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SUBSTANTIAL BENEFIT AND BORROWERS OF CONVENIENCE

Elise Ivory and Jon Denovan

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Introduction

The new Banking Code of Practice **(BCOP),** effective 1 July 2019, provides that if borrowers will not obtain a substantial benefit from a loan, the lender must take further steps to ensure that the affected borrowers are not disadvantaged. In addition, Dentons consider that borrowers who do not receive any money or money's worth from a loan cannot be a borrower (for the simple reason that they did not borrow) and should instead be a guarantor.

It is likely that the principles set out in BCOP will be considered best practice by AFCA, courts, and regulators and so this report raises issues which are relevant to all lenders and not just ADIs who subscribe to BCOP.

What does the BCOP provide?

The new BCOP provides as follows.

54. If, on the information that you have provided to us in the course of applying for this loan, you will not receive a substantial benefit from the loan, we will not approve you as a co-borrower unless we:

(a) have taken reasonable steps to ensure that you understand the risks associated with entering into the loan, and understand the difference between being a co-borrower and a guarantor;

(b) have taken into account the reasons why you want to be a co-borrower; and

(c) are satisfied that you are not experiencing financial abuse.

55. A substantial benefit includes where:

(a) you acquire a reasonably proportionate legal or equitable interest in assets purchased with the loan funds; or

(b) a reasonable portion of the loans funds are used to repay your debts, or other obligations owed by you.

What is a substantial benefit as used in BCOP 54?

It is unclear whether 'substantial benefit' means a financial benefit or includes more illusory benefits such as achieving a personal objective (for example, helping children).

However, we are satisfied that when co-borrowers are spouses or de facto, there is sufficient benefit in being a borrower even if the property is owned by only one of the co-borrowers *so long as the asset (eg home, car) is for joint use.* This is because the law will normally protect spouses and de factos in relation to asset splits upon relationship breakdown.

In the absence of a spouse/de facto situation, the relationship between the co-borrowers can be easily terminated by one borrower, leaving the co-borrower liable for a debt for which they are receiving no benefit. Further, they do not have the benefit of the law that protects spouses and de factos. Accordingly, the substantial benefit will usually be unclear in these circumstances.

Establishing a 'substantial benefit' can be an imprecise activity. Some uncertainty may be resolved by the equally or more important consideration of whether the co-borrower should be a borrower at all, as discussed below.

What does the law provide?

Borrowers may be able to escape or reduce their liability for a loan by demonstrating that (amongst other things):

- at least in respect of loans regulated by the National Credit Code, the loan did not meet their requirements and objectives (remembering that arguably requirements and objectives are not what borrowers state are their requirements and objectives, but rather what a reasonable person's requirements and objectives would be in the same circumstances);
- there was undue influence;
- the transaction is unconscionable;
- the borrower did not receive any of the money – ie the person did not receive a benefit and was not appropriately classified as a borrower.

The last bullet point was considered in *Dungey v ANZ Banking Group (New Zealand) Limited* [1997] NZFLR 404 (HC). In this case, the person named as borrower received none of the money – it all went to a relative. As such, Mrs Dungey should have been a guarantor not a borrower and so her liability and the mortgage over her home were declared void. This is not a novel concept, but rather a self-evident fact - people who do not borrow money cannot be treated as borrowers.

What about parents assisting children?

It is arguable that if parents are made joint owners of real estate (and so joint borrowers) so that their earnings can be taken into account in the loan assessment, the parents are receiving no benefit of the loan proceeds. In fact they are taking on an onerous obligation only to help their children buy a property.

It is most likely that the parents have no 'real' ownership. It is likely that often the parents' share is held on trust for the children so that in due course the title can be transferred to the children without paying stamp duty. So, the parents are really not owners at all and lenders could be deemed to be on constructive notice of this.

How does the statement in the last paragraph fit with clause 55(a) of the BCOP which provides that a substantial benefit includes where *'you acquire a reasonably proportionate legal or equitable interest in assets purchased with the loan funds'*? Despite referring to 'legal' interests, to achieve a fair result this clause must be interpreted to refer to a beneficial or real ownership. It is not sufficient for parents simply to be made part purchasers for convenience, because this arrangement will fail both the substantive benefit and the 'real borrower' test.

Other risks arise because parents may be coerced by children into entering these arrangements. Also, our research has indicated that often people who become joint borrowers do not understand that they are liable for the whole debt – they think they are liable only for their proportion of the debt.

While the 20% ownership rule is widespread in the industry, there is a risk of challenge for the reasons outlined above, and in many cases these 'borrowers of convenience' should be guarantors instead.

Proportionate ownership and being a co-borrower is appropriate if the parents will genuinely own a share of the property or borrow money which they lend or gift to their children. However, if the ownership share is small, further inquiries should be made to ensure that this is genuine ownership and that the borrowers understand that they are jointly and severally liable for the whole debt (because of the potential misunderstanding of joint and several liability).

The fact that a person is incorrectly categorised as a borrower is likely not to be rectified by taking the 'remedial' steps in clause 54 of the BCOP (explanations, consideration of reasons for being a co-borrower, and reviewing financial abuse).

Can guarantors' income be taken into account when assessing Credit Code regulated loans?

RG209 negated the 'urban myth' that a guarantor's income cannot be taken into account when assessing a loan. RG209.32 deals with 'indirect income' and it is clear that taking into account the income of a person who will be supporting the borrower is acceptable so long as this arrangement is verified and acknowledged by the contributor. We recommend that guarantors who are likely to be required to make regular payments sign an acknowledgment to that effect – see Annexure 2.

Limitations of pursuing guarantors

It is important to remember the restrictions on recovery against guarantors. These restrictions will apply despite holding the acknowledgment in Annexure 2.

- Credit Code regulated loans:

  A judgement against a guarantor cannot be enforced unless:

  (a) the lender has obtained a judgment against the debtor for payment of the guaranteed liability and the judgment remains unsatisfied for 30 days after the lender has made a written demand for payment of the judgment debt; or

  (b) the court has relieved the lender from the obligation to obtain a judgment against the debtor on the ground that recovery from the debtor is unlikely; or

  (c) the lender has made reasonable attempts to locate the debtor but without success; or

  (d) the debtor is insolvent.

- BCOP loans:

  113. Lenders must not enforce any mortgage or other security given to them by the guarantor unless they have first enforced any mortgage or other security that the borrower has provided. (not applicable to a standard margin loan).

  114. As per (a), (c), and (d) above re Credit Code loans.

  115. Clauses 113 and 114 do:

  (a) not apply if the borrower is a small business;

  (b) not apply if the guarantor specifically agrees in writing **after the default notice is issued** and the lender has informed the guarantor of these limitations; or

  (c) not require lenders to first enforce any mortgage or other security that the borrower has provided if they reasonably expect that the proceeds of that enforcement will not be sufficient to repay a substantial portion of the guaranteed liability.

Suggested policy

Against this background, Dentons has developed some workable guidelines for the finance industry - see Annexure 1.

We appreciate that taking personal guarantees can add to process complications, but there is risk in not doing so when the person is correctly classified as a guarantor and not a borrower.

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ANNEXURE 1 – SUGGESTED POLICY RE CO-BORROWERS

Rules

1.	Work out who are the borrowers. Who is the advance being paid to or on behalf of?
2.	Any persons other than borrowers providing financial support must be guarantors.
3.	If guarantors are expected to contribute regularly to repayments, obtain an acknowledgment of that fact – see Annexure 2.
4.	If a co-borrower owns only a small proportion (say 30% or less) of the asset being acquired by the loan obtain a Joint and Several Liability Acknowledgement – see Annexure 3.
5.	If a co-borrower is providing a large proportion (say 70% or more) of the security to support a loan made to all borrowers, obtain a High Security Acknowledgement – see Annexure 4.

It is best practice to notify all borrowers and guarantors of any material movement on joint accounts to counter arguments that customers should not be liable for transactions of which they were not aware.

Example situations

In the following table 'owner' and 'owned' refers to the beneficial owner – ie the 'real owner' of the asset.

Situation	Example	Policy	Comment
Spouses/de factos co-borrow, asset owned by one party only for joint use.	A owns a home occupied by spouses/de factos A+B A buys a car to be used by spouses/de factos A+B	Co-borrowers OK.	Despite only one borrower owning the relevant asset, both receive a clear benefit and have rights in relation to marital property.
Spouses/de factos borrow for investment purposes, but the asset will be owned by one party only and will not be for	A+B borrow to acquire shares or an investment property to be owned by A only.	Non-owner (B) should be a guarantor.	Family law protections may not extend to investment assets. In any event, the non-owner is not borrowing any money and so cannot be a borrower.

joint use.			
Spouses/de factos borrow on the security of property owned by one party to acquire a joint use asset (eg home)	A+B co-borrow on security of property owned by B to acquire home owned by A+B.	Owner must obtain legal advice or sign an acknowledgement that A understands that A is contributing a disproportionate share of the security (High Security Acknowledgement – see Annexure 4)	Legal advice required for unsophisticated borrowers in addition to the High Security Acknowledgement.
Parents supporting children by allowing their income to be included for serviceability purposes.	Parent A will be borrower with Child B to purchase a home or investment property to be owned by Child B	Parent A must be guarantor unless genuinely owning a share of the asset.	The parents are not borrowing any money unless there is genuine ownership, so can't be classified as borrowers. Parents can only be borrowers if they are genuinely acquiring a portion of the asset. If the ownership is disproportionate, there should be a Joint and Several Liability Acknowledgement - see Annexure 3.
Joint venture in respect of an investment or commercial activity, but some or all the investment assets are owned by one party only.	A+B buying shares, an investment property, or a business. A is providing the only security or a disproportionate share of the security	Co-borrowers OK A should obtain legal advice and/or sign a Joint and Several Liability Acknowledgement –see 3.	Legal advice required for unsophisticated borrowers in addition to the Joint and Several Liability Acknowledgement **-** see Annexure 4.
Loan to be used for multiple purposes	A+B borrow to purchase a jointly owned home and an investment to be owned by B	Provide separate loans, cross collateralise if required.	Choosing the structure by adopting the dominant purpose may result in a person being incorrectly categorised as a borrower, and not receiving a substantial benefit.

ANNEXURE 2 - Acknowledgment when guarantors are expected to provide cash flow support to borrowers on a regular basis

[Prepare on lender's letterhead]

ACKNOWLEDGEMENT THAT YOU MAY HAVE TO ASSIST MAKING REPAYMENTS ON A REGULAR BASIS

Loan to:
Guarantor:
Security for loan:
Amount of loan:

We have approved this loan even though the repayment obligations are greater than we assess can reasonably be made by the borrower.

In deciding to approve the loan, we have taken into account the regular financial support to be given by you to the borrower during the term of the loan.

Prior to proceeding with the loan, it is important to consider how the repayments will be funded. The repayments may increase if the interest rate increases. Borrowers need to provide for not only normal regular living expenses including loan repayments, but also for other one off expenses such as repairs, ill health, periods of unemployment, and so on.

You (the guarantor) acknowledge that in order to prevent hardship arising to the borrower, you may need to provide regular financial support from time to time. We are making the loan on the basis that you agree to provide regular financial support to the borrower to ensure that the loan repayments can be made on due date.

If you do not provide financial support from time to time, the borrower may incur financial hardship. We are not prepared to lend when borrowers may suffer financial hardship. It is a fundamental term of us making the loan that you will provide regular financial support whenever it is required throughout the term of the loan.

Normally, by law, guarantors can recover from borrowers any money they pay under a guarantee. This is called a right of subrogation. It could cause financial hardship to the borrower if you attempt to recover money you pay under your guarantee from the borrower. .

The borrower and guarantor sign this acknowledgment to confirm they have read and understood this document, and after considering these circumstances have both agreed to proceed with the proposed loan. Guarantors are liable for the entire debt owing by the borrower, and if there is more than one guarantor, each of you are liable for the whole debt.

Signed by the Borrower	Dated
Signed by the Guarantor (you)	Dated

ANNNEXURE 3 – JOINT AND SEVERAL LIABILITY ACKNOWLEDGEMENT

[User note: This document should be obtained from borrowers who only own a low proportion (less than 35%) of the security provided or a loan. For example: A (as to 20%) and B (as to 80%) jointly buy an asset and are co-borrowers. A should acknowledge that despite only owning 20% of the property, A is liable for 100% of the debt.]

Loan to:
Guarantor:
Security for loan:
Amount of loan:

To **[name of lender]**

I/We understand that:

- I/we only own a minor share of the asset being financed by this loan;
- despite only owning a minor share, I/we are jointly and severally liable for **100% of the debt**; and
- as a result action could be taken against us for the whole of the debt even though we do not own 100% of the property.

I/We warrant that:

- I/we understand the situation explained above;
- have assessed the risks of proceeding with this loan;
- have not been pressured into proceeding with the loan or signing this acknowledgement by our co-owner(s) or anybody else;
- have been encouraged to obtain independent legal and financial advice in respect of this situation; and
- have decided to proceed.

Signed by [name] Dated

ANNNEXURE 4 – HIGH SECURITY ACKNOWLEDGEMENT

[User note: This document should be obtained from borrowers who provide a higher proportion (say 75% or more) of the security for a joint loan. For example: A (as to 20% of value) and B (as to 80% of value) provide security for a joint loan. B should acknowledge that B has more assets at risk that A.]

Loan to:
Guarantor:
Security for loan:
Amount of loan:

To **[name of lender]**

I/We understand that:

- I/we only are providing significantly more security than our joint borrower(s) to secure repayment of this loan;
- as a result, if there is default and you decide to enforce the security provided by me/us, I/we may suffer more loss than my/our joint borrower(s).

I/We warrant that I/we:

- understand the situation explained above;
- have assessed the risks of proceeding with this loan;
- have not been pressured into proceeding with the loan or signing this acknowledgement by our co-borrower(s) or anybody else;
- have been encouraged to obtain independent legal and financial advice in respect of this situation; and
- have decided to proceed.

Signed by [name] Dated