Reading 34

Moody's Investors Service 2011, International Structured Finance, Sector Comment, *Modified loans*, 28 February.

Note:
This report is provided purely for educational purposes and must not be relied upon, reproduced, disseminated or otherwise used in any manner whatsoever. The information in this document may not be current and must not be used for the purpose of making a decision in relation to a particular financial product or class of financial products.

MOODY'S
INVESTORS SERVICE

SECTOR COMMENT

Modified Loans

Extracted from 'Structured Thinking: Asia Pacific', dated February 2011

Analyst Contacts

Arthur Karabatsos
Vice President – Senior Analyst
612.9270.8160
Arthur.Karabatsos@moodys.com

ADDITIONAL CONTACTS:
Beijing: 86.10 6642 8968
Hong Kong: 852.3551.3077
Seoul: 82.2.787.2277
Singapore: 65.6398.8308
Sydney: 61.2.9270.8100
Tokyo: 81.3.5408.4100

Website: www.moodys.com

» The principal legislation regulating consumer credit in Australia – which has existed since 1996 – was replaced by the National Consumer Crediot Protection Act (NCCP) in January 2011.

» The NCCP expands the type of loans for which modifications may be requested due to hardship.

» No rating implications are expected due to the NCCP.

Since 1996, Australian consumer credit laws have allowed mortgage borrowers to have their loans modified on the grounds of financial hardship. If a borrower qualifies, the loan may be modified in one of three ways:

» reducing the repayments by extending the term of the mortgage

» postponing repayments in part or in full for a specified period (typically 3 months)

» a combination of the two solutions above.

If payments are postponed or reduced, any unpaid interest continues to accumulate and added to the principal balance. At the end of the specified period, repayments are reset to repay the mortgage within the original term. The law does not allow for any forgiveness of principal or interest.

To be considered for hardship, the borrower must demonstrate to the lender that the inability to meet current repayments is temporary in nature and rectifiable within a foreseeable period.

What is Moody's Structured Thinking: Asia Pacific?

'Structured Thinking: Asia Pacific' is a new monthly Moody's publication that focuses on news, opinion and credit insight relating to the securitisation markets in the Asia Pacific region, including emerging Asia, Australia, New Zealand and Japan. We aim to bring you our best structured thinking on the region from our structured finance, sovereign, and financial institutions analysts as well as economists from our sister company, Moody's Analytics.

The top reasons for borrowers being granted hardship provisioning are:

» unemployment

» reduced income

  o downturn in business for self-employed

  o reduced bonuses and overtime for non-self-employed

» relationship breakdowns

» medical reasons

Other reasons for hardships are matters such as changing personal circumstances, for example, maternity or paternity leave, death in the family, and natural disasters, such as floods or bushfires. Lenders are expecting to receive request for modifications due to the recent Queensland floods, but to date, these requests have been few in number.

In 1996, the Uniform Consumer Credit Code (UCCC), the principal legislation regulating consumer credit, was introduced, governing most consumer lending. It was developed in response to a national initiative to standardize credit practices and protect consumers. It required lenders to inform borrowers of their rights and obligations when entering a consumer credit contract and clearly state the amount of credit, interest, fees and charges, repayments, etc. It also required lenders to conduct responsible and prudent lending.

All lenders that provide credit as part of their business were covered by the code, meaning both bank and non-bank lenders were covered.

But, the UCCC did not cover certain types of credit, such as investment and business loans. This meant that loans for the purpose of purchasing investment properties (buy-to-let) were not covered. The code also excluded loans for amounts above $320,000[1].

The UCCC was considered state-level legislation. But, as of October 2009, the Commonwealth assumed responsibility for consumer credit by enacting a federal law and replacing the UCCC with the National Consumer Credit Protection Act (NCCP)[2].

Essentially, the NCCP is the same as the UCCC with the following key enhancements:

» Investment (buy-to-let) properties are now covered

» The loan amount cap has been raised to a flat $500,000

» Membership of in External Dispute Resolution (EDR) body for lenders is now mandatory

» A national licensing regime has been established requiring providers of consumer credit as well as credit-related broking services and advice to obtain a license from the Australian Securities & Investments Commission (ASIC). In other words, mortgage brokers must be licensed.

[1] Was set as a percentage of the average sales price of properties in each city

[2] Non-banks have been covered as at 1 July 2010 and banks as at 1 January 2011

The two key additional lender obligations under the NCCP are that lenders are required to respond to all applications for hardship within 21 days and that a borrower who disputes a decision by the lender can take the matter to an External Dispute Resolution (EDR)[3] body, whose decision is binding. Additionally, lenders have to more clearly demonstrate their compliance with their existing responsible lending obligations and that the mortgage was "not unsuitable" for the borrower.

These additional obligations have not altered how lenders assess hardship cases (they are still required to modify loans only if it is a genuine temporary inability by the borrower to make repayments) or their underwriting decisions (they are still required to conduct responsible lending). In a practical sense, these obligations are more of a compliance issue than anything else. For example, default notices must now contain standard wording on the option of the borrower to request a modification and his/her right to take a dispute to the External Dispute Resolution body.

Apart from the compliance issues its largely business as usual for Australian lenders. For example although the UCCC previously excluded loans used to buy investment property or loans of more than $320,000, lenders would still approve hardship provisions and modify such loans, as a matter of good business practice, if they could ascertain that the borrower's inability to meet repayments was temporary and rectifiable.

Anecdotal Observations

Loan modifications are not leading to back ended losses. Historically they have proven highly successful with typical loan modifications involving postponing repayments in full for 3 months after which about 90% of borrowers are cured, the remaining are cured by month 6. Over the last couple of years only a handful of borrowers who have had their loan modified have consequently defaulted resulting in a loss and a claim on mortgage insurance.

There is no standard in reporting of modified loans, but lenders would typically not include them in delinquency reports and not reported to an external credit agency.

In our view, the NCCP should not have any negative implications for RMBS deals.

3 Financial Ombudsman Service (FOS) or the Credit Ombudsman Service Ltd (COSL)

Report Number: SF237979

Author
Arthur Karabatsos

Senior Production Associate
Diana Brimson

MOODY'S
INVESTORS SERVICE