Karen Cox, Co-ordinator, Consumer Credit Legal Centre, Sydney

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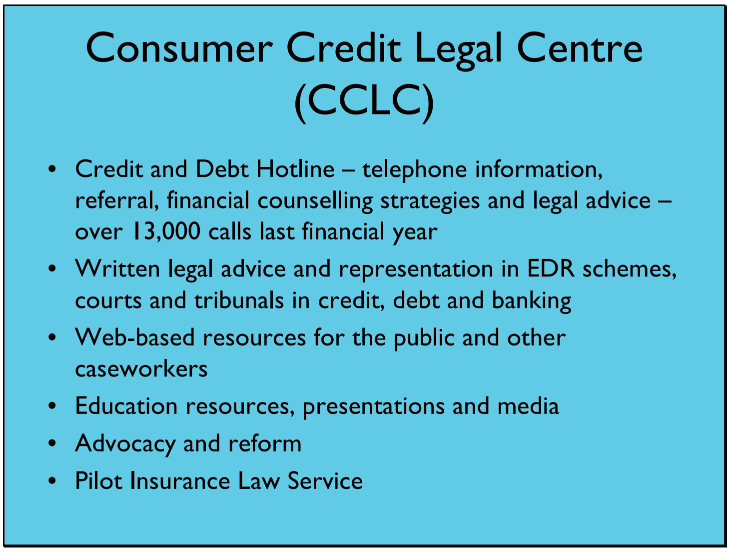
Slide 2



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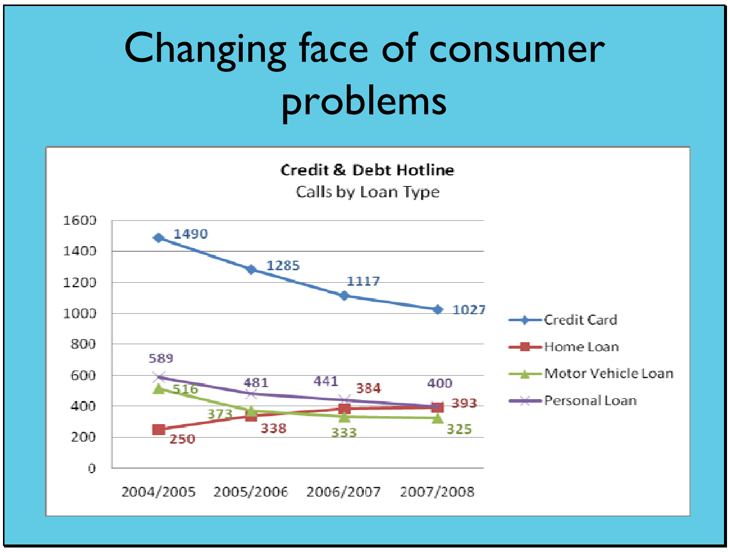

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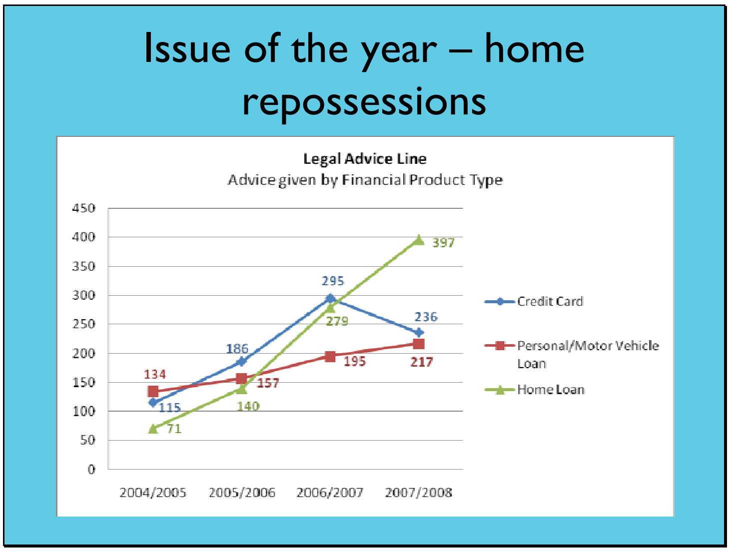

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Key Points

- Focus on mortgages – most serious impact but not the most frequent problem
- Consequences of regulating a sub-section of an activity (i.e. consumer lending only)
- Consequences of uneven regulatory arrangements by type of lender
- How do we regulate for responsible lending?

Slide 6

Consumer Credit Code 1996 ("UCCC")

Uniform template legislation – jurisdiction of State Government consumer protection agencies, only covers lending for personal domestic, household purposes

- Disclosure (before, and during contract)
- Some limitations on fees
- Hardship provisions
- Processes for enforcement of defaults
- Interest rate caps in some states

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ASIC Act 2001

- Credit not included in Financial Services Reform generally
- ASIC given limited role in relation to misleading and deceptive conduct, unconscionable conduct, suitability for purpose and debtor harassment
- ASIC Act covers small business and individual investment, UCCC does not.

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History of avoidance: regulators playing constant catch-up

- Short-term lending (payday lending)
- Interest expressed as fees to avoid interest rate caps
- Split entities charging brokerage, cheque cashing fees, and other means of avoiding minimum credit charge (to be caught by UCCC) or caps
- False business or investment purposes declarations to facilitate predatory and exploitative asset-based lending
- Price of goods are inflated and associated loans are characterised as "interest-free"
- Promissory Notes and Bills of Exchange

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Failed to keep pace with market developments

Not kept pace with product development…
"Mortgages go down over time" - no longer true:

- Reverse mortgages
- Shared appreciation mortgages
- Interest-only loans
- Line of credit loans

More complex interaction with property values

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Failed to keep pace with market developments

Growth of complications in the supply chain:

- One or more brokers/aggregators
- Mortgage managers
- Mortgage originators

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Uneven regulation across sectors

Home lending - ADIs cf non-bank lenders. Latter have:

- No licensing obligations (no AFSL)
- No requirements to belong to EDR
- No oversight by APRA
- Complex supply chains which are more difficult to hold to account through current law of agency and fact that UCCC largely covers products not players

Slide 12

CCLC statistics for 2007/08

Of 238 calls analysed about home loans:

59% non-bank lenders against a peak market share of about 20%

- 22 % major banks

16% other banks

3% mutuals

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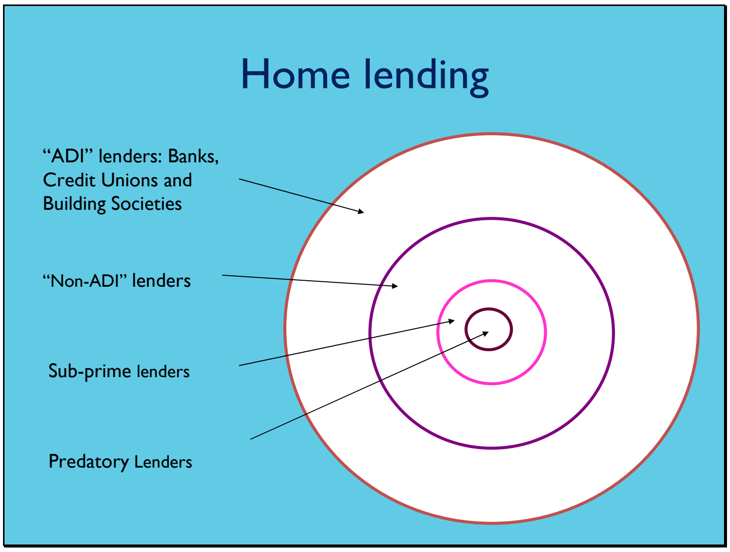

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Problems for consumers in non-bank sector

- Predatory lending
- Asset based lending
- Risk based pricing
- Risky debt consolidation/repetitive refinancing
- High exit costs
- Lack of access to dispute resolution
- Lack of understanding of roles of players in the supply chain

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Predatory Lending

- Lender relies solely on asset which borrower has no desire to sell, indifference to income, poor credit history, including arrears on current mortgage
- Borrowers are vulnerable due to desperation, a lack of financial sophistication, or both
- High set up costs (usually financed into the loan) and significant penalty interest, default fees and enforcement costs
- The use of one or more brokers, solicitors or other intermediaries

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Predatory Lending

- Avoidance of the UCCC (most commonly using a business purpose declaration)
- Referred to solicitor for "independent" advice when solicitor appears associated with the broker or the lender
- Short terms such as 1-5 years, or even bridging finance with the interest rate stated on per month basis
- Interest-only and sometimes periods of "prepaid" interest in which additional amounts are borrowed to cover the interest payments, greatly adding to the cost of the loan.
- Rollovers, where the loan is rolled over at the end of the term, and another set of brokerage and fees are added to the amount borrowed.
- Swift enforcement action, particularly if there insufficient equity for a rollover.

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Predatory Lending

- Couple with four children and another on the way. Unemployed and in receipt of social security payments. Already in default on their existing sub-prime home loan. Need money to convert garage into another bedroom and to register car.
- Sold loan with double the repayments on their existing loan. Undisclosed set-up costs of close to $30,000 (Brokerage and lenders solicitors fees alone $20,000).
- Were told they would get a six month "repayment holiday" to get back on their feet (really prepaid interest) which did not eventuate.
- Defaulted immediately.

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Predatory Lending

- A had home unit in Sydney and a first mortgage with a bank. She was up-to-date on her bank loan. She was from a non-English background and sought a loan to pay strata fees.
- She was given a loan secured by an equitable second mortgage.
- Fees were over $1500 on a $3000 loan and the interest rate was 5% per month.
- When fell into default and proceedings were issued in the Supreme Court. The lenders first demand was for $20,000 to settle the proceedings.

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Fringe lending proposals

Uncertain future due to announcement in early July 2008 that Federal Government will take over the regulation of all types of credit

Key provisions:

•Amendment to business/investment purposes declaration provision

•Greater regulation of fees

•Prohibition on "blackmail" securities

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Business/Investment Purpose Declaration ("BPD") Provisions

- S11 (1) Code presumed to apply unless contrary established
- S11(2) a valid BPD will defeat the presumption
- S11(3) "however, such a declaration is ineffective....if the credit provider (or any other relevant person who obtained the declaration from the debtor) knew, or had reason to believe, ...that the credit was in fact to be applied" for personal purposes.

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UCCC avoidance explained...?

- *Employee 1*:The Applicants [the borrowers] would have been unable to obtain a personal loan as they were **unable to provide proof of income**. The only appropriate means to obtain finance would be a mortgage (emphasis added).

- *Employee 2:* It would have been impossible for the Applicants to obtain a personal loan, if they [the broker] **cannot do a loan conforming with the provisions of the Code then it may be appropriate to obtain a different type of loan**. A limited credit history must have been provided by the Applicants as the Respondent [the broker] only arranges private mortgages in such circumstances (emphasis added).

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Proposed Amendment to BPD provisions

- S 11(1) presumption remains unchanged
- New sub-section 11(2) The contrary can be established for the purposes of subsection (1) only by establishing that-
- (a) the credit provider under the contract made inquiries about the purpose of the credit provided, or intended to be provided, under the contract; and
- (b) as a result of the inquiries, the credit provider was given information by or on behalf of the debtor that the purpose of the loan was wholly or predominately for either of both of the following-

  (i) an identified business purpose

  (ii) an identified investment purpose

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Alternative BPD proposal

•The UCCC will apply, despite a BPD, if it is proved that the funds are actually used wholly or predominantly for consumer purposes (actual use test)

• However, if the credit provider has made appropriate/reasonable inquiries when making its decision to approve the application for credit, the UCCC applies, without civil or criminal penalties for non-compliance with contractual formation requirements;

•If the credit provider has not made sufficient inquiries, the civil and criminal penalties apply.

•Reasonable enquiries' test open-ended and referable to the nature of the transaction and circumstances of the customer (reasonable enquiries test)

Slide 24

Current provisions in relation to fees

UCCC (s72) currently gives the court or tribunal the power to review unconscionable fees and charges but these are limited to:

•A change in the annual percentage rate

•An establishment fee or charge

•A fee or charge payable upon early termination of a credit contract

•A fee or charge for a prepayment of an amount under the contract

Enforcement costs also able to be challenged as "in excess of those reasonably incurred" (s99)

Slide 25

Proposals in relation to fees

- Provisions extended to cover all fees however named and *unconscionable* replaced with *unreasonable*
- Limits on the fees already covered by s 72 not greatly altered
- Appears to limit all fees to underlying costs, or in the case of default fees, the credit provider's estimated reasonable loss flowing from the default
- Court may have regard to standards of commercial practice generally in deciding on reasonableness
- Government Consumer Agency given standing to apply under this division on behalf of a debtor, groups of debtors or the public interest.

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Proposals in relation to fees

Interest charges (APR) disclosed must include all charges "that are in the nature of interest charges (whether or not it is expressed to be interest charges)"

Eg Credit contract for $20,000 over four years. Interest rate expressed as 17% but there is a $16,000 establishment fee.

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Fee issues for consumers

Fees and charges can

- Detract from ability to genuinely compare cost of contracts - anti-competitive
- Defeat interest-rate caps when they apply
- Severely exacerbate hardship and lead to further default – default/penalty fees
- Detract from motivation to properly assess ability to repay (eg predatory home lending/payday lending)
- Trap consumers in uncompetitive loans

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Effective fee regulation

- Must be comprehensive – all fees
- Must be limited to reasonable estimate of underlying losses for default charges/penalty fees
- Must consider anti-competitive effects (generally and exit fees in particular)
- Must include capacity for regulator to take action

Slide 29

Broker Regulations

•Currently patchy regulation in some states. Licensing only in WA

•Other states have no regulation or limited and tied to UCCC

•Brokers market share has increased rapidly to about 37% of new loans in 2007

•Finance Broking Bill 2007 out for comment in late 2007 after 4 year gestation period

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Finance Broking Bill

- Covers all finance/mortgage brokers, other intermediaries (such as mortgage managers and originators) and credit advisers (for example, debt reduction scheme consultants)
- Compulsory licensing, minimum training standards, fit and proper person test, and compulsory membership of EDR
- Exemptions from some parts of the bills for small business broking and "white label" originators but all must be licensed and in EDR

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Controversial Provisions

- Obligation to assess capacity to pay
- Lender liability
- Stay of proceedings

Consumer groups are also lobbying for a limit on the amount of brokerage, if any, that can be financed under a loan/mortgage

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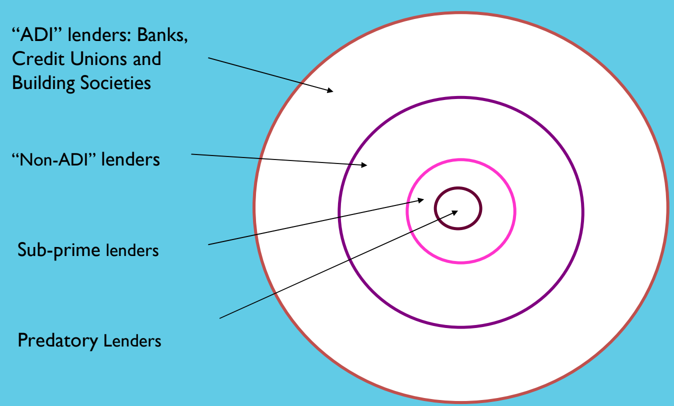
Home lending



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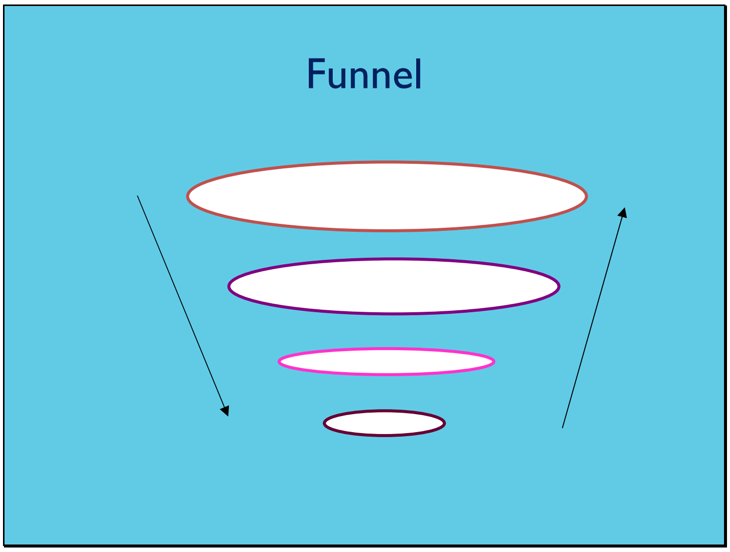

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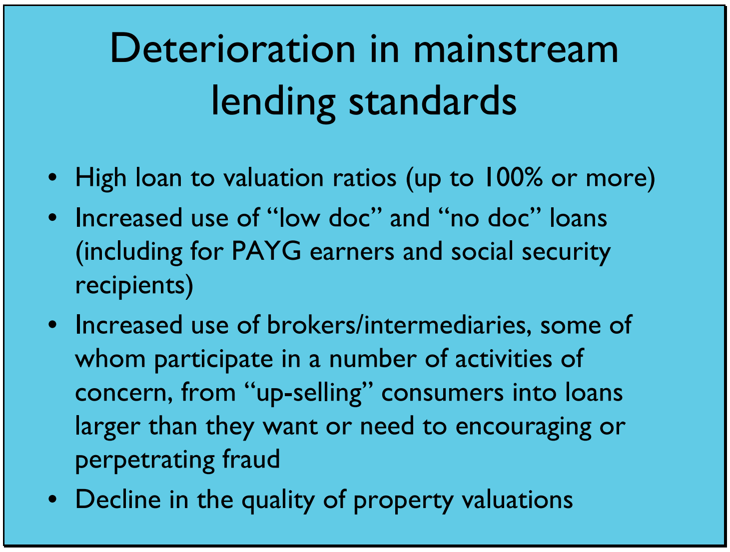

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Deterioration in mainstream lending standards

- Acceptance of a wider range of income types from more insecure sources
- Creative but arguably dangerous product design (older people sold lines of credit secured over their home with no capacity to repay the loan once it is fully drawn except to sell their home, for example)
- Deterioration in quality control and verification processes within lenders.

Slide 36

Low-doc and *no-doc*

Moody's Investor Service report June 2008 re loans 2004-2007

•defaults most prevalent for contracts with high loan to value ratios (more than 90 per cent), "low doc" and "no-doc" loans.

•95 per cent or more LVR had risen from negligible to 4.7% in 2006 and 14.2 % in 2007

•Low-docs peaked in 2006 and 2007, representing almost 17% of loans issued in the latter year

Fitch ratings report June 2008

•sharp rise in low-doc and no-doc loans in WA due to economic boom, 28.8% of mortgages written in 2007

•NSW the worst performing states and WA the best, but mortgage performance in WA is deteriorating at fastest rate of all the states despite the mining boom

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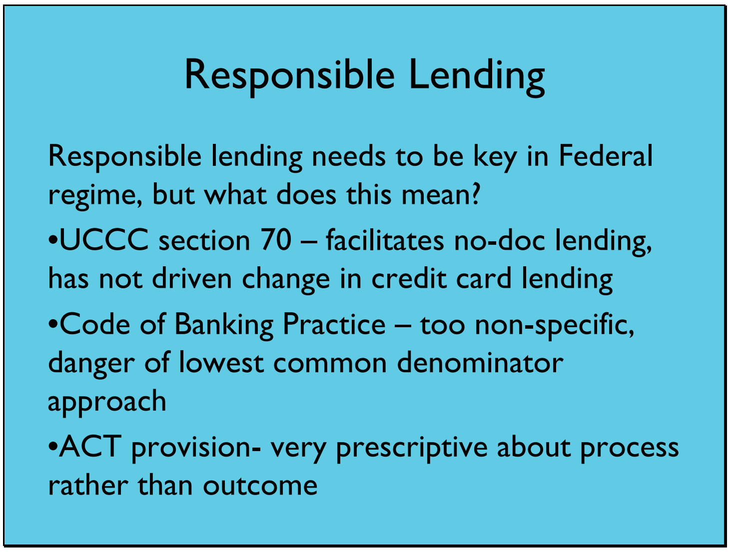

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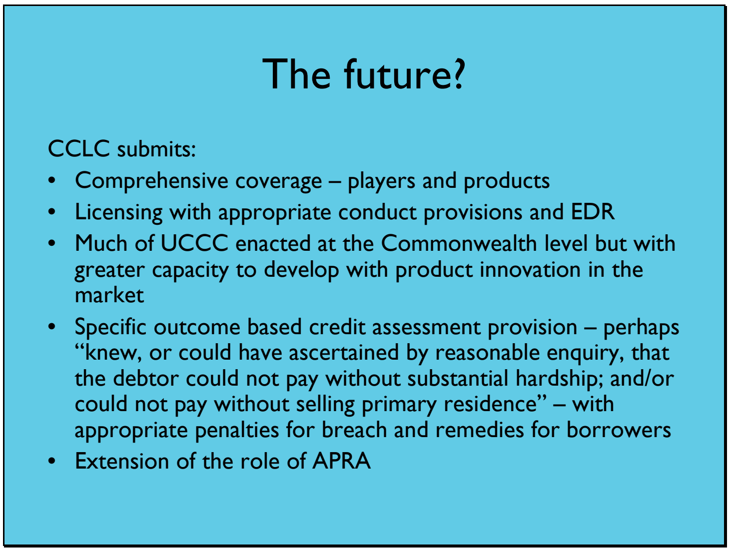

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Challenges

- Appropriate remedies for consumers
- Credit advice – mathematics v actual human behaviour
- Appropriate treatment of revolving credit
- Aging population
- Marketing
- Interest rate caps