



SUBMISSION 15

ASIC

Australian Securities & Investments Commission

GPO Box 9827 in your Capital City

30 July 2007

Mr Andrew McGowan
Inquiry Secretary
House of Representatives Standing Committee
on Economics, Finance and Public Administration

by email to: andrew.mcgowan.reps@aph.gov.au

Dear Mr McGowan

Inquiry into home lending practices and processes

Thank you for your invitation to provide a submission to this Inquiry, and to attend the roundtable public hearing on 10 August 2007.

ASIC will advise its attendee(s) shortly, and will provide the completed witness form as requested.

In the meantime, I have attached a short submission providing information and commentary regarding four areas relating to home lending. ASIC has limited its submission to those areas in respect of which it has been particularly active, reflecting its jurisdiction in relation to home lending.

I should emphasise that ASIC's jurisdiction with respect to home lending, and therefore its experience, is quite limited as explained in the submission. ASIC therefore does not have access to primary data sought by the Inquiry. Most of our experience is with the activities of some fringe lenders or brokers. ASIC understands that there is something of the order of 7 million home loan accounts in Australia. This submission, which focuses on our experience with individual matters, relates to a tiny fraction of those accounts, and should not be read as suggesting that the issues discussed are in any way representative of the way the home loan market operates.

If you have any queries regarding this submission please contact Greg Kirk, Director – Consumer Protection, Compliance & Campaigns on 02 9911 2073.

Yours sincerely,

Greg Tanzer
Executive Director – Consumer Protection

Australian Securities and Investments Commission

Submission to the Inquiry into Home Lending Practices and Procedures House of Representatives Standing Committee on Economics, Finance and Public Administration

July 2007

ASIC's limited jurisdiction in relation to credit

1. ASIC has responsibility for credit facilities and services relating to credit¹ under the *Australian Securities and Investments Commission Act 2001* (Cth) (ASIC Act). This contains provisions modelled on the consumer protection provisions in the *Trade Practices Act 1974* (Cth) (TPA).² These provisions contain prohibitions on misleading and deceptive conduct and unconscionable conduct.
2. Under the *Corporations Act 2001* (Cth) (Corporations Act) ASIC is responsible for administering licensing, disclosure and quality of advice requirements for financial products and services. These requirements do not apply to credit products or related services such as advice about credit products.
3. ASIC therefore does not have access to primary data on issues covered by the Inquiry's Terms of Reference, such as market share of non-conforming lenders, or default and repossession levels on home loans. We would expect industry and the Reserve Bank and APRA to be able to provide such information as the Inquiry requires.
4. Indeed, ASIC understands that there are some 7 million home loans outstanding in Australia. The issues that we raise in this submission are based on matters which ASIC is aware, and would likely represent issues in a tiny fraction of the total number of loans.
5. ASIC can provide information and commentary in areas where it has been active in respect of unfair conduct in relation to home lending. These areas are:
 - a. Mortgage and finance brokers,
 - b. Low doc and no doc lending,
 - c. Reverse equity loans, and
 - d. Mortgage minimisation schemes.
6. The Corporations Act requires all licensees dealing with retail clients to be a member of an ASIC-approved external dispute resolution (EDR) scheme.³ ASIC can therefore also provide some commentary on the use of EDR schemes in the home lending context.

¹ See the definition of financial product in s 12BAA and *Australian Securities and Investments Commission Regulations 2001* (Cth) reg 2B.

² Part 2 Division 2.

³ Corporations Act 2001 s 912A(1)(g) and (2).

7. Given the limited nature of ASIC's jurisdiction in relation to home lending, it is not suggested that these issues constitute all relevant issues or are necessarily the most significant issues. Further, ASIC is not in a position to comment on the extent or prevalence of the identified practices within the home lending market.

Mortgage and finance brokers

8. The mortgage and finance broking industry is one of the fastest growing sectors in the finance industry.⁴ ASIC has been active in examining consumer issues in this sector. In 2003, ASIC released a report on the mortgage broking industry prepared by the Consumer Credit Legal Centre NSW which found that consumers who use mortgage brokers can face a range of problems including poor advice, increased costs from being recommended to enter inappropriate loans, inadequate disclosure of fees and commissions by some brokers, inconsistent documentation, uncertainty about the nature and price of services and, in a small number of cases, fraudulent activity including manipulating loan applications.⁵
9. ASIC has recently undertaken a detailed analysis of the practice of 'equity stripping'. 'Equity stripping' is where some unscrupulous brokers and lenders (typically operating in the fringe of the industry) target vulnerable borrowers who are experiencing financial difficulties. The broker refinances the borrower's home loan debt into a new, higher cost loan. While in the short term this new loan may appear to solve the borrower's immediate problems, the borrower's underlying lack of capacity persists and default on the new higher cost loan is almost inevitable. A substantial portion of the equity the borrower has built up in their home is effectively stripped from them and transferred to the broker and lender via the high fees and charges associated with the refinance.
10. Another strategy that we have seen used by fringe brokers is to arrange refinances for borrowers experiencing financial difficulties using short term interest-only loans. These loans appear to have been approved based on the equity availability in the borrower's home, rather than the capacity of the borrower to meet the repayments or, more commonly, the final repayment of principal.
11. The risk of consumer detriment is increased where brokers recommending short term interest-only loans arrange for the borrower to meet the repayments by including an allowance for prepaid interest in the amount borrowed, for some or all of the loan term. The use of prepaid interest suggests that the broker knows the borrower would be unable to repay the principal in the future without selling their house. Advancing the interest repayments upfront in the loan amount maximises the return to the lender at no risk to that lender. At the end of the loan term the borrower needs to refinance or sell their home.
12. Some borrowers in unaffordable loans have entered into a cycle in which they default and refinance again. The more they refinance the more equity they lose in their home due to application charges by the new lender, broker fees, costs

⁴ Consumer Affairs Victoria, *Report of the Consumer Credit Review* (2006), Section 8.

⁵ ASIC Media Release 03-102, *ASIC releases report into mortgage brokers* (26 March 2003).

arising from default and early termination charges. We have seen cases where brokers choose to recommend that the borrower refinance in order to earn fees, rather than advising that the borrower end the refinancing cycle (by selling their home, allowing them to preserve any remaining equity). A recent decision of the Supreme Court of NSW, *Permanent Mortgages Pty Ltd v Cook*⁶, is an example of this process. In this case the borrowers had defaulted and refinanced their home loan five times. The Supreme Court found that the final refinance was unjust within the meaning of the *Contracts Review Act 1980* (NSW), and reduced their liability under the contract.

13. The Ministerial Council of Consumer Affairs is currently working to develop a uniform regulatory regime for finance brokers including licensing, minimum competence requirements and written broker agreements, including full disclosure of fees and commissions. Recommendations by brokers would be required to meet quality standards and brokers would be required to give reasons for their recommendations, as well as to belong to an external dispute resolution scheme approved by ASIC.⁷ ASIC notes that these recommendations have wide support, including from broker industry associations.

In relation to the Committee's issues

- Declining credit standards. ASIC assumes that by 'declining credit standards' the Committee means less rigorous assessment or eligibility criteria. If that is correct, then it is noted that this is an integral feature of this type of fringe lending.
- Link between declining credit standards and arrears and repossessions. As this type of fringe lending tends to involve consumers committing a higher proportion of their income to loan payments, default and repossessions are likely to increase as those consumers will have less capacity to cope with change in circumstances. Where the loan is unaffordable to begin with, default or entry into a cycle of default and refinance is almost inevitable.
- Are borrowers in financial difficulty being treated appropriately by lenders? These types of practices rarely involve adequate response by lenders to financial difficulty. This type of fringe lending often involves evasion of the Uniform Consumer Credit Code (UCCC) to the detriment of the consumer.⁸ The UCCC includes a mechanism allowing consumers to pursue a variation on the grounds of financial hardship.⁹

An additional complication for these consumers is that where a broker has placed them in an unaffordable loan then they will have no remedy against the

⁶ [2006] NSWSC 1104

⁷ National Finance Broking Regulation RIS Discussion Paper (2005).

⁸ Most commonly by documenting a home loan as being predominantly for business or investment purposes, a characterisation that excludes the operation of the UCCC. The involvement of brokers in this practice is not new and has been highlighted as a problem in both ASIC's 2003 broker report and the NSW Office of Fair Trading *Regulatory Impact Statement—Discussion Paper*, February 2005. Making it more difficult for fringe players to exclude the operation of the Code would deliver significant benefits to this small but disadvantaged group of borrowers.

⁹ Sections 66-68

lender, should they commence repossession action.

Low doc loans

14. Equity stripping is a practice that is at least in part facilitated by products such as low doc or no doc loans. It is not a practice, however, that defines those products, and is better viewed as being at the extreme end of the spectrum.
15. Low doc and no doc loans were introduced specifically to meet the needs of consumers, such as those who are self-employed, who are genuinely unable to substantiate their true income. ASIC's experience is that some brokers have utilised the lack of verification of the borrowers' income to arrange loans that would be rejected as unaffordable if the borrowers' financial position was fully reviewed.¹⁰

In relation to the Committee's issues

- Declining credit standards. By definition, these loans involve a lower level of enquiry by the lender into the financial circumstances of the prospective borrower, and a willingness by the lender to accept information without seeking to substantiate it. At the extreme end, this can involve no inquiry at all into a prospective borrower's circumstances or capacity to meet payment obligations, or even a disregard of other evidence that suggests a lack of capacity to pay.
- Link between declining credit standards and arrears and repossessions. The higher risk to lenders is usually reflected in higher interest rates and/or other charges, varying from lender to lender. ASIC has not investigated this issue, but at a theoretical level this higher interest rate is likely to result in a higher level of repayments and therefore defaults. ASIC is aware of individual instances where consumers have refinanced a bank loan in arrears to a low doc or no doc loan without resolving their underlying lack of capacity and therefore merely delayed repossession or sale of the home. ASIC has not researched the extent of this practice but this class of consumers are at an above average risk of losing their home.
- Are borrowers in financial difficulty being treated appropriately by lenders? Financial difficulties normally arise due to a change in circumstances (for example, loss of income or increase in interest rate). In the context of no doc and low doc lending, financial hardship may be more likely if the transaction was improvident to begin with.

There is some evidence of divergence generally in the responses to financial hardship by different lenders. In its May Bulletin, the Code Compliance Monitoring Committee reported that it had identified numerous incidences of non-compliance with the Code of Banking Practice commitment to assisting consumers experiencing financial hardship.¹¹ Anecdotally, ASIC is aware of

¹⁰ For an example of this conduct see Media Release 06-373, *ASIC acts against ACT Mortgage Broker*, available at <http://www.asic.gov.au/asic/asic.nsf/byHeadline/06-373>.

¹¹ Code Compliance Monitoring Committee, Bulletin No 7 – May 2007.

suggestions that non-bank lenders tend to move more quickly towards repossession than bank lenders.¹²

Reverse equity products

16. A further market development in financial services is the growth in equity release products. ASIC's report *Equity Release Products: An ASIC Report* (2005) describes a number of equity release products on the Australian market or in development, including reverse mortgages, home reversion schemes and shared appreciation mortgages.¹³
17. The reverse mortgage sector is expanding rapidly.¹⁴ An industry report estimates that the potential market for these products could reach \$15 billion by 2010.¹⁵
18. Equity release products can be a useful way for consumers to access the equity in their homes. However, they are complex products operating over an indeterminate period, and if used inappropriately or as a result of poor advice can lead to borrowers exhausting their equity prematurely and losing financial flexibility in the future, when they may, for example, have a need for supported accommodation.
19. Additional risks can arise in the context of hybrid products, an example of which is the use of a line of credit as a reverse mortgage. Lines of credit are facilities that allow consumers to borrow cash against the equity in their home. Interest payments are required, but regular payments of principal are not. The interest payments on a line of credit can be capitalised but only up until the facility's credit limit. At this point the borrower either needs to make payments to reduce the amount owing or refinance.
20. ASIC has seen examples of consumers seeking a reverse mortgage being placed into a line of credit, with a credit limit greater than the amount sought in order to create a buffer of available surplus funds. This buffer is used to meet the interest payments on the account as they fall due. Over time the balance of the loan increases as the payments drawn down from the available surplus are debited to the loan account.
21. Once the buffer has been exhausted, the borrower is required either to refinance or sell their home. Depending on the increase in the loan balance and the available equity refinancing may not be an available option.

¹² For example, *"They want to take our house", An Investigation into House Repossessions in the ACT Supreme Court*, Consumer Law Centre of the ACT.

¹³ This report is available on ASIC's website at

http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=Equity_release_report_.pdf. See also accompanying Media Release MR 05-358 available at <http://www.asic.gov.au/asic/asic.nsf/byHeadline/05-358%20ASIC%20report%20highlights%20the%20benefits%20and%20risks%20of%20equity%20release%20products%20?opendocument>.

¹⁴ For a summary of the growth in equity release products see ASIC, *Equity Release Products* (November 2005) at 4 – 5.

¹⁵ Trowbridge Deloitte, *The Equity Release Opportunity for Financial Planners* (July 2005).

22. This type of product contains an additional risk, in that unlike the reverse mortgages currently available in Australia they do not include a "no negative equity guarantee". This means that in addition to losing their home a consumer could end up with a residual debt to the lender.

In relation to the Committee's issues, ASIC cannot comment, as the reverse equity market is relatively new and there is insufficient practical experience.

Mortgage minimisation schemes

23. ASIC recently obtained Orders in the Federal Court in relation to Sample & Partners, a mortgage broking business promoting a mortgage minimisation scheme.¹⁶ This scheme was promoted on the basis that consumers can save considerable amounts of money, without disclosing that it was not the new credit facility that generates those savings but instead the fact that the consumer would be making extra repayments.
24. Promoters are able to attract interest from potential consumers through a greater interest by borrowers in means to pay off their mortgages more quickly, given the increase in the average size of home loans. In addition to fees payable directly to promoters of such mortgage minimisation schemes, in the Sample & Partners matter ASIC found that consumers incurred additional transaction costs including exit costs from their current loan and the costs of entry into a new loan, moved to a credit facility with a higher annual percentage rate, and did so to obtain benefits that are largely illusory.
25. In the wake of the Federal Court Orders above, ASIC is working with the Mortgage and Finance Association of Australia to improve standards of conduct by its member in respect of the promotion of these schemes.

In relation to Committee's issues, the second, third and fourth do not necessarily arise.

- Declining credit standards. In their worst manifestations, these schemes involve an approach to lending that ignores the needs and circumstances of the borrower, and results in them taking longer to pay off their home loan, rather than a shorter period.

External dispute resolution schemes

26. The Corporations Act requires all licensees dealing with retail clients to be a member of an ASIC-approved external dispute resolution (EDR) scheme.¹⁷ We are required to take a number of principles into account when considering whether to approve a scheme, including accessibility, independence, fairness,

¹⁶ See ASIC MR 07-144, *Court finds major mortgage broker's conduct misleading and deceptive*, 28 May 2007.

¹⁷ Corporations Act s.912A

accountability, efficiency and effectiveness.¹⁸ ASIC has approved seven EDR schemes.¹⁹

27. ASIC Policy Statement 139 and section B of ASIC Policy Statement 165 set out our approach to approving schemes. For example, we require that:

- schemes are free to consumers;
- providers are bound by scheme procedures and decisions;
- schemes reach final decisions and can make financial awards;
- both providers and consumers are afforded procedural fairness;
- consumers who do not accept scheme decisions can initiate legal proceedings; and
- schemes give written reasons for their decisions.

28. The seven schemes deal with approximately 125,000 consumer enquiries and 7,000-8,000 formal complaints per year. The three biggest schemes (the Banking and Financial Services Ombudsman, Financial Industry Complaints Service and Insurance Ombudsman Service) deal with 90% of enquiries and complaints. Schemes are required to determine complaints based on what is fair and reasonable in all the circumstances.

29. The Corporations Act also requires that relevant licensees have an internal dispute resolution (IDR) procedure that meets standards set by ASIC. The existence of EDR also encourages providers to further enhance their IDR procedures. This has meant that more complaints are resolved at the institutional level, saving time and money.

30. As noted in paragraph 2 above, credit products are not regulated by the Corporations Act. While they are regulated by the ASIC Act, that Act does not make any provision for EDR or IDR. This has resulted in a number of gaps.

31. Some home lending does allow access to EDR. Most commonly, that is the case where the lender is also a financial services licensee, and adopts a consistent approach to IDR and EDR across all its products and services.²⁰ ASIC has also provided licensing relief to entities that advise consumers about mortgage offset accounts (which involve a deposit account which is regulated by the Corporations Act) where those entities are members of an ASIC-approved EDR scheme.²¹ Finally, some home lenders have voluntarily become members of an approved EDR scheme, or to fulfil membership requirements of an industry peak body.²²

¹⁸ Corporations Regulation 2001 reg 7.6.02

¹⁹ Banking and Financial Services Ombudsman (BFSO), Financial Industry Complaints Service (FICS), Insurance Ombudsman Service (IOS), Insurance Brokers Disputes Ltd (IBD), Credit Ombudsman Service Ltd (COSL), Credit Union Dispute Resolution Centre (CUDRC) and Financial Co-operative Dispute Resolution Scheme (FCDRS).

²⁰ This is the case for most banks, many of which have made a formal commitment to providing IDR and EDR for all customers by adopting the Code of Banking Practice.

²¹ ASIC Class Order 03/1048, *Mortgage offset accounts*. This is particularly relevant to mortgage brokers, many of which are now members of COSL or the BFSO.

²² For example, the Mortgage and Finance Association of Australia requires that its members be a member of an approved EDR scheme.

32. Despite this, many fringe lenders and mortgage brokers are not members of an EDR scheme.
33. Regardless of whether a borrower does or does not have access to EDR, complications arise where a dispute relates to conduct of a mortgage broker or other intermediary. Any remedy available to such a borrower will be available against the broker and not the lender, despite the fact that the effect of the broker's conduct may be manifesting itself in the ongoing operation of the home loan.
34. With recent increases in property prices, it is also important to ensure that the monetary limits of relevant EDR schemes continue to reflect market realities.