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Debt reduction schemes: Guiding your client through the pitfalls

By Carolyn Bond, Consumer Credit Legal Service, Melbourne

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If any representation is being made to a customer that involves a comparison (in years or dollars) between the customer's current situation and another product or plan, the comparison should be based on the same monthly payments being allocated to the mortgage.

If there are any savings arising for other reasons (for example a lower interest rate), the broker should clearly apportion any claimed "savings" between savings arising from making increased payments towards the mortgage and savings arising from other factors.

Upfront promises and fancy presentations can dazzle some consumers into believing that they can magically pay off their home loans sooner. As Carolyn Bond writes, this is an area where brokers have an especially vital role to play in looking after the interests of their clients.

As home loan players race to secure greater shares of the mortgage market, the risk of clients being on the receiving end of over-enthusiastic marketing campaigns naturally increases. And perhaps nowhere is this more the case than with mortgage reduction schemes.

Clients at risk

Consumer advocates would usually welcome any initiative that promised to reduce the debt burden on Australian families. However, there is now increasing concern about the promotion of some mortgage reduction schemes and line-of-credit mortgages by some lenders and debt reduction firms - concerns that brokers need to be well aware of.

Marketing campaigns that stress the advantages of such schemes without clear explanation of circumstances in which they can be disadvantageous can often lead clients to believe that great savings can arise from line-of-credit mortgages, or offset accounts. However, some of the industry advertising and mortgage reduction plans that have been reviewed by the Consumer Credit Legal Service (CCLS), show that the savings claimed are predominantly (if not entirely) a result of paying more towards the mortgage.

The end result of these marketing techniques for some clients is a more expensive mortgage product, or added costs of unnecessary refinancing. In some unfortunate cases, the borrower's home is put at risk due to the inappropriateness of a line-of-credit mortgage for the particular client. Those paying for a debt reduction plan can also be an extra \$5000 out of pocket.

Some companies target clients with cold-calling and high-pressure sales techniques, while charging high fees for so-called debt reduction services. Clients who then choose not to proceed with the plan (or the refinance) can find themselves pursued for thousands of dollars in fees.

While these tactics have not generally been associated with traditional mortgage brokers or lenders, these sectors have played a role - in some cases an inadvertent one - in the promotion of these schemes, either by inappropriate promotion of loan products or by making finance available through debt reduction operators without questioning the sales methods.

Using a line-of-credit

The advantages for client of paying salary into a line-of-credit mortgage are often exaggerated. Comparisons are made between the client's current situation and the debt reduction plan (or new mortgage product). In all cases that CCLS has inspected, the amount allocated to the mortgage each month is greater under the debt reduction plan than the borrower is currently paying. However, this increase in payments is not pointed out, and is often hidden in a presentation that hides the mortgage contribution in an (often complex) income and expenditure plan.

CCLS lodged a complaint with ASIC last year about Westpac's advertising. The advertisement claimed that borrowers could save \$69,610 using the Rocket home loan and offset account. However, CCLS calculations showed that the monthly payment on the standard home loan in the example was about \$995, where the monthly amount accumulating in the Westpac product was \$1,238. We claimed that almost all the savings were due to higher mortgage payments - not the advertised product.

In November last year, ASIC said it was concerned that representations in the advertising could have been misleading, and Westpac agreed to suspend and amend the promotion.

As it now stands, the banks have got the message, but some players continue to use this type of marketing, particularly in relation to line-of-credit mortgages.

Refinancing other debts

In some cases the plan involves refinancing other debts, and it may initially appear that total debts will be finalised sooner without any increase in monthly payments.

The problem here is that a comparison is only made with current debt payments. In fact, most clients who have a number of debts will find that as each debt is paid off over the years, monthly debt payments will decrease. Clients may benefit from maintaining the same level of monthly payments as debts are finalised. Such a strategy could bring about a similar outcome to the proposed refinance, without the costs of refinancing.

What brokers should do

There are many reasons why borrowers may wish to refinance a mortgage, use a line-of-credit mortgage or consolidate their debts. However, it is a problem if clients are doing this for the wrong reasons, or because they are misled or confused about the benefits.

If any representation is being made to a customer that involves a comparison (in years or dollars) between the customer's current situation and another product or plan, the comparison should be based on the same monthly payments being allocated to the mortgage (and/or other debts). If the customer is being shown the impact of increased payments, this should also be shown in relation to the customer's current loan/s. The broker can be of great service to the client by pointing this out and explaining it.

If there are any savings arising for other reasons (for example a lower interest rate), the broker should clearly apportion any claimed "savings" between savings arising from making increased payments towards the mortgage and savings arising from other factors.

A number of businesses charge for a debt reduction service, and this is problematic for a number of reasons. Clients often agree to pay a fee based on a representation that the plan can save thousands of dollars. They don't realise until much later that most of the savings are due to larger mortgage payments.

CCLS examination of some of these plans has shown that many clients would be financially better off by sticking to the proposed budget (although this is often unrealistically tight) and by keeping their current mortgage. It appears that the recommendation to refinance is often driven primarily by the need for the debt reduction service to obtain its fee, rather than any benefit for the customer.

Whether or not a broker or lender promotes debt reduction, it is important they are aware of the risks arising from these techniques. Brokers should inform themselves of the marketing strategies used by particular lenders, and serve their clients in such a way that they won't complain of sharp conduct. The knock-on effect on future business and referrals from those clients speaks for itself.

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What do debt reduction plans usually involve?

- a claim that the plan will cut years (or thousands of dollars) off the mortgage;
- refinance of the mortgage with line of credit where:
 - i. salary is paid into the line-of-credit mortgage
 - ii. most living expenses are paid with a credit card
 - iii. the credit card is paid in full at the end of each month

The plan may also include:

- income and expenditure assessment (budget)
- consolidation of other debts