previously have been the case, and is clearly contemplated by section 71.

Ultimately, the aim of sections 70 and 71 of the UCCC is to avoid injustice. To order a borrower to repay amounts that should never have been lent – the repayment of which will cause significant financial hardship or result in the loss of the borrowers home – is clearly unjust, and accordingly should not be favoured.

One of the problems for consumer advocates, however, is that the level of uncertainty in pursuing this outcome, when combined with the inherent vulnerabilities of those borrowers that do seek assistance, makes it very difficult to pursue the matter as far as would be necessary to test these provisions.

Cost of credit

The UCCC generally implements the principle that disclosure of the cost of credit, and any fees and charges, and relying on market forces to monitor costs, is an appropriate model of consumer protection. However, in the implementation of the UCCC, there are two important exceptions to this rule.

Under the *Consumer Credit (Victoria) Act* 1995, a credit contract is unenforceable if the annual percentage rate exceeds 48%. In addition, a mortgage relating to a credit contract with an annual percentage rate of more than 30% is void insofar as it relates to that contract.[41] While the interest rates in many solicitor loans are high, we did not find any instances where the maximum interest rates were exceeded.

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[40] for example: *Esanda Finance Corporation Ltd v Murphy* (1989) ASC 55-703
[41] *Consumer Credit Code* s 39, 40.

Section 72 of the UCCC allows a borrower to challenge an establishment fee or other charges on the grounds that it is unconscionable. For most borrowers this offers very incomplete relief, but may be useful in some situations. In practice, however, we are not aware of many circumstances in which this provision has been successfully used, nor of any circumstances in which a Court or Tribunal has considered the application of this section.

Indeed, the failure of these sections to provide effective protection for borrowers, is illustrated by the nature and extent of fees payable in respect of solicitor loans, as shown below.

Misrepresentations

A debtor is also entitled to recover any loss suffered as a result of a false or misleading representation that is material to entry into the credit contract.[42] As is noted elsewhere in this report, the common problem is less one of positive misrepresentation as a failure to properly advise as to the nature of the transaction.

There are at least three other reasons why this right may not actually assist a borrower:

(1) As is usually the case in the context of misrepresentation, it is a particularly difficult claim to prove;

(2) The utilisation of third parties – including brokers and independent solicitors – serves to distance the lender from any false or misleading representation, providing good protection against any subsequent claim by the borrower; and

(3) Perhaps most importantly, there is a question as to the loss suffered by a borrower who enters into a transaction of this type as a result of a false or misleading representation. Essentially, this relates back to the question of whether relief from the obligation to repay the principal is the appropriate outcome. While this relief is clearly relevant in the context of ss.70 and 71, it may be more difficult to justify in the context of compensation for loss suffered.

Hardship variations

Section 66 of the UCCC provides that, in certain circumstances, a borrower can apply to the credit provider for a variation to their contract on the grounds of hardship. If the credit provider does not agree to a variation, the borrower can make an application to the relevant Court or Tribunal.[43]

However, this right is only available for loans of less than $125,000,[44] and only variations of a particular type are permitted. In addition, to take advantage of this option, the consumer must be able to demonstrate that the hardship is temporary and that they will

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[42] *Consumer Credit Code* s 144

[43] In the case of Victorian debtors, the relevant tribunal is the Victorian Civil and Administrative Tribunal.

[44] The Ministerial Council on Consumer Affairs recently agreed to increase this threshold, and the amendment was dueto be implemented by the end of October2004. See: http://www.creditcode.gov.au/display.asp?file=/content/whatsnew.htm, (Accessed: 2004, November 3)

be able to meet their obligations if the contract is varied.[45] Where the hardship is likely to be ongoing, section 66 will have little application.

In any case, the extent of borrowers' knowledge of this right seems to be very limited, if the level of hardship applications to VCAT is any guide.[46] In addition, none of the borrowers that were interviewed for this research appeared to have taken any action in reliance on this section (or to have any knowledge of it).

Time to remedy defaults

Where a consumer has defaulted on a contract, the UCCC imposes some restrictions on the enforcement action that can be taken by the creditor. In particular, the creditor must normally give 30 days written notice of the default before taking enforcement action.[47] This can, for example, give the consumer time to remedy the default by, for example, refinancing the contract or borrowing from a family member or friend. Clearly, however, such options will not be available to all consumers.

We did not identify any instances where solicitor lenders failed to comply with these notice periods. However, it is worth noting that most of the borrowers interviewed indicated that, for them, it seemed that the creditor acted with unreasonable haste in taking enforcement action (including proceedings to repossess the property).

Venue for exercising rights and seeking remedies

The *Consumer Credit (Victoria) Act* 1995 provides that the venue for most disputes under the UCCC in Victoria is the Credit List of VCAT.[48] The VCAT was created in 1998 by merging a number of specialised tribunals, including the former Consumer Credit Tribunal.

VCAT offers "a one stop shop dealing with a range of disputes, providing Victorians with access to a civil justice system which is modern, accessible, efficient and cost effective."[49]

However, in practice, it appears that borrowers rarely use VCAT to access their rights under the UCCC. During 2002-2003, VCAT received 103 new cases, but the majority (68%) of these were applications by creditors to repossess secured goods.[50] VCAT also

[45] *Consumer Credit Code* s 66(1).
[46] The most recent annual report from VCAT (2002/2003) does not specify the number of hardship applications made during the reporting period, however, the number is likely to be fairly small: of 103 applications received in 2002/2003, 70 were repossession applications from credit providers; the remaining 33 included government agency applications for civil penalties; applications for hardship variations; and applications relating to claims that repossess goods were not sold for the best price: VCAT Annual Report 2002/2003, p. 13.
[47] *Consumer Credit Code* s 80.
[48] *Consumer Credit (Victoria) Act 1995* s 8(1)(a)
[49] *About VCAT*, <http://www.vcat.vic.gov.au/CA256DBB0022825D/page/About+VCAT?OpenDocument&1=10-About+VCAT~&2=~&3=~> (Accessed: 2004,May 22).
[50] VCAT Annual Report 2002/2003 p 13.

deals with applications from credit providers in relation to breaches of the key requirements of the UCCC.

Applications from consumers during 2002-2003 included applications for hardship variations and applications that the mortgaged goods were not sold for the best price reasonably obtainable.[51] However, the figures above suggest that borrowers only use VCAT on rare occasions.

The apparent reluctance of borrowers to use VCAT is compounded by the fact that a number of consumer advocates in Victoria have some concerns about the operation of both the Credit List and the Civil List (in which applications under the *Fair Trading Act 1999 (Vic)* are heard). These include a lack of appropriate rules of civil procedure required for the conduct of complex litigation through VCAT; inappropriate use of mediation; and the use of mediators who are unaware of the relevant law or legal merits of a claim.

More accessible to consumers than VCAT have been the industry based external dispute resolution schemes, such as the Banking and Financial Services Ombudsman. These schemes are provided at no cost to consumers, and can make decisions taking into account what is fair and reasonable in all the circumstances.[52]

However, there is simply no industry dispute resolution scheme available for consumers who borrow from solicitors' mortgage investment schemes.

4.2 Borrower protection – Consumer Credit (Finance Brokers) Act

A large percentage of the borrowers surveyed and interviewed for this report used a mortgage or finance broker to assist them to find a loan. Part 4A of *Consumer Credit (Victoria) Act* 1995 (introduced in 1998) provides additional regulation rights and remedies for consumers who use brokers.

For example, Part 4A provides that:

- Certain categories of persons (for example, persons convicted of fraud or dishonesty) cannot operate as a finance broker.[53]
- Brokers can be subject to a civil penalty if they do not have a written agreement with the borrower, but subsequently demand or receive a fee from the borrower.[54]
- Written agreements must include certain information, including information about the fee paid by the borrower to the broker (but not the commission paid to the broker by a credit provider), and the type of credit to be sought.[55]

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[51] VCAT Annual Report 2002/2003 p 13.
[52] See for example, Banking and Financial Services Ombudsman Ltd, *Terms of Refernce, Available:* <http://www.abio.org.au/ABIOWeb/ABIOWebSite.nsf/0/B385C2D0F3E87335CA256C0E0045047A/$file/BFSO+Terms+of+Reference_11-2003.pdf> (Accessed: 2004, June 23)
[53] *Consumer Credit (Victoria) Act(1995) ss* 37C – 37E
[54] *Consumer Credit (Victoria) Act(1995) s* 37J
[55] *Consumer Credit (Victoria) Act(1995)* s 37J(1)(c), s 37J(3)

If a broker contravenes these provisions, the borrower can apply to VCAT for the broker fee to be refunded.[56]

However, this Part only applies to credit that is covered by the UCCC.[57] As discussed above, the signing of a business purposes declaration by the borrower can operate to limit the applicability of the UCCC, and thus also the impact of the broker legislation. In discussing this issue, a report by Consumer Credit Legal Centre (NSW)[58] ("the CCLC Broker Report") suggested that brokers are often instrumental in obtaining business purposes declarations, and that, as a result:

> "borrowers who are entering into the most disadvantageous form of credit are also those being denied the protection of the UCCC".[59]

In addition, the Part provides little remedy if the broker's recommendation results in the borrower taking out an unsuitable loan, or one which the borrower has no capacity to repay. In these circumstances, the borrower is left to rely on the unjust or unconscionable provisions discussed elsewhere in this report, with the additional difficulty of demonstrating that the broker's conduct should be attributed to the credit provider.

4.3 Economy-wide consumer protection

Borrowers and investors alike can also benefit from economy-wide protections offered under mirror provisions in the *Australian Securities and Investments Commission Act* 1989 (Cth) ("the ASIC Act"), *Trade Practices Act* 1975 (Cth), and/or the State and Territory Fair Trading Acts, including the *Fair Trading Act* 1999 (Vic). Our focus here, however, is on the availability of remedies for borrowers under the ASIC Act.[60]

<u>Misleading or deceptive conduct</u>

The ASIC Act prohibits a corporation from engaging in misleading or deceptive conduct or from making certain false or misleading representations in trade or commerce.[61] These requirements are similar to those found in section 144 of the UCCC, discussed above, and consumers face similar difficulties when trying to enforce rights under these provisions.

<u>Undue harassment or coercion</u>

The ASIC Act also prohibits a corporation from using physical force, undue harassment or coercion in connection with the supply or possible supply of financial services to a

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[56] *Consumer Credit (Victoria)Act(1995) s* 37N – s37P
[57] *Consumer Credit (Victoria) Act(1995)* s 37A
[58] Consumer Credit Legal Centre (NSW) Inc. *A Report To ASIC On The Finance And Mortgage Broker Industry, March 2003* available at www.asic.gov.au.
[59] Id, 44
[60] The *ASIC Act 1989* (Cth) applies to transactions and conduct involving financial services, including credit: see definitions in s. 12BA(1).
[61] *ASIC Act 1989* (Cth) ss 12DA, 12DB.

consumer, or the payment for financial services by a consumer.[62] Consumers can seek damages if they have suffered loss due to non-compliance with this provision.[63]

There is a range of difficulties for consumers who might try to take action under this provision. In any case, it is likely that for most consumers who have taken out unsuitable or unaffordable loans, their primary concern relates to relief or otherwise under the contract. For example, few of the borrowers in this research specifically raised harassment as a concern.

Unjust/unconscionable conduct

The ASIC Act can operate to give borrowers relief from unconscionable conduct.[64] Similarly, general equitable principles of unconscionability may also be relevant.

In addition, the *Contracts Review Act* 1980 (NSW) can provide relief from unjust contracts. Section 7 of this Act provides that if a Court finds a contract, or a provision of a contract, to have been unjust in the circumstances relating to the contract at the time it was made, the Court may, among other things, decide to refuse to enforce any or all of the provisions of the contract. Contracts can be procedurally unjust and/or substantively unjust.[65]

Section 9 provides a list of factors that the Court shall consider, to the extent that they are relevant to the circumstances. These factors are similar to those contained in s. 70 of the UCCC, however, in line with the fact that the provisions are of general application, the factors do not include specific reference to the consumer's ability to meet the repayments.

These general consumer protection provisions are to some extent mirrored by sections 70 and 71 in the UCCC. However, while the UCCC provisions have not been particularly helpful in relation to solicitor lending, case law under the *Contracts Review Act* has considered asset-based lending, and may be relevant to solicitor lending cases.

The appellant in *Elkofairi v Permanent Trustee Co.*[66], a decision of the NSW Court of Appeal, was a co-borrower with her husband under a loan, the dual purposes of which were to refinance the mortgage on the family home, and to provide extra funds for undisclosed business or investment purposes.

A business purposes declaration was signed, but the appellant's signature on this declaration was forged. At the time of the loan in question, the appellant had no income, and there was no reference to her income or financial position in the correspondence from her husband's accountant that supported the loan application.

The Court held that the both the general law principles of unconscionability and the provisions of the *Contracts Review Act* operated to provide relief for the appellant.

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[62] *ASIC Act 1989* (Cth)s12DJ
[63] *ASIC Act 1989* (Cth) s 12GF
[64] *ASIC Act 1989* (Cth) Div 2, Subdiv 2.
[65] West v AGC (Advances) NSWCA (1986) 5 NSWLR 610
[66] Elkofairi v Permanent Trustee Co (2003) 11 BPR 20,841;

In relation to unconscionability, Beazley JA relied heavily on the fact that the lender did not have relevant information to assess the appellant's capacity to meet the repayment obligations under the mortgage, and that the only source of repayment would have been the selling of the appellant's only asset. Her Honour found that:

> "… it was unconscientious for the respondent to lend a large sum of money to a person with no income with full knowledge that if the repayments under the loan were not met, it could sell that person's only asset."[67]

The Court also held that the contract was unjust, and that relief should be granted under s. 7 of the *Contracts Review Act*. In making this determination, the Court also relied on the following factors:

- the appellant had no income;
- the lender was content to lend on the value of the security only;
- the appellant's educational background
- the appellant's inability to read or write English, or to understand other than the most basic spoken English; and
- her difficult domestic circumstances.[68]

In terms of relief, the Court considered that account should be taken of the benefit that the appellant had derived from the transaction – that is, the extent to which the loan monies were used to repay the debt relating to her interest in the family property.[69] The Court therefore ordered that the appellant should pay the lender half of the funds used to pay out the existing loan on the property, and subsequent to this payment, the mortgage would be set aside as far as the appellant is concerned.[70] The lender would be constrained to proceeding against the husband's interest in the property. In practice, this would mean that the lender could exercise a power of sale over the property.

Note, however, that in this case, the equity in, and value of, the security property was such that the lender's claim was likely to be satisfied from the husband's interest in the property,[71] and that the appellant was likely to retain over $350,000.[72]

In a very recent case, *Small v Gray*, [73]the Supreme Court of NSW similarly relied on the facts of improvident lending to provide relief to a co-borrower under what appears to have been an interest-only loan. As in *Elkofairi*, the Court in this case held that the wife (Kristine) was entitled to relief under both the Contracts Review Act and the common law principles of unconscionability.

In relation to the Contracts Review Act, the Court noted that "it was apparent on the face of the transaction that the role of Kristine was, in substance, as a guarantor of the

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[67] Id, [59]
[68] Id, [79, 53]
[69] Id, [80]
[70] Id, [86]
[71] Id, [110(iv)]
[72] Id, [109 (v)]
[73] *Small & Ors v Gray & Ors* [2004] NSWSC 97 (5 March 2004)

loan .."[74], and that: "It was also apparent, on such material that the plaintiffs had, that if Kristine were called upon to perform her obligations then … it would involve the loss of her residence and only substantial asset."[75]

The Court also said:

> "Finally, the inference is open – indeed, I think, inevitable – that the plaintiffs chose to lend solely upon the basis that they were amply secured … in circumstances where they had no basis for thinking that Jarrod and Katrina, or for that matter, Kristine or Rodney, could keep up the payments on the mortgage. Indeed, on the information available to the plaintiffs, none of these persons could."[76]

In making a decision that the Court was entitled to grant relief under the *Contracts Review Act*, the Court also referred favourably to the decision in *Elkofairi*.[77]

In considering the question of unconscionability, the Court noted:

> "… the circumstance that the plaintiffs failed (on the evidence) to consider, let alone make enquiry as to, what appeared to be a significant discrepancy in the information that they procured, Kristine's financial circumstances, is sufficient to make it unconscionable for them to rely on the mortgage in circumstances where they were lending only on the basis that there were well secured and where they had no reason to be confident that the borrowers could service the loan. In those circumstances, it must have been apparent to them that Kristine, having no material interest in the transaction, was at risk. Their action in proceeding was, I think, in all the circumstances, unconscionable."[78]

In determining relief, the Court found that the mortgage should not be enforced against Kristine.[79] However, similar to the case in *Elkofairi*, the security property was jointly owned by the defendant and her [former] partner (Rodney). In this case, the equity in the property was *not* greater than the outstanding amount of the loan, and a claim against Rodney would have had the effect of depriving Kristine of her home in any case.

Here the practical outcome was in fact somewhat unclear. The court found that, as between the lender and Rodney, the lender was entitled to possession.[80] However, it was also noted that Rodney had settled a cross-claim against the Registrar General that had arisen because his signature on the loan contact was forged.[81]

These cases show that the Courts, at least in NSW, may be taking a stronger line on lending where the borrower has simply no capacity to meet the loan repayments, or the lender has not made any enquiries about capacity to pay. It will be interesting to see how these approaches develop, and the extent to which they are taken up in cases litigated under the UCCC.

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74 Id, [100]
75 Id, [101]
76 Id, [103]
77 Id, [104]
78 Id, [114]
79 Id, [115]
80 Id, [119]
81 Id, [117]

Again, the issue of the remedies remains problematic. In both *Elkofairi* and *Small v Gray*, the Court found that the lender was entitled to possession as against the co-owner of the house. The unusual circumstances in both cases meant that, in practice, the recipient of the unjust/unconscionable conduct was likely to be able to either remain in her home, or to retain sufficient equity to buy another property. However, in the more typical circumstances, where there is not sufficient equity in the home to have a reasonable sum left over after the lender has proceeded against a co-borrower, the practical effect for borrowers without the capacity to pay may be little different than in the *Neuendorf* case referred to earlier.

In addition, it should be noted that, in many cases, there are considerable barriers to borrowers taking action to enforce these rights, including the costs of legal action, and legal representation (particularly in the Supreme or Federal Courts); uncertainties in outcome; potential liability for costs if an unfavourable decision is made; difficulty in proving verbal representations; and for many consumers, reluctance to use the legal system because of unfamiliarity and embarrassment.

4.4 Investor Protection Regulation

Originally, mortgage investment schemes that were managed by law firms were primarily regulated at the State/Territory level, under the supervision of the professional legal associations, including the Law Institute of Victoria.

In 1998, the *Managed Investments Act 1998 (Cth)* ('MIA') was passed, amending the *Corporations Act 2000 (Cth)* and imposing registration, licensing, disclosure, and other conduct obligations on managed investment schemes. The primary aim of the legislation was to better protect investors.[82] The definition of a 'managed investment scheme' in the MIA is such that many mortgage investment schemes, including those operating by law firms, would be included:

> 'In general, mortgage investments that are subject to the provisions of the Law should be regulated in the same way as other managed investment schemes.'[83]

However, at the time of implementing the MIA, ASIC accepted that mortgage investment schemes required additional transitional arrangements and some specific relief from the MIA provisions.

Thus, under an ASIC class order, businesses, including law firms that were operating mortgage investment schemes were given a deadline to comply with the legislation, or to close down the scheme (as long as the arrangements for these "run out" schemes[84] were complied with).[85]

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[82] Further amendments have been made by the *Financial Services Reform Act 2001* (Cth)
[83] *Mortgage Investment Schemes,* (2000, March 2), Australian Securities and Investments Commission (ASIC) Policy Statement PS 144.6 Available www.asic.gov.au> (Accessed: 2004, June 23)
[84] "Run-out schemes" were permitted to operate under the previous regime (supervision by the relevant law society) until the deadline on condition that no new loans were offered, and existing loans were not renewed on expiry.
[85] *Short extension for "run out" schemes*, (2001, August 24), Australian Securities and Investments Commission (ASIC) Information Release IR 01/10, see also *Mortgage Investment Schemes,* (ASIC) PS144 *'Run out' schemes* p15 ss 144.51-144.56. Available www.asic.gov.au (Accessed: 2004, June 23)

However, even after the deadline for run-out schemes had expired, ASIC class orders provided that small mortgage investment schemes can, in some circumstances, be relieved from complying with the relevant *Corporations Act* requirements.

<u>Requirements for mortgage schemes subject to the full *Corporations Act*</u>

Under the *Corporations Act*, managed investment schemes (including mortgage investment schemes) must be registered with ASIC and be operated by a "responsible entity". The responsible entity must be a public company, and hold an Australian Financial Services licence authorising it to operate a managed investment scheme.[86] The scheme must have a compliance plan and scheme constitution,[87] and the responsible entity must also establish a compliance committee if less than half of the directors of the responsible entity are external.[88] The responsible entity must also provide disclosure documents to potential investors.[89]

When the changes applied to solicitors' mortgage practices, those legal practices wanting to formalise their status under the MIA formed new companies as "responsible entities", and existing loans were transferred to the new companies. It is understood that practitioners in the legal practice, or directors in the nominee companies were often appointed as directors of the responsible entity. In fact, this experience was born out during the research process. [90]

It was also recognised by commentators. For example, Hodgson noted: "many investors feel they are still dealing with the same operators [as they were before the MIA came into effect]". He noted:

> "This is understandable when responsible entities are operating out of the same solicitor's office, with the same personnel and for all intents and purposes, running the same mortgage lending business."[91]

In terms of the transition process to the new regulatory requirements, one lawyer noted:

> "The registration and ASIC approval process has not been easy for any applicant from the legal world. Mortgage practices and their usual procedures have been investment operations with which ASIC is familiar and this lack of has contributed to the degree of difficulty experienced by many applicants. "[92]

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[86] *Corporations Act 2001* (Cth) s 601FA
[87] *Corporations Act 2001* (Cth) s 601EA
[88] *Corporations Act 2001* (Cth) s 601JA
[89] *Corporations Act 2001* (Cth) Part 6D.2
[90] For example, in a 2002 case involving the respondents Rengay Nominees and Rennick & Gaynor Mortgages (the credit providers), the Court noted: "Mr Rush is a partner of Rennick & Gaynor solicitors and a director of both respondent companies (para 7)." Similarly, one of the solicitors interviewed during the course of this research advised that he was both a partner in the law firm, and a director of a responsible entity that provided mortgage investment schemes.
[91] Hodgson, *Run-Out Mortgage Schemes* para 8.8. ss 122B & E of the *Legal Profession Act 1987* (NSW) and s124 of the *Legal Profession Regulation 2002* (NSW) note that a solicitor must ensure that the office of a responsible entity for a managed investment scheme is not located on the same part of any premises on which the legal practice of the solicitor is conducted. However, there is no similar requirement in Victoria.
[92] Dan FitzGerald, *Welcome to the Managed Mortgages Section.* Available www.liv.asn.au/sections/mortgage/#Heading4 Accessed (2004, June 23)

Once licensed by ASIC, those responsible entities that were formed to operate mortgage investment schemes previously operated by law firms are treated no differently to responsible entities.[93]

Regulation by an Industry Supervisory Body

However, not all solicitor lending practices have transferred their mortgage practice to a responsible entity, governed by the *Corporations Act*. An alternative way of delivering the investor protections provided by direct compliance with the relevant chapters of the *Corporations Act* has been created for small mortgage investment schemes.

Under ASIC's Class Order 00/203, relief from the relevant provisions of the *Corporations Act* is given if a number of conditions are met, including:

- Scheme operators are supervised by an Industry Supervisory Body (ISB), and must comply with the rules issued by the ISBs. (As at 1 January 2000, only the Law Institute Victoria ("LIV") and the Law Society of NSW have asked to be considered as ISBs.[94])

- The mortgage business is operated in accordance with the ISB conditions specified by ASIC. These include restrictions on loan to valuation ratios; prohibitions on investing by those located outside the jurisdiction of the mortgage property; prohibitions on advertising investments; requirement that investors choose the mortgages in which their funds are invested; and cash forming part of the scheme assets is held in a designated trust account.

- The total principal of loans outstanding in a scheme does not exceed $7.5 million.[95]

In 2000, the LIV established the Managed Mortgages Section, and published the *Managed Mortgage Rules 2000* to regulate small solicitor operated mortgage schemes. These Rules do not apply to any corporation that is licensed to operate under *Corporations Act*, or to schemes that have 20 or less investors, but outstanding loans of more than $7.5 million.[96]

The Managed Mortgages Rules are primarily designed to protect investors. However, a number of provisions also provide protections for borrowers. For example, the Rules provide that:

- Practitioners must ensure that the provisions of the *Credit Act 1995*[97] must be complied with for relevant contracts and mortgages (rule 21); and

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93 See *Mortgage Investment Schemes,* (2000, March 2), Australian Securities and Investments Commission (ASIC) Policy Statement PS 144.6 Available www.asic.gov.au> (Accessed: 2004, June 23)
94 Id, PS144.46
95 Id, See ASIC Class Order 02/238 section 4; PS 144.33 – 144.46.
96 The *Managed Mortgages Rules 2000,* rule 4, < www.liv.asn.au/standards/standards-Victoria-3.html> (3 September 2004)
97 It is assumed that this should in fact be reference to the *Consumer Credit (Victoria) Act* 1995.

- Practitioners must take reasonable steps to conduct an assessment to be satisfied about the borrower's credit worthiness (rule 30).[98]

Non-compliance with these rules can result in disciplinary or legal proceedings being instituted against the lawyer.[99]

Schemes with 20 or fewer investors

The *Corporations Act* provisions do not apply to schemes with less than 20 investors.[100] However, the *Managed Mortgages Rules* contain no similar restriction, and thus, the Law Institute will regulate all small schemes that fall within its criteria for industry supervision.

The combination of the MIA exclusion for schemes with less than 20 investors, and the limitation of industry supervision to schemes with outstanding loans of $7.5 million or less means that schemes:

- With 20 or less investors; and
- With outstanding loans of more than $7.5 million

are effectively unregulated from an investor protection perspective.

4.5 Solicitors' client protection regulation

In many cases in solicitor lending, the investor will also be a client of the solicitor. Where this happens, the solicitor will owe additional duties to the client/investor. For example, in Victoria, the *Legal Practice Act 1996 (Vic)* provides that a solicitor, in the service of a client, must act:

> (i) honestly and fairly in the client's best interests; and
>
> (ii) so as not to engage in, or assist, conduct that is calculated to defeat the ends of justice or is otherwise in breach of the law; and
>
> (iii) with all due skill and diligence; and
>
> (iv) with reasonable promptness.

Avoiding conflicts of interest, regular reporting, and maintaining client confidentiality are also important components of the *Legal Practice Act*.[101]

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[98] The *Managed Mortgages Rules 2000,* rule 30, < www.liv.asn.au/standards/standards-Victoria-3.html> (3 September 2004)
[99] *Managed Mortgage Rules 2000*, Rule 33 allows both the LIV and ASIC to refer practitioners suspected of breaching these rules to the Professional standards Division for Investigation.
[100] *Corporations Act 2001* s 601 ED(1)(a); CO 02/238 section 2.
[101] *Legal Practice Act 1996* (Vic) s64.

These principles are reflected in the Professional Conduct and Practice Rules 2003, promulgated by the LIV.[102] Lawyers who fail to comply with the rules or the act can be subject to disciplinary and/or legal action, and clients who have suffered loss can recover damages.

4.6 Regulatory tensions

The above discussions on the regulatory framework for solicitor lending highlight some areas of potential tension that are specific to this type of lending.

For example, solicitors owe a duty of care to their clients (the investors in a mortgage investment scheme). Failure to adequately manage a mortgage investment scheme – including by taking speedy action on defaults – can give the investors rights to seek compensation from the legal practice under investor protection and/or client protection regulations.

Other credit providers do not owe such duties to third parties. The risks and costs of default and failure of a portfolio of loans will be borne by the credit provider, and ultimately its shareholders (owners). In general, the losses will not directly affect third parties. In these circumstances, for example, a credit provider might make a commercial decision to write off a loan that had originally been unwisely granted, or to give the borrower further leeway in meeting their obligations under the loan.[103]

At the same time, solicitors (as well as other credit providers) providing consumer finance are required to comply with the UCCC. Among other things, this legislation gives borrowers rights to seek a variation to the contract on the grounds of hardship, and prescribes the steps that must be taken before a credit provider can take enforcement action under the loan contract.

There is a potential for these various duties to clash. Where there is a conflict, the Commonwealth investor protection legislation will prevail over the state-based consumer credit regulation, and the tensions will be resolved in favour of the investor and the solicitor managing the investment scheme or other mortgage practice.

On the other hand, at the front end of the loan, there are additional pressures and obligations for the lender in a mortgage investment scheme to make proper enquiries as to the borrower's capacity to meet the repayments on the loan, and of the proper value of the security. It is not clear why these pressures have not, in practice, limited or eliminated the use of interest only loans to consumers, that are provided on the basis of the security value only.

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102 Professional Conduct and Practice Rules 2003 <http://www.liv.asn.au> (15 August 2004)

103 Of course, shareholders may also have rights to take action against directors if this type of conduct is against the interests of the company

PART C – RESEARCH RESULTS

5. Demographic and loan data

5.1 Note on the Statistics

The sample in this research is neither large nor representative.[104] Given the sources used to contact consumers, those responding to the project were likely to be those experiencing problems.

Due to the complex nature of the circumstances surrounding many of these loans, it is not possible to clearly correlate the number of interviewees to the number of borrowers and number of loans. In some cases where a loan was taken out by two borrowers only one was interviewed – in other cases both. In some cases one borrower had obtained two loans. In one interview we didn't speak to the borrower, but to a family member who had assisted the borrower by refinancing the solicitor loan.

Overall, the interviews and surveys represented:

- 21 households;
- 35 borrowers; and
- 32 loans.

In this section, we describe some of the characteristics of the borrowers who have used finance provided by solicitors. We also describe the common features of the loans that we have examined, or been advised of, in the research.

The data in this section is based on:

- Consumer interviews (19 borrowers interviewed in detail (from 17 households); 1 borrower subsequently interviewed by telephone), covering 22 loans;
- Interviews with borrower's relatives who were also involved in the transaction (2 cases, involving 2 loans). However, from this source of information, we included only objective and demographic information about the borrowers and their loans in the results below;[105]
- Consumer surveys (8 surveys, covering 8 solicitor loans, and the experiences of 13 borrowers (in 8 households)[106]);
- Supreme Court files (74 matters, with 100 defendant borrowers).

[104] See Chapter 2.
[105] Information from this source is not included in Tables 9 and 12.
[106] Note that we received a total of 10 surveys (2 from NSW, 8 from Victoria). However, two of the Victorian surveys were discarded for the purposes of this analysis as the borrowers described in the surveys were subsequently interviewed for this project.

In total, the consumer interviews provided us with information about 22 borrowers in 20 households, with 24 loans between them.

As noted earlier, the sample of consumers that we have surveyed or interviewed is not necessarily representative of the experiences of consumers who obtained finance through or from a law firm. The information below does show some interesting trends about the types of consumers who can get into difficulties with this type of finance. It is also mirrored in the experiences of borrowers as shown through anonymous case studies that were provided to the researchers (see Appendix C).

5.2 Borrower characteristics

Age of borrower at time of research project

The majority of consumers surveyed or interviewed were in the older age group, as shown in Table 1 below. A significant proportion (just under one-third) were at or above normal retirement age (65 years), a number were in their seventies, and two-thirds of this sample group were aged 55 years or older at the time of the interview or survey.

In contrast, only six of the borrowers surveyed or interviewed were under 45 years old.

Table 1: Age of borrower at time of research

Age	Borrower surveys	Borrower interviews	Totals
18-24 years	0	1	1
25-34 years	2	0	2
35-44 years	0	3	3
45-54 years	3	3	6
55-64 years	6	6	12
65 years +	2	8	10
Not disclosed	0	1	1

This trend towards older people using this type of finance may simply reflect the fact that it is older consumers who are more likely to be asset rich, at least to the extent that they own their home, but cash poor because they are primarily reliant on the aged pension for their income. While they may have significant equity in their home, their income may be too low to qualify for other types of finance.

Income levels and sources

The household income levels, and sources of income, at the time that the loan was provided varied across the sample, as shown in Tables 2 and 3 below. Note that:

- Four borrowers nominated more than one source of income – either casual work and the age pension or unemployment benefit, or the aged pension and cash investments;
- In cases where the borrower discussed more than one loan, we have only included information about the first loan discussed in the interviews;

- In some cases, it was unclear whether the reported income was the gross or net amount. In these cases, we have assumed the reported income was gross income.

Reflecting the older age of the sample, the age pension was the source of all or part of the borrower's income in just over one-third of the loans covered by the sample. As at September 2004, the maximum age pension was $470.70 per fortnight for a single person, and $786.00 per fortnight for a couple. The same level of income is provided to those in receipt of a Disability Support Pension.

In a further five cases, the borrowers reported that they were unemployed at the time of obtaining finance. The maximum Newstart Allowance for a person, aged above 21 years old, and with no children, is $394.60 per fortnight for a single person, and $712.00 per fortnight for a couple.

In four cases, borrowers reported casual work as a source of income; and in seven cases, borrowers reported that they were self-employed at the time of the loan.

Thus, a large proportion of the borrowers interviewed or surveyed for this research had income levels or income sources that would make it difficult for the borrowers to obtain finance from mainstream lenders.

Only four of the borrowers reported that they were employed on a full-time basis at the time of the loan.

Table 2: Borrower income source at time of loan

Income source	Individual borrowers - surveys	Individual borrowers – interviews	Totals
Full-time	3	1	4
Part-time	0	0	0
Casual	1	3	4
Self-employed	2	5	7
Unemployed	2	3	5
Pension (Age or other)	3	12	15
Other 1 – Homemaker	1	1	2
Other 2 – Cash savings	0	1	1
Other 3 – Superannuation	1	0	1

Table 3 shows that household income reflected this spread of income sources. For those borrowers relying entirely or mostly on the aged pension, other social security payment, or casual work, household income was less than $20,000 per year. In fact, half of the sample had household incomes of less than $20,000 a year.

On the other hand, some borrowers reported fairly high incomes, with three of the households in the research reporting a household income of more than $60,000.

Table 3: Household income at time of loan

Household income	Surveys	Interviews	Totals
Less than $20,000	2	13	15
$20-29,000	1	3	4
$30-39,000	2	0	2
$40-49,000	0	1	1
$50-59,000	1	0	1
$60,000 or more	1	2	3
Not disclosed	0	1	1

5.3 Finding the loan

Source of referral

In the surveys and interviews, we asked borrowers how they first made contact with someone about the loan. Table 4 shows the results and multiple responses were permitted. In all cases where the borrower reported two loans, the source of referral was the same, and the loans are therefore not separately counted in this table.

Most borrowers surveyed or interviewed did not approach the solicitor lender directly, but used an intermediary. In most cases, the intermediary was a finance or mortgage broker.[107] Other intermediaries used included a real estate agent, friends or acquaintances, or the borrower's own solicitor. Often these initial intermediaries referred the borrower to a broker.

In fact, as discussed in the next section, a number of the borrowers interviewed were not even aware of the fact that there was a solicitor lender involved, until they received the contract for signing.

This was perhaps a surprising result, given that we had originally thought that borrowers might choose solicitors deliberately on the assumption of higher ethical standards than other lenders.

More detail of the use of referrals was provided in the consumer interviews than in the surveys. Analysis of the interview responses shows that there were only four cases where the borrower approached the lender directly, without using an intermediary. In one case, the borrower found the lender by contacting law firms directly;[108] in another, the borrower was referred to the lender by her solicitors (and subsequently dealt directly with

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[107] The CCLC Broker Reportfound that 1% of the brokers surveyed included solicitors on their panel of lenders, and 23% included private investors on their panel of lenders: Consumer Credit Legal Centre (NSW) Inc. (2003) *A report to ASIC on the finance and mortgage broker industry* Table B.9, p 104-5.
[108] Interview with Paul (13 November 2003)

the lender);[109] and in the other two cases, the borrowers (who were related) responded to an advertisement by the lender.[110]

Of the remainder, in nine cases the borrower(s) used a finance or mortgage broker to source the loan, and six used another intermediary to 'broker' the loan.

Table 4: Making contact about a loan

How did you first make contact with someone about the loan?	Household response – surveys	Household response – interviews	Totals
Through a finance/mortgage broker	5	6	13
Responded to an ad (newspaper, radio, TV)	1	6	7
Law firm contacted borrower directly	0	0	0
Broker contacted borrower directly	1	0	1
Law firm was recommended to borrower (*by someone other than a broker*)	3	0	3
Other – Real estate agent	0	1	1
Friend/acquaintance	0	3	3
Own solicitor	0	3	3
Accountant	0	1	1
Contacted law firm directly (not in response to an advertisement)	0	1	1
Financial adviser	0	1	1

Note that, the borrower interviews show that, where the borrower responded to an advertisement, it usually turned out to be an ad from a broker. Understandably, none of the borrowers interviewed could remember the exact wording of the advertisement that they responded to. Most suggested that it was an advertisement promoting the availability of credit in the *Herald Sun* newspaper, Yellow Pages, or similar publication.

The following illustrates the type of advertisement that can be found in the Herald Sun.[111]

[109] Interview with Fiona (4 December 2003)
[110] Interview with Edith (4 December 2003)
[111] *Herald Sun*, 10/02/2004, p. 60.

ABOUT TO LOSE IT ALL?
NEED HELP …?
YOUR WORRIES ARE OVER!

LOANS IN ARREARS?
BAD CREDIT?
DEBT CONSOLIDATION
NO TAX RETURNS?
UNABLE TO PROVE INCOME?

1st & 2nd MORTGAGES INCLUDING
COUNTRY AREAS

… [Company Name] Gets Results …

It is assumed that it was advertisements along the lines of those above that caught the eyes of many of the borrowers that responded to our survey or took part in an interview.

Getting advice about the loan

All survey respondents and borrowers interviewed were asked whether they sought or received any legal or financial advice about the loan, and if so, who provided this advice.

In the interviews, further questions were asked in order to clarify whether an independent person provided the advice. (For the purposes of this report, advice was independent if it was given by someone other than the broker or solicitor procuring the loan, or the broker's own solicitor).

Tables 5 and 6 below show that for most loans, the borrowers did receive legal or financial advice. In a number of cases, however, the independence of that information or advice is questionable because, for example, it was provided by the lender or the lender's solicitor.

Table 5: Receiving legal or financial advice

	Household response – surveys	**Household response - interviews**	**Totals**
Did receive legal or financial advice about the loan	4	20	24
Did not receive legal or financial advice about the loan	4	4	8

Table 6: Source of advice

Source of advice	**Household response – surveys**	**Household response – interviews**	**Totals**
A solicitor chosen by the borrower	1	10	11
An accountant chosen by the borrower	0	0	0
A solicitor that the	2	6	8

lender or broker recommended			
An accountant that the lender or broker recommended	0	0	0
Broker	1	0	1
Broker's solicitor	0	1	1
Financial adviser provided by lender	0	0	0
Solicitor acting as broker	0	3	3

Of those borrowers who had received legal or financial advice, most saw a solicitor that they had chosen, or a solicitor recommended by the broker or the lender.

5.4 Loan terms and conditions

Amount borrowed

As would be expected from this small sample, the amount borrowed varied significantly (see Table 7). Half of the loans were for less than $50,000 and more than 75% were for less than $100,000. At the higher end of the scale, one borrower had a loan for $490,000.

Table 7: Amount borrowed

Amount borrowed per loan	Surveys	Interviews	Totals
$25,000 or less	1	4	5
$26-50,000	3	6	9
$51-75,000	0	5	5
$76-100,000	3	3	6
$101-150,000	1	2	3
$151-200,000	0	1	1
More than $200,000	1	2	3
Unclear	0	1	1

Loan type and terms

All of the borrowers surveyed and interviewed identified that their loan was an "interest only" loan, secured by real property.

Table 8 shows that most commonly, the loans provided to the consumers surveyed and interviewed were for a term of 1 or 2 years. In a number of cases, loans were refinanced with the same lender on more than one occasion.

Table 8: Term of loan

Term of loan	Surveys	Interviews	Total
< 1 year	0	0	0
1 year	2	7	9
2 years	3	9	12
3 years	3	2	5

4 years or more	0	1	1
Unclear	0	5	5

For the vast majority of borrowers surveyed and interviewed, the loan(s) in question was secured by a first mortgage over the borrower's home. This is consistent with the practices of lenders interviewed for this project.

Other securities used included unimproved land and a combined shop/residence.

5.5 Understanding of key terms

In the consumer survey, borrowers were asked a series of questions to get a sense of the extent to which they understood the key terms of the loan agreement(s). Similar questions were asked of the borrowers interviewed. Where the borrower(s) took out more than one loan, they did not distinguish their understandings for the different loans, so the results in Table 9 are provided for each household, rather than each loan.

Table 9: Understanding of key terms at time of loan

	Household responses – surveys (8 households)	**Household responses – interviews (18 households)[112]**	**Totals**	**% of all responses**
Borrower(s) knew how much the repayments would be	8	15	23	88%
Borrower(s) realised might have to pay a higher interest rate if default on a payment.	7	10	17	65%
Borrower(s) realised that might lose your house if defaulted on the loan	5	9	14	54%
Borrower(s) realised that would have to repay principal amount at end of loan term.	7	10	17	65%

Overall, most of the sample stated that they understood the key terms of an interest only loan. However, it is of concern that a large minority in the sample indicated that they did not understand the interest only nature of the loan, or the consequences of this type of lending. As discussed in the next sections, low levels of understanding appear more likely to be found with one subgroup of the borrowers identified in this research.

Of course, where we interviewed only one borrower to a joint loan, it is possible that the other borrower had a greater understanding of the loan terms than the borrower who was interviewed. However, we assumed that it was more likely that the interviewed borrower had a similar or higher level of understanding than the non-interviewed

[112] Table 9 does not include data from the two borrowers not directly interviewed (interview 13B and 16A).

borrower, as the interviewed borrower had been interested enough to participate in the project.

5.6 Solicitors and Lenders

The borrowers surveyed and interviewed used a total of 15 different law firms to facilitate the finance. (For two interviews, the borrower was unable to identify the law firm involved.)

A total of 14 law firms were identified as being involved in solicitor lending through the Supreme Court records, but only two of these firms were also identified by the borrowers surveyed or interviewed.

Interestingly, one firm (Law Firm A) is regularly represented in the borrowers' experiences – 16 of the loans described by borrowers in surveys and interviews, and 47 of the Supreme Court files. However, it is difficult to draw any conclusions from this fact without information on the relative market shares of the different lenders and firms.

Another seven firms were involved in more than one of the loans covered by the interviews, surveys and/or writs searched. The remainder of firms were only mentioned or identified on one occasion.

There was a similar spread of coverage for the entities noted on the contract as the lender.

One managed investment scheme (Lender 2), closely associated with the Law Firm A,[113] was the lender in 16 of the loans described by borrowers in surveys and interviews, and 42 of the Supreme Court files examined. This lender was also a responsible entity, regulated by ASIC, and a registered credit provider in Victoria.[114]

A smaller number of credit providers were the lender on more than one contract of the loans described by borrowers or on the Supreme Court files.

Private clients (ie not a nominee company or other company structure) featured occasionally as lenders. As noted earlier, where the lender is a private client, they are unlikely to be "in the business of lending", and the UCCC will not apply to the loan.

Table 10 shows, where available, which regulatory regime applies to the different lenders identified in this research, together with information on whether the lender is a registered credit provider in Victoria.

Table 10: Lenders used

Lender	**Lender Type**	**Registered credit provider (in Vic)**	**Surveys**	**Interviews**	**Supreme Court writs**	**Totals**

[113] For example, the Chairman of Lender 2 is also a partner at Law Firm A.

[114] All lenders providing finance for personal, household or domestic use in Victoria must be registered with Consumer Affairs Victoria: s 11(1) *Consumer Credit (Victoria) Act 1995*.

Lender 1	Unclear	N	1 (in NSW)	0	-	1
Lender 2	Responsible entity	Y	4	11	42	57
Lender 3	Responsible entity	Y	1	2	5	8
Lender 4	Unclear	N	0	1	-	1
Lender 5	Unclear	Y	0	2	-	2
Lender 6	Unclear	N	0	1	-	1
Lender 7	Individual	N	0	1	-	1
Lender 8	Unclear	N	1	0	2	3
Lender 9	Individual	N	0	1	-	1
Lender 10	Unclear	N	1 (in NSW)	0	-	1
Private clients	Individuals	N	1	3	-	4
Not known	-	-	0	2	-	2

5.7 Interest rates

Borrowers surveyed and interviewed were asked to identify the normal interest rate on their loan, and the interest rate that would be applied if payments were in default.

Where borrowers interviewed were unsure, we referred to their documentation (if available) to confirm the interest rate.

Table 11 shows the minimum, maximum and average interest rates and default interest rates on the loans taken out by the borrowers surveyed and interviewed, and on the loans identified through the Supreme Court records, where these could be identified. Even within single years, interest rates varied considerably, with the lowest "normal" interest rate being 7.15% (in a 1999 contract), and the highest "default" interest rate being 28% (in a 2002 contract).

To illustrate the differences between the rates on solicitor loans and those of mainstream lenders, the table below also includes the interest rate in July of the relevant year, offered by a major bank for a 2 year fixed residential home loan.[115] This information is provided as an illustration only, as the loan type and risk profile are not directly comparable. Note also that not all contracts included a default interest rate.

Table 11: Interest rates

Interest rates on loans identified through the research		**Min interest rate**	**Max interest rate**	**Average interest rate**	**Major bank – interest rate on 2yr fixed residential (July)**
1998 (1 contract)					
	Normal rate	8.00	8.00	8.00	

[115] Cannex *Interest Rate Bulletin*, July 1999, July 2000, July 2001, July 2002, July 2003.

	Default rate	10.00	10.00	10.00	
1999 (3 contracts)					6.75
	Normal rate	7.15	8.00	7.55	
	Default rate	17.30	17.50	17.40	
2000 (1 contract)					7.65
	Normal rate	8.50	8.50	8.50	
	Default rate	17.30	17.30	17.30	
2001 (7 contracts)					6.49
	Normal rate	7.55	10.25	8.31	
	Default rate	9.75	16.50	13.54	
2002 (16 contracts)					6.59
	Normal rate	7.20	20.00	11.95	
	Default rate	11.30	28.00	16.86	
2003 (2 contracts)					5.89
	Normal rate	9.00	16.00	12.50	
	Default rate	17.25	17.25	17.25	

5.8 Fees and charges

Borrowers were not specifically asked about fees and charges in the surveys or interviews. However, concerns about the size and frequency of fees and charges were volunteered by a number of interviewees and/or mentioned in survey responses.

In order to get a better understanding of the level of fees and charges associated with these products, we reviewed a number of the contracts associated with solicitor loans.

In these contracts, there were significant fees attached to these loans, payable to the various parties to the transaction and, in some cases, on the happening of a wide range of events.

In addition to application fees, valuation fees, and legal fees, one solicitor lender includes establishment fees (e.g. 1% of the loan amount); ongoing compliance fees (e.g. 0.36% per year); and interest collection fees (e.g. charged annually, $50 or $20 if interest collected by electronic bank debit). The same lender also includes as a range of fees in relation to disclosure of information and defaults, such as:

- for issuing a statement of the account - $70;
- for providing a letter of conduct (advising of the borrower's performance under the loan) - $250;
- if a payment is dishonoured - $45;
- on issuing a reminder notice - $200 if direct debit default; $100 if not a direct debit default;
- on issuing a default notice - $400;
- additional fees – billed as per a legal firm (eg $300/hr for work performed by a Partner/Director, etc). Borrower interviews found that this can include fees for photocopying documents and/or responding to queries from the borrower or his or her adviser. For example, one caseworker advised the researchers that his client asked him not to contact the lender on the client's behalf, as every time the caseworker did so, the client was charged an additional fee.

It is difficult to accurately compare the level of these fees with those of other lenders providing mortgage loans, because for the most part, it is not possible to compare "apples with apples". Also, a number of the contracts that we examined were not written as Credit Code contracts, and therefore did not appear to fully disclose all applicable fees and charges.

Of course, the expected outcome of high and frequent default fees and default interest is that it becomes even more difficult for the borrower to meet their obligations under the loan. This experience was borne out in the borrower interviews.

The imposition of fees for provision of information regarding a loan can also act as a powerful disincentive for borrowers to exercise rights that are otherwise available and can operate as an impediment to the activities of consumer advocates.

When combined with the higher interest rates for these loans (see above), it is clear that the cost of this form of credit is significantly higher than that obtainable from mainstream lenders.

5.9 Defaults

As was to be expected, given the sample group targeted, borrowers had defaulted on four of the loans covered by the survey sample, and on 20 of the loans covered by the interview sample.[116]

However, it is possible that the survey results underestimate the extent of default among respondents. This is because, in the interviews, it was apparent that borrowers did not immediately categorise a payment that was not paid on time as a "missed payment" (the terminology used in the surveys).

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116 In two cases, it was unclear whether the borrower(s) had defaulted on their second loan.

Reasons for missing or delayed payments varied, as shown in Table 12 below. Respondents could give more than one reason, and a number of reasons given by borrowers were similar or closely related.

Table 12: Reasons for defaults[117]

Reasons for defaults on individual loans	**Surveys** (4 loans)	**Interviews** (20 loans)	*Total*
Could not afford repayments from the start / insufficient income	0	5	5
Illness	1	1	2
Loss of employment	0	0	0
Reduced income	3	4	7
Family break-up	1	0	1
Unexpected expenses	2	1	3
Could not pay principal at end of loan	0	1	1
"Beneficiary" was expected to pay, but didn't[118]	0	7	7
Possible gambling problem of 'beneficiary'	0	3	3
Could not pay default penalty	0	1	1
Was going to refinance, but delays in settlement	0	2	2
Waiting on bill payments	0	1	1
Did not know that loan had commenced	0	1	1
Could not meet additional costs of extending loan	0	1	1
Refused to pay extra fees charged for compulsory change in lender	0	1	1
Couldn't pay costs of extending loan	1	0	1
Unclear	0	1	1

5.10 Legal action – extent and outcomes

Solicitor loans typically involve two distinct types of payment obligation – interest only payments (often made monthly or quarterly) and repayment of the principal at the expiration of the term.

In the event that there is a default in payment, the lender will be entitled to enforce its rights under the loan contract and/or mortgage, and will be entitled to demand payment in full of the amount lent together with interest, fees and costs.[119]

[117] Table 12 does not include data from the borrowers not interviewed – interviews 13B and 16A.
[118] See discussion below re: Group A.
[119] Time delays are imposed on this right where the loan is governed by the *Consumer Credit Code*, see for example, section 80.

Where the default involves failure to make the interest only instalment payment, some lenders elect not to enforce. This may be due to the fact that in the event of default a higher rate of interest is charged, and provided the value of the secured asset exceeds the borrower's increasing liability, the lender actually profits from allowing the situation to continue. For example, the Hodgson report referred to earlier suggested that:

> It is a known fact that some operators see loan defaults with the possibility of large legal fee income from resultant default proceedings as "cash cows".[120]

Once the lender does decide to enforce, proceedings will usually be commenced in a court of higher jurisdiction to take possession of the mortgaged property. These enforcement proceedings can add significantly to the borrower's ultimate liability, with the legal costs incurred by the lender being borne by the borrower pursuant to the terms of the contract.

The lender instituted legal proceedings to seek repossession of the security in five loans reported by the survey respondents, and in 18 loans reported by the interviewees.

For those cases where a writ of possession was sought, the outcomes are shown in Table 13 below. Note that, in some cases, more than one response was provided.

Table 13: Enforcement action

Enforcement action taken on loans?	**Surveys**	**Interviews**	**Totals**
Yes	5	18	23
No	3	6	9
Outcome of enforcement action	**Surveys**	**Interviews**	**Totals**
House sold by lender	0	0	0
Settlement b/w borrower and lender	1	3	4
Borrowed from another lender to pay out loan	1	5	6
Found money to pay out loan through friends/relatives	1	1	2
Borrower sold house	2	5	7
Sold house and paid arrears/costs with super payout	1	0	1
Matter not finalised	0	3	3
"Beneficiary" borrowed from another lender to pay out loan	0	1	1

120 A G Hodgson (2002) *Report to Australian Securities and Investments Commission: Run-out mortgage investment schemes,* para 6.4.

The most common outcomes were that the borrower(s) sold the house (7 loans) or the borrower(s) or 'beneficiary' refinanced the loan through another lender (6 loans). In four loans, the outcome of the enforcement action was a settlement between the borrower(s) and lender.

Information on enforcement outcomes in solicitor lending matters was also found in the Supreme Court files. The 74 files examined were all proceedings instituted by the lender seeking a writ of possession. In 36 of these cases, default judgment was obtained against the borrower. For most of these 36 cases, a writ of possession was issued in favour of the lender on the same day as the default judgment was obtained or shortly after.

The results of those matters that did not proceed to judgment are not known. However, it is assumed that, as with the borrowers surveyed and interviewed, some would have been resolved by the borrower refinancing the loan, obtaining funds from friends or relatives, and/or selling their home.

Time taken in legal proceedings

Discussions with borrowers showed that many were surprised at the speed with which the lender took enforcement action following a default. To assess the extent to which these perceptions have wider application, we determined, for most of the Supreme Court files we reviewed, the time between:

- The mortgage date and the first default;
- The first default and the notice of demand in relation to default;
- Notice of demand and the originating writ being issued; and
- The originating writ and a default judgment being entered.

The results are shown in Table 14 below.

Table 14: Time taken in enforcement proceedings

Time (in calendar days) taken between:	**Minimum**	**Maximum**	**Average**	**Mean**
Mortgage date and 1st default	31	2080	340.3	176
First default and notice of demand	1	1159	37.4	8
Notice of demand and issuing of originating writ	8	133	36.9	38
Originating writ and default judgment entered	15	120	44.6	40

These results show that the time taken to enforce a loan contract varies considerably. However, closer examination shows that at least some lenders do move very quickly to enforce loans in the event of default.

For example, in 14 of the 36 cases that had proceeded to default judgment, the time between the originating writ and the date of default judgment was 30 days or less. And in one case, there was only 15 days between the originating writ and the date of default judgment.

6. Overview of the borrower interviews

This section of the report expands on some of the findings in the previous chapter, and provides more details about the experiences of borrowers. The results in this and the following 4 chapters are based on 18 interviews with borrowers and others with an interest in the loan.

6.1 Interview subjects

Most of the interviews for this project were conducted with the original borrower or borrowers, although in one case, we interviewed both the borrower and her son (the "beneficiary" of the loan) together (Heather and William).

There were two cases where we did not interview the original borrower:

- Interview 13 was conducted with Peter and Angela, the son and daughter-in-law of the borrower (Edith). Upon Edith's death, Peter and Angela refinanced the existing loan in their own names, using the same lender, and borrowing additional funds.

- Interview 16 concerned two loans to different members of the one family. We originally interviewed Catherine, the daughter-in-law of the actual borrower (Marissa) on the largest loan. We also subsequently spoke to the second borrower, Adrian (Catherine's son) by telephone.

Although we were not able to interview the original borrowers Edith and Marissa, we have included some information about their loans in this report, based on information and documents provided by the interviewees.

The majority of the loans considered in this part of the project were sole borrower loans. A smaller number were joint loans between both partners of a couple, however, in only one of these cases, did we interview both co-borrowers (together).

6.2 Describing the borrowers

The experiences of the interviewees tended to broadly fall into one of three different groups, which we have described as:

Group A: Elderly, quasi guarantors;
Group B: Understood the loan but had problems; and
Group C: Borrowers seeking finance of last resort.

The size of each group was roughly comparable. Appendix D summarises the age, income source, and household income of all interviewees.

There was considerable overlap between the groups, and there is necessarily a degree of subjectivity in the placement of the borrowers into the different groups. We allocated borrowers into groups according to the defining characteristics of the borrowers described below. In particular, there were two borrowers (Christopher and Paul) who could have been placed in one of two groups.

Group A: Elderly, quasi guarantors (8 households)

The borrowers in this group were elderly and/or of a migrant background, with an average age the greatest of all three borrower groups. They tended to borrow relatively smaller amounts (especially when compared with Group B), and were mostly reliant on the aged pension or other social security benefit as their sole source of income.

The distinguishing feature of this group is that, for these borrowers, the impetus to borrow was provided by a third party, usually the person who was in fact going to benefit directly from the loan proceeds – a relative or friend. For the most part, the "beneficiary" of the loan proceeds organised the loan, and had the primary dealings with the broker or lender. The borrowers expected that the "beneficiary" would repay the loan, and therefore tended to pay little attention to the detail of the loan arrangements.

As a group, the borrowers had a low understanding of the terms of the loan contract, in particular of the interest only nature of the loan, and the fact that, at the end of the loan, they would be required to repay the principal sum borrowed.

Most of the borrowers in this group did receive independent advice about the loan, but despite this, felt that they did not have a proper appreciation of the loan.

Group B: Aware, but experienced problems (6 households)

In contrast to the borrowers in both Group A and Group C, the borrowers in this group had borrowed larger amounts of money, and were reasonably well off – even if they were cash-poor, they were asset-rich. These borrowers were also fairly experienced in business terms, and were familiar with financial matters.

The main characteristic of this group is that they were fully aware of the nature of the loan before they signed the contract. All of them had read and understood the loan contract. All of them understood the interest only nature of the loan. And all of them had either specifically chosen a solicitor loan, or, even if they might have preferred a more mainstream loan, were quite comfortable with this type of lending.

While this group did not have concerns about the nature of the loan, or their capacity to repay the loan, they did have significant concerns about the way in which the loan was administered by the lender and/or associated law firm.

Group C: Seeking finance of last resort (6 households)

The borrowers in this final group were generally younger than the borrowers in both Groups A and B. For this group, there was considerable variance in the size of the loans, in the extent to which they received advice, and the extent to which they understood the terms of the loan contract, the fees and charges, and the interest only nature of the loan.

The common characteristic of the borrowers in this group is that they were already in serious financial trouble before they signed the loan contract. Problems included: substantial arrears on a previous loan, other pressing debts, and legal proceedings had been instituted to take possession of their property. Borrowers in this group believed that they would not have been able to get finance through a mainstream lender, and most were so distressed at the time of the loan that they felt that they had no option but to sign the loan contract, even if the terms were very unfavourable.

7. Group A – Elderly, quasi guarantors

Representative Group Member

"Michael and Ann", both aged pensioners, have lived in their own home for 47 years. They bought their house and repaid the mortgage when they were still relatively young. They see themselves as "…ordinary people, honest and just in what we were doing. … Finances have never been our good spot. …. We are fairly uneducated in the financial world".

At the end of year 2000, one of their children got into financial difficulty. Michael and Ann decided to help their son (Jacob) and borrowed $87,000, on an interest only basis, secured against their home from a solicitor mortgage practice.

Jacob took charge of organising the loan while his parents assumed that he would make payments on the loan. They went to the offices of a solicitor who advertised in the Herald Sun for 'easy, no paper work required, loans'. This solicitor suggested a loan through a solicitor mortgage practice.

Michael and Ann signed the loan contract in the solicitor's office. They assumed this solicitor was acting on their behalf. He went over the contract with them, but both Ann and Michael felt that he 'hurried them through it'; they did not understand that they would have to repay the principal at the end of the loan term.

Michael felt that their solicitor could have "explained a few more things in the contract with more detail". They did not ask him questions about the contract, because, "…. we sort of trusted the man. We were too trustful."

Realisation, at a much later stage, that they would have to repay $87,000 at the end of the loan contract came as a real shock. "We just didn't know what to do because we knew we couldn't repay the amount no matter how hard we tried."

Unfortunately their son also missed some payments on the loan and did not mention this to his parents. Soon after Michael and Ann received an eviction notice from the sheriff. With the higher interest rate and default penalties the debt ballooned to $146,000 in April 2001. "The whole thing had sort of sprung up on us. With the bank you would have more time they would tell you that you are falling behind and that you need to make it up this money, get in touch with us if you cannot. There was nothing like that." -- Ann said.

Michael and Ann realised that they were way out of their league with this loan and contacted a financial counsellor. With pro bono legal assistance, they reduced the debt to less than $100,000. To repay this amount, Michael and Ann sold their home. However, with the remaining equity, they were able to purchase another (smaller) house. They feel lucky that there were lots of people to help them in the time of trouble, but their experience with solicitor lending greatly upset them. They felt that the lender was not interested in getting loan repayments, but wanted to sell their house instead.

7.1 Describing the group members

As discussed above, the defining characteristic of the borrowers in this group was the fact that the original impetus to borrow money came from a third party to the loan. For most of the members of this group, funds were primarily borrowed to help someone else (a family member or friend), and were paid to the third party and/or that person's creditors, or to refinance a loan that was originally taken out to help a third party.

We also included in this group an eighth member (Christopher), who shared most of the characteristics of the rest of the group, including age, income level and source, and understanding of the loan. However, in this case, there was no evidence to suggest that the loan arose because of the desire to help a third party.

At one level, Christopher's experiences reflected some of the experiences of the third group "borrowers of last resort". However, we have included Christopher's experience in this group, rather than the "borrowers of last resort" group, because he was not proactively seeking a loan to overcome significant financial difficulties.

7.2 Age, income and education

With one exception, all of the members of this group were over 60 years of age at the time of the interview, and five were more than 70 years old. The average age of this group at the time of the interview was 69.2 years. Most had relatively low levels of formal education, with none having finished high school.

Again, all members of this group bar one relied on a social security payment or benefit for their primary source of income. Maria was the exception. She described herself as a homemaker, and also worked in the family fruit shop. She did not disclose the profits from the family business, except to say, "we did not have much income".

7.3 About the loan

For the borrowers in this group, loan amounts were relatively small. Most interviewees borrowed less than $100,000, and none borrowed more than $120,000. The average amount borrowed was $71,500.

Where the information was available, we calculated the ratio of the loan repayment amounts to the borrower's income. For this group, the ratio was generally high, ranging from repayments amounting to 20.4% of income, to repayments amounting to 82.4% of income.

In the most extreme example, Anita's loan required her to make monthly repayments of approximately $812 ($9,744 annually), compared with a fortnightly income $456 ($11,856 annually). This would leave her with an annual disposal income of $2,112, or approximately $40 per week, to cover daily living expenses. Of course, if interest payments were missed, the amount payable each month would increase further.

7.4 Reasons for borrowing

The defining characteristic of the borrowers in this group is that, at least at the outset, the borrowers had no overriding imperative to apply for a loan on their own behalf. Instead, someone else generally suggested the loan to them, with (in all but one case) the loan proceeds intending to primarily benefit the person who suggested the loan, or to cover the losses associated by lending money to the third party.

For example:

Marissa borrowed $100,000 to help her grandson. According to Catherine, Marissa's daughter-in-law:

> "He [her son, Adrian] wanted to do something. He was working, and he was feeling a bit desperate at this point. "What am I doing with myself?" He thought that if he had something to work towards and stop wasting his money, and he thought that buying a house was a good idea …. the only problem was that he didn't have a deposit. That's where mum [Marissa] came in to help with the mortgage of the place."[121]

Maria was working at a charity organisation, and subsequently got personally involved with one woman who was seeking assistance. Maria:

> "started to give her money; first it was a phone, then they had nothing to eat… I started helping her because she was always distressed, always had nothing to eat … she told me that this solicitor "David" … would pay me back. … Then she or her solicitor suggested that I should get a loan, which this solicitor would organise. … So I got a loan out, it was about $5000, … but then she asked me to get another $20,000 because she needed some money urgently for different things, her car was breaking down, etc. So this is how I borrowed the first $25,000."[122]

In each of these cases, and others in this group, the ultimate beneficiary had been unable to obtain finance in his or her own name, because of a poor credit record, insufficient income, and/or lack of assets.

Often the borrowers told the lender or broker the true purpose of the loan – that the proceeds of the loan were to be given to a third party, and the borrowers were not going to receive any direct benefits from the loan. For example, Ann said, of the solicitor organising the loan:

> "… they knew it was not for business. We told them. They knew that it was [their son] who was really going to pay it."[123]

Similarly, the loan documentation signed by Anita clearly stated that the loan was for the benefit of her son to establish a painting business.[124]

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[121] Interview with Adrian (4 February 2004)
[122] Interview with Maria (6 November 2003)
[123] Interview with Ann & Michael (30 October 2003)
[124] A Statutory Declaration provided by Anita to the mortgage manager for the loan included the following: "1. I have applied for a new loan of $100,000 to be secured by a first mortgage of $89,000 and a second mortgage of $11,000 for the purposes firstly of repaying the existing loan over the property and to pay portion of the balance to my son [..] for his Painting Contracting business. 2. The existing loan

Here, it is interesting to contrast the obligations of the Revised Code of Banking Practice (2004), which provides that:

> **We** will not accept **you** as a co-debtor under a credit facility where it is clear, on the facts known to **us**, that **you** will not receive any direct benefit under the facility.[125]

The exception to the rule in this group was Christopher, who sought finance for his own purposes (to pay bills, buy a new car, and pay for repairs to his house). Christopher's application was not linked to, or connected with, a third party's need for funds. However, like all of the other borrower's in this group, the idea to get the loan in the first place was generated by a third party (a real estate agent); it was not the borrower's idea.[126]

7.5 Obtaining the loan

With two exceptions,[127] the borrowers in this group did not actively participate in the process of sourcing the loan. Instead, it was the intended beneficiary who suggested the loan amount, approached one or more mortgage brokers for assistance, provided the initial information about the reasons for the loan and relevant financial circumstances, and arranged for the borrowers to receive and sign the loan documents. This is consistent with the fact that these borrowers were not seeking the loan for themselves or on their own initiative.

In most cases, however, the loan was sourced through a mortgage or finance broker or other intermediary. None of the borrowers or beneficiaries specifically sought out an interest only loan, or a loan from a solicitors' mortgage practice.

7.6 Signing the contract and independent advice

All of the borrowers in this group received legal advice before signing the contracts, including the one borrower who was living in Greece at the time.[128] With one exception, all of the borrowers signed the contract in the solicitor's office or other neutral setting. Anita, however, signed the contract in her own home on a Sunday. [129]

7.7 Borrower's understanding of the loan terms

Despite the fact that all borrowers in this group had been provided with legal advice, the group as a whole reported that they had limited understanding of the key terms of the contract at the time of the loan.[130]

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obtained in April 2002 was for the benefit of my said son and who was at that time establishing his painting business." Loan documents provided in Interview with Anita (19 November 2003)

[125] Clause 26.1, 2004 Code of Banking Practice available at: www.bankers.asn.au/ABA/PDF/20030801%20Code20%Word%Document.DOC

[126] Interview with Christopher (16 October 2003)

[127] Interview with Christopher (16 October 2003) who was originally seeking a loan on his own behalf, and Pauline, Interview (19 November, 2003)

[128] Marissa signed the contract at the Australian Consul in Greece, with advice provided by a Greek-speaking solicitor.

[129] Interview with Anita (19 November 2003)

[130] Note that, in this section, we have not included the understandings of Edith and Marissa, as we did not interview them directly.

For example, of the borrowers we interviewed in this group, only Maria said that she understood the interest only nature of the loan, and the fact that she would have to repay the principal at the end of the loan term.

In contrast, other borrowers interviewed thought that the repayments were reducing the principal amount borrowed, and likened the contract to a normal 25 or 30-year mortgage:

- Heather said that she and her husband had paid a home loan for the last 40 years, and had never had problems, so *she assumed that this loan would be the same*.[131]

- Similarly, Pauline explained that she "understood that I must pay that sum at the end of the contract, but I believed that it would be less than that amount because I give them every month an instalment. … I believed that … by the end of the contract time it would be less than the main amount that I borrowed".[132]

A number of borrowers in this group also had a limited understanding of the fact that higher interest rates would be payable if a payment was not made on time.[133]

Only two of the borrowers (Anita and Maria) admitted that they understood that their home was at risk if payments were not made. Anita explained:

> "I understood, you know, what I understood was that … the loan was in my name, [her son] was getting the money … I knew that if [son] didn't keep up these payments that would mean they'd come up and sell this up on me."[134]

Others were less clear in their understanding of the consequences of default.

For example, both Heather and Christopher were advised that their home was at risk if payments were not made, however, in the interviews, it was not clear that the borrowers had a realistic appreciation of what this meant.

Michael said that the solicitor did not explain what would happen if they missed a payment, or if they were late for a payment. He noted: "None of this was mentioned at all."[135] Similarly, Pauline explained that the lawyer did not give her advice on the fact that she would lose the house if she failed to make payments.[136]

7.8 Reasons for lack of understanding

Quality of the legal advice

A number of the borrowers mentioned that they did not feel that the solicitor adequately explained the loan contract to them. For example, Michael said, "I felt that he [the solicitor] could have explained a few more things with more detail".[137]

[131] Interview with Heather (16 October 2003)
[132] Interview with Pauline (19 November 2003)
[133] Interview with Ann & Michael (30 October 2003)
[134] Interview with Anita (19 November 2003.
[135] Interview with Ann & Michael (30 October 2003)
[136] Interview with Pauline (19 November 2003)
[137] Interview with Ann & Michael (30 October 2003)

Few of the borrowers asked any questions of the solicitor about the contract that they were being asked to sign. Sometimes this was because of the trust that the borrower placed in the solicitor.[138] For others, the circumstances in which the borrowers were signing the loan were such that the borrower felt pressured to sign the contract, or the solicitor did not encourage questions.[139] Anita's circumstances were typical:

> "He [the solicitor] came down, he sat where you're [the CCLS researcher] sitting now, and I had papers to sign and I never had time to read them. Sign there, sign there, sign there."[140]

<u>Reading the contract</u>

Of the borrowers in this group, only Maria read the contract. However, even she admitted to only reading a bit of the contract, "nothing really to take in".[141] Other borrowers admitted that they did not read the contract because: it was "very thick";[142] the borrower had limited English;[143] or the borrowers just wanted to get it over and done with.[144]

<u>Disengagement from the loan process</u>

Another factor impinging on the extent to which this group of borrowers understood the contract, or the consequences of default, was the fact that most of the borrowers believed that the loan beneficiary would make the payments. These borrowers simply did not turn their mind to the reality of the contract terms.

For example, Maria said she understood "that we were taking it out for a year and that we had to pay that much a month. In my mind, she [the "friend"] or her solicitor was going to pay so I did not really take that much notice, because it was not really my debt."[145]

Similarly, Ann and Michael thought that their son would make the repayments, as he was working at the time and [as they thought] "had enough income to pay it".[146]

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138 For example, Ann said they didn't ask any questions because "we sort of trusted the man. We were too trustful…", interview with Ann & Michael (30 October 2003) p5. See also Interview with Pauline (19 November 2003)

139 Christopher did not read the contract because "it was very thick". He did not ask questions. The lawyer did not explain the contract and did not encourage him to read it. Interview with Christopher (16 October 2003)

140 Interview with Anita (19 November 2003) Note that, in this case, the contracts were signed at the borrower's home, on a Sunday.

141 Interview with Maria (6 November 2003)

142 Interview with Christopher (16 October 2003)

143 Interview with Pauline (19 November 2003)

144 Interview with Maria (6 November 2003)

145 Ibid

146 Interview with Ann & Michael (30 October 2003)

Lack of financial experience

Finally, this group of borrowers overall had little formal education, and had limited experience of financial transactions. A majority of the borrowers had not had any direct experience in borrowing money to buy a house, either at all, or in the recent past. For example, Christopher had inherited his home on his parents' death, and Pauline had initially bought her house outright, with funds provided by her family.[147]

7.9 Assessment of capacity to repay

As noted earlier, the entirety of this group relied solely or primarily on a government pension or benefit for their income, and for most, they had little or no likelihood or expectation that their income would increase over time.

All of the borrowers in this group said that they did not meet or speak with the solicitors mortgage practice concerned. In four interviews, the borrowers explained that neither the broker nor the lender asked for information about their financial position. None of the borrowers interviewed were asked to provide evidence of their financial position (income and expenses). It is therefore difficult to know how the lender could have properly assessed that the borrower had the capacity to repay the loan.

Indeed, in at least one case, there was information available to the lender that would suggest that the borrower did not have capacity to meet the loan repayments. In that case, Heather defaulted on the *first* interest payment due on the loan. She then signed a second contract with the same lender, and the proceeds of the second loan were used to repay the missed interest payments and default costs on the first loan.[148]

However, in every case, the mortgage practice arranged for a valuation of the property that was to secure the loan. While this is prudent practice, one borrower suggested that it was in fact the value of the property, rather than the income of the borrower, that was the key criteria considered by the lender:

> "In hindsight, I think they just looked at the fact that we have a good house, because they came and did the valuation. They valued it at only $200,000, but we sold it for $320,000. They probably thought that it is a good house, we will be all right. They would put it up for sale, and the friend of theirs will get it for a very low price so the money that they would get will only more or less cover the loan."[149]

7.10 Defaults

For most of these borrowers, they expected the intended beneficiary would make the agreed repayments. Their comments in the interviews suggested that, for the most part,

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[147] Also: Heather's husband had managed all their financial affairs – including their home purchase and mortgage – until his death. Since his death, her son William has handled her financial affairs. Ann and Michael explained that they had bought their house when they were very young, and that "Finances have never been our good spot".

[148] Interview with Heather (16 October 2003)

[149] Michael, Interview with Ann & Michael (30 October 2003) Similar conclusions were drawn by borrowers in other groups.

they did not monitor progress on the loan and were not aware of whether in fact the beneficiary was making the loan repayments. In some cases, there may have been a possibility that the actual borrowers never received default notices from the lender, as the loan beneficiary may have intercepted the mail. Maria explained:

> "She [the friend] used to get my mail; she used to pick it up. But all the time I thought that it was her business, not mine."[150]

In five of the cases discussed in this section, the loan default occurred because the person who the borrowers had expected to make the payments did not do so. Gambling was a possible source of the problem in two cases;[151] fraud in another;[152] and in two cases, the beneficiary had their income reduced.[153]

When these borrowers eventually realised that the interest payments had not been made, and the loan was in default, they became (understandably) very confused and upset. Ann and Michael's experience is illustrative:

> "We were just trying to help our son. The next thing we know, we open a letter, which says that the sheriff is going to come to take the house. We did not know anything about the sheriff. … The whole thing had sort of sprung up on us."[154]

These borrowers often tried to deal with the solicitors' mortgage practice, and to negotiate alternatives, but found them less than helpful or sympathetic. This experience is consistent with the most of the borrowers interviewed – see discussion in section 5.

In two cases,[155] the borrower did not expect anyone else to make the loan repayments, and in both of these cases, there did not seem to be any specific event that had precipitated the default. Instead, the borrowers simply did not have enough money to meet the payments.[156]

In only one case was there no default on the loan. The beneficiaries here (Peter and Angela) were very clear about the importance and priority that they were giving to the loan. They explained:

> "We weren't about to let mum down, of course. It was her house being on the line. We would absolutely honour every payment."[157]

Other "beneficiaries" may also have had a similar commitment,[158] but may have been more constrained in their finances.

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150 Interview with Maria (6 November 2003) Also, Interviews with Ann and Michael, (30 October 2003) and Heather (16 October 2004)

151 Interviews with Heather (16 October 2003) and Ann & Michael (30 October 2003)

152 In the Interview with Maria (6 November 2003), it seems that the "friend" never had any intention to repay the funds.

153 Because of reduced hours at work, Interviews with Anita (19 November 2003) and Adrian (4 February 2004)

154 Interview with Ann & Michael (30 October 2003)

155 Interview with Christopher (16 October 2003) and Pauline (19 November 2003)

156 Christopher also decided not to try to make any more payments once he realised that he would ultimately have to repay the loan principal; Interview with Christopher (16 October 2003)

157 Interview with Peter (4 December 2003)

158 For example, Catherine explained that her son, Adrian "was not going to let his grandma down. He was

7.11 Outcomes

For this group of borrowers, the outcomes of their solicitor loans were:

- Two borrowers were forced to sell their home following defaults. Christopher moved to a nursing home; Ann and Michael purchased a smaller property in a suburb further away.
- Maria refinanced the loan with a fringe lender, but subsequently defaulted, was forced to sell her house, and now rents a property.
- With pro bono legal assistance, Heather lodged a defence to the writ for possession issued by the lender. The defence is on the grounds that the loans and mortgages were unconscionable and unjust.[159]
- Pauline's loan was still on foot at the time of her interview. However, she does not know how she will repay the principal when the term expires.
- In three cases, the "beneficiary" refinanced the loan in their own name (Anita's son; Edith's son and daughter-in-law (Peter and Angela); and Marissa's grandson (Adrian). The difficulties that Peter and Angela, and Adrian, experienced in the refinancing and settlement of the loans are described in the next section.

prepared to sell the house at any time, but Grandma was not going to lose her house. Because she went out of her way to help him. And he so much appreciated that." Interview with Adrian (4 February 2004)

159 Sadly, Heather became very unwell and died early in 2004. It is not known whether the estate will continue the legal proceedings.

8. Group B – Aware but had problems

Group representative

Jason is a 58-year-old, self-employed fisherman. He borrowed $490,000 from a solicitor mortgage practice to re-finance his home. He borrowed through a solicitor, rather than a bank, because he was planning to sell his house and wanted a short-term loan. It was Jason's solicitor who mentioned solicitor loans to him and recommended a broker who eventually found the loan.

The loan was organised in a matter of one or two weeks and Jason signed the contract in the office of the solicitors' mortgage practice. He fully understood the interest only nature of the loan, the length of the contract and repercussions for missing payments or being unable to repay the loan amount at maturity.

Jason fell behind in his interest payments, due to the costs of repairing his fishing boat. Contract pre-payments allowed him to reduce some of the deficit, and he advised the lender that he would be able to pay the remainder of his arrears when the balance of the contract was due.

However, the contractor did not pay the balance on the due date, and Jason's cheque to the lender subsequently bounced. The mortgage practice instituted proceedings to repossess and sell the property. Jason did not receive the required notices because he was still out at sea. When he found out, he immediately returned to Australia, and paid the arrears to stop the sale.

Jason also spoke to the agent who had been engaged to sell Jason's property. Jason was concerned that there was some collusion between the agent and the solicitors' mortgage practice, because the agent was quoting a sale price that was equivalent to the outstanding amount on his loan, despite the fact that the house had previously been valued for a significantly greater amount:

"How can he [real estate agent] say to people that it will go for $560,000? … He knew that I owed $490,000 on that, plus the couple of months of arrears, he knew that, and he just quoted the exact figure, that's what I hated. … Just as long as [the solicitor mortgage practice] get their money back, they don't care about getting profit or anything for me."

Jason's next fishing contract did not eventuate, and he fell into arrears again. This time, he was unable to find the funds to stop the possession proceedings, and his house was sold at auction for $740,000.

Jason felt that solicitor mortgage practice did not give him time to get back on top of his finances. "They most certainly didn't muck around. And I could have got it refinanced without any problem. They did not give me time." Jason thought that it was impossible to negotiate with solicitor mortgage practice and he thinks that in situation like this "there's got to be give and take in both avenues".

8.1 Describing the borrowers

The second group of six households we collectively categorised as those who were aware of the terms and conditions, but still reported considerable difficulties associated with the administration and/or settlement of the loan. Because of this experience, they were highly dissatisfied with their loan.

8.2 Age, income and education

The overall profile of this group is of a slightly younger age than the first group. Most borrowers are in their late 50's or early-mid 60's, with the average age being 56 years. The one exception to the age profile of this group is Adrian, who was only 24 at the time of interview.[160]

In contrast with the other two groups considered in this research, only one of the borrowers in this group (Fiona) relied on a social security pension or benefit. However, Fiona also reported that she had substantial savings and investments,[161] unlike pension recipients in the other groups.

Most of the borrowers in this group were in fact self-employed, and thus had some experience of the business world and financial matters. Household income reported by the borrowers in this group varied considerably – from approximately $20,000 (for tax purposes) to $1 million annually.

Most of the borrowers in this group had been educated to mid-late secondary school level, and three had undertaken some form of post-school education or training.

8.3 About the loans

The loans taken out by this group of borrowers were, on average, significantly higher than the loans taken out by the borrowers in the other groups. The smallest loan was $25,000,[162] the largest $490,000,[163] and the average was $228,333.

For this group, the interest payment as a proportion of income varied considerably – from 8.7% (Adrian) to 264% (Fiona). However, Fiona also had substantial savings and investments, in addition to the security property and to her pension income.[164] In addition, for a number in this group, the reported income could underestimate actual benefits, because some living expenses might be channelled through the business.[165]

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[160] Adrian borrowed $25,000 to buy a house. However, there was also a second loan of $100,000 provided to his grandmother, and secured by her property, and the proceeds of this loan were also used to buy Adrian's house. Interview with Adrian (4 February 2004).
[161] Interview with Fiona (4 December 2003)
[162] But note that a second loan was also taken out (by the borrower's grandmother) for $100,000 – Interview with Adrian (4 February 2004).
[163] Interview with Jason (20 November 2003)
[164] Interview with Fiona (4 December 2003)
[165] Brian commented that: "my income is very hard to judge, because it goes through the business …" Interview with Brian (8 January 2004)

8.4 Reasons for borrowing

The borrowers in this group sought finance for a mix of consumer and business reasons:

- Philip and Jason were seeking to refinance their home loan (with mainstream lenders) after defaults;
- Adrian wanted to buy a home;
- Brian needed extra funds for his business;
- Peter and Angela wanted to subdivide their elderly mother's land, and build a second house on the land for their residence; and
- Fiona wanted to buy her sibling's half of her deceased mother's land.

8.5 Reasons for using this type of finance

Most of the borrowers in this group used a solicitors' mortgage practice because they felt that they would not be able to get a loan from a mainstream institution.

However, only two (Adrian and Fiona) had in fact applied for one or more loans from a mainstream lender at around the time of the relevant loan, and had been rejected (in Fiona's case, for the amount sought).[166] Three other borrowers assumed that they would not qualify for finance from a mainstream lender:

> "We probably wouldn't have qualified through the bank because of financials. Our income was perhaps spasmodic … we saw interest only loan and we thought – and no financials required – and so we thought well this is probably the thing to go."[167] (Peter and Angela)

> "My credit rating was shocking, it was a waste of time even trying [to get finance from a bank]. It was my fifth refinance. So I knew what you can and cannot do. I knew it was pointless for me to go to the bank. I was already in trouble with the bank, it was hopeless to try another one."[168] (Philip)

> "They [the banks] weren't interested, even though I had a huge amount of assets. They weren't interested because of the type of business I do is very different to most and I just found that banks were not an option." (Brian)[169]

One borrower, Jason, advised that he had always borrowed through law firms. He only wanted a short-term loan, and intended to sell the property at the end of the loan term.[170]

[166] Interview with Fiona (4 December 2003)
[167] Interview with Peter (4 December 2003)
[168] Interview with Philip (30 October 2003)
[169] Interview with Brian (8 January 2004)
[170] (Interview with Jason (20 November 2004)

8.6 The experience of getting the loan

For this group, the experience of getting the loan was relatively straightforward. Most used a broker or other informal intermediary (for example a friend or acquaintance) to source the loan, while two borrowers approached the lender directly.

With one exception,[171] all of the borrowers in this group received legal advice on the contract.[172] All borrowers in this group signed the contract in a solicitor's office, and all read, or had read to them, the contract.

The borrowers in this group all had a good understanding of the key terms of the loan. All understood the interest only nature of the loan- the fact that the principal would have to be repaid at the end of loan term and the applicable interest rates (including default rates). They were also aware that the terms were somewhat disadvantageous, but went ahead with the loan in the absence of other alternatives.[173]

Of the other key terms, only Philip explained that he didn't completely understand the applicable fees – particularly those charged by the solicitor,[174] and only Fiona said that she did not understand that she could lose her land if she defaulted on payments:

> "I didn't realise that part. I didn't realise that part at all because I don't believe that it was mentioned."[175]

8.7 Assessment of capacity to repay

The extent to which brokers or lenders sought information on which to assess the capacity of borrowers to repay the loan appeared to vary with the borrowers in this group.

In most cases, the broker (at least) knew of the borrower's financial circumstances.[176] However, none of the borrowers in this group advised that they had been asked to provide a tax return or other proof of income and expenses. Brian noted that:

> "… they would have known that I was self-employed, but there was virtually no research into it other than doing a valuation on the property …"[177]

[171] Ibid

[172] One borrower, Philip had particular concerns about the legal advice provided. His main concern was that the solicitor had not amended the contract to reduce the early repayment penalty from 3 months to 2 months, despite Philip's request and the solicitor's assurances that he would be able to make the change. Interview with Philip (30 October 2003)

[173] See for example, Interview with Brian (8 January 2004)

[174] Interview with Philip (30 October 2003)

[175] Interview with Fiona (4 December 2003)

[176] Peter and Angela were an exception – explained that the lender did not ask any information about their incomes.

[177] Interview with Brian (8 January 2004)

8.8 Defaults

With the exception of Peter and Angela, all of the other borrowers in this group defaulted on their interest payments. Reasons for the defaults included:

- Other businesses not paying the borrower's bills on time (Jason[178] and Brian[179]).
- Insufficient income (Philip[180] and Adrian[181]).
- Attempted refinancing, but the arrangement feel through after the time for interest payment had passed (Fiona[182]).

8.9 Difficulties with the administration of the loan

As noted earlier, this group generally understood the nature of the contract, and the fees and charges associated with the loan. However, they all had considerable difficulties or concerns with the way in which the loan was administered by the mortgage practice. These included:

- Inflexibility in responding to defaults;
- Delays and difficulties caused by the original lender when the borrower sought to refinance;
- High, undisclosed, and/or unauthorised fees, charges, and commissions;
- Unauthorised disbursements;
- Additional costs for disputing settlement account; and
- Selling the property at less than true value.

As borrowers in other groups also experienced similar issues, these issues are discussed in detail in the next section.

8.10 Outcomes

For all bar one of the borrowers in this group, the outcome of their matter was to refinance the loan with another lender. These refinanced loans were still on foot at the time of interview.

Jason was unable to catch up on his arrears, and the lender sold his property at auction. However, he felt very aggrieved by the way in which his loan was handled, and the fact that the lender did not give him enough time to enable him to refinance, and advised that he intends to fight the matter.[183]

178 Interview with Jason (20 November 2003)
179 Interview with Brian (8 January 2003)
180 Interview with Philip (30 October 2003)
181 Interview with Adrian (4 February 2004)
182 Interview with Fiona (4 December 2003)
183 Interview with Jason (20 November 2004)

9. Group C – Used Lenders of Last resort

Group representative

Brett is a 48 year old who had a debt of about $65,000, arising after a fairly prolonged and dehabilitating depressive illness. Creditors were seeking to have him declared bankrupt, and were threatening to sell his house (which he owned outright).

Brett explained his situation to a friend, who in turn referred him to a solicitor. Brett attended an interview with the solicitor, who told Brett that his only option was to go through a finance firm, and he mentioned one lender only. The solicitor contacted the lender by telephone, and the loan was secured verbally within the hour.

Three days later, Brett attended the solicitor's office again to sign the contract. The solicitor explained the terms of the contract. Brett understood that it was a 12-month loan, which could be renewed at the discretion of the lender. However, Brett was reticent to ask deeper questions because of his need for the loan. In retrospect, he felt that the solicitor should have provided more details:

"I think that sort of a much more clearer explanation should have been given about the fact that it was purely an interest only loan, and that … eventually one day you would have to pay the entire amount in full. [That] there was never any option of paying the actual balance of the loan back in any payment form whatsoever."

He understood about the fees and interest rates, but was less clear about the consequences of default.

Brett did fall behind on his interest payments, but was usually able to pay the interest within a few days of its due date. Each time, Brett approached the lender to make arrangements to pay the additional default interest in instalments, but the lender refused to accept anything less than the entire arrears. After the 3rd default, the lender advised that it was calling in the loan, and instituted proceedings seeking a writ of possession against Brett's home. Brett explained:

"At that stage, I was in a bit of a state. I just didn't know where I was going to go or what I was going to do. And it seemed to happen so quickly from the letter from the lender to the actual process of the repossession order … it was almost … it was only a matter of two weeks or something like that … it seemed to be so quick; I didn't seem to have time to think …"

Brett was unable to negotiate with the lender. The lender obtained default judgment against Brett, but he was able to pay out the balance through an informal loan from a friend.

However, Brett remains concerned that he has been unable to get a statement detailing how the settlement figure was calculated. He would not recommend this type of finance to anyone, and felt that these type of lenders "prey upon people who are so desperate that they don't really … understand what they are signing away, and what the ramifications are."

9.1 Describing the group members

The final group of interviewees we classed as borrowers who used lenders of last resort.

The key characteristic that was common to all members of the group was that, at the time that they borrowed from a solicitors' mortgage practice, they were already in serious financial difficulties, and were operating under significant financial and time constraints that meant they felt compelled to go ahead with the loan, even though they might have had some misgivings.

One member of this group, Paul, was less financially stressed than other members of the group. When the term of his first solicitor loan expired, he looked around to "find a better deal".[184] In fact, Paul had hoped that with the refinance, he would be able to get a "normal loan" through a bank.[185] Unfortunately, he was unable to do so, and ended up refinancing through another solicitor's mortgage practice, although on slightly better terms than the original loan.

9.2 Age, income and education

The overall profile for this group is younger than both previous groups. However, the age profile varies quite considerably, from 37 to 74 years, and the average age was 50.1 years.

Similarly, the income source and amount varied for this group. Four of the borrowers relied partially or solely on unemployment benefits. The remainder of the group were working at the time of their first solicitor loan – full-time (Glen), casual (Carlos), or self-employed (Paul).

As with the majority of borrowers interviewed for this project, the borrowers in Group C had relatively low levels of formal education, with most not taking up further study after leaving secondary school.

9.3 About the loan

The amounts borrowed by interviewees in this group varied from $18,000 to $144,000, and the average amount borrowed was $73,666.

In all cases, we were given an estimate of the borrower's income, and were able to come up with an approximate ratio of income to interest payment obligation. As with most characteristics in this group, there was considerable variance in this ratio, from 16.4% (Paul) to 132.1% (Frank).

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184 Interview with Paul (13 November 2003)
185 Ibid

However, these figures do not necessarily accurately reflect the financial stress being placed on households. For example, Margaret's loan repayments amounted to about 18% of her household income. However, the family's income was so low, and the family's other debts and costs of running a household of 5 people (2 adults, 3 children) were such that the interest payments were in fact unmanageable for the family:

> "And inside my stomach is like knots because I am terrified every day, because of what this guy [the broker] has done. I have $3,000, I have to pay my rates, buy a new car, and pay my water bill, and I can't do it."[186]

9.4 Reasons for seeking a loan

All of the borrowers in this group had sought a loan to refinance and consolidate existing debts that were in default, where the original lender (often a mainstream lender) had taken, or was threatening to take, legal action to repossess the security. Some of the borrowers in this group were also seeking additional funds, for example, to upgrade a vehicle,[187] or to provide funds for redevelopment.[188]

9.5 Reasons for using this type of finance

As with borrowers in the second group, the borrowers in this group used solicitor lending because they knew, or believed, that this was their only option. They would have preferred to have a more traditional loan, where repayments covered both interest and principal, however, a number of borrowers assumed that this was not an option.

Often a broker or other intermediary encouraged this assumption. For example, Brett said:

> "as the solicitor explained to me, I wouldn't have any chance whatever of securing finance from a bank or any other financial institution like that, because I wasn't working, and even though I owed my house, it was sort of like bankruptcy, etc."[189]

Similarly, Glen explained that he asked the financial adviser whether he should go back to the Building Co-op (where his current loan was), but he was told: "oh no, you've got no hope … of getting more money from the Building Co-op". Glen said "And being in the state I was in at that time, I believed him, I believed the experts, as they say".[190]

Of the borrowers in this group, Paul, Carlos, and Frank did make their own enquiries directly with financiers, but those enquiries were unsuccessful, and they had to rely on the assistance of an intermediary in order to find a lender that was prepared to assist.

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[186] Interview with Margaret (26 November 2003)
[187] Interview with Christopher (16 October 2003) and Margaret (26 November 2003)
[188] Interview with Frank (5 November 2004)
[189] Interview with Brett (8 January 2004)
[190] Interview with Glen (7 January 2004) Interestingly, it was this same Building Coop who subsequently refinanced Glen's loan with the financier.

9.6 Obtaining the loan

With one exception (Paul), all of the borrowers in this group used a mortgage broker or other intermediary to assist them in finding a loan.

Half of the members in this group received legal advice on the transaction. One borrower (Glen) was given the option of seeking legal advice, but chose not to do so:

> "They didn't insist on one [an independent solicitor] to be honest, they just said its up to you if you want to get one or not. But they knew it [the contract] had to be signed by a certain date, obviously. I didn't really have time for that anyway. I didn't have the money, which they knew, and I didn't have the time."[191]

In contrast to the other borrowers interviewed, the loan contracts for this group were signed either in the broker's office, or at the borrower's home.

Carlos was the only borrower in this group who was confident that he had read the loan contract fully. In contrast, Frank said that he did not read the contract, but put his faith in the lender.[192]

Other borrowers in this group did try to read the contract. Margaret explained:

> "He'd [the broker] give me the big pile of documents, and I'd say to him, "I'll just have a read of this thank you". And he'd say, "Oh that's okay, but everything is alright in there and you'll find that its pretty much a standard …" da da da da da da. … And I'd start, I'd just be scanning the page, because every time I'd start to get in depth in reading, he'd start talking and there was no silence, I had to read it with him talking at me all the time …"[193]

Glen explained that he read the contract:

> "very briefly, at that stage where you're in the state of mind you just need the money to pay off other people, you know, and you go, oh, I'll work through this later on."[194]

9.7 Understanding of the loan

Despite the fact that a number of borrowers in this group did not receive independent legal advice on the transaction, and not all of them read the loan contract, all had a general understanding of the key terms of the contract. In particular, they all understood the interest only nature of the loan; although it was less clear whether they all realised that the principal would have to be repaid at the end of the loan term.

For example, Paul explained that he understood the loan to be for "forever and a day", as long as he paid the rollover fee at the end of each loan term.[195] Glen, Carlos and Brett also referred to the possibility of the loan being renewed at the end of the loan term.[196]

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191 Interview with Glen (7 January 2004)
192 Interview with Frank (5 November 2003)
193 Interview with Margaret (26 November 2003)
194 Interview with Glen (7 January 2004)
195 Interview with Paul (13 November 2003) p 5

Most of the borrowers in this group understood the interest rates (including default rates) and fees applicable.

However, they did not all have a high level of appreciation of the real consequences of default. For example, Margaret, Frank and Brett were unclear about the extent to which their homes were at risk if they defaulted on the loan,[197] and Paul didn't really turn his mind to the consequences of default, because he couldn't see any reason for defaulting:

> "How are you not going to pay $70 a week? There's got to be something wrong with you."[198]

As mentioned earlier, a key problem for this group was that they were under severe financial constraints at the time of seeking the loan. They felt that they didn't have any options but to go ahead with the solicitor loan, even though:

- they were not entirely comfortable with the loan terms; and/or
- the contract that was presented to them to sign included terms that were inconsistent with their previous discussions with the broker.

For example, Frank explained that when he went to the broker's office to sign the contract, he:

> "noticed that it seemed as though he [the broker] had changed the interest rates on the contract, and he said "well you know it's too late". And I said "you know, I suppose I've got to sign it now, otherwise I'll have the Sheriff's note, you know that's on my property. So I said "Look, the 15% in normal circumstances I wouldn't go near that with a 10 foot pole. I may not be too brainy by I'm not completely stupid either. He told me 11%, he said maximum 13%. I said you've got 15% on it."[199]

In relation to the interest only nature of the loan, Margaret voiced her concerns to the broker, and was told:

> "This is only temporary with this type of loan, until we get you all out of debt and everything everywhere, we get you all cleaned up, your account, and then we can go and get you a loan at the bank, and we can counteract and wipe all these loans out and get you a proper loan at the bank."[200]

9.8 Assessment of capacity to repay

Each of the borrowers in this group said that they provided either the financier (if dealing direct) or the broker information about their current financial situation. Even for

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[196] Interview with Glen (7 January 2004) Interview with Carlos (19 January 2004) Interview with Brett (8 January 2004)
[197] Interviews with Margaret (26 November 2003) Frank (5 November 2003) Brett (8 January 2004)
[198] Interview with Paul (13 November 2003)
[199] Interview with Frank (5 November 2003) Glen and Margaret also found that the contract presented to them contained an interest rate significantly higher than the rate that had been mentioned in initial discussions: Interview with Glen (7 January 2004) Interview with Margaret (26 November 2003).
[200] Interview with Margaret (26 November 2003)

those on unemployed benefits or other low incomes, they were told that it "wouldn't be a problem"[201] to get a loan. In the case of Frank, he suggested that the financiers for his first loan were happy to give him a loan, despite being on unemployment benefits, because of "the size of the property".[202]

Only one borrower in this group, Carlos, said that he was asked to provide proof of their financial circumstances.

In this group, most of the borrowers did not meet the credit provider. However, in each case, the broker or lender arranged for an independent valuation of the property.[203]

9.9 Defaults

With one exception, each of the borrowers in this group was late with one or more payments on their solicitor loan(s). Reasons for delay or non-payment included:

- pressure to give preference to other debts also due;
- delay in accessing the proceeds from another property sale;
- lack of information about the fact that the loan had in fact been provided; and
- generally, insufficient income to make all payments on time.

One borrower, Frank, *did not default* on the regular interest repayments because in fact, the interest payments were taken out of the loan proceeds at the start of the loan.[204] This meant that he simply had to repay the principal at the end of the loan term, or refinance. In fact, at the end of the term of the first loan, Frank was forced to refinance with another lender, because his first lender refused to renew the loan.

It is worth noting that this practice of requiring interest payments in advance has been unfavourably commented on in the Hodgson report referred to above.[205] However, Frank was the only borrower that we observed with a loan of this type throughout this project.[206]

9.10 Outcomes

For this group of borrowers, most of the loans were still on foot at the time of the interview:

- Following the introduction of the *Managed Investments Act*, Paul's loan was transferred to a responsible entity. He is currently disputing the terms of the

201 For example, Margaret said that when the broker asked her about her income, she "told him that she was on Centrelink payments, and he said that wasn't a problem." Interview with Margaret (26 November 2003).
202 Interview with Frank (5 November 2003)
203 Although this was not clear in case of Glen (Interviewed 7 January 2004)
204 Interview with Frank (5 November 2003)
205 A.G. Hodgson, *Run-Out Mortgage Investment Schemes - A Report to ASIC,* 7 March 2002
206 Although we came across references to the practice in at least one reported case: Davdent Pty Ltd v Attinger [2001] NSWSC 902, see paras 33, 48.

agreement with the new lender, and is also being pursued in the Supreme Court because of his failure to pay a disputed fee.

- Brett forestalled a warrant of possession issued against his home through an informal loan from a friend: "I'm more or less paying a friend back each month just on a purely gentleman's agreement, with no documents that have been signed, nothing whatsoever, purely just a word of mouth, he's trusted me and I'm trusting him …"[207]
- Glen eventually refinanced his solicitor loan through the same Co-operative that he had previously borrowed from.[208]
- Frank's loan was still on foot at the time of the interview. He does not know what he will do at the end of the loan term, but wants to try to redevelop the property.[209]
- With the assistance of CCLS, Margaret pursued the broker for unjust contracts, and the matter was settled at mediation. However, she still owed a significant sum to the lender, which must be repaid in mid-2004.[210]
- Carlos' loan was still on foot at the time of the interview. The lender had instituted proceedings against him for defaults, but he had managed to repay the outstanding amount plus costs.[211]

[207] Interview with Brett (8 January 2004)
[208] Interview with Glen (7 January 2004)
[209] Interview with Frank (5 November 2003)
[210] Interview with Margaret (26 November 2003)
[211] Interview with Carlos (19 January 2004)

10. Other issues

In addition to the key characteristics described in the previous sections, there were also a range of issues that were identified in interviews, but were not characteristic of one group or another. Instead, borrowers in each of the three groups experienced these issues.

This section describes these issues further.

10.1 Use of mortgage or finance brokers

As previously noted, most of the borrowers used the services of a finance or mortgage broker to assist them with finding a loan, or were referred to a broker or lender by a third party – a friend, acquaintance, or other professional (for example, a solicitor, accountant, or real estate agent).

Most of the brokers used were clearly in the business of broking and advertised as such. However, in a small number of cases, an acquaintance or professional effectively acted as a broker for the loan. For example, Philip explained:

> "An acquaintance of mine … he said "I could get you a loan" … so this was discussed several times and he said "I will make some phone calls for you" … he said "I can get you a loan on 8% or something like that". He also said that he would negotiate the broker fee down…. He had mentioned that he had been in the finance game before. … I would go to his place in the evening, because he lives very locally, and would have a chat and a beer…"[212]

However, even in these casual arrangements, as long as the "broker" sought a fee for negotiating the credit, Part 4A of the *Consumer Credit (Victoria) Act* may apply.

The following summarises some of the issues reported by borrowers in this research. To a large extent, these are consistent with the findings in the 2003 *Report to ASIC on the finance and mortgage broker industry*, prepared by the Consumer Credit Legal Centre (NSW)[213] ("the CCLC Broker Report").

<u>Misrepresentation of the loan terms and conditions[214]</u>

A number of borrowers interviewed mentioned that the interest rate on the final contract differed markedly from what had originally been discussed with the broker.[215] Despite this, borrowers felt they had no option but to go ahead with the contract because of financial and/or time constraints.

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[212] Interview with Philip (30 October 2003)

[213] *Consumer Credit Legal Centre (NSW) Inc. A Report To ASIC On The Finance And Mortgage Broker Industry, March 2003 available at www.asic.gov.au*

[214] Id, 127-128

[215] For example, Margaret was told that the interest rate offered by the solicitor was "very low", 8% to 18% as the higher rate. In fact, the contracts came back with a normal interest rate of 18%, and a default rate of 28%. Interview with Margaret (26 November 2003)

Other alleged misrepresentations related to the fees that were to be charged by the broker,[216] and the fact that the broker had suggested that he would assist the borrower with redevelopment of his property.[217]

Quality of advice and inappropriate loans

Most of the borrowers interviewed for this research did not specifically seek out a solicitor loan, or an interest only loan. Instead, such a loan was often the suggestion, recommendation or only option proffered by the broker or lender.

However, the fact that a large percentage of borrowers in this sample were on low or fixed incomes, and had no intention of selling the property at the end of the loan term, could indicate that the solution offered by the broker was inappropriate. The CCLC Broker Report specifically mentions concerns about brokers inappropriately placing consumers in interest only loans.[218]

The failure of many of the brokers used by this sample group to offer a range of different options, or of lenders, to the borrowers also raises implications about the quality of advice. As an example, Margaret's broker told her that he "only uses the one solicitor, and this guy is very, very good".[219]

In turn, commissions and/or other arrangements between brokers and lenders may influence the range of options provided to consumers. For example, Glen was referred to a "financial adviser", who was employed by a financier. Despite being advised that this "financial adviser":

> "might be able to help you about how to go about fixing up my money, my accounts up, and also getting me a good loan – through a bank – to consolidate everything"[220]

the adviser simply told Glen to apply for an interest only loan through the financier.

Misrepresenting the purpose of the loan

Most of the borrowers in this group reported that they were seeking to borrow for personal, domestic or household purposes, and we would have expected that the UCCC would have governed the loans.

We were not able to review the contracts of all the borrowers interviewed. However, of those that we did review, a number misrepresented the purpose of the loan as reported by the borrower, and/or had required the borrower to sign a business purposes declaration.

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[216] Interview with Glen (7 January 2004)
[217] Interview with Frank (5 November 2003)
[218] *Consumer Credit Legal Centre (NSW) Inc. A Report To ASIC On The Finance And Mortgage Broker Industry, March 2003, 30-31, available at www.asic.gov.au*
[219] Interview with Margaret (26 November 2003)
[220] Interview with Glen (7 January 2004)

For example, Marissa signed a contract headed "Loan application – Business or Investment Purpose", and also signed a Business Purposes Declaration, but the loan was the purchase of a home for her grandson.[221]

While some of the borrowers appeared to be complicit in the misrepresentation, it is not clear that they understood the implications of the misrepresentation:

- Christopher took a loan to pay some bills, buy a new car, and undertake some repairs to his house. The broker told him that the loan being proposed was meant only for business or investment purposes, but that he (the broker) could "fix it". The broker told Christopher that he should tell anyone who asks that he planned to invest the loan proceeds, and Christopher advised the independent solicitor that the loan proceeds were going to be invested in a company that Christopher had seen advertised on television. [222]

- Philip borrowed money to refinance his home loan. However, the purpose was noted in the contract as "to discharge current facilities for the purpose of refinancing the business and/or investment loan". Phillip explained:

    > "I did not know before we got to our solicitor's office that this loan was a business loan. He [the solicitor] said that it was a business loan not a mortgage as such. I did not see the difference."[223]

- Margaret said to her broker "But it's not a business loan". In response, the broker said to her:

    > "A house on this size of your block of land is not a domestic sized block of land, therefore you can put it under a category like "hobby farm", and I know all these twists and turns that I can do to get you the money at the best rates …"[224]

    Interestingly, the rates on Margaret's loan were among the highest of all of those that we were advised of in this research.

Given the significant consequences for consumers if a loan is unregulated, any involvement of brokers in misrepresenting the purpose of the loan (whether with or without the borrower's acceptance) is of serious concern.[225]

Fees, charges, and commissions

A number of the borrowers interviewed commented negatively about the existence, level, and/or disclosure of costs associated with using a broker. Margaret explained:

> "I even signed a piece of paper that said … that I would never pay more than $3,500 tops to him [the broker] for what he was doing, and even that I thought was too much

[221] Interview with Marissa (4 February 2004)
[222] Interview with Heather (16 October 2003)
[223] Interview with Philip (30 October 2003)
[224] Interview with Margaret (26 November 2003)
[225] *Consumer Credit Legal Centre (NSW) Inc. A Report To ASIC On The Finance And Mortgage Broker Industry, March 2003, 129-130, available at www.asic.gov.au*

> money. And I said that to him. I said "I hope you're not expecting to be paid $3,500 for what you're doing, because its not $3,500's worth of work. I mean it's not like we are buying a million dollar yacht or something …" And he said "Oh no, no, it won't be anywhere near that figure."[226]

In fact, the broker charged $2550 for procuring a loan of $18,000.

Philip raised concerns that he was paying the brokerage fee twice – once to the acquaintance that introduced him to the solicitor-broker, and once by the solicitor-broker. He said that, as far as he was aware, he had not signed a broker agreement with the acquaintance, although he was not sure exactly what he had signed. But, as he explained:

> "Be that as it is, the solicitor was already charging the brokerage fee. You do not pay brokerage twice; you have got to be crazy to do that."[227]

Other borrowers also raised concerns about the fees and charges imposed by brokers or other intermediaries. Again, these experiences are consistent with the findings in the CCLC Broker Report.[228]

<u>Other issues with brokers</u>

Margaret reported a number of additional disturbing practices of the broker that she used. These included considerable delays in arranging the loan; transferring Margaret's electricity account into his name; failing to provide copies of documents on request; and failing to give Margaret information about the bills and debts that he purported to have paid on her behalf.[229]

With free legal assistance, Margaret pursued the broker for breaches of the *Consumer Credit (Victoria) Act*. However, the matter was settled at mediation because, as Margaret explained:

> "I just couldn't take the chance of going to court, having them make me out to be someone so bad, lose everything, come out with nothing … So I took what I could [the settlement offer] and walked away. I didn't walk away happy, far from it …"[230]

10.2 Assessing capacity to repay[231]

As discussed in Chapter 4, under various legislative requirements, solicitor lenders may have an obligation and/or incentive to make an adequate assessment of the borrower's capacity to repay a loan and meet any regular repayments. This obligation stands whether or not the lender meets the borrower directly.

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226 Interview with Margaret (26 November 2003)
227 Interview with Philip (30 October 2003)
228 *Consumer Credit Legal Centre (NSW) Inc. A Report To ASIC On The Finance And Mortgage Broker Industry, March 2003 available at www.asic.gov.au.* For example, see pages 29, 32-33, 127-129.
229 Interview with Margaret (26 November 2003).
230 Interview with Margaret (26 November 2003)
231 Consumer Credit Legal Centre (NSW) Inc. *A Report To ASIC On The Finance And Mortgage Broker Industry, March 2003, 29, 129-131,* available at www.asic.gov.au

In this research, most borrower applications were made through a broker or other intermediary, and most borrowers indicated that they told the intermediary of their income at the time of seeking the loan. However, it was less clear that brokers asked about the borrowers' expenses,[232] and very few were asked to provide proof of their financial position.

We had no information from which to assess whether brokers passed on borrower's financial information to the lender. However, some examples in the research appear so imprudent on the face of the documents that they could indicate that the lender either did not know of the borrower's financial position, and/or chose not to ask or assess the borrower's capacity to repay the loan.[233]

Also, a significant minority [majority? – or should it just be 'many of the borrowers…'?] of borrowers interviewed reported that the broker did not ask for *any* information about their financial position. In these cases, the lender would simply not be able to make an assessment of the borrower's capacity to repay the loan, and, as some borrowers suggested, may be relying instead on the value of the security property.

10.3 Lenders not in the business of lending

Previous mentions [not sure what you mean by 'previous mentions'] of solicitor lending[234] had suggested that much of it would escape coverage of the UCCC because the lender was an individual, and therefore unlikely to be "in the business of lending".

In fact, for many of the borrowers interviewed or surveyed for this research, the lender was a company that was clearly in the business of lending – for example, it was a responsible entity and/or a registered credit provider.

We did identify a number of loans as being provided by an individual, and thus unlikely to be covered by the UCCC. For example, Pauline's second mortgage includes the following in the Annexure:

> "The Mortgagor acknowledges having been advised that the Mortgagee is not a Credit Provider within the meaning of the Consumer Credit Code and the Consumer Credit Code does not apply to (or regulate) the finance secured by this Mortgage."[235]

10.4 "Independence" of advice

While the majority of the borrowers interviewed did receive legal advice on the transaction, two of these borrowers were referred to a particular legal adviser by the

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[232] Margaret said of the broker that: "he didn't even ask me hat I needed to buy for the kids on a weekly basis, nothing, and you know it costs a lot to keep three kids … You buy clothes and shoes and food and their books and their crap that they want … for Christmas and birthdays … kids' stuff costs a phenomenal amount of money", Interview with Margaret (26 November 2003).
[233] Interview with Frank (5 November 2003)
[234] An example is the PIR review, KPMG Consulting, *NCP Review of the Consumer Credit Code, Final Report,* December 2000.
[235] Interview with Pauline (19 November 2003)

broker. This could suggest that the solicitor might not be completely independent of the transaction.

In addition, one borrower was given advice by the solicitor who had effectively brokered the loan,[236] and one borrower received legal advice from the broker's solicitor.[237] Of those who did not receive advice, one borrower (Margaret) was told by the broker that the broker's solicitor "had gone through the contract on [Margaret's] behalf, and they ensured that it was all okay."[238]

10.5 Administrative issues

Responding to defaults

A majority of the borrowers interviewed (including a majority of the borrowers in Group B) specifically raised concerns about the attitude of the lender to defaults. All of these borrowers accepted that the lender was entitled to charge additional interest if they defaulted in interest repayments. However, they felt that the lender did not exercise these rights appropriately, or within the spirit of the commercial arrangement.

For example, Brian explained:

> "It has been mainly like you'd ring up … you might have had the money in the bank, and you're waiting for the cheque to clear, and you say "it will be through and I can be in there by 2pm [to pay the instalment]". And they would say "No, no. If you are not in here by 10.30am, you'll cop the penalty, or you'll cop this, or you'll cop extra fees". So I mean there was absolutely, literally to the minute … no flexibility."[239]

For Jason and Adrian in particular, this inflexibility was compounded by the fact that they kept the lender informed of their circumstances. They gave advance warning if they were not going to be able to make a payment in full by the due date, explained the circumstances, and gave an indication of when the payment was likely to be made. In return, the lender seemed to accept the proposals and gave no indication that further action would be taken (other than seeking the additional interest).[240] Despite this, the lender continued to send default letters (charging additional fees for each letter),[241] and/or commenced legal proceedings.[242]

Adrian explains:

> "I had already warned them that I am going to be in default, but they still sent me those threatening letters and change me $300 for two pieces of paper."[243]

[236] Interview with Pauline (19 November 2003), Interview with Brett (8 January 2004)
[237] Interview with Frank (5 November 2003)
[238] Interview with Margaret (26 November 2003)
[239] Interview with Brian (8 January 2004)
[240] Jason: After explaining when rest of arrears would be made, "he said fine, that's okay…" (Interview with Jason (20 November 2004); Adrian gave the lender a call and said he would not be able to pay full amount. They assured him that everything is going to be alright; they would look after him. Interview with Adrian (4 February 2004)
[241] Interview with Adrian (4 February 2004)
[242] Interview with Jason (20 November 2003)
[243] Interview with Adrian (4 February 2004)

Another concern raised by one borrower was that lenders effectively kept her in default by refusing to accept interest repayments whilst other costs, such as legal costs, allegedly remained outstanding. Fiona explained:

> "I went in there [the lender's office] to give him the cheque. In writing to me they said that they wanted $11,822 in late payments to cover the lot – I had it in a cheque form ready, but they wanted a cheque for [over $3,000] … they wanted it straight on the spot with the other cheque."[244]

This additional sum was for the costs associated with filing for a writ of possession, but Fiona believed that she had 30 days to pay this bill. On the advice of her solicitor, she left the interest payment cheque with the lender's receptionist. However, the cheque was subsequently posted back to her solicitor.[245]

Similarly, Brett found that the lenders would not accept payment of the outstanding arrears, despite the fact that he could demonstrate that he would be able to make future payments on time. Instead, the lenders sought to call in the whole loan.[246]

An issue for Philip was that payments made late on the day that they were due were banked on the next day, and noted as late payments, with additional costs.[247]

Refinancing and settlement

Another of the common problems found were delays and difficulties that appeared to be created by the lender when they sought to refinance the loan, either during the term of the loan or at the end of the loan.

In two cases (Brian and Adrian) delays in settlement resulted in the borrower missing another interest payment – because the refinance was due to settle before the next repayment was due, but was subsequently delayed. In these cases, the default resulted in extra fees and interest being demanded by the lender. In another case, Peter and Angela, delays were caused by the lender losing the property titles, and in making application for fresh titles.[248]

Fees, interest, commissions and other charges

Concerns about the fees and charges imposed by brokers were discussed above. Many of the borrowers surveyed also raised concerns about other fees, interest, commissions, and other charges – the right or reasonableness to charge them, and/or the size of the fees, and/or non-disclosure.

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[244] Interview with Fiona (4 December 2003)
[245] Ibid
[246] Interview with Brett (8 January 2004)
[247] Interview with Philip (30 October 2003)
[248] Interview with Edith (4 December 2003)

While a number of the borrowers understood that additional interest would be charged if payments were late, they were still upset that it was charged on payments that were only late by a matter of hours or by a day or two.[249]

Other concerns about fees, charges and commissions included:

- Excessive legal fees (such as legal costs of extending the loan because of delay in settlement at refinance[250]; cost of independent advice;[251]) and/or legal fees not disclosed.[252]
- Real estate agent's fees, cleaning fees, advertising fees, and real estate commission (prior to putting the house up for sale);[253]
- Costs associated with getting information about the loan – for example, $150 for a statement of account;[254] $150 to confirm settlement date in writing;[255] $150 for the lender to respond to calls from the conveyancer about delays in settlement when borrowers tried to refinance;[256]
- Requesting payments that had already been made;[257] and
- Unexplained or unauthorised disbursements, for example, to lender's solicitor,[258] or to other alleged creditors. [259]

Other issues

Other administrative-type issues raised (less frequently) by borrowers included:

- Unauthorised disbursement of loan funds to a builder, in contravention of an agreement mediated through the Law Institute,[260]
- Providing two settlement figures – the first settlement figure represented the amount due if the borrowers agreed not to dispute the figure; the second representing the amount due if the borrowers wanted to have a right of redress against the lenders. The second figure was about $2,500 more than the first;[261]
- Failure to disclose the way in which the amount due had been calculated. [262]
- Selling the security property at less than its proper value;[263] and
- Rolling over the loan to another lender, without the borrower's consent, and on different terms and conditions to the original loan.[264]

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249 For example, Interview with Philip (30 October 2003)
250 Interview with Philip (30 October 2003)
251 Interview with Philip (30 October 2003)
252 Interview with Philip (30 October 2003)
253 (Interview with Jason (20 November 2003)
254 Interview with Adrian (4 February 2004) Interview with Brian (8 January 2004)
255 Interview with Brian (8 January 2004)
256 Interview with Adrian (4 February 2004)
257 Interview with Brian (8 January 2004)
258 Interview with Brian (8 January 2004)
259 Interview with Fiona (4 December 2003)
260 Interview with Edith (4 December 2003)
261 Interview with Edith (4 December 2003).
262 Interview with Brian (8 January 2004)
263 Interview with Jason (20 November 2004)
264 Interview with Paul (13 November 2003) The reason for the roll-over was that the lender was a solicitors' mortgage practice in run-out mode, which transferred all its ongoing loans to another

11. Overall perceptions

At the conclusion of each interview, borrowers were asked (i) about their overall perceptions of their experience with solicitor lending, and (ii) whether they would recommend this form of finance to others.

As can be discerned from the above comments, most of the borrowers interviewed were fairly dissatisfied with their experiences and would be wary of recommending solicitor lending to others. A number, however, recognised that solicitor lending might be the only form of finance available to some borrowers (as was their experience).

Survey respondents were also asked to provide any additional comments on their experience with solicitor lending.

A sample of the comments from interviewees and survey respondents is provided below.

11.1 Overall experience of solicitor lending

> "I have had the wool pulled over my eyes."[265] (Christopher)
>
> "I am really worried. Do not know what to do. It's like a big black cloud. I went completely numb when they told me that I am going to lose the house."[266] (Heather)
>
> "We have learnt that much, before you sign anything now I would get this form and would get someone's advice on it. And do not take money from people who you pluck out of the paper."[267] (Michael)
>
> "Too bloody greedy. They just use the letter of the law to exploit their customer's position and to use their ability to fast track legal procedures and … its very dollar oriented. … the moral of the story, don't owe them anything you know?" (Brian)
>
> "I certainly knew what I was getting myself into, but what gets up my nostril is that if they can play such hard ball with myself where I'm asset rich, single, and used to the cut and thrust of business. I just feel terribly sorry for anyone who is a normal homeowner or small business who perhaps has a family and battling. I think they would be done like a dinner …" (Brian)
>
> "I think it [solicitor lending] is fine. There is nothing wrong with solicitor loans if they stick to the deal." (Paul)
>
> "This loan was taken out in light of the knowledge that it was an intention to sell at the current address, therefore we did not see a problem with an interest only loan … Interest rate was charged, but solicitor took the equivalent of 0.75% each quarter." (Survey H)
>
> "We were so disgusted with these people we sent a dossier to ASIC, and the Ombudsman, and the Office of Fair Trading, and others." (Survey F)

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company, a responsible entity regulated under the MIA.

[265] Interview with Christopher (16 October 2003)

[266] Interview with Heather (16 October 2003)

[267] Interview with Ann & Michael (30 October 2003)

11.2 Costs and charges

"It would probably be all right apart from the fact that it is very high. Just paying the loan, the interest alone is a fair amount for people to pay."[268] (Maria)

"I think the rates are too high. I think the conditions of the loan, how you pay forever and you never pay it off, ever, ever!" (Margaret)

11.3 Administration of the loan

"I think the situation is that, like everything else, buyer beware, you know, you certainly don't go into a situation on the expectation that you're not able to meet your commitments, but when these circumstances occur, I think that you'd have more leeway even with some other legal institutions than you would with this group. I certainly wouldn't recommend them to anyone else." (Brian)

"It can be okay on short-term, I suppose, if you choose the right one, but not one who's going to do to you what they've done to me. But I suppose I was at fault a bit with being behind but … there's got to be give and take in both avenues." (Jason)

"I just think that a solicitor would have you, to put it quite crudely, by the long and short of it, if you got into difficulties. I think they would soon rake in the money. They'd rather sue you because you know, this is better for them … They're there to make money and I know the banks are there to make money, but the banks would be a bit more lenient I think than what these would, or any finance company really." (Carlos)

"[Law Firm] were very professional from the start, but once we were late with a payment, the whole situation changed, and costs/fees/arrears spiralled out of contract. Treated with distaste by [Law Firm]." (Survey B)

"Interest rate understated originally. Loan was meant to be through a bank. Settlement fees outrageous. [Lender] unwilling to discuss settlement." (Survey E)

"This lender was truly evil. The way they went about their action to sell us up was unbelievable. I missed one payment … and in the end to stop them selling us, and costs … my loan was $420,000, now $560,000 after paying out [Lender]." (Survey J)

11.4 Recommending this type of finance

"I would say that solicitor loan is an emergency; it is very hard to recommend. It is like recommending a dentist. I know what I would do now; I would go directly to a number of solicitors and look at the paperwork. But people who want solicitor loans are not in this situation … People who take solicitor loans are "either builders who know exactly what they are doing, or people who are in the poo, exactly like I was, and need money in a hurry." (Philip)

"Well I'd recommend it [this type of finance] if you're desperate, because there is no other way. But I would recommend going to the bank first …" (Carlos)

"Depending on the sort of person, but no, no. From what I've seen … I feel that private finance companies like that seem to basically prey on people who are so desperate that

[268] Interview with Maria (6 November 2003)

they don't really, on some occasions, [understand] what they are signing away, and what the ramifications are, etc. It's a very dicey thing." (Brett)

"No, not unless you made sure that you had time to possibly, if you had to, to renegotiate it. In other words, if they send the contract to you via mail, and if you've got the ability to go and see an independent person and say "this is not what we agreed to". Whereas they wait until you're in the situation where you've got no time either to negotiate or to seek legal assistance." (Frank)

"No. It's too expensive, you don't know who you're dealing with at all. You've got no idea. At least with a bank you know who you're dealing with. With these people, you don't know who you're dealing with. If I'd known who the loan was actually from when I owed that $1000, and I asked them about speaking to these people. … I could have worked something out with them [the actual lenders], and they [the responsible entity] said don't bother, we've already spoken to the people." (Glen)

"I wouldn't recommend it. Because the only one it benefits is the solicitor. That's why. It doesn't benefit the lender at all. Not even in a remote possible way. Maybe for a very, very short time, but in the long run its just worse." (Margaret)

"[Law Firm] charge maximum fees, give no service. As an estate agent marketing large projects, I would not recommend them to any clients. I refer 80-100 conveyances a year to solicitor practices." (Survey I)

12. Other perspectives

As noted earlier, to complement the information provided by borrowers, we also consulted others with an interest in, or experience of, solicitor lending. Their responses are briefly summarised in this section.

12.1 Solicitor lenders

As part of this research, we spoke with the Law Institute of Victoria, and interviewed representatives from three different law firms involved in solicitor lending. Two of these firms were members of the Managed Mortgages Section, and one was closely associated with a responsible entity licensed under the Corporations Act.[269]

While all of the solicitors interviewed were supportive of this research, most suggested that the vast majority of solicitor loans in Victoria are provided for business or investment purposes. One solicitor estimated that less than 5% of solicitor lending was consumer lending; another estimated than the proportion was less than 10%.

On the other hand, the third solicitor advised that the responsible entity with which this solicitor was associated devoted approximately 35 to 40% of its lending business to consumer lending.

As noted earlier, it is difficult to assess the size of the market in solicitor lending for consumer purposes. However, it is worth noting that estimates of the size of the market may also be incorrect if consumer loans are incorrectly documented as business or investment loans.

Other comments provided by one or more of the solicitors interviewed included:

- Conflicts of interest mean that solicitor lenders will not act for the borrower and the lender. In turn, the solicitor rarely meets the borrower.
- Small solicitor lending, in particular, provides a community service. It operates as another form of finance for borrowers, who like the local service, and as a useful investment for retirees.
- Some borrowers also like the fact that solicitors' mortgage practices can be more flexible in their lending criteria, and the flexibility of being able to repay or reduce the principal at any time. For example, where income is variable, or they receive a lump sum.
- Protection for consumer borrowers comes in the form of prohibitions against unconscionable and unjust contracts. Solicitors normally protect themselves against such conduct occurring by making it a condition of the loan that the borrower receives independent legal advice. In addition, businesses have an incentive to ensure that a borrower can meet their repayment obligations.
- For borrowers, the issue of overwhelming documentation for loans regulated by the UCCC is very real. In addition, consumers are focusing on their need for the finance, and are unlikely to fully appreciate issues of risk, even if they receive an

[269] A partner in the law firm was also a Director of the responsible entity.

explanation of the contract terms. Borrowers do not want to think about what might happen if they miss a payment, and usually do not, or cannot, read the contract;
- Borrowers are often referred to a solicitor lending practice through a finance or mortgage broker. Word of mouth, as well as solicitors who do not provide finance, are also sources of referral for lending practices and
- Investors come from all walks of life and are usually referrals from word of mouth.

12.2 Financial counsellors and other caseworkers

Financial counsellors and other caseworkers provided general comments and case studies to the researchers throughout the research. For those financial counsellors who had had clients with solicitor loans, the main concerns that they reported included the high cost of the loans, the suitability of the loans, and their interest only nature, and the lack, on the part of credit providers, of proper assessments of a borrower's capacity to pay.

In order to gain a sense of the scale of these issues, we sent a short email survey to all members of the Financial and Consumer Rights Council. We received 20 responses to the survey:

Thirteen of the respondents reported that they had seen clients with solicitor loans. However, in each case, these clients represented only a very small percentage of the respondent's casework. Most of the loans observed were of an interest only nature and most of the borrowers used a finance or mortgage broker to source the loan.

Respondents were also asked to provide any other comments on solicitor lending. The vast majority of the comments were negative in nature, raising issues such as:

- Very high interest rates, repayments, and fees. In turn, this means that the equity in the security property rapidly decreases;
- Clients are "trapped" because they cannot get a loan from a mainstream lender;
- Undermining of the professional relationship between a solicitor and a client, where the borrower is a client of the solicitor;
- Loans provided to vulnerable consumers – including those on pensions, with low levels of English literacy, and/or in financially desperate situations;
- Asset-based lending;
- Lack of redress options if there are problems with the loans and
- Unprofessional administration of the loans.

These responses, while not conclusive, are consistent with some of the issues and concerns that were described by the borrowers interviewed and surveyed in this research.

One respondent did, however, have some more positive comments to offer. This financial counsellor noted that the borrowers using this form of finance are typically high risk and therefore attract higher interest rates. Borrowers like solicitor loans because all the interest payments are tax deductible, repayments are usually less than those that would apply under a principal and interest loan and they can be obtained in circumstances where banks will not provide finance.

PART D – ANALYSIS AND CONCLUSIONS

13. Observations on the issues raised in the report

While this research was intended to be exploratory in nature, many of the concerns raised by the borrowers surveyed or interviewed for this research reflected the experiences and concerns of caseworkers in this area. The issues raised are also consistent with problems and difficulties raised in other research and reports on non-mainstream lending to consumers.[270]

This section summarises the key themes and issues that were raised in the research, and their implications for regulatory reform.

13.1 Suitability of the loan

All of the borrowers surveyed or interviewed during this research had received finance in the form of an interest-only loan. In most cases, these loans were secured by a mortgage over the borrower's family home, and only asset, and the loans were obtained for personal, domestic or household purposes. In most cases, there is little indication that the brokers, lenders, or borrowers turned their mind to the question of how the principal amount borrowed would be repaid at the end of the loan term.

As previously noted, interest only loans have historically been used for business and investment purposes. Often the funds are used to build or develop the security, with the expectation that the security will be sold at the end of the loan term, and the profits used to repay the principal. In these circumstances, finance in the form of an interest only loan is reasonable.

However, where the funds are borrowed for consumer purposes, and there is no intention to sell the security property at the end of the term, the suitability of an interest only loan looks questionable. This is even more the case where the consumer has limited or fixed income, as was the case for many of the borrowers who participated in this project.

One law firm suggested that an interest only loan might assist cash-poor, asset-rich elderly consumers, to remain in their home for a longer period of time. In this scenario, the principal could be repaid with the sale of the property when the consumer dies or moves to some form of supported accommodation.

Another suggestion, made by brokers to a number of borrowers in this project, is that an interest only loan would give the borrower an opportunity to improve their credit record, with the aim being that the loan would ultimately be refinanced on a principal and interest basis, with a more mainstream lender.

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[270] Including Dean Wilson (2002) *Payday Lending in Victoria – a research report;* Consumer Credit Legal Centre (NSW) Inc. *A Report To ASIC On The Finance And Mortgage Broker Industry,* March 2003, available at www.asic.gov.au.

However, in both of these scenarios, the high cost of the loans and high penalties for default, suggest that, in practice, the theoretical ideal may be difficult to achieve. Analysis of the borrowers in Groups A and C, as well as some in Group B, suggests that, for the most part, the interest only loan was not a suitable form of finance, and in fact only made their position worse. Clearly the law did not protect these borrowers from entering into an unsuitable loan.

It is also worth remembering that the fact that an interest only loan might be the only type of finance that a borrower is able to obtain does not, of itself, mean that the loan is a suitable loan for that person.

This discussion suggests that there may be some grounds for limiting the circumstances in which interest only loans can be provided for consumer purposes.

One option might be to require borrowers to state – in writing – how they intend to repay the principal at the end of the loan. This might have the effect of better drawing the attention of borrowers to the interest only nature of the loan. Of course, careful wording of the statement, and careful monitoring of the practice of credit providers, brokers and others providing the statement will be needed to ensure that such a requirement has its full effect.

In addition, implementation of such a requirement would need to be coupled with initiatives that give real alternative options to consumers unable to obtain mainstream finance. Better monitoring of broker practices and increased regulation for brokers will also be needed.

13.2 Capacity to repay

A key issue raised in this research is that there appears to be little, if any, assessment of the borrower's capacity to repay the loan principal or to meet the interest repayments. Instead, the clear impression that the borrowers obtained was that the decision to provide finance was predominately based on the value of the security property. In our view, this is asset-based lending.

Again, it is clear that current legislative provisions do not operate to ensure, as a matter of practice, that the lender undertakes a proper assessment of the borrower's capacity to repay before providing finance. Indeed, some solicitor lenders, other credit providers, and brokers, are quite explicit about the fact that proof of capacity to pay is not required.[271]

Nor do the additional ethical and other obligations imposed upon solicitors through the *Legal Profession Act* appear to have had much impact for the borrowers that we interviewed.

[271] For example, one lawfirm suggests that one of the benefits for borrowers of solicitors mortgage finance is that 'Proof of capacity to pay is usually waived'; http://www.philwil.com.au/news/mortgage.htm (accessed 1 April 2003).

In addition, even if the borrower was subsequently successful in an action for unconscionable conduct or unjust contracts, there is a very real question about the extent to which the courts or tribunals can and will provide an adequate remedy.

As well as being clearly against the spirit of the UCCC, and inconsistent with investor protection regulations, such asset-based lending practices can have severe and long-lasting consequences for the affected borrowers, as can be seen from the interviews.

Others have commented on the inappropriateness of asset-based lending. For example, in their 2003 research report on third party guarantees, the NSW Law Reform Commission noted:

> "Asset-based lending, where the borrower and guarantor appear unable on the face of the transaction to be able to repay the loan, is a feature of improvident transactions."[272]

The Banking and Financial Services Ombudsman (BFSO) has also commented unfavourably on asset-based lending, and suggests that it may lead to a claim of maladministration against the bank. It quotes the following with approval:

> "No banker should rely on realisation of assets held as security as the primary source of repayment and the banker must be satisfied that there is a clear repayment source."[273]

The BFSO also notes that:

> "It should be fundamental to any loan contract that the borrower can meet the repayments in the expectation that the security will be released when the loan is repaid."[274]

The need to properly assess a borrower's capacity to pay has also recently been considered in relation to credit cards.

In 2002, amendments to the *Fair Trading Act 1992* (ACT) increased the responsibilities on credit providers to undertake a "satisfactory assessment process" in relation to continuing credit contracts and increases in credit limits,[275] and the issue of credit card overcommitment is on the current agenda of the Uniform Consumer Credit Code Management Committee.[276]

In addition, the revised Code of Banking Practice imposes a positive obligation on banks to assess a borrower's capacity to repay *before* offering a loan. Banks signing up to the Code promise that:

> Before **we** offer or give **you** a credit facility (or increase an existing credit facility), **we** will exercise the care and skill of a diligent and prudent banker in selecting and applying

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[272] N.S.W Law Reform Commission, –" ***Darling, please sign this form: a report on the practice of third party guarantees in New South Wales"- Research Report 11*** (Jenny Lovric and Jenni Millbank) (2003), 63 para 4.58.
[273] Banking and Financial Services Ombudsman Limited *Policies and Procedures Manual* p24- Available at www.bfso.org.au.
[274] Id, 26.
[275] *Fair Trading Act 1992* (ACT) s28A.
[276] See http://www.creditcode.gov.au/display.asp?file=/content/whatsnew.htm.

> **our** credit assessment methods and in forming **our** opinion about **your** ability to repay it.[277]

It seems unlikely that a decision to lend to a consumer based only on the borrower's security would be consistent with this obligation.

Along with unsolicited credit limit increases, asset-based lending is another example of poor or non-existent assessment of a borrower's capacity to repay a loan. Governments and industry need to further examine assessment of a borrower's capacity to repay can be encouraged and improved.

13.3 The role and regulation of finance and mortgage brokers

Finance and mortgage brokers played a key role in most of the transactions considered in this research. The borrower interviews suggest that, at best, the brokers used provided poor or limited advice, and were influential in the borrower being steered towards a particular loan type that was rarely appropriate.

The experiences of borrowers in this research are consistent with the findings of the CCLC Broker Report. This identified a need for higher standards of conduct by mortgage and finance brokers, and suggested that regulatory reform was needed to ensure:

- Improved disclosure of costs and other information;
- Improved standards of advice and conduct;
- Elimination of unfair practices; and
- Improved redress and accountability.[278]

The CCLC Broker Report has acted as a catalyst for action by State and Territory governments to work towards national regulation of finance brokers, and it is understood that the relevant agencies have prepared a "policy framework", and will be undertaking full public consultation on proposals for reform.[279]

Regulatory reform that addresses the issues identified in the CCLC Report will also be relevant to solicitor lending practices, and should be progressed as fast as possible.

13.4 Borrower understanding of key terms

The research suggested that many of the borrowers, particularly those in the first group, did not understand the key terms and conditions of their loan agreement. In particular, many said that they did not understand the interest only nature of the loan, the fact that the principal would have to be repaid at the end of the loan, or the consequences of default, including the speed at which legal proceedings could be instituted. Many also had

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[277] Code of Banking Practice: Clause 25.1.

[278] Consumer Credit Legal Centre (NSW) Inc. *A Report To ASIC On The Finance And Mortgage Broker Industry*, March 2003, 67-69, available at www.asic.gov.au

[279] See http://www.creditcode.gov.au/display.asp?file=/content/whatsnew.htm

an expectation that the lender would be prepared to be flexible in cases of financial difficulty.

There are a number of factors that may have contributed to low levels of understanding.

Role of brokers and legal advisers

Most borrowers reported that they did not feel that they had received much help or advice from either the broker or legal adviser, where one was used. Instead, conversations were rushed, and borrowers felt that they had been given scant explanation of the key terms and conditions. In addition, none of the borrowers interviewed obtained financial advice, which may have been able to highlight the improvidence of the transaction.

Reforms to improve the quality of broker advice should assist in this regard in the future.

However, there remains a question about the effectiveness of legal advice in relation to consumer credit transactions. This issue has been given considerable attention in the context of consumer guarantors, where lender practices often require that the guarantor receive independent legal advice.

However, the NSW Law Reform Commission report referred to above, suggests that there has been too much emphasis on independent legal advice "as a cure for unfair dealing, a source of information or empowerment for the guarantor, and as a protection against lender liability"[280] might be unwarranted. The report concludes:

> "While the presence of legal advice may protect a lender from an action to set aside the transaction, such advice as it is currently typically provided does not appear to offer the guarantor very much in terms of information on the loan, advice on the transaction, or empowerment to refuse or renegotiate the terms of the transaction."[281]

These comments apply equally to the experience of legal advice as reported by most of the borrowers in this research. There is also a further question of what role, if any, independent financial advice should play in consumer credit transactions.

Desperation

As demonstrated by some of the borrowers in Group C, those who are in financially desperate situations may be disinclined to ask too many questions if a lender has agreed to provide finance. In addition, the external financial pressures can place time constraints on any ability to read the documentation, or to reflect on the agreement away from the broker or lender. This desperation can also be taken advantage of by unscrupulous brokers and/or lenders.

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[280] Id, [8.17]148.
[281] Ibid

Disengagement

Disengagement with the process of obtaining the loan was a particular feature of the borrowers in Group A. As discussed later, their involvement in the transaction was, in their minds, more in the nature of a guarantor than a principal borrower. As they fully expected the "beneficiary" to meet the obligations under the loan, they did not fully engage with the process of obtaining the loan, and did not necessarily turn their mind to the details of their obligations under the loan.

Financial literacy levels

A majority of the borrowers interviewed were elderly, had relatively low levels of education, and limited financial or business experience. Recent research on financial literacy suggests that consumers in these demographics are more likely to have lower levels of financial literacy than consumers in other demographics.

For example, the *ANZ Survey of Financial Literacy in Australia* found that, among others, the following demographic groups were strongly or moderately over-represented in the lowest financial literacy quintile:

Strongly over-represented:

- Education less than Yr 10;
- No occupation;
- 70+ year olds; and
- unskilled workers.[282]

Moderately over-represented:

- retired;
- gross personal incomes under $20,000; and
- semi-skilled workers.[283]

In contrast, those with higher personal and household incomes, higher levels of education, and in white collar or professional occupations were more likely to be over-represented in the higher financial literacy quintiles.[284]

Improving financial literacy levels is currently a major focus of governments and government agencies at the Commonwealth and State/Territory levels. For example, in February 2004, the Commonwealth Government announced the establishment of a National Consumer and Financial Literacy Taskforce:

> to map and evaluate current consumer and financial literacy programs in Australia, to identify any gaps or ways of working more effectively and to develop a National Strategy to raise the levels of consumer and financial literacy in Australia.[285]

[282] Roy Morgan Research (2003) *ANZ Survey of Adult Financial Literacy in Australia Final Report* p13.- .
[283] Id, 14.
[284] Id, 18.

Efforts to improve financial literacy are important and should be supported. However, in doing so, it is important to also consider the external factors that can lead consumers to make improvident or inappropriate transactions. In the case of solicitor lending, this can include broker or lender misrepresentations, financial pressure, and lack of alternatives.

13.5 Cost of credit

The costs associated with solicitor loans are generally considerably higher than the costs of mainstream credit. In addition to interest rates that can be twice as high or more than those of equivalent loans with mainstream lenders, many solicitor loans include:

- high default interest rates;
- additional costs for application fees, compliance costs, procurement fees, interest collection fees;
- fees for issuing a statement of account;
- high dishonour fees; and
- fees for issuing reminder and default notices.

In addition, a particular feature of some solicitor loans is that, for every enquiry, request or discussion with the lender (or associated law firm), the borrower is charged as if the borrower was an actual client of the solicitor. Further, it is arguable that some charges (for example, for issuing a statement of account or a reminder notice, or the imposition of a higher interest rate on default) do not reflect the actual cost to the lender, and thus may amount to a penalty fee.[286]

As discussed earlier, existing regulation does not appear to constrain the costs of these types of loans. In addition, the imposition of a maximum interest rate cap can be circumvented in practice by increasing the fees and charges instead of the interest rate.

The introduction of the comparison rate regulations may have some impact on the disclosure of the true cost of credit, at least for those loans regulated by the Credit Code. However, as discussed below, disclosure will be of little effect if borrowers feel that they have no other options.

It is also possible that some fees, and charges, and the way in which they are imposed, *might* amount to an unfair contract term under recent amendment to the *Fair Trading Act 1999* (Vic).[287] However, these provisions are still very new, and as yet untested in relation to substantive contract terms. In addition, they do not apply to contracts regulated by the UCCC.[288]

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[285] See http://cfltaskforce.treasury.gov.au/content/terms.asp?NavID=2
[286] For example, see discussion in *Non-status lending, Guidelines for lenders and brokers,* Office of Fair Trading, UK, Nov 1997, Para 51.
[287] *Fair Trading Act (Vic) 1999*, Part 2B-Unfair Terms In Consumer Contracts.
[288] Section 32V(a).

13.6 Code avoidance

The research reiterated concerns that loans that are essentially for consumer purposes can be structured to avoid the operation of the Credit Code. The primary avoidance mechanisms are:

- the lender is not "in the business of lending"; and
- the borrower has signed a business purposes declaration.

In relation to solicitor lending practices, the UCCC amendment proposed in the PIR to address this first issue is needed and should be implemented as soon as possible. However, it should also be expanded so that it applies equally to other businesses that provide a similar service.

Code avoidance through use of a business purposes declaration is not confined to solicitor lending transactions,[289] and needs to be addressed on a wider scale.

13.7 Guarantor-like transactions

The borrowers in Group A raised a key issue about the practices of lenders of documenting as a principal borrower a person who will not in fact receive the benefits of the loan. For most of these borrowers, the loan funds were to be provided directly to a third party to the loan. In practice, the borrowers may have been likely to view their role as more akin to that of a guarantor than a principal borrower.

This raises the question of whether the borrowers in Group A would have been better protected if they had in fact been guarantors on a loan, with the 'beneficiary' as the principal borrower. Certainly there is an argument that this is the case. For example, if the guarantee was regulated by the UCCC, the guarantors would have been given additional information about the nature and risk of the transaction, including during the life of the loan; would only have been responsible for the loan if the principal borrower defaulted; and the credit provider would have been required to take proceedings against the principal debtor first.[290]

In any case, it is clear from these cases, that the current regulatory framework does not place sufficient pressure on lenders to ensure that the parties to the loan are in fact the ones that will receive the loan proceeds.

13.8 Financial exclusion

A key theme running through many of the interviews was that the borrower felt that the solicitor loan was the only option available to them, because of their poor credit record and/or low or irregular income. They felt that they had no option but to take this form of finance, despite the fact that some were aware, at least to some extent, of the high cost of the loan and/or the onerous terms.

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[289] For example, see CCLC Broker report p 68, para 3(e).
[290] See for example, Consumer Credit Code, Part 3 Div 2.

For some, the acceptance of a solicitor loan simply delayed the inevitable sale of their home, but in the process, considerably reduced the equity in the home at the time of the sale, due to the additional and high fees for each refinance.

This difficulty has been highlighted in relation to other lending on the margins, for example, payday lending.[291] There are simply very few, reasonably priced, credit options available to low income or credit impaired consumers, and the lack of options can be unfairly exploited by credit providers and brokers.

A 2001 report by the Financial Services Consumer Policy Centre examined financial exclusion in relation banking and transaction products, and provided a number of recommendations for addressing this problem.[292]

Some work has also been conducted on ways to reduce financial exclusion in consumer credit – including no and low interest loans.[293] However, further research and work is needed to ensure that consumers do not need to rely on exploitative credit.

13.9 Access to redress

Another key issue highlighted in this research is that of access to redress. While some legislative provisions may be of assistance in cases similar to those discussed in this report, they will be of little practical use if the consumer can only exercise these rights by instituting legal proceedings in a court or tribunal. Cost and other considerations mean that, for many consumers, instituting legal proceedings is not a realistic or likely option.

The increase in industry dispute resolution schemes in the finance sector has improved in access to justice for many consumers. However, for those consumers who have taken out a loan through or with a law firm, there is generally no external dispute resolution scheme ("EDR") that can assist. Similarly, there is only limited coverage of brokers by EDR schemes, as the most relevant scheme, the Credit Ombudsman Service, does not have full industry coverage.

In order to resolve the disparities in access to justice for consumers, regulators need to consider imposing a requirement on all consumer credit providers to belong to an approved EDR scheme, as is currently the case for other financial services providers.[294]

13.10 Administration issues

Finally, many of the borrowers interviewed raised considerable concerns about the way in which the loan was administered – including the failure on the part of the credit provider to be sympathetic or provide assistance when advised of financial difficulties. This contrasts markedly with commitments given by mainstream lenders to provide

[291] Wilson *Payday lending in Victoria*, Chapter 5.
[292] Chris Connolly & Khaldoun Hajaj (2001) *Financial Services and Social Exclusion* Ch 6.
[293] For example, see Brotherhood of St Lawrence (2003) *Conference Proceedings: Banking on the Margins*, October 2003 available at http://www.bsl.org.au/pdfs/Banking_on_margins_conf.pdf
[294] See *Corporations Act 2001* (Cth) s 912A(1)(g) and s 912A(2).

assistance to consumers in financial difficulties. For example, the Code of Banking Practice provides that:

> With **your** agreement, **we** will try to help **you** overcome **your** financial difficulties with any credit facility **you** have with **us**. **We** could, for example, work with **you** to develop a repayment plan. If, at the time, the hardship variation provisions of the Uniform Consumer Credit Code could apply to **your** circumstances, **we** will inform **you** about them.[295]

There was also clear surprise by the borrowers at the speed at which enforcement proceedings were taken, and the rapidity with which additional fees and charges were imposed whenever there was a breach or request.

It is unlikely that this type of conduct contravened any legal requirements. However, it points to a clear dissatisfaction with service standards of solicitor lenders that in turn might reduce the market share of poor performers, especially if alternatives are made available.

[295] Revised Code of Banking Practice 2004 clause 25.2

14. Conclusions and recommendations

This research illustrates a number of problems and difficulties that consumers may experience when using finance from solicitor lenders for consumer purposes. While the research was not intended to assess the scope of any problems with solicitor lending, it does highlight particular issues where regulatory or other reform is needed to ensure that consumers are adequately protected from poor lending practices

As well as illustrating the practices of solicitor lenders, the case studies also show broader failures in consumer protection. It supports other evidence that the Uniform UCCC is not achieving the intended outcomes.[296]

The interviews and surveys focused on borrowers who had experienced problems, however, within this group, there were a number of borrowers who were aware of the nature of the loan, and despite recognizing this form of borrowing as a "last resort" were still prepared to use it because they felt they had no other option.

However, for the most vulnerable consumers (who in this research had usually borrowed funds for another person) these loans put the family home at significant risk. For this group - who tended to have little understanding of the loan, were likely to be elderly and in receipt of a pension - the outcome was, or is likely to be, devastating. These cases, in particular, show that the current regulatory regime is failing to protect the most vulnerable borrowers.

14.1 Consumer Credit Regulation

"Business Purpose" Lending

While all of the borrowers interviewed for the project had borrowed funds primarily for consumer purposes, some of the loans were provided for "business purposes", thereby avoiding coverage (and consumer protections) of the UCCC.

Recommendation 1: Credit laws should cover loans for business, as well as personal purposes in line with more recent legislation (such as the *Financial Services Reform Act 2001* (Cth)). This would ensure that business purposes declaration could not be used to avoid Code coverage in circumstances where the loan is for personal, domestic or household purposes.

"Guarantors"

While no consumers signed guarantor contracts, some signed on the understanding that the loan was for the benefit of a third party who would make the payments. The beneficiary of the loan usually made the initial arrangements, and other parties involved (such as finance brokers) were aware of the purpose of the loan. Therefore, this group

[296] See Niven D & Gough T, *The Operation of the Consumer Credit Code*, Consumer Credit Legal Service (Vic), 2004

tended to have the mindset of someone who was a guarantor rather than a borrower. Where advice was provided, often they did not 'take it in' because they did not see the transaction as directly relevant to them.

Guarantors are regarded as a group who need specific protections.[297] However, the fact that some of the people in our survey signed as borrowers reduced any protections that might be available to a guarantor. This highlights the need for specific protections for any consumer who has liability under a credit contract but does not intend or expect to receive the benefit.[298]

*Recommendation 2***:** Consumer credit legislation should provide additional protections to consumers who enter into a credit contract where they receive no personal benefit – regardless of whether they are documented as a guarantor, co-borrower or borrower. Such provisions should include a cooling off period, and a requirement that the consumer is advised, and signs the documents, in the absence of the person who is to benefit from the loan.

Credit Code Coverage When Lender is an Individual

In some cases the loan was not subject to the UCCC because the lender was an individual (not a business or in the business of lending). The Post-Implementation Review of the UCCC recommended that the CCC should be amended so that a solicitor is considered to be the credit provider where the solicitor lends money on behalf of investors. This amendment would extend coverage of the CCC, however the "loophole" would still be available to brokers who wanted to arrange loans from individuals.

Recommendation 3. *A*mend the CCC by adding an additional sub-clause to Section 6 to ensure coverage of loans by individuals if commercially arranged. Section 6(e) would read:

> "the person arranging the credit arranges the credit in the course of a business of arranging credit or as part of, or incidentally to, any other business of the person arranging the credit".

Asset Based Lending and Overcommitment

The UCCC allows a consumer to apply to a court or tribunal for an unjust credit contract to be reopened. Included in a list of factors that the court or tribunal can take into account is: "whether at the time the contract….was entered into or changed, the credit provider knew, or could have ascertained by reasonable inquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship".[299]

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297 See Clause 28 of the Code of Banking Practice and Part 3, Division 2 of the Uniform Consumer Credit Code.

298 For example, see 26.1 of the Code of Banking Practice that provides some protection for "quasi guarantors" in that it states that a person will not be accepted as a co-debtor where it is clear that the person will not receive any direct benefit from the loan.

299 *Consumer Credit Code* s.70(2)(l)

The effect of this provision remains unclear, and it appears to do little to dissuade some lenders from providing credit in circumstances where it would be clear that the borrower doesn't have the capacity to pay.

Recommendation 4: The UCCC should be amended to incorporate a positive obligation on credit providers to assess capacity to pay before consumer credit is offered or accepted. This should include:

- a prohibition against making loan decisions on the basis only of the value of the security property;
- for an interest only loan, a requirement to obtain written advice from the borrower as to how the principal is to be paid; and
- an assumption that an interest only loan that requires payment of the principal in a lump sum is unjust unless the lender has made adequate enquiries and reasonably believes that the borrower will have the means to pay.

The UCCC should specify how remedies should be determined in such cases, so that it is clear that the principal (as well as interest and fees) can be reduced if payment would cause undue hardship.

Obtaining Regular Information About the Loan

The UCCC requires lenders to provide regular statements of accounts to consumers with continuing credit accounts (for example credit cards) and loans with variable interest rates (for example home loans). However, statements are not required to be provided for loans with a fixed interest rate. The research provides examples of consumers with fixed interest rate loans who may have benefited from the information provided in a statement, by (for example) confirming the "interest only" nature of the loan and providing clear information about fees and charges.

Recommendation 5: Section 31(3)(a) of the UCCC should be deleted, so that consumers with amounts outstanding on fixed interest loans receive regular statements.

14.2 Other Credit Regulation Issues

Other issues relating to credit regulation that require further investigation include:

- Whether there is a need for additional disclosure to consumers before they enter a "high cost loan";
- Whether there should be restrictions on circumstances in which interest only loans can be offered for consumer purposes;
- The high level of fees, charges and interest rates on interest only loans; and
- The extent of interest only loans and other asset-based lending practices in the consumer credit market.

The above recommendations raise a number of questions about the effectiveness of the UCCC. Unfortunately, despite various reviews of the UCCC, a number of recommendations that have been before the Uniform Consumer Credit Code

Management Committee for many years have not yet been adopted. We therefore hesitate to suggest a further review, but propose that the mechanism for reviewing and amending the UCCC be overhauled – and consideration given to whether this role should now be transferred to the Commonwealth.

Recommendation 6: Federal and State Governments should immediately instigate a review of the effectiveness of the UCCC, and the mechanism for reviewing and amending Code, in achieving outcomes for consumers with a view to an overhaul of credit regulation in Australia.

14.3 Regulation of Financial Services

Most financial services are governed by Commonwealth legislation, and are required to be licensed by the Australian Securities and Investments Commission (ASIC). These financial services include deposit-taking institutions (DTIs) such as banks and credit unions, insurance companies, financial advisors and insurance brokers. However, generally excluded from this regulation are non-DTI credit providers and finance brokers. This excludes many lenders (including solicitor lenders) and finance brokers [300] from licensing provisions and from the requirement to belong to an approved alternative dispute resolution scheme (such as the Banking and Financial Services Ombudsman).

Recommendation 7: All businesses providing consumer credit should be required to meet similar requirements to other financial services (including belonging to an approved alternative dispute resolution scheme) in addition to complying with specific consumer credit regulation.

14.4 Finance Brokers

Some of the case studies in this report highlight one of the disadvantages for consumers using finance brokers – the role of the finance broker can enable the lender to separate itself from much misleading and unfair conduct, thereby reducing the consumer's access to remedies against the lender. The most effective way to address these problems is legislation that would deem a broker to be an agent of the lender. Consumer advocates are generally in favour of this option.[301]

We would also expect to see some changes developed nationally (by State agreement) include licensing of finance brokers that would include training requirements, an obligation to obtain credit suitable for the borrower's circumstances and compulsory membership of an industry alternative dispute resolution scheme.

Recommendation 8: Introduce legislation that would deem a broker to be the agent of the lender. In the short term, urgently pursue the proposed national approach to regulation of finance brokers (including a requirement that all brokers arranging credit to be

[300] Finance brokers who provide loans with off-set accounts would have been required to be licensed, however they have an exemption from licensing on the condition that they become a member of an ASIC approved alternative dispute resolution scheme.

[301] For Consumers Federation of Australia's policy on finance brokers see http://www.consumersfederation.com/financebrokers.htm

licensed, to obtain an appropriate loan for the borrower's circumstances and to belong to an approved industry external dispute resolution scheme).

14.5 Legal Advice for Borrowers

Independent legal advice has been considered an important factor in ensuring that consumers make informed choices in relation to some forms of credit. Independent legal advice is not generally recommended or suggested by lenders, however it is often recommended where the lender believes the borrower may be at some risk (in mainstream lending this is most often the case in relation to guarantors). By suggesting that the borrower obtain independent legal advice, the lender is somewhat protected – if the borrower fails to obtain the advice, the lender can show that it had been suggested – if the borrower obtains the advice and claims later that s/he didn't understand the terms of the loan, the lender can point to the fact that the borrower had legal advice. In the latter case the borrower may have an action against the legal advisor rather than the lender.

Despite the fact that most borrowers obtained legal advice, some had a limited understanding of the key terms of the contract – particularly the most vulnerable group – the elderly, quasi guarantors. While some borrowers chose their own source of legal advice, others were referred for advice by the lender or broker.

The report raises questions about the quality and independence of legal advice obtained by some borrowers. Similar issues were raised in a NSW Law Reform Commission Report [302] on guarantor issues. The report found that some guarantors thought that they were given perfunctory advice, and that solicitors often restricted themselves to a brief explanation of the effects of documentation, and failed to indicate "whether consenting to the transaction was wise or improvident".[303] The research also raised questions about the independence of legal advice in circumstances where it was arranged by the lender.[304]

Recommendation 9: Research should be undertaken to identify the role that independent legal and/or financial advice plays in consumer credit transactions, and what factors influence the quality of the advice – including whether the quality of legal advice differs depending on whether the consumer chooses the source of the advice or whether the source is recommended by the lender or broker.

14.6 Specific Regulation of Solicitor Lenders

While the Rules of the Managed Mortgages Section of the Law Institute of Victoria are primarily for the protection of investors, they require members to comply with credit legislation for relevant contracts and to assess the borrower's capacity to repay.

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302 NSW Law Reform Commission, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales: Research Report 11*; by Lovric J, Millbank J, (2003)
303 Id, 88
304 Id, 90

Recommendation 10: The Law Institute of Victoria should review the extent to which members of the Managed Mortgages Section are complying with MMS rules, including the obligation to assess the borrower's capacity to repay.

Appendix A: Borrower survey

**** CONFIDENTIAL ****

CONSUMER CREDIT LEGAL SERVICE (VIC)
CONSUMER SURVEY – SOLICITOR LENDING 2003

About the survey

Consumer Credit Legal Service (Vic) is conducting research on lending by solicitors and law firms. We want to find out about the experiences of people who have borrowed money from or through law firms. We will use the information that we gather to write a report for the government and to argue for changes to the law and industry practice to protect consumers.

If you have used this type of finance, and would like to participate in our research, please complete this short survey and return it to Consumer Credit Legal Service at Level 1, 11-19 Bank Place, Melbourne Vic 3000 or by fax on (03) 9670 7205.

Alternatively, if you are based in Melbourne, and would like to talk about your experiences in more detail with a CCLS Researcher, please contact us on (03) 9670 5088. Interviews will be held at a time and place to suit you. We can also provide a payment of $30 to compensate you for your time in participating in an interview.

Any information that you provide will be treated confidentially.

The survey

Have you obtained a loan from a law firm, or through a law firm? Y / N

If **No**, you do not need to complete the survey.
If **Yes**, please answer the following questions.

Information about you and your household

Household composition:

Number of Adults ……. Number of children (under 18) ……..

Borrower 1 Details	Borrower 2 Details
Sex M / F	**Sex** M / F
Age …..	**Age** …..
Work status (at the time you got the loan) Full- time Part-time	Work status (at the time you got the loan) Full- time Part-time

Casual Self-employed Unemployed Pensioner (aged, sole parent, disability, etc.) Other………………………………….	Casual Self-employed Unemployed Pensioner (aged, sole parent, disability, etc.) Other………………………………….
Home postcode …………………………	**Home postcode …………………………**

Total household gross income (per year) at the time that you got the loan

…$...…………………….

Taking out the loan

When did you take out your loan? ..……..…..……..

What was the name of the solicitor or the law firm that arranged the loan?

……………………………………………………….………………………………...

What was the main reason for borrowing?
For business or investment purposes
To buy a family home
To refinance an existing loan
To pay bills or other debts
To consolidate debts
To renovate
To buy a car
To travel
Other (please specify)…………………………………………………………...

Approximately how much did you borrow?
$25,000 or less
$26,000 to $50,000
$51,000 to $75,000
$76,000 to $100,000
$101,000 to $150,000
$151,000 to $200,000
More then $200,000

Did you know how much the repayments would be under the contract? Y / N

What was the original duration of the loan? …………………………. years

Did you use your <u>family</u> home as a security for this loan?
Yes.
No – another property was used.
No – the loan was unsecured.

What type of loan did you sign?

an Interest Only Loan (**Eg**. You borrow $10,000 for 2 years. Each month you pay interest on the sum you have borrowed. At the end of 2 years you have to re-pay the $10,000 in one lump sum.)
Or
a Principal & Interest Loan (**Eg.** You borrow $10,000 for two years. Each month you pay part of that sum and interest. At the end of two years you have fully paid off $10,000 as well as all of the interest.)
Or
Don't know

When you signed the loan, did you realise that you might:
Have to pay a higher interest rate if you missed a payment?
Y / N / Not Applicable
Lose your house if you defaulted on the loan? **Y / N / Not Applicable**
Have to pay the total amount borrowed at the end (if it was an interest only loan)?
Y / N / Not Applicable

How did you first make contact with someone about the loan?
Through a broker
Responded to an ad (newspaper, radio, TV)
The law firm contacted you directly (letter or phone call)
A broker contacted you directly (letter or phone call)
Some one recommended the law firm to you
Other (please specify)
…………………………………………………………………………

Did you get any legal or financial advice about the loan? Y / N

If yes, who provided this advice?
A solicitor chosen by you.
An accountant chosen by you.
A solicitor that the lender or broker recommended.
An accountant that the lender or broker recommended.
Someone else (please specify) …………………………………………………

Details of the contract

You may find it easier to answer the following questions if you have your loan contract in front of you. If you do not have your contract please answer from your memory.

What was the normal interest rate? ….………....

What was the interest rate for late payments? …………….

What was the name of the lender on the contract?
…………………………………………………………………………………….…...

Repaying the loan

Did you miss any repayments on the loan? Y / N

If YES, what was the main reason(s) that caused you to miss payments on the loan?
You can tick more then one
Could not afford re-payments from the start
Illness
Loss of job
Reduced income
Family break up
Unexpected expenses
Could not pay the principal sum at the end of the loan period
Other (please specify)**………………………………………………………..**

Was there any legal action taken against you on this loan? Y / N

If YES, what was the outcome of the legal action?
The house was sold by the lender
There was a settlement between you and the lender
You borrowed from another lender to pay out the loan.
You have found the money to pay out the loan through relatives or friends
You sold the house
Other (please specify) ……………………………………………………….

Do you have any other comments about your loan?

………………………………………………………………………………………….

………………………………………………………………………………………….

………………………………………………………………………………………….

THANK YOU

Thank you for completing this survey. Please return it to CCLS at Level 1, 11-19 Bank Place, Melbourne or by fax on (03) 9670 7205 by 12 December 2003**.**

If you would like to talk about your experiences with solicitor lending in more detail with a CCLS Researcher, please complete the details below. We will contact you to arrange a suitable time and place for an interview. Alternatively, you can call CCLS directly on (03) 9670 5088.

Yes, I would be happy to be interviewed for the CCLS research project on solicitor lending. My contact details are:

Name: **Phone number:**

Address: **Email:**

We will keep these details confidential and will not disclose them to any other person or organisation.

More information?

If you have any questions about this survey or the interviews, or would like to know more about our research project, please contact Elena Mogilevski or Nicola Howell on (03) 9670 5088, email cclsvic@iinet.net.au **or mail Level 1, 11-19 Bank Place, Melbourne VIC 3001.**

We hope to finish our research by April 2004, and a report of our research will then be posted under "Publications" on www.ccls.org.au.

Appendix B: Interview questions

INTERVIEW

Can I have a look at your loan contract?

I just want to make sure that we will cover all details

Why did you get this loan (leading up to the loan)?

1. When did you take out this loan?
2. What did you need the money for?
   What were your circumstances at the time?
3. Can you tell me why you have borrowed through a law firm rather then other money lending institution?

Your financial circumstances at the time of the borrowing (were they communicated to the lender)

4. Were you working at the time you took out this loan?
   fulltime, part time, casual, self-employed, unemployed, pensioner
5. Were you the only borrower, or there were more borrowers?
   Ask about other borrowers
6. Did you have a Guarantor for your loan?
   Who it was details?
7. How would you estimate your total household income at that time?
8. Were you asked to provide any proof of income by the law firm, or broker?
9. Did a broker or a solicitor talked to you about your financial situation?
10. What did you tell the broker or the solicitor about you income?

How did you find the law firm (circumstances)?

11. How did you find out that this particular law firm is lending money?
12. Did you employ a broker to get you this loan?
13. Did you find the broker or the broker found you?
    If the broker found you how did he do it?
14. Tell me about this broker, how did he conduct his business?

Getting the loan/signing the documents/ terms of the loan

15. How much did you borrow?
16. From which law firm or solicitor did you borrow?
17. Did you realise that the law firm itself was not providing the money for the loan?
18. Do you know where the solicitor/law firm got the money from?
19. How long did it take to organize this loan?
20. What did you use as a security for this loan?
21. Was your loan interest only?

22. What did you understand about the contract
    - Length
    - Interest only
    - Fees
    - Interest rate
23. What did you tell the broker or solicitor was this loan for?
24. Did you sign a part of the loan document or a separate document that stated that the loan was for business or investment purposes?
25. Did broker or solicitor tell you why you needed to sign this form?
26. What was the normal interest rate?
27. What was the rate for late payments?
28. Was your house valued before the issue of the loan?
    Who did the valuation, law firm have send some one, a broker found an evaluator or you found one yourself?

<u>Did you receive any advice on the loan contract from an independent source?</u>

(Eg. from a lawyer of your own choosing, who was not working for the lender as well)

29. Who was this lawyer? What advice did he give you?
30. Did you understand it?
31. How did you find this lawyer?
32. Did you sign your loan contract in the presence of a lawyer of your own choosing?
33. Did you read the contract before you signed it?/ Why not?
34. If you read it did you understand it?
35. If you had trouble understanding did you ask questions?
36. Did you get answers for your questions in an easy to understand form?
37. Where was the contract signed, how long did it take to do all the paper work?

<u>Loan over its life</u>

38. Did you miss any of your payments?
39. What was the main reason for falling behind?
40. What happened next?
41. Did you try to get legal advice at that point?
42. Was there a court hearing?
43. What was the outcome?

<u>Impact this loan have had on you life.</u>

44. How would you rate your experience with solicitor lending?
45. Would you recommend this type of finance to someone else?
    Why not/yes?

APPENDIX C: Further examples and case studies

Case Study 1

Mavis, an aged pensioner living alone, approached a finance broker for a loan to pay off some outstanding debts. The broker arranged an interest only loan from a solicitor mortgage practice secured by first mortgage over her home. Mavis had no idea this was an interest only loan. She had no means of repaying the principal once the loan term expired, and did not realise one of the documents signed by her was a business purpose declaration. There was no direct contact between the lender or solicitor and the borrower. Consumer Credit Legal Service (CCLS) lodged an application at Victorian Civil and Administrative Tribunal (VCAT) seeking to have the contract reopened on the basis that it was unjust. CCLS argued that despite obtaining Mavis' signature on the Business Purposes Declaration, the broker knew that the loan was clearly not for business purposes. However, while VCAT found that the declaration was not in the required form, it found that it provided evidence supporting the lender's argument that it had a genuine belief that the loan was for business purposes. On that basis, VCAT found that the UCCC did not apply and the application was rejected. Mavis lost her home.

[Source: Neuendorf v Rengay Nominees P/L & Anor, decision of the Victorian Civil and Administrative Tribunal, No. M31/2001.]

Case study 2

Anne recently sought assistance from a free financial counselling service. Anne is in her 70s. Her income is the aged pension and her only asset is her home. Anne's son responded to a newspaper advertisement by a finance broker. He completed two loan applications over a period of six months to a solicitors mortgage practice, and asked his mother to sign – which she did. None of the broker, solicitor, or lender, ever met Anne. The total amount borrowed was $120,000. The interest payments on these 3-year loans were approximately equivalent to Anne's total income. Less than 12 months after the first loan was made Anne has received a default notice in relation to arrears. Anne has no way of paying the amount owing, and is at risk of losing her house.

[Source: Eastern Access Financial Counsellor-Victoria, 2002]

Case Study 3

Mrs. S was a pensioner who was in serious financial difficulties. She was facing repossession of her car by the Sheriff, as she was unable to pay a judgment debt. She contacted a finance broker who obtained finance through a solicitors mortgage practice.

This loan was arranged to pay the Sheriff as well as paying out other debts, and was secured by first mortgage over her home. The mortgage practice insisted she seek independent legal advice prior to signing the contract, and recommended she see a solicitor practising in rooms adjacent to them.

Mrs. S now finds herself with an interest only loan that she has no hope of repaying unless she sells her house, in addition to which she is being required to pay various fees that, although provided for in the terms of the contract, substantially add to the cost of the loan. The actual lender was an individual who was not in the business of lending, so the contract was therefore not regulated by the UCCC. Had the contract been regulated, Mrs. S could have challenged the high fees, and could have applied to have the contract re-opened on the basis that it was unjust. However, the outcome would have been unlikely to have saved her house.

While Mrs. S was in financial difficulty when she applied for the loan, it would have been clear that a pensioner could never afford to repay the loan, and that the new loan would worsen her situation.

[Source: Consumer Credit Legal Service]

Case Study 4

Two sisters obtained an interest only loan through a finance broker in order to allow a third sister to start up a business. It is clear the third sister exercised considerable influence over them, and neither had a realistic understanding of the risks they were incurring. The loan was for $11,000, for a term of 3 years, and was secured over property jointly owned by them.

The loan soon fell into default and the sisters returned to the finance broker to refinance the loan. Finance was obtained through a firm of solicitors operating a substantial first-mortgage practice. The second loan was for approximately $26,000, the increase being due to additional fees, unpaid interest and default charges.

The third sister's business venture failed, and the two borrowers have no chance of repaying the principle once the term of the loan expires.

[Source: Consumer Credit Legal Service]

Case study 5

Mr. and Ms. D took out a three-year, fixed interest, interest only loan for $47,500 with a solicitor mortgage practice. At the end of the three-year period they were not happy with the way this solicitor mortgage practice conducted its business and decided to refinance with another lender. This coincided with the need for them to make an urgent trip overseas in order to see a dying parent. They decided to increase their loan to $60,000 giving them $12,500 to finance their trip. Mr. and Ms. D notified solicitor mortgage practice in writing about their intention to refinance their loan with another lender, however Mr. and Ms. D felt that solicitor mortgage practice refused to recognise and co-operate with a new lender. They claimed that Mr. and Ms. D planed to extend their loan with them. Every time the new lender or their solicitor tried to communicate with solicitor mortgage practice, the solicitor mortgage practice made things as difficult as they possibly could. Mr. and Ms. D felt that as soon as solicitor mortgage practice realised that they were losing Mr. and Ms. D's business, solicitor mortgage practice used delay tactics in order to 'milk their clients'. Mr. and Ms. D believe that those delay tactics cost them $7,400, thus leaving them virtually no money for their trip overseas after they paid their airfares. Mr. and Ms. D voiced their complaint with the Ombudsman and ASIC, however their complaint was dismissed.

[Source: Information provided by survey respondent, not formally interviewed.]

APPENDIX D: Borrower demographics

Interview No	Interviewees	Group	No of loans	No of borrowers	Age (at time of interview)	Income source (at time of loan)	Personal income (at time of loan) – gross, approx	Household income at time of loan (if different) – gross, approx
1	Christopher	A	1	1	68	Age Pension	$450 f/night	
2	Heather	A	2	1	73	Age Pension	$450 f/night	$900/month
4	Ann Michael	A	1	2	A: 72 M: 77	A: Age Pension M: Age Pension		$756 f/night
6	Maria	A	2	2	61	Homemaker	Not disclosed	Not disclosed
8	Pauline	A	2	1	43	Disability support pension	$450 f/night	
9	Anita	A	1	1	68	Age Pension	$450 f/night	
16	Marissa*	A	1	1	75	Age Pension	$450 f/night	
13	Edith*	A	1	1	Deceased. Was 86 at time of loan.	Age Pension (at time of loan)	$450 f/night	
3	Phillip	B	1	2	57	Self-employed		$700-800/week
10	Jason	B	1	1	58	Self-employed	$1 million/year	
12	Fiona	B	1	1	62	Age pension + Investments	$435 f/night Income from investments not known	

Interview No	Interviewees	Group	No of loans	No of borrowers	Age (at time of interview)	Income source (at time of loan)	Personal income (at time of loan) – gross, approx	Household income at time of loan (if different) – gross, approx
14	Brian	B	1	1	62	Self-employed		$20,000 (for tax purposes)
13	Peter Angela	B	1	2	65 65	P: Self-employed (but irregular work) A: Secretary		$20,000 annually
16	Adrian	B	1	1	24	Self-employed	$40,000 annually	
5	Frank	C	2	1	42	Loan 1: Unemployment benefits Loan 2: TAC payments	$450 f/night $480 f/night	
7	Paul	C	1	1	48	Self-employed		$18,000 year
11	Margaret	C	1	2	37	Unemployment benefits		
15	Brett	C	1	1	48	Unemployment benefits + casual	$450 f/night + max $100 week	
17	Glen	C	1	2	52	Full-time work		$1,200 week
18	Carlos	C	1	2	74	Casual work		$1000 fortnight

* These borrowers were not directly interviewed.