THE Financier

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THE FINANCIERS ASSOCIATION OF AUSTRALIA LIMITED NEWSLETTER

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Welcome to the Spring 2008 edition of The Financiers Association of Australia Limited newsletter.

As usual we try to keep up with any legislative changes in the credit code as well as inserting any interesting general business pieces gleaned from various sources.

A welcome is also extended to new members at this time.

Consumer credit regulation to be transferred to Commonwealth

Senator the Hon Nick Sherry, Minister for Superannuation and Corporate Law, has announced that the Commonwealth Government reached agreement with the States and Territories at the Council of Australian Governments (COAG) meeting in Sydney on 3 July, to assume responsibility for regulation of all consumer credit.

Consumer credit includes personal loans, credit cards, pay day lending and micro loans.

"Current consumer credit regulation is duplicated, patchy, very hard to change or even non-existent and does very little to protect Australians, whilst imposing unnecessary red tape on business."

"It's currently a lose/lose situation, but now we've moved to a win/win", said Minister Sherry.

"We will introduce a regulatory structure for the 21st century, one which includes simple, standard national regulation, replacing regulation in six states and two territories."

COAG has also formally agreed that the Australian Government will assume responsibility for regulating mortgages, mortgage brokers, trustee companies, non-bank lenders and margin loans.

In March, COAG requested that the case for reform of consumer credit be further examined. To this end, the Government released a *Green Paper on Financial Services and Credit Reform* in early June. Submissions closed on 1 July. Targeted consultations with the States and Territories and the business and consumer sectors have established the case for quick action to transfer regulation of all consumer credit to the national level.

"National consumer credit regulation will close loopholes that have existed in various State and Territory jurisdictions and have allowed unscrupulous credit providers at the fringe end of the market to take advantage of people in desperate circumstances."

The agreement was formalised at the COAG meeting in Sydney. During the coming months, the Commonwealth Government, in consultation with the States and Territories, will develop a plan to present to COAG in October 2008 on how this major agreement will be implemented.

The States and Territories have done a worthy job up to now. The reality is that financial products have developed to a point where we now need national consumer protections and clear rules for businesses," Minister Sherry said.

At the same time the Ministerial Council on Consumer Affairs (MCCA) will be considering its response to the Final Report of the Productivity Commission's Review of Australia's Consumer Policy Framework for presentation to COAG in October as agreed.

Background to transfer of consumer credit regulation to Commonwealth

After 20 years of indecision by state and territory governments, the Commonwealth Government's drive for regulatory reform combined with concerns about predatory lending and fringe operators is about to force the consumer credit regulation pendulum to swing to the extreme regulation mode. The days of "negative" licensing (whereby any one can lend until they are disqualified) are nearly over.

The Commonwealth Government's Green Paper on Financial Services and Credit Reform outlines options for the future regulation of mortgages, mortgage brokers, margin lending, non-bank lending and trustee companies, debentures and property spruikers as well as the regulation of other credit products, such as credit cards and personal loans.

The policy rationale for this approach is to provide a consistent national regime in areas that are national or international, where there are conflicts or gaps in the existing regulatory framework and where there is evidence that significant numbers of consumers are suffering losses and other detriment because of the failings in the regulatory regime.

The Commonwealth proposes to assume responsibility for mortgages (ie home loan mortgages) by treating mortgage advice, mortgage brokers and non-deposit taking institutions involved in home loan mortgages.

If new licensing, conduct and disclosure requirements are adopted lenders and brokers will need to change their documents, systems and procedures to provide more information to consumers and provide a dispute resolution procedure and compensation schemes.

Mortgage brokers, who are only currently required to be licensed in Western Australia, will need to be licensed nationally.

ASIC would become the new regulator for home mortgages. But it is not clear whether ASIC would become an additional regulator or take over regulation entirely from the state and territory governments. Nor is it clear whether ASIC would issue special credit provider licences or require credit providers to take out an Australian financial services licence for their credit products.

The Green Paper also discusses the option of transferring responsibility for other forms of consumer credit (eg credit cards, car loans, personal loans), as well as mortgages, to the Commonwealth as recommended recently by the Productivity Commission.

The Green Paper shows why developing a cohesive framework has been so difficult to date. The tableau shows a patchwork of credit regulation which has struggled with coverage of businesses which do not themselves accept deposits or provide credit.

Regulation of credit providers would involve three phases: licensing of credit providers, the setting of minimum standards of disclosure of information and rules for the conduct of credit providers. Failure to observe these rules would result in fines and/or disqualification.

Reports and surveys by the Uniform Consumer Credit Code Management Committee (UCCMCC) over the last 10 years have failed to clearly demonstrate the benefits to consumers of disclosure tools such as mandatory comparison rates and highly regulated contract disclosure tables.

Some schemes or products are just unlawful: schemes to defraud people which are obvious crimes or products which are inherently unsafe should of course be prevented.

But in daily life consumers demand choice and are willing to exchange risk for reward. Can you regulate to protect people from themselves?

The arguments that credit providers previously put up unsuccessfully will again be raised by fringe operators:

1. the cost of regulation will be passed on to those who can least afford it and who the regulation is meant to protect (namely consumers).

2. disclosure will only make credit documents longer, more complex and difficult to understand.

3. more regulation will stifle product innovation

4. more regulation will benefit existing providers and reduce competition.

The Government is unlikely to accept these arguments.

But the Green Paper shows an understanding of constitutional difficulties and local differences. Although the Australian Constitution gives some financial services regulatory powers to the commonwealth, in other areas the commonwealth and the states must act cooperatively to achieve consistent national regulation. As a result, the regulation of financial services in Australia is sometimes by function and sometimes by type of organisation; sometimes it is national and sometimes state-based.

For example:

• Financial products and services, deposit-taking, payment facilities, banking and insurance are commonwealth regulated but regulation of credit is a state-based power. Commonwealth regulated financial service providers require an Australian Financial Services Licence issued under the Corporations Act 2001 (Cth).

• Under the Banking Act 1959 (Cth) only a body corporate that is authorised can carry on a banking business in Australia. A body corporate that is granted an authority to carry on a banking business in Australia is referred to as an authorised deposit-taking institution, or ADI. Only certain ADIs can call themselves "banks", "credit unions" or "building societies".

• The Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) applies to a wide range of financial services providers, the gambling industry and others.

• Consumer credit regulation may vary from state to state.

• Land title and personal property [redacted] from state to state.

Consumer credit hardship relief

Under section 66 of the Consumer Credit Code "a debtor who is unable reasonably, because of illness, unemployment or other reasonable cause, to meet the debtor's obligations under a credit contract and who reasonably expects to be able to discharge the debtor's obligations if the terms of the contract were changed in a manner set out in subsection (2) may apply to the credit provider for such a change."

Under subsection (2) , a debtor can request to extend the term of the loan (and reduce the repayments) without any change to the interest rates or for payments to be postponed or a combination of both.

The Code and Regulations sets a hardship threshold above which section 66 does not apply. From 8 August 2008 the threshhold will be $336,050. Section 66 relief and the debtor's right to apply for a stay of enforcement proceedings therefore applies to loans up to that amount.

Lenders must take hardship requests seriously: under section 68, if the credit provider does not change the credit contract in accordance with the application, the debtor may apply to the Court to change the terms of the credit contract.

Under section 88 if the debtor, mortgagor or guarantor is unable to negotiate a postponement, the debtor, mortgagor or guarantor may apply to the Court for a postponement. The Court may, if it thinks it appropriate in the circumstances, stay any enforcement proceedings under the credit contract or mortgage until the application has been determined.

Further, unreasonable conduct by [redacted] declaration of unjust conduct.

A $240,000 company loan compounds to $11,588,845 in two years!

Galadriel Lothlorien Pty Ltd v Station 1 Pty Ltd [2008] NSWSC 91 (15 February 2008)

Stojan Paceskoski, Antonio Saglimbeni, and Anna Maria Saglimbeni were all directors of Station 1 Pty Ltd. Station 1 owned a property which it wanted to subdivide, in Rockdale, Sydney. It borrowed $2.3 million from Perpetual Trustee Company Limited which took a registered first mortgage over the property.

It borrowed another $120,000 from Filmseal Pty Ltd under what is known in the finance industry as a "caveat loan".

This is where money is borrowed on a second mortgage, but that mortgage isn't registered nor intended to be registered. Instead, it is protected by a caveat on the title. In Latin, "caveat" means "beware". The caveat was sufficient to warn anyone dealing with the title about Filmseal's interest in the property. The Filmseal loan was for three months, maturing on 5 December 2004. The interest rate was 3 per cent per month and the default interest rate was 4.5 per cent per month. Unpaid interest was capitalised monthly. The directors of Station all gave personal guarantees for both loans.

By early March 2005, the Filmseal loan was well past due and was unpaid. The payout figure was in the vicinity of $180,000. Station and its directors were desperately seeking a replacement short term loan. They were obviously not an attractive proposition to conventional lenders.

Working through a finance broker, they found another lender, Galadriel Lothlorien Pty Ltd. Station borrowed $240,000 for two months. The documentation provided in the conventional way for a higher rate of interest to be reduced to a lower rate on timely payment. The higher rate of interest was specified as 14.5 per cent per month. The lower rate of interest was specified as 7.25 per cent per month. Even the lower rate was substantially higher than the default rate on the Filmseal loan! Any arrears in interest compounded *daily*.

Even by the standards of the caveat lending trade, the rates are extremely high. On an annual basis they equated to 87 per cent and 174 per cent, even without the daily compounding.
Leon Angelopoulos, a finance broker who referred Station 1 to Galadriel, gave evidence that normal concessional rates in this market were around 5 per cent, but that the higher rate was not double, but generally 2 to 3 per cent more than the concessional rate. Previously Galadriel had generally charged 5 per cent as the concessional rate, although its higher rates had been double the concessional rate. Angelopoulos described the rates charged on the subject loan as "highway robbery". Pamela Reading, the principal of Galadriel, agreed that it was "extraordinarily expensive finance".

Station 1 defaulted on the loan and was unable to refinance because the amount required to refinance was so high. Galadriel sued Station 1 and the guarantors. Station 1 went into liquidation. Mr Saglimbeni went bankrupt and did not defend the matter. Paceskoski and Mrs Saglimbeni defended on the grounds that "the Court should, pursuant to section 7 of the Contracts Review Act (NSW) 1980, refuse to enforce the terms of the guarantee."

In essence they claimed that the rate was extortionate and Galadriel took advantage of their desperate situation.

In an affidavit of 25 June 2007, Ms Reading stated the amount due under the loan of $240,000 advanced in March 2005 with interest calculated on the higher rate as $11,588,845.51 The judge said this was "a graphic example of the effect of a very high interest rate and the daily compounding provision."

I am of the view that the interest rate imposed was extortionate, even by the standards of the market in caveat loans and all the more so in light of the daily compounding provision. The plaintiff was well aware of this and equally well aware that the defendants were in no position to bargain and would accept whatever interest rate, however extortionate, was stipulated by the plaintiff.

I find that the contract, insofar as it related to the guarantees given by the second defendant and the fourth defendant, was unjust within the

If you come across or would like to contribute any article that may be of interest for the newsletter please fax on (02) 9299 1433 or post to the Association c/- GPO Box 3463 Sydney NSW 1043.

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