Productivity Commission

Review of the Consumer Protection Framework

Submission by Consumer Credit Legal Centre (NSW) Inc

June 2007

1 Introduction

This submission has been prepared by the Consumer Credit Legal Centre (NSW) Inc. Additional case studies were also supplied by other services, largely financial counselling services, including:

- Centacare
- Illawarra Legal Centre
- Salvation Army, Moneycare
- Consumer Law Centre, ACT
- Lismore and District Financial Counselling
- Lifeline Financial Counselling Services, Newcastle and Hunter
- St Vincent de Paul
- Wesley Mission

The above organisations share our concerns in relation to lending to vulnerable consumers but have not had the opportunity to review this submission. As a result we do not purport to represent their views.

In addition to preparing this submission, CCLC staff members have also contributed to the Consumers Federation of Australia paper on A Strong Consumer Voice.

1.1 About Consumer Credit Legal Centre

Consumer Credit Legal Centre (NSW) Inc ("CCLC") is a community-based consumer advice, advocacy and education service specialising in personal credit, debt and banking law and practice. CCLC receives over 70% of its recurrent funding from the NSW Office of Fair Trading, and the remainder from the national Community Legal Services Program funded by both State and Federal Attorney-Generals Departments. Funding is also received periodically from other government and non-government sources for specific projects.

CCLC employs solicitors and financial counsellors. The CCLC Credit and Debt Hotline is the first port of call for NSW consumers experiencing financial difficulties. We provide legal advice, financial counselling, information and strategies, and referral to face-to-face financial counselling services, and limited direct financial counselling. In the 2006/07 financial year to the end of May, CCLC staff have taken 10,433 calls from consumers seeking assistance. This is the largest number in the history of the service, at an increase of about 2,800 calls from the number of calls received per annum in 2002 to 2005. CCLC has also recently received funding (from the Legal Aid Commission of NSW and the NSW and Victoria Law Foundations) to operate a pilot insurance service over the next 18 months.

CCLC acts for clients in Courts and Tribunals, and provides assistance in preparing and arguing complaints through External Dispute Resolution Schemes. This casework assistance is usually provided for between 120 and 160 clients per year, with cases selected on the basis of either the level of disadvantage of the client, or the significance of the issues at stake for other consumers, or both. CCLC also provides extensive website resources, education kits and workshops (often for financial counsellors and other community workers), and media comment.

A significant part of CCLC's work is in advocating for improvements to advance the interests of consumers, particularly disadvantaged consumers. In this way CCLC seeks to influence developments in law, industry practice, dispute resolution processes, government enforcement action, and access to advice and assistance. Activities include but are not limited to:

- Writing to or meeting directly with industry
- Participation in committees (government and industry)
- Liaison with external dispute resolution schemes
- Making submissions /giving evidence to government initiated inquiries
- Responding to government requests for information
- Making complaints and representations to government
- Obtaining funding to produce research reports
- Raising the profile of issues in the media

2 Summary of Submissions

2.1.1 General consumer protection framework

1. The rationale for intervention in markets should include:
   - Improving consumer confidence by setting minimum standards and opportunities for redress and therefore encouraging economic activity;
   - Encouraging enterprises that improve the overall productivity and efficiency of the market (provide a net benefit to the community) by offering goods and services (including information/intermediary services) which are of genuine value to consumers, rather than enterprises which set out to dupe or mislead, or simply derive income without adding value;
   - Addressing information asymmetry which may result in poor choices being made resulting in misleading signals from the demand side to the supply side;
   - Addressing particular anomalies or market failures, by targeted intervention;
   - Achieving broader social objectives that cannot be achieved through other means, or cannot be achieved solely through other means, and to ensure government spending in other portfolios such as welfare (income support), health and housing is cost-effective; and
   - Guarding against broader risks to the population or economy posed by particular business models/practices.
2. The business of providing credit warrants particular attention under all of the rationale above because of the consequential risks to individuals, community, government service providers, investors and the economy.
3. Behavioural economics offers the potential to better understand the reality of markets as opposed to the theory and, therefore, to develop more effective intervention. Specifically, behavioural economics may assist policy makers to predict where attempts to empower consumers may fail or succeed and/or the conditions in which certain types of market misconduct are likely to flourish.
4. While conducting a cost-benefit analysis of any proposed regulatory intervention is supported in theory, consumers and consumer advocates are rarely well-placed to conduct a detailed analysis on the consumer side. Industry participants often hold all the cards in so far as they have the motivation, the expertise and the access to relevant data to establish the case for non-intervention.
5. Regulators need to undertake more pro-active investigation and analysis, not rely on weighing up submissions alone.
6. Consumer assistance and advocacy organisations need to be better resourced to participate in policy debates. In particular, there should be better capacity to

coordinate consumer input nationally, develop informed consumer policy responses and conduct or commission independent research.

7. Regulators need to be pro-active in their response to emerging trends.
8. Sometimes "soft" intervention is more pervasive, costly and less effective than "hard", but well targeted, interventions that are avoided as paternalistic or overly interventionist.
9. Unfair terms regulation is needed to reduce transactional complexity, improve consumer confidence, protect consumers from excessively punitive contract terms, and reduce the need for inefficient, individual litigation on unfair contract issues.
10. Access to advice is vital for consumers. Preventative advice would be very useful but existing agencies do not currently have the resources to keep up with reactive advice. Preventative advice, however, will not be sufficient in some circumstances, particularly those involving particularly desperate and/or vulnerable consumers. Some products and transactions are so detrimental that elimination from the market where possible is the most appropriate response.

2.1.2 Credit

11. The current State-based uniform template legislation model is too cumbersome and unresponsive. There should be one primary regulator, preferably ASIC, and a single policy making unit with the capacity to respond effectively to market developments.
12. Credit legislation should be extended to cover small business and individual investment borrowers.
13. Credit regulation needs to recognise and encompass the changing nature of credit products and the credit market, including but not limited to reverse mortgages and shared equity products.
14. ASIC approved internal and external dispute resolution ("EDR") should be available to all borrowers, and should therefore be compulsory for all credit providers and credit intermediaries.
15. EDR Schemes cannot give independent advice and cannot replace the role of the regulator. EDR schemes are successful as a result of mandatory membership and regular review, which are in turn underpinned by legislation, policy statements issued by the regulator, and regulatory oversight.
16. There are currently differing levels of regulation for different types of lender. This means that there are different standards for different lenders, and that there is a constant competitive pressure on mainstream lenders to adopt some of the practices of those who are less regulated in order to protect market share.
17. Competition and existing legislation are not delivering fair or sustainable outcomes in some areas of the credit market.

18. Credit card debt is at unsustainable levels in the community. Credit card limits are too high, credit assessment for credit cards is insufficient to match consumers with appropriate credit limits and minimum repayments are too low as a percentage of the total amount owing. Increasing minimum repayments on existing accounts, however, would precipitate a crisis as most borrowers have been assessed on their ability to meet existing minimum repayment level only.

19. Debt consolidation/refinancing is an area where poor advice is particularly rife and consumers are on average more vulnerable. As a result some consumers enter into loan transactions that increase their overall indebtedness, or level of repayments, or the cost of their debt, causing their financial position to deteriorate. In many cases, whether or not they save money, consumers take unsecured debt and secure it against their home, greatly increasing their risk of the loss of their primary residence upon default.

20. Sub-prime lending is an area in which consumers particularly experience the problems outlined in the previous point in relation to debt consolidation. Further, lenders tend to have relatively high entry and exit costs, priced for risk products, which can be expensive and exacerbate financial problems, and rapid, inflexible enforcement processes.

21. There is a small group of lenders, brokers, and associated parties such as solicitors and accountants who participate in what CCLC refers to as “predatory lending”. These industry participants offer expensive loans to vulnerable borrowers with little hope of repaying the debt with a view recovering the loan and considerable fees and charges from the security property. These loans are highly damaging to borrowers, who often lose their home, or significant further equity where loss of the home was already inevitable. They are also potentially harmful to the economy.

22. Small amount lending by non-mainstream lenders is another area where there is a significant volume of lending to vulnerable consumers. This type of lending needs to be regulated by the UCCC along the lines of mainstream lending and to have up-front costs regulated via an interest rate cap inclusive of fees and charges. Security should not be permitted to be taken over essential household goods which would generally be protected in bankruptcy, and punitive default clauses should be addressed either using unfair terms legislation, or industry specific legislation enabling penalty charges to be challenged as unreasonable or excessive to compensate the lender’s loss.

23. The UCCC is not currently effective to ensure that consumer lending is sustainable. Many the lenders avoid the legislation successfully. Even when the UCCC applies, there is no clearly stated obligation to have regard to a borrower’s ability to repay a loan, with associated penalties and remedies.

24. Borrowers are often not in a good position to self-assess their ability to repay a loan. Regulatory provisions that are designed to exclude those borrowers who take on repayment obligations they cannot meet would not adversely affect those borrowers who can make sound judgments about their ability to repay as they would self-exclude regardless.

25. While there may be significant costs to the lender, and therefore consumers, as a result of improved credit assessment processes, there are very high costs associated with default.

26. There should be a multi-pronged approach to the problems of unsustainable lending and predatory market behaviour including:

    - Creating a stand-alone obligation in the ASIC Act, or the UCCC or it successor, to have regard to the borrowers ability to repay a debt without substantial hardship with penalties in the case of a breach of the provision;
    - Giving clear power to the courts and tribunals to relieve a debtor of not only fees, charges and interest, but also part of the principle debt in appropriate cases;
    - Instituting a comprehensive licensing regime for creditors, with the power to exclude players from the market for systemic breaches of the relevant legislative provisions; and
    - Extending the role of APRA to supervise lenders that are not Authorised Deposit Taking Institutions.

3 Response to the Issues Paper

This submission will not attempt to answer the questions raised in the Issues Paper question by question in the order in which they are posed. CCLC does not have the expertise to approach some of the questions at the broad level at which they are pitched. On some issues CCLC has no relevant experience or knowledge at all. Instead we will begin this submission with a selection of broad policy observations, drawing on our experience in credit and related consumer matters, some of which are relevant to a number of different questions in the Issues Paper. What then follows is a section dedicated to the topic of credit regulation in particular, also covering some of the questions in the Issues Paper.

4 Part 1 – Broad observations in response to the issues paper

4.1 The Rationale for Intervention in Markets

There are a number of reasons why governments intervene in markets to provide protection for consumers. Many of these are outlined in the Issues Paper, along with some of the risks associated with intervention. CCLC posits the following reasons, including some that are covered in the Issues Paper, and some which are not:

- to improve consumer confidence by setting minimum standards and opportunities for redress and therefore encouraging economic activity;
- to encourage enterprises that improve the overall productivity and efficiency of the market (provide a net benefit to the community) by offering goods and services (including information/intermediary services) which are of genuine value to consumers, rather than enterprises which set out to dupe or mislead, or simply derive income without adding value;
- to address information asymmetry which may result in poor choices being made resulting in misleading signals from the demand side to the supply side;
- to address particular anomalies or market failures, by targeted intervention;
- to achieve broader social objectives that cannot be achieved through other means, or cannot be achieved solely through other means, and to ensure government spending in other portfolios such as welfare (income support), health and housing is cost-effective; and
- to guard against broader risks to the population or economy posed by particular business models/practices.

As the first three reasons given are broadly accepted, subject to debate about their application in particular circumstances, we will not comment further in relation to them at this stage. We now elaborate on the other reasons as follows.

4.1.1 To address particular anomalies or market failures, by targeted intervention

While in many circumstances the market may be the most efficient and effective mechanism for delivering positive consumer outcomes, this is not always the case. Further, some failures are sufficiently systemic and structural that they cannot be easily addressed by traditional free-market approaches such as improved and compulsory disclosure. A key example of this type of failure is the use of intermediaries in financial services. Whereas consumers and traditional lenders may have a clear vested interest in the long-term sustainability of a loan, intermediate parties such as brokers, advisers, and introducers have a single interest in closing a deal and securing the highest possible commission, an interest that may be clearly at odds with the needs of the principal parties to the transaction. Added to this is the fact that people generally conduct a relatively small number of large loan transactions in their lifetime, leading to limited opportunities to learn from transactional mistakes and less incentive for intermediaries to satisfy customers for the purpose of repeat business.

Similar problems occur in the financial planning arena, where inexperienced investors are reliant for advice on advisers remunerated by up-front commission (again this leads to no vested interest in the long-term performance of the investment). This is a problem of growing significance as the population ages and is expected to pay for or share in the cost of its own retirement through the investment of accumulated superannuation funds.

4.1.2 To achieve broader social objectives that cannot be achieved through other means, or cannot be achieved solely through other means, and to ensure government spending in other portfolios such as welfare (income support), health and housing is cost-effective

While the welfare system is clearly the most appropriate mechanism for the redistribution of wealth, there are other aspects of market regulation that have the potential to play a role in fulfilling social policy objectives. At the very least, consumer protection law should seek to ensure that government policies and spending in other portfolio are not wasted.

Examples of this principle in action that are generally accepted include unconscionability principles in the common law and in statute (the *Australian Securities and Investments Commission Act* 2001 (Cth), *Trade Practices Act* 1974 (Cth) and state Fair Trading Acts), which prohibit the exploitation of clearly vulnerable and disadvantaged members of the community, outlawing products on the grounds of health risk or accident risk. CCLC argues that this principle can and should be taken further. Business practices which target low-income consumers with expensive, poor value products, or which simply result in higher prices for low-income consumers are not only unfair, but they undermine the effectiveness of government spending on income support and other community services. Examples range from targeted sales through to the unintentional consequences of broader practices including but not limited to:

- Overpriced goods and services such as vacuum cleaners, computer programs, funeral benefits sold door-to-door, often with associated finance

- The disproportionate impact of penalty fees imposed by banks[1] (see Case Studies 1 and 2 below)
- Small amount lending (this is expounded in detail in Section 5.6.5)
- Debt consolidation specialists and predatory lending (also covered detail in Section 5.6.2 and 5.6.4)
- Interest-free promotions that tend to capture those with less resources into paying very high interest at the end of the interest-free period (a type of cross-subsidisation where those who can afford to pay out the loan within the interest-free period are only afforded this opportunity as a result of the higher rates paid by those who cannot)
- Where government subsidies or payments for a particular purpose (such as the first home-buyers grant) are siphoned away without achieving the intended purpose (see for example Unfair Terms - Vendor Finance in Section 4.7.1.1)
- Risk-based pricing (though rarely offered by mainstream credit providers to date) allows greater discrimination in the risk-assessment process – it arguably allows lower interest rates to be offered to very good credit risks, in return for a higher rate being payable by those who are poorer credit risk. While risk-based pricing does occur in some sectors of the credit market now, any extension of this phenomenon could lower the cost of borrowing for some consumers, but will increase the cost for others. This type of pricing structure risks entrenching hardship and making it more difficult for people who have endured a financial crisis to recover financially.
- Some countries allow access to credit scores/reports by employers. Again this could lead to employment difficulties for consumers who may have undergone an illness, family breakdown or business failure, for example, thereby decreasing their opportunities for productive contribution to the economy and personal financial recovery.

Case Study 1 – Penalty Fees

W's sole source of income is Centrelink. She has a savings account with a bank. She needed to rent a fridge for her family. She had to pay by direct debit. Sometimes she did not have sufficient money in her account and a direct debit dishonour fee was charged of $50. She had to make up the payment to the rental company and repay the bank leaving her with little money for food. $50 represents over 10% of her total fortnightly income.

Case Study 2 – Penalty Fees

H has a loan at 43% p.a. for $2000 with a small amount lender. The loan is paid by direct debit. H's sole source of income is Centrelink. H had a number

[1] We note that both the National Australia Bank and the ANZ Bank have taken steps to reduce or eliminate such fees for Centrelink recipients in basic transaction accounts.

of bills and did not have sufficient money in his account for the direct debit to the lender. The lender charged him $25 for the direct debit dishonour and her bank also charged $30. Now H is in default of his payday loan and the bank is demanding $30 plus interest.

Unsustainable credit, meaning credit that cannot be repaid, or at least cannot be repaid without causing considerable financial hardship, is also a health risk in that more and more evidence has linked financial stress to other poor outcomes for individuals and families. A survey conducted by Wesley Mission reported the impacts of financial stress and/or indebtedness as including relationship breakdown, substance abuse, increased or frequent gambling and violence.[2] CCLC reported to ASIC in July 2006 that, based on the comments of respondents a small survey in relation to refinancing in response to financial difficulty:

> *"Eviction or the reluctant sale of a person's home (or family's home), has considerable impacts on the emotional well-being of those people affected, which can manifest itself in poor health, poor productivity, relationship and family breakdown, and bitter alienation from community and society."*[3]

All of the above involve costs: costs in terms of the well-being of the individuals concerned; costs to the society in terms of social cohesion; and direct costs to the state for social services and other interventions. A US Study on the public intervention cost of homelessness found that the average annual cost per family that became homeless, for example, was $77,200.[4]

None of the above factors or examples are presented as conclusive evidence that there should be market intervention on a particular issue, or that regulatory intervention is the most appropriate. Rather they are presented as examples of where the consumer protection framework has the potential to work to complement other government policies and programmes such as income support, health care and subsidies, to not only ensure the efficient functioning of markets but, in some cases, to pursue broader policy objectives. At the very least, the consumer protection framework should endeavour to ensure that other government policies and expenditure are not significantly undermined or negated by the market. While social justice and the distribution of income/wealth may properly be the concerns of other parts of government policy, to completely ignore market outcomes that seriously undermine those other policy objectives is obviously counter-productive.

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[2] Wesley Mission, "Finance Stress and Its Impact on Individual, Family and the Community."2006, www.wesleymission.org.au

[3] CCLC, Refinance Survey Project Report ("Refinance Report"), 2006, p71, unpublished. In May 2006, CCLC surveyed 14 sets of borrowers who were clients of community legal centres or financial counsellors and had refinanced their home loan in the last five years in response to financial difficulty. The report prepared for ASIC examined the experiences of those borrower in considerable detail. It is anticipated some of the results may be publicly reported by ASIC in 2007 along with related findings from independent activities undertaken by ASIC.

[4] Reported in the National Community Legal Centres Budget Submission Document, "Community Legal Centres: An Investment in Value", August 2003.

4.1.3 To guard against broader risks to the population or economy posed by particular products/business models/practices

Some products that pose risks to the broader population or economy are prohibited or heavily regulated as a result. Examples include tobacco, alcohol and other drugs (recreational and therapeutic), and dangerous goods. Pyramid schemes are another example.

Other health issues, such as responding to obesity, have a potential cross-over with the consumer protection framework. Sustainability and the tensions between the resource-intensive, short term benefits of rampant consumerism and the long term need to have regard to sustainable communities and economies, also suggest the need for a whole of government approach which would be likely to involve some cross-over into the realm of consumer protection, although the exact nature and extent of that cross-over is clearly an area in which there is room for considerable debate.

Credit is another such product that poses potential threats to the broader economy. Australia is experiencing unprecedented levels of personal debt, largely in the housing market, but also in the unsecured personal lending sector. Debt-to-income ratios are at 160% and among the highest in the world.[5] Interest payments are absorbing 12% of disposable income, up 6.9% from just five years ago.[6] Until recently the housing sector in Sydney for example was experiencing a period of constant and arguably unsustainable price rises. As expressed by the then Deputy Governor of the Reserve Bank of Australia:

> *"It is really the leverage that accompanies asset-price movements which is the issue, rather than the asset-price movements themselves … all sizeable asset-price misalignments presumably do some damage, but the ones which do the most damage are those associated with a big build-up in leverage, which always carries the risk of forcing abrupt changes in behaviour by borrowers and their lenders when the prices turn."*[7]

To date, unregulated credit provision has been clearly recognised as a potential threat to the viability of deposit-taking institutions such as banks and credit unions, which are regulated accordingly by Australian Prudential Regulatory Authority (APRA). However, while both APRA and the Reserve Bank have kept a watching brief on non-bank lenders, the risks posed by this sector have not to date been fully appreciated or acted upon.

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[5] Gordon & Moncrief, "The Home Front", Business Day, Page 1 & 6, The Age, Melbourne, 2/6/07. Reserve Bank Statistical Tables, B21-Household Finances – Selected Ratios at http://www.rba.gov.au/Statistics/Bulletin/index.html

[6] ibid

[7] Glenn Stevens, Reserve Bank of Australia, Roundtable/Wrap –up Discussion, Reserve Bank of Australia 2003 Conference, Asset Prices and Monetary Policy, http://www.rba.gov.au/PublicationsAndResearch/conferences/2003/index.html, p295.

The immediate impact on the housing market of mortgagee sales on any significant scale is one possible threat. A less immediate and less understood threat is the flow on effect to the economy, both nationally and internationally, as a result of any losses worn by lenders and investors in this sector. For example, nearly one hundred per cent of sub-prime lending in Australia is funded via the capital market, compared to only 7% to 25% of the mortgage lending of major and regional banks.[8]

> *"The rapid growth of sub-prime lending in new markets, combined with the introduction of new and complex loan types, could raise some issues for financial markets. One question is whether lenders and investors are able to assess accurately the risks of this lending given a lack of previous experience. Another question is whether the risk of contagion from larger domestic housing finance markets via bond market has increased."*[9]

The recent US experience in relation to sub-prime mortgages[10] is a timely warning about the potential economic consequences of some types of consumer lending.

Unsecured lending also poses risks to the economy if it is both unsustainable and of a sufficient scale. CCLC submits that credit card lending may be in this category. Over-indebted households do not have any discretionary income with which to spend, leading to a repression of economic activity. Further, as debtors cannot go bankrupt selectively, creditors that would otherwise have been paid may suffer as a result of bankruptcies that occur as a result of unrestrained consumer lending.

Some of the consequences of unrestrained consumer lending have begun to manifest themselves recently, despite the apparently healthy economy. Bankruptcies overall in Australia were up 7.44% in 2005/06 and were most numerous in NSW where they increased nearly 20% on the previous year.[11] Year-to-date statistics up until the end of March for 2006/07 show a further increase of 16% across the country.[12] Mortgage defaults have increased slightly across the prime sector, but are at 14.2% in the sub-prime lending sector.[13] There has also been a disturbing increase in mortgage repossession applications[14] in NSW since about 2002, culminating in a 59% increase between 2004 and 2005.[15] Applications grew another 10% in 2006 to a record high of 5,368.[16] Increases

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[8] Committee on the Global Financial System, Bank for International Settlements, "CGFS Papers No26 Housing Finance in the global financial market", CGFS working group report, JEL Classification numbers:G21, R21, R31, January 2006, p17

[9] Ibid

[10] Reserve Bank of Australia, "Financial Stability Review", March 2007, p 23-25, available at http://www.rba.gov.au

[11] Administrations under the Bankruptcy Act 1966 Statistics (Provisional) January – March 2007, www.itsa.gov.au

[12] Ibid.

[13] Gordon & Moncrief, "The Home Front", Business Day, Page 1 & 6, The Age, Melbourne, 2/6/07. Note a significant number of lenders are not required to report their default rates.

[14] Applications do not necessarily relate to owner-occupier housing and may include investor housing and commercial properties.

[15] Statistics obtained from the Supreme Court of NSW "Announcements: Mortgage Defaults Stabilise", 12/02/2007, http://www.lawlink.nsw.gov.au/practice_notes/nswsc_pc.nsf/pages/383

have also been experienced recently in the ACT[17] and Victoria.[18] Court applications may also understate the real size of the problem, with many borrowers opting to sell voluntarily or surrender their property rather than face costly and humiliating court proceedings.[19]

CCLC is also seeing ample evidence of increasing consumer stress as the following figures demonstrate:

Figure 1

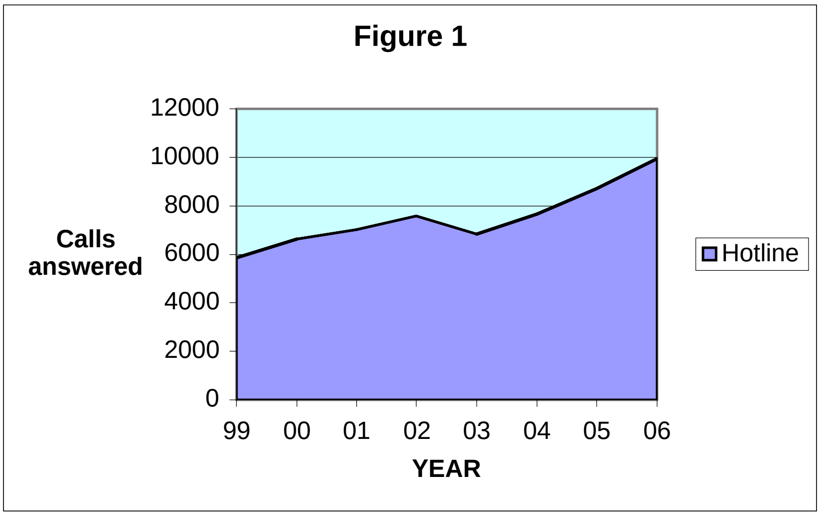

Figure 1 - Calls taken by the Credit and Debt Hotline over time

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[16] Ibid, historical records attached to the Announcement reveal this number to be at least a 16 year high and much higher than the last peak of 3287 in 1991.

[17] Kilpatrick, A. "They wanna take my house: An Investigation into Actions for House Repossessions in the ACT Supreme Court & Experiences of ACT Consumers", 2006. Increase in applications for possessions and writs for possession in 2005 in the ACT reported in the Introduction on page 2 and analysed throughout.

[18] Gordon & Moncrief, above n 13, page 1.

[19] Klan, A. *True rate of home defaults hidden*, The Australian, 16 May 2007, http://theaustralian.news.com.au/printpage/0.5942,21739387,00.html

Figure 2

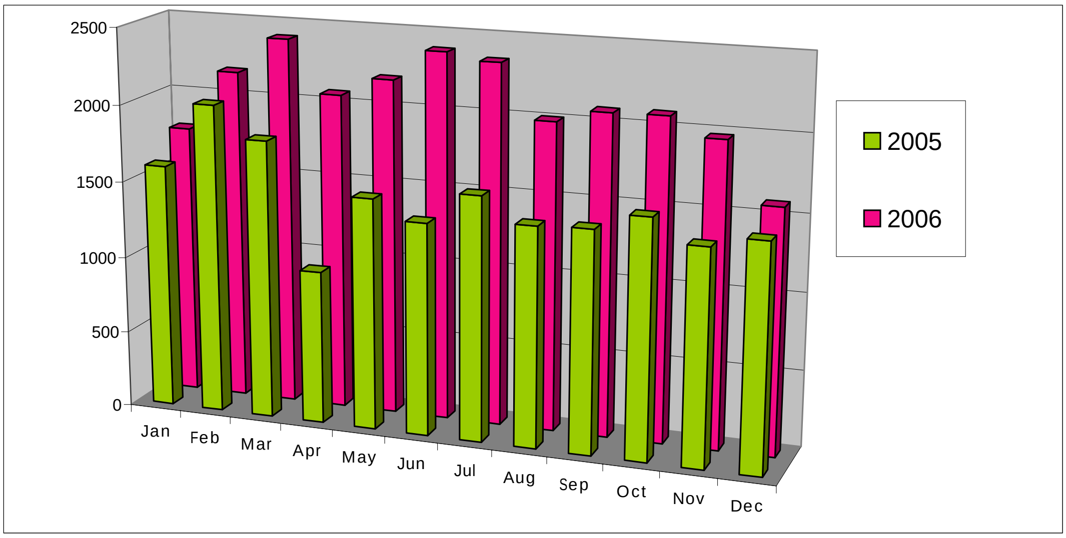

Figure 2 – Calls charged to the Hotline in 2006 (Total calls as opposed to answered calls shown in Figure 1) as compared to the same month in 2005 revealing that demand is outstripping the growth in service provision.

4.2 Consumer policy implications of behavioural economics

As noted in the Issues Paper, behavioural economics have potential implications for shaping or informing consumer protection policy. It is impossible to generalise about these possibilities. The behavioural bias that suggests that consumers can be frozen into indecision by an excess of choice, for example, is undoubtedly useful for retailers seeking to optimise the number of brands or varieties of a product to display, or for governments in designing incentive programs, but is unlikely to suggest a need for regulatory intervention.

On the other hand, "future discounting" has possible policy implications insofar as it suggests that people may make less and less "rational" choices in circumstances where the costs of their choices can be deferred. The obvious examples of this bias at work are where people accept and use higher credit limits on their credit cards than they can realistically expect to repay. Interesting research[20] conducted by ASIC a few years ago suggested that consumers who took advantage of interest-free promotions not only failed in many cases to fully investigate the competitiveness of the terms of the finance provided to facilitate their purchase, but they were also more likely to neglect to make the most basic comparisons in relation to the price of the goods as compared to other retail outlets offering similar interest-free terms. In other words, the incentive to shop around

[20] Reported verbally to CCLC by ASIC staff when CCLC staff were researching the pitfalls of interest-free promotions for inclusion in a media warning.

for the best value product was significantly undermined by the ability to defer the cost. These findings have policy implications in terms of the most *effective* target for legal responsibility for credit assessment. In other words, consumers perhaps should self-assess whether they can afford a particular loan, and in many cases do so successfully, but there is fairly strong behavioural evidence to suggest that a significant number of consumers will not do this well. It also suggests that the free availability of credit, particularly the type of credit where repayments can be delayed for extended periods, is impeding other aspects of competition from operating as effectively as might otherwise be the case.

Generally speaking, behavioural economics can assist policy makers to describe and better comprehend some behaviours that appear at face value to defy the basic premise of traditional economic theory that, provided all the relevant information is available, consumers will act in their own best interests. Further, while behavioural economics is usually discussed in the context of the demand side of the equation, it may provide the power to better predict the behaviour of consumers *and* potentially traders/service providers in response to possible policy responses, allowing for more effective design of targeted intervention.

It has been suggested that behavioural economics can assist government and community educators to empower consumers to recognise and resist some unhelpful behavioural tendencies or biases. While this may be the case, CCLC would suggest that the real power of behavioural economics is in its potential to assist stakeholders to design market interventions that recognise and work with, rather than against, predicted behavioural responses. Behavioural economics may also assist to guide policy makers to recognise market scenarios where certain problematic behaviour by consumers and/or traders is so probable as to be almost inevitable.

Clearly, behavioural economics does suggest the need for more sophistication in the analytical framework and policy toolkit, including particularly more research on actual behaviour in the marketplace by all relevant parties. It may be overstating the situation to suggest that traditional views of the role of government in this area are less relevant. However, it is possible that further research could not only assist governments in addressing market failures by an improved understanding of their causes, but also suggest policies and interventions that have the potential to optimise market outcomes for the benefit of the society those markets serve.

4.3 Establishing the cost of not intervening in the market – a Herculean task

CCLC and other consumer assistance agencies have extensive contact with consumers who have experienced difficulty in the marketplace and yet their experience is often under-valued in the policy-making process as a result of unrealistically high “burden of proof” required before market intervention is considered justified. While industry have the means and motivation for conducting extensive costs-analysis in relation to the cost of proposed regulatory intervention, and the trump card that these costs will be passed on to consumers, it is very difficult to set a dollar figure on the cost of not intervening. While consumer assistance agencies can easily identify the existence of problems manifesting in the marketplace through advice and casework, they have limited resources and expertise with which to estimate the extent of these problems, let alone to cost them in economic terms.

Example 1

In 2006 the Combined Community Legal Centres Group NSW and the National Association of Community Legal Centres commissioned a report by the Institute for Sustainable Futures to assess the economic value of community legal centre services.[21] A CCLC case study involving a $30,000 loan to a pensioner with a modest $1,000 brokerage fee was used as part of the analysis. The loan was unsustainable as the borrower had no means of repaying it at the end of the two-year term and the borrower faced the loss of his home.

An analysis was then conducted of the amounts that would be saved by introducing legislation to prevent such loans and concluded the following:

- The prevention of direct financial loss to the borrower was valued at $9780 made up of brokerage, interest payments and the cost of selling his house (this is likely to be a serious underestimation of actual default costs if house foreclosed upon)
- The saving to the State of not having to provide public housing to the borrower was in the order of $63,000 (if he lived another 18 years)
- Plus a range of other savings in relation to health care etc

Calculations were then carried out by multiplying the savings in this case by the number of credit and debt cases across the country, amounting to millions of dollars without taking into account lost opportunity costs. This case is in many ways less severe than other cases reported in this submission involving significantly larger amounts and larger families. The cost of not regulating in this area is clearly high, but as a general rule community legal centres and other frontline services do not have the time or the requisite expertise to make those calculations.

Example 2

Consumer assistance agencies have been sounding the alarm about credit card lending practices since at least the late 90s. Financial counsellors and legal services around Australia have continuously produced examples of credit card lending from diverse lenders that share common features:

- Credit limit increases are offered without regard to current income and liabilities;

[21] Edgerton & Partridge, "The Economic Value of Community Legal Centres", Institute for Sustainable Futures, UTS 2006

- Minimum repayments are low and many people retain debts for lengthy periods;

- Credit limits are high in relation to income, presumably because the ability to make minimum repayments is the criteria for setting limits; and

- Customers who are already paying interest on their accounts due to a revolving balance are offered higher limits to address their "cash-flow" problems.

Extreme examples include pensioners who owe tens of thousands of dollars and cannot even pay the minimum repayment on their account. Less extreme examples occur more regularly, with debtors able to meet their repayments yet unable to pay off their debt, leading to long-term financial stress. The response from industry has been to pour resources into demonstrating that these cases are in the minority (for example the Visa reports), without addressing the issues raised (at least until recently). The response from government has been, with some notable exceptions, to seek more and more "proof" that there is a problem. In the meantime household debt has continued to grow at alarming rates and the examples seen by consumer assistance agencies have increased in seriousness (for example, a retiree with $100,000 plus in credit card debt).

In 2004, CCLC obtained a modest amount of funding from the NSW Office of Fair Trading to negotiate a joint project with the main players in the credit card industry to obtain an independent analysis of credit card data to better establish the parameters of the problem in order to inform the debate about solutions. While CCLC was successful in establishing an agreement with two major banks, two smaller banks and a non-bank credit provider about the terms of reference, the data set and a neutral research agency, the project has not yet proceeded due to a failure to secure sufficient credit providers to be representative of the market. This represents the loss of an important opportunity to set the record straight on an issue of considerable public interest and demonstrates the difficulties faced by consumer agencies in proving the extent of a particular problem when key data required to make that assessment is controlled by the industry seeking to avoid regulation.

Consumer assistance agencies such as CCLC will never be able to "prove" the extent of a problem statistically. We can, however, demonstrate that a problem exists, and often that it is systemic. Sometimes one form letter can be sufficient to demonstrate the existence of a systemic problem. While the need for "evidence-based" consumer regulation is supported in principle, one interpretation of that principle sets an impossible standard and wastes valuable intelligence about disturbing developments in the market place. The consumer protection framework needs to be more responsive to the concerns of consumer assistance agencies, and to take a more pro-active role in seeking further information, and if necessary *requiring* further information, from those who are in a position to provide it – the industry. Further, while a legislative response may not always be the best one, a real threat of legislative intervention is often necessary to induce meaningful responses rather than elaborate public relations exercises.

4.4 Making more of the experience of consumer organisations

Another reason the experience of consumer assistance agencies is sometimes squandered at the policy-making level is that there is a lack of investment by government in the policy capacity of consumer advocates. CCLC, for example, made 16 submissions to government inquiries, wrote 14 letters or submissions to government on issues that were not the subject of a current inquiry, made 10 complaints to regulators, met with industry representatives 9 times and participated in numerous other meetings, committees and working groups in the last financial year. The pressure to provide services for thousands of consumers in need, and to meet key performance indicators under various funding agreements, means that much of this work happens on a volunteer basis by dedicated staff working on their own time.

Governments, and to an extent industry, encourage our participation in consultation processes, committees and inquiries so that they can meet best practice benchmarks, and yet no significant resources are committed to these activities. On the contrary, key performance indicators, especially for advice and casework assistance, operate to ensure that funded resources are not available to facilitate effective policy input.

CCLC has been fortunate enough to secure project funding to execute a number of significant policy projects,[22] but every successful funding application has invariably been preceded by a number of unsuccessful applications, all requiring considerable time and effort to present. These projects are of course accompanied by a set of performance criteria and reporting requirements that add to the administrative load of the service. Finally, if there is not a steady stream of project funding availability, then there is usually a need to recruit new staff for each project, leading to short term staff, and the consequent inability for appropriate staff to develop the requisite skill and expertise in CCLC's area of specialisation. In short, while such projects are good value for those who fund them because the value-add by the Centre in terms of office facilities, access to client examples, legal expertise, management/administration and consumer networks is considerable, they are extremely taxing for the Centre and tend to add considerably to the workload of permanent staff.

While the importance of providing frontline services cannot be understated (and CCLC has exceeded performance indicators for information and advice considerably in recent times due to pressure to meet the growth in demand for assistance), the lack of recurrent funding for policy work condemns frontline organisations to the role of ambulance (to use the old analogy) when some of our resources would be better placed building fences at the top of the cliff, or better still, providing input on the re-routing of roads.

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[22] *Credit Reporting: Getting it Right for Consumers*, CCLC, May 2007; *Refinance Project Report* (unpublished) to ASIC, July 2006; Debt Collection Research Report, April 2004; Finance and Mortgage Brokers, A Report to ASIC, March 2003; Caseworker Survey Report and Submission to the Review of the Code of Banking Practice, 1999/2000

At the same time, frontline consumer assistance agencies struggle in isolation to interpret the experiences of their clients, and present possible solutions, in a form that makes sense in a broader economic and regulatory framework. As a general rule, frontline agencies struggle to compare notes with other similar agencies around the country, let alone keep up with national and international developments in consumer protection and the implications of behavioural economics. It is difficult to envisage a genuinely effective consumer protection framework without the existence of a national organisation resourced to:

- Collate the experience of frontline agencies;
- Compare that experience nationally and internationally;
- Undertake pro-active, independent research; and
- Provide meaningful, informed consumer input into the development and operation of the broader consumer protection framework.

4.5 Pro-active monitoring of market trends – developing an early response

A related issue is that of waiting for a problem to manifest itself before taking action. In some cases the logic behind a particular business model or practice should of itself be sufficient to warrant further examination. For example, there are a number of industries that have appeared and/or grown significantly in recent years as a direct result of levels of indebtedness in the community:

- Debt consolidation specialists
- Part IX debt agreement administrators
- Credit repair businesses

4.5.1 Debt consolidation specialists

Debt consolidation businesses target people who are struggling with unmanageable debt. While there are some people who can benefit from debt consolidation, and debt consolidation can be arranged by many mainstream brokers and directly through credit providers, there are businesses which target those in serious financial difficulty in order to gouge considerable profit while offering illusory benefits to consumers. These businesses take up-front fees that are large multiples of industry averages, and place people in loans that they clearly cannot afford. Consumers in danger of losing their primary residence through foreclosure are prime candidates for these transactions because their ability to rationally evaluate a complex transaction is compromised by their emotional attachment to their home and/or their perception of personal failure at the prospect of losing the family home. These companies advertise openly in the media, their practices are well known to regulators, and yet regulators appear powerless to take any significant action to curb these activities.

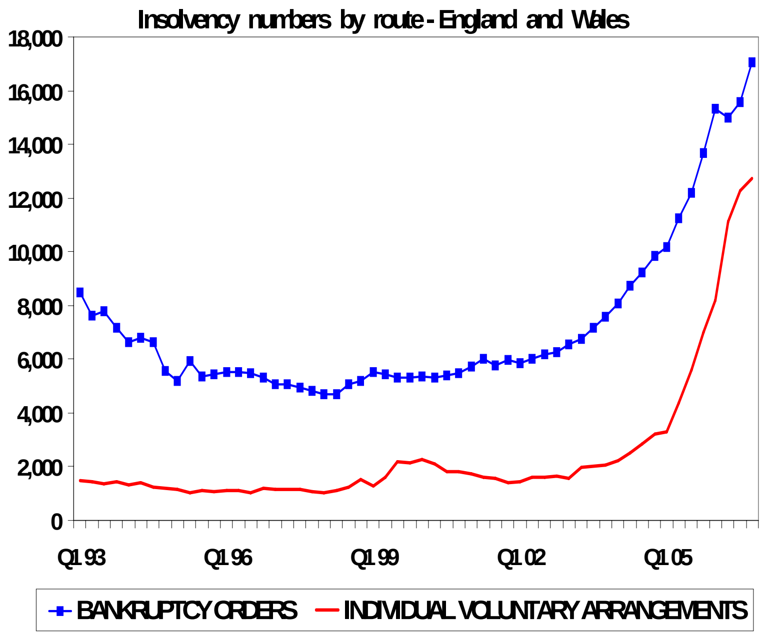
4.5.2 Part IX debt agreement administrators

Part IX administrators assist consumers to negotiate a reduction in their debts under Part IX of the *Bankruptcy Act* 1959 (Cth). Consumers then make set repayments to the administrator that are distributed to their creditors in the proportion agreed, ostensibly until the reduced debt has been repaid. Proposing a Part IX Debt Agreement is an act of bankruptcy and its impact on future credit worthiness is synonymous with bankruptcy. Administrators charge both up-front fees for making these arrangements and ongoing administration fees while the agreement is in force. There are many problems with these arrangements, many of which are related to the essential conflict of interest between the administrator, or “salesperson”, who place themselves in the position of adviser, and the consumer who may benefit from a range of other options available to them which do not involve any money passing to the “adviser”.

Both the above industries are aimed at making a profit from consumers whose essential problem is that they are already in serious financial difficulty and cannot meet their commitments to existing creditors. The first business model ensures that existing creditors are paid, but then proceeds to strip equity from the consumer’s property which may have been accumulated over many years (for older consumers, a lifetime). The second business model makes its profit by diverting some of the limited funds available to pay existing creditors to the debt agreement administrator. While this may have some net benefit for the community (but not necessarily the debtor) if every debtor who entered a Part IX Agreement would have otherwise gone bankrupt, CCLC’s experience, however, suggests that this is far from reality (some CCLC clients do not appear to have even been insolvent at the point of entering a Debt Agreement).

The Attorney-Generals Department reviewed the operation of Part IX of the Bankruptcy Act in 2006 and a new regulatory regime for Debt Agreement administrators is due to commence in July 2007. CCLC is skeptical that this will be sufficient to address the underlying problems in the concept of private companies trading in personal insolvency. While this is an area within the jurisdiction of the Attorney General’s Department and therefore apart from the consume protection framework as generally understood, the interaction of Debt Agreement Administrators with their customers is a standard customer/service provider relationship which is subject to the general principles of consumer law.

Figure 3



In the UK, Individual Insolvency Agreements ("IVAs") are similar to Debt Agreements in Australia and marketed in a similar way. The blue line in the graph above represents all bankruptcy orders including IVAs, and the red line represents IVAs only, clearly demonstrating the degree to which IVAs have contributed to recent bankruptcy activity in that jurisdiction. One of the major listed UK companies has recently entered the Australian market.

English creditors have recently become very concerned at this growing trend and started to take action to resist IVA proposals:

> "*In 2006, IVAs became the main driver behind impairment growth, as the number of companies marketing debt reduction services increased ...The bank took early action during 2006 with regard to IVAs, which helped reduce average levels of debt forgiveness, as well as highlighting misleading claims by some debt advisors"* (HSBC)

Debt Agreements have grown rapidly in Australia since their inception in late 96 from 300-500 in the first few years to 4,000 to 5,000 in the past few years[23]. Year to date figures for Debt Agreements for up until the end of March 2007 show a 34.03% increase on the previous year.[24] If Debt Agreements continue at the current rate for 2006/2007

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[23] Quarterly Bankruptcy Statistics, Insolvency Trustee Service of Australia, www.itsa.gov.au
[24] Administrations under the Bankruptcy Act 1966 Statistics (Provisional) January – March 2007, www.itsa.gov.au

there could be over 6,000 in this financial year.[25] While this is nothing like the statistics presented for the UK, CCLC is concerned that the recent entry into the market of a large listed company from the UK[26] could accelerate this trend.

4.5.3 Credit Repair Businesses

Credit repair businesses present themselves as being able to "fix" a person's credit report. However, in the absence of illegal activity, only inaccurate credit reports can be "repaired". Consumers have a right at law to correct inaccurate information contained in a credit report, and while there have been serious inadequacies in this process, these are now being addressed to a certain extent by industry, and may shortly be the subject of reform proposals by the Australian Law Reform Commission. Any representation that changes can be made to a credit report, which correctly and lawfully contains material that could have a negative impact on the subject's ability to access credit, is misleading. Consumers should be able to exercise their rights to have an incorrect credit report listing amended without paying a third party for assistance. The responsibility and cost of this should lie with the credit reporting agency that is profiting from the sale of this information to creditors and/or the creditor who provided the incorrect or misleading information.

The above industries should be subjected to serious scrutiny by a vigilant regulator. Further, there are advantages to acting early and sending clear signals when new business practices appear. Delays allow industry segments to grow and vested interests to develop, hampering government ability to take decisive action in the future. It is never desirable from a government's perspective to waste resources invested by industry, and/or to negatively affect the livelihood of those involved by regulatory intervention.

At the same time, business ventures which are designed to make money from the plight of consumers whose main problem is that they don't have enough money is essentially flawed. The success of some businesses in this category is arguably evidence in itself of a failure of consumer protection. The consumer protection framework needs the capacity to take a pro-active stance in relation to such businesses.

4.6 A simple, drastic solution is sometimes the most effective *and* the least costly

Traditional market theory dictates that regulatory intervention should maximise consumer empowerment and choice, and minimise the level of prohibitive, paternal intervention in the market place. Simply stated, whenever possible the market should develop and innovate without inhibition, and consumers should be armed with the skills and information necessary to take responsibility for their own consumer choices. While the

[25] Based on year-to-date until the end of March 2007 figure of 4525 reported by ITSA, above n 25.
[26] See Debt Free Direct at http://www.debtfreedirect.com.au/index.php?menuid=2

limitations of this approach have been clearly recognised in relation to unsafe products for example, the considerable bias against interfering with this principle on occasions leads to outcomes that are, in CCLC's view, nothing short of bizarre.

4.6.1 Disclosure

Disclosure is the best example of the minimalist approach leading to complex regulation and significant costs. Designed to improve consumer information and hence consumer choices without the need for heavy-handed intervention, developments in disclosure regimes in recent years have largely benefited the paper and printing industries. Consumers investing in or purchasing financial products are inundated with more information than the average person has the time to read and digest, let alone understand, while many of the practices the regulation was designed to address continue unabated.

The current NSW finance broker regulation, enacted in response to the national competition review of all regulatory instruments to replace an earlier Act, requires brokers to give extensive disclosure[27] including:

- A list of the pool of credit providers to which the finance broker may direct the borrower's application;
- A statement to the affect that the above does not represent all possible credit providers supplying consumer credit of the nature required by the client;
- The fact that the finance broker may receive a financial or other benefit from a person or persons other than the borrower (non monetary payments such as sporting tickets must be disclosed);
- The highest and lowest financial or other benefit the finance broker may receive depending on where s/he directs the borrowers' application;
- An undertaking to provide the information in this sub-list upon making a recommendation about the specific loan involved:
    - The actual amount or benefit payable or how it will be calculated;
    - Whether or not the finance broker can recommend any of the conditions of the loan (such as interest rate, fees or term) and whether this will affect the benefit payable to the finance broker;
    - Any financial or other benefit payable to another person (not the finance broker) that could be reasonably expected to influence the finance broker's recommendation;
    - Any interests or relationships (such as shares in or directorships of credit providers for example) that could be reasonably expected to influence the finance broker's recommendation;

[27] Consumer Credit Administration Regulation 2002 (NSW), Regulations 2C & 2D

From this consumers are supposed to discern that:

- The broker may be motivated by commission, or other financial or non-financial benefit, as much or more so than the consumer's needs;
- The broker may not recommend the best product;
- The consumer should not rely on the broker but should shop around.

The consumer is then supposed to compare the actual commission payable on the loan the broker recommends with the range quoted to determine whether the broker has been motivated by commission, and to figure out how to independently evaluate the loan to check it is the best product available that meets their needs. Of course if the consumer succeeds in all of the aforementioned, they have negated the need for the broker in the first place. Unless of course the consumer is in a highly nebulous financial position and does not believe they will be able to obtain a loan directly from a credit provider. In the latter case the consumer will be likely to ignore the mandated disclosure and accept whatever is offered regardless.

This disclosure regime is annoying to brokers, baffling to consumers, and yet does not address the key consumer protection issues at stake. Consumers approaching consumer assistance agencies often present with contracts that, but for the existence of the broker, could have been challenged at law as unjust, or otherwise the subject of a legitimate dispute with the credit provider. However, at common law the broker is often found to be acting for the consumer and the credit provider is therefore unable to be held responsible for the actions of the broker.

A simple legislative reversal of the common law rules of agency in the case of credit intermediaries could have addressed this problem, ensuring that consumers had access to redress, and placing an onus on credit providers to adequately screen and monitor the activities of third party brokers and other intermediaries distributing their products. This solution was not palatable to the credit industry[28], which understandably preferred the government to take responsibility for policing their origination force, and was not seriously considered as a result. While the complex national licensing regime[29] likely to be imposed to address these serious problems with intermediaries in the credit industry is long-awaited and welcome, it will impose considerable costs on government, industry and ultimately consumers. This may not have been necessary had the simple, drastic solution suggested above been implemented.

[28] Despite the fact that this solution was implemented in the insurance industry to deal with insurance brokers.

[29] Unlike the NSW legislation, it is anticipated that the national regime will require brokers to meet fairly stringent standards of fitness to hold a licence, and to make reasonable recommendations for suitable products and to justify such recommendations with written reasons. CCLC supported these requirements.

4.6.2 Price Capping

Another problem identified by the consumer assistance agencies in relation to brokers is the level of fees imposed directly on the consumer. Experience assisting consumers demonstrates that there are two clearly distinguishable types of broker transaction which predominate in the market:

- Those transactions in which the commission is payable by the credit provider to the broker and the broker's services are free to the consumer (except in so far as the commission is included generally in the cost of providing the loan);
- Those transactions in which the consumer must pay an up front commission directly to the broker, which may or may not be in addition to a commission payable by the credit provider, and which is often financed by the loan (or sometimes secured by a caveat over the consumer's home in the event that the loan does not proceed).

As a general rule, the worst cases seen by consumer assistance agencies of consumers being placed in loans they can clearly not afford fall into the latter category of transaction. Further, as suggested by Table 1 below, the size of the upfront commission appears to correlate more closely with the desperation and/or vulnerability of the consumer and/or the unscrupulousness of the broker, than the size of the loan or the complexity of the transaction. In other word competition is completely ineffective at this end of the market, as these consumers have no alternative mainstream finance options available and therefore are presented with expensive credit on a take it or leave it basis.

This data in the Table below was extracted from the responses to the refinancing survey conducted by CCLC for ASIC[30] where a fee or commission was paid directly to the broker by the borrower instead of, or in addition to, a commission paid by the lender. All of the relevant borrowers were in financial difficulty at the time of the relevant transactions. It is therefore telling in itself that many of them have paid significant fees against the industry norm, which is that the service is free to the borrower and the broker is remunerated via commission from the lenders. The data is presented in descending order from the highest brokerage when expressed as a percentage of the loan. Of the three sets of borrowers who have paid the highest brokerage as a percentage of their loan, one set were facing mortgage foreclosure proceedings, another enforcement proceedings in relation to another debt and the third were in default of an onerous vendor terms contract.

[30] Refinance Report, op cit, material extracted from pages 16 and 19.

Table 1

Brokerage by Loan Size		
Loan amount	Brokerage	Percentage of loan
$122,000	$19,615	16%
$255,000	$19,855	7.7%
$255,000	$8,920	3.4%
$502,000	$16,000	3.1%
$110,000	$2,995	2.7%
$223,750	$5,500	2.4%
$300,000	$4,030	1.3%
$170,000	$1,105	0.65%
$256,000	$300	0.12%

In response to this CCLC recommended the legislature impose a cap on the amount of commission or fee able to be charged for the brokers services. One of the arguments against capping costs is that the market tends to move towards the cap. This appears unlikely in a market where competition is highly effective in protecting empowered consumers with no credit impairment or affordability issues. Further, the main objective of capping costs in this case would be to dramatically decrease the profitability of these highly inappropriate and unsustainable loans with a view to eliminating them. This solution has not been considered.

The other area in which consumer groups have argued for price control is in the small amount loan segment of the market. While there is broad agreement that this is a segment of the market where there has been considerable exploitation, there are differing opinions on the best approach to regulation. While there are interest rate caps in three jurisdictions, only NSW and the ACT have taken steps to include fees in the calculation of interest for the purpose of the cap, closing a former loophole where charges were expressed as fees rather than interest to avoid the cap. Victoria has an interest rate cap but the recent credit review decided not to include fees in the calculation of the interest rate cap. Other states have no interest rate cap at all, although several jurisdictions have recently considered the pros and cons of implementing a cap or taking other action to address over-priced and exploitative lending.

The Victorian Credit Review and the national Fringe Credit Providers – Decision Makers Regulatory Impact Statement and Final Public Benefit Test propose addressing problems in the short terms lending market via extending the provisions allowing consumers to challenge unreasonable or unconscionable fees. CCLC submits that this is far more costly and far less effective than the more “drastic” intervention of a cap:

- A cap sends an immediate and clear message to all credit providers that there is a line in the sand, an easily calculable delineation between legal and illegal lending.
- There is no need to litigate every fee or charge to determine their legality. The

former Consumer Credit Legal Service (Vic) Inc. commenced a number of proceedings in the Victorian Civil and Administrative Tribunal against the same fringe credit provider in relation to the same issues pursuant to section 70 of the Code, all of which have settled. While this has benefited those consumers on whose behalf CCLS (Vic) acted, it has not and cannot be expected to bring about behavioural and systemic change, and will not assist the vast majority of consumers who have obtained credit from that fringe credit provider, or other credit providers.

- CCLC has also sought to challenge issues in the fringe credit industry through litigation but has found that such cases invariably settle because our clients are: often disadvantaged in multiple ways (poverty, disability, literacy) and are easily intimidated by the litigation process; unlikely to obtain significant personal advantage from the litigation process (or in some cases to understand it), and therefore have little commitment to it; and are very likely (and understandably so) to settle with the lender for either the forgiveness of their debt and/or very small amounts in "compensation". The process of challenging fees individually in this manner is hard to estimate but it is clearly considerable. The efficacy is poor.
- A cap is more easily enforced by consumers or government agencies (there is no risk of a repeat of the City Finance Loans and Cash Solutions scenario referred to in the Victorian Credit Review[31]).
- Short term lending can continue under either approach, albeit with some modification of the amounts and terms able to be made available, but the cap approach places an absolute limit on the cost of lending for those most in need of protection.

CCLC submits that while price capping is inconsistent with current market theory, it is sometimes the most effective method of curbing the activities of businesses that are preaching choice while peddling exploitation.

4.6.3 Prohibition or repeal

Part IX Debt Agreements referred to above were introduced as a "low cost" alternative to bankruptcy. When they were introduced it was not envisaged they would be promoted and administered by commercial operators. CCLC's submission to the recent review of this legislation proposed its repeal. Problems in the industry which have arisen in the wake of the enactment of Part IX include:

- Misleading conduct - debtors believe they are consolidating their debts and/or do not appreciate that they are committing an act of bankruptcy;
- Debtors are not advised of alternatives, such as direct negotiation with their creditors, bankruptcy, or assistance with the previous options from free financial counselling agencies;

[31] 'The Report of the Consumer Credit Review", Consumer Affairs Victoria, 2006, p. 110.

- Debtors are placed in Debt Agreements when they are not insolvent, or alternatively, are placed in Debt Agreements they cannot afford;
- Debt Agreements promoters and administrators take their fees prior to paying creditors, meaning Debt Agreement may fail without creditors ever being paid, or being paid less then the administrator;
- Debtors are advised to stop making payments pending the consideration of a Debt Agreement proposal by creditors, leading to ballooning debts as a result of compounding interest.

Again, instead of seriously considering repealing the legislation, or seeking to amend the legislation to achieve its original objectives, the review has decided to implement a costly licensing and oversight regime to regulate the activities of Debt Agreement Administrators.[32]

4.7 Negotiated contracts and other fairytales – the need for unfair terms regulation

The standard form contract used in most contemporary consumer transactions is simply not negotiable. As a consequence, the legal concept of a contract being a "meeting of minds" has no relevance to modern consumer contracts at all.

Consumers face the following problems when entering into a contract for consumer goods and services:

- The consumer cannot afford to obtain legal advice in relation to the contract. Even if the consumer did seek legal advice, the contract terms would not be negotiable anyway. The benefit of the legal advice would only be to ascertain whether the contract was so onerous as to be a poor decision. Many consumer transactions are not worth sufficient money to warrant the cost of legal advice, and even if they are, many consumers are not in a position to meet the cost.

- The consumer is unlikely to read the contract, as the terms cannot be negotiated anyway. Furthermore, even if the consumer read the contract and found an unfair term it is probable that the same unfair term would also be in other suppliers' contract.

- Consumers are so used to "one-sided non-negotiable contracts" that consumers have largely given up trying to negotiate "standard" terms.

- Consumers purchase lots of goods and services each year. It is completely impractical to negotiate and carefully consider each consumer contract. For this reason standard contracts could be an efficient solution, provided they were fair to both consumer and provider.

[32] Again we concede that this is better than allowing the status quo to continue.

Legislation prohibiting unfair terms is essential because:

- Consumers have no means to negotiate for the deletion of an unfair term from any standard contract

- Businesses will always seek to draft contracts as widely as possible to protect their own interests. The drafting of standard form contracts is for the most part completely unfettered by current consumer protection legislation. This is a poor outcome for consumers.

- The case law and legislation on unjustness and unconscionability is focused on procedural unfairness. It is very rare for consumers to obtain a remedy for a substantively unfair term in a consumer contract.

- There has been a complete failure of competition to deliver fair "standard" terms in consumer contracts.

Rather than supplying a long list of examples of unfair contracts, we will use two examples to demonstrate two particular points in relation to the need for unfair contract legislation: vendor finance, and penalty clauses for default or early termination of contracts.

4.7.1.1 Vendor finance

Vendor finance is when a consumer buys a home from the vendor by paying regular instalments over a number of years. The vendor usually has a loan for the property and the instalment contract provides that the purchaser pays that loan plus an additional margin of interest. The vendor remains the owner of the property until the final payment is made which can be 25 years later. This is the way the vendor makes a profit.

Vendor finance contracts almost always contain a term that states that in the event of default:

> *" the Purchaser shall forfeit to the Vendor and the Vendor shall keep the deposit and all instalments paid under this Contract, as liquidated damages for non-performance of the Contract, without necessity for the Vendor to give notice or to do any other thing; and*
>
> *the Purchaser shall retain no title to the improvements to the property and replacement to fixture (all of which all remain with the property) and the Purchaser shall have no claim against the Vendor for the cost or value of any improvements or replacement to fixtures made by the Purchaser to the property."*

This means that the Vendor retains all the instalments and the deposit (which is usually the first home buyer's grant) in the event of default by the purchaser. This is an extremely unfair term.

This term has recently been considered in a case in the Consumer Trader & Tenancy Tribunal in NSW being *Lewis v. Ormes* (2005) NSWCTTT 481 (18 July 2005). The Tribunal took the rare step of finding the above term unfair in itself, aside from any procedural injustice in the making of the specific contract between the parties under consideration. The decision in this case was confirmed on appeal in the NSW Supreme Court.

Despite this, this term continues to be used by vendor financiers all over Australia.

Case Study 3 – Unfair Terms

A current client of CCLC, Ms. P, is an Aboriginal woman with low income, a low level of education and has poor literacy and financial skills. She contacted CCLC because she was falling behind in making payments towards the purchase of a property and was given a notice to vacate. It transpired that Ms. P had entered into a vendor finance agreement. The effect of this type of agreement was that Ms. B was obligated to make periodical payments towards the purchase price over a 30-year period, but title to the property would not pass until the last payment was made.

The amount of each instalment was almost double that of the market rate of rent and Ms. B was never in a position to be able to afford the purchase. Despite this, the vendor finance company approved her application and she fell into arrears just months after the agreement commenced. She did not understand, and it was never clearly explained to her, that she would not own the property until the entire balance was paid. The contract also contained a forfeiture clause, which stated that, upon termination for default, the purchaser has no claim against the vendor for any paid instalments or improvements to the property.

The contract has since been terminated and Ms. B has vacated the property. CCLC is currently exploring the avenues available to recover some of the money paid by Ms. B by contesting the forfeiture clause. We are aware that there are many other potential clients in Ms B's position who may not have access to legal advice. It is highly unfair that such consumers are unlikely to be aware that the onerous terms of their contracts may be contestable. It is also highly inefficient that each case would need to be independently negotiated and possibly litigated, and a drain on the resources of government and government funded services such as CCLC.

4.7.1.2 Penalty clauses for default or early termination of contracts

It has been argued before the Commission that unfair terms legislation could increase prices payable by consumers in the long term by, for example, decreasing the opportunities for traders to offer discounted prices in return for a guaranteed period of custom.[33] CCLC does not understand the proposed regulation of unfair terms to necessarily produce this result. The purpose of unfair terms powers would not be to limit the extent to traders can offer fixed term contracts and discounted prices, but instead to limit the penalties associated with exiting such fixed terms to the extent necessary to protect the interests of the trader.

For instance, many service contracts permit the trader to alter fees and charges and other terms unilaterally and without justification. This means that the consumer is contracted to remain with the trader for a predicated period (telecommunications contracts for example), but the trader does not have to offer anything in return except a non-specific promise that the consumer is receiving a better price by entering the contract than by not doing so. This does not encourage competition on quality and price. On the contrary it creates a game whereby the object to *lure and secure* customers and then increase costs as close as possible to, but remaining sufficiently shy of, the point where consumers would save money by switching providers and paying the consequent penalty. One of the objectives of unfair terms regulation in this context is not to discourage fixed term contracts, but to ensure that the consumers get genuine contractual commitments from traders in relation to price in return for committing to a contract for a specified period.

Another objective of regulation in this area should be to ensure that clauses that specify the penalty payable in the event of a consumer terminating a contract within the specified term should not significantly exceed the actual losses borne by the trader as a result of this early termination. It should also be noted in this context that in many cases, it is not only consumers who are seeking to switch providers who fall foul of default clauses, but consumers who are experiencing financial difficulty in meeting their contractual commitments. Leases for households goods such as white-goods, furniture and computers, for example, are often used by Centrelink recipients because they cannot afford to purchase such goods outright, and they cannot access affordable credit. The penalties for breaching such contracts, however, often exceed the cost of continuing with the contract, including for example that the lessee must return the goods *and* pay out the value of the contract as if they had retained the use of the goods for the entire period originally envisaged.[34] CCLC often becomes involved in negotiating solutions to such claims on behalf of clients who have defaulted due to a simple lack of capacity to pay.

Limiting the extent to which unfair terms can be relied upon should also mean that Governments could spend less money on impractical campaigns to encourage consumers to read endless contractual material in order to check the fine print for the catch that is oftentimes also present in the competitors' product. There would also be less need for industry specific legislation in relation to issues such as penalty fees in credit contracts and the prevention of "blackmail" securities[35].

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[33] Field, C, Productivity Commission Inquiry in Australia's Consumer Policy Framework, Perth Hearings, 23 March 2007, pp173-174.

[34] Which, of course, is impossible if you are unable to meet the regular rental payments.

[35] The latter refers to the practice of taking essential household goods and furniture, including for examples baby's cots, which are of no real value to the creditor but place enormous pressure on the debtor to keep up repayments at the expense of all else, including basic living costs.

In summary, it is practical to encourage standard form contracts to simplify day-to-day transactions for increasingly complex services. Consumer protection legislation specifically regulating unfair terms, however, is essential to maximise confident consumer transactions and reduce transactional complexity. Consumer and traders alike could then safely concentrate on the real issues of service quality and price. Governments, likewise, could concentrate on regulating unfair terms rather than on producing material in which to convey unheeded, and in many cases pointless, warnings. Finally, the burden on advice and assistance services to negotiate and litigate individual contracts should be significantly reduced.

4.8 Advice: its importance and its limitations

Access to advice is vital to consumer protection. Advice services such as CCLC and financial counsellors based in community agencies are largely confined to damage control once a consumer is already in difficulty. This is an important function, and one that is in enormous demand, as demonstrated by Figure 1 and Figure 2 in Section 4.1.3 above.

This form of advice plays an important role, including but not limited to:

- Giving consumers realistic expectations in relation to the resolution of disputes and encouraging repayment of amounts within the consumers' means;
- Advising consumers of the availability of relevant services such as industry-based dispute resolution, and other government or community assistance such as material aid (for food and utilities) and mortgage assistance;
- Advising consumers about debt collection processes and their associated rights, such as the right to file an arguable defence, the availability of instalment applications and in some cases, to file for voluntary bankruptcy;
- Assisting consumers to avoid behaviours which may exacerbate their financial problems, such as ceasing to make payments altogether because they cannot cover the amount of their contractual commitment;
- Assisting consumer to recognise and resist entering contracts which are likely to exacerbate their financial situation, such as further unsustainable borrowing or placing their home at risk by consolidating unsecured debt;
- Assisting consumer to frame their complaints/disputes to creditors and dispute resolution schemes and where necessary advocating on their behalf;
- Representing consumers in Courts and Tribunals where appropriate.

Services such as CCLC, which exist in three states and the ACT only, have to be selective in the application of their resources to this type of advice because the demand exceeds the resources available to supply it. Financial counsellors, who offer many of the above services (except the last) and perform additional functions such as assisting with preparing money plans (budgets), and suggesting more constructive financial habits, are also overstretched with many services having waiting lists of several weeks and periodically closing their books to new appointments for periods of a month or more, due to the demands of existing clients.

4.8.1 Preventative Advice

There are no resources available to provide preventative advice in any systemic way, except in the limited circumstances of "harm minimisation" outlined above. Current providers of advice are not well equipped to provide such advice at present either - it has not been the focus of their training and experience. That said there is clearly a role for more preventative advice. While we applaud recent attempts to address financial literacy by both State and Federal Governments, particularly in relation to updating existing curricula with current financial examples, CCLC is concerned that some of these resources (financial literacy more generally) could be better spent on providing preventative advice.

Generic materials produced to educate the public on fairly complex financial products such as credit, investments and insurance almost inevitably fall into the category of being too detailed and boring to be read or digested by consumers who are not currently considering a specific contract or opportunity, but of insufficient detail to be useful to those who are. Many low to middle income consumers cannot afford expert legal or financial advice, and yet increasingly they are being expected to make complex decisions with the potential to make or ruin their financial future. Not only has the pressure to self-fund retirement grown tremendously, but also decisions like choosing a home loan have become more complex than ever before, as competitors have sought to distinguish their products through complex price structures, linked facilities and additional features. Reverse mortgages, and now shared equity products, add an additional layer of complication with borrowers being required to be able to understand the likelihood and implications of asset price movements to appreciate the ramifications of the contract they are entering. Given the unreliability of advice offered through brokers and other intermediaries referred to above, there is a clear need for improved access to genuinely disinterested advice.

Credit providers have in recent times expressed some interest in funding consumer advice services. Legitimate market participants recognise the advantages posed by both preventative advice, which can ensure that consumers enter contracts in full appreciation of their obligations and reduce the likelihood of later disputes, and problem management advice, which assists lenders to collect bad debts by facilitating manageable repayment arrangements in situations which may otherwise have resulted in the ongoing capitalisation of interest and/or bankruptcy. CCLC has been approached on a confidential basis by two lenders, one seeking to specifically donate funds to the operation of the Credit and Debt Hotline and the other seeking to explore funding models that have been used overseas to enable creditors to fund independent advice services. While services such as CCLC cannot accept funding directly from credit providers because we need to preserve our robust independence to act in the best interests of our clients, and to advocate for consumers generally, there is a potential role for government in garnering the resources of industry either through voluntary contributions or a levy, and making them available via a trust or other arrangement which preserves the independence of community organisations to whom the funds are distributed.

In short, CCLC supports an extension of government funding (including if necessary from those resources already dedicated to financial literacy and /or an industry levy) to extend the availability of genuinely independent advice. While the support of industry is clearly important, and probably necessary, to meet demand in this area, it is vitally important that there is a clear investment of government resources to ensure the ongoing independence of consumer advocacy[36] on behalf of those who are by definition unable to meet their financial commitments and therefore unable to pay for any other form of advice or assistance.

4.8.2 Limitations of Advice – No panacea

While improved access to advice would improve the ability of consumers to transact in the market for mutual benefit, it cannot cure all ills and should be part of a multi-faceted approach to consumer protection. There are three main reasons why preventative advice will not always be sufficient:

- Advice cannot protect consumers from losses in income or other changes of circumstances, which may prevent them from being able to meet contractual commitments that were manageable at the time the contract was initiated. These consumers will continue to need advice and assistance to manage their situation;
- It is impractical for advice to be available for every transaction, market misconduct will continue to occur and consumers needs access to advice in relation to complaints and remedies;
- Advice is just that and nothing more and may not be heeded. Some market practices are so "dangerous" to both the individual consumer and the broader economy that they should be eradicated or tightly controlled as far as is practicable.

On the last point there are two particular circumstances where consumers are particularly vulnerable to making poor decisions that are particularly relevant in relation to credit. The first is where consumers are struggling financially:

> *The effect of poverty is often to relax foresight and self-control and to tempt us to 'trust to luck' for the future, if only the all-engrossing need of present necessities can be satisfied.*[37]

This is not to say that people of limited means are always poor money managers (the reverse is often true) or always prone to enter exploitative contracts, but it does say that

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[36] Including both individual advice and casework assistance, and broader policy representation.
[37] Fisher, I. *The Rate of Interest*, 1930, quoted in the Expert Opinion of Steve Keen in the matter of *Permanent Mortgages Pty Ltd v Michael Robert Cook and Karen Cook* [2006] NSWSC 1104 at p 44.

people in this position are more vulnerable to this possibility than people who can exercise genuine choices (the decision to pay or not to pay your rent, electricity, car registration is not really a genuine choice). This problem can be exacerbated when people struggle with compulsive/addictive behaviours such as substance abuse or gambling, or are afflicted by mental illness.

The second circumstance where advice may fall on deaf ears is the situation where consumers are faced with losing their primary residence, often the "family home". CCLC has assisted many clients who have accepted loans on highly unfavourable terms, rather than voluntarily surrender their home, or face possession proceedings. Unfortunately these arrangements often lead to the eventual loss of the home regardless and significant loss of equity along the way (see Section 5.6.4 below). Despite our first-hand experience of these scenarios, it can be very difficult for CCLC staff to convince a borrower faced with the inevitable loss of their home to walk away and realise what equity they have rather than refinance on worse terms.

In reality, consumers do not always seek advice, even when such advice is available. While advice can be mandated for larger, riskier transactions, our experience of compulsory advice leads us to approach this option with some skepticism. In the area of guarantors, for examples, where lenders may require the guarantor to seek independent advice before proceeding to accept a guarantee, such measures tend to be reduced to hurdles which have to be crossed to get ticks in boxes, with the subject of the advice having determined their path and having no real interest in the content of the advice. Further, in the case of guarantors it is often not legal advice that is needed but a prediction of the likelihood of default on the part of the borrower, and a clear picture painted of the impact of that default on the guarantor's financial circumstances and relationship with the borrower.

In the survey undertaken by CCLC for ASIC in 2006,[38] extensive details were taken down about 14 sets of borrowers (some were couples) who had refinanced their home loan in response to financial difficulty, largely to their detriment. In total, these 14 sets of borrowers had participated in 23 loan transactions secured over their home in the past five years. Only 17 of these transactions were covered in detail in the survey. Solicitors were consulted at the insistence of the lender in 9 of those 17 transactions, involving 7 sets of borrowers.[39] None of the borrowers had a solicitor of their own to consult and they were referred to solicitors by the brokers, lenders, and even the real estate agent in one case. Some solicitors appeared to do little but obtain signatures on the loan documents, others explained the legal meaning of the essential terms, others even mentioned that the clients were being exploited as a result of their failure to qualify for mainstream finance, but none successfully convinced a set of borrowers not to proceed with a highly prejudicial transaction. In other words, the use of solicitors in these circumstances does not assist borrowers as they usually do not provide advice on the merits of the transaction, and would usually be prevented from doing so by their professional indemnity policies. Their primary role is to ensure the borrower understands the

[38] CCLC, Refinance Report, above n 22.
[39] Ibid, pp 14-15

transaction, and that their house is at risk; however, their involvement may in fact give false comfort to borrowers that a loan is 'above board'.

5 Part 2 Credit Regulation

This section considers in detail some of the deficiencies in the current regulatory framework for credit and some suggestions for improvement.

5.1 National Regulation?

The pace of legislative change under the uniform template legislation model has been painfully slow. As outlined in oral evidence to the commission, there are numerous examples of changes which have been agreed to in principle and have unilateral support but which have taken, or are taking years to implement.[40] Despite pockets of dedication and commitment in the component parts of the uniform regime, the result is a cumbersome process that takes years to respond to even the most urgent and obvious of issues. The likelihood of any of the very difficult, controversial problems ever being effectively dealt with by that process seems extraordinarily slim.

While moving responsibility for credit to the Commonwealth may not necessarily result in faster legislative responses, there is at least in theory fewer barriers to fast decisive action than the necessity of getting every piece of proposed reform through eight state bureaucracies, the Office of Regulatory Review, several consultation processes and eight State Parliaments.

While there were historical reasons for leaving credit out of the financial services reform process undertaken around the turn of the millennium, largely to do with the energy that had recently been expended on the development of the UCCC, those reasons have ceased to have any relevance. The carve-out of credit from the financial services package has always appeared odd to commentators and consumers alike, and it would make considerable sense to address the anomaly. Further, and importantly, ASIC has proven itself a creative and pro-active regulator within the confines of its currently narrow credit jurisdiction.[41]

There are risks to this eventuality from CCLC's perspective, including the fact that the majority of our funding is provided by the NSW State Government, we have invested considerable effort into establishing and maintaining our relationship with State Fair Trading agencies, and above all, the potential loss of several consumer protections that

[40] The changes to the Hardship Variation threshold under s66 and 68 of the UCCC, reform of the business purpose declaration and purpose of loan provisions, fringe lending reforms in relation to the use of blackmail securities, avoidance of the UCCC using Bills of Exchange and Promissory Notes, national finance broking regulation.

[41] Enforceable undertakings re: Westpac, funding finance broker report and playing significant role in National Working Party, Action re: Commonwealth Bank lending in remote aboriginal communities, action against finance broker in the ACT, Enforceable undertaking by GE to change its life insurance sales practices and to compensate affected consumers. Recent successful action taken in relation to broker/mortgage minimisation scheme promoters, Sample and Partners.

are more stringent in NSW[42] than in other states and in our view, very important. Despite this, the advantages of one cohesive regime, with a streamlined process for reform and (hopefully) a dedicated policy development body with "one head", are likely to benefit consumers nationally. Industry participants that invariably operate nationally, or at least across State borders, and desire complete jurisdictional uniformity would undoubtedly welcome such a development unanimously. There are many roles that State Consumer Protection Agencies currently play, and could continue to play, even if the central policy development and law reform function was passed to the Commonwealth. In fact, without vital resources diverted to the cumbersome policy development and reform process, State agencies could potentially play a more effective role in the development of advice and assistance programs, intelligence gathering, compliance monitoring and enforcement.

5.2 Extending coverage of the Consumer Credit Code

5.2.1 Including a broader range of borrowers

The failure of the Uniform Consumer Credit Code (UCCC) to afford protection to small business borrowers, and individuals borrowing for investment, is out of step with the remainder of financial services regulation. The general regulation of financial services under the *Corporations Act* 2001 (Cth) includes small business and investors, as does the limited credit jurisdiction under the *ASIC Act* 2001 (Cth). Important industry codes, such as the Code of Banking Practice[43], cover small business and investors. The forthcoming national finance broking regime will also cover small business and investment broking.[44]

There are a number of reasons why this development is necessary. Firstly, there has been widespread recognition that small businesses and individual investors can be as vulnerable as individual consumers making household domestic purchases. The economic damage done by unacceptable market conduct in this market sector is just as destructive as in the personal domestic domain. Further, there has been an increasing recognition that as risks and financial responsibilities have been shifted from government to households, there is a greater need for protection of ordinary individuals seeking forms of self-employment, or investing for a self-reliant future.

CCLC receives calls for advice and assistance in relation to investment loans in particular, including but not limited to:

- Borrowers who have borrowed against their homes to invest in Westpoint and the Karl Suleman schemes and subsequently lost the invested sum;
- Borrowers who borrowed money to attend the National Investment Institute (Henry Kaye) through a linked credit provider and were disappointed with the

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[42] NSW and the ACT are the only states which impose a 48% interest-rate cap on consumer lending that is inclusive of fees and charges. NSW was the first state to bring pay-day lending under the UCCC. NSW is also one of only a handful of states that has any regulation of finance brokers at all (albeit inadequate).
[43] Code of Banking Practice cl. 1.1.
[44] See discussion in National Finance Broking Regulation – Regulatory Impact Statement Discussion Paper, 2005, p. 60.

misleading claims made and/or who were now overextended attempting to repay the loan;

- Borrowers who have purchased one or more investment properties and are now facing possession proceedings.

CCLC is not specifically funded to assist these consumers, and in many cases remedies are not available or are impractical to pursue because neither these types of loan, nor the advice pertaining to real estate investment, are regulated under either the consumer credit laws or the broader financial services regime, except in very limited ways.[45] In some cases consumers may be referred to ASIC, but the usual pre-requisites of regulator intervention clearly must apply, meaning that individuals cases may not be pursued, and individual remedies may not be applicable or practical even where the regulator does takes some form of enforcement action.[46]

There is no reason why the majority of the protections contained in the Code should not also be available to business and investment borrowers. While the effectiveness of the disclosure provisions has been justifiably questioned, a quick perusal of the information required to be disclosed reveals little that is not of vital consequence to any potential borrower seeking to make an informed decision. The provisions relating to access to information, and notices in the event of default are similarly uncontroversial. Even the unjust contract provisions are almost identical to those already available in relation to business and investment contracts in NSW under the *Contracts Review Act* 1980. Further, the Banking and Financial Services Ombudsman already determines disputes in relation to maladministration in relation to small business and investment loans. There may be an argument to exclude business borrowing from the hardship variation provisions of the Code[47] and there are perhaps other sections that could be specifically modified or made unavailable to business borrowers. While credit providers are likely to resist the extension of the Code to further categories of borrower, there are long-term advantages to having a single set of rules and required documentation.

Secondly, extension of the Code would be the most effective response to widespread avoidance of the Code, an issue that is covered in detail in Section 5.7.2 below.

5.2.2 Better accommodating a broader range of products

Credit and investment products can no longer be easily delineated. While the purchase of a family home is often the most significant investment many consumers will ever make, there is little recognition of this in the regulatory regime. The credit aspect of the

[45] A small business or investment loan may still be subject to the misleading and deceptive conduct, unconscionable conduct, and suitable products provisions of the ASIC Act. The lender will not, however, be required to be in EDR, meaning the consumer would have to pursue such remedies through the court, most commonly at their own expense.
[46] This is not to say that ASIC does not obtain remedies for individual consumers in any case. Examples of where individual compensation has been ordered or negotiated include Cash King and Sample and Partners for example.
[47] UCCC, sections 66 & 68.

purchase is regulated in a similar manner to a car loan or credit card. This investment aspect has been recognised by the UK authorities where mortgages have been carved out for oversight by the Financial Services Authority and other credit is within the jurisdiction of the Office of Fair Trading.[48] Relatively recent product developments, specifically reverse mortgages and shared equity loans, have thrown this limitation of the UCCC, which considers the credit side of the equation but not the investment aspect, into sharp relief.[49] The particular risks associated with these products are not addressed at all in the UCCC regime. The much-awaited broker regime will attempt to address some of the issues pertaining to advice given in relation to these products, but this is being approached in a piece-meal, product-by-product fashion, rather than addressing the conceptual shift in the nature of the products and market being regulated. Further, these obligations will not encompass credit/investment products such as those being sold directly by banks and other credit providers rather than through intermediaries.

Case Study 4 – Pseudo Reverse Mortgages

CCLC is currently acting for three older couples, who did not qualify for standard reverse mortgages products sold by banks, and were therefore sold an alternative product by a finance broker[50]. In all three cases the couples were put into five-year loans, with the entire debt due and payable at the end of the term. Each couple was reassured that no repayments would be necessary and that they would not lose their houses because another loan would be organised at the end of the term.

They were not informed, however, that the lack of repayments was made possible by a draw-down of the interest as a lump sum at settlement, and that further interest would be charged on the interest and principle for the entire period of the loan. The result of these arrangements is that these couples have paid a much higher effective interest rate than that disclosed on the contract, thereby diminishing their equity to the point that a further loan is unlikely to be granted.[51] As a result, all three are facing a homeless retirement.

CCLC is attempting to challenge these arrangements under the current law. These cases highlight, however, the increasing complexity and risk associated with credit products, and the intersection between credit regulation and the challenges of an ageing population.

[48] CCLC does not have any evidence about whether this has produced better outcomes for consumers in practice.
[49] Where a borrower takes out a traditional mortgage for part of the value of their property and then takes out a shared equity loan for another portion. The latter portion is "interest-free" while the debtor is not in default, in return for which the creditor takes a proportion of any increase in the value of the property at the time the debt is paid out (usually upon the sale of the property or refinance).
[50] The same broker acted in all three cases, although the borrowers are otherwise unknown to each other.
[51] It is possible that the loan-to-valuation ratios on these properties was such that another loan was never a realistic proposition, even if the interest had capitalized in the manner of a standard reverse mortgage. Either way the representations of the broker were completely unfounded.

5.3 Compulsory IDR/EDR should be available to all borrowers

All financial service providers except those that only provide credit products are currently required to be a member of an approved external dispute resolution (EDR) scheme in order to hold a financial services license under Federal legislation. This has created a situation where credit providers are out of step in this regard with every other sector of the financial services industry. Further, some credit providers, as a result of the taking of deposits and/or the sale of other financial products (such as insurance), are required to be members of EDR schemes while some are not. In recent times we have also seen a large number of non-bank credit providers such as GE Money, and the Perpetual Group of businesses become members of the Banking and Financial Services Ombudsman, and in the latter case the Credit Ombudsman also, despite there being no legal obligation to do so. Unfortunately there are many other credit providers that are not members of an EDR scheme, including a number of unscrupulous small or fringe lenders who engage in predatory lending, and when the debtor cannot pay, harassing and coercive debt collection practices. Consumers affected by these practices are more often than not denied access to fair and proper dispute resolution and also access to justice. It is highly unlikely that smaller fringe players will become members of an EDR scheme unless it becomes compulsory to do so. Further, voluntary members can relinquish their membership at any time if it no longer seems expedient (in response to adverse decisions for example).

The Regulatory Impact Statement Discussion Paper in relation to the possible uniform national regulation of finance brokers contemplated making membership of an EDR scheme compulsory for credit intermediaries. There is wide support for this among both industry and consumer groups alike. In fact the Mortgage Finance Association of Australia already makes membership of such a scheme a compulsory condition of membership, which has resulted in many of the larger and better-known non-bank lenders being members of the Credit Ombudsman Scheme and/or the Banking and Financial Ombudsman Scheme. We consider it likely that compulsory EDR is to be a fundamental part of that legislation, as it is with other financial services regulated by the federal government.

At the same time, we are concerned that this will create a serious anomaly whereby finance brokers and other mortgage intermediaries such as mortgage managers will be required to be in an EDR scheme, but some credit providers will not. This inconsistency will create some serious repercussions, including possible unreasonable shifting of liability to the broker due to the lack of incentive for the credit provider to resolve disputes, or of consumers being left without adequate redress. Indeed in many cases involving brokers, the most appropriate solution is an adjustment in the amount or terms and conditions of the actual loan, a remedy that can only be achieved if the credit provider is brought to the negotiating table.

In particular, the finance broking regulation contemplated may require credit providers to use only brokers that are licensed and therefore in an EDR scheme. It would be highly inconsistent for the credit provider to demand this from the broker but not be required to do so themselves.

5.4 Advantages and Limitations of EDR

In CCLC's view, EDR in the financial services industry has been extremely successful in improving access to justice for consumers. Outcomes for individual consumers are generally fair and in many cases could not have been realistically pursued through the court system. More importantly, the most successful schemes have driven improvements in dispute resolution at the service provider level (in some cases even reducing complaints that are required to be dealt with by EDR) and positively impacted on industry standards by providing constant feedback both formally through publications such as the BFSO Bulletins and Conferences, but also informally through direct liaison. While there is always room for improvement, there are mechanisms for driving this improvement through consumer representations on the various management structures, regular scheme reviews, and the upcoming ASIC review of Policy Statement 139.

It is important to note that there are two roles EDR schemes can never be expected to play:

1. Adviser
2. Regulator

5.4.1 EDR schemes cannot give advice

EDR schemes can assist consumers who are illiterate or otherwise struggling with written or spoken expression to frame their complaint. They can indicate that a person's complaint is outside their jurisdiction, suggest what evidence may be important in establishing a case, even sometimes suggest to a complainant that the real problem is something other than that portion of the facts on which complainant has chosen to focus. They cannot give legal advice. This is because the scheme and its representatives must maintain their strict independence of both member and complainant (service provider and consumer). Further, while such schemes can give limited information and guidance on making a complaint, they cannot give other vital advice about ongoing options for money management, negotiations with other non-member creditors, and other possible causes of action (for example, to a court or tribunal, or a regulator).

It is not uncommon for EDR schemes to refer complainants to services such as CCLC for advice, particularly if the complaint involves complex and/or contentious issues of fact and/or law. Most members, after all, have access to legal advice either in-house, externally, or both. In the last 2 years and 9 months, the CCLC Credit and Debt Hotline has received 251 referrals from industry based external dispute resolution schemes including (in order of frequency) the Banking and Financial Services Ombudsman, Telecommunications Industry Ombudsman, Credit Ombudsman Scheme, Energy and Water Ombudsman, Financial Complaints and Dispute Resolution Scheme, the Financial

Industry Complaints Scheme, Insurance Enquiries and Complaints Service and the Credit Union Dispute Resolution Scheme.

5.4.2 EDR Schemes cannot replace the role of the regulator

The primary function of an EDR scheme is, evidently, "dispute resolution". The EDR schemes are funded by member organisations, and one of the roles of the EDR scheme is to work *with* the members to improve compliance and reduce potential disputes. Within these parameters some of the financial services schemes have been effective, even highly effective. There are limits to what they can achieve, however, in terms of systemic change, especially in areas in which the law is ambiguous or unhelpful, or where enforcement in addition to or instead of compensation or dispute resolution is warranted.

Further, and importantly, robust EDR schemes are a result of effective co-regulation. It is the involvement of the regulator in both dictating and monitoring standards that creates the atmosphere of accountability and continuous improvement.

5.5 Different levels of regulation for different lenders

There are currently varying levels of regulation applying to credit providers. This is particularly evident in the home lending market where borrowers have access to a wide array of traditional and non-traditional lenders and no comprehension of the different levels of market regulation that apply. While some of the problems created for consumers by different levels of regulations are dealt with in specific sections below, it useful to first outline the regulatory landscape.

In simple terms the various levels of regulation include:

- Banks, Credit Unions and Building Societies
- Non-bank lenders provide prime loans and sub-prime loans under the UCCC
- Lenders who avoid the UCCC

Of course, in practice some lenders may offer products or become involved in transactions from several of the above categories.

5.5.1 Banks Credit Unions and Building Societies

Otherwise known as Authorised Deposit Taking Institutions ("ADIs"), these lenders are subject to the highest level of regulation. They are required to hold Financial Services Licenses and as a result are required to be members of approved EDR schemes. The banks in particular have a Code of Conduct that covers a broad range of issues, including their response to financial hardship, and a mechanism for monitoring and enforcing the Code. The Credit Unions and Building Societies are updating their Code at present. These lenders also generally comply with the UCCC, and they are subject to prudential oversight by the Australian Prudential Regulation Authority ("APRA"). The latter can give consumers some level of comfort in relation to lending standards, and ensures regular reporting of statistics including default rates to the Reserve Bank, to ensure transparency and accountability. Despite this level of regulation there has been clear competitive pressure on the banks and other ADI lenders in recent years to participate in riskier lending strategies to retain market share. Details of this deterioration in lending standards are outlined in section 5.10.1 below.

5.5.2 Prime and Sub-prime lenders who comply with the UCCC

Lenders (or loans) in this category, comply with the UCCC. They are not, however, required to be licensed or to belong to alternative dispute resolution. While many of the better-known lenders in this category have joined EDR schemes on a voluntary basis, there are many lenders who have not. Further, those who have joined could easily withdraw their membership in response to an unfavourable determination or other unwelcome development in the operation of the scheme to which they belong. Some lenders in this group are members of a recognised industry association such as the Mortgage Finance Industry Association of Australia and, as such, are required to adhere to a Code of Conduct. Again, many are not.

While APRA has no role in relation to these lenders, their jurisdiction being confined to ADIs as a result of the recognized need to protect the viability of key financial institutions for the sake of the broader economy, default rates are published by organisations such as Standard and Poors and Moodys, at least in so far as they relate to corporate/institutional lenders and securitised mortgages. These statistics suggest that non-bank lenders have generally higher default rates than banks[52], and that sub-prime loan default rates are particularly high at about 14%.[53] CCLC has also noted in providing advice and assistance to borrowers that non-ADI lenders are generally faster to take enforcement action in relation to default and more intransigent in negotiations in relation to hardship.

5.5.3 Lenders who avoid the UCCC

There are also a variety of lenders and credit intermediaries who lend outside the UCCC. As discussed above, small business and investment loans are not covered by the UCCC. There are also many loans being written for individual consumers for personal, household, domestic purposes that are also not compliant with the UCCC. This avoidance of the UCCC is discussed in more detail in 5.10.2 below. Loans made in this category are effectively unregulated, apart from the Contracts Review Act in NSW, misleading and deceptive conduct under the ASIC Act and unconscionability under both the common law and the ASIC Act (all of which also apply to the other categories above). The specific problems that occur in this category of lending are outlined in section 5.6.4 and 5.6.5

[52] See for example Australian Bankers Association Press Release, “Banks Maintain Strong Lending Standards Compared to Other Lenders”, 30 April 2007, http://www.bankers.asn.au/default.aspx?ArticleID=1075 which quotes Moodys statistics to the effect that non-banks lenders 30 days past due delinquency rates are at 2.15% compared to 0.78% for banks lenders.

[53] Gordon & Moncrief, “The Home Front”, Business Day, Page 1 & 6, The Age, Melbourne, 2/6/07. Sub-prime lending by its very nature results in higher default rates. The question from a public policy perspective is how high is too high in terms of the costs to individual defaulters and the flow-on effects for the economy and wider community.

below. In CCLC's experience the most egregious cases of inappropriate lending occur in this category of loans. The mismatch between Supreme Court possession proceedings in NSW and reported default rates[54], also suggests that those lenders who are not required to report their default rates may be over-represented in the court statistics.[55]

5.6 Specific aspects of credit where competition and existing legislation are not delivering fair or sustainable outcomes

5.6.1 Credit Card Lending

Of the types of debt identified as a problem by callers to the CCLC Credit and Debt Hotline, credit card debt is the most common.

CCLC Client Analysis

CCLC conducted an analysis of callers in the period from 1 September 2004 – 30 June 2006 whose primary reason for seeking assistance was credit card debt.[56] Credit cards were defined to include store cards and products such as the AGC Creditline product and its successors offered by GE Money.[57]

After the removal of calls involving the same person seeking further advice (as far as practicable), there were 2553 calls for which sufficient detail[58] was taken to perform some meaningful analysis. Of those callers the average amount owed across all credit card accounts was $14,099 and the largest total amount owed was $200,000. The average amount owed on a single credit card account was $9,843. As shown in Table 2 below, 48 callers owed over $80,000 in credit card debt.

[54] See for example Australian Bankers Association Press Release "No Understatement of Housing Default Statistics", 16 May 2007, http://www.bankers.asn.au/default.aspx?ArticleID=1081 which points out that defaults rates were reported by the reserve bank at the end of 2006 at 0.31% of the housing loan book.

[55] Breakdown of Supreme Court proceedings by lender, or loan type, is not available. CCLC has requested further information from the Supreme Court but although some information was provided it was confined to defended hearings, which make up a small proportion of the proceedings filed. The ABA and CCLC among other members of the ABA Consumer and Community Consultative Forum have now written jointly to the Supreme Court requesting access to further information for analysis.

[56] This analysis has not been published because the data is still being subjected to some further quality control. There may be some minor changes to these statistics as a result.

[57] Interest-free purchases for furniture, white goods computer and entertainment equipment for example, often involve the provision of a credit card which can then be used again for other purchases which are not interest-free and attract an interest rate of around 27%. Interest-free purchases, which are not paid off within the interest-free period, also attract interest at this rate.

[58] Due to the large demand, many callers to the Hotline may be given a referral to a financial counsellor or other relevant agency without many details being taken about their individual debts.

Table 2

Debt Range – Total amount owed across all credit card accounts	
Amount Owed	**Number of callers within range**
Under $3,000	500
$3,000 - $5,000	460
$5,000 – $9,999	501
$10,000 - $19,999	528
$20,000 - 39,999	372
$40,000 - $79,999	144
Greater than $80,000	48
Insufficient information given	0

While 65% of callers owed money on only one credit account[59], the remaining callers had between 2 and 14 accounts. This is shown in Table 3.

Table 3

Number of cards held per debtor	
Number of card	**Number of callers**
1	1657
2	456
3	183
4	76
5 or more	47
Insufficient information given	134

The bulk of callers were in the 26-45 year age group, but there were callers from all adult age groups including 198 who were over 60 years of age.

[59] Debunking the theory that more comprehensive credit reporting and hence more information about callers other accounts is all that is required to address the problem of over-indebtedness.

Table 4	
Age of callers	
Age range	**Number of callers**
18-25 years	209
26-45 years	1530
45-60	562
Over 60	198
Insufficient information given	54

The caller's income was low in 58% of cases (below $26,000) and a further 15% were medium (below $52,000). Only 3% identified an income level of over $52,000 and the remainder did not specify their income level.[60] Gambling was identified as an issue in 99 calls and mental illness in 105 calls.[61] Credit limit increase offers were identified as a specific issue in 125 calls.

Thirty-seven percent of callers indicated that they had other debts that were contributing to their overall financial problems, including personal loans, mortgages, telecommunications and other utility accounts, and a range of other miscellaneous debts. The remaining 63% had one or more credit card debts only.

Clearly inappropriate lending[62] could be identified in 144 cases from the facts presented. However it is also of concern that 844 people on government benefits, for example, owed over $3,000[63] and 38 people on low incomes (under $26,000) owed over $33,000 in credit card debt, and 192 callers (of varying income levels) owed over $40,000 in credit card debt. All 2,553 callers reported an inability to meet their repayments as they fell due and/or a sense of despair as they were unable to significantly reduce their balance despite long periods of paying as much as they could afford.

Other services report similar experiences on the part of their clients. Over the years 2000 to 2003, the Financial Counselling Association of NSW partnered with academics from Newcastle University to conduct an analysis of clients presenting for financial

[60] A more recent analysis of clients overall suggests that this distribution is changing with an increase in the number of callers in the medium and high-income brackets.
[61] It is likely that these statistics understate these problems as many callers do not disclose this information.
[62] Innappropriate lending was defined as the borrower clearly having insufficient income to support the credit limit allocated *at the time* it was allocated. To draw this conclusion the record had to contain information about the caller's income at the time the credit was granted, or the limit increased. This information is not obtained in relation to every debt.
[63] Analysis by CCLC suggests that most Centrelink recipients would struggle to pay off $3,000 over five years at an average credit card rate of about 16% if they ceased using the card and made consistent repayments. In reality many callers had store cards and other forms of continuing credit with significantly higher interest rates.

counselling. The final report of that study found that of the 2,322 clients who used financial counselling services for assistance in overcoming financial difficulty in the year 2003, credit card debt was the most frequently reported type of debt across each household group studied. Further while the incidence of credit card debt was lower in households earning less then $30,000 than those earning over $30,000, the incidence of credit card debt was nevertheless over 50% in each lower income range. Further, while the proportion of clients with credit card debt grew in all age groups between 2000 and 2001, there was a notable decrease in the proportion of clients with credit card debt in the 18-24 age group in the 2002 and 2003 years and an increase of credit card debt among clients aged 65 years and older[64], suggesting that the common conception that this is a problem of "irresponsible youth" may be ill conceived.

The Banking and Financial Services Ombudsman in his submission to the Senate Economics Inquiry into Possible Links between Household Debt, Demand for Imported Goods and Australia's Current Account Deficit, noted that over the five year period ending 31 December 2004, complaints received by the BFSO in relation to lending maladministration increased exponentially, with the largest increase being in relation to the granting of credit for credit card facilities.[65] In 2000, complaints about maladministration in relation to the granting of credit for credit card facilities totalled only 24.32%, while in 2004 it had increased to 65.05% of all maladministration in lending disputes. The BFSO specifically cited the practice of offering existing customers an increase in the limit of their credit card without undertaking re-assessment of their capacity to pay as a contributing factor to this increase.

CCLC notes two particular problems in relation to credit card lending:

1. The practice of offering credit limit increase offers to customers on the basis of account performance, and without any reference to capacity to pay;
2. Very low minimum repayments as a percentage of the overall debt and the consequential effects on the size of credit card limits.

5.6.1.1 Credit limit increase offers

As a general rules credit limit offers are based on the customer's performance on the particular account for which they are being offered a credit limit increase. No account is taken of how the customer is paying the account, or indeed whether they have shown any capacity to substantially reduce the balance owing on the account, let alone pay it off completely. No attempt is made to determine the customer's actual financial position at the time of the offer, and it would appear, any information previously obtained by the bank about the customer's financial position (when they opened the account for example) is not taken into account. While some banks have recently modified their systems to ensure that credit limit offers are not sent to customers who appear to be under stress in

[64] 71% if the 91 clients aged 65 and older presented with credit card debt.
[65] Banking and Financial Services Ombudsman, Submission to the Economic References Committee Public Inquiry into the Possible Link between Household Debt, Demand for Imported Goods and Australia's Current Account Deficit, p. 3.

relation to other loans with the same bank, and to audit their offers to ensure they are not sent to known Centrelink beneficiaries, these developments have not been uniform across the market and, in CCLC's view, they are welcome, but insufficient to address the problem.

The net result of the above practice is a steady stream of clients at consumer assistance services who have credit card debts they cannot pay, and clearly never could have. A growing number of retirees, for example, seem to have been "rewarded" for consistent repayments with bigger and bigger limits, and are now presenting at our service with debts they simply cannot service on their limited income. While the overall number of consumers in this category is somewhat smaller than the category of consumer who has suffered a change of circumstances, the debts can be staggeringly disproportionate to the customer's income. Further, as their debts grow, these customers become more and more susceptible to credit limit increase offers, as the pressure of the existing debt strangles their cash flow.

5.6.1.2 Minimum repayments and credit limits

Another problem with credit card lending, which affects a larger group of consumers than the class described in 1 above, is the level of contractual repayments required. With minimum repayments set at levels as low as 1.5 -2%, card providers can offer consumers comparatively high limits, because they consider only the ability to meet this very low monthly repayment. Customers who fully utilise their limits can therefore be locked into a situation where they can meet their minimum repayments but cannot significantly reduce their outstanding debt. Further, repayments reduce as the debt reduces, constantly reducing the rate of repayment and increasing the overall cost of credit.

These customers can often suffer financial strain without ever missing a repayment. Further, they become disheartened over time, as the goal of paying off the account recedes perpetually into the future, and they become more likely to consider options such as debt consolidation, Part IX Agreements and Bankruptcy. Importantly, the longer consumers carry a debt, the more likely it is that the vicissitudes of life will intervene at some point in the lifespan of the debt to reduce their capacity to pay even the minimum repayments as a result of accident, illness, unemployment and eventually retirement. CCLC staff note that callers to the Hotline who cite illness or unemployment or other similar change of circumstances as the reason for their inability to pay, will often admit that they have carried the balance on their account for months, sometimes years, prior to the adverse event which finally tipped a sustained problem over into crisis.

The above problems with credit card debt are often overlooked because past due/default rates have been historically low. However, there are two main problems with reliance on default rates as the only indicator of unsustainable lending.

Firstly, there are many opportunities in the market for people to mask financial difficulties. The easy availability of credit means that debts can be managed creatively and refinanced, sometimes several times, without a debtor registering as a default, thereby masking real levels of financial stress. CCLC has advised numerous clients in the past couple of years who report difficulties in paying their home loan after refinancing their credit card or other unsecured debt into their home loan, sometimes more than once. The refinancing in response to financial hardship survey conducted by CCLC for ASIC in May 2006 included 8 sets of borrowers who had refinanced other unsecured debt into their home loan (in 10 different transactions)[66]. Other clients have reported using cash redraws from one card to pay another for extended periods.

Secondly, as noted above, the concept of the minimum payment typical of credit cards has revolutionised consumer debt. Many lenders base their assessment of the customer's capacity to pay on whether they can afford the minimum monthly payment. This means that even where some form of credit assessment is carried out, borrowers may face financial difficulty if they fully draw their account. The result of this is that there is a gap between financial difficulties as measured by default rates and real levels of debt-related stress in the community. People are meeting the minimum payment but cannot repay the principal debt.

CCLC notes, however, that it would be disastrous if minimum repayments were now increased on existing accounts, inevitably leading to increased financial stress, defaults and bankruptcies. Credit providers need to be flexible in their approach to managing existing debts going forward if a crisis is to be avoided. On the other hand, CCLC supports the increase of minimum payment on new accounts, provided this is clearly disclosed to consumers (not just as a percentage, but with example repayment amounts) prior to incurring debt. At the very least, credit assessment must be performed against a significantly higher benchmark than the current level of minimum repayments.

5.6.2 Debt Consolidation

Debt consolidation is an area in which clients are particularly vulnerable to poor advice. The advantages of debt consolidation are easy to promote and include:

- Simplified finances with one easy repayment
- A lower interest rate on some debts (for example, where credit card debts are refinanced into a home loan)
- Lower repayments.

This is very attractive to borrowers, especially if they are suffering from financial stress. A lot of advertising has been directed to this market in recent years as consumer debt has grown. Even media advice columns and financial commentators have been slow publicise the downside of consolidation.

The disadvantages of debt consolidation, however, are serious:

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[66] CCLC, Refinance Report, above n 22, p 18

- A credit card debt paid off over the term of a home loan costs significantly more than if paid off over a much shorter term, despite the lower interest rate.
- Overseas research[67] has shown that borrowers who consolidate credit card and other personal debts, run a considerable risk of running up further similar debt in addition to their consolidated debt because of a failure to address the underlying difficulties which led to the accumulation of debt in the first instance. CCLC is aware anecdotally of Australian borrowers who have done exactly the same.
- One secured creditor is less likely to accept a reduced repayment offer or even to accept a negotiated settlement than a number of small, unsecured creditors

> *"The refinance made my situation worse because it took a bunch of unsecured debts and made them secured against my home. I went from a small mortgage I could afford, to one beyond what the pension can cover. The payments barely cover the interest charged each month. If I had any idea that I would be entering into a mortgage where my payments would not deliver any benefit, I would have solved my debt problems in a different way."* (Refinance Survey Respondent, May 2005[68])

Although we are aware that some financial advisers who are remunerated by commission, and have a vested financial interest in the consolidation loan proceeding, do tell consumers about these pitfalls, there are many who do not, or who fail to emphasise their seriousness. In fact as housing affordability for new home buyers has diminished, and the property market has slowed, debt consolidation is becoming the staple business of many of the finance/mortgage brokers spawned by the period of strong growth.

For consumers who are particularly vulnerable because they are facing enforcement action (or threatened enforcement action) from other creditors, either in relation to their existing home loan or other debts, there is a real possibility they will end up in a more expensive loan.[69] Consumers who are told they can reduce their credit card interest from 16% for example to 9% by consolidating do not always realise that the extra 2% on their entire housing loan balance will far outweigh the savings on the credit card debt. Even if they do realise this, they are more likely to accept the deal in order to fend off enforcement action.

[67] "The Plastic Safety Net:The Reality Behind Debt in America", Demos and the Center for Responsible Lending, October 2005. This US survey found that of 1,000 borrowers surveyed, half had refinanced or taken a second mortgage to pay down credit card debt. The same homeowners had added on average $US12,000 to their mortgage debt and still had at the time of the survey $US14,000 on average in credit card debt. Office of Fair Trading research in the UK, "Debt Consolidation: A Report on an OFT Study", March 2004, found that 24% of respondents who had consolidated debt borrowed further amounts after consolidation, including obtaining new credit cards. 38% of those who had consolidated debt had done so before.

[68] CCLC, Refinance Report, op cit, p 28

[69] Ibid.

In the survey undertaken by CCLC for ASIC in 2006 to examine the experience of borrowers refinancing in response to financial difficulty, the difficulties faced by the borrowers prior to the refinance covered in the survey ranged from foreclosure proceedings by their current mortgagee to financial stress in meeting credit card repayments. In summary, all but one of the 14 sets of borrowers surveyed ended up in more expensive loans with higher overall repayments (across all credit accounts) and 6 of the borrowers lost their homes. Another five had faced enforcement proceedings in relation to the second loan and would probably have lost their homes also but for the intervention of a legal centre or financial counselling service. Only three were back on track financially at the time of the survey. Those three sets of borrowers had managed to refinance back to the mainstream, although in each case the entire episode had added tens of thousands of dollar to their loan balance. The experience of the survey participants highlighted the particular vulnerabilities of borrowers in financial difficulty, all of who had refinanced through finance/mortgage brokers.

5.6.3 Sub-prime lending

The sub-prime market (in home lending) is relatively new in Australia, but it is growing rapidly. In 2004, the non-conforming loan market in Australia was estimated to be worth approximately $6 billion,[70] yet in a short space of 12 months, the sector was estimated to have increased to $20 billion,[71] while Macquarie Equities even estimated at that time that the non-conforming mortgage market alone could be worth up to $30 billion.[72] It is a newly- emerged market sector that has seen exponential growth in recent years. The biggest player in the sub-prime lending market, Liberty Financial, is said to be growing at a faster rate than the industry itself. Bluestone, the number one fasting-growing small to medium size enterprise in 2004[73] was writing approximately $100 million in loans a month, and expected about $12 million in profit in 2005, up from $9 million in 2004.

Lenders in what we have dubbed the ‘mainstream’ sub-prime market are keen to promote their record as providing “second chances”, and sometimes first home-buying opportunities, for those borrowers who would otherwise be excluded from the market. These lenders particularly champion their role in providing options for borrowers who, as a result of a one-off misadventure such as a failed business, or relationship breakdown, are unacceptable risks to traditional lenders, but have a current ability to pay. While this logic is difficult to fault, the stories recounted by clients suggest that in some cases at least, the reality does not live up to the rhetoric.

There are three main concerns with this part of the market evident in these borrowers’ stories:

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[70] ‘Low-doc lender triples profit’, Lisa Murray, *Sydney Morning Herald,* Tuesday 5 October 2004, Business, p.23.
[71] Oldfield, S. “Non-conforming loans continue to sizzle”, The Australian Financial Review, 1 August 2005.
[72] Ibid.
[73] ‘What goes around …’ Max Walsh, *Money Magazine*, November 2004, p. 34.

- Exclusive reliance on brokers, without the stringent accreditation criteria increasingly required by banks,[74] in combination with the frequent use of 'low-doc' and 'no-doc' products, exposes such lenders to accepting fraudulent applications on behalf of borrowers with no genuine ability to pay;
- Risk-based pricing equates to expensive loans for many borrowers, which coupled with high entry and exit costs raises serious questions about whether these loans are viable on an ongoing basis for a significant number of borrowers (even those on steady middle incomes)
- Inflexible responses to hardship and high default costs that are at odds with the stated mission of the "second chance" and financial inclusion.

Over half of all non-conforming loans are to borrowers who self-certify their income, and the business is done exclusively through brokers. The survey conducted for ASIC referred to above also revealed that some brokers were prepared to coach people to leave out liabilities or exaggerate their income on their loan application, or simply supplied false details for them.[75] While this behaviour involved a relatively small number of brokers, the problem is structural in cause, and based on lenders outsourcing verification and assessment of income capacity to brokers, meaning that they can engage in deceptive practices with little risk of being exposed. The potential for these practices is clearly an ongoing problem that is not solved by removing a few brokers.

Many loans in these categories involve fees for early prepayment of the contract or a deferred establishment fee if the loan is paid out within a certain time. As one set of borrowers put it when they discovered that their interest rate and, consequently their repayments, were higher than they had been led to believe: *"We had no idea that the fees would be so high on entry and early exit. It basically trapped us into the loan."* [76] They could barely afford to pay the loan and yet they could not afford to leave because of early termination penalties of thousands of dollars.

At the same time, high default interest rates guarantee that borrowers who experience repayment stress rapidly careen into disaster. This was the experience of several of the borrowers in the Refinance Survey, who described how they paid and paid but only went backwards. Four of the borrowers were subject to legal proceedings for possession of their home by a lender in this category after their refinance. All four reported that the lender was intractable and difficult to deal with in relation to their repayment difficulties.[77]

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[74] For example, CCLC recently wrote to Sherman Ma, Managing Director and founder of Liberty, asking that they cease from accepting business from a broker firm that has been expelled from the MIAA for misconduct.
[75] CCLC, Refinance Report, op cit, pages 10-14
[76] Ibid, p 24.
[77] Ibid, pp 23-26.

5.6.4 Lenders of last resort in secured lending (Predatory lending)

"Predatory lending" is a term we apply to expensive loans that are targeted at people with insufficient capacity to pay, with a view to almost inevitable enforcement. Predatory lending is a subset of sub-prime lending, distinguished by very high fees and the extremely high likelihood of default. These loans are only offered to consumers who have a significant asset, usually their home, usually with a view to relieving the borrower of much as their equity as possible. They are sold via a chain of intermediaries including at least one broker, a solicitor, sometimes an accountant and one or more lenders. Sometimes the actual creditor is an individual or small business investor, sometimes a trust vehicle used for funding securitised mortgages, or another non-bank lender.

Case Study 5 – Predatory Lending

Mr and Mrs X contacted CCLC because they defaulted on their mortgage and the lender was seeking possession of their house. At the time of entering the mortgage, they were both unemployed with 4 children and another on the way. Their sole source of income was Centrelink benefits.

Mr and Mrs X wanted the loan because they needed to refinance their existing home loan which was in serious arrears, pay off some other personal debts, pay for renewal of registration for their car and to cover the cost of renovating their house to convert the garage into a fourth bedroom to accommodate their expected fifth child. They approached a mortgage broker who arranged for the loan amount to be split into two separate loans with two separate lenders. The first loan accounted for about 60% of the total loan amount and had an interest rate of 8.95% p.a. with a default rate of an additional 3% p.a., while the second loan had an interest rate of 23.6% p.a. with a default interest rate of 31%.

From the outset, Mr and Mrs X had informed the broker of their level of income and that they were unemployed. In spite of this, neither the broker nor the lender took steps to ascertain whether or not Mr and Mrs X could meet the repayments. In fact, the broker told our clients that he knew they would not be able to afford the loan, so he would structure the loan to include an amount equal to six months of interest payments so that they would not have to make any payments for that period. He assured them that after the 6 months, he would change the loan over to a "normal loan" for no extra charge. He also assured our clients that they would receive $26,000 at settlement. Over the weeks that followed, the broker informed our clients of several changes made to the loan arrangement, which ultimately resulted in our clients not having an interest free period as promised, leaving them with repayments that they could not afford. The amount they received at settlement also turned out to be significantly less than promised.

It appears that the broker completed the loan documents dishonestly as the documentation was witnessed by a person that Mr and Mrs X had never met and statements as to their income and employment status were also filled out by someone other than our clients.

The broker told our clients to complete a business purpose declaration form, stating that the loan was for investment purposes. Our clients signed as instructed without any comprehension that the document would deprive them of significant protections under the law. CCLC is currently defending the court action for possession of our client's home by arguing that the UCCC should in fact apply and that the contract is unjust. The broker was paid a number of fees and commissions totaling approximately $15,000 and the lenders fees were also significant. The total amount owing under the relevant contracts is now about $30,000 higher than the balance when the loans were taken out, which in turn was about $35,000 higher than the balance on the loan refinanced.

Case Study 6 – Predatory Lending

This very young couple occupied a small home outside Sydney with their three children. They were occupying the house under a vendor finance contract and wanted to buy the property outright and obtain a modest amount of funds to renovate their kitchen. Both were of modest education and Mr T was in intermittent employment. They responded to an advertisement placed by a Sydney broker.

The broker promised to secure sufficient funds for the clients to purchase their property and conduct the desired renovations. In the event the loan was insufficient to execute the renovations and $30,000 disappeared in set-up costs to lender, the brokers and the lenders solicitors. The cost of the loan was much higher than mainstream home loan rates and the borrowers quickly defaulted. The lenders sought possession of the property, which by then hard started to fall in estimated value. The borrowers were facing a growing shortfall and eventually obtained legal assistance. The solicitors negotiated the surrender of the property in return for which the lender agreed to forgo the shortfall.

Case Study 7 - Predatory Lending

Mr and Mrs F were migrants who had lived in Australia for over 35 years. They had accumulated considerable equity in their family home when, in their 60s, they approached their lender to refinance to pay out personal debt accumulated at a time of family crisis. Rejected by their mainstream lender, they turned to a broker who arranged three successive loans over the next two years. The borrowers took out loans for higher and higher amounts to meet growing interest repayments they could never afford. They were encouraged to take additional cash out along the way to improve the house and meet their living expenses. Eventually they were forced to sell the house and walk away with nothing, despite 25 years of steady repayments on their original home loan.

Case Study 8 – Predatory Lending

A married couple with a large family and standard bank loan of under $200,000 fell into financial difficulty in 2004 and approached a broker for assistance. They took out a one-year, interest-only loan, including sufficient funds to pay out their bank loan and pay almost $30,000 in brokerage and establishment fees and other transaction costs. The loan was significantly more expensive than their bank loan and they did not manage to make a single interest payment. Within 5 months they had been taken to the Supreme Court and served with a Notice to Vacate the premises.

In desperation the couple then went to another broker who arranged a loan with yet another lender. The interest rate was higher again and another $60,000 was added to the outstanding balance, this time covering not only brokerage and establishment fees but also enforcement expenses in relation to the previous loan. By this time one of their children had reached adulthood and was written into the loan contract as a co-borrower. The couple could never service the debt, a fact that should have been obvious from the outset. The house has since been sold and their adult child has recently approached CCLC for assistance because she is being pursued for a shortfall of $130,000. She is barely 20 years old.[78]

Predatory loans are characterized by:

- Excessively high set up costs which are financed by the loan
- One or more intermediaries such as finance brokers
- High ongoing interest rate and default interest rate
- Swift enforcement action
- False categorisation as a business or investment loan to avoid the Consumer Credit Code
- No access to alternative dispute resolution
- Reliance on an assets rather than income to meet loan repayments.

In most cases people who seek assistance in relation to predatory loans are those who perceived, rightly or wrongly, that they would not get a loan from a mainstream credit provider. Commonly they are people in a financially precarious situation at the time of taking out the loan, such as facing enforcement action in relation to their existing home loan or other debts. In some cases they owned their own home outright and needed money for some unexpected contingency, such as legal fees or urgent repairs to their home or vehicle, or travel to visit a relative who has taken seriously ill.

In other cases people have taken out such loans because their credit report was impaired by a past default or default(s), or because they were financially unsophisticated and did not understand how disadvantageous the terms of the loan were compared to others available on the market. Borrowers who place their fate in the hands of an unscrupulous broker are particularly at risk because the higher commissions on these loans make them very attractive business to write for some intermediaries.

One of the defining characteristics of a predatory loan is that either:

[78] Case studies from the legal casework service of Consumer Credit Legal Centre (NSW) Inc.

- The borrowers could have obtained a loan on better terms; or
- The borrowers are such a poor credit risk because of their financial situation that default on this loan is almost inevitable.

While some borrowers may benefit from access to sub-prime loans, it can be said that, by definition, no borrower is likely to benefit from a predatory loan.

Even for borrowers who would never have qualified for any other loan at the time they obtained their predatory loan, the fact of the loan transaction alone adds thousands to their debt (or creates a significant debt if they did not have one prior to the loan) because of the high set up costs and this compounds with every passing month as a result of high interest and other charges. The amount owing as a result of the loan is usually significantly higher than the amount actually required by the borrower. The net effect of this is that the equity accumulated in the borrowers home over their lifetime, often comprising their only savings or wealth, is rapidly stripped away over a matter of months as a result of a very bad decision, usually made at a time of high stress and vulnerability.

In a recent determination of the Credit Ombudsman Service Ltd[79], the Ombudsman Raj Venga, found against the broker member under several heads of law and awarded an amount be paid to the borrower representing the broker's commission, lender's legal fees and other disbursements associated with setting up the loan. In finding that the broker had acted unconscionably within the meaning of the provisions of the ASIC Act he said as follows:

> *"I consider that [the broker] would have been aware that the Complainants (a) were not sophisticated in financial affairs; (b) had defaulted on their [previous mortgagee] loan; and (c) were anxious, if not desperate, to avoid losing their home. [The Broker] was also aware, despite their subsequent protestations, that the Complainants were unemployed and in receipt of Centrelink payments."*
>
> *"I consider that [the broker] took unconscientious advantage of its position as their agent by arranging a loan for the Complainants that (a) required repayments of more than double those of their existing [previous mortgagee] loan; (b) that was significantly larger than the [previous] loan, primarily because of the excessive broker commissions and lenders' fees charged; (c) that significantly reduced the equity in the value of their home; and (d) that was secured over their only asset, their home."*[80]

This is the description of an archetypal predatory loan. Despite the decision of the Credit Ombudsman, neither lender involved in the case is in EDR and the amount awarded to the consumers will not be sufficient to meet the default and enforcement charges under the mortgages, let alone save their home. The broker has not paid the amount awarded to

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[79] Credit Ombudsman Scheme Ltd, Determination 003,May 2007 at http://www.creditombudsman.com.au/5737,01,1-0-Determinations.php

[80] ibid, p17

date and until there is adequate regulation of brokers in place, he will be able to continue trading despite non-payment in accordance with the determination.

The Center for Responsible Lending in the US estimates that abusive home mortgage lending costs homeowners US$9.1billion per year in the United States.[81] There are no such estimates for Australia. Clearly our market is considerably smaller. Nevertheless, with a rapidly growing sub-prime market, decreasing property values and increasing interest rates, the time is ripe for this sort of abuse and action should be taken to reduce the incidence of this type of loan before they become commonplace.

The CCLC cases described above are very similar to a case recently argued in the NSW Supreme Court, *Permanent Mortgages Pty Ltd v Michael Robert Cook and Karen Cook*[82]. In an expert report prepared for that case, Associate Professor Steven Keen described the type of loan described above as a "Ponzi Loan", that is, a loan that can only be repaid by selling an asset or obtaining another larger loan. He also outlined the risks to the economy posed by this type of lending:

> *Were the practice of Ponzi lending to become widespread, it would substantially increase the tendency of the Australian financial system to asset bubbles and subsequent financial crises, by:*
> *i. Accelerating the accumulation of excessive debt during the upswing to an asset bubble;*
> *ii. Accelerating the rate of decline during the bursting of the bubble; and*
> *iii. Causing the recovery to take much longer*[83]

While Associate Professor Keen concedes disagreement among economists as to the likelihood of such lending taking hold on a significant scale, CCLC has witnessed an increase in this type of lending experienced by our clients in recent years, and can see no reason in the market, or the current law, why this lending will not continue to spread whilst ever consumers are in vulnerable situations and have equity in their homes available.

In the *Cook* case the Supreme Court found in favour of the borrowers, both in setting aside a business purpose declaration, and in finding that the loan was unjust under the UCCC. The remedy, however, was the reduction of some fees and charges with both the principle and interest both remaining payable. This decision is subject to appeal as this remedy is of little comfort to the borrowers who will lose their home regardless. Importantly, this decision provides no disincentive whatsoever to other lenders seeking to go down this path as the possible loss of exorbitant up-front fees and charges only presents little real business risk when compared to the possible returns.

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[81] Center for Responsible Lending, Predatory Mortgage Lending robs homeowners and devastates communities, CRL Fact Sheet, p1, available at www.responsiblelending.org, downloaded January 2006.
[82] [2006] NSWSC 1104.
[83] Ibid, p 8.

5.6.5 Small amount lending

Lenders who fill the gap left by mainstream lending for small amounts (usually less than $5,000) present a particular problem for regulators. There is clearly a significant demand for these types of loans that is not being met by the mainstream market and yet, as demonstrated by the following case studies, gathered from financial counsellors in a two week period in May 2007 from current casework, this area is rife with exploitation of borrowers who may be vulnerable for a range of reasons including mental illness, intellectual and other disabilities, problem gambling, substance abuse and/or insufficient income.

Case Study 9 – Small Amount Lending

Borrower 1 is 45 years of age. She has been on the Disability Support Pension for 3 years. She suffers from serious depression.

Borrower 1 pays rent of $180 per week, which is 69% of her pension payment. She fell into arrears with the repayment of her rent and was threatened with eviction if her rental arrears were not brought up to date. She applied for a personal loan from a few mainstream lenders without any success because she could not demonstrate that she could afford to make the requisite repayments.

Desperate to keep a roof over her head, she successfully applied to a specialist small amount lender for a $2000 loan. The loan was not regulated by the UCCC because it was extended under a Bill of Exchange. The amount payable 32 weeks after the date of the contract was $2,753 32. The majority of the borrower’s necessary household items, including a fridge, microwave, lounge, dining table, washing machine, cloth dryer and a television, were mortgaged to secure the contract. The costs of borrowing $2,000 over 32 weeks under this contract is $753.00, or the equivalent of 104%, if expressed as an annual percentage rate.

The contract does not disclose the amount of weekly or fortnightly repayments. If she was to repay the loan fortnightly, she would have to pay $172.06 per fortnight. Borrower 1’s fortnightly pension is $525. She would have a shortfall of approximately seven dollars per fortnight just paying her rent and this loan. She would have no money at all with which to pay food, electricity, phone, transport or medication for example.

Not surprisingly, Borrower 1 has not been making any weekly or fortnightly payments and will not be able to repay the $2,753 on the termination date.

Case study supplied by financial counsellor, Regional NSW.

Case Study 10 - Small Amount Lending

Borrower 2 is a 55 year old receiving the Disability Support Pension and living in Department of Housing accommodation. She also suffers from mental illness including psychosis, schizophrenia and anxiety.

She has two loans from different small amount lenders:

- $500 loan for which direct debits are used to ensure repayments of $45 per fortnight, outstanding balance now $1,171.98 including accumulated interest, fees and charges

- Loan for which the original loan amount is not known, but the balance is now $400 and fortnightly repayments of $88.33 are direct debited from her pension.

Borrower 2 also has rental payment for her fridge and washing machine of $47.00 per fortnight. She also has a Centrelink repayment of $20.00 per fortnight, and another regular repayment of $21.00 per fortnight. With her rent also being directed debited, she has very little pension that she actually receives in her bank account to pay for food, utilities and other living expenses.

Case study supplied by financial counsellor, Outer Metropolitan Sydney

Case Study 11 – Small Amount Lending

Borrower 3 is a male who suffers from schizophrenia. He borrowed $1000 under a promissory note secured by a bill of sale over his home unit. The amount repayable over 12 months is $2,476, an effective interest rate of almost 150%. The contract also disclosed a number of possible penalty charges including $48 for a dishonoured direct debit ($35-50 may also be payable to the borrower's bank for this dishonour), $20 for the reschedule of payment, and a penalty service charge of 48% per annum payable on the remaining balance for any period during which the borrower is one or more repayments in arrears. Clearly Borrower 3's home unit is at serious risk for a $1,000 loan.

Case study supplied by financial counsellor, Regional NSW.

Case Study 12 – Small Amount Lending

Borrower 4 is a 33 year-old living in Department of Housing accommodation. She is a sole parent with 6 children. She has an unsecured debt of $4000 to a small amount lender. Her repayments are $142 per fortnight. The loan was taken out for Christmas/birthday presents for the children and to repair her old car. She now has an Eviction Notice for $3000 in rent arrears.

Case study supplied by financial counsellor, Outer Metropolitan Sydney

Case Study 13 – Small Amount Lending

Borrower 5 is a 68 year old woman on the Disability Support Pension. She has three loans from two different lenders, all taken out in late 2006 in order to simply survive. All three loans disclosed the purpose of the loan was to purchase white goods. Two of the three loans avoid the UCCC by using a Promissory Note and a Bill of Exchange arrangement. Two of the loans were secured over basic household necessities. The interest rates were approximately 163%, 224% and 44% respectively. The cheapest loan was UCCC compliant. The client could not pay any of the loans as they fell due and the interest and charges began to accumulate.

Case study supplied by financial counsellor, Outer Metropolitan Sydney

There were a number of other case studies supplied that were not used here because they related to incidents that happened 12 months ago or more. These included a woman who went bankrupt over a $7,000 dollar loan because she could not pay the $5,000 in interest and a loan which was rolled over 11 times when the borrower could not repay, attracting over $620 per roll-over transaction.

CCLC acted in the following cases in 2005/6:

Case Study 14 – Small Amount Lending

Our client T needed money for airfares to visit a sick relative and responded to an advertisement in the local paper. The advertisement stated "Easy Loans No Credit Checks". T rang up and asked if she could borrow $2,500 and explained the purpose of the loan. She said she was out of work and was receiving Centrelink benefits.

She was asked and confirmed that she had an existing mortgage on a house. An appointment was made and the next evening Mr 'D' arrived at her home. Our client signed some documents consisting of a 'statement' that detailed the Loan amount to be $3,550, which included (but did not explain) a 'fee' of $1,050 and a document purporting to authorise an unregistered mortgage plus a caveat on her land and home.

D stated he wouldn't charge any interest but if the whole loan was not paid back within one month, he would lodge the caveat and charge 10% interest *per month*. P agreed to the loan, as she had no other way of getting the money. The caveat was in fact lodged the day after the loan was approved.

P could not pay out the loan within one month and 4 weeks later she was sent a 'Default Notice" from D stating she would be issued with a bankruptcy notice and that she would be forced to sell her house if the balance plus accrued interest was not paid within 30 days.

Case Study 15 - Small Amount Lending

CCLC was approached by Ms. A, who had received a Statement of Claim (Equity Division of the Supreme Court) filed by a small fringe lender seeking possession of her home. Our client had taken out a small loan of $5,000 to pay strata fees on her home unit. In fact the amount borrowed was for about $3,500 with the remaining $1,500 representing fees and charges added at settlement. The interest rate was 5% per month. The lender had taken a second unregistered mortgage over her home unit. The loan was described as being for business purposes even though it was for personal purposes. A first mortgage was held by a major bank. The borrower could not pay in accordance with the terms of the loan and the lender's first claim in order to stop the Supreme Court proceedings was for an amount in excess of $20,000.

While CCLC accepts that there is considerable demand for these products that is not being met by the mainstream credit market and that there are fixed costs associated with lending that increase the relative cost of providing smaller loans, we submit that the risks for vulnerable consumers are such that these type of loans cannot be left effectively unregulated. Competition has not produced demonstrable advantages in this sector. Queensland, for example, has considerable numbers of small amount lenders and reports some of the highest effective cost of credit in the country[84]. In fact, quite a different type of competition appears to occur in some pockets of the sector with lenders vying to charge the highest up-front costs, and/or to come up with the most punitive default clauses. This reflects what we have observed in the housing market for particularly desperate or ill-informed consumers and seems to be an inevitable consequence of markets which operate to "serve" the desperate, disadvantaged or otherwise disempowered sections of the community.

Access to credit is an important issue for consumers. However, there is no point in enabling access to a service that simply exacerbates underlying disadvantage. It is often argued that consumers use small amount lending to pay for legitimate and necessary goods and services. Unfortunately, when a person has insufficient income or other resources to pay for an essential service, borrowing to pay for that item or service, results in even less income to cover essential goods and services in the future, as income is further diminished by the need to repay previous loans. This problem is increased manifold, if the amount to be repaid is considerably greater than the amount borrowed because of high fees and charges or interest. As expressed by one of the financial counsellors who submitted a case study for this submission, after noting that his client had taken out several loans in order to survive:

> *"Which is interesting because if you can't survive already then the impost of exorbitant repayments can only make that worse."*

[84] 'Feeding frenzy for sharks: the needy are the losers in the loan shark business', *The Courier-Mail*, Queensland, 10 July 2006.

CCLC submits that the right balance to allow this sector to continue to provide a product for which there is considerable demand is to:

1. Ensure that it is regulated by the UCCC along the lines of mainstream lending,
2. Control up-front costs via an interest rate cap inclusive of fees and charges,
3. Prohibit security being taken over essential household goods which would generally be protected in bankruptcy, and
4. Address the punitive default clauses either via unfair terms legislation, or via industry specific legislation enabling penalty charges to be challenged as unreasonable or excessive to address the lender's loss.

As argued in Section 4.6.2 above, CCLC is of the opinion that an effective interest-rate cap is the simplest and most cost-effective method of controlling cost. We accept that this will force some types of loan out of the market completely (such as very low amount, very short-term loans) as unprofitable. It is not the profit margin we are objecting to, but the effect on vulnerable borrowers. A different cap could perhaps be adopted for loans below a certain amount, to reflect the higher relative cost of providing this type of loan. This would be preferable to leaving cost completely unregulated, or left to be determined on a case-by-case basis. However, CCLC is strongly of the view that there should not be a different rule for the poor or vulnerable to the balance of the community who are able to rely on the 48% cap.

> *"I believe that these lenders may well have a place in the market but unfortunately they appeal to the vulnerable and the vulnerable are able to be taken advantage of. I would argue that they should be highly regulated, with legislation that forces them to lend under the UCCC… [a reference to wide-spread avoidance even in NSW] …and a lower cap than currently, although if they lent within the current cap the burden on the clients I see would be much less than it currently is."* -- Financial counsellor – South Western Sydney

5.7 Current legislative position in relation to unsustainable lending

The Honourable Faye Lo Po, then Minister for Consumer Affairs, in introducing UCCC into NSW Parliament in 1995 and in particular in relation to section 70(2)(l):

> *"It was clear that many borrowers were being offered credit they could not possibly repay, simply because the credit provider did not make adequate inquiries about a potential borrower's financial commitments, income and expenditure."*[85]

[85] Second Reading Speech, *Consumer Credit (NSW) Bill*, 23 May 1995. Available online: http://www.parliament.nsw.gov.au/prod/parliament/hansard.nsf/V3Key/LA19959523055

This is still the most serious problem faced by consumers today, with enormous potential cost to the entire community. There are two main reasons for this. The first is the inadequacy of the provision addressing sustainable lending in the UCCC itself and the second is widespread avoidance of the UCCC in the segments of the market which service those most in need of protection.

5.7.1 Sustainable lending and the UCCC

Despite the Minister's reference to unsustainable lending above, the only provision in the UCCC that directly addresses this problem is a sub-section of the unjust contracts provision:

Section 70 of the UCCC provides that the Court may reopen an unjust contract. Specifically, section 70(2) states that:

> (2) Matters to be considered by Court. In determining whether a term of a particular credit contract, mortgage or guarantee is unjust in the circumstances relating to it at the time it was entered into or changed, the Court is to have regard to the public interest and to all the circumstances of the case and may have regard to the following—
>
> …
>
> (l) whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider knew, or could have ascertained by reasonable inquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship …

This sub-section represents one factor in a shopping list of 15 factors to be taken in consideration by a court or tribunal in determining whether a particular loan contract is able to be re-opened on the grounds of unjustness. This means that there is no clear provision in the UCCC that specifies that a lender should consider a borrower's ability to repay a loan and no penalty for failing to do so. Further, while section 70 has been widely applied by the BFSO to assist borrowers and lenders to arrive at affordable negotiated outcomes, including loss of interest and fees and sometimes a reduction in the principle debt, the few court decisions that have been handed down have interpreted the section narrowly and/or applied a very limited remedy. The net result of this is that there is little incentive for lenders to ensure that borrowers have the capacity to pay.

In credit card lending reliance is placed on overall profitability of the portfolio, rather than the capacity of any particular borrower. While credit card lenders do take considerable trouble to avoid bad debts, such measures do not include ensuring that borrowers can pay off their debts within reasonable periods, or to taking steps to ensure that individual borrowers do not accept limit increases which are disproportionate to their capacity to pay. In some cases, even credit card lenders appear to rely on the fact that the borrower owns real property rather make a proper assessment of capacity to pay.

In secured lending, competition has led to a relaxation of lending standards including:

- Less scrutiny of valuations;
- High reliance on third parties to originate loans/introduce business;
- Acceptance of a range of income sources for borrowers that would have previously been considered insecure;
- Higher loan-to-valuation ratios;
- Low documentation lending;
- Sub-prime lending (lending to those borrower who do not meet the lending criteria of mainstream or prime lenders, usually because they have been default listed or have too many other debts to be considered an acceptable risk at mainstream prices).

Research released by APRA in June 2007[86] found evidence of deteriorating lending standards among ADIs including: only five of forty-seven lenders compared to about half of those surveyed in 1998 used the 30% of income for repayments rule, others preferring net income surplus models, some of which estimated the amount required for day-to-day expenses at below the poverty level; 5% of loans were for more than 95% of the value of the security property, compared to 1% in 2002-03; about half the lenders surveyed offered riskier “low-doc” loans which allow borrower to self-certify their income, representing 10% of all home loans by value. These findings prompted warnings to lenders from the APRA Chairman, John Laker. CCLC notes that while we have seen examples of these practices among clients who have ADI loans, the larger proportion of our clients with problematic loans have borrowed from the sector that is not supervised by APRA and not subject to this level of scrutiny.

Low documentation lending in particular has stretched the UCCC to its limit. It is unlikely that when the legislators inserted the phrase “reasonable enquiry of the debtor” into the UCCC that they intended for lenders to simply ask borrowers to sign a form indicating that they earn a certain level of income. Even less likely that the legislators envisaged that borrowers would be guided in completing this form by a broker who advised them how much they “should” earn to obtain a particular loan rather than how much they actually earn. It is far more likely the designers of the UCCC had a more rigorous line of questioning such as how much do you earn, from what sources, what are you other commitments and how can you verify any of this information.

Lenders who rely on the borrower’s assets alone to lend, and structure their products to ensure that they are able to recover both the principle debt, significant up-front fees, interest and default charges from the borrower’s equity, take no real risk and have no incentive to lend sustainably apart from any limitation provided by law. The current law has proven a very ineffective deterrent. Further, there is a contagion of deterioration in lending standards that has begun to affect the mainstream.

[86] Reported by Washington,S, “Banks throw out loans rule book”, Sydney Morning Herald, 23 June 2007, http://www.smh.com.au/news/business/banks-throw-out-loans-rulebook/2007/06/22/1182019375951.html

5.7.2 Avoidance of the UCCC

Avoidance of the UCCC is the other main reason for its ineffectiveness. As a service that specialises in consumer lending, CCLC would expect to be making representations about breaches of the UCCC. A significant proportion of CCLC's casework and advice, however, involves loans that are ostensibly outside the scope of the UCCC.

There are three main methods of avoidance:

- Business purpose declarations (common in both secured lending, motor vehicle lending and small amount lending);
- Promissory Notes (particularly in small amount lending); and
- Bills of Exchange (particularly in small amount lending).

Small amount lenders in NSW, for example, have taken one of three approaches to the all-inclusive cap on the cost of credit in NSW, including continuing to breach the cap and risking enforcement action, moving to structure their loans to comply with the cap or avoiding the cap by one of the above three approaches. Of the loans described in Section 5.6.5 above, only one complied with the cap. The degree of avoidance is exacerbated by systemic avoidance by one large multi-branch, high profile lender.

There is also a group of lenders in NSW who are known as lenders of last resort among brokers and who lend solely on the basis of the borrower's assets, including the family home (See section 5.6.4 above). As a general rule such lenders rely on false business purposes declarations obtained by intermediaries such as brokers.

There has been very little enforcement under the UCCC for any reason, including systemic avoidance. Whether this has been due to a lack of resources, other priorities, or a lack of clear powers is a question that would be better answered by the state regulators. The opportunity for avoidance, however, has been created by the narrow scope of the legislation and its various exceptions. While the state regulators have been examining options for closing these loop-holes, CCLC submits that the most comprehensive answer to wide-spread avoidance is to extend the coverage of the Code to cover small business and investment, to make applicability of any part thereof dependant on the objective purpose of the loan (actual use of the funds) rather than the knowledge of the lender or the intention of the borrower. At the very least, any attempt to plug the loop-holes in the current regime should be accompanied by anti-avoidance provisions to allow regulators to take action in the event of further innovation on the part of lenders aimed at avoiding the law.

5.7.3 Borrowers should borrow responsibly (paternalism versus empowerment)?

This is somewhat of a moot point in relation to credit. Clearly borrowers should take care to borrow only as much as they can repay, and many, perhaps even the majority (50% or more) do so. The cases and statistics above, however, demonstrate that there are a significant number of borrowers, from a range of social and educational backgrounds, who have, often inadvertently, exceeded their personal capacity to pay, or at least placed themselves in a position where repayment has become exceedingly difficult.

There are a number of reasons why this may occur and why borrowers are often not in a good position to assess their ability to pay:

- Some borrowers simply do not have the mathematical skills to accurately make this assessment;
- Some borrowers are overly optimistic about their future potential income, about their job stability, and about their ability to live within a given budget (in particular they do not allow sufficient funds for irregular events such as car repairs or emergency travel);
- Borrowers tend to underestimate the likelihood of events which may adversely affect their ability to pay;
- Repayment is often more difficult than anticipated, particularly if credit is being used for day-to-day expenses as a result of inadequate income;
- Borrowers may be sufficiently committed to a particular purchase or course of action to exclude the possibility of making an assessment of their ability to pay dispassionately;
- Borrowers accept a higher limit than they can comfortably repay "just in case of an emergency" and then find that their debt slowly creeps towards the limit simply because it is available;
- Borrowers may realise that they are already in too deep, but accept offers of further credit to meet their immediate cash flow problems and to delay the frightening consequences of their true financial position (sometimes in the hope that things will somehow improve if they can just buy some more time).

If it accepted that "responsible" borrowers will not borrow more than they can afford to repay, then legislative measures aimed at ensuring borrowers have the capacity to pay a loan, at least at the point of its origination, will not impinge on the freedom of consumers who have no need of the imposition of external limits.

5.8 Regulating for sustainable lending

There is no single solution to the problems described above. There is no perfect formula for lending and borrowers will always be subject to unforeseen events that affect their ability to pay.

Sustainable, affordable borrowing stimulates economic activity. Unsustainable borrowing ties up income in loan repayments, suppresses economic activity and eventually leads to bad debts, which can have a ripple effect through the community. Some forms of unsustainable borrowing are even more dangerous, driving up asset prices without any real underlying cause and intensifying cycles of boom and bust.

One of the reasons that lenders in the mainstream market give for not taking further steps to investigate ability to repay is costs, and the fact that these costs will be passed on to all consumers. CCLC submits that the costs in terms of default in this area have perhaps been underestimated and that these costs will also be passed on to all consumers, and the community as a whole. On the other hand, we suggest that it is unnecessary for the legislature to prescribe the process by which proper credit assessment should be done, only that it stipulate that it must be done and impose serious consequences for the credit provider and useful remedies for the debtor when it is not. Further, such an obligation should be absolute and not referenced to general standards in the marketplace, as this creates a situation whereby competition places downward pressure on lending standards, which in turn reduces the standard at law. This would be a very unsatisfactory outcome.

One of the limitations of the current approach is that the courts have not been prepared to forgive any part of the principle debt where the borrower has received a benefit. While this line of authority has a sound base in the principles of unjust enrichment, the result is that the remedy for borrowers is usually inadequate to prevent the loss of their home and/or bankruptcy.[87] Further, these authorities have failed to have a significant deterrent effect, with lenders confident that court challenges will be rare and will not involve the loss of the principle amount lent when they do occur. CCLC advocates that a stand-alone provision requiring lenders to assess the capacity of borrowers to repay their loans is warranted, with penalties for non-compliance and remedies for borrowers, including the possibility of a reduction in the principle debt.

CCLC recognises, however, that the above recommendation could have serious ramifications for investors and depositors, depending on the size of the debts concerned and whether there is a security property that could be sold to realise a debt that would otherwise not be paid. As a result, CCLC accepts that the power to reduce a principle debt would need to be couched fairly narrowly. It is not in the public interest that borrowers are too easily forgiven their debts.[88] On the other hand, unsustainable lending

[87] The BFSO has circumnavigated this problem in unsecured lending, mainly in relation to credit cards, by convincing the banks of the efficacy of accepting a reduced debt with a repayment arrangement over bankruptcy.

[88] It is, however, in the public interest that bankruptcy is an option available to those debtors who need it and that troubled debtors who have some hope of financial recovery are given a reasonable opportunity to pay their debts rather than be forced into selling their asset at a fire sale or entering voluntary bankruptcy. This is another important theme about responding to financial hardship, which is very topical at present but

is not in the public interest and prevention needs to be key. For this reason we argue that lenders should also be licensed, with the licensing authority empowered to revoke a license in situation where lenders are found to systemically flout the law, including in relation to sustainable lending. Loans extended by unlicensed lenders should be unenforceable.

Licensing all lenders, including subjecting them to compulsory standards in relation to IDR and to belong to ASIC approved EDR, would also make for a more level playing field for industry, and ensure equal rights and access to justice for consumers regardless of their choice of lender. Currently, consumers have little hope of appreciating the differences between the different types of lender and their different levels of regulation until it is too late:

> *"I didn't realize home lenders were so different from each other. I was only behind by one and a half payments and [the lender] took court action. A bank would not have done that. People ought to be warned about that."(Consumer Borrower – CCLC Refinance Survey for ASIC)*

Further, while it may be beyond the scope of this review to recommend the extension of financial system oversight from a stability perspective, CCLC is of the view that APRA should be empowered in the interests of the broader economy to have oversight of non-bank lenders in addition to ADIs.

While licensing is a cumbersome and invasive form of regulation, inclined to favour established industry providers at the expense of new competitors, this is an area in which we would argue this step is justifiable for the following reasons:

- The risks to the individuals concerned are significant, and in the case of home lending, likely to have lifelong ramifications;
- The risks to the economy are serious;
- The risks to government and the community who have to foot the bill of depression, family breakdown, and in extreme cases, homelessness are high; and
- With ADI lenders already required to be licensed, credit intermediaries likely to be required to be licensed at some point in the next two-three years, it makes sense to close the loop and bring in the remaining section of the lending sector, to create a level playing field for lenders and equal rights for consumers regardless of their choice of lender.

CCLC therefore proposes a multi-pronged approach to the problem of unsustainable lending and predatory market behaviour including:

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has not been covered in this submission, and yet would be greatly assisted by such measures as extending compulsory EDR.

- Creating a stand-alone obligation in the ASIC act (or the UCCC or it successor) to have regard to the borrowers ability to repay a debt without substantial hardship with penalties in the case of a breach of the provision;
- Giving clear power to the courts and tribunals to relieve a debtor of not only fees, charges and interest, but also part of the principle debt in appropriate cases;
- Instituting a comprehensive licensing regime for creditors, with the power to exclude players from the market for systemic breaches of the relevant legislative provisions; and
- Extending the role of APRA to supervise lenders that are not Authorised Deposit Taking Institutions.