

## **Proposed UCCC Amendments – Submission – 20 September 2007**

### **Introduction**

This submission has been prepared by Gadens Lawyers for the Mortgage and Finance Association of Australia (MFAA). The MFAA is Australia's peak industry body for the mortgage and credit industries.

The submission is also made by Gadens Lawyers on behalf of a number of bank and non-bank mortgage lenders.

### **General Comments**

It is well known that the MFAA supports responsible lending and consumer protection.

However, some of the proposed UCCC amendments have the potential to:

- increase interest rates for consumers;
- further impact on home affordability as larger deposits will be required; and
- cause significant disruption to capital markets;

while providing no commensurate benefit or protection for consumers.

These serious consequences flow from the significant uncertainty that will be caused by:

- the requirement to express all charges "in the nature of interest" as an interest rate;
- concerns that any fee which is not directly reflected by cost may be irrecoverable; and
- the risk of challenge to credit contracts by government consumer agencies.

While the amendments are stated to be targeted at fringe lenders, we cannot state too strongly that there are very serious consequences in these proposals for the mainstream mortgage market. Enquiries in the industry show that these amendments, if passed, would act to increase interest rates significantly. It is essential these proposals are re-considered.

Even if these proposals provide protection for a small minority (and it is unclear how they do), they disadvantage the vast majority of borrowers.

If, despite our submissions to the contrary, the proposals opposed in this paper proceed, industry will need significant time to amend systems, products, and documents.

### **Require all lenders to join an ASIC approved EDR.**

The key current issue for the mortgage industry (ignoring the US induced funding issue) is predatory lending. The proposals do nothing to address that issue.

The problem of predatory lending could be addressed at least in part by requiring all UCCC lenders to be members of an ASIC approved dispute resolution scheme. We understand Victoria proposes to

introduce legislation to this effect by the end of this year. This initiative should occur nationally, and occur urgently. The governments should appreciate the importance of providing access to justice for the disadvantaged and act now.

### Executive Summary

Under this heading we list the proposals and provide a summary of our position.

Proposal	Submission
Remove the conclusive presumption provided by a business purpose declaration	Supported.  Many of our members and clients have adopted uniform procedures for Code and non Code loans. However, the spectre of a class action by regulators will be a significant impetus for "adverse steering" – i.e. trying to construe loans as unregulated. This will be a significant retrograde step. It would create a reason for mainstream lenders to start adverse steering in order to protect their position, being a practice which until now has been confined to fringe lenders.
Show charges "in the nature of interest charges" as an annual percentage rate	Opposed.  The requirement is unclear and its application will be misleading for consumers. What charges are in the nature of interest? Must contingent charges be disclosed?
Provide that fees, charges, and interest rates may be reviewed if unreasonable	Changing the test from "unconscionable" to "unreasonable" is not opposed. However, the link to underlying cost is opposed.
Applications to re-open transactions can be made by government consumer agencies	Opposed, as this creates too much uncertainty for lenders and will create a bias in favour of adverse steering.
Fees paid by borrowers to associates of the lender must be included as a charge by the lender in determining whether the interest rate exceeds the maximum for the exemption of short term loans to apply	Supported but only if the maximum for interest and charges in NSW, ACT, and Victoria is first removed or adjusted. The impracticability of these caps for short term lending is well known, and it likely to force short term lending underground where it will be harder to assist distressed consumers.
Clarify pawnbroker exemption	Supported
Prohibit mortgages over essential household property	Supported
Further information about direct debit arrangements	Opposed. Lenders need to collect repayments by direct debit. The absence of a direct debit will increase the incidence of default which may incur default fees and increase hardship.
Retrospective operation of the proposed legislation	Opposed.

	<p>As drafted, the amendments apply to loans made prior to the commencement of the amendments. We strongly oppose what is effectively retrospective legislation. It is important that the finance industry is not sent a message that retrospective legislation is a risk of conducting business in Australia. Such a message could have unexpectedly wide adverse ramifications on the Australian financial markets. Instead, the amendments should apply to credit contracts having a disclosure date after the amendments commence.</p>
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The reasons for our views are discussed in more detail below.

### **Disclosure of fees "in the nature of interest" as an interest rate**

As noted above, this proposal is opposed. There are significant problems with this proposal.

- The proposal discriminates against product development such as shared appreciation mortgages and Islamic loans(also known as Shariah Banking or Fiqh al-Muamalat) where an interest rate cannot be stated. Shared appreciation mortgages have the potential to help housing affordability and so it is important that the product is not marginalised. Islamic loans are needed to avoid discrimination against a sizeable portion of Australians.
- We do not know how to identify a charge "in the nature of an interest charge". Similar legislation introduced in NSW and the ACT in 2006 was accompanied by a "Statement of Regulatory Intent" stating that despite the wording of the NSW legislation, the requirement contained in the legislation to disclose an annual percentage rate calculated on the basis of "charges under the contract that are in the natures of interest" did not change the existing disclosure requirements. So far as we are aware, no lenders have amended their contracts in response to the NSW and ACT legislation. For example, is an annual line fee, such as is commonly used in professional pack products, a charge in the nature of interest?
- It is unclear whether the section applies to contingent fees in the nature of interest.
- Does the proposal mean that the "normal" interest rate needs to be disclosed separately from the "aggregate" interest rate which includes "fee" interest? The exposure draft requires the total of the "normal" interest and the "charges" interest to be shown under s.15(E), and so perhaps it is envisaged that there can only be one disclosure of an "all up" rate. We do not understand how this will work.
- The disclosure of two interest rates (ie the "normal" interest rate and the interest rate represented by fees) would be unnecessarily confusing for consumers.
- Industry would face significant costs and systems issues to calculate an interest rate where the fee is a fixed amount and not a percent of the principal sum.

We appreciate that the objective is to assist consumers to understand the cost of credit and to facilitate product comparison. Surely, this is the purpose of the comparison rate legislation? It is inappropriate that there should be two attempts at disclosure of the cost of credit. This adds cost to industry and confuses consumers.

If it is felt that a further disclosure of the cost of credit is required in credit contracts, this could be done by requiring a comparison rate schedule to form part of the credit contract, but why provide this information twice?

## **Review unreasonable interest and other charges**

The change of the test from unconscionable to unreasonable is not opposed, although we are not aware of any evidence that the unconscionable test has been found wanting. However, the link to underlying cost is most strongly opposed.

Under the proposal, it is possible that a court could declare that any amount which is not clearly backed by a corresponding cost or loss is unreasonable.

A key reason for our opposition to this proposal is the adverse impact limiting fees to cost will have on the mortgage market. We strongly believe that fees are an appropriate feature of product design.

This issue is so fundamental that we have provided significant information clearly demonstrating the importance of fees for both consumers and lenders.

Attachment A – Deferred Establishment Fees – an explanation

Attachment B – Edited paper on Financial Stability in the Australian Mortgage Market

Attachment C – How are fees incurred by the credit provider in a securitised program?

Attachment D – Report from Trowbridge Deloitte provided to a lender. This report is included with thanks to Trowbridge Deloitte and is subject to the reliances and limitations detailed in the letter.

The issue is most relevant in relation to deferred establishment fees (DEFs). While we maintain that there is a very strong correlation between costs and DEFs, to the extent that DEFs cannot easily or specifically be justified by cost, the enforceability of DEFs will be placed at risk. If DEFs are uncertain the consequences include:

- significantly increased cost of credit for consumers;
- increased deposits required by homebuyers (adding to home affordability problems)
- reduced competition;
- disadvantaging loyal customers (as they will have to pay for unprofitable customers);
- promoting bad customer behaviour (encouraging lender swapping);
- reduced customer choice (less product flexibility);
- encouraging adverse steering; and
- not competitively neutral as it impacts lenders differently depending on their funding and marketing structure.

In addition, the proposal presents the following problems.

1. If the test of reasonableness is cost, a lender would need to continually monitor the cost of each activity in its business, which is quite impractical.
2. In the absence of any guidance as to what is "reasonable", lenders will be faced with the prospect of regulators in eight jurisdictions having different attitudes to what is reasonable. That's not reasonable or acceptable!

3. Section s72A(3) is inefficient as any action taken by a single jurisdiction can only apply to loans made to residents of that jurisdiction. Will a lender be subjected to eight separate applications at once?
4. Proposed ss.72(3), (4), and (6) can be read to mean that any fee in excess of cost is de facto "unreasonable". Arguably, this is not the case given ss.72(7) and (8) which provide for other tests, namely the standards of commercial practice generally, and comparable cost. The operation of sections 72(3), (4), and (6) should be made clear by changing "is unreasonable only if" to "can only be unreasonable if".

The requirement to refer fees to cost creates significant problems for securitised mortgage programs as the cost may be incurred by the Master Servicer or Mortgage Manager, but not by the credit provider. This problem is discussed further in Attachment C.

If despite our objections the provision becomes law, it is important that the industry is given significant guidance as to what is considered unreasonable.

Presumably, from a regulator's perspective the objectionable aspect of contingent fees is that they make assessing the cost of credit more difficult for the consumer, and because of the "surprise element" – ie fees not properly and prominently disclosed. Rather than destroy product flexibility to protect a small minority, these problems would be better addressed by requiring:

- (a) a prominent warning that a DEF applies; and/or
- (b) a statement of the effective interest rate if the fee is paid – this idea is further developed in Attachment A.

### **Further information about direct debit arrangements**

It is unlikely that adding this information at the end of the already quite long Information Statement will bring the matter to the attention of consumers.

It is very important for mortgage lenders to be able to collect repayments by direct debit. If borrowers are able to choose a method of payment, the cost of administering mortgage loans will significantly increase.

A statement of the kind proposed might mislead consumers because exercising the right to cancel a direct debit may be default under the loan agreement which requires all payments to be made by direct debit (most do). The absence of a direct debit will increase the incidence of default which may incur default fees and increase hardship.

The confusion created by such a change will exceed any benefit. The Customer Services Agreement which must form part of each direct debit authority is sufficient disclosure and already states something to the effect of "You may terminate the DDR at any time by giving written notice directly to us, or through your Financial Institution. Notice sent to us should be received at least 14 business days prior to the date of termination."

## **Attachment A– Deferred establishment fees**

Deferred establishment fees (sometimes called Early Repayment Fees or Postponed Establishment Fees) are fees payable if the borrower repays within a specified period from the settlement date (usually 1-5 years).

DEFs are an important financial tool which benefits both borrowers and lenders because:

- without a DEF borrowers would need to pay much higher loan establishment fees (thus worsening home affordability);
- without DEFs lenders would need to charge a much higher interest rate in the early part of a loan to cover the costs of establishing the loan and manage the risk of early repayment.

The enforceability of DEFs is threatened if fees are limited to cost recovery, unless the definition of cost is widened to cover the total cost of establishing a loan and then incurring an early repayment. Many commentators consider that the current UCCC provisions already severely limit the type of costs which can be taken into account when assessing establishment fees.

Even if the definition of cost is widened, there are significant challenges for securitised programs as the credit provider may not incur the cost – ie the cost may be incurred by some other entity in the securitisation chain.

Both banks and non banks have revenue models that rely on a loan running for a certain period of time during which the lender can generate sufficient net margin to cover its start up and running costs and generate an acceptable return. A loan product without a fee component must rely solely on the interest spread, with the result that all borrowers end up paying more. It is important to remember that a DEF is never payable if a loan is not repaid early. The DEF "user pays" model is much more equitable than if this cost was paid upfront by all borrowers or built into the interest rate.

Rates and margins were much higher prior to the commencement of the UCCC. This was not just because of reduced competition but was also a consequence of greater prescription. The current situation where the cost of borrowing is reduced where appropriate rather than everyone sharing the same burden is an example of a market operating efficiently.

It is important that the enforceability of such important revenue items as DEFs is not uncertain. The industry is keen to work with regulators to find an acceptable solution.

### **Industry input**

One major lender calculated that if it removed its DEF it would need to increase interest rates for *all borrowers* by 1.55% pa. This lender commented that "a one size fits all model is inevitably less sophisticated leading to unintentional winners and losers."

Another major lender reported that it would need to increase establishment fees payable by borrowers by up to 1% of the loan amount if DEFs were removed, but was also concerned that such an establishment fee could be challenged under the proposed regime. This scenario leads to a great degree of uncertainty for lenders.

See input from Trowbridge Deloitte as Attachment D which reports that removal of DEF would increase interest rates for all borrowers by up to 0.65% per annum

### So what's the problem with DEFs?

It seems the main problems are:

- the existence of a DEF is sometimes "hidden" in the credit contract – this can be addressed by a prominent warning in the credit contract, and possibly a statement that the loan may not be suitable for short term borrowing;
- DEFs may not be properly disclosed at point of sale and disclosure in the credit contract is too late – this could amount to misleading and deceptive conduct for which borrowers already have adequate remedies. These remedies are likely to be strengthened in proposed national uniform broker legislation currently;
- consumers have difficulty in assessing the real cost of DEFs – this is the same challenge that surrounds the debate over the effectiveness of comparison rates. This could be addressed by requiring disclosure of the DEF as an interest rate. Although we oppose a general imprecise requirement to express fees as an interest rate, there may be benefits here. See example below.

#### *Example*

Assume a percentage base DEF of 4/3/2/1 payable over years 1-4 respectively, and an interest rate of 7% per annum.

If the borrower repays just before the end of year 1, the borrower will have paid 7% base interest and 4% DEF, so the total interest rate will be 11% per annum.

This provides us with the following table.

<b>When repaid (months from settlement)</b>	<b>Interest rate</b>	<b>DEF</b>	<b>Annualised DEF</b>	<b>Combined interest rate</b>
3	7%	4%	16%	23%
6	7%	4%	8%	15%
9	7%	4%	6%	13%
12	7%	4%	4%	11%
15	7%	3%	2.4%	9.4%
18	7%	3%	2%	9%
21	7%	3%	1.71%	8.71%
24	7%	3%	1.5%	8.5%
27	7%	2%	1.2%	8.2%
30	7%	2%	0.80%	7.80%
33	7%	2%	0.72%	7.72%

36	7%	2%	0.66%	7.66%
39	7%	1%	0.31%	7.31%
42	7%	1%	0.28%	7.28%
45	7%	1%	0.27%	7.27%
48	7%	1%	0.25%	7.25%

The calculation of the annualised DEF and the combined interest rates in the above example is overstated, as it does not allow for the fact that the DEF component is paid in arrears when the loan is repaid. The actual annual percentage rate calculated in accordance with the UCCC will be lower.

The point is that this table gives the borrower a much better idea of the real cost of the credit, and demonstrates that this product is unsuitable for short term borrowings.

Contingent fees can not be included in the "normal" interest rate, as they are only payable *if* the fee event occurs.

### **Commercial commentary on DEFS**

1. DEFs are a way of hedging prepayment risk.
2. There is the potential for substantial destabilisation of the financial markets if DEFs are not enforceable. This is because lenders need to hedge against prepayment risk. Although some new entrants or large organisations can afford to "punt" the prepayment risk, it is inappropriate for large segments of the market to do so.
3. A DEF conforms with the "user pays" philosophy. It is important, however, that the DEF is fair and transparent. Lenders using DEFs should emphasise the existence of DEFs a number of times during the origination process.
4. The imposition of a DEF gives the lender an opportunity to raise capital by a NIM bond (net interest margin bond), which is cheaper than raising venture capital, both because of the source of the money, and because the risk is hedged by the DEF. This saving is passed through to borrowers.
5. Telcos have overcome the prepayment risk by having a fixed term for mobile phone contracts. Imagine the Telco who provided an expensive piece of equipment with no fixed term obligation. There would be long queues at the Telco's door, but short business prospects for the Telco.

Lenders cannot mandate a fixed term because of s.75 of the UCCC.

6. A higher upfront fee is non selective as it applies to all borrowers regardless of how long they intend to stay with the lender. An upfront establishment fee also requires a financial outlay that some borrowers may struggle with. At the end of the day an upfront fee is unfair because it prejudices loyal customers and encourages bad behaviour.
7. Lawyers now have wildly divergent views on the UCCC provisions concerning the enforceability of DEFs. This has led to confusion in the market, and although many lenders

now charge a DEF, many are left partially unhedged. This confusion in the market is not good for integrity of the financial markets.

8. Doubts concerning the UCCC also have the adverse affect of encouraging adverse steering – asking consumers to sign a declaration that a loan is for investment purposes when it isn't, so as to escape the provisions of the UCCC.
9. DEF structures are increasingly being utilised to provide a prepayment hedge, allowing a lender to recover costs incurred from a borrower who prepays within a defined period of time. Overseas a number of lenders have failed in the past due to liquidity stress. The economy as a whole, including consumers, is prejudiced when the financial markets are unstable. There are strong arguments to minimise the uncertainty.

## **Attachment B – Financial Stability in the Australian Mortgage Market**

The below is edited extracts from a paper on the above topic.

### **The Role of Deferred Establishment Fees in the Australian Mortgage Market**

#### ***Overview***

A feature of the mortgage market in Australia is the charging of deferred establishment fees or DEFs. These fees are charged when a borrower repays a loan within a pre-set period of time, typically 3 – 5 years.

Rather than being a hidden charge designed to increase a borrowers cost of borrowing (and hence revenue to a lender), well designed DEF structures provide an important protection for lenders and borrowers, improving the prospects for financial stability for financial institutions, and decreasing the average cost of borrowing for Australians.

#### ***Background***

Many banks and finance companies have revenue models that rely on a loan or contract running for a certain period of time, during which the lender can generate sufficient net margin to cover its start-up and running costs and generate an acceptable return. In a loan product without any fee components, the income generated is primarily the difference between the retail interest rate paid by the customer, and the cost of funding the product. The longer a borrower stays in a product, the greater the present value of the loan, and sensible lenders run retention strategies designed to encourage borrowers to extend the life of their loan, to increase the value of the loan asset.

#### ***Investment and return dynamics in mortgage loans***

One characteristic of mortgage loans, that sets them apart from other retail products, is the relatively high up-front costs of originating the product. The creation of a new loan includes three key steps as follows.

1. ***Sourcing of the customer*** either directly (via branch network or direct to consumers) or via outsourced distribution channels (a broker network, for instance). Distribution costs vary from channel to channel, but these costs need to be covered by the economic value of the new loan for a lending business to be profitable. If distribution costs were paid that ultimately amounted to more than the net loan value, the new contract would clearly be profitless.
2. ***Underwriting the loan***, to ensure that a new contract fits within criteria established by the lender.
3. ***Arranging funding for the loan***, either on a short term (warehouse) or longer term basis.

Once a loan has been originated, the costs associated with the maintaining the product are somewhat lower, and depending on portfolio performance, quite predictable. Some lenders allocate a portion of their net margin to cover servicing costs – in general, these costs are less than 50% of the gross margin available, and this proportion is relatively static, however this will vary depending on the type of loan.

We noted above that income is generally earned over time for financial products. When the majority of the costs are incurred up-front and income is generated over time, two financial risks are created – a *working capital risk*, and a *prepayment risk*.

The *working capital risk* is the funding required to balance the timing mismatch between costs incurred and income generated. In essence, this means that a lender must be able to raise enough working capital to allow them to invest in the up-front costs to write new business, and then repay this funding from the net income generated over the term of the loan. If the lender is unable to raise the required amount of working capital to fund the timing mismatch (either externally in the debt or equity markets, or from its own balance sheet resources) the lender must reduce their investment in the origination of new loans, which would impact either the quantum of new business, or more importantly, the quality of new business.

The second financial risk is associated with the timing mismatch between costs incurred and income received is *prepayment risk*, the risk that borrowers prepay their loan prior to the up-front costs of originating the loan being recovered. If a borrower individually repays their loan prior to the costs associated with their loan having been recovered, the lender suffers a financial loss. If all borrowers prepaid earlier than expected, perhaps due to attractive honeymoon rates available elsewhere in the market, or a loss-leading strategy by a competitor, a major stress could be applied to lenders who had assumed a more benign prepayment environment. If the lender has leveraged future income to fund their up-front costs, this stress could be fatal. If a number of lenders were hit by such a stress, the combined effect could potentially destabilise the financial markets.

### *Consumer / Lender dynamics*

All sensible market participants want to provide good quality products and services to consumers, and generate a market return for their funders and shareholders. History has shown that lenders who under-estimate their customers levels of sophistication quickly fall behind, and informed consumers in an efficient market should be expected to operate rationally and in their own best interests. In general, consumers do not expect a free lunch, and tend to look at such offers with suspicion. They are generally happy with a "user-pays" philosophy, provided it is fair and transparent.

In financial terms, a borrower who has benefited from the receipt of a loan product which required a significant upfront investment by the lender and which they can prepay without cost has been granted a free option.

Mobile phone companies have long been aware of this dynamic when providing subsidised handsets on a fixed term contract or plan. A subsidised handset represents a real cost to the telco, and in general, the telco requires the consumer to enter into a fixed term contract to ensure that it will recover these costs, and generate a reasonable return on its investment. It is difficult to conceive of an expensive handset being made available to a consumer who could terminate their contract the day after receipt and keep the handset – there would be a long queue at the door of the telco marketing this tempting offer, and in all likelihood a business with a limited life expectancy!!

And yet when a loan is provided to a consumer without a prepayment hedge or cost recovery mechanism, this is effectively what is happening. In this instance, a consumer is being provided with a product for which they have not generally paid all the establishment costs, and if they repay the loan the day after signing, the lender can be left with substantial, irrecoverable costs. In accordance with section 75 of the Consumer Credit Code, lenders are not allowed to mandate a fixed term for the loan, in the way a telco can fix a contract term as this section allows borrowers to repay at any time. So either a lender must contemplate taking a substantial loss on some loans where borrowers effectively exercise their free option and pre-pay early, or the lender must charge a fee or charge which allows them to recover some or all of their establishment costs.

Alternatively, a lender could charge a higher up-front fee, to more closely match the income and expense profile of the loan product. This has two drawbacks – a higher up-front fee is non-selective (it is applied to all borrowers regardless of how long they intend to stay in the product), and it requires a financial outlay which some borrowers may struggle with. If the up-front fee is funded into the loan

balance, it runs the risk of being less visible to the consumer. Most lenders are prepared to make that investment on behalf of a borrower to facilitate the delivery of a product, provided they know the investment terms. By either increasing rates or up-front fees, a lender has taken a cost which would only have been crystallized by that portion of a portfolio who prepay early, and applied it to all borrowers.

### *The rationale for deferred establishment fees*

Deferred establishment fees are fees charged to a consumer who repays their loan within a fixed period of time, usually 3 – 4 years. The fee is generally expressed in one of three ways – a % of the repaid amount, a fixed \$ amount, or a number of months of interest. Some DEFs step down over time, so that the economic cost to a consumer who repays with the DEF horizon reduces as the years pass. This is intended to reflect the amortization of the cost base of the loan, as net margin flows to cover costs and start generating an economic return to the lender. Most DEFs are not designed to be profit making, although the UCCC does not state that a cost recovery fee cannot also generate a profit. As with any efficient market however, informed consumers with access to a choice of products will gravitate towards the one that delivers the best economic return at the lowest cost, ensuring all fees are balanced into the equation.

A DEF sized to match exactly the costs incurred in writing a loan provides a powerful hedge for the lender, and substantially mitigates the risks identified in the proceeding sections. In the case of a loan that runs for just one day, the investment made by the lender in originating the loan is offset by the recovery of the costs via the charging of the DEF. This still represents an unsuccessful outcome for the lender, as a zero return has been generated for funders and shareholders despite the non-costed effort expended. However, the investment made in writing the loan has been recovered, and the financial viability of the lender has not been jeopardized. If the loan runs for one year, a net income equivalent to the gross margin less servicing and funding costs has been generated – prudent lenders will still use retention strategies, product innovation and administrative cost reduction to optimize the net margin. Competitive dynamics can be relied upon to ensure that the lender with the most efficient operating cost structure, delivering the optimal cost / benefit to the consumer, will prosper.

Consumers assessing a product with a DEF will recognize that the free option they may have been presented with has now been costed. That is not to say they have been disadvantaged, as the interest rate they are paying is likely to be lower, reflecting the fact that the lender was able to hedge the cost exposure they faced. Rather than take a defensive view of pre-payment speeds when designing their product (as their viability depended as a lender depended upon getting it right), they can focus on delivering the best product at the lowest cost, knowing that the longer the loan runs, the more profitable it is.

Using our mobile phone analogy above, when using a DEF structure, the telco is now effectively charging for the handset if the borrower does not stay with the plan for a given period of time. Rather than mandating a term, the lender charging a DEF is mandating a cost recovery structure. As with all efficient markets, fortune will favour the lender with the lowest cost structure relative to the economic value they provide.

In the proceeding sections, reference has been made on a number of occasions to ‘informed’ consumers. Herein lies one of the key risks with DEF structures. Consumers who are unaware of deferred charge structures when they are assessing the product are unable to factor this contingent cost into their appraisal of the costs and benefits. If their horizon for staying in the product is shorter than the DEF scale, they may face unexpected costs, which could tip the balance in favour of alternative products. So whilst DEF charging provides a critical hedge in efficient financial markets, it is vital that as with other key terms and conditions, consumers are aware of the DEF cost structure. They will weigh the length, ramp, and quantum of the DEF, and flexibility of the product (re-draw or security portability for instance) to assess its relative merits. Sensible lenders highlight DEFs at multiple

stages during the origination process to ensure consumers are aware of, and have factored in, these contingent costs. Products specifically targeting shorter term borrowers (so called bridge loans) could be expected to have a shorter DEF horizon and higher rates.

### ***Conclusion***

Lending has a number of unique characteristics which give rise to specific risks.

DEF structures are being increasingly utilized to provide a hedge, allowing a lender to recover costs incurred from a borrower who prepays within a defined period of time. This comfort allows them to make an appropriate investment in the origination of the loan, and ensures that only those borrowers who repay before the costs associated with writing their loan have been recovered, carry that cost. Without a DEF structure, or with laws in place that make it easier for a DEF structure to be challenged, lenders must make a conservative assumption regarding the loan term, and price their product accordingly to recover their costs and generate a net profit. In an efficient market, this uncertainty is priced and applied to the interest rate and up-front fees paid by a borrower. It is likely that a market that charges DEFs results in a lower cost of borrowing for consumers.

### **Attachment C – How are fees incurred by the credit provider in a securitised program?**

The issue of justifying the costs of the lender in a securitisation program creates special problems not applicable to most balance sheet lenders. This is because the expenses are often incurred by the master servicer or other third party and may not be fully passed on to the lender (or not passed on at all).

These issues can even impact balance sheet lenders such as banks if they securitise their book after origination.

If it is accepted that all fees should be matched by recoupment of costs, the issue then arises as to whether section 30 applies to limit the fee to the borrower to the net cost to the lender. The best known example of the application of section 30 is the recoupment of LMI premiums, where borrowers should only be charged the premium less the RITC. Can section 30 have application to other fees charged to borrowers that are represented by fees charged to the lending trust by the master servicer? As far as we know, this issue has not been widely considered by lenders and their lawyers. (To put it another way – if it is correct that the only fees a lender may charge are to cover costs, does s30 apply to all those fees?)

A key unknown is whether a court would look at the master servicer and the lending trust as a single entity, or as two separate entities. Without appearing too cynical, it is likely that a court might adopt the interpretation which best assists the consumer (and that interpretation may differ from issue to issue). Accordingly, there is at least a risk that if a lender attempts to justify fees on the basis of cost, that section 30 will operate to limit the amount that can be recouped.

There is some room for flexibility in this approach by the master servicer acquiring supplies and bundling them when re-supplying to the lender. The cost for the bundled supply could be agreed to be exactly equal to the fee charged to the borrower (allowing for the RITC) – ie the agreement would say "master servicer will charge lending trust an amount exactly equal to the amount the lending trusts charges and recoups from borrowers".