SUBMISSION TO DEPARTMENT OF FINANCE ON THE REGULATION OF SUB PRIME AND OTHER UNREGULATED PROVIDERS OF FINANCIAL SERVICES

FREE LEGAL ADVICE CENTRES, OCTOBER 5TH, 2007

Introduction

Free Legal Advice Centres welcomes the decision of the Government and the Department of Finance to introduce legislation to extend the scope of financial regulation and the consumer protection code to entities that are currently unregulated such as sub-prime lenders and other non-deposit taking providers of financial services.

This legislation is particularly necessary as many vulnerable consumers have been adversely affected by the activities of such lenders during the period in which they operated without regulation, in relation to both assessments of suitability and the terms and conditions upon which loan products were offered to customers.

This submission from FLAC (Free Legal Advice Centres) focuses on how the proposed legislation will affect borrowers. It raises questions about how the proposed regulation will protect consumers. FLAC is an independent human rights organisation which is dedicated to the realisation of equal access to justice for all. As part of its work, FLAC focuses on particular areas of law and law reform which have a very high impact on those who are marginalised and especially vulnerable. Amongst these categories are many borrowers from sub-prime lenders and other non-deposit taking lenders who are the subject of the proposed legislation.

This submission first notes the dearth of regulation in this area until now. It goes on to seek more detailed information on the form of regulation than is available in the consultation paper. FLAC recognises that the mechanics of the form of regulation are important but is concerned that certain underlying substantial issues remain unclear including matters which are of primary interest to borrowers such as the setting of interest rates, and the imposition of charges. FLAC is strongly recommending that all institutions affected by this legislation, existing and new entrants, be obliged to produce up to date details to comply with the new legislation. The danger of duplication is far less than the potential danger from lack of clarity in the system such as now exists. FLAC then points to dangers for consumers arising from gaps in the existing legislation and urges their rectification now. Above all, FLAC trusts that this legislation will be used in order to strengthen the protection and supervision available to consumers. A summary of FLAC's conclusions appears at the end of the paper.

The case for regulation (prior to now)

The Consultation Paper states at page 1 that *'there is currently no EU or domestic requirement for firms to be authorised to lend money from their own resources at their own risk* '. Page 1 also makes explicit reference to the fact that all non-deposit taking lenders fall within the terms of the third Money Laundering directive which must be transposed into Irish law by December 15th of this year. It seems to be clear from the paper that equally, there was no impediment which prevented regulation of such firms.

At page 2 of the Consultation Paper, it is stated that *'the CPC* (Consumer Protection Code) *currently applies to firms that require registration or authorisation'* and '*was issued by the Financial Regulator drawing on powers conferred by Central Bank Acts'* but that *'there is no corresponding legislation in respect of non-deposit taking lenders under which the CPC can be extended to them'.* Here again, the suggestion in the paper is that there was nothing preventing the application of the Code to sub prime lenders (and other non deposit takers) but that the necessary legislation was not put in place to facilitate this.

As long ago as 2002, the draft Central Bank and Financial Services Authority of Ireland Bill, which followed on the McDowell report of 1999, proposed that a non deposit taking financial institution might not issue a loan secured on the principal private residence of the borrower, unless it were licensed by the new regulator to do so and that the Regulator might lay down conditions to be adhered to by such lenders in relation to such lending activity. This proposal was never acted upon. In the interim, there has been massive product development in relation to the provision of credit and marketing techniques are evolving all of the time. More recently, there has been a crisis in sub-prime lending in the USA and public and media concern about sub-prime lending in Ireland.

While the transposition of the directive may have been the immediate spur for this legislation, the State does have a duty to protect consumers from being exploited, and that requires ongoing vigilance on its part. It is therefore important that the State prioritises consumer protection in enacting this legislation and ensures thereafter effective monitoring and supervision.

Conclusion.
We believe that the necessity to comply with EU legal instruments should only be one part of the regulation of financial services in Ireland. Where a member state is not precluded from further regulation in its own right, it should be pro-active in ensuring that consumers receive the necessary protection.

2. Proposed method of regulation

We note that the Consultation Paper proposes four options for the regulation of previously unregulated entities and clearly favours as its preferred option, amending Part V of the Central Bank Act 1997. As a preliminary comment, we are not nearly as concerned with the method that the Oireachtas choose to transpose the third Money Laundering directive in regulating non-deposit taking lenders as we are with the form and vigour of that legislation when it transpires.

As noted in pages 3-4 the Consultation Paper, Part V of the 1997 Act already provides an infrastructure for the supervision of regulated businesses. An authorisation and a process of application for that authorisation are required, obligations are imposed on holders of authorisations and an appeal, inspection and enforcement mechanisms are provided for. In relation to extending regulation to non-deposit takers etc, it is proposed to define three new categories of previously unregulated providers – home reversion lenders, 'retail' credit firms and 'commercial' credit firms. The provisions of the Code will apply to the first two categories and both will become regulated whilst the commercial firms will only be required to register with the Regulator.

The paper then proposes that additional provisions may be introduced concerning these newly regulated entities on matters such as probity and competence of management and directors, conducting investigations before granting authorisation, the classification of such entities and any supervisory role of regulators in other EEA states. In addition, the Regulator '*would also be empowered to impose conditions or requirements on retail credit and home reversion firms in the interest of proper and orderly regulation or* ***protection of consumers'.***

The above seems to us to be the bones of the proposed regulatory process. Our primary concern is how this will translate into practice particularly in relation to the **protection of consumers.**

3. What form will regulation take?

Three main concerns arise in relation to the protection of consumers in considering the form of the regulation. These relate to

- setting interest rates;
- Regulation of charges other than interest rates, and
- Other decision making processes of lenders.

- **What requirements will firms currently well established in the market but unregulated and already prescribed for the purposes of the Consumer Credit Act 1995 have to satisfy in relation to the setting of interest rates?**

The largest sub prime lender in the housing market in Ireland was granted prescribed institution status by the Consumer Director of the Financial Regulator on November 16th 2004 through S.I No 715/2004 but is not otherwise regulated. Under S.2 (1) of the CCA 1995, it can act as a prescribed credit institution provided it does not charge over 23% APR. The fact that a mortgage lender is notionally allowed to charge up to this extortionate interest limit for a housing loan and still retains its credit institution status is extraordinary.

By virtue of S.149 of the CCA (as amended), a credit institution must notify the Central Bank of every proposal to impose any **charge** in relation to the provision of a service to a customer that has not been previously notified to the Bank. What does not currently require sanction is the rate of **interest** that a lender proposes to charge customers as S.149 of the CCA 1995 defines charge as including '*a penalty or surcharge interest by whichever name called, being an interest charge imposed in respect of arrears on a credit agreement or a loan'.* This does not include the original interest rate struck at the outset of the agreement as it is clearly not imposed in respect of arrears.

The cumulative effect of these provisions, therefore, is that non-deposit takers specialising in sub-prime loans are currently given prescribed credit institution status (and therefore legitimacy) for the purposes of the CCA and can charge a customer what they wish in terms of interest. Others are already credit institutions by virtue of their regulation in another EU Member State.

The lender referred to above recently announced a unilateral increase of 0.4% for its existing customers and 0.9% for new customers to its already very high rates, with many of the other sub-prime lenders in the housing loans area making similar announcements. Another non-deposit taking credit institution, authorised in another EU Member State and operating on a branch basis in Ireland, specialises in sub prime personal loans and offers credit at up to three or four times the market average rate. These companies did not have to commercially justify these rates before any authority and are currently free to pass on increases to already hard pressed customers as their loans are expressly variable. Sub prime lenders argue that their substantially higher rates of interest are justified by the increased risk they are taking by lending money to people with either a poor credit rating or no credit rating (such as, for example, migrant workers). At present, there does not appear to be any process whereby these assertions have to be verified by objective criteria. Equally, there does not appear to be any examination of the justification for the difference in rates between prime lenders and sub prime or any classification of customers into risk categories.

Conclusion:
With so called 'risk based lending' becoming an increasing feature of the consumer credit market in Ireland, it is imperative that a process be put in place whereby an independent regulator assesses proposed interest rates that are above standard market rates. At present moneylenders are the only credit providers who have to apply for a licence and state on that application what they propose to charge customers. When non deposit takers become regulated, a rigorous assessment process of proposed rates of interest must also apply to them. Authorisations must be refused where rates are considered unjustified and such lenders must be required to carry out a thorough risk assessment before offering a rate and be in a position to justify that offer. A consumer should have a right of complaint to the Ombudsman for Financial Services where s/he feels a rate is unjustified.

- **What requirements will entities currently well established in the market but unregulated and already prescribed for the purposes of the Consumer Credit Act 1995 have to satisfy in relation to other charges?**

By S.149 of the CCA (as amended), a credit institution must notify the Central Bank of every proposal to impose any **charge** in relation to the provision of a service to a customer that has not been previously notified to the Bank. Similarly, any proposal to increase a charge must be notified and approved. In relation to non-deposit takers, domestic entities granted prescribed credit institution status inform the Bank of what they propose to charge for a variety of services and these are sanctioned or refused and resubmitted. Presumably, non deposit taking credit institutions that have a banking licence in another EU state have similarly to submit their proposed charges to the Central Bank for approval. We say presumably because there does not appear to us to be a lot of information available on this process. The website of the Financial Regulator does not seem to publish a list of prescribed entities under the CCA 1995, let alone details of their charges.

Where can information on this decision making process be publicly accessed?
What is the rationale for allowing charges that are ultimately approved?
What charges have been approved and in respect of whom?
Where is a list of these charges to be found?

Take the largest sub prime lender in the area of housing loans mentioned earlier in this submission. In addition to an interest rate substantially above the market rate, this lender has in the past also charged or proposed to charge the following elements:

- An 'arrangement fee' of 0.5% (for example €500 on a €100,000 loan)
- An 'administration fee' of €1000 payable to the 'applicant's' mortgage broker
- A 'valuation fee' of €205 payable to the 'applicant's' mortgage broker
- Compound interest on arrears at the same (generally high) rate that already applies to the loan with the right to charge an additional 1% on the arrears balance, where the arrears persists for a month and no arrangement is made to clear them
- Sundry other charges, including €12 extra for an unpaid instalment, €10 for a 'Reminder letter on an outstanding instalment', €6 for a statement on request, €50 for a 'Call Out Fee' (whatever that may be) and €25 to issue a giro payment book

Have all these charges been sanctioned under S.149 and, if so, using what criteria and what assessment of their commercial justification?

To what extent has the necessity to **protect the consumer** from arbitrary charges been considered, especially those charges that are taken off the top of the loan or are imposed when the customer gets into financial difficulties?

Apart from in the loan agreements of the lenders, where would a potential borrower find these approved terms and conditions and is there any right for a member of the public or a consumer group to object to them?

Conclusion.
We note with concern the proposal on page 6 of the Consultation that existing prescribed credit institutions under the CCA should not be required to resubmit their charges under S.149 and S.149 (A) for approval as a result of becoming regulated businesses. We do not believe that this would be duplication. On the contrary, we believe that a transparent consumer as well as commercial focused review of all the charges of non-deposit taking entities is urgently required.

- **Will regulation of non deposit takers look at some of the other decision making practices of these entities that may impact adversely upon consumers?**

It is welcome that the provisions of the Consumer Protection Code (CPC) will apply to these lenders when they become regulated, though we would still have concerns about how rigorously the Code will be enforced. The provisions of the Code in relation to knowing the consumer and assessing the suitability of the consumer for a particular product should prove especially useful. However, we would still be concerned that secured loans are being offered by sub prime lenders in some cases where an inadequate evaluation of the borrower's ability to repay has taken place and the role of mortgage brokers may on occasion exacerbate this.

There is a delicate balance to be achieved between a right of access to credit and irresponsible credit. However, the consequences of defaulting on a secured loan for the consumer and his/her dependants are particularly pronounced. Legal proceedings brought by sub prime lenders to repossess property have been steady through 2007. Very few of these result in actual repossession orders at present but on the other hand, the terms upon which these cases are settling (for example voluntary sale) and the consequences for the borrowers and society in general remain largely unmapped.

It is notable that too that the High Court is the court of choice for sub prime lenders rather than the Circuit Court. Although the High Court has full and original jurisdiction to deal with any legal matter under Bunreacht na hEireann, 1937, the normal venue for such proceedings where the rateable valuation of the property is under £200 is the Circuit Court. It is speculated that this is being done for a number of reasons. Firstly, the matter initially comes before the Master of the High Court sitting exclusively in Dublin and the chances of a borrower whose home is in Kerry or Donegal, for example, appearing to challenge the proceedings is reduced. Secondly, the costs of the proceedings to be added to the debt are generally greater. Thirdly, adjournments generally granted to facilitate a borrower to reach an accommodation are shorter and add on each occasion to the costs to be borne by the borrower.

Conclusion.
We believe that the regulation of non-deposit taking entities should consider the imposition of a strict 'ability to repay' standard upon sub-prime lenders at the point the loan is made, with a requirement to verify information of means supplied by the potential borrower. We are also of the view that the practice of such lenders in bringing repossession proceedings in the High Court where the rateable valuation of a property is under £200 should be investigated by the Regulator.

4. Regulation of any new entrants into the non-deposit taking lending market
Conclusion.
The foregoing recommendations in relation to the regulation of non-deposit takers should equally apply to any new entrants into the market.

5. Other issues.

As this proposed legislation is the first to address regulation of non-deposit taking lenders and the first for some time to consider consumer protection in the provision of credit, FLAC submits that the opportunity should be taken to address two further specific lacunae in the CCA 1995 that allow credit institutions to potentially overcharge their customers.

Regulating the charges of deposit taking credit institutions under the Consumer Credit Act 1995

Credit institutions may charge moneylender rates without having to undergo the scrutiny to which a moneylender is subject because of one such gap in the law.

A moneylender under Section 2 (1) of the CCA is defined as **not** including a credit institution. In turn a moneylending agreement is an agreement into which a **moneylender** enters or offers to enter. It follows that, as a credit institution is not a moneylender, it cannot be involved in a moneylending agreement. In principle, any credit agreement where the total cost of credit is in excess of 23% APR is a moneylending agreement and the creditor proposing to charge this rate or over must have a moneylender's licence. In addition, any entity wishing to become a 'prescribed' credit institution must confine its charges to under 23% APR.

However, existing credit institutions licensed under the Central Bank Acts or holding a banking licence in another member state of the European Union are not so confined and as a credit institution is not a moneylender and thus cannot be involved in a moneylending agreement, it is free to charge whatever APR it wishes without having to apply for a licence to do so.

Although competition does, in the vast majority of situations, ensure that credit institutions do not charge these kinds of rates, there have been exceptions. One prominent domestic bank, using another business name has in the past charged up to 29% APR to finance credit sale agreements for the purchase of computers. An existing entity with a banking licence in another EU member state routinely charges well over 23% APR on personal loans of three to five years duration to its customers in Ireland.

Conclusion.
This is a loophole in the legislation that should be closed. These kinds of rates of interest are very hard to justify even based on risk and in our view there is a strong case for reducing the 23% limit. At the very least, any credit institution proposing to charge what are moneylending rates (charged over a longer period of time) should have to apply to do so and provide a commercial justification for these charges.

Non application of S.47 of the Act to credit institutions or prescribed entities
A related gap in the CCA is the non-application of Section 47 to credit institutions. This section in theory allows a consumer to make a complaint to the Circuit Court that the total cost of credit in an agreement is excessive. When the CCA was first published, this section was intended to apply to all creditors. However, it was amended to 'not apply to any credit agreement relating to credit advanced by a credit institution or a mortgage lender'.

Conclusion.
The exclusion of credit institutions from S.47 of the CCA may have been grounded on a belief that competition would look after the interests of the consumer. However, this is not guaranteed in all cases and with the growth of the sub prime market, there is a case for not only screening rates as part of a regulatory process but also allowing a court to review rates and excessive charges.

Summary of conclusions and recommendations.

1. **FLAC believes that the necessity to comply with EU legal instruments should only be one part of the regulation of financial services in Ireland. Where a member state is not precluded from further regulation in its own right, it should be pro-active in ensuring that consumers receive the necessary protection.**

2. **With so called 'risk based lending' becoming an increasing feature of the consumer credit market in Ireland, it is imperative that a process be put in place whereby an independent regulator assesses proposed interest rates that are above standard market rates. At present moneylenders are the only credit providers who have to apply for a licence and state on that application what they propose to charge customers. When non deposit takers become regulated, a rigorous assessment process of proposed rates of interest must also apply to them. Authorisations must be refused where rates are considered unjustified and such lenders must be required to carry out a thorough risk assessment before offering a rate and be in a position to justify that offer. A consumer should have a right of complaint to the Ombudsman for Financial Services where s/he feels a rate is unjustified.**

3. **FLAC is concerned to note the proposal on page 6 of the Consultation that existing prescribed credit institutions under the CCA should not be required to resubmit their charges under S.149 and S.149 (A) for approval as a result of becoming regulated businesses. We do not believe that this would be duplication. On the contrary, we believe that a transparent consumer as well as commercial focused review of all the charges of non-deposit taking entities is urgently required.**

4. **We believe that the regulation of non-deposit taking entities should consider the imposition of a strict 'ability to repay' standard upon sub-prime lenders at the point the loan is made, with a requirement to verify information of means supplied by the potential borrower. We are also of the view that the practice of such lenders in bringing repossession proceedings in the High Court where the rateable valuation of a property is under £200 should be investigated by the Regulator.**

5. **The foregoing recommendations in relation to the regulation of non-deposit takers should equally apply to any new entrants into the market.**

6. The provision which permits a credit institution to charge rates which money lenders could only charge after being licensed should be amended. These kinds of rates of interest are very hard to justify even based on risk and in our view there is a strong case for reducing the 23% limit. At the very least, any credit institution proposing to charge what are moneylending rates (charged over a longer period of time) should have to apply to do so and provide a commercial justification for these charges.

7. The exclusion of credit institutions from S.47 of the CCA may have been grounded on a belief that competition would look after the interests of the consumer. However, this is not guaranteed in all cases and with the growth of the sub prime market, there is a case for not only screening rates as part of a regulatory process but also allowing a court to review rates and excessive charges.

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