Credit
Ombudsman
Service

Financial Services and Credit Reform Green Paper, June 2008

Submission by
Credit Ombudsman Service Limited

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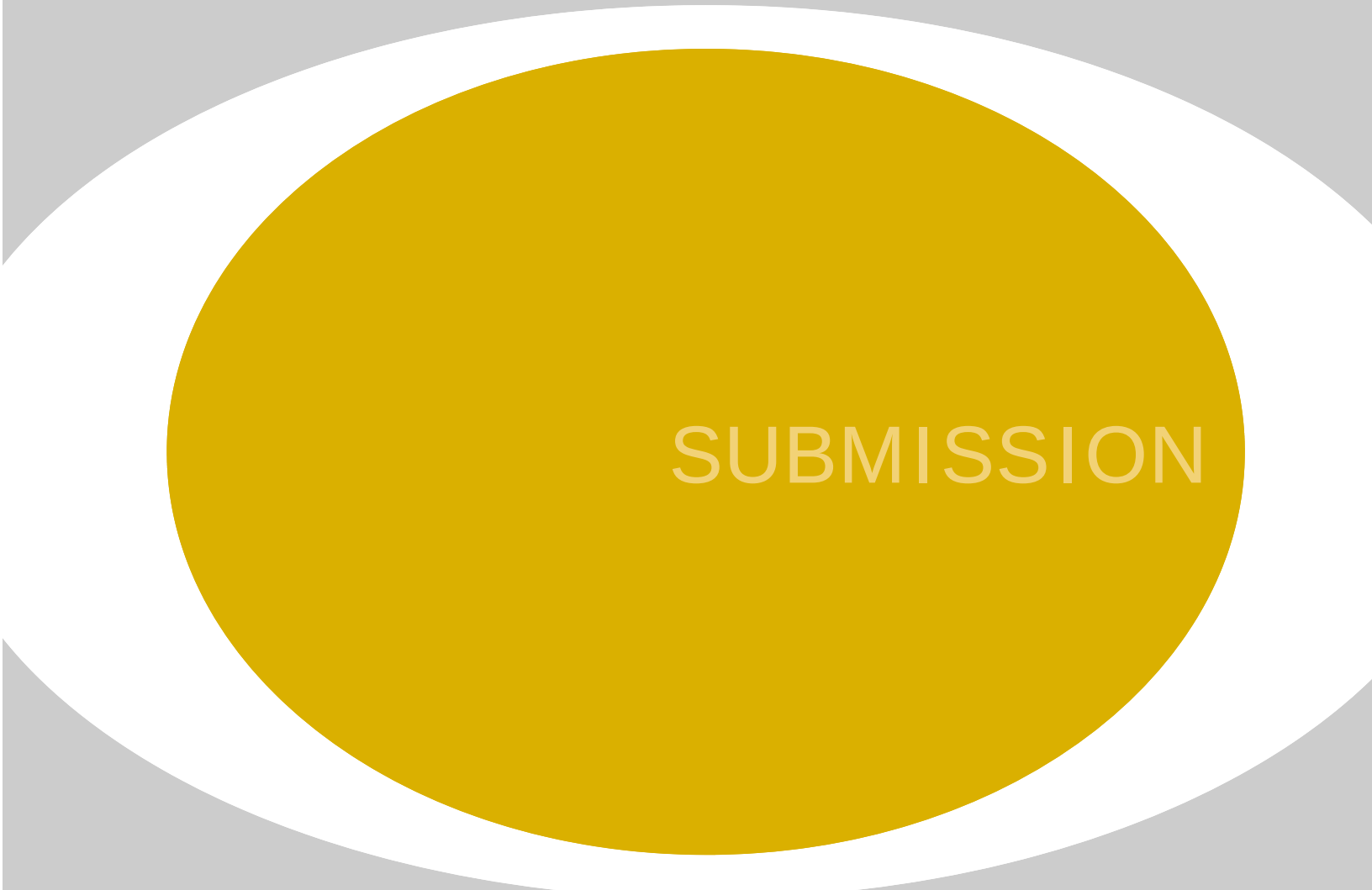

1. Our organisation

COSL is an external dispute resolution (EDR) scheme approved by the Australian Securities and Investments Commission (ASIC).

As a condition of ASIC's approval, COSL is required to meet the stringent conditions prescribed by ASIC's Regulatory Guide 139.

COSL is a not-for-profit company. It is required to be impartial, accessible and independent, as well as absolutely free of charge to consumers. It provides consumers with an alternative to legal proceedings for resolving disputes with its members.

The key objects of COSL are to:

(a) act as the primary complaints resolution body for the credit industry; and

(b) ensure the timely, efficient and effective resolution of complaints against members, having regard to the criteria of relevant legal requirements, recognised industry Codes of Practice, good practice in the credit industry, and fairness in all circumstances.

Importantly, COSL is able to award compensation in an amount of up to $250,000 for loss. It is also able to make orders compelling a member to do or refrain from doing specified acts.

COSL's membership comprises mainly mortgage brokers[1], but also mortgage originators, non-bank lenders, aggregators and mortgage managers.

The overwhelming majority of mortgage brokers in Australia are either members of COSL or loan writers for whom COSL members have assumed responsibility.

[1] The expression 'mortgage broker' in this submission refers also to finance brokers

Importantly, about 36% of all home loans written in Australia are written by members of COSL or their loan writers.

COSL's membership now stands at about 8,500 members, and covers about 16,000 (non-member) loan writers. COSL's strategic aim is to expand its coverage in the credit industry and so provide more consumers with further access to an EDR process.

An estimated 75% of loan writers who would not otherwise be covered by an ASIC-approved EDR scheme are covered by COSL, and this benefits consumers enormously.

About 95% of enquiries and complaints received by COSL are resolved by non-adjudicative means, that is, by conciliation, although the Credit Ombudsman does exercise his power to make Determinations, the terms of which are then published on its website.[2]

Like all ASIC RG139 approved schemes, Determinations made by the Credit Ombudsman bind members but not consumers. COSL's services are funded by a combination of membership fees and complaint fees paid by its members. It is free for consumers and is controlled by a Board with equal representation from industry and consumer organisations and an independent chair.

2. This submission

Given the nature its membership, COSL is in a unique position to comment on the regulation of mortgage providers, mortgage brokers and non-mortgage credit providers.

Consequently, this submission will only canvass issues raised in Chapters 1 and 6 of the Green Paper.

[2] www.creditombudsman.com.au

3. Transfer of credit regulation to the Commonwealth

3.1 Regulation of credit under present laws

Currently the States and Territories regulate consumer credit products and lending through the Uniform Consumer Credit Code (UCCC) and, in some jurisdictions, consumer credit providers through different licensing regimes. Only some States and Territories regulate mortgage brokers and they do this differently. Commonwealth regulation of financial services providers under the Corporations Act largely excludes credit facilities, but the ASIC Act provides general consumer protection rules which cover credit.

3.2 Productivity Commission Report

The Productivity Commission in its recent Report[3] on a consumer policy framework recommended transferring responsibility for regulating *all* consumer credit to the Commonwealth Government. The new regime would:

- cover all credit products and intermediary services (including broking services and the provision of advice)
- include a national licensing system for finance brokers and a licensing or registration system for credit providers, both of which would be required to join an approved external dispute resolution scheme, and
- re-enact the UCCC as Commonwealth law, to operate independently within the broader financial services regulatory regime.

3.3 Green Paper Options

Three options are canvassed in the Green Paper:

- Option 1: Maintain the status quo (which in the face of the COAG agreement and the problems identified is unlikely);

[3] http://www.pc.gov.au/inquiry/consumer/docs/finalreport

- Option 2: The Federal Government regulate all credit - this would achieve uniformity and a single regulator but, according to the Green paper, there would be significant transitional and ongoing costs for both the Government and businesses; or
- Option 3: The Federal Government to regulate all aspects of mortgage credit (mortgage lenders and brokers and mortgage advice), but not bank fees or charges, leaving the States and Territories with responsibility for all other consumer credit except margin loans.

3.4 COSL's preferred position

COSL calls for the transfer of all consumer credit regulation to the Commonwealth so as to achieve a horizontal and vertical integration of regulation in this market (ie. Option 2).

3.5 National Market

As discussed in Chapter 1 of the Green Paper, the market for consumer credit is now national with almost all residential mortgage providers, both those which are authorised deposit-taking institutions and those that are not, serving all States and Territories.

Option 3 of the Green Paper canvasses the possibility of only mortgage credit being transferred to the Commonwealth and other types of consumer credit, including pay day lending and motor vehicle finance, being retained by the States. This will exacerbate vertical fracturing of regulation of the consumer credit market. This option assumes, falsely, that these other types of consumer credit are never mixed in the same transaction with residential mortgages. They often are.

Also, a transaction may start out as being unsecured but may become a complete refinance of a residential mortgage. Under the "partial" transfer option, the transition from unsecured to secured consumer credit would mean shifting between substantially different regulatory regimes. This is anti-competitive, inefficient and unlikely to produce positive outcomes for consumers.

As to brokers, while individual loan writers are, of course, likely to be geographically based, they are also very likely to be working for a franchise, originator or brokerage operating in several States. Many complaints to COSL about the conduct of brokers, require a response from a COSL member who is not in the same State as the complainant.

Further, COSL provides EDR services to the vast majority of mortgage brokers in Australia. The EDR market, therefore, for mortgage broking is national and serviced chiefly by one national provider, COSL. While not axiomatic, it is sensible, that regulation of this industry also be on a national basis.

Further, if consumer credit is regulated nationally then the financial intermediaries who operate in the consumer credit market should also be regulated nationally.

Option 2 of the Green Paper should be the preferred position of the Commonwealth and of the States; namely, that the Commonwealth take over regulation of all forms of consumer credit.

4 Draft Finance Broking Bill

COSL submits that the Commonwealth adopt, largely, the *National Finance Broking Bill*[4] produced by the NSW Government in November of 2007 ("the Draft Finance Broking Bill") as its model for regulation of the finance and mortgage broking market.

4.1 Industry Support

The NSW Government was assigned the task of conducting consultations and drafting national finance broking legislation by the Ministerial Council for Consumer Affairs ("MCCA").

[4] NSW Office of Fair Trading, November 2007 National Finance Broking Scheme Consultation Package

It received more than 100 submissions from key stakeholders on the bill before producing the final Draft Finance Broking Bill. The process has taken over two years and the industry representatives, with whom COSL has a close working relationship, have come a long way in their support for most of these regulatory proposals.

To abandon this work and "start again" runs the risk of losing this support which is necessary for the success of any co-regulatory process.

4.2 Key Features of the Draft Finance Broking Bill

The Bill provides, among other things, that:

(a) a broker must be licensed and:

(i) undergo probity checks;

(ii) meet prescribed educational qualifications or skills;

(iii) join an approved EDR scheme; and

(iv) hold professional indemnity insurance;

(b) a representative of a broker must also join an approved EDR scheme;

(c) the licensed broker is liable for the conduct of their representative as if the conduct were its own (draft clause 28(1))

(d) a broker must have a reasonable basis for any recommendation. Specifically, clause 33 specifies that:

> *"…it is the broker who is responsible for ascertaining the consumer's credit needs and for determining whether the consumer has the capacity to repay a loan that satisfies those needs."*

The Draft Finance Broking Bill also addresses conflict of interest issues, including that brokers disclose: the names of the credit providers through which they can access credit; all costs that the consumer will be liable for; and commissions received from lenders.

The Bill also covers small business operators, so as to prevent brokers restructuring their activities to avoid regulation, (although business credit would be subject to different requirements that more closely reflected business needs).

Clearly, the Draft Finance Broking Bill represents significant advances for consumers in their dealings with financial intermediaries in credit. The Productivity Commission referred favourably to its provisions and it calls for a national licensing scheme for finance brokers as well as credit providers.[5]

Finance and mortgage broking should be regulated by the Commonwealth incorporating the draft *National Finance Broking Bill* produced by the NSW Government in November of 2007.

5. FSR template is not appropriate

It appears from the Green Paper that Option 3 (and presumably also Option 2) would roll mortgage credit regulation into the FSR regime in Chapter 7 of the Corporations Act, meaning that credit providers (ADIs and non-ADIs) and mortgage brokers would be subject to the AFSL licensing regime and the product disclosure and financial advice disclosure requirements.

COSL opposes any suggestion that credit law should somehow be "squeezed' into Chapter 7 of the Corporations Act. This regime, although nominally directed at "financial services" is exclusively for deposit taking, investment and advice on investment. It is no accident that the FSR regime expressly excludes credit.

Consumer credit is a very distinct area of consumer law. Likewise, finance and mortgage broking are very different from investment advising and financial planning. While ASIC may be the appropriate agency to administer consumer credit law for the Commonwealth, it does not follow that it should do so through the same legislative framework as it administers other financial services.

[5] Productivity Commission, Review of Australia's Consumer Policy Framework (2008) vol 2, pp 451- 453

6. Mandatory EDR

6.1 Credit providers

At present, only credit providers who are authorised deposit-taking institutions ("ADIs), and so require an AFS licence, and credit providers who are non-ADI members of the Mortgage and Finance Association of Australia ("MFAA") are required to be members of an approved EDR scheme.

Accordingly, credit providers that are neither holders of an AFS licence nor members of the MFAA are under no obligation to join an approved EDR scheme.

The absence of EDR coverage for these types of lenders represents a gaping hole in the coverage, and therefore the effectiveness, of the consumer dispute resolution regime in Australia.

It is interesting to note that more than ten years ago in the Financial Systems Inquiry Final Report, the Wallis Commission recommended that coverage of dispute resolution schemes should be broader.

Specifically, the Wallis Report said there should be "the creation of a nationally uniform dispute resolution scheme for finance companies."[6] Ten years on, finance companies are still not required to join an approved EDR scheme.

A very few, such as GE Money, have voluntarily joined the BFSO (soon to be merged in the Financial Ombudsman Service – FOS), but most have not. Some of the reasons for this may be:

- fear of being "submerged" in a large institution dominated by banks;
- a lack of a cultural and operational "fit" between banks and finance companies; or
- avoiding the issue because it is not a legislative compliance requirement.

[6] Financial Systems Inquiry Final Report, 1997, www.fsi.treasury.gov.au/content/Final Report/Recommendation

In terms of fringe credit providers, COSL's own experience accords with that of the Consumer Credit Legal Centre (NSW); that is, that there is a small group of credit providers, brokers, and associated parties such as solicitors and accountants, who participate in what it refers to as "predatory lending".[7]

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.

In terms of "pay day" lenders, the Consumer Law Centre (ACT) cites an example of a client of their service who presented with several credit contracts and a promissory note with various pay-day lenders in South Australia[8]. The interest rates applied ranged from 230% to 855%, plus additional fees and charges. (The same contracts in the ACT would have been illegal and may have resulted in the revocation of the credit provider's license.)

The new credit regime should include a national licensing system for both credit providers. One of the conditions of the licence should be a requirement that the licensee join an ASIC-approved external dispute resolution scheme.

6.2 Brokers

COSL is particularly supportive of the mandatory requirement in the Draft Finance Broking Bill for brokers to be licensed and to join an approved EDR scheme.[9]

In contrast, we note that there is only a passing reference in the Green Paper to a national approach requiring coverage by dispute resolution schemes for consumers.[10]

[7] http://www.pc.gov.au/inquiry/consumer/subs/sub095.pdf at page 7.
[8] http://www.carefcs.org/srcfiles/CLCSubPCReviewMay07%2Epdf
[9] See N 4 above pp 8-9 Clauses 9 and 11

It is, of course, a standard condition of an AFS licence that the licensee belongs to an approved EDR scheme to resolve consumer complaints,[11] and we assume that the proposed Commonwealth regime for credit will also require a licensee to be a member of an approved EDR scheme (notwithstanding that credit is not rolled into the FSR regime, as we submit it should not).

The existing exemptions in the NSW Consumer Credit Administrative Act in relation to mortgage managers and 'white label' brokers should not be adopted by the Commonwealth credit regime, so that the licensing framework and consumer remedies will apply to both these entities.

Certainly, the stated intention of the Draft Finance Broker Bill was to cover "all types of broking structures …: mortgage brokers, finance brokers, single line broking and single mobile operators, as well as aggregators and franchised organisations."[12]

It has since been acknowledged that the "intermediary exemption" in clause 3 in Schedule 1 of the Draft Bill was drafted too widely and inadvertently exempted from the application of the entire Draft Bill (not just the relevant provisions in Part 3):

- mortgage managers who do not deal directly with the consumer;
- trust servicers of securitisation programmes; and
- aggregators.

The drafters of the Commonwealth credit legislation should be mindful of this when taking into account the provisions of the Draft Finance Brokers Bill.

Indeed, it is quite common, for example, for a broker firm to arrange a loan for a borrower and then assume the role of a mortgage manager of that loan after settlement[13].

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[10] Some specific reference is made about the intention of the new legislation to develop more cost effective and timely dispute resolution procedures, but only for trustee corporations.
[11] Sections 912A(1)(g) and section 912A(2)(b) Corporations Act
[12] See "'Overview of Legislation' and 'Invitation to Comment' issued by the NSW Government in relation to the Draft Finance Broking Bill.
[13] As a broker, a person is generally treated as an agent for the borrower and owes corresponding duties to the borrower (normally fiduciary, unless the scope of the duty is limited by the scope of the engagement). As a mortgage manager, the person is an agent for the credit provider and will only owe the borrower such duties, if any, as may arise in the particular facts of the case.

COSL is of the view that up-the-line intermediaries should not be exempted from broader licensing requirements. Otherwise, the ability of the licensing authority and approved EDR schemes to provide an effective remedy for the consumer may be seriously compromised.

COSL submits that mandated membership for all brokers of an approved EDR scheme will address many of the access to justice issues facing consumers of credit and investment schemes.

Mandate finance brokers to join an external dispute resolution scheme approved by ASIC under its Regulatory Guide 139

6.3 Representatives of brokers

The FSR regime only requires an AFS licence holder, not its authorised representative, to be a member of an ASIC-approved EDR scheme.

We submit that the proposed Commonwealth regime should require representatives of brokers to individually join an approved EDR scheme for the following reasons:

(a) The FSR regime provides a mechanism for sheeting liability for the conduct of an authorised representative to the licensee.[14] Similarly, the Draft Finance Brokers Bill provides a mechanism for attributing liability to the licensee for the conduct of their representative.[15]

However, both these provisions also allow a licensee to avoid liability for the conduct of its representative where the consumer could not reasonably have expected to have relied on, and did not in fact rely on, that conduct.[16] This has the effect of shifting focus away from the conduct of the representative that caused the loss.

[14] Div 6 of Part 7.6 of Chapter 7 of Corporations Act
[15] Clause 28 Draft Finance Brokers Bill
16 Section 917A(1)(b) and (c) Corporations Act and clause 28 Draft Finance Brokers Bill

If a representative of a broker was required to be licensed or to join an ASIC-approved EDR scheme, the representative would be liable for its own conduct. This would not preclude the possibility of making the licensee broker also liable for its representative's conduct[17] if it was intended that "deeper pockets" should be available for consumer redress.

(b) Furthermore, neither section 917A Corporations Act nor clause 28 Draft Finance Brokers Bill address the liability of a representative other than for compensable conduct.[18]

The terms of reference of an ASIC-approved EDR scheme, on the other hand, allow the EDR scheme to consider complaints about conduct extending beyond compensable conduct. That is to say, an EDR scheme is not limited to compensating a consumer for loss occasioned by a breach of financial services laws[19]. It may also consider and conciliate complaints, and award compensation, for loss suffered by a consumer as a result of contraventions of other laws, industry codes of practice; good industry practice and general fairness principles.

(c) The regime for financial planners under the FSR regime allows for multiple "authorised representatives" of a licensee with only the licensee being required to hold membership of an approved EDR scheme. This frequently results, for instance, in complaints to the Financial Industry Complaints Service (soon to be part of the Financial Ombudsman Service) being bogged down in disputes over whether the person whose conduct is in question was an authorised representative of the respondent member at the relevant times.

(d) COSL has encountered several cases where a representative (eg. a loan writer or contractor) severs ties with his principal broker and the principal broker is then left to deal with a complaint made against the representative.

17 either on agency principles, on the basis of vicarious liability or a specific legislative enactment
18 Compensable conduct is conduct which breaches a relevant legislative provision and causes a pecuniary loss to the consumer
19 "financial services laws" refer to certain provisions of the Corporations Act, the ASIC Act and other Commonwealth, State or Territory legislation that covers conduct relating to the provision of financial services, but only in so far as it covers conduct relating to the provision of financial services – section 761A Corporations Act

In these circumstances, the principal broker is generally unable to deal with the complaint effectively because, for example, it cannot compel the representative to provide a response or relevant documents pertinent to the complaint or its account of the events. Simply making the principal broker responsible for the conduct of its representative in these circumstances would unnecessarily penalise the broker and not generally assist a consumer in obtaining redress (given the consumer may be unable to make out its case without the representative's co-operation).

(e) If mandatory membership of an approved EDR scheme for representatives was prescribed, there would be no need for a consumer to enquire into whether the conduct of the representative:

(i) was authorised by the licensee broker (in which case, the broker may be liable for loss caused by the representative's conduct); or

(ii) was not authorised by the licensee broker (in which case, the broker may escape liability).

If the representative was a member of an approved EDR scheme in its own right, the representative would be liable for its own conduct and the consumer would not need to concern itself as to the scope of the representative's authority.

(f) COSL presently holds information about representatives of each COSL member. This enables us to have a multi-dimensional view of a representative, such as their previous dealings with COSL, the principals for whom they have acted previously, and the number and nature of complaints made against them both in their current role and in their previous roles.

This is particularly important as it allow us to identify systemic issues by checking if the representative against whom a complaint is made has in the past received the same or similar type of complaints, and whether these were made against the representative in a different capacity (broker, mortgage manager or originator), or while the representative acted as a director, contractor, loan writer or broker of another entity.

A requirement that a representative must be a member of an approved EDR scheme will facilitate the reporting of systemic breaches and afford the regulator an insight into the representative's previous conduct in different roles and capacities. This would not otherwise be available.

(g) In certain circumstances, it is not realistic to expect a broker to willingly address a complaint against the conduct of its representative where:

(i) the broker and the representative have had a falling out, such that the broker wants nothing to do with the representative and refuses to accept a complaint brought against the representative; and

(ii) the representative ceases to trade; leaves the broker and becomes a representative of, or contractor for, another broker; or acts for other brokers as well and it is unclear under whose authority the represented acted. In each of these cases, the broker, in our experience, would normally be unwilling to accept a complaint made against the representative.

In such circumstances, a consumer's ability to seek effective redress can only be assured if the representative is a member of an approved EDR scheme.

It is most significant that the Draft Finance Broking Bill requires representatives of broker licensees to be individually members of an approved EDR scheme.[20]

We consider that the proposed Commonwealth regime should also require representatives of brokers to become members of an approved EDR scheme in their own right.

All representatives of brokers should be required to be members of an ASIC- approved external dispute resolution scheme.

[20] Clause 23 of the Draft Finance Broking Bill

7. The Uniform Consumer Credit Code ("the UCCC")

7.1 Adopt the UCCC

It is almost trite to comment that in assuming regulation of consumer credit, the Commonwealth should adopt the UCCC. The legislation was the result of a process commenced with the Credit Acts in the early 1980's and which culminated in the Uniform Credit Laws Agreement of 1993 and the Code itself in 1994.

We note that the Green Paper does not discuss whether the other substantive regulation of credit in the UCCC (eg. advertising restrictions, enforcement, comparison rates, re-opening of contracts) would carry across into Commonwealth law as the Productivity Commission recommended (either for all consumer credit under Option 2 or for mortgage credit under Option 3).

The Uniform Consumer Credit Code should become Commonwealth legislation to be administered by Commonwealth agencies.

7.2 Continued reform of the UCCC

As noted in the Green Paper, the Productivity Commission has been critical of the pace of reform and amendment of the UCCCC and the complexity of obtaining agreement between the States through the MCCA process dictated by the Uniform Credit Laws Agreement.[21] It is conceded that after the Post-Implementation Review and National Competition Policy Review Reports into the UCCC in 1999 and 2001, respectively, there was a "hiatus" in any legislative or regulatory review of the UCCC until 2005.

[21] N 5 above, p 450

What the Green Paper did not address, but was noted by the Productivity Commission in its report, is the significant number of reforms being advanced through this process since then.

These include:

- Mandatory Comparison Rates, both their introduction and review;
- Promissory Notes are no longer a "loophole" used by fringe lenders
- Pay day lenders using the short term loan exemption are now caught by the Code
- Instalment contracts (particularly those for land) are now clearly caught by the Code
- Business purpose declaration loopholes have been closed to prevent lenders escaping Code regulation
- The Pawnbroker exemption has been narrowed
- Lenders can no longer take "black mail" security over household goods which would be normally exempt from bankruptcy or enforcement of judgements
- Responsible lending is being investigated
- A new prescribed information statement about Reverse Mortgages is being developed.
- A new pre-contractual disclosure regime has been proposed.

COSL is concerned that the progress made in updating and reforming the UCCC in the last few years is continued and not delayed or abandoned in any transfer to the Commonwealth.

Existing processes of reform of the Uniform Consumer Credit Code should be completed as part of the transfer of credit laws to the Commonwealth.

All non-uniform matters between the States, under the Uniform Consumer Credit Code, should be standardised under the new consolidated Commonwealth Code.