LENDERS'

MORTGAGE INSURANCE

&

SHORTFALL DEBT

Ian Macdonald
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LENDERS' MORTGAGE INSURANCE
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1.1 What is Lenders' Mortgage Insurance

Lenders' Mortgage Insurance, which I shall refer to as LMI, is an unusual form of insurance in which a borrower pays the premium for the insurance, but the lender derives the benefit. The normal structure of an insurance contract is that the person who wants the cover, the insured, pays the premium, and gains the benefit of the policy if a loss within the terms of the policy occurs (1).

The way LMI works in practice is that if a borrower has less than a 20% deposit for a purchase of property, the lender may seek some security beyond a mortgage of the property concerned. This may take the form of a guarantee from a parent or family member, who gives security over their own property, or it may take the form of LMI.

If the borrower gets into financial difficulty and cannot pay, the lender can sue under the terms of the mortgage, get a judgment, take possession of the property and sell it. If there is a shortfall, the lender claims under the LMI policy. The LMI insurance company is likely to pay out the lender, then sue the borrower. The borrower may feel it is unjust that they have been required to pay the premium, the lender gets the benefit of the insurance, then the LMI insurer sues them to try to get back what they have paid out. A borrower who has lost a home, and is then sued for the shortfall, may feel there is little alternative other than to become bankrupt, and start again with a clean slate.

1.2 The Morality of LMI

As we have seen, borrowers required to pay LMI premiums, and then being sued by the LMI insurance company may feel they have had a very bad deal. It is like paying somebody to shoot you. Is LMI iniquitous?

1.3 Arguments For LMI

The main argument in favour of LMI is that it allows borrowers to borrow a larger sum than a prudent lender would otherwise agree to lend. Traditional bank lending was limited to 60% of the valuation of the property. In the past, keen borrowers would borrow as much as they could on first mortgage, and then go to a second tier lender such as a finance company to get a second mortgage to "top up" to the purchase price. This was normally at a higher interest rate. With an LMI backed mortgage of the full amount, the whole loan is at a lower interest rate. This is a saving for the borrower. Another advantage of LMI is that it does not involve friends or family members of the borrower, unlike a guarantee. A guarantee can be an alternative to LMI for a borrower wishing to borrow a large amount, but it can be disastrous for the guarantor. There have been many cases of parents or other family members at risk of losing their own homes due to having given a guarantee for a child or other family member.

1.4 Arguments Against LMI

Apart from the general unfairness argument considered above, there are two principal arguments against LMI. The first is that it runs counter to the principles of responsible lending. A lender is forbidden from entering a credit contract if the contract is unsuitable. A contract is unsuitable if it does not meet the borrower's requirements and objectives, or if the borrower is unlikely to be able to comply with the financial obligations under the contract, or can only comply with substantial hardship (2). To push the borrower's borrowing capacity to the point at which the lender thinks a safeguard like LMI (or a guarantee) is necessary may be seen as an admission that the lender has doubts that the borrower can pay in accordance with the contract. The second argument against LMI is that it has the tendency to inflate housing prices, and the level of household indebtedness in the nation. Australian households are carrying a heavy burden of indebtedness. Households in which the owner has a mortgage, and is in the age range of 25 to 44 years are likely to be over-indebted, according to the Australia Bureau of Statistics (3). Enabling higher borrowing levels facilitates over-indebtedness, creates barriers to entry into home-ownership by raising prices, and increases the fragility of a major part of the Australian economy.

2. Default

2.1 What Is Default?

In the context of a credit contract, default is a failure to pay money when it is due. A credit contract will usually define “events of default” which can lead to enforcement action under the contract. The credit contract or mortgage may also define other events such as failure to insure the property as events of default.

2.2 Enforcement Only if Default

It is vitally important, when acting for borrowers, that a lender can only take action against a borrower if the borrower is in default. A lender may become nervous if the value of the mortgaged property has fallen sharply, and watch the situation closely, however the lender is prohibited from taking action under a mortgage unless:

* the borrower is in default under the mortgage;
* the lender has given the borrower a default notice complying with the requirements of subsection 88 (3) of the National Credit Code; and
* the default has not be remedied within 30 days from the date of the notice, or such longer time as the notice specifies.

A lender wishing to take enforcement proceedings must serve a valid default notice and wait until the 30 days has expired. At any time during this 30 days the borrower has the opportunity to rectify the default. A lender which takes enforcement proceedings in contravention of section 88 of the Code commits a criminal offence (4).

2.3 Bankruptcy Is Not Default

Section 302 of the Bankruptcy Act 1966 (Commonwealth) makes void any provisions in a mortgage or similar document which purports to allow the lender to take action under the mortgage if the borrower becomes bankrupt or enters a personal insolvency agreement. This means that a borrower who can pay the mortgage but not other debts can become bankrupt, but continue to make the mortgage payments. A borrower

might do this if there is little or no equity in the property, in the hope of being able to buy the equity from the trustee after bankruptcy. The borrower must understand clearly that becoming bankrupt means the house vests in the trustee.

The borrower should also be warned that if they buy the equity from a trustee in bankruptcy, they must:

* pay stamp duty on the unencumbered value of the property transferred to them (7); and
* pay the costs of the bankruptcy trustee (8). This warning must be in writing, to avoid any misunderstandings.

2.4 Exceptions To The Default Notice Requirement

There are some exceptions to the requirement that a default notice be served. These are:

* if the lender reasonably believes it was induced by fraud on behalf of the borrower to enter the contract;
* the lender has made reasonable attempts to locate the borrower, but without success; or
* the court authorizes the lender to begin enforcement proceedings.

If the lender reasonably believes the default cannot be remedied, the default notice need only specify the default. However, the lender must still wait thirty days after the date of the notice (s. 88 (5) and (6)).

3. Judgment

3.1 What Is A Judgment?

A judgment is the determination of a court in legal proceedings. Usually civil proceedings about a credit contract are commenced by a plaintiff, perhaps a lender, suing a defendant, a borrower, in a court. Action under a mortgage is commenced in the Supreme Court, because it has jurisdiction in matters of land title. When the court

has heard the matter, or if there is a default judgment because the defendant does not defend the proceedings, the court pronounces a judgment that ends the matter. In assisting borrowers who have been in default under a credit contract, it is important to find out if a judgment has been entered in the court. This is because a judgment limits the options which a defaulting borrower has.

3.2 Judgment and AFCA

The rules governing AFCA, the Australian Financial Complaints Authority, have a number of mandatory exclusions - that is, categories of complaint which AFCA must exclude unless all parties to the complaint, and AFCA, agree to AFCA considering the complaint. One is a complaint that has already been dealt with by a court, unless the person making the complaint has requested a stay on the execution of a default judgment on the basis of financial difficulty, and the lender has declined the financial difficulty request. What this means is that once a court has entered judgment, the merits of the matter cannot be considered by AFCA, but only the way the judgment is enforced.

3.3 Significance for Borrowers

When dealing with borrowers in default under their mortgages, it is vital to find out straight away where the matter is up to. If a judgment has not yet been entered, a borrower can make a complaint about the loan or the lender: for example, arguing that the lender did not comply with responsible lending laws. If judgment has been entered, it is too late for that. All a borrower can do is to argue about financial difficulty, and get some leeway in the enforcement of the judgment.

4. Options For Dealing With Shortfall Debt

4.1 Where Are Things Up To?

As discussed in section 3 of this paper, one of the main factors determining the options open to borrowers in default is just where things are up to. If the lender has sued and obtained a judgment against the borrower, it is a matter of ways of managing the judgment debt. If judgment has not yet been entered, the borrower has the option of

lodging a complaint with AFCA. Once this has been done, the lender cannot continue with legal proceedings against the borrower until the complaint has been dealt with (5). This gives the borrower the opportunity to make a complaint about the lending process, for example if there has been a breach of responsible lending rules, or if the borrower wants to seek a hardship variation to the contract.

5. Options If Judgment Has Been Entered

5.1 Process With Judgment Enforcement

A lender which has LMI insurance is likely to sue and get a judgment, and at least make a demand on the borrower. Its LMI policy may require it to do this, before making a claim on the LMI policy. After this, the defaulting borrower (now a judgment debtor) is likely to receive a demand from the LMI insurer.

5.2 Bargaining With LMI Insurer

At any point in the judgment enforcement process the debtor can seek to negotiate or bargain. It is necessary to tell a borrower who is a judgment debtor that this is a rather one-sided process, in that the judgment creditor can use all the resources of the Civil Judgment Enforcement Act 2004 (WA).

5.3 Civil Judgment Enforcement

The main enforcement processes are the property (seizure and sale) order (PPSO), which enables the judgment creditor to seize and sell a wide range of the debtor's property, and a means inquiry. A PPSO enables the sheriff (acting through a bailiff) to seize and sell the debtor's interest in:

* real estate - land and houses;
* personal property - chattels - such as vehicles, boats, caravans;
* business equipment other than protected tools of trade;
* household equipment, other than a small range of protected household goods.

A sheriff comes to real estate and personal property as it is: that is, the sheriff cannot take leased goods (or land) because it does not belong to the debtor. Real estate or personal property subject to a mortgage is only valuable, and able to be sold, if there is a worthwhile amount of equity.

The other popular way of civil judgment enforcement is to summon the debtor to a means inquiry. This can lead to a time for payment order, an instalment order, or in some circumstances an earnings appropriation order. There is a paper called Bailiff Powers and Civil Judgment Enforcement on the FCAWA website which gives details of the civil judgment enforcement process in Western Australia.

5.4 Laying Out A Plan

With the reality of the civil judgment enforcement processes available to the judgment creditor in mind, it is desirable then to lay out a plan for the judgment debtor to deal with the debt.

5.5 Considering Desirability of Bankruptcy

In order to lay out an effective plan for dealing with a shortfall debt, it is necessary to weigh up the desirability of bankruptcy for the particular client. Even if the client does not wish to become bankrupt, it is necessary to explore this possibility. One consideration is that the client may be forced into bankruptcy by a creditor's petition. To check the pros and cons of bankruptcy for a particular client, the Bankruptcy Checklist on the FCAWA website is useful. If bankruptcy may pose a problem for a particular client, the option of a Part 1X Debt Agreement, or a Part X Personal Insolvency Agreement can be examined. In evaluating the suitability of different options for a person who has been wrestling with financial difficulty for some time, it is particularly important to check if the client has incurred debt recently without having any reasonable prospect of paying it. If so, it is desirable at least to defer bankruptcy for as long as practicable, if not to avoid it altogether. Conduct which becomes a criminal offence if the person becomes bankrupt usually has a time limit attached to it. For example, incurring debt without a reasonable expectation of being able to pay it,

or gambling offences, are limited to the period of two years preceding the bankruptcy (6)

5.6 Preparing For Hard Bargaining

Having considered the implications of bankruptcy for the client, it is then time to prepare for hard bargaining with the creditor. If bankruptcy is not of great concern to the client, the bargaining can be quite firm: an offer of modest payments over a limited period of time, in amounts the client can afford, and would prefer to make to avoid bankruptcy. At the outset you can be clear that if your reasonable offer is not accepted, the client will petition promptly. If bankruptcy does pose a problem for the client, for the sort of reasons mentioned in 5.5 above and the Bankruptcy Checklist, a more conciliatory tone may be needed. However, if the sort of risk which makes bankruptcy a concern for the client has a time component, like the two-year period of concern relating to gambling or taking on credit with no reasonable prospect of paying, the client may consider a strategy which seeks to keep the creditor at bay until the two years has passed.

5.7 Consider Use of AFCA

As mentioned in paragraph 3.3 above, AFCA is of use to borrowers against whom a judgment has not been entered, if they wish to challenge the lending decision, or some other aspect of the lender's conduct. If a default judgment has been entered, the borrower can use AFCA if they are suffering financial hardship due to judgment enforcement. These potential uses of AFCA need to be borne in mind in preparing for hard bargaining.

5.8 Achievable Long-Term Goal

Clients who have lost a house, or several houses, and are left with a large shortfall debt may be quite shaken, and unsure of themselves as they grapple with the misfortune that has befallen them. They may feel pressured to make unrealistic offers. Unless a client has a particular reason for wishing to avoid or defer bankruptcy, as

mentioned in 5.5 above, then it is wise for the client to insist on any deal relating to paying a shortfall debt meets the following criteria:

* the payments must be affordable, in the light of the client's capacity as tested by a thorough income and expenditure statement;

* the payments should be limited to a defined and relatively short period, for example three years, or five at the most;

* the agreement must make it clear that the defined series of payments is made in full and final settlement of all liability of the client to the creditor - that is, no other interest or costs can be added;

* it is desirable to be wary of any clause which provides that if the client misses or is late in making any payment, the agreement is at an end, and the creditor is at liberty to enforce the judgement. Unless the client has some spare financial capacity to ensure payments are met reliably, the client runs the risk of making a series of payments for two or more years, then being obliged to become bankrupt due to a missed payment, which may be for a perfectly legitimate reason, such as illness or unemployment.

6. Planning For Bankruptcy

6.1 Avoid Accumulation of Assets

When a person becomes bankrupt, all of their assets other than the range of property protected by section 116 of the Bankruptcy Act 1966 (Commonwealth) vests in the trustee in bankruptcy. There are two important things to consider about this. The first is that a debtor should be warned not to dispose of any property in anticipation of becoming bankrupt.

6.2 Do Not Dispose of Assets Prior to Bankruptcy

It is necessary to be very firm with a client planning bankruptcy who may think of concealing or disposing of property. It is necessary to warn that person in writing that

disposing of, or creating a charge over any property with intent to defraud creditors in the twelve month period before the presentation of the petition by virtue of which that person became bankrupt is an offence punishable by imprisonment up to five years (9). Because this subsection creates a period of twelve months before the presentation of a petition on which the person becomes bankrupt, a client who has disposed of property must avoid bankruptcy and any steps prior to bankruptcy for at least that period of time. Even after that time, a disposal of property at any time prior to bankruptcy is void as against the trustee in bankruptcy if the main purpose was to prevent the property from being available to creditors (10).

6.3 Do Not Buy New Divisible Property

The income a person earns during bankruptcy does not vest in the trustee in bankruptcy (11). While the bankrupt has money, for example in a savings account which has been built up during the period of bankruptcy, it does not vest in the trustee. However, if the bankrupt uses the money to buy non-protected property, for example a block of land, the block of land vests in the trustee as after-acquired property (12).

6.3 Acquiring Motor Vehicles

Vehicles, or property used by the bankrupt for transport up to the value of $8,000 are protected in bankruptcy (13). This refers to the equity in the vehicle. A vehicle worth $20,000 upon which is secured a loan of $30,000 will not be disturbed by bankruptcy, because there is a negative equity of $10,000. A leased vehicle is not disturbed in bankruptcy because the bankrupt lessee does not own it. If a person becoming bankrupt has a vehicle of low value, and during the bankruptcy it becomes unserviceable and the bankrupt acquires another vehicle worth no more than $8,000 it is also protected. This is because although after-acquired property vests in the trustee, this does not include protected categories of property: Bankruptcy Act s. 58 (6).

6.4 Bankruptcy and Superannuation

The interest of a bankrupt in a regulated superannuation fund, and lump sum payments made to the bankrupt from such a fund **on or after** the date of the bankruptcy are protected in bankruptcy (14). If the person planning bankruptcy has received a lump sum from a superannuation fund before bankruptcy it is not protected. It is just money, and will vest in the trustee. Such a person may think of putting the money back into the superannuation fund. However, this runs into the difficulty that a superannuation contribution made to defeat creditors is void as against the trustee in bankruptcy - section 128B - Bankruptcy Act. If a person has received a lump sum from superannuation and is not bankrupt, the best path may be to seek to negotiate with creditors a pro rata payment to them in full and final settlement of the debts. If some creditors were resistant the person could consider the alternatives of a Part 1X or Part X agreement.

While it is true that a lump sum payment into a superannuation fund by a person who subsequently becomes bankrupt is void as against the trustee, small and regular payments eg: the same modest figure each payday do not attract this provision - section 128B (3).

6.5 Pay Rent & Utilities

There is a section in the Bankruptcy Act, section 122, which makes void as against a trustee in bankruptcy a payment to a creditor which has the effect of giving that creditor a preference over other creditors. This relates mainly to unusual or one-off payments of a substantial amount made as a result of pressure or threats by a particular creditor. Question 36 of the Statement of Affairs is designed to elicit this. However, subsection 122 (2) (a) provides that this rule about preferences to creditors does not apply to payments made in good faith and in the ordinary course of business to a payee who gave appropriate consideration for the payment. Payment of rent and utilities fall into this category. Accordingly, it is good planning for a debtor intending to petition in bankruptcy to have all these payments up to date. It has the benefit of avoiding the possibility of eviction or the cutting off of services due to non-payment.

6.6 Personal Development and Qualifications

A person who becomes bankrupt may have been used, for some time, to juggling their available income to try to meet the demands of creditors. Bankruptcy, by removing those demands, may leave the bankrupt with free income, after any contribution from income that must be paid. A bankrupt may ask what they can do with spare income, if any non-protected property will vest in the trustee as soon as it is acquired. One answer is that bankrupts can use their newly unencumbered income to follow personal development, education or training to gain new skills or qualifications. This may equip them better for life after bankruptcy.

Ian Macdonald
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NOTES:

1. Prudential Insurance Co. v Commissioner of Inland Revenue [1904] 2KB 658
2. National Consumer Credit Protection Act 2009 s. 133
3. Australian Bureau of Statistics: Household Income & Wealth, Australia 2015-16 [6523.0]
4. National Consumer Credit Protection Act 2009 -
   National Credit Code - s. 88 (2) (d) and Crimes Act 1914 (Commonwealth) s. 4AA - 50 penalty units - A unit is currently $210.
5. AFCA Rules A.7.1 (October version)
6. Bankruptcy Act 1966 (Commonwealth) ss 265 (8) and s. 271
7. Duties Act 2008 (WA) s. 10 and S. 108
8. Bankruptcy Act 19666 (Commonwealth) s. 109 (1)
9. Bankruptcy Act 1966 (Commonwealth) s. 266 (3)
10. Bankruptcy Act 1966 (Commonwealth) s. 121
11. Re: Gillies; Ex Parte Official Receiver in Bankruptcy v Gillies 115 ALR 631
12. Bankruptcy Act 1966 (Commonwealth) s. 58 (1) (b)
13. Bankruptcy Act 1966 (Commonwealth) s 116 (2) (ca)
14. Bankruptcy Act 1966 (Commonwealth) s. 116 (2) (d)