SUBMISSION 18

Credit
Ombudsman
Service

Inquiry into Home Loan Lending Practices and process

House of Representatives Standing Committee on
Economics Finance and Public Administration

Submission By

Credit Ombudsman Service Limited

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SUBMISSION

About the Credit Ombudsman Service Limited ("COSL")

COSL is an ASIC-approved external dispute resolution scheme ('EDR') scheme that is entirely free to consumers. It is industry funded.

It is a reasonably large scheme with more than 8,000 members, mostly mortgage brokers with some mortgage originators, non-bank lenders, trustee companies, mortgage insurers, aggregators, mortgage managers and some finance brokers. There are about 20 non-bank lenders who are members of COSL.

Importantly, about 36% of all home loans written in Australia are written by members of COSL or their loan writers.

Sector largely unregulated

Credit, unlike other financial services regulated by the Commonwealth's Corporations Act, remains a State-regulated activity.

Consequently, there is no legislative requirement for COSL members to join or remain in COSL. The membership of COSL is entirely voluntary.

The result of this is that if a broker or non-bank lender is responsible for a borrower's loss, but is not a member of COSL or another EDR scheme, our ability to provide effective relief may be limited or sometimes non-existent.

For example, in the Ombudsman's most recent Determination (which, incidentally, was on predatory lending), the lender was not a member of COSL and COSL was limited to awarding compensation on the basis of the broker's activities, not the lenders'.

The lender in this case is one of the many fringe lenders operating in an unregulated industry to the detriment of vulnerable consumers.

It is therefore vital that all credit providers and financial intermediaries are required to join an independent industry-based consumer dispute resolution scheme to address many of the access to justice issues facing consumers.

The importance of EDR schemes

EDR schemes play a significant role in society. They:

- provide a speedy, low-cost way to resolve complaints and reduce the risk of the costs and lengthy delays that can arise from court proceedings
- allow consumers to have complaints that would not be brought before a court for financial reasons, aired and resolved
- have the power to make a binding decision if another resolution is not achieved
- allow industry to improve standards and conduct
- promote market confidence by encouraging, prompt, fair and consistent dealing for consumers and members
- are an essential part of the broader consumer safety net
- are an important and necessary element of a just and fair society.

Financial hardship

COSL is seeing more cases of borrowers requiring some sort of forbearance from lenders on grounds that they are suffering financial hardship.

COSL's initial response to a hardship situation is always to negotiate with the lender first. We attempt, through conciliation, to persuade the lender to agree on a method of payment that the borrower can manage. These include persuading the lender to accept payment by instalments, reduce or freeze interest, postpone payments, and or possibly reduce the lump sum.

However, in none of these cases is the lender under any obligation to agree.

If the loan is regulated by the Uniform Consumer Credit Code, COSL will require the lender to genuinely and promptly consider the borrower's request to vary the contract under section 66 of that Code. The lender is not permitted to take into account considerations that are extraneous to the threshold requirements of section 66. In effect, this means that the lender must not make it a condition of its consideration of the borrower's request that the borrower first apply for the release of its superannuation or seek the financial assistance of family and friends.

COSL is obliged under its Constitution to have regard to applicable codes of conduct when considering a complaint from a consumer. One such code is the Code of Conduct prescribed by the Mortgage and Finance Association of Australia ('MFAA'). Members of the MFAA (the overwhelming majority of which are also members of COSL) are contractually bound to comply with the MFAA Code of Conduct.

COSL has proposed specific changes to the MFAA Code dealing with hardship relief for consumers. If these changes are adopted by the MFAA, the Code's approach to hardship relief will serve as best practice for the rest of the finance industry in Australia.

Predatory lending

COSL has observed a disturbing trend among some lenders, normally fringe lenders, to refinance home loans in circumstances where the borrower has no capacity to repay the loan. These lenders rely solely on the value of the security, not the borrower's ability to meet the repayments. The borrower is invariably in default of their existing loan and is at risk of losing their home.

These loans are provided on the basis that they are intended for investment or business purposes so as to avoid the application of the Uniform Consumer Credit Code which allows such loans to be set aside on grounds of unconscionability.

A borrower desperate not to lose their home may be prepared to sign a false declaration to the effect that the loan is for investment purposes and that they are able to service the loan.

From its own experience, COSL has observed that these predatory loans are always lo doc loans. There is little verification of the borrower's income or capacity to repay the loan.

These loans have been referred to as 'Ponzi' loans; that is, loans that can only be repaid by taking out larger loans or selling the security.

Some of the characteristics of these loans are excessive commissions and charges being loaded onto the principle sum borrowed; higher interest rates and even higher default rates; and very short terms of 6 months to 12 months.

In most of the predatory lending cases COSL has encountered, the borrower defaults on making loan repayments within a very short time of the loan being advanced, sometimes in the first month. This is only to be expected, given that the repayments under the new loan are much higher than the previous one – sometimes twice as much.

The end result is that the borrower loses their home and the equity in their home is substantially reduced by the amount of the excessive commissions, charges and interest rates.

It seems to us that with predatory loans, it is never intended or expected that the borrower will be able to repay the loan. The whole exercise appears to be for the sole purpose of loading the loan with commissions and charges and making a quick return.

Low doc

COSL does not have a view on low doc loans.

Clearly they have a place in the market, particularly in relation to self-employed persons, immigrants, and the like.

There does, however, appear to be an unmistakable co-relation between low doc loans and predatory lending practices, particularly where the borrower has a diminished capacity to protect its own interests, for example:

- persons who are vulnerable or desperate because they are in dire financial circumstances or risk their home being lost
- persons from low socio-economic backgrounds
- persons who are pensioners and advanced in age
- persons of low education
- persons suffering from learning disabilities and mental health problems such as bi-polar and schizophrenia
- persons who are geographically isolated and who have little access to advice and services.

In *Permanent Mortgages Pty Ltd v Michael Robert Cook and Karen Cook [2006] NSWSC 1104,* the Court heard evidence from Dr Steve Keen, Associate Professor of Economics and Finance at the University of Western Sydney.

Professor Keen described the loan in question as a "low doc" loan, that is, one where borrowers self verify their income in the application process. He said that such loans were "designed mainly for the self-employed or those with irregular income who do not have the documentation required to obtain a conventional housing loan."

As to the public interest involved in "low doc" and "Ponzi" loans, Professor Keen said:

"(a) Standard home loans are limited in size by the need for the borrower to establish that he/she can repay the loan out of income.

(b) Legitimate "Low "Doc Loans" are a necessary development of income-based loans in light of the changing composition of the Australian workforce.

(c) Ponzi loans are loans that can only be repaid by either taking out a larger subsequent loan, or by selling the asset that was financed using the loan.

(d) Ponzi lending can occur in low doc loans because the loosening of income-verification standards enables loans to substantially exceed the size that could be met out of borrower's actual income."