



Australian Government

The Treasury

Financial Services and Credit Reform

Improving, Simplifying and Standardising
Financial Services and Credit Regulation

GREEN PAPER

JUNE 2008

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FOREWORD

The fundamentals of the Australian economy are strong. We are an open, trading nation linked closely to the global economy, in which the services sector plays an ever increasing role. In particular, financial services form a major part of both the domestic and export economy.

As illustrated by recent turbulence in the financial services sector internationally, the market for financial services is increasingly complex and involves many highly sophisticated products.

Australia is no different. Financial services are increasingly an Australia-wide, national sector of our economy. Products are becoming more and more sophisticated and the providers offering them are organised and operate across State boundaries. Ensuring a clear, simple and standard approach to regulating such services is increasingly necessary.

At present, many financial services are already regulated by the Commonwealth. Reflective of their national and international nature, the regulatory regimes covering licensing, conduct, advice and disclosure in relation to securities, shares and debentures, futures and derivatives, managed funds, superannuation, general and life insurance, deposit accounts and means of payments services, are all regulated nationally.

However, credit-related financial services remain without any comprehensive national approach. This includes the systemically important area of **mortgages and mortgage broking and advice**, including reverse mortgages. Similarly, inconsistency in the regulatory regimes governing certain aspects of fair and transparent mortgage fees, including mortgage exit fees, is of growing concern.

In addition, **non-deposit taking institutions** which represent up to 20 per cent of the total lending market, are largely unregulated at the Australian level. Their lending practices are regulated by the Uniform Consumer Credit Code (UCCC). However, the cooperative State-based framework for credit makes it difficult to amend the UCCC, meaning that problems remain unaddressed for long periods of time.

Trustee corporations is another area in need of action. Now managing over \$450 billion in assets, trustee corporations face inconsistent and duplicated licensing and reporting burdens. The creation of a national market through the implementation of Commonwealth legislation is expected to deliver significant efficiency and competition benefits to the trustee corporations industry.

Also of considerable and growing concern are investment loans, such as increasingly popular **margin loans**, which are not regulated under specific legislation either at State or Commonwealth level.

It is in this context that the Prime Minister and State and Territory leaders have placed reform of the regulation of these financial services firmly on the national agenda. The March meeting of the Council of Australian Governments (COAG) agreed that the Commonwealth would assume responsibility to regulate trustee corporations and agreed in-principle that it would assume responsibility for regulating mortgage credit and advice, margin lending and non-bank lenders.

In addition to the four areas outlined above, the Commonwealth believes that the regulation of **debentures**, which are debt instruments used primarily to raise funds from investors such as those issued by a number of failed property development companies including Westpoint, can be improved to ensure retail investors are adequately protected.

Further, the Commonwealth is seeking views on issues relating to property investment advice, including **property spruikers** and on the most appropriate regulation of a range of **other credit products** such as credit cards, personal loans and micro-lending.

This Green Paper examines a pathway to ensuring consistent national and appropriate regulation of these seven critical areas of Australia's financial services. The Green Paper considers this is best achieved by transferring responsibility for these areas to the Commonwealth or improving the regulatory regime where the responsibility is already in the hands of the Commonwealth.

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 Rudd Government's vision was made clear at the last election: to reduce the regulatory burden on business, better protect the interests of consumers and ensure the Australian economy is modern and strong.

Already the work of the Financial Services Working Group to simplify product disclosure statements is well underway and the major proposals contained in this Green Paper Financial Services and Credit Reform: Improving, Simplifying and Standardising Financial Services and Credit Regulation contribute directly to these critical objectives.

A handwritten signature in black ink, appearing to read "Nick Sherry". The signature is written in a cursive, flowing style.

Senator the Hon Nick Sherry
Minister for Superannuation and Corporate Law

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REQUEST FOR COMMENTS

Treasury is calling for public and stakeholder comments on each of the proposals set out in this Green Paper *Financial Services and Credit Reform: Improving, Simplifying and Standardising Financial Services and Credit Regulation* (June 2008).

In order to better understand the financial or other implications of the Green Paper proposals, please provide information in relation to the likely compliance costs, impacts on competition and any other costs or benefits.

This information will be considered in the preparation of a Regulatory Impact Statement and any other necessary regulatory documents.

Comments are requested by COB Tuesday, 1 July, 2008 and can be submitted to financialservicesgreenpaper@treasury.gov.au

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Confidentiality

It will be assumed that submissions are not confidential and may be made publicly available. If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly. A request made under the *Freedom of Information Act 1982 (Cth)* for a submission marked confidential to be made available will be determined in accordance with that Act.

GLOSSARY OF TERMS

Australian financial service licence

Any person who wishes to carry on a financial services business (such as advising on financial products, dealing in financial products or operating a registered scheme) must hold an Australian financial services licence. ASIC regulates the provision of licences and the conduct of licensees.¹

Authorised Deposit-taking Institutions

Authorised Deposit-taking Institutions (ADIs) are corporations which are authorised under the *Banking Act 1959*. ADIs include banks, building societies and credit unions.²

bull market

A period when share prices rise because people are optimistic and buy shares.³

business purpose declaration

A declaration made by a consumer applying for a credit loan with a provider stating as follows — ‘I/We declare that the credit to be provided to me/us by the credit provider is to be applied wholly or predominantly for business or investment purposes (or for both purposes).’ This statement is used as evidence in proving that a loan was provided for business purposes and therefore does not fall under the Uniform Consumer Credit Code.⁴

consumer credit

The credit given by shops, banks and other financial institutions to consumers so that they can buy goods.⁵

debentures

Any document issued by a body corporate that evidences its indebtedness in respect of money deposited or lent.⁶

1 <http://www.fido.gov.au/fido/fido.nsf/byheadline/Definition+of+terms?opendocument>.

2 www.apra.gov.au/ADI.

3 Bloomsbury Reference, Dictionary of Banking and Finance, 3rd edition.

4 Consumer Credit Regulation s 10.

5 Bloomsbury Reference, Dictionary of Banking and Finance, 3rd edition.

6 Butterworths Concise Australian Legal Dictionary, 2nd edition.

equity stripping

[Occurs] where some brokers and lenders (typically operating in the fringe of the industry) inappropriately target vulnerable borrowers who are experiencing financial difficulties. The broker refinances the borrower's home loan debt into a new, higher cost loan.⁷

external dispute resolution scheme

An external dispute resolution scheme is a scheme formed to resolve complaints that cannot be settled directly between the consumer and the product provider. These schemes are free for the consumer and are binding on the product provider. Legally, most financial services businesses licensed by ASIC are required to belong to an independent complaints scheme.

insider trading

The illegal buying or selling of shares by staff of a company or other persons who have secret information about the company's plans.⁸

managed investment scheme

Managed investment schemes are also known as 'managed funds', 'pooled investments' or 'collective investments'. Generally in a managed investment scheme:

- people are brought together to contribute money to get an interest in the scheme ('interests' in a scheme are a type of 'financial product' and are regulated by the *Corporations Act 2001*);
- money is pooled together with other investors (often many hundreds or thousands of investors) or used in a common enterprise; and
- a 'responsible entity' operates the scheme. Investors do not have day to day control over the operation of the scheme.⁹

margin call

If the market value of the investments underlying the margin loan falls below an agreed level, a request (known as a call) is made by the lender to the purchaser to increase the level of assets securing the loan.¹⁰

margin loan

A margin lending product allows an investor to borrow money to invest in securities and financial products. Depending on the product and the provider, these might include

7 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.

8 Bloomsbury Reference, Dictionary of Banking and Finance, 3rd edition.

9 <http://www.asic.gov.au/asic/asic.nsf/byheadline/Managed+investment+schemes?openDocument>.

10 <http://www.fido.gov.au/fido/fido.nsf/byHeadline/borrowing%20money%20to%20invest%20margin%20lending>.

listed shares, fixed interest securities and units in managed funds. The money that the investor borrows is secured by the underlying investments.¹¹

mezzanine finance

A hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.¹²

The term was also used to refer to certain types of subordinated debentures issued by companies such as Westpoint to raise funds from retail investors.

mortgage broker

A person who arranges mortgages, by putting a borrower in touch with a possible lender.¹³

non-bank lender

A financial institution that provides credit products which does not source any of its funding through deposit-taking. Also called non-deposit taking institutions in this paper.

non-conforming loans

Loans made to borrowers who do not satisfy the standard lending criteria of mainstream lenders, including banks.¹⁴

non-deposit taking institution

See non-bank lender.

payday loans

A payday loan is a small, short-term loan (typically no more than \$500) which is often provided without a credit check within 24 hours of application.¹⁵

product disclosure statement (PDS)

The document that the issuer of a financial product must provide to potential investors of the product. It gives information about the issuer, benefits, risks and costs of the product and certain other information.¹⁶

11 <http://www.fido.gov.au/fido/fido.nsf/byHeadline/borrowing%20money%20to%20invest%20margin%20lending>.

12 <http://www.investopedia.com>.

13 Bloomsbury Reference, Dictionary of Banking and Finance, 3rd edition.

14 Reserve Bank of Australia, Financial Stability Review, March 2005, page 41.

15 http://www.docep.wa.gov.au/ConsumerProtection/Content/Credit_and_money/Types_of_credit/Payday_loan.html.

16 <http://www.fido.gov.au/fido/fido.nsf/byheadline/Definition+of+terms?opendocument>.

promissory notes

An unconditional promise in writing made by one person to another, signed by the maker, engaging to pay a sum certain in money, to or to the order of a specified person, or to bearer. Such notes are negotiable instruments, and are used mainly as security for money lending transactions.¹⁷

redraw facilities

A facility which allows the borrower to redraw from the mortgage any extra funds they have repaid over and above the scheduled repayments.¹⁸

responsible entity

A licensed entity or body that operates a managed investment scheme.¹⁹

retail client

Advice is provided to a person as a retail client unless:

- (a) the price for the provision of the product or the value of the product is above the prescribed amount
- (b) the advice is provided for use in connection with a business that is not a small business
- (c) the client has net assets or net income in excess of the prescribed amounts
- (d) the client is a professional investor (e.g. a licensee or APRA-regulated body),²⁰ excepting when in regard to general insurance and superannuation or retirement savings accounts.

reverse mortgages

An arrangement where the owner of a property mortgages that property to receive a regular income from the mortgage lender (and not vice versa), based on the equity value of the property.²¹

securitisation

The process of making a loan or mortgage into a tradeable security by issuing a bill of exchange or other negotiable paper in place of it.²²

17 Butterworths Concise Australian Legal Dictionary, 2nd edition.

18 http://www.mortgageworldaustralia.com.au/loan_advice/faq.htm;
<http://www.justice.qld.gov.au/Department/Fair+Trading/Home+Buyers/Getting+finance/Home+loan+facilities#Redrawing%20equity>.

19 <http://www.fido.gov.au/fido/fido.nsf/byheadline/Definition+of+terms?opendocument>.

20 Regulatory Guide 175: Licensing: Financial product advisers — Conduct and disclosure, page 10.

21 Bloomsbury Reference, Dictionary of Banking and Finance, 3rd edition.

22 Bloomsbury Reference, Dictionary of Banking and Finance, 3rd edition.

statement of advice (SOA)

When an investor receives personal advice from an Australian financial services (AFS) licensee or its authorised representative then they generally will receive an SOA. The SOA records the advice you have been given and explains the basis for the advice.²³

sub-prime loan

A type of loan that is offered at a rate above prime to individuals who do not qualify for prime rate loans. Quite often, sub-prime borrowers are turned away from traditional lenders because of their low credit ratings or other factors that suggest that they have a reasonable chance of defaulting on the debt repayment.²⁴

trustee corporations

Corporations licensed under State and Territory Government Trustee Companies Acts for the purpose of providing personal trustee and estate administration services.

unlisted debenture

Debentures that are not listed on a public market.

23 <http://www.fido.gov.au/fido/fido.nsf/byheadline/Definition+of+terms?opendocument>.

24 <http://www.investopedia.com/terms/s/subprimeloan.asp>.

1. MORTGAGES, MORTGAGE BROKING AND NON-DEPOSIT TAKING INSTITUTIONS

A. Background

i. Credit and mortgages in Australia

According to the May 2008 final Productivity Commission's report on the *Review of Australia's Consumer Policy Framework* (the PC Report) there has been an increased use of credit in Australia over the last 20 years.

Credit allows consumers to borrow money to buy goods or services now, but pay for them later. Credit providers include banks, building societies, credit unions, finance companies and other businesses.

Credit is used for a variety of purposes including the purchase of personal items, domestic items such as furniture, or larger items such as real estate, cars and overseas holidays. According to ABS statistics, in 2005-06 Australian consumers borrowed over \$180 billion.

The largest sector of consumer credit lies with residential mortgages which are estimated to account for over 86 per cent of all consumer loans.

The Productivity Commission is currently reviewing the overall consumer policy framework in Australia and in its final Report has recommended the Commonwealth take over the regulation of credit.

COAG has agreed in principle to the Commonwealth assuming responsibility for regulating mortgage credit and advice, including persons and corporations engaged in mortgage broking activities, for the purpose of protecting consumers.

Consultation with various stakeholders including government bodies, industry and consumer bodies, will take place to determine the way forward.

The credit sector

The provision of consumer credit is a significant industry in Australia. Since the 1970s, due to a series of reforms resulting in a shift away from direct control of banks from quantitative lending guidelines to consolidated risk weighted capital requirements, banks have developed more diversified and less costly ways of financing loans. These reforms have also removed barriers to entry for other lending institutions. As a result, the non-bank sector has also grown, providing both further competition in the provision of credit and easier access to credit for consumers.

This growth has contributed to historically high levels in the stock of debt held by households as well as increased commitments required to service debt. Evidence suggests that these increases have come about mostly as a result of the growth in the size of home loans over the years.

Further, growth in the sector has resulted in the availability of other modified types of credit, such as non-conforming loans, reverse mortgages and redraw facilities.

Due to the number of choices now available in the marketplace, consumers are also more likely to rely on financial intermediaries, such as mortgage and finance brokers, to guide their credit decisions.

Current state of credit

Table 1 below shows that personal credit accounts for the majority of total credit on issue. Within personal credit, housing loans make up 86 per cent of personal credit. Therefore, as agreed in principle by COAG, by regulating mortgages the Australian Government would be taking over the regulation of the vast majority of personal credit.

As of March 2008, total credit on issue, including securitisations, was \$1,821.7 billion. Of this, housing credit on issue stood at \$940.2 billion; other personal credit on issue was \$153.5 billion; and credit to businesses was \$728.0 billion. Mortgages therefore constitute the overwhelming majority of consumer borrowing.

Table 1: Aggregate levels of credit held as at March 2008 (seasonally adjusted, including securitisations)

Type of Credit	Aggregate (\$billion)	Per cent of category
Housing	940.2	86%
Other Personal	153.5	14%
Total Personal	1093.7	100%
Total Business	728.0	
Total Credit	1821.7	

Source: RBA.

ii. Non-deposit taking institutions

The non-deposit taking institutions sector has grown as a result of dissatisfaction among consumers about the cost of obtaining mortgage finance from the banks. Since the early 1990s, in particular, non-bank mortgage lenders have grown in volume largely funded by issuing mortgage-backed securities, and have won significant market share from the banks. As a result, more recently the margins on mortgages have been more competitive than previously. Non-bank lenders have provided additional competition to the mortgage sector in particular, and have been able to provide consumers with lower cost finance.

The current credit crisis may improve the banks' market share, as non-bank lenders are experiencing difficulties sourcing funding from the offshore wholesale market. It is unclear at this point how much market share will be lost and for how long. Banks generally fund their home loans through their retail deposit books; that is, through consumer savings, rather than relying on offshore investors.

Table 2: Different types of housing loans (as a per cent of total housing loans)

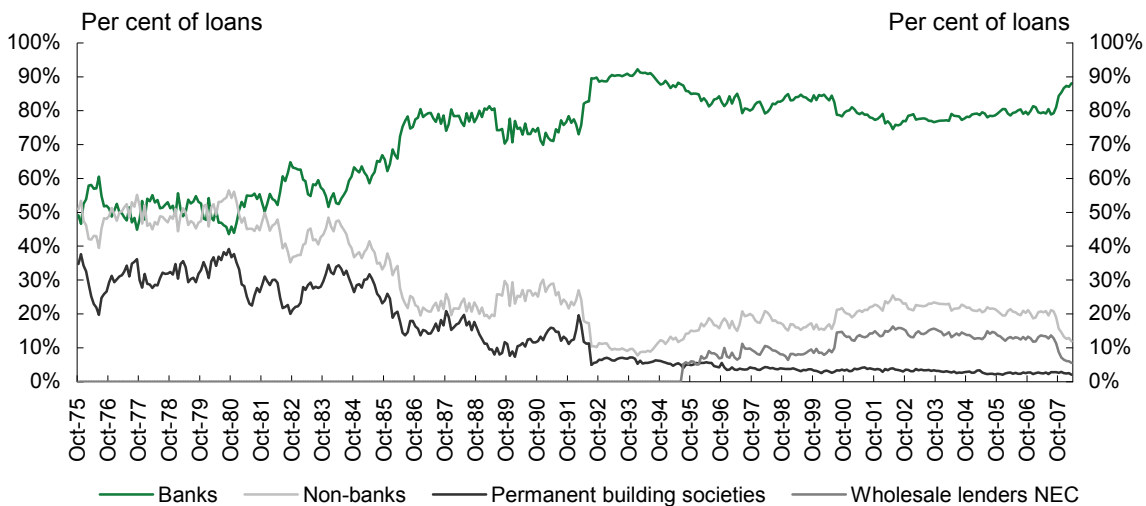
	2000	2002	2004	2006	2007
Prime loans					
Full-doc	>99	96	88½	88	92
Low-doc	<½	3	10	10	7
Non-conforming loans (sub-prime)	<½	1	1½	2	1

Source: Joint RBA — APRA submission to the House of Representatives inquiry into home loan lending practices and processes.

Table 2 above indicates that in spite of the increase in number of low documentation home loans over the past seven years, full documentation home loans make up over 90 per cent of the total Australian market. Unlike the United States, the Australian sub-prime or nonconforming loan segment of the market remains very small. It should be noted that low documentation loans are not considered to be sub-prime loans.

The chart below sets out the number of new loans, by value, for banks, non-banks, permanent building societies and other wholesale lenders since 1975.

Chart 1: Total new housing loans (by value) for each lender type



Note: Permanent building societies and wholesale lenders form part of non-banks.

Source: data from ABS catalogue: 5609.0 Housing Finance, Australia, Table 13b. Housing Finance Commitments (Owner Occupation), By Purpose and Lender: Australia, Original.

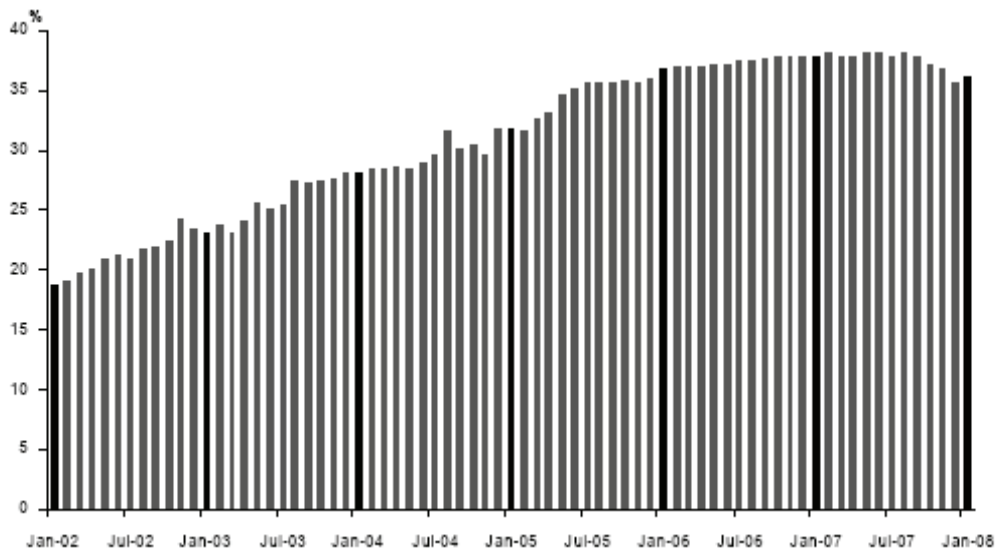
The chart above shows the banks' share of home lending peaked at 90 per cent in the early 1990s, before falling to around 80 per cent for most of the time since 2000. Over the past few months the banks' share has been significantly higher, due to the wholesale lenders' lack of access to funds.

iii. Mortgage Brokers

Lenders are increasingly relying on mortgage brokers to originate loans.

In 2003, 25 per cent of home loans were originated by mortgage brokers. A report entitled 'Australian Mortgage Industry — Volume 7' published by Fujitsu and JPMorgan in March 2008 stated that broker share has grown since then. The proportion of broker originated home loans was said to have risen to above 37 per cent in 2007. The following chart taken from this publication demonstrates the trend toward mortgage brokers over recent years.

Chart 2: Broker originated loans as a proportion of total housing loans outstanding



Source: Fujitsu Consulting estimates.

The Reserve Bank of Australia in its Financial Stability Review of March 2007 stated, ‘It appears that broker-originated business lending has grown strongly (albeit from a low base) in recent times and, although precise data are unavailable, it has been estimated that as much as one third of small- to medium-sized businesses currently access finance through brokers.’

iv. Reverse mortgages

Reverse mortgages allow consumers to borrow against the equity in their home. Reverse mortgages are primarily available to people aged over 60. Generally regular repayments on the loan are not made until the borrower leaves their home to move into care, sells their home or dies. At this point the loan ends and must be repaid with interest.

Reverse mortgages have experienced strong growth in recent years partly driven by aggressive marketing by providers. According to industry reports the total volume of reverse mortgage loans outstanding increased from \$239 million in 2004 to \$624 million in 2006, equating to annual growth of 61.7 per cent. A combination of factors such as interest rate rises and global credit market uncertainties have resulted in slower growth in 2007. Total loan volume is reported to have reached \$660 million in 2007, up 5.8 per cent over 2006.

In its November 2007 report *‘All we have is this house: Consumer experiences with reverse mortgages’* ASIC identified reverse mortgages as an area of regulatory concern and has devoted considerable effort to identifying the key consumer protection issues. The research has shown that many borrowers did not know how much the loan was likely to cost them over time, and many did not know the consequences of breaching a loan condition.

The report surveyed 29 borrowers and found that that the borrowers did not always clearly understand the trade-off between accessing loan funds now and having less available in the future. Several borrowers commented about how difficult it had been to resist the constant availability of credit. Very few of the borrowers had done long-term planning about how their financial needs might change over the next 10 or 15 years. The report indicated there were gaps in the financial advice received by borrowers. Of the 29 interviewed borrowers:

- only four reported that they discussed alternatives to reverse mortgages;
- 20 did not recall receiving any information about the risks involved;
- none received financial advice that focused on planning for their longer-term future;
- only one borrower was provided with a document setting out the advantages and disadvantages of taking out a reverse mortgage.

To reduce the risk of problems relating to reverse mortgages the report recommended improving:

- the structure and operation of these products;
- the information available to consumers; and
- consumers' access to financial advice.

One key issue concerns the unequal regulatory treatment of intermediaries such as financial planners and mortgage brokers which play an important role in the distribution of reverse mortgage products to consumers. Whereas financial planners are subject to a national regulatory regime in the form of Commonwealth legislation, mortgage brokers are currently subject to a variety of State and Territory regimes, while important aspects of their activities remain largely unregulated. Creating a level playing field for all parties involved in distributing and issuing reverse mortgages would therefore increase transparency for consumers and create consistency as well as certainty for industry.

B. Current arrangements

i. Regulatory responsibility

Responsibility for consumer credit, including mortgages, is shared between the Australian Government (regulated by ASIC) and the State and Territory Governments (through their respective Fair Trading Offices).

The States and Territories regulate credit and consumer lending through the *Uniform Consumer Credit Code* (UCCC). The UCCC focuses on pre-contractual disclosure and a limited range of conduct requirements. While consumer credit is currently excluded from the *Corporations Act 2001*, ASIC regulates some consumer protection aspects of consumer credit. In particular, the *Australian Securities and Investment Commissions Act* (ASIC Act) prohibits conduct that is misleading or deceptive, or is likely to mislead or deceive, in relation to credit products and services.

Victoria, New South Wales, Western Australia and the ACT have limited broker specific regulation in addition to the UCCC. The Western Australian legislation requires all finance brokers to be licensed.

History of the Uniform Consumer Credit Code (UCCC)

In 1993, the States and Territories agreed that consumer credit laws should be nationally uniform. They entered a Uniform Credit Laws Agreement (the Uniformity Agreement) under which the UCCC was developed. The UCCC is template legislation, substantially uniform in

all Australian States and Territories. It was enacted in Queensland by the *Consumer Credit (Queensland) Act 1994* pursuant to the Uniformity Agreement, and in the other States and Territories through various arrangements.

Under the Uniformity Agreement, amending legislation and regulations requires approval by two thirds of the Ministerial Council for Uniform Credit Laws (the Council), which is an offshoot of the Ministerial Council on Consumer Affairs (MCCA). Membership of the Council consists of the State and Territory ministers responsible for consumer credit laws. Changes to the Uniformity Agreement itself require the unanimous approval by the Council.

The Uniformity Agreement permits non-uniformity in:

- interest rate upper limits;
- licensing schemes for credit providers;
- jurisdiction vested in specialist tribunals; and
- the establishment of consumer credit funds to receive civil penalty payments.

The Australian Government is not a member to the Uniformity Agreement and does not have a formal vote in matters relating to the UCCC. It is however invited to comment on all matters relating to the UCCC considered by the Council.

Day-to-day administration of matters arising under the UCCC is entrusted to the Uniform Consumer Credit Code Management Committee (UCCCMC), which consists of officials representing each State and Territory. The Chair of the UCCCMC is currently Victoria.

C. Current issues

i. United States and the sub-prime crisis

By mid-2007, a combination of falling house prices, lax lending practices, inappropriate mortgage broker behaviour and the expiration of introductory discount rates on loans originated in the past few years resulted in a sharp increase in delinquencies among sub-prime mortgages in the United States. This led to increased financial market volatility caused by uncertainty over investor and financial institution exposure to credit risk and an associated disruption to market liquidity.

There has been evidence in the United States that increased broker commissions for selling sub-prime loans played a role in the recent sub-prime crisis.²⁵ There have been various reports of mortgage brokers receiving commissions from banking institutions to persuade borrowers to opt for expensive sub-prime loans, even where the borrower had good enough credit to qualify for 'prime loans'.²⁶ Media reports have stated that mortgage brokers could earn up to 3 per cent instead of the typical 1 per cent commission by selling customers loans with interests rates that were higher than market rates without verifying the borrower's income.²⁷

25 'Brokers, bankers play blame game', MSNBC, 22 May 2007, <http://www.msnbc.msn.com/id/18804054/>.

26 'Cash-up or get out, sub-primer told', The Wall Street Journal, March 31 2008.

27 'Mortgage brokers get fatter payoff for selling riskier loans', North County Times, May 5 2007.

The lax lending behaviour which gave rise to the sub-prime problem in the United States did not occur in Australia in part because the regulatory environment encourages a more cautious lending culture. However, any predatory practices of fringe lenders and brokers need to be addressed to prevent the possibility of any problems reaching the dimensions currently seen in the United States. Regulatory options to achieve this are outlined and evaluated in this paper.

ii. Systemic implications of inappropriate borrowing by consumers

Inappropriate advice and mis-selling in relation to mortgages and investment loans is likely to lead to excessive levels of debt taken on by consumers. This will lead to rising levels of defaults in situations where interest rates and/or unemployment start rising.

Defaults on home loans can cause intense personal hardship to individuals and families, especially in cases of home repossessions. Because of the high overall level of mortgage borrowing, and the general importance of the housing sector to the economy, implications may also arise on the systemic level.

Rising levels of mortgage defaults may impact the profitability of the banks, and in extreme situations may even affect capital adequacy ratios, although there are no indications that there is any possibility of this occurring in Australia. Because of securitisation of home loans and other sophisticated financial techniques, the effects of widespread home loan defaults may however be felt through the wider financial markets, as is being currently demonstrated in the case of the sub-prime crisis in the United States.

iii. Australian mortgage fees

In April 2008 ASIC produced a report at the request of the Treasurer on mortgage entry and exit fees entitled *Review of Mortgage Entry and Exit Fees*.

The report notes that Australian early termination fees are high compared to the UK and the US, while entry fees are low. The range and size of mortgage fees in Australia have increased over the past 20 years. Non-deposit taking institutions charge the highest fees, followed by large banks, then other banks, then credit unions and building societies. ASIC notes that it is likely that the fees in many cases exceed the costs of early termination to the lenders.

ASIC found that it is difficult for consumers to compare the cost of mortgage packages, given that descriptions and applications of the fees are very varied, and the characteristics of the mortgages vary widely.

The report states that mortgage brokers play a significant role in establishing mortgages, recent research indicating that more than 37 per cent of current loans are broker initiated and the broker share of refinancing is over 50 per cent.

The report also notes that while the current regulation by States and Territories (UCCC) and by the Commonwealth (ASIC Act) provides some protection to consumers, not all the provisions are being taken advantage of by consumers to assist them with avoiding unconscionable fees. In particular, no use has been made to date of protections against fees exceeding costs to the lender.

iv. Equity stripping

In its recent report *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress* ASIC stated that fringe brokers may take advantage of the desire of mortgage borrowers in default to save their home by engaging in 'equity stripping'. These are loans in which brokers and lenders take advantage of the desire of borrowers in default to save their family home by charging them high fees and charges to refinance. If borrowers cannot service the debt their homes are repossessed.

The report found that the two brokers reviewed in detail charged fees to borrowers of more than 20 per cent of the existing equity in their homes, and at a rate up to 22 times higher than industry standards, while the highest fee charged in dollar terms was \$24,320. The report also concluded that the refinancing cost the three borrowers examined on average 33 per cent of the equity they had accumulated in their home. They incurred a minimum of \$34,476 in fees and charges; and in all three cases the brokers arranged loans with higher repayments. The refinancings therefore did not address, even in the short term, the underlying problem of the borrowers' lack of capacity and their need for a significant reduction in repayments.

Borrowers were prepared to pay excessive fees because they had a strong attachment to their home and were motivated by a desire to avoid its sale. This meant they were predisposed to ignore options that, while financially more rational, would involve its sale. In particular:

- They were readily inclined to trust brokers who told them that they could arrange a loan that would save their home. Fringe brokers were able to arrange credit with lenders who determined eligibility solely on the equity held in the home, whereas borrowers relied on brokers to put them into loans they could afford.
- Borrowers did not make inquiries into the total costs of the refinance, and some brokers did not disclose their fees or total costs in sufficient time for the borrower to make a considered decision. Six of the twelve borrowers surveyed said that if they had been fully advised of the costs of refinancing they would either not have proceeded with the transaction or they would have investigated alternatives.

It should be noted that the report's findings are not indicative of the mainstream broking industry but a reflection on a very small subset of fringe brokers who target borrowers who are in mortgage stress and have defaulted on their mortgage.

v. Changing regulation

There has been significant discussion over recent years about the issues arising from credit being regulated across State and Territory jurisdictions. More recently, calls have been made to bring the regulation of credit under one national regime. In particular, the PC Report issued in May 2008 highlights the existing problems in cross jurisdictional regulation and recommends a national approach.

A major problem with the current approach is that it delays the formulation and passing of legislation, due to the need to create a consensus among all stakeholders, as well as separate processes for passing of the legislation in some of the States (WA and Tasmania in particular).

The issues in relation to some (but not all) credit products tend to be national in nature with similar problems being experienced in all jurisdictions in Australia. It has been suggested that

this warrants one single regulatory framework for the regulation of credit and in particular mortgages. The regulation of mortgage brokers differs from jurisdiction to jurisdiction which may allow unscrupulous practices of some brokers to emerge in jurisdictions with a lower level of regulation.

A national approach will potentially:

- address any gaps in consumer credit regulation;
- provide for licensing of credit providers, with the relevant conduct requirements in place;
- require coverage by dispute resolution schemes for consumers; and
- bring consistent regulation across the country.

A national approach would also address the problems that arise when credit providers operate in different states — differences across States and Territories can mean that one provider offering the same service nationally is subject to up to eight different regulatory environments.

Differences in the policy or practice of regulating credit can distort the market or result in varying levels of consumer protection.

Further, inconsistency in regulation across jurisdictions can increase business costs. National regulation would make it easier for businesses to move or expand across States and Territories, increasing competition and the benefits that competition can bring to consumers through lower prices and more innovative services.

Consistency also improves efficiency, as it eliminates unnecessary differences in regulation that might artificially advantage one type of service provider or encourage them to change their services to avoid regulation.

Consistent national regulation would make consumer protection easier by reducing businesses' and consumers' confusion about the standards required, and would reduce the cost of administering regulation by eliminating duplication.

Additionally, because the current regulatory regime spans many jurisdictions, regulation of credit has not been able to keep pace with developments in the financial services sector. These factors have largely influenced the PC's review.

Mortgage broking

The conduct of, and advice given by, some mortgage brokers has been unsatisfactory, and this is difficult to address because regulation and licensing is not uniform and to a large extent does not cover brokers.

A single national regulatory regime covering both mortgages and mortgage brokers is an efficient response to the need to address a number of malpractices on the part of certain brokers.

There have been stories of inappropriate lending by some providers as well as over borrowing by some consumers. Overborrowing is, to some extent, due to unrealistic expectations, but unscrupulous behaviour by a small number of mortgage brokers is also a

factor and the current regulatory structure may be considered inadequate to prevent this behaviour.

For instance, brokers' recommendations may be skewed towards products that give them higher commissions and which are not the most appropriate loan for the client (for example because of higher costs or unaffordability). Or, they may misrepresent applicants' financial details so they qualify for larger loans that give brokers higher commissions.

There are also concerns about the broking of reverse mortgages. An ASIC survey has shown that many borrowers did not know how much the loan was likely to cost them over time, and many did not know the consequences of breaching a loan condition.

Non-deposit taking institutions vs ADIs

Advice in relation to credit given by either non-deposit taking institutions or Authorised Deposit-taking Institutions²⁸ (ADIs) is also unregulated. Non-deposit taking institutions, which represent less than 20 per cent of total market share, are largely unregulated at the Australian Government level. In contrast, ADIs are subject to prudential regulation by the Australian Government. Like ADIs, their lending practices are regulated by the UCCC. However, the cooperative State-based framework for credit makes it difficult to amend the UCCC, meaning that problems may remain unaddressed for long periods of time.

There are suggestions some non-deposit taking institutions have been attempting to circumvent the consumer credit laws. There are also some indications that lending standards among non-deposit taking institutions are less stringent than among ADIs.

- While lenders are now required to disclose comparison rates, some non-bank lenders may have attempted to circumvent the comparison rate legislation by offering low rates, but having high fee structures, particularly early exit fees which are often very high and are not necessarily disclosed upfront.
- The business purpose declaration (a tool used to exempt business loans from the UCCC) is being misused by some lenders. That is, consumers wishing to borrow money for a house are being asked to sign a business purpose declaration and as a result the mortgage falls outside the UCCC.
- Home repossession figures appear to indicate that non-deposit taking institutions initiated a disproportionate share of repossession actions compared to their market share. Recent media reports from Victoria state that non-bank lenders initiated more than half of all repossessions in spite of having less than 25 per cent of the market in that State. This may be an indicator of lower lending standards by non-deposit taking institutions.

Table 3 on pages 14 and 15 sets out the differences in the regulation between ADIs and non-deposit taking institutions.

28 Authorised Deposit-taking Institutions (ADIs) are corporations which are authorised under the *Banking Act 1959* (Cth). ADIs include banks, building societies and credit unions. All ADIs are subject to the same Prudential Standards but the use of the names 'bank', 'building society' and 'credit union' is subject to corporations meeting certain criteria.

D. Recent developments

i. COAG

At the Council of Australian Governments (COAG) meeting on 26 March 2008, COAG agreed in principle to the Commonwealth assuming responsibility for regulating mortgage credit (including non-deposit taking institutions) and advice, including persons and corporations engaged in mortgage broking activities, for the purpose of protecting consumers. COAG also agreed in principle to the Commonwealth regulating margin loans.

ii. House of Representatives Standing Committee (2007)

A recent inquiry into home lending practices and procedures by the House of Representatives Standing Committee on Economics, Finance and Public Administration recognised the importance of consistently regulating non-bank lenders and mortgage brokers by recommending that the Commonwealth take over the regulation of credit including the regulation of mortgages.

The Committee has suggested that credit be included in the definition of a financial product for the purposes of the Corporations Act as 'providers of credit products and services would then be subject to rules about quality of advice and disclosure, and would be required to hold an Australian financial services (AFS) licence'. The Act would then regulate all home lenders and all mortgage brokers. Predatory lenders and brokers providing inappropriate loans or advice would be subject to sanctions from ASIC and may face the loss of their AFS licence.

The Committee has noted that 'credit regulation has failed to keep pace with the rapidly evolving and growing credit market. The current regulatory framework is ineffective in dealing with the new practices that have emerged.'

The Committee noted a number of inadequacies with the UCCC including: the State based nature of the UCCC has made it hard to change, and 'this is probably the major reason it has been unable to adapt as the market has changed and predatory practices have become more prevalent.' Problems include the lack of positive obligations on lenders to assist people facing financial hardship, and the lack of explicit requirements on lenders to provide credit only to people who can afford it. Also, because it does not apply to investment and small business loans, fringe lenders can avoid the UCCC's requirements by inducing consumers to complete a false declaration about the loan's purpose.

iii. Productivity Commission

The PC released its Final Report into the consumer policy framework (including regulation of consumer credit) on 8 May 2008. It recommended that responsibility for regulating finance brokers and other credit providers be transferred to the Australian Government.

The PC believes that consumer protection regulation for credit (including mortgages) should be 'comprehensive such that there are no gaps that can be exploited by unscrupulous providers' and 'the level of protection for consumers does not depend on where they live'.

The PC has noted that while the UCCC is notionally consistent additional requirements have been introduced by some jurisdictions. The PC was also critical of the length of time it took to amend the UCCC.

iv. NSW Draft National Finance Broking Bill

In November 2007, the New South Wales Government released the *National Finance Broking Bill* for public comment. The Bill contains a number of reforms aimed at the national regulation of the finance broking industry (including mortgage brokers) and the elimination of predatory practices by some fringe brokers. This work will assist in the development of Commonwealth regulation in this area.

E. Reform

i. Options for reform

Three options

There are three options for Commonwealth regulation:

1. maintain status quo;
2. regulate all credit; and
3. regulate mortgages (and consequently mortgage lenders and brokers).

Analysis of options

Option One

Under the first option, in the short term consumers would only have recourse to the existing limited jurisdiction and remedies available under the UCCC, the ASIC Act and (where applicable) State and Territory legislation.

In the medium term, it is likely that the current draft *National Finance Broking Bill* may be adopted by the States and Territories. While this would achieve a degree of uniformity, there is likely to be a further delay before the legislation is finalised, and subsequent changes would also take a long time. There is also the risk that key elements, including the licensing and enforcement regime, may not be entirely uniform in nature. Non-deposit taking institutions would remain unregulated under Australian Government legislation.

It should be noted that under this approach non-deposit taking institutions would not be covered by the new broking regulation (and thus remain regulated by the UCCC) and as such certain fringe lenders may still be able to operate in a predatory manner. As set out above, there are various reasons indicating that non-deposit taking institutions may not be satisfactorily regulated under this option.

The inquiry into home lending practices and procedures by the House of Representatives Standing Committee on Economics, Finance and Public Administration noted that further amendments to the *National Finance Broking Bill* (once enacted) would involve a drawn out process. Therefore it would face similar problems to that which the UCCC faces currently and as such it would not be able to respond quickly to changes in the market.

Option Two

Under the second option, the Australian Government would assume responsibility, not only for mortgages, but also for other forms of consumer credit, such as credit cards, car loans

and other personal loans. While this would achieve uniformity as all regulation would reside with one level of government, there would be significant transitional and ongoing costs for both the Government and business. The States and Territories would be entirely excluded from the regulation of consumer credit. Aspects of this option are discussed further in Chapter Six.

The primary rationale for the Commonwealth to regulate in a particular area is the existence of a national market consisting of consumers with uniform characteristics and needs. In such cases Commonwealth regulation under a single regime is efficient and serves the needs of consumers.

As stated in the Foreword to this paper, certain key financial services are organised to operate in an increasingly national or even international market. However, this does not mean that all products within the financial services sector have these characteristics. In particular, when considering the characteristics and needs of a market, the impact on consumers must be the prime consideration. The existence of large national providers of financial products/services alone may not be sufficient as evidence of the need for a nationally uniform market, because in such circumstances whilst Commonwealth regulation may be efficient for the service providers it may not adequately serve the needs of consumers.

It is clear that the markets for the provision of mortgages and mortgage advice meet this requirement as these markets are both served by large national providers and the problems faced by consumers tend to be similar throughout Australia. The same factors apply to margin loans. As a consequence, Commonwealth regulation is proposed for these markets.

The characteristics of smaller loans sought by consumers, often for the purpose of household consumption, such as through a credit card, may not naturally lend themselves to a national regulatory regime in a similar way to credit used for investment purposes, such as mortgages and margin loans. The advice and disclosure requirements suitable for these consumption credit products may require specific rules based on their characteristics and the varied needs of consumers.

It is not self-evident that smaller loans such as personal loans are best regulated through a single national regime. The use of credit facilities such as credit cards or payday loans may be affected by regional differences which may need to be accounted for in the regulatory regime applying to these products. It is therefore important to analyse the markets for these products and their characteristics in detail before concluding that a single national regime would best serve the needs of consumers.

As evidence of these possible differences there have been difficulties in maintaining the uniform credit regime among states. Examples are the interest rate caps that apply only in NSW, Victoria and the ACT and the ACT's special credit card regulations.

Further discussion and analysis may therefore be necessary before recommending Commonwealth regulation of credit instruments other than mortgages and margin loans. This work will be most appropriately progressed through the Council of Australian Governments and the Ministerial Council on Consumer Affairs.

Option Three

Under the third option, there would be uniform rules for mortgages, including reverse mortgages, across all jurisdictions with a single body responsible for licensing credit providers and brokers as well as for policing and enforcing standards. Aspects of this option

are discussed in Chapter Six. By taking over this area of financial services, the Australian Government would cover the most important forms of consumer credit, accounting for over 86 per cent of consumer credit on issue by amount. This will be significantly more consistent and efficient than the current regime.

States and Territories could continue to play a role in the regulation of other forms of consumer credit where a local network and on the ground contacts are important considerations.

Consistent with the Government's election commitment to introduce simple, readable financial services disclosure documents, any transfer of regulatory responsibilities to the Australian Government would include improved disclosure for mortgage products and advice.

This table shows that the current regulatory regime is inconsistent with respect to banks, non-deposit taking institutions and mortgage brokers.

Table 3: Differences in the regulation of Authorised Deposit-taking Institutions (ADIs) and non-deposit taking institutions/brokers with respect to credit

Regulation of non-deposit taking institutions & brokers	Regulation of banks and other ADIs
<p><i>Disclosure and conduct</i></p> <ul style="list-style-type: none"> • Primary regulation is at the State and Territory level, based on the UCCC. Focuses on pre-contractual disclosure and a limited range of conduct requirements. • At the Australian Government level there is general consumer protection legislation (the ASIC Act) about conduct dealing with financial services including consumer credit. • There is no prudential regulation of non-deposit taking institutions. • Also at the Australian Government level, Corporations Act entities are required to prepare audited financial statements and make detailed disclosures in the entity's Directors' Report. 	<p><i>Disclosure and conduct</i></p> <ul style="list-style-type: none"> • Regulation of credit rests with the UCCC. • However, primary regulation for other financial products that ADIs may deal in is at the Australian Government level. Financial products that the banks offer are subject to the disclosure, licensing and advice requirements under Chapter 7 of the Corporations Act. <ul style="list-style-type: none"> – Disclosure requirements tend to be more onerous than those of the UCCC. • Also at the Australian Government level, Corporations Act entities are required to prepare audited financial statements and make detailed disclosures in the entity's Directors' Report. • In addition, ADIs are subject to prudential regulation under the APRA Act and the conduct requirements of the ASIC Act.
<p><i>Licensing</i></p> <ul style="list-style-type: none"> • Non-deposit taking institutions and brokers are unlicensed under Australian Government law. • Only in Western Australian are finance brokers required to be licensed. 	<p><i>Licensing</i></p> <ul style="list-style-type: none"> • Like non-deposit taking institutions, ADIs are unlicensed with respect to credit. However, as providers of financial services, ADIs are licensed under Corporations Act Pt 7.6 to deal in and advise on financial products (excluding credit).

Regulation of non-deposit taking institutions & brokers	Regulation of banks and other ADIs
<p data-bbox="199 264 534 293"><i>Advice in relation to mortgages</i></p> <ul data-bbox="239 302 774 633" style="list-style-type: none"> <li data-bbox="239 302 774 360">• The provision of advice in relation to credit is not regulated under the Corporations Act. <li data-bbox="239 369 774 450">• The UCCC includes some provisions that affect the conduct and activities of finance and mortgage brokers. <li data-bbox="239 459 774 517">• Four jurisdictions have limited broker specific regulation. <li data-bbox="239 526 774 633">• The two main representative bodies in the mortgage and finance broking industry have taken a (limited) regulatory role by introducing codes of conduct 	<p data-bbox="810 264 1145 293"><i>Advice in relation to mortgages</i></p> <ul data-bbox="850 302 1380 705" style="list-style-type: none"> <li data-bbox="850 302 1380 439">• The regulation of advice in relation to mortgages is the same for ADI and non-deposit taking institutions owing to the exclusion of credit from Ch 7 of the Corporations Act. <li data-bbox="850 448 1380 528">• There are no additional regulatory requirements for ADIs to meet in order to give advice on mortgage products per se. <li data-bbox="850 537 1380 705">• However, given that banks have to meet the Ch 7 requirements to give advice for other financial products it is possible that the quality of the advice they give regarding mortgages meets a similar standard as for other financial products.

Proposed changes

As outlined above as part of the COAG process, the Commonwealth proposes to assume responsibility for mortgages as a financial product, including associated advice. This option would ensure regulation of mortgage brokers by adopting the approach in Chapter 7 of the Corporations Act, which focuses on products rather than providers.

This option would also ensure coverage of non-deposit taking institutions as well as banks, thereby creating a level playing field.

Regulating mortgage advice would allow governance of its appropriateness and quality. Ensuring that advice meets appropriate standards is likely to minimise the possibility of inappropriate lending.

It is important to note that the Government does not intend to regulate bank fees and charges as part of this option. Regulation of bank fees and charges discourages new investment and innovation, increases compliance costs for industry and may actually lead to an increase in prices for consumers. The Government considers a competitive market to be a more effective mechanism for driving down fees and charges.

Under the proposed changes a consistent regulatory regime would be created as set out in the table below.

Table 4: Proposed regulation of Authorised Deposit-taking Institutions (ADIs) and non-deposit taking institutions/brokers with respect to credit

Proposed regulation of mortgage provision and advice (non-deposit taking institutions and brokers)	Proposed regulation of mortgage provision and advice in relation to mortgage products (banks and other ADIs)
<p>Mortgages would be subject to licensing, conduct and disclosure requirements. This would mean non-deposit taking institutions and mortgage brokers would be required to:</p> <ul style="list-style-type: none"> • obtain a licence from ASIC; • meet appropriate disclosure requirements (for example in relation to fees, contract terms); and • meet appropriate requirements regarding financial product advice. This may mean for example that any advice given: is appropriate to the client’s needs; has a reasonable basis; and is not misleading or predatory. Where personal advice is provided to a retail client, a statement setting out the advice may have to be provided. Other conduct requirements may also apply. 	<p>Mortgages would be subject to licensing, conduct and disclosure requirements. This would mean that banks and other ADIs would be required to:</p> <ul style="list-style-type: none"> • obtain a licence from ASIC for these additional products and services (this is already required with respect to other financial services provided); • meet appropriate disclosure requirements in relation to these products; and • meet appropriate advice and conduct requirements in relation to these products.

Implications for the UCCC and State/Territory regulation

The States and Territories could retain responsibility for other areas of consumer credit, including credit cards, car loans and personal loans. These consumer loans could continue to be regulated under the UCCC.

The Australian Government will be looking to act in partnership with the States and Territories in relation to regulating credit other than mortgages. While the Australian Government would regulate mortgage brokers, the States and Territories could continue to regulate brokers of consumer loans other than mortgages.

By regulating mortgages, the Australian Government will cover the overwhelming majority of the consumer credit market. There may be a legitimate and ongoing role for the States and Territories to continue regulating other forms of consumer lending.

The preferred implementation strategy is for the Commonwealth to examine whether it has constitutional power to regulate comprehensively in the area of mortgage credit and advice, including regulation of those engaged in mortgage broking services. If there is doubt about the Commonwealth’s capacity to legislate comprehensively, the Commonwealth will explore a referral of power to cover the shortfall in power.

2. TRUSTEE CORPORATIONS

A. Background

Historically, only a natural person could undertake the role of personal trustee when acting as an executor or administrator appointed by a will. The rationale for this was that the trustee could be personally liable for default in relation to the assets they held on trust.

Over a hundred years ago, trustee company legislation was introduced to permit trustee corporations to enter the market to provide an alternative to natural person trustees and alleviate a shortage of trustees. Another aim of the legislation was to facilitate the establishment of long term and perpetual trusts, such as charitable trusts. The legislation prescribed a number of entry conditions and restrictions on the activities of trustee corporations, including personal liability of the directors of trustee corporations. Generally, the State and Territory Governments have only authorised large public companies with a broad spread of ownership as trustee corporations on the basis of their resources and stability.

Traditionally, trustee corporations specialised in personal trust services and a significant proportion of their business activities were in the area of personal trust and estate administration services. The market for personal trust and estate administration services has changed significantly since the trustee companies legislation was originally introduced. Trustee corporations have diversified their businesses and now provide a range of financial services, including acting as a trustee for superannuation funds and issuers of debentures. The majority of trustee corporations' business operations are in the area of corporate activities and funds management.

The industry generally refers to the part of their business dealing with personal trusts and the provision of estate administration services as 'traditional activities'. In relation to these 'traditional activities', the clients of trustee corporations include testators and grantors as well as the beneficiaries of the funds held on trust.

At around the same time that the legislation for trustee corporations was originally enacted most of the State and Territory Governments created government controlled public trustees. Currently, there is a public trustee operating in each jurisdiction.

Except in Victoria, public trustees are subject to separate public trustee legislation in each of the jurisdictions rather than the legislation for private trustee corporations. The public trustee in Victoria, State Trustees Ltd, which is a corporate entity owned by the Victorian Government, is subject to both regulatory frameworks. Except for State Trustees Ltd, most of the public trustees are directly responsible to a State or Territory government department, such as the Department of the Attorney General or the Department of Justice, in the jurisdiction in which they operate.

Since the public trustees are owned and operated by the respective State and Territory Governments, they do not have cross-border operations nor do they have concerns about the compliance costs associated with seeking to operate nationally. For these reasons, public trustees are outside the scope of this review of the options for the reform of the

regulation of trustee corporations. However, consideration will need to be given to the scope of coverage of the new regulatory framework for State Trustees Ltd.

The size of the trustee corporation industry

The trustee corporation industry is relatively small with approximately eleven licensed trustee corporations. The majority of these trustee corporations are licensed and have operations in multiple jurisdictions. Some of the smaller markets and jurisdictions only have one licensed private trustee corporation providing these services or in the case of the Northern Territory, there are currently no trustee corporations in operation. In some of the larger markets, such as New South Wales, Victoria and Queensland, there are seven to eight licensed trustee corporations operating. Most of the trustee corporations and all of the public trustees are members of a single industry body, the Trustee Corporations Association of Australia (TCA). The TCA has 17 members, comprising nine trustee corporations and 8 public trustees. There is only one licensed trustee corporation (Plan B) that is not a member of the TCA.

According to TCA data for 2006, trustee corporations (excluding Plan B) and public trustees have approximately \$452 billion of assets under management. In aggregate, public trustees account for approximately \$8 billion of the assets under management and a large proportion of these assets are under management in personal trusts. TCA member trustee corporations and State Trustees Ltd manage approximately \$20 billion of assets in personal trusts. While trustee corporations originally focused their business activities in the area of personal trustee services, increasingly a lesser proportion of their business is in the administration of estates and trust management. Trustee corporations now offer a range of financial services, including as the administrator for superannuation funds, trustee for debenture and note issues and the Responsible Entity for managed funds.

The bulk of trustee corporations business is in the field of investment products. TCA member trustee corporations and State Trustees Ltd have approximately \$21 billion in assets under management in superannuation funds and \$403 billion of assets under management in corporate activities, such as managed funds, securitisation programs and debenture and note issues.²⁹ Based on these figures, in aggregate, corporate activities represent approximately 96 per cent of TCA member trustee corporations' business and personal trust business represents approximately 4 per cent.³⁰

The role of trustee corporations in regard to their activities as trustees for issuers of debentures is explored in Section 4 of this paper.

The corporate structures of trustee corporations vary considerably. Some of the trustee corporations are subsidiaries of authorised banks, some are subsidiaries of other entities and several trustee corporations are listed companies. In some cases, the same legal entity that holds the trustee corporation license is also a Registrable Superannuation Entities (RSE) licensee and has Responsible Entity status for managed investment schemes. In other cases, the RSE Licensee is a subsidiary of the trustee corporation.

29 This data was provided by the TCA. It covers TCA member trustee corporations and State Trustees Ltd.

30 This figure includes State Trustees Ltd.

B. Current arrangements

At an entity level, trustee corporations are subject to State and Territory based regulatory regimes. Trustee corporations are currently licensed under State and Territory trustee company laws³¹ to provide personal trustee services similar to those of a natural person, including acting as an executor of a will, obtaining probate and acting under power of attorney. There are separate licensing requirements and supervisory arrangements in place in each of the jurisdictions. Once licensed, trustee corporations are required to submit regular financial returns to the respective jurisdictions, but are not subject to significant ongoing supervision.

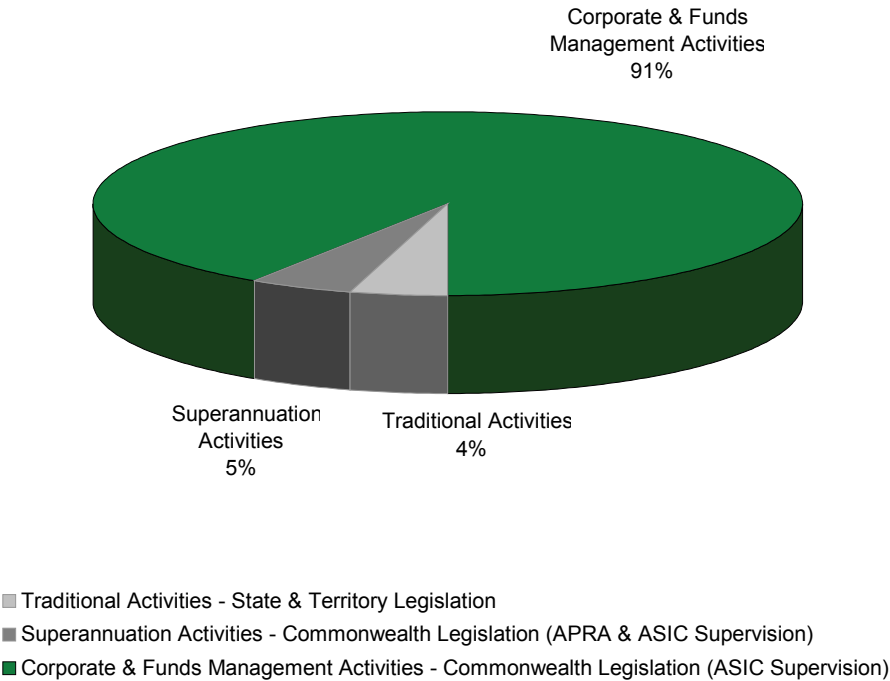
While the regulatory frameworks are broadly similar, there are a number of differences in the operational and reporting requirements across the States and Territories. Broadly, the State and Territory trustee company Acts include restrictions on the ownership of trustee corporations, fees (in some states there are fee caps), common funds, capital requirements, professional indemnity insurance, and directors' personal liability. In some instances the legislation imposes relatively restrictive rules, particularly in relation to prescribing fees and the rules governing the management of common funds.

Where trustee corporations engage in activities other than 'traditional activities', such as acting as a superannuation trustee, acting as a Responsible Entity for managed funds, or acting as a trustee for debenture holders, they are subject to Commonwealth legislation, including the *Superannuation Industry (Supervision) Act 1993* and *Corporations Act 2001*. As a result of the 1997 Financial System Inquiry (the Wallis Inquiry), this legislation, and the approach to financial sector regulation more generally, is to regulate the activity being undertaken rather than the entity. As such, the regulation of acting as a trustee for superannuation funds and debenture holders, and a Responsible Entity for managed funds, applies to all entities or individuals undertaking those activities. The regulation of these activities is not within the scope of what is being discussed in this section of the paper for the purpose of reforming entity level regulation of trustee corporations.

The chart below shows that most of the activities undertaken by trustee corporations are already regulated by Commonwealth legislation. As such, Commonwealth entity based regulation of trustee corporations would likely streamline supervision and reduce business compliance costs.

31 Trustee corporations are currently licensed and regulated under the *Trustee Companies Act 1964* (NSW); *Trustee Companies Act 1984* (VIC); *Trustee Companies Act 1968* (QLD); *Trustee Companies Act 1987* (WA); *Trustee Companies Act 1988* (SA); *Trustee Companies Act 1953* (TAS); *Trustee Companies Act 1947* (ACT); and *Companies (Trustees and Personal Representatives) Act* (NT).

Regulation of Trustee Corporations by Activity



In addition to being subject to the respective State and Territory Trustee Company Acts, trustee corporations are subject to other State and Territory legislation when undertaking ‘traditional activities’. For example, each State and Territory has a Trustee Company Act as well as legislation regarding wills, estate administration and probate. This legislation and associated common law regulates particular activities and, as such, all providers, such as solicitors, accountants, financial advisers and trustee corporations, are subject to the same requirements in undertaking these activities. The scope of reform for the regulation of trustee corporations will not result in changes to the general responsibilities of the States and Territories with regard to trust law and the basic equity law and statutory framework governing trustee responsibilities. The State and Territory legislation governing these ‘traditional activities’ is not within the scope of this process.

C. Current issues

Attempts to modernise and harmonise the State and Territory based regulation of trustee corporations have a long history dating back at least ten years. The 1997 Wallis Inquiry recommended that the regulation of trustee corporations be modernised and applied on a uniform national basis.

The main concerns with the existing regulatory framework relate to the unnecessary regulatory burden associated with the inconsistencies in the regulatory requirements and the duplicate licensing and reporting requirements across jurisdictions.

The State and Territory legislation for trustee corporations at an entity level remains largely unchanged since its introduction over a century ago. As a result, the operational requirements and the licensing and market entry mechanisms in the legislation are still very

restrictive. In a number of jurisdictions, the legislation governing trustee corporations must be amended to permit a new entrant in the market. The licensing decision making processes also lack transparency.

The State and Territory licensing arrangements restrict trustee corporations from operating across borders. The need to obtain a licence in each jurisdiction, combined with the lack of transparency and consistency in licensing requirements, creates barriers to entry and restricts competition in the marketplace. The State and Territory based licensing requirements also create cost burdens for corporations that operate in more than one jurisdiction. These costs not only include the initial costs associated with obtaining licences in each jurisdiction that they wish to operate in, but also the ongoing compliance costs of meeting differing requirements, including reporting requirements, in different jurisdictions.

There is also some concern about the effectiveness of current supervisory arrangements for trustee corporations. This is largely the result of a combination of factors, such as the small number of trustee corporations in each jurisdiction and the assumption of regulatory responsibility for the financial system by the Commonwealth in the late 1990s. A single supervisor would be expected to exploit economies of scale, reduce duplication, and over time, build up a greater level of expertise. This would increase the effectiveness and efficiency of supervision of trustee corporations.

There are also concerns about the need for a more cost effective and timely alternative dispute resolution mechanism for beneficiaries to enhance the protections available for personal trust assets.

Trustee corporations have long been critical of the lack of uniformity of the legislative requirements, the duplication of licensing and reporting arrangements, and a number of restrictive operational requirements in the current regulatory framework.

The creation of a national market through the implementation of modern and national regulation, supervision and licensing arrangements for trustee corporations at an entity level would deliver significant efficiency and competition benefits to the trustee corporations industry. It would also be expected to improve the effectiveness of entity level regulation and supervision of trustee corporations.

D. Recent developments

i. Council of Australian Governments

At the Council of Australian Governments (COAG) meeting held on 26 March 2008, COAG agreed to the Commonwealth assuming responsibility to regulate trustee corporations. At that meeting, COAG also agreed that the regulation of trustee corporations is an area where early action and progress should be achieved in 2008. This issue is being progressed through the COAG Business Regulation & Competition Working Group (BRCWG).

ii. Standing Committee of Attorneys-General

At the July 2007 meeting of the Standing Committee of Attorneys General, State and Territory and Commonwealth Ministers agreed to the establishment of a working group to consider all options for the development of nationally consistent regulation and supervision of trustee corporations. The options under consideration in this process included both

Commonwealth regulation and the harmonisation of the State and Territory legislation for the regulation of trustee corporations at an entity level.

Similar to Commonwealth regulation, harmonisation of State and Territory legislation would create a national market for the trustee corporations industry. However, Commonwealth regulation in this area would provide additional benefits in relation to the implementation of new legislation and any subsequent legislative amendments required. A Commonwealth framework would also include supervision for trustee corporations by a Commonwealth financial sector regulator with specialised experience. A Commonwealth regulator would streamline the licensing and supervisory arrangements and enhance the improvements that could be made in relation to reducing business compliance costs, the direct cost of regulation and the barriers to competition.

E. Reform

i. Policy objectives for Commonwealth regulation

The assumption of regulatory responsibility for trustee corporations by the Commonwealth will require the implementation of Commonwealth legislation and the State and Territory Governments to repeal their Trustee Company Acts. The Commonwealth's ability to regulate trustee corporations is based on its constitutional powers to make laws with respect to 'trading or financial corporations' (Section 51(xx) of the Constitution).

The main policy objectives for a Commonwealth regulatory framework are:

- To enable approved corporations to act as trustees, executors and administrators with powers and duties similar to those of natural persons providing these services.
- To ensure there are adequate protection arrangements in place regarding the organisational capability and management of trust estates administered by trustee corporations to protect the interests and assets of their clients.
 - The protection arrangements would be aimed at reducing the risks of inadequate management and protection of assets held on trust by trustee corporations for beneficiaries.
 - The protection arrangements would also ensure adequate information is available to allow clients to assess the performance of the trustee.
- Reduce the regulatory burden on business by rationalising the reporting and accountability requirements for trustee corporations in a way that is consistent with Australia's framework for financial sector regulation.
- Facilitate a competitive national market for trustee corporations.

The introduction of Commonwealth legislation that is implemented by a Commonwealth financial sector regulator would achieve the objective of creating a national market and would be expected to enhance the effectiveness of supervision. However, the extent that a Commonwealth regulatory framework would reduce regulatory burden on business and address competitive neutrality issues is dependent on the type and level of intensity of the regulation enacted by the Commonwealth. The costs and benefits of both options will be examined as part of this process.

ii. Options for reform

Two options

There are two options for Commonwealth regulation of trustee corporations at an entity level:

1. Consumer protection supervision; and
2. Prudential regulation.

Analysis of options

Option one

In the Commonwealth regulatory framework, consumer protection and disclosure regulation is implemented by the Australian Securities and Investments Commission (ASIC). Consumer protection and disclosure regulation implemented by ASIC is aimed at protecting the interests of consumers of a wide range of financial services and products. It seeks to ensure that the activities of financial service providers are subject to scrutiny and accountability to the regulator for the purpose of consumer protection.

Under this option, the Commonwealth would implement legislative amendments to the *Corporations Act 2001* to provide for the licensing and supervision of trustee corporations by ASIC. In broad terms, a consumer protection focused regulatory regime could provide for the following:

- Disclosure obligations for trustee corporations that would enhance the ability of their clients to assess the performance of trustee corporations.
- The licensing and ongoing oversight of trustee corporations, which would encompass the following:
 - objective and transparent licensing criteria to enable appropriate corporations to provide trustee services;
 - objective and transparent standards setting out minimum levels of organisational capability, financial resources and funds management expertise for trustee corporations;
 - controls on the provision of services by trustee corporations through licensing mechanisms;
 - ongoing oversight of compliance with standards;
 - enforcement powers for situations where there is a failure to comply; and
 - licensing and enforcement decisions would be subject to administrative review.
- A mechanism for beneficiaries to address issues of trustee underperformance in a cost effective way.

While the specific standards and requirements for a consumer protection and disclosure regime would need to be developed, some of the standards and requirements could be adapted from the regime applying to custodial or depository services under the Australian Financial Services Licence.

While Commonwealth regulation of trustee corporations would be expected to deliver significant competition and efficiency benefits, consumer protection supervision would also enhance the effectiveness of regulatory oversight and accountability of the regulated entity, reduce competitive neutrality issues and reduce regulatory burden on business.

Option two

In the Commonwealth regulatory framework, prudential regulation is implemented by the Australian Prudential Regulation Authority (APRA). Prudential regulation is generally aimed at protecting the prudential health of systemically important financial institutions, primarily for the maintenance of system stability. Prudential regulation is applied to a narrow range of financial institutions, whereas consumer protection regulation is aimed at protecting the interest of consumers in relation to the activities of financial service providers.

Under this option, the Commonwealth would implement legislation along the lines of a trustee corporations prudential supervision act to provide for licensing arrangements and ongoing prudential supervision by APRA. The Commonwealth would also need to amend legislation for the purpose of levying trustee corporations to fund the cost of supervision. The levy would be based on the asset pools managed by trustee corporations, similar to the way in which levies are applied to other prudentially regulated entities.

Under a prudential regime, it would be the role of APRA to put in place appropriate prudential standards under the legislative framework. APRA's standards would likely cover the following:

- fit and proper requirements for directors and senior management;
- risk management systems;
- outsourcing;
- adequacy of resources; and
- capital requirements — net tangible assets.

While a prudential regulatory regime would create a national market and eliminate the unnecessary compliance costs and barriers to competition resulting from the State and Territory based regimes, the compliance costs and the competitive neutrality issues associated with prudential regulation would be significantly greater than for a consumer protection and disclosure regime.

A prudential regulatory regime would aim to address the objective of ensuring effective management and safeguarding of trust assets by providing for third party oversight of the management processes of trustee corporations. A prudential regime would not focus on empowering clients to enforce their rights in the same way that a consumer protection and disclosure regime would.

Prudential regulation provides for more intense oversight of the risk management systems and policies of the regulated entities. Standards under a prudential regime are generally more prescriptive and intrusive into the management of the entity. This oversight is more intense than in a consumer protection supervision regime as it is directed at the prudential affairs of the corporation, including the imposition of capital adequacy requirements, which are directed at the health of the entity itself, as distinct from directly focusing on the entity's capacity and resources to effectively manage trust assets for beneficiaries. Similarly,

licensing requirements under a prudential regime may be more intense than under a client protection regime.

Prudential regulation is a significant intervention into a market and implies a regulatory intensity and burden significantly greater than that under the existing State and Territory regimes or that of consumer protection and disclosure regulation.

Since trustee corporations are not part of the payments system and do not generally provide capital guaranteed funds or hold trust assets on their balance sheets, they have a low level of systemic risk and there is less of a case for the level of regulatory intensity and burden associated with prudential regulation.

Prudential regulation of trustee corporations also raises significant competitive neutrality issues because the main competitors of trustee corporations in the personal trust and estate administration market, such as public trustees, lawyers, and accountants, are not subject to prudential regulation. Prudential regulation of trustee corporations at entity level would also have competitive neutrality implications in relation to their main competitors in the funds management business and their other main corporate activities, which are not subject to prudential regulation.

3. MARGIN LENDING

A. Background

i. Margin lending

Margin lending describes an arrangement under which investors borrow money to buy financial products (such as listed shares, fixed interest securities and units in managed funds). The underlying financial products are then used to secure the loan for those products. As with most other loans, investors must pay interest on the amount borrowed under a margin loan. Margin loan facilities are based on contractual arrangements between the lender and the client. Primary disclosure of the terms and conditions governing the loan occurs through the lending agreement signed between the two parties.

Repayments for the loan may be required if the investment is subject to a 'margin call'. This occurs where the market value of the investment falls below the level agreed under the contract. This could be caused by a fall in the value of the investment or if there is a significant fall in the market. A margin call requires the investor to increase the level of assets securing the loan to return the portfolio to the agreed limits stated under the contract. This can be done by paying extra cash, selling some of the assets or giving the lender additional security. The lender is under no obligation to contact the investor when a margin call is made. The responsibility falls on the investor to increase the asset level as security in accordance with the time line set out in the margin loan agreement.

The amount an investor can borrow depends on the loan-to-valuation ratio (LVRs) offered by a lender for each stock. This can vary from as low as 30 per cent to as high as 90 per cent. Stocks that are deemed to be low risk will have higher LVRs, and the investor is able to borrow more.

Traditionally, margin lending products in Australia have been sold through licensed financial advisers. In recent years, there has been a developing trend of service providers such as banks selling loans direct to consumers. There has also been some growth in online brokers linking these loans with execution-only internet services.

ii. Growth

Margin lending has grown strongly in recent years. The table below summarises the main indicators.

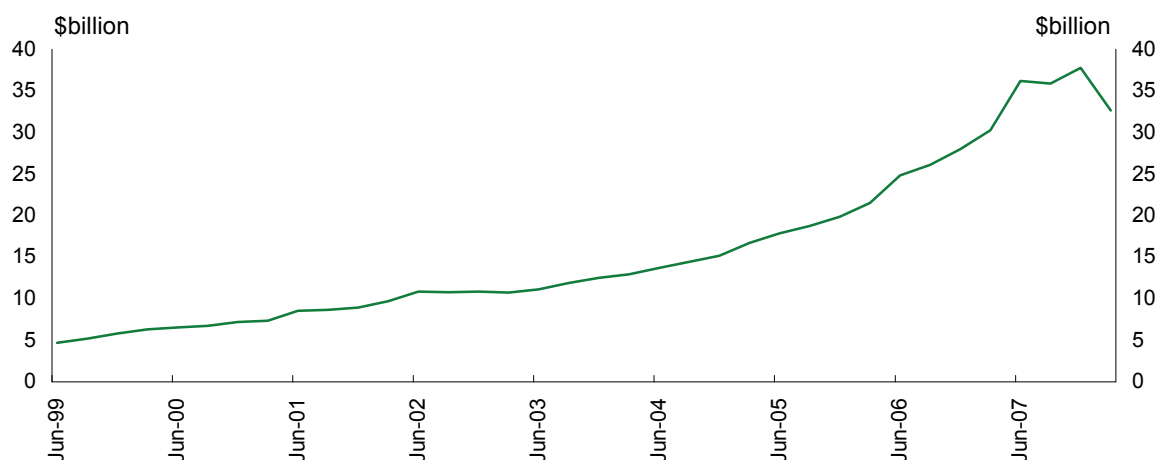
Table 5: Margin lending growth — a summary

Indicator	Sep-00	Mar-08	Variation (%)
Total margin lending (\$ million)	6,739	32,630	484
Protected financing (\$ million)	272	2,826	1041
Aggregate credit limit (\$ million)	8,437	76,905	912
Value of underlying security (\$ million)	13,403	75,541	564
Number of client accounts (thousand)	84	202	239
Average number of margin calls per day per 1,000 clients (unit)	1.28	3.85	301

Source: RBA Bulletin Table D10; March 2008.

The chart below shows that there been a rapid growth in the value of margin loans with the total value increasing from under \$5 billion in June 1999 to over \$37 billion in December 2007. More recently the total value of margin loans has dropped back to around \$32 billion in response to the recent market turbulence. Consistent with the growth over the past 9 years, the number of clients taking out margin loans has increased from 87,000 in 2000 to 202,000 in 2008.

Chart 3: Number of margin loans in Australia (by value)



Source: Data from RBA Bulletin Table, D.10, March 2008³²

In spite of this increase shares financed by margin loans still only account for 2.5 per cent of the domestic market capitalisation.³³

³² <http://www.rba.gov.au/Statistics/Bulletin/D10hist.xls>.

³³ Australian Financial Review p 5, 19 February 2008.

B. Current arrangements

Margin loan facilities are based on contractual arrangements between the lender and the client. Primary disclosure of the terms and conditions governing the loan occurs through the lending agreement signed between the two parties.

Margin loans consist of a credit component and an investment component. Where the investment aspect involves a financial product such as shares, Australian Government regulation in the form of the Corporations Act applies. However, the credit component of the margin loan transaction is currently largely unregulated.

As margin loans are supplied by a variety of providers, including banks and stockbrokers, various industry regulations may apply. Examples include the Code of Banking Practice and the Australian Stock Exchange (ASX) Market Rules.

Corporations Act 2001

The Corporations Act excludes all credit under the agreement with the States and Territories. However, where a margin loan is provided through a financial planner as part of an overall financial plan, ASIC considers that the Corporations Act applies to all the elements of the plan, including the margin loan facility as it is considered to be an investment vehicle.

Australian Securities and Investment Commission Act 2001 (ASIC Act)

Misleading and deceptive conduct in relation to margin lending is regulated under the ASIC Act. Under this legislation ASIC can, for instance, take action against misleading advertising or misleading statements made by financial advisers in relation to the provision of margin loans.

Code of Banking Practice

The Australian Bankers' Association (ABA) *Code of Banking Practice* (the Code) applies to margin lending provided by its members. If the provider is a member of the ABA there is an obligation on the bank to exercise care and skill in determining a customer's ability to repay the loan. Under the Code members are required to provide both an internal and external dispute resolution scheme for customer disputes.

Uniform Consumer Credit Code

State and Territory legislation governing consumer credit excludes investment loans. Margin loans are not covered by the UCCC,³⁴ as credit provided for investment purposes is not covered by the UCCC.

C. Current issues

With the strong performance of the Australian stock market over the recent years, the instance of margin calls has been very low. However, with the stock market moving into a time of more uncertain growth, there has been some recent concern surrounding retail clients' understanding of how their margin loan product operates. Recent market volatility has

34 S11, s 6 Uniform Consumer Credit Code.

been alarming for small investors, particularly those who have only been in the market since 2003.³⁵ This has highlighted the current absence of consumer protection regulation concerning margin loans, particularly in relation to retail investors.

Currently, there are serious concerns that consumers are not necessarily aware of the extent to which margin lending contracts place the risk of changes to market conditions on them. In particular, some contracts allow for the ability of the lender to unilaterally withdraw the facility or withdraw a particular company's stock from their acceptable list of equities over which margin lending is accepted, thereby forcing full repayment.

Margin loans are complex contractual documents which set out the mechanism for margin calls to be made, often with less than 24 hours for the investor to cover the loan before the call is made. Furthermore, it is not clear that investors fully understand how the LVR works and that the loan provider is able to change this in a very short period of time. There are serious concerns that marketing material, separate from the contract itself, highlighting 'bull market' gains make margin loans seem much simpler than they in fact are and do not fully disclose the downside risks.³⁶

Some industry players have backed calls for standardising the timing of margin calls and disclosure requirements across the industry.³⁷ It is argued that this will assist in ensuring the long-term viability of the margin lending industry.

Further, there have been recent suggestions that company directors have failed to properly disclose trading in company stock in a timely manner. In response to this ASIC and the ASX cooperated to release a media release on 'Disclosure Guidance for Listed Entities' and a Companies Update providing guidance on the disclosure of material information relating to margin loans held by a company's directors.³⁸

The conduct of company directors in purchasing shares is governed by the Corporations Act's insider trading rules and general duties imposed on company directors to act in good faith and in the interests of the company. In addition, the Corporations Act and the ASX Listing Rules oblige company directors to disclose certain transactions to the regulator and the market. The purpose of these rules is to ensure that the market is properly informed of the nature of directors' trading activities in company shares.

35 Australian Financial Review p 39, 29-30 March 2008.

36 Australian Financial Review p 39, 29-30 March 2008.

37 Australian Financial Review p 51, 18 February 2008.

38 Companies Update no 02/08 Important information for ASX Listed Entities, 29 February 2008.

D. Reform

i. Options for reform

Three options

There are three options for reform:

1. maintain status quo;
2. include margin loans as a financial product under the Corporations Act and apply the Chapter 7 regime; and
3. develop a separate Commonwealth regulatory regime for margin loans.

Analysis of Options

Option One

This option would leave the current situation unchanged. Margin lending would continue to be largely unregulated. Disclosure will continue to only occur through the contractual arrangement between investor and provider. Where the margin loan is provided through a financial adviser, disclosure requirements under the Corporations Act will continue to apply.

The main argument supporting this option would be that the current arrangements are appropriate, and provide an acceptable balance of risk in an industry where the investors are high net worth individuals with a high level of investment knowledge.

The large margin lenders have a sound liquidity base and solid risk management systems. Most of these providers are members of the Australian Bankers Association and therefore are bound by the Code of Banking Practice which requires the bank to exercise care and skill in determining a customer's ability to repay the loan.

However, this option disregards the recent marketing of margin lending to wider circles of less sophisticated retail investors. Margin loans are increasingly being provided to retail clients by non-bank institutions. Clients of these lenders do not benefit from the protection of industry codes such as the Code of Banking Practice.

Option Two

This option would see Chapter 7 of the Corporations Act amended to allow for the inclusion of margin loans as a financial product under the Corporations Act. As Chapter 7 deals with financial services, financial service providers and financial markets the positioning of the regulation of margin lenders within this chapter would appear to be a natural extension of the regime. This will see a more comprehensive response to the regulation of margin lenders than the current environment. Currently, the Corporations Act excludes regulation of all credit under the agreement with the States and Territories.

This movement into the Chapter 7 provisions will mean that any representations made in relation to the lending mechanism within the margin loan without reasonable grounds will be taken to be misleading.³⁹

LICENSING FRAMEWORK

Bringing the regulation of the lending component under the Corporations Act will require an addition to the licensing provisions under Part 7.6. Australian financial services licence holders will be required to have as a condition of their licence an ability to provide margin loans or be in breach of their licence. This will mean that margin lenders will be required to have in place adequate arrangements for the management of conflicts and ensure that their representatives are adequately trained and competent to provide those services; and that they have in place operational lending dispute resolution systems complying with ASIC regulatory requirements.⁴⁰

DISCLOSURE AND ADVICE FRAMEWORK

Defining a margin loan as a financial product will make the Chapter 7 disclosure regime applicable to margin lending products and make them subject to disclosure requirements such as the statement of advice (SOA) and product disclosure statement (PDS) requirements. The loan disclosure will need to be provided in addition to any disclosure requirements for the investment side of the margin loan product. Whether new disclosure requirements should be added into the Corporations Act disclosure regime to more closely reflect loan document requirements⁴¹ would need to be considered.

Within the Corporations Act, financial advice can be defined as ‘personal’ or ‘general’ advice. The definition of general advice is broad, as it constitutes any financial product advice that is not personal advice. The definition of financial product advice includes recommendations, statements of opinion or reports of either of those things intended to influence people in making a decision about a financial product. Licensing and training requirements apply to entities providing general advice to retail clients. Bringing margin lending under the Corporations Act will help to protect retail clients who are most vulnerable to misunderstanding how a margin loan will work.

ENFORCEMENT

All margin lenders will become subject to the enforcement provisions of Chapter 7 surrounding market manipulation; false or misleading statements; inducing investors to deal using misleading information; and engagement in dishonest, misleading or deceptive conduct.

Option Three

This option would see a new Commonwealth regulatory regime developed separate from Chapter 7 of the Corporations Act. This would provide a regulatory environment for margin loans and margin lenders specific to these products.

This new regime would involve the creation of a system to:

- regulate the licensing of margin loan providers including a set of specific requirements for a margin lender licence to be granted and obligations for a margin lending licensee;

39 Under s 769C (1) *Corporations Act 2001*.

40 S 912A (1); (2) *Corporations Act 2001*.

41 For example, to reflect the requirements under s 15 Uniform Consumer Credit Code.

- regulate the new disclosure requirements for margin loan products and products which could be bundled with a margin loan;
- regulate for the prohibition on forms of market misconduct which could arise in regard to margin lending; and
- regulate for the enforcement of prohibited conduct relating to margin loans and margin lenders.

This option would allow for the specific tailoring of these provisions to margin loan products and margin loan product providers. This may allow for a disclosure system that can more clearly set out pre-sale disclosure document requirements and avoid any regulatory gaps.

However, this option would result in a separate regime that would, arguably unnecessarily, mirror the Corporations Act creating regulatory overlap for businesses offering margin loans and other financial products. This would create inefficiencies for businesses that would be required to obtain separate licences for different products and develop disclosure documents for those products under different regimes.

4. DEBENTURES

A. Background

Over the past two to three years, there have been a number of high-profile collapses of property development companies, starting with Westpoint and followed by Fincorp, ACR and Bridgecorp.

Consumers were able to invest in these property development companies by acquiring a debenture issued by the company. In broad terms, a debenture is a financial product that is a fixed interest security with a fixed maturity date and a specified rate of interest return payable by the company to the investor. Each of the collapses involved property development companies offering debentures which promised high returns.

Investment in these companies was promoted to consumers through advertising and by financial advisers, agents and others working on behalf of the companies.

These collapses have had significant impact with some investors losing considerable amounts of money. Total losses are estimated at around \$900 million, invested by around 20,000 investors across Australia (although some of those funds will be recovered, particularly in the case of Fincorp and ACR).

In this context, questions have been raised about aspects of the investor protection regulatory regime as it relates to the issue of debentures.

Case Study — Westpoint

The most high-profile collapse has been that of the Westpoint group. Westpoint was a privately owned property development company located in Perth, Western Australia. It was active in several capital cities across Australia, including Melbourne and Sydney. Westpoint collapsed in early 2006 after insolvency proceedings were instigated by ASIC in November 2005.

The difficulties experienced by Westpoint relate to a number of projects for which part of the funding was raised through the issue of promissory notes, a form of debenture, to retail investors. This so-called mezzanine financing promised to pay a high yield in the range of 12 per cent per annum, but was secured only by second mortgages over the properties under development. Investors in these notes therefore ranked behind senior debt holders when the projects were wound up.

The notes were issued with a face value of \$50,000 or more for the purpose of avoiding the disclosure requirements in the law. Promissory notes are regulated in the *Corporations Act 2001* (Corporations Act) either as debentures or as financial products depending on their value. However because of some uncertainty about the regulatory treatment of Westpoint's notes, ASIC took Westpoint to court. It was eventually confirmed in June 2006, after appeal, that the promissory notes on issue were subject to the disclosure and other

Case Study — Westpoint (continued)

requirements under the Corporations Act as they took the form of an interest in a managed investment scheme.

It has been estimated that Westpoint raised a total of approximately \$300 million through the promissory note issues from some 3,000-4,000 investors. The majority of Westpoint's companies are now in liquidation.

B. Current arrangements

i. Regulation of debentures

Debentures are regulated under the *Corporations Act 2001* (Chapter 2L). Debentures are debt instruments used by the issuer to raise funds from investors in return for the payment of interest.

The features of the regulatory regime include the following:

- Debenture issues are required to be governed by a trust deed and must have a trustee. The trustee is required to undertake certain specified actions intended to safeguard the interests of debenture holders. It is also specified who can act as a trustee.
- The duties of the borrowers are defined, including the requirement to conduct its business in a proper and efficient manner and the provision of certain reports with specified contents to the trustee and to ASIC.
- Different naming rules apply to debentures under the Corporations Act depending on the nature of the debenture being issued, that is whether it is a 'mortgage debenture', 'debenture', 'unsecured note' or 'unsecured deposit note'. The rules generally reflect the type of security available over the debenture.
- Debentures are issued as a source of finance for a range of business activities, including debt capital funding, mortgage lending for residential or commercial property, participation and ownership of commercial and residential real estate or to facilitate membership of clubs, groups or franchise operations.
- Debenture issues can be listed or unlisted.

Unlisted issues of debentures

In further analysing the property development company collapses, it has now been identified that, in particular, unlisted debentures pose an increased risk for retail investors. In particular, investors do not have the benefit of the market to provide:

- a readily available value for the debenture;
- public scrutiny of the ongoing performance of the issuer either through market forces or via listing rules, as would be the case if the issue were in the public domain; and

- an easy market for the sale of their interests, particularly where the investor may have lost confidence in their investment.

Risks to investors further increase where the funds provided through the issue are on-lent, often through other companies in the group for development purposes as there is much less certainty about returns until such time as developments are completed and sold for the anticipated returns. ASIC has issued revised guidelines to immediately address these risks for consumers — (see Section Cii).

ii. Regulation of promissory notes

Promissory notes used to raise funds, such as those issued in the Westpoint case, are a form of debenture whereby borrowers raise funds from investors and promise repayment at a future point in time.

The formal characteristics of promissory notes are covered by the *Bills of Exchange Act 1909*. However, the investor protection regime, including disclosure, licensing and conduct rules, is contained within the Corporations Act.

Promissory notes are regulated in the Corporations Act either as debentures or as financial products depending on their value:

<\$50,000 = debenture

- Promissory notes under \$50,000 are regulated as debentures (Chapter 2L):
 - debenture issues are governed by a trust deed and trustee (Chapter 2L) and must be accompanied by a prospectus (Chapter 6D);
 - issuers and/or financial advisers must also meet disclosure, conduct and licensing requirements (Chapter 7).

>\$50,000 = financial product

- Promissory notes valued at \$50,000 or over are excluded from the definition of debentures and are regulated as a financial product (Chapter 7):
 - promissory note issuers must provide a Product Disclosure Statement (Part 7.9 in Chapter 7).
- Sometimes promissory notes are issued in the form of an interest in a Managed Investment Scheme (MIS):
 - As such, the MIS must be registered and have a licensed responsible entity in place;
 - Each MIS must provide a Product Disclosure Statement (Chapter 7).
 - : Westpoint mezzanine/promissory note issues were characterised as MISs by the WA Supreme Court.
- Some promissory notes may not be defined as either a debenture or a financial product.
 - However, most promissory notes are likely to fall under one of these two categories.

The current regime is summarised in Table 6 below.

Table 6: Summary of the current regulatory framework for promissory notes

Promissory note face value	Under \$50,000	Over \$50,000 but < \$500,000		
		Financial Product		Non-Financial Product
		Managed Investment Scheme (MIS)	Non MIS	
Disclosure	Chapter 6D	Part 7.9		Not regulated
Advice, dealing and licensing	Chapter 7	Chapter 7		Not regulated
Other aspects	Chapter 2L	Chapter 5C	Not applicable	Not regulated

*Note: >\$500,000 — investor is not considered to be a retail investor.

C. Current issues

i. Systemic risks with collapses in this sector

Even after the fallout from the collapses which attracted significant media attention, studies suggest that retail investors still have a high degree of confidence in their own ability to make appropriate investment decisions. Yet it is apparent that many do not understand or recognise risk and the need to diversify their investments.

The lack of financial literacy has already resulted in serious impacts on individuals involved in the recent corporate collapses. Some had invested their entire retirement savings and may now need to rely on age pensions in retirement.

Longer term there is a risk that these collapses and the subsequent losses incurred will trigger a general loss of confidence in the high yield finance sector and may potentially result in investors withdrawing funds from any companies active in the sector. In a worst case scenario this could lead to further collapses through a snowball effect. This has happened in New Zealand where over a dozen finance companies have collapsed, leading to a general loss of liquidity in the sector.

Collapses can therefore have systemic implications, impacting:

- individual savings, leading to increased reliance on Government pensions, with a corresponding Budget impact;
- general confidence levels in debenture issues, which may lead to viable companies collapsing due to liquidity shortfalls, as has happened in New Zealand; and
- the financing of fundamentally viable projects, which may not be able to proceed with potential wider consequences for employment and economic growth.

It is therefore important to ensure the investor protection regime for debentures is sound and that retail investors investing in these products are provided with sufficient resources to make informed decisions.

Any proposed action also needs to be balanced against the risk of increasing costs for business.

ii. ASIC's work

Since early last year, ASIC has prioritised the area of unlisted and unrated debentures as a high risk sector. All the collapsed property development companies issued this type of instrument.

ASIC has also established a Retail Investor Task Force to undertake research into the retail investment sector, focusing on improving retail investor education generally to assist retail investors better understand their investment options and the risks they may incur.

To date, ASIC has released two sets of guidelines addressing the two areas of immediate concern, to improve disclosure in relation to the unlisted unrated debentures market and setting out guidelines on the way these products are advertised. The guidelines set out specific measures to provide better quality information to retail investors about the risks of such investments.

ASIC has recently released a report on the results of its research on the characteristics of investors in unlisted and unrated debentures, as well as a guide to assist investors in making decisions on investments in such debentures.

D. Reform

i. Proposed changes

In addition to the ongoing work to be undertaken by ASIC in improving investor protection in the unlisted unrated debentures market, further changes are now proposed to the regulation of debentures. These are:

1. harmonisation of the regulation of promissory notes, regardless of their value;
2. extending the licensing requirement for debenture issuers;
3. requiring debenture trustee companies to be licensed; and
4. reviewing the duties of trustees.

In the context of the corporate collapses and their impact on retail investors, ASIC's analysis of the unlisted and unrated debentures sector and in the wider context of the regulatory regime for debentures generally, the Government is proposing to address a number of changes to the regulation of debentures to provide improvements as well as more certainty in some areas.

ii. Analysis of proposed changes

Harmonisation of regulation of promissory notes

Promissory notes are regulated in the Corporations Act either as debentures or as financial products depending on their value. That is, if the promissory note is valued at under \$50,000, it is regulated as a debenture (Chapter 2L). If the promissory note is valued at \$50,000 or over, it is excluded from the definition of debentures and regulated as a financial product (Chapter 7);

Additionally, sometimes promissory notes are issued in the form of an interest in a MIS. Westpoint mezzanine/promissory note issues were characterised as MISs by the WA Supreme Court.

However, questions arise about whether the inconsistency in the regulatory regime is justified or whether all promissory notes should be regulated under a single regime as attempts have been made to exploit the inconsistency to avoid the operation of the law.

It is proposed to harmonise the regulation of promissory notes so that all promissory notes issued to retail investors will fall under the definition of 'debenture' and therefore the regulatory regime applicable to debentures.

This could be achieved by removing the threshold within the definition of debentures relating to promissory notes.

Promissory notes form an important part of the money market in commercial paper. However, this proposed amendment is not expected to affect this market, as participants are largely professional investors.

Licensing of debenture issuers

Certain issuers need to obtain an Australian financial services licence (AFSL) for issuing debentures to retail investors (section 766C). Under the provisions, issuers that carry on an investment business and invest funds subscribed following an offer to the public are required to be licensed. As a consequence, approximately one third of unlisted, unrated debenture issuers are currently licensed by ASIC.

However, the licensing requirements for debenture issuers lack consistency, particularly when compared to operators of registered managed investment schemes. The intent of the law is to ensure that entities which carry on an investment business whose main source of funding comes from the issue of securities to retail investors are adequately qualified and resourced to carry on such activities.

A clear and consistent regime would require all issuers carrying on an investment business which regularly offer securities to retail investors and for whom such issues constitute their main source of funding, to be licensed by ASIC.

Further, the reference in the current legislation to an 'offer to the public' test (s766C(5)) was generally abandoned in the 1990s, and is now anachronistic and should also be reviewed.

Licensing of trustees

The law currently sets out which entities can function as trustees of debenture issues (section 283AC). However, the current provisions relating to trustees of debenture issuer do not require them to be licensed.

Trustees carry out important functions in safeguarding the interests of investors. It is therefore important that entities acting as trustees are properly resourced and qualified. A clear and consistent regime would require that all trustees of debenture issues be licensed by ASIC (it is noted that many corporate trustees are already licensed.) The list at section 283AC could then be removed.

Review of trustee duties

The current provisions in the Corporations Act include a list of trustees' duties (section 283DA). In general, trustees are subject to an obligation to exercise 'reasonable diligence' in monitoring the issuer's ability to repay the debtentures. A number of further, specific duties are also included.

This list has now been expanded in the light of the issue of ASIC's new Regulatory Guide 69 *Debtentures — improving disclosure for retail investors* which was issued in response to the major property development company collapses.

A clear and consistent regime would include a newly updated list of duties to better reflect the appropriate elements of the obligations required of trustees under ASIC's Regulatory Guide 69 *Debtentures — improving disclosure for retail investors*.

5. PROPERTY SPRUIKERS

A. Background

Australians have a relatively high rate of investment in residential real estate. Apart from their own home, an investment property is one of the major assets individuals will invest in other than superannuation. The Institute of Chartered Accountants in 2006 estimated that 20 per cent of Australians already own an investment property and 29 per cent would consider buying one in the next 10 years.

The desire for investment in real estate has increased in recent years possibly due to a range of factors including, the perception that 'bricks and mortar' is a safe investment, the volatility of the share markets, the recognition of the need to build more assets towards retirement and favourable taxation treatment of these investments. As a result, the property investment advisory industry has also grown significantly.

The problem — advice or spruikers?

Property investment advice refers to the actual or reasonably stated intention to influence consumers and investors' decisions about property investment. Property investment advice can be provided by a range of individuals and entities, including real estate agents, property valuers and property developers as well as accountants, buyers agents, financial planners and finance and mortgage brokers.

However, evidence shows that most complaints about property investment advice are made against those commonly referred to as 'property spruikers'. The term property spruiker tends to be used in a derogatory fashion. Property spruiking needs to be distinguished from wealth creation seminars which, while run along similar lines, do not offer direct interests in residential real estate investments.

The area of greatest concern to consumers is the way property spruikers deliver their advice. Property spruikers generally operate outside the real estate licence regime and the characteristics setting them apart is the way in which they conduct their business and their behaviour. The major characteristics of property spruiking may include:

- high-pressure, fast-paced presentations that encourage people to make decisions there and then that they may otherwise not take;
- misrepresentation or exaggeration about the benefits of buying properties, including the overstating of property values, rental returns and capital growth;
- financial advice to assist the purchase without the adviser being an Australian financial services licensee under the Corporations Act; and
- aggressive or harassing behaviour.

Property spruikers take advantage of regulatory gaps and inconsistency between fair trading laws, the financial services regime and the real estate agent licensing regime administered by the states. Principally:

- there are no legislated codes of conduct within the industry;
- consumers have little or no recourse if they feel they have been deceived, misled or cheated out of money; and
- Governments have limited powers to take action against problem operators.

There are ongoing calls that more consistent national legislation should be put in place. In this context, to date, it has been difficult to specifically define and quarantine the property spruiking sector for specific regulation from other areas of the real estate industry.

B. Current arrangements

Property investment advice is not directly regulated by the Australian Government or the States and Territories. However, certain consumer protection legislation may apply.

In the case of the Australian Government, this includes the general consumer protection provisions in the *Trade Practices Act 1974* (TPA) as well as the *Australian Securities and Investments Commission Act 2001* (ASIC Act). Action to date has utilised various provisions including in relation to misleading or deceptive conduct and making reckless, misleading, false or deceptive statements.

Each State and Territory also has general consumer protection laws based on the TPA which are administered by their consumer protection agencies and these may be used against property spruikers. However, the relevant real estate laws protect vendors and owners rather than purchasers and there is an inconsistent approach across Australian jurisdictions.

C. Recent developments

i. MCCA

At the August 1, 2003, meeting of the Ministerial Council on Consumer Affairs (MCCA), the Commonwealth Government agreed to set up a joint working party with the States and Territories to investigate property investment advice.

The project to date has considered problems created by property spruikers, evaluating five options including voluntary self-regulation by the industry, co-regulation based on approved codes of conduct, improved conduct and disclosure requirements across the board and setting up a comprehensive licensing, conduct and disclosure regime.

ii. Other inquiries and reviews

The Parliamentary Joint Committee on Corporations and Financial Services (PJC) commenced an inquiry into the regulation of property investment advice, releasing its report in June 2005.

In March 2007, the Law Reform Committee of Victoria also undertook an inquiry on property investment and property marketeers.

D. Reform

There have been widespread calls for property investment advice and property spruiking in particular to be better regulated. Whilst the Commonwealth continues to support the continuation of the MCCA project, stakeholders are requested to submit views on possible options for reform, including in line with the recommendations raised in the Parliamentary Joint Committee Report of June 2005.

6. OTHER CREDIT PRODUCTS

A. Background

Chapter One discusses the transfer of regulation of mortgage credit advice and products from the States and Territories to the Australian Government. It puts forward various options to achieve this. One option outlined was for the Australian Government to regulate mortgages and margin loans with the regulation of the balance of credit products and services remaining with the States and Territories. A further possible option is for the Australian Government to assume regulatory responsibility for all credit products and services.

In addition to mortgages and margin loans, there exist a number of other consumer credit products that the UCCC currently regulates. The balance of products includes credit cards, personal loans and micro (or payday) loans.

This chapter seeks specifically to canvass views regarding the various responses and regulatory models for the balance of credit products and services.

B. Current arrangements

All credit products are currently regulated under the UCCC. Details of this regulation are set out in Chapter One.

As discussed in Chapter One, mortgages represent 86 per cent of the credit market, leaving a small minority (14 per cent) of the market spread across credit cards, personal loans, and micro loans. These credit products have the following characteristics in Australia:

- Credit cards are a revolving form of credit with an average balance of \$3000. Businesses and consumers use credit cards for a variety of different purposes across the household and business sectors. Credit cards are both used as a cash management tool (consumers taking advantage of interest free periods) and as a loan instrument.
- Personal loans may be provided by banks and finance companies. Personal loans can be both secured (for example car loans) and unsecured (for example a loan for a holiday). Like credit cards, households and businesses use personal loans for a variety of purposes.
- Micro loans tend to be offered by small businesses operating in one jurisdiction. Consumers tend to use micro loans to meet short-term loan requirements such as to pay off an unexpected expense. The average size of loans is \$250 and the length of loans generally ranges from 7 to 62 days. Unlike other loans, instead of charging interest providers of micro loans tend to charge fees for their services.

Generally, the market for the balance of credit products and services has distinct characteristics from that of mortgages and margin loans. It is not easy to place these products in homogeneous categories. For example, this segment of the credit market

contains both secured and unsecured loans, fixed term and revolving credit, and the size of the loan can range from very small amounts to tens of thousands of dollars.

C. Recent developments

At the Council of Australian Governments (COAG) meeting on 26 March 2008, COAG requested identification of the most appropriate regulation of the balance of credit products and services. COAG is seeking to determine which financial services activities, outside mortgages and margin loans, best sit within the Commonwealth's regulatory responsibility.

D. Reform

i. Options for reform

Options for reform of the balance of credit products and services are at a preliminary stage of development. This paper seeks to ascertain initial views regarding the regulation of the balance of credit products and services. However, further discussion and analysis may be necessary before recommending any particular option given the early stage of the development of this issue.

At a high level, there are two options for Commonwealth regulation:

- (a) Regulate all credit products and services; or
- (b) Regulate only mortgages (and consequently mortgage lenders and brokers) and margin loans.

Analysis of options

Option One

This option has been discussed extensively in Chapter One. In summary, the Australian Government would assume responsibility, not only for mortgages, but also for other forms of consumer credit, such as credit cards, car loans and other personal loans. While this would achieve uniformity as all regulation would reside with one level of Government, there would be significant transitional and ongoing costs for both the Government and business. The States and Territories would be entirely excluded from the regulation of consumer credit.

Option Two

Again this option is discussed further in Chapter One. The States and Territories could retain responsibility for the balance of consumer credit, including credit cards, car loans and personal loans. These consumer loans could continue to be regulated under the UCCC.

By regulating mortgages, the Australian Government will cover the overwhelming majority of the consumer credit market. It appears there may be a legitimate and ongoing role for the States and Territories to continue regulating other forms of consumer lending.