AUSTRALIAN MORTGAGE BROKERS – CURRENT ENVIRONMENT AND THE FUTURE

Background

In the late 1980's, the Australian financial market was deregulated. New financial players entered the markets, a number of mergers occurred and competition was intense. Particularly for credit products. As a result, the lending market has had to compete vigorously for market share and this has led to the growth of alternative distribution networks. In the last ten years, the Australian mortgage broker industry has sprung up and represents a cheaper method for lenders to reach their target markets.

Formerly, Australians would go to their bank with whom they had had a relationship but the banks have closed a lot of their branches and personal banking is being conducted electronically and through the internet. In fact, it is common to conduct all personal banking without ever coming into now contact with a person. Further, consumers in Australia have become time-poor which has encouraged this form of banking. The mortgage broking industry offers a solution in the form of a method of obtaining credit without face-to-face contact, the promise of the best loan at the most advantageous terms, and at little to no expense with a possible saving.

Statistics

Statistically, in 1986 to 1987 Australians borrowed A$15 billion in housing finance from lenders who were most exclusively banks, building societies and credit unions. In 2002 to 2003, only 15 years later, Australians borrowed A$151 billion to buy, refinance or build their homes.

The Australian Prudential Regulation Authority (APRA)[1] has estimated that each bank on average currently receives loan applications from 740 brokers. The four major banks received 60% of all broker loan applications in the March 2002 quarter.[2] Credit Unions have been slower to deal with mortgage brokers having relationships only on average, with 13 and having dealt with them only for three to four years.

According to APRA, the use made by banks, credit unions and building societies of broker services is to increase and this is corroborated by the Australian Central Credit Union, Australian National Credit Union and Credit Union Australia purchasing a 8.2% share in Mortgage Choice which is one of the nation's largest mortgage brokers. As will occur to most of you, this presents an interesting issue in relation to conflict of interest.

It is estimated that 50 new mortgage brokers enter the market each week.[3] It is estimated that 2,000 broker firms operate Australia wide.[4] Although relatively few mortgage broking organisations dominate the majority of the market, there is a long tail of small operators, including sole traders.

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1 APRA "Report on Broker – Originated Lending" January 2003 page 6

2 Consumer Credit Legal Centre (NSW) March 2003, page 11; Market Intelligence Strategy Centre, "Mortgage Broking" Media Release, 17 April 2002.

3 Solomon Smith Barney, "Australia's Mortgage Market" 2 May 2001; Consumer Credit Legal Centre Op. cit. page 12

4 Market Intelligence Strategy Centre, Op. cit.

In January 2003, it was estimated by APRA that 23% of home loans were through brokers equating to A$76 billion of home loans.[5] In the report by the Consumer Credit Legal Centre (NSW) in March 2003, which was commissioned by ASIC in 2002, it was recognised that the mortgage broking industry was constituted of three broad types of intermediary. The three categories were identified as mortgage and finance brokers, mortgage managers, and intermediaries who promote "loan or debt reduction" schemes where the borrower refinances an existing home loan. There is also a fourth category where the broker solicits funds from investors and makes these available to the public as loans. These brokers have generated a number of criminal prosecutions and this type of fund raising is now strictly regulated by ASIC following amendments to the *Managed Investments Act 1998*.

Legislation

Mortgage broking as a profession in Australia is not uniformly regulated. With the exception of Western Australia and the Australian Capital Territory, there is no requirement for the registration of brokers nor for positive licensing. It is therefore, impossible to know how may mortgage brokers are operating or to track them around the country should they decide to move from State to State. I will, for the purposes of this paper, be concentrating on the regime in place in New South Wales, which contains the majority of mortgage broker activity.

The Act which principally governs the activities of mortgage brokers is the *Consumer Credit Administration Act (NSW) 1995* which was amended to include finance brokers on 1 August 2004. The Act governs the activities of finance brokers who are defined as persons who engage in finance broking. A finance broker is defined as a person who:-

> "acts or purports to act, as an intermediary to negotiate and obtain consumer credit for a person….. in return for a commission or financial benefit, whether payable to the intermediary by the person, the credit provider or any other person or body."

The Act will therefore, only govern the activities of finance brokers where they are purporting to negotiate and obtain consumer credit. "Consumer credit" means credit to which any consumer credit legislation applies, which principally includes the *Consumer Credit (NSW) Act 1995* (including the *Consumer Credit (NSW) Code*).

The Consumer Credit Code took 10 years to eventuate. It is template legislation and has been adopted from the Queensland legislation by New South Wales. It regulates the credit contract, including the conduct of lenders, borrowers and by the *Consumer Credit Administration Amendment (Finance Brokers) Act 2003*, from 1 August 2004, mortgage brokers where the credit is provided or intended to be provided wholly or predominantly for personal, domestic or household purposes[6].

Credit for the purpose of investment is not to be taken as credit provided for a personal domestic or household use. It is possible for a broker to exempt the application of the Code by having the borrower sign a business purpose declaration in the credit contract. This possibility is enshrined in section 11 of the Code which provides that:-

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[5] APRA Op. cit. page 2
[6] s6 (1)(b) Consumer Credit Code

"Presumptions relating to application of Code

11 (1) [Code presumed to apply] 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.

(2) [Debtor's declaration as to purpose] 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).

(3) [Credit provider's knowledge as to purpose] 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 brokers) through whom the credit was obtained."

Sub-section 3 has the effect that where the business purpose declaration is signed by a borrower but the borrower can prove that the mortgage broker had reason to believe that the credit was for a personal purpose, that the Code will have application to the contract. In practice it is very difficult for a borrower to prove what was in the mind of the broker at the time of entering into the contract and the Courts have been reluctant to go behind investment purpose declarations[7].

If the Code applies, the Consumer Trader and Tenancy Tribunal has power to make any order it thinks reasonable and proper, which includes the broker paying a specified amount.

There is no provision in the Code that allows the Tribunal to award compensation to a borrower as a result of the breaches of a broker although there is such a provision against lenders[8].

If the Code does not apply, the borrower must sue the broker for breach of agency agreement in the courts. This will not have the effect though, of re-opening the credit contract against the lender. The best the borrower can hope for is that he or she will be upheld and that dependant on the breach, the measure of compensation will be that they will be placed in the position they would have been in, had the contract been performed. This would usually have the borrower client still as a borrower with a loan to repay though perhaps on different terms. The present situation is that it is difficult for a borrower to prove breach of agency, or that the agent was acting outside the terms of the agency where the broker has no contract. This is particularly so where the loan application is signed by the borrower.

The borrower, in order to re-open the contract against the lender must sue under the Contracts Review Act 1987 (NSW) and in order to do this, must surmount the hurdle that by appointing an

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[7] Taylor and Another v. Third Szable Holdings Pty Ltd (2001) ASC 155-050
[8] s 107 (1) Consumer Credit Code

agent in the form of the mortgage broker, he or she has had the benefit of equal bargaining power with the lender.

It is obvious that the new market and the lag in or lack of, legislation, has provided lenders with lesser liability and decreased costs than they had prior to the entry of mortgage brokers into the market. They are able now, to be less diligent in their vetting of potential borrowers due to the agency relationship between the broker and the borrower and therefore, have both the benefit of a performing loan in the event the borrower can pay, and recourse to the security in the event of default. All with the lesser potential for the loan contract to be overturned by the courts.

Mortgage brokers provide a convenient buffer to liability.

At the same time, mortgage brokers have little regulation to fear-not even the removal of their licences, because they don't have any-nor do they have need of training, registration, a compulsory association membership, a compulsory professional indemnity insurance policy [unless they want to remain a member of the professional association] or even a contract with the client borrower where the loan is for investment purposes. If a lender decides that they are not providing well performing loans, the lender stops using the broker and the broker moves on to another lender.

Survey and Case Studies

In 2002, the Consumer Credit Legal Centre in NSW was commissioned by ASIC to compile a report on the finance and mortgage broker industry. The report was delivered in March 2003. The report gathered data from a survey of mortgage brokers and from case studies.

The survey revealed that 11% of brokers did not compare credit products. 54% had a contract with their client borrowers, of this 54%, 73% advised that the agreement addressed the amount of credit and type of loan being sought and 51% specified the interest rate requested by the borrower client.

The Code does not require that the broker provide the client borrower with a statement why a particular loan product is recommended nor does it provide that advice in the form of a statement of recommendation must be given to the client borrower. Brokers who may be paid commission from the lender on a volume basis therefore may direct all client borrowers to the one lender or may indeed, have only one lender on their panel.

Likewise, where no commission is paid by a lender and the broker therefore must rely solely on the borrower client for payment, it is unlikely that these lenders will get any business from the broker. Some brokers are paid both by the client and by the lender in the form of an upfront commission and then a trailing commission. The trailing commission is paid to the broker for as long as the loan performs but is of limited percentage. There is little incentive in the trailing commission for the broker to ensure that the load is sustainable.

Some of the types of scenarios that the Legal Centre recounted were:-

1. Interest only loans to inappropriate client borrowers.

   Mrs M is an aged pensioner. Her only income is the pension and she struggled to meet her basic living requirements. She is poorly educated, has difficulty reading and writing and lives in the country. She had a debt to legal aid for divorce and custody proceedings, which she wanted to repay. She owned her home, which was valued at

$40,000. She wanted to consolidate her debts. She saw an advertisement in the paper which stated "no credit checks" and "loans up to 90% of valuation". She rang the broker and gave some details over the phone. She then went to the broker's office with a friend. The broker told her he could get her a loan of $24,000 secured over her home. He gave her the loan document and the mortgage. Her friend suggested that she take them to a solicitor but the broker said that if she wanted the loan she would have to sign immediately which she did. She asked how long the loan was for but was not given an answer. It turned out that the loan was for interest only for the first year and that the principal had to be repaid in 12 months. The interest rate was 13%, and the broker was to receive a procuration fee of $1500. Mrs M met the monthly repayments but when the time came, was unable to pay the capital of $24,000. She sought legal advice and was advised to sell her home.

2. The Code enables the broker to charge a commission notwithstanding the loan agreement is not completed.

Ms O and her partner arranged for a broker to visit them at home to discuss options for refinancing her home loan. The broker advised Ms O that he would be able to find them a cheaper loan, and so they signed the agreement that day. They did not read it before signing it and the broker did not explain it to them.

The broker subsequently contacted Ms O and sent her documents to sign to enter into a new loan to refinance her home loan. When she examined these documents she decided not to go through with it as it was not cheaper and she did not believe she would be able to meet the repayments. The broker is now pursuing her for a $6000 brokerage fee.

3. Fraud

The report of the Consumer Credit Legal Centre noted that the shift in responsibility for the preparation of the loan application from persons such as bank employees to brokers has seen a shift from applying proper risk assessment to lesser risk management due to the incentive by the broker to earn commissions through having the loan approved.

Soft fraud is occurring where the broker manipulates or camouflages the borrower client's circumstances such as by not describing liabilities, reducing the number of dependants or inflating the value of assets. Sophisticated fraud is where the broker creates a fictitious person and then steals the money.

It is stated by the Consumer Credit Legal Centre that this type of fraud accounts for 3.2% of frauds committed against financial institutions. Professional indemnity insurers have, the report says, refused to insure valuers in respect of transactions with identified particular lenders with lax lending practices.

Mr H had recently been retrenched and was approached by a broker he formerly knew from working with a lender. He was told that the lender was stealing his money. Mr H had recently purchased an investment unit off the plan. The completion time was approaching. The broker told him that he could refinance his existing loan and get finance for the purchase price of the investment unit. Mr H filled in the loan application but the broker arranged for false documents to accompany the application including doctored bank statement, a false employment reference which suggested that Mr H was employed in sales and that he was earning over $80,000 in commission annually. The loan was approved.

Where the borrower submits a loan application containing fraudulent information, the application is invariably signed by the borrower, so establishing that the false details were included without the borrower's consent or knowledge will be extremely difficult.

There were several other case studies demonstrating the practise of equity skimming by refinancing existing loans substituting a loan of no better result but with the broker's charges having the effect of eroding the equity in the borrower client's house. There were other instances where the broker required the payment of up front fees before putting in the loan application then the broker disappearing. There were also incidences of the lodging of the loan application but it not being successful and the broker still charging significant fees.

The Consumer Credit Legal Centre's report was then followed by the Discussion Paper of the NSW Department of Fair Trading in 2004/5. This Paper advanced options for the regulation of mortgage brokers in Australia. The Discussion Paper will be considered together with industry submissions in reply at the end of 2005 by the Ministerial Council on Consumer Affairs. This council is constituted of voting members from the States and Territories and the Federal Government is an observer only.

Options for the regulation of the mortgage broking industry

Several options are advanced by the Department but not encouraged. The option which receives the most support is that of broker specific regulation in each state and territory using the template model.

The features of the scheme as advanced are:-

1. The legislation is to cover not just personal credit but all credit so as to prevent broker avoidance of legislative requirements. The only credit to which it would not apply is where the applicant is a business entity which employs more than 100 people if it is a manufacturing business. If it is not a manufacturing business the legislation will not apply where the business entity employs more than 20 people. The legislation would also not apply where the credit sought is for an amount of more than A$2M.

2. The definition of broker would be the same as in the newly amended NSW legislation being:-

   > "a person who acts, or purports to act, as an intermediary to negotiate or obtain credit for a person (other than the intermediary's employer, or a principal who is not the client of the intermediary) in return for a commission or financial benefit, whether payable to the intermediary by the person, the credit provider of any other person or body."

3. There would be positive licensing which would include checking a person's record and excluding undesirable individuals from legitimately entering the market. Also, to prevent migration of fraudsters. An Alternative Dispute Resolution scheme is recommended to follow the licensing regime together with a responsibility in the licensee for the training of employees.

4. Brokers/employees are to complete a training course/s assessed by an authorised assessor and listed on the ASIC training register. Alternatively, advisers with at least 5 years relevant experience over the immediate past 8 years are to be individually assessed.

5. As contained in the NSW amendments to the Code in relation to finance brokers, there would be a requirement that the brokers enter into a written contract with the borrower client before commencing the broking and that the contract state the details of the brokers access to credit providers [how many and who] as well as documenting the credit required by the borrower client.

6. An addition it is proposed, that the borrower client be provided with a statement of reasons setting out why the credit product recommended by the broker is the most appropriate product for the borrower client's circumstances. This would require that the loan be suitable for the client borrower.

7. Offences be created where certain requirements are contravened and compensation be available where these contraventions cause the client borrower to suffer loss.

8. A stay of proceedings be available where the client borrower has legal proceedings against a broker for compensation or damages to prevent the client borrower's house being sold.

9. Professional indemnity insurance to ensure that compensation is payable. It is noted in the Paper that there are 6 underwriters offering coverage and that they were being educated about the risks involved in insuring brokers and lowering their premiums as a result. It is recommended that coverage be for work that the broker undertakes regardless of the name given to it, that the cover be for breaches of contract, The Trade Practices Act where the claim could also be made in negligence, that continuous coverage be provided and compulsory run off cover for about 6 years. Also that the coverage extend to decisions of the ADR scheme.

10. It is proposed that there be membership of an ADR scheme approved by ASIC.

Commentary

The UK system has similar features and I understand that recently, the Financial Services Authority has come to regulate the industry. The UK regulation requires that brokers have to be:-

1. Licensed.

2. Must advise whether they are acting on an execution basis only or providing advice and if the latter, provide details of the number of lenders and credit products reviewed prior to making the recommendation.

3. Required to assess whether a loan secured by mortgage is appropriate for the borrower client and if so further consider what type of loan is suitable and meets the client borrower's circumstances.

The options proposed by the NSW Department of Fair Trading for the States and Territories are more stringent than this. There is for instance no scope for the argument by the broker that he or she has been appointed to act on an execution basis only. The Department of Fair Trading is of the opinion that there is no substance to the claim that brokers habitually provide an 'execution only' service and that for the majority, advice and recommendations are provided to the client borrower.

The recommendations contained in the Discussion Paper are primarily to correct the behaviour of rogue and fraudster brokers who target the poor, desperate and naïve. By definition, the defrauded or gullible, are unable to commence proceedings to recover their losses either against the brokers or the lenders. This is why an ADR scheme, whose decisions are covered by professional indemnity insurers who in turn are subject to the various legislation that governs their products, is advanced as an option.

What is not discussed in the Department Paper, is that such insurance traditionally does not cover penalties and therefore, the client borrower will as always, have to rely on a claim for compensation against the broker to derive the benefit of any insurance monies. Such claims for compensation are usually out of scope of the various ADR schemes. Hence, the same barriers to the borrower client will exist as prior to the legislation, that is, the inability to access resources to conduct litigation against the broker and the need to prove breach of agency.

If this is correct, the claims litigated against brokers they remain as infrequent as they are now.

There has been a considerable reaction to the Department of Fair Trading Discussion Paper from the mortgage industry in Australia, which is anxious to ensure that the reputable brokers are not disadvantaged in the market by the disreputable. It is in their interests to ensure an even playing field. What is clear is that within the next 2 years, some form of uniform regulation consistent with that now regulating those industries providing a financial product, will eventuate. It is notable that the underwriters of the mortgage broking profession have not been requested to participate in this process. The risk will therefore, have to be assessed by those underwriters in the light of the changes after they are introduced, and it may be that the existing underwriters will no longer be interested or conversely, there may be increased interest, depending on projected claims activity.

Author Linda Hamilton

Date 18 July 2005
Address Curwood & Partners
Level 11, 1 Castlereagh Street
Sydney, NSW 2000
Phone 61 2 9231 4166
Facsimile 61 2 9221 3720