Submission in response to the Treasury Green Paper on Financial Services and Credit Reform

July 2008

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Introduction

CHOICE welcomes the Commonwealth Government's Green Paper on Financial Services and Credit Reform. It responds to a range of financial service issues that were either not adequately resolved in previous financial services reforms or which have arisen since. Some issues have also become more pressing with changes in the market. CHOICE strongly supports the Commonwealth taking action on these matters. However, we do not support the preferred option for the regulation of credit.

The Productivity Commission, in its May 2008 *Report on Australia's Consumer Policy Framework*[1] recommended that the Commonwealth take responsibility for all consumer credit. This approach would have clear advantages to consumers, businesses and regulatory authorities.

The Green Paper departs from the Productivity Commission's recommendation. It proposes a split in credit regulation between different levels of government. If this proposal is adopted, mortgage credit will be regulated by the Commonwealth Government but other forms of credit, including personal loans and credit cards, would remain with the State governments. We believe that this is undesirable and may not be possible.

The Green Paper misconceives the nature of the market problems with consumer credit and relies on a partial and selective consideration of the relevant data. Based on this incorrect analysis the Green Paper fails to adequately consider the consequences of policy options. If implemented, CHOICE believes the preferred proposal would create regulatory duplication and uncertainty with significant costs for consumers and business.

Key Points

CHOICE welcomes the release of this Green Paper and supports action to respond to the various problems identified in the paper.

In particular CHOICE believes that Commonwealth regulation of consumer credit products and non deposit taking institutions is long overdue.

[1] Productivity Commission *Review of Australia's Consumer Policy Framework* Volume 2 Chapters and Appendixes No 45 20 April 2008. Hereinafter refer to as Productivity Commission *Report.*

CHOICE also welcomes the proposals to improve the regulation of debentures and lending for investment purposes.

We are however extremely concerned about the possibility that mortgage credit and mortgage broking would be regulated separately to other forms of consumer credit. This would increase the regulatory burdens faced by financial service providers. Australian consumers would end up paying for two compliance regimes. It would also significantly undermine consumer protection. Consumers will not receive the benefits of a single national market on the most common form of credit – credit cards. Credit cards are the biggest category of disputes about consumer credit contracts handled by the Banking and Financial Services Ombudsman – and yet they would not be included in the Commonwealth law. Many consumers obtain credit cards as part of a package from their bank or credit union when they purchase a mortgage. In this instance two forms of closely linked credit would be regulated by different levels of government.

The proposed dual regulation model would present opportunities for regulatory arbitrage. It would create uncertainty as to which laws applied to particular existing or future products.

The Green Paper assumes that because mortgage credit has a greater market share (by value) consumer protection for mortgage lending is of more consequence to consumers than other forms of credit. However, there are many more contracts for non-mortgage forms of credit. Non-mortgage credit is also the cause of more credit defaults.

If the Commonwealth is to regulate consumer credit (as it should) then it must regulate all consumer credit products. The Commonwealth should adopt the approach set out in the Productivity Commission Report (Recommendation 5.2 and text at pp 105-107).

In developing a national regulatory system for consumer credit, the following matters need to be considered.

1. *Adequate dispute resolution arrangements.*

In addition to providing consumers with access to redress that is currently denied many, a good dispute resolution system will reduce the burden on the regulatory agency or agencies responsible for enforcement and compliance. An adequate dispute resolution system requires effective external dispute resolution (EDR) - for example, mandated membership of the Financial Ombudsman Service - adequate access to information, general advice, financial counselling and legal advice, and access to a tribunal or court with specialist knowledge and the power to making binding decisions in complex matters.

2. Enforcement of national credit regulation

Ultimately ASIC should take the role of primary regulator. It is important to note that ASIC already has a track record of enforcement on credit matters under the ASIC Act The potential problems that ASIC may face in taking a broader role in credit enforcement are less significant than might be suggested. There may be a role for parallel State enforcement for 3-5 years while ASIC recruits and trains staff and develops systems.

3. Policy development

The regulation of credit will be a new policy activity for the Commonwealth Treasury. It will take time for it to build relevant experience to undertake quality policy development in this area. There may be need to maintain a role for the States and Territories in the policy development process and/or arrange for the transfer of skilled personnel.

Experience suggests that one of the strengths of the State contribution to policy development has been the close relation between enforcement and complaint handling experience. Such a relation will not exist if policy development responsibility lies wholly with Treasury. There must also be formal mechanisms to involve the regulator (ASIC) in the policy development process.

4. Existing work by the Ministerial Council for Consumer Affairs and State Governments

It is essential that new Commonwealth regulation of consumer credit builds on current work undertaken by the Ministerial Council for Consumer Affairs and individual states to improve the UCCC. In particular the Commonwealth should adopt the well advanced MCCA proposals on regulation of finance broking, fringe lending and fees and charges. It should also build on existing proposals to apply or extend unfair contracts laws to financial services.

5. Regulation of bank fees and charges

CHOICE does not support the statement in the Green Papers that the Commonwealth intends 'not … to regulate bank fees and charges'. CHOICE agrees that where a competitive market operates, the market will deliver the best outcomes to consumers, including in relation to fees and charges. But there are a number of areas where it is widely accepted that the market does not operate to produce optimal fee outcomes and in particular where unfair fees and charges persist. These include

- exit fees on mortgages;
- fees imposed for default;
- interchange fees; and
- fees for subsidiary products sold along with a principal product (for example consumer credit insurance).

In these and similar areas there should be no absolute conclusion that fees should not be regulated, rather policy makers should examine all available options and choose that which delivers best outcomes for consumers based on the available evidence.

Balance of this submission

The first part of this submission provides extensive argument against splitting credit regulation between judiciaries and discusses matters numbered one to four above. Sections two to five comment on a number of other matters discussed in the Green Paper.

There remain several other areas of key consumer protection in the financial services sector that should be tackled by government. These include

- compensation for loss when consumers suffer loss as the result of the wrongful conduct of a financial adviser who later becomes insolvent
- conflicts of interest in financial advice
- multiple superannuation accounts
- potential for abuse and other losses through inappropriate use of self managed super funds
- access to reasonably priced advice about superannuation

We have provided brief comments on some of these in sections six to eight and look forward to government addressing these problems in the near future.

1. The Regulation of Mortgages and Consumer Credit

1.1 National Regulation of Consumer Credit

In our submissions to the Productivity Commission's Inquiry into Australia's Consumer Policy Framework (completed in May 2008[2]) we argued that consumer credit should be regulated by the Commonwealth[3]. Most credit providers operate nationally. Although there is 'uniform' legislation regulating credit (the Uniform Consumer Credit Code 'UCCC'), the legislation is in fact not fully uniform. Moreover, the States have not been sufficiently responsive in updating the Code as required. Elsewhere we have documented the excessive amount of time that it has taken to prepare draft legislation regulating finance brokers despite the fact that problems in that industry requiring regulation have been known for nearly a decade and the issue has been on the agenda of the Ministerial Council for Consumer Affairs since 2003[4].

We note that most of the major credit providers in Australia are regulated by the financial services provisions of the Corporations Law in relation to their non consumer credit financial services businesses and subject to regulatory oversight by ASIC. It makes sense for their consumer credit business to be regulated by the same body.

We believe that there will be both regulatory and efficiency gains if all consumer credit is regulated by the Commonwealth. Ultimately this should include both policy development and enforcement. However, given that some State government agencies have current expertise in these areas, consideration must be given to ways to make that expertise available to the Commonwealth in the transitional period and beyond. These matters are addressed below.

1.2 Regulating Mortgages or All Consumer Credit

The Green Paper raises the possibility of the Commonwealth regulating mortgage credit while leaving regulation of non mortgage credit to the States.

We are strongly opposed to this proposal. It will not produce an effective policy outcome. There are no obvious advantages and a number of clear disadvantages.

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[2] Productivity Commission *Report*.

[3] CHOICE Submission June 2007 to the Productivity Commission Review of Australia's Consumer Policy Framework p 68 available at http://www.choice.com.au/files/f129518.pdf.

[4] CHOICE Submission June 2007 to the Productivity Commission Review of Australia's Consumer Policy Framework p 90 available at http://www.choice.com.au/files/f129518.pdf

In this section we describe the disadvantages in detail and then in subsequent sections offer constructive solutions to perceived problems with full national regulation.

a. Mortgage products are not the only important products for consumers

The Green Paper's analysis of the relative importance of mortgages as opposed to other credit is fundamentally flawed. The paper notes that mortgage lending makes up 86% of consumer lending by value[5]. This is not the only measure of significance and in our submission not the most important measure. In particular, evidence from financial counsellors suggests that, for people seeking assistance with their debt problems, mortgage credit is not the most important issue for many (see details below).

Other potential measures of relative importance include:

- the number of credit contracts on foot at a given time
- the number of Australians who hold a particular product
- the number of transactions associated with each product
- the number of consumer problems caused by each product, particularly for low income consumers
- the credit products sold to inexperienced, low income or vulnerable consumers.
- the number of credit contracts entered into each year
- the amount of credit advanced on mortgage and non mortgage products in a year.

Data on the first four of these is presented below.

Number of credit contracts on foot June 2007[6]

	Number on foot June 2007 (millions)	Value (billions)
Housing loans	5.0	$872
Personal loans	1.1	$50
Credit cards	**14.0**	$43
Margin loans (March 08)	0.2	$32

As shown in the table, credit card contracts outnumber housing loans by nearly three to one.

Number of Australians with consumer credit products

There are a bit over 7 million households in Australia. Only about one third owe money on their home. According to Reserve Bank Governor Glenn Stevens, "about 35% of households owe money on their home… [while] closer to 70% of households carry debt of some kind[7]. This suggests that up to twice as many Australian households have non mortgage consumer credit products as hold home mortgage products.

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[5] Table 1, page 2 and cited numerous other places in the paper.

[6] Margin loan data from the Green Paper. Other data supplied by Australian Bankers Association based on RBA data and member bank advice. The value for personal loans is an ABA estimate.

[7] APRA Quarterly Bank Performance September 2007 (issued 25 March 2008).

[7] G Stevens *Monetary policy and inflation: how does it work?* Australian Treasury Seminar Series 11 March 2008.

Number of transactions
Over the 12 months to the end of February 2008, there were 1.4 billion credit card transactions. This was 78.6 million (5.9%) more transactions than for the previous year to the end of February 2007[8]. It's hard to see mortgage transactions exceeding 100 million.

Credit card transactions differ in amount and potential impact on a consumer. Mortgage payments are generally of the same amount at regular intervals and other than over commitment are unlikely to cause consumer problems. The initial contract can of course include problems if the consumer does not understand the terms and their implications.

Even though the amount at stake with a mortgage at any one time is much greater than a debt owing on a credit card, the sheer number of transactions combined with the less structured payment arrangements for credit cards means that there is greater potential for consumers to face problems.

Problems caused by credit products
Low-income people are much more likely to experience a financial service consumer problem related to a non-mortgage credit product than a mortgage product. First, low-income people are less likely to have mortgages. Second, consumers accessing financial counselling services rarely seek advice exclusively in relation to their mortgages, even where they have one.

Comprehensive statistics on use of financial counselling services are not maintained. We have consulted the Australian Financial Counselling and Credit Reform Association and individual counselling services. Jan Pentland, Chair of AFCCRA advises as follows:

> While some proportion of clients seen by financial counsellors have mortgage problems the large majority don't have mortgages - their debt problems are credit cards, personal and car loans, and fringe lending.
>
> Also, with mortgage problems they rarely go without there being other credit involved and it's hard to know sometimes what finally pushes people over the edge. Mortgages are refinanced to pay out other credit; credit cards and personal loans are used to meet mortgage payments.[9]

David Tennant of the ACT based CARE Financial Service reports as follows:

> … the majority of Care's clients (July to December 07) were still clearly the financially vulnerable, for example:
>
> - Centrelink recipients - 53%
> - Reported incomes less than $25,000 - 60%
> - Were in rental accommodation (38% government, 23% private).
>
> Number 2 in the top 10 reasons for seeking assistance for years has been credit card debt (21% in the last 6 months of 2007). Number 1 invariably is 'budgeting and financial management' , a sort of general catch all heading.

[8] ABA.
[9] Personal communication 8 June 2006.

> There are also increases in demand both in number and complexity and unmet need is going through the roof (up 20% for the start of 2008 in comparison to the same period last year)[10].

And Tricia Ross, Manager of Anglicare Financial Counselling in Darwin advises:

> Anglicare NT has 4 financial counselling programs throughout the region, one Indigneous specific. Only 5 % of our clients present with mortgages, and they are mostly through our Darwin program. The remaining all have credit card, personal loans, utilities and fringe lender liabilities.[11]

These conclusions are supported by data from the Banking and Financial Services Ombudsman.[12] In 2006/07 the BFSO dealt with 1710 complaints which involved consumer finance and only 818 involving housing finance of which 13% involved investment loans. Note that the BFSO does not have full industry coverage. It is likely many more non-mortgage credit contracts are issued by non-members than mortgage contracts.

External dispute resolution for consumer credit

The absence of a comprehensive external dispute resolution scheme that applies equally to all forms of consumer credit is one of the most serious weaknesses of Australia's current consumer protection framework.[13] A large proportion of consumer problems relate to non mortgage credit products from credit providers that are not licensed by ASIC, in particular to contracts entered into by vulnerable and disadvantaged consumers. This gap arises because all consumer credit is not regulated at the Commonwealth level, and thus ASIC requirements for financial service providers to belong to an EDR scheme do not apply.

Comprehensive access to an effective EDR scheme is one of the highest priority reforms in the area of consumer credit. It would be very straightforward to achieve if all credit providers were required to belong to an ASIC approved external dispute resolution scheme as recommended by the Productivity Commission.[14] Doing so would have the added advantage of reducing the workload of government information and mediation services currently provided by the State and Territory Offices of Fair Trading.

b. *The current regulation of non-mortgage credit by the UCCC is a vital piece of consumer protection legislation*

Consumer credit policy development has a long history. Modern approaches to consumer credit policy develop are rooted in the US *Truth in Lending Act* (TILA) first adopted in the 1960s. TILA formed the basis for the NSW and Victorian *Credit Acts*, enacted in 1984. This legislation revolutionised consumer credit law in Australia by requiring credit contracts to be provided to consumers in a form they were likely to understand, prohibiting certain unfair terms and practices, creating more accessible dispute resolution tribunals and allowing those tribunals to reopen unjust contracts. With some

[10] Personal communication 10 June 2008.
[11] Personal communication 6 June 2008.
[12] BFSO *Annual Repor*t 2006-2007 pp 20-21.
http://www.bfso.org.au/AR2007/uploads/downloads/BFSO/ProductCategoryTable.pdf.
[13] The Productivity Commission describes it as 'the most glaring gap in consumer dispute resolution processes" *Report* p 200.
[14] Recommendation 5.2.

amendments, the NSW and Victorian Acts were transformed into the Uniform Consumer Credit Code which came into force in 1994.

It is important to note that during the 1980s and 1990s policy makers' attention was focused most strongly on non-mortgage products. Indeed home lending was not included in the 1984 Acts. It was with non-mortgage credit that consumers were routinely exploited by sharp practices and unfair contract terms whether in unfair hire purchase deals, or through loan sharking or loading up high interest motor finance contracts with unnecessary and overpriced additional products such as extended warranties and consumer credit insurance.

Enactment of the UCCC, enforcement action by Offices of Fair Trading and providing consumers with access to OFT assistance, financial counsellors, credit tribunals, specialist consumer credit legal centres and other advice has had a significant impact on the market and has eliminated or reduced the incidence of many types of consumer harm. It is true that there are a number of practices that have sprung up to get around protections found in the UCCC – fringe lending via promissory notes is one example. And the rise of finance and mortgage brokers has created a new set of problems. But current policy development must recognise that the UCCC does a lot of work to ensure the fairness of mainstream consumer credit products (including most mortgages).

The regulation of non mortgage credit is a vitally important part of the consumer protection landscape. It should not be considered less important than mortgage lending.

c. *Regulatory consistency*

Mortgages and non-mortgage credit are currently regulated in exactly the same way by the same provisions of the same Act except as the nature of the product requires (ie the UCCC). In many cases mortgage credit can be used to fund purchases which could equally be funded by non-mortgage credit. For example, a consumer could borrow against the equity in their home to purchase a car. There is no obvious reason why mortgage and non-mortgage credit should be regulated differently. There is a risk that differences would emerge if there were two parallel systems for regulating mortgage and non-mortgage credit.

We note that the Productivity Commission identified as one of the key features of any future national scheme for the regulation of consumer credit that "there is consistency in the regulatory requirements applying to different financial services and service providers and in the enforcement of those requirements across Australia"[15].

Creating two separate systems would perpetuate – in fact worsen – the problem that the Green Paper purports to fix – that of credit providers being accountable to two different regulatory environments.

Companies which develop and market credit products would need to consider both sets of rules in the design of their products. They may be unclear as to which apply, or may wish to design products to fit within one or the other. All of these processes will incur additional product design and legal costs.

[15] Productivity Commission *Report*, p99.

d. *Regulatory uncertainty*

Creating two separate systems will create regulatory uncertainty as a number of products are not clearly either mortgage products or non-mortgage products. This would inevitably require ongoing regulatory resources to analyse and decide which products fell into commonwealth and state jurisdictions, and would thus reduce the efficiency and speed of regulatory and enforcement actions. It is commonly observed that regulatory failure is more likely to arise at the boundary or gap between different regulatory regimes or different regulators.

Mortgage credit is not defined in the Green Paper. Mortgage credit might normally be thought of as credit advanced for the purpose of purchasing a residential property[16] which is secured by a mortgage over that (or perhaps another) property.

On this definition a home equity loan and a reverse mortgage would not be included. But if these products are to be included, then would a credit card that was linked to a home loan account also be included? If not, would the one product which included the home equity loan and the credit card be regulated by two different regulatory schemes?

It is conceivable that regulators would disagree about whether or not their powers applied to a particular product. This could create both gaps (no-one responsible) and overlaps (two regulators requiring different action).

e. *Regulatory arbitrage*

Creating two separate systems will create opportunities for regulatory arbitrage. If one system is perceived as less onerous or more advantageous in a particular respect then it will create incentives for credit providers to design products that avoid those regulations (or indeed avoid both schemes).

We note that one of the Productivity Commission's key features of any future national scheme for the regulation of consumer credit is that "product/service coverage is comprehensive such that there are no gaps that can be exploited by unscrupulous providers".[17]

f. *Increased Information Technology Costs*

Creating a new system for mortgage products but keeping the current system for credit products will create the potential for increased IT costs within credit providers, especially where mortgage and non mortgage products are linked.

In passing we note that sticking as closely as possible to the current UCCC will minimise transition costs for institutions.

g. *Financial literacy*

Creating two systems will confuse consumers and make it harder to increase financial literacy through experience and education.

[16] Or land on which to build a residential property and/or the cost of building on that land.
[17] Productivity Commission *Report,* p 99

If there is one set of rules that applies to mortgage credit and a different set of rules that apply to non mortgage credit it will be more difficult and more costly to produce consumer education materials that help consumers understand these financial products.

More importantly, as much consumer understanding is derived from experience, it will be easier for consumers to learn if all credit products operate in the same way.

1.3 Dispute resolution and enforcement

To be effective consumer protection laws must be supported by effective dispute resolution and enforcement systems. Dispute resolution and enforcement are closely related. The better the dispute resolution system, the less the regulator will need to take enforcement action in relation to individual complaints. If there is a set of effective dispute resolution arrangements in place, the regulator can focus attention on following up on the systematic matters that arise from the complaints process.

Dispute resolution

A good dispute resolution system includes at least the following elements

- sources of advice and assistance for consumers, including advice for consumers about how and when to pursue a dispute;
- an accessible body that can determine disputes;
- access to judicial processes where needed; and
- a process for following up on systemic matters.

In this section we discuss the need for access to external dispute resolution, the ongoing role of States and Territories in providing consumer advice and informal assistance with disputes and the likely need for continued access to low cost specialist dispute resolution Tribunals.

External dispute resolution schemes

Since their creation 15 or so years ago external dispute resolution (EDR) bodies have provided access to low cost and effective dispute resolution for customers of Authorised Deposit-taking Institutions (ADIs). This access is denied to customers of credit providers that are not legally required to join a scheme and have not voluntarily elected to do so. One of the primary advantages of national regulation of consumer credit will be the opportunity to extend EDR to all consumer credit customers.

EDR schemes were developed because of the almost insurmountable barriers in taking small and medium value consumer finance disputes to ordinary courts. In NSW and Victoria an alternative and more accessible tribunal system had been developed in conjunction with the introduction of the UCCC in the early 1990s as an alternative response to this problem.

Depending on their state of residence and the type of credit provider involved, consumers may have access to an external dispute resolution scheme, a specialist tribunal and/or a court. There are four ASIC approved EDR schemes which deal with complaints about financial institutions and consumer credit: The Banking and Financial Services Ombudsman (BFSO)[18]; the Credit Union Dispute Resolution Centre (CUDRC); the

[18] The BFSO is soon to become the Financial Ombudsman Service after merger with the Insurance Ombudsman Scheme and the Financial Industry Complaints Service.

Credit Ombudsman Service (COSL); and, the Financial Co-operative Dispute Resolution Scheme (FCDRS). Where a credit provider is a member of one of these schemes consumers have access to an effective dispute resolution in relation to most disputes.[19]

Any new consumer credit regulatory arrangements will need to ensure that dispute resolution is accessible to all consumers. We noted above that the absence of a comprehensive external dispute resolution scheme that applies to all consumer credit matters is a serious problem in Australia. The best solution is to require all credit providers to hold a national license[20]. This will immediately bring them within scope of the Corporations Act requirement that they belong to an approved EDR scheme.

We suggest that the EDR scheme or schemes that will have jurisdiction to hear consumer credit complaints will need to make a significant investment in increasing accessibility to consumers with credit relation problems. It will be necessary to ensure that the dispute resolution scheme provides many points of access and is widely promoted. Options include contracting community based services such as financial counselling agencies and/or regional offices and outreach services of State Offices of Fair Trading to promote the scheme and assist vulnerable and disadvantaged consumers gain access. State Offices of Fair Trading will have an ongoing role in promotion of and referral to such EDR schemes whether or not they have any ongoing role in enforcement.

As an example, we note that the NSW Office of Fair Trading employs around ten Indigenous liaison officers. Their role is not limited to consumer credit, however the liaison officers are available to Indigenous consumers for advice on a range of consumer problems including credit. In the absence of this assistance many consumers would not reach the appropriate assistance service (currently other officers within OFT or an advice service such as Consumer Credit Legal Centre; in the future the Financial Ombudsman Service).

A further problem is that the Corporations Act allows for multiple EDR schemes to exist. This can create problems in relation to similar standards applying to all credit providers and where multi party transactions involve members of two different schemes (for example a finance broker may be a member of COSL and a lender a member of BFSO). This is an argument for rationalisation of schemes. We are pleased that there has been some rationalisation of EDR schemes but the process needs further encouragement. Legislative amendment may be necessary.

Consumers will also need access to financial counselling and legal aid services (see Productivity Commission Report Recommendation 9.6).

Role of State and Territory Agencies

Consumers will continue to approach State and Territory Offices of Fair Trading with consumer problems including both pure consumer credit issues and problems which have consumer credit and non consumer credit elements. These agencies will remain the most efficient and effective way to deliver an important source of advice to consumers. Indeed they are likely to be able to solve many disputes quickly through information

[19] An important area which is not covered is that of default or penalty fees.

[20] It may be that where the only financial service product offered by a prospective licences is consumer credit the requirements to obtain a license could be simpler than current FSR requirements. Licensing is discussed further below.

provision either to the consumer or the relevant credit provider or trader. In our view State and Territory governments should commit to maintaining their role in consumer education and consumer advice in relation to consumer credit. Further, in conducting this role they will continue to be a valuable source of policy advice.

Likely need for a continued role for low cost accessible Tribunals

Many consumers in NSW or Victoria have access to an effective low cost Tribunal. But where the credit provider is not a member of an EDR scheme and the consumer lives outside NSW or Victoria then the consumer's only recourse is to the courts. For most consumers in most situations this will not be a practicable option unless they are eligible for legal aid. Even then, the risk of an adverse costs order will deter most consumers from pursuing their dispute.

The Tribunal process has both advantages and disadvantages compared to an EDR scheme. There are strong arguments in favour of maintaining access to Tribunals – indeed extending it across Australia - even in parallel to effective accessible EDR. We acknowledge that there are some practical difficulties in doing so.

Tribunals are more suited than EDR schemes to dealing with matters which have complex legal issues, where evidence needs to be tested and where it is desirable to develop a body of legal precedent. EDR schemes on the other hand are more suited to matters which can be dealt with informally, especially where high volumes and low amounts are involved.

The following arguments support retention of a Tribunal system.

First, credit providers will often issue recovery proceedings in a court. Currently it is possible for the consumer to transfer the proceedings to the less costly and less formal Tribunal setting. At present, once court proceedings have commenced, EDR can't intervene. It may be possible to overcome this limitation and we understand that a working party auspiced by the Australian Bankers Association is looking at this issue – although progress has been slow.

Second, consumer access to tribunal plays a role in 'keeping the EDR honest'. The threat that a consumer can go to tribunal if dissatisfied with EDR outcome ensures that EDR remains relevant, speedy and makes decisions in conformity with the law. In the event of an unsatisfactory outcome at EDR, the consumer retains the capacity to take a matter to a tribunal. Although such an outcome would be rare, CHOICE is aware that consumers have taken this course of action on occasion and received a better result from the Tribunal than through EDR.

Third, Tribunals might be more appropriate to deal with three-way disputes, such as linked credit providers. This would include areas such as door to door sales of maths software with finance provided by a finance company. If the consumer took the finance matter to EDR, could the consumer get an effective outcome about the contract directly with the service provider? That seems unlikely under present arrangements.

Fourth, there are some areas of consumer complaints that EDR schemes say are outside their jurisdiction. The BFSO for example is not prepared to examine the quantum of fees even when they are exorbitant and there are no competitive forces keeping them in check such as bank penalty fees. Consumers need access to an accessible dispute forum where the issue is outside the jurisdiction of the EDR schemes which, to date, have been negotiated by industry with consumer representatives rather than being extended to all possible disputes.

Finally, there may be credit providers operating under the radar that aren't members of EDR schemes. While this should result in enforcement action by the regulator, there may be delays with that, meaning an individual consumer wouldn't have access to a low-cost and speedy remedy.

There are a number of difficulties that would need to be overcome to maintain access to Tribunals. If the consumer credit legislation becomes solely an Act of the Commonwealth Parliament (whether as part of the Corporations Act or as new stand alone legislation) then it would not be possible to vest in an existing State Tribunal the judicial power of the Commonwealth and it would be difficult to devise an effective Commonwealth Tribunal (see for example Brandy v HREOC[21]).

Enforcement

The UCCC is enforced by State and Territory Offices of Fair Trading and equivalent. ASIC is responsible for enforcement of the financial service provisions of the Corporations Act and the ASIC Act. Its market monitoring and enforcement and compliance work covers many of the market participants that offer consumer credit products who are required to hold a financial service licence. There are a small number of large credit providers (eg GE Money) and a number of small credit providers (eg pay day lenders) that do not require a financial service licence as they do not offer products regulated by the Corporations Act.

We believe that ASIC should take the primary enforcement role for all consumer credit products. The preferred policy outcome is for ASIC to eventually have enforcement responsibility in relation to all financial service matters.

ASIC has a track record with enforcement actions against small players under the ASIC Act - for example non-compliant mortgage brokers[22]. In other words, using its limited powers available under the ASIC Act, the national regulator has already demonstrated a capacity to take on such matters when they have not been picked up by the states.

It would not be difficult for ASIC to recruit and train appropriate staff to build on its current skills. ASIC will have the opportunity to recruit employees from State agencies if desired. There may be a case for a transition period of 2-3 years during which current enforcement arrangements operate in parallel.

The Commonwealth will need to assess the resources required for ASIC to undertake this new role. It's important to establish exactly the level of resources allocated by State Offices of Fair Trading to consumer credit enforcement. In particular we need to distinguish the role of Offices of Fair Trading in responding to consumer complaints and

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[21] Brandy v Human Rights and Equal Opportunity Commission [1995] HCA 10.

[22] See for example ASIC media release 07-266 ASIC obtains orders against Canberra mortgage broker over 'low-doc' loans and media release 07-144 Court finds major mortgage broker's conduct misleading and deceptive.

the role in pure compliance/enforcement work. Our inquiries and research suggests that at present most resources are allocated to complaint handling rather than to enforcement work. We suggest that much of the complaint handling role will pass to the Financial Ombudsman Service and other EDR schemes and some will remain with the State Offices of Fair Trading (at least in providing initial guidance to consumers).

In 2007 CHOICE sought information from all State/Territory Offices of Fair Trading on, among other things, the number of enforcement matters that they had taken over the previous five years. Some jurisdictions were unable to provide those figures. Those who did so did not report large volumes of completed enforcement actions. Over the five years to 2005/2006 Consumer Affairs Victoria reported between 4 and 7 matters per annum (a mixture of criminal prosecutions and civil matters). Tasmania, the ACT and the Northern Territory reported zero matters. Western Australia reported between 3 and ten matters, except in 2000/01 in which they undertook 26 matters. Note that WA figures include matters involving finance brokers which were not at the relevant times separately regulated in other jurisdictions. NSW, Queensland and South Australia were unable to provide the requested data. On this basis it seem reasonable to estimate that it would be a rare year in which more than 30 matters were undertaken nationally. Of course there are or should be many more investigations resulting in no action or a warning than civil or criminal proceedings.

In our view the current level of enforcement is not adequate in all States. ASIC should be funded to undertake more matters than the current volume of State consumer credit enforcement matters. But if we compare the figures for State work with ASIC's current total annual enforcement matters involving litigation – between 218 and 338 – then it can be seen that the additional burden imposed by the current or even a much improved level of consumer credit enforcement is clearly manageable with a reasonable increase in resources for the regulator[23].

It is worth noting that State agencies would potentially retain a role in enforcement action in relation to consumer credit. They would clearly retain a role as a contact point for consumers with disputes.

Finally, it is no objection to ASIC regulating all credit providers that there are a number of small credit providers that operate only in a single jurisdiction. Such credit providers make up a very small percentage of the market by both amount of credit and number of contracts. In any case ASIC already regulates small corporations in other areas of financial services. For example in relation to financial planning ASIC is responsible for oversight of a one-person operation in Darwin as well as the larger multi-state firms. ASIC is responsible for mis-selling of insurance by agents operating in remote Aboriginal communities as much as insider trading in a CBD.

For reasons set out below there may be a case for enabling State/Territory OFTs to retain enforcement powers in relation to consumer credit when investigating matters where consumer credit is part of a broader consumer complaint, as may arise for example in relation to one-off finance issued by motor vehicle dealer or similar retailer. Similar challenges are currently being dealt with by the Ministerial Council on Consumer Affairs and the Business Regulation and Competition Working Group in designing

[23] All data in the paragraph from CHOICE 2008 forthcoming.

enforcement arrangements to support the proposed generic consumer law as recommended by the Productivity Commission.

As noted above, it is essential that all consumers have good access to an external dispute resolution scheme for complaints in relation to consumer credit in the same way that they have access to external dispute resolution schemes for other financial services. Providing such a dispute resolution scheme will, in addition to increasing consumer access to justice, very substantially reduce the demand for the provision of individual client services by enforcement agencies.

1.4 Policy Development

Transferring consumer credit regulation to the Commonwealth will require increased policy development capacity within the Commonwealth to ensure ongoing quality policy work.

There are two related issues that will need to be addressed.

1. The Commonwealth Treasury does not currently have sufficient policy development capacity including relevant experience to undertake quality policy development in this area.

As noted above consumer credit policy development has a long history. There are half a dozen officials in the State Offices of Fair Trading – particularly in NSW, Victoria, WA and Tasmania – with considerable policy expertise that has been gained through up to 20 years engagement with consumer credit policy issues. These officials have a very great depth of experience about what has and hasn't worked in relation to consumer credit policy. They have high level skills in assessing the arguments and evidence put forward by stakeholders.

If policy responsibility is quickly transferred to Treasury with no involvement from the existing sources of expertise then it is difficult to see how policy errors can be avoided. A way to maintain access to this expertise in the short and medium needs to be developed, whether this is through institutional arrangements (that is some ongoing role for the States in policy development) or an innovative approach to staff transfer or secondment.

Perhaps the most effective system will be for the States to retain a role in policy development, with an agreement that an expanded MCCA will determine policy with the agreement of the Commonwealth and three States or two States and a Territory. This arrangement could be reviewed after five years and if the States and Territories no longer have any significant role in enforcement and complaint handling and the Commonwealth has amassed policy expertise then arrangements could be changed.

2. Experience suggests that one of the strengths of the State contribution to policy development has been the close relation between enforcement and complaint handling experience. Such a relation will not exist if policy development responsibility lies wholly with Treasury.

Under our preferred model ASIC will have primary responsibility for enforcement and FOS (and if full rationalisation cannot be achieved, other EDR schemes) will have primary responsibility for complaint handling, although any systematic complaints – those likely to require policy responses – would be passed on to ASIC for action in accordance with current EDR procedures.

In our submission there is a need to build ASIC into the policy development process in a formal way. At least the following actions are required

1. Government should clearly provide that ASIC has policy development or at least policy advice functions and that they are to perform this function based on their experience with enforcement, compliance, complaint handling, stakeholder liaison and research into the market.
2. ASIC should be asked to identify areas for policy review and to give initial thoughts on policy directions.
3. Treasury should be formally required to consult with ASIC at each step of the policy development process.
4. ASIC should be invited to formally comment on each policy proposal at the point it is submitted to the OBPR and at the point it is submitted to the Minister.

1.5 Licensing

It is not clear from the Green Paper how it is proposed that credit providers be licensed. There is an existing licensing scheme under the Financial Service Reform provisions of the Corporations Act. This scheme is probably more onerous on business than is necessary. The Draft Finance Brokers legislation proposes a less onerous licensing regime. A licensing scheme should require credit providers to be members of an (or the) approved EDR scheme and impose obligations that the credit provider acts fairly and reasonably. It may also impose standard probity and character checks which could perhaps be deemed to be satisfied for those that held certain other license such as a license under FSR. The reporting requirements imposed by FSR licensing are probably not required in relation to credit providers.

1.6 MCCA's Current Consumer Credit Work Program

The MCCA, through the UCCC management committee, has a number of current policy projects to fix flaws in the UCCC and to extend regulation to finance brokers. Most of these are well advanced.

These projects are listed in Appendix E to the Productivity Commission Report. They include fringe lending, finance brokers, pre-contractual disclosure, responsible lending and credit card over-commitment, property investment advice (specifically picked up in the Green Paper) and comparison rates.

Each of these processes is at a relatively advanced stage. Those processes should continue and lead to amendment to the UCCC if that can be achieved prior to transfer to the Commonwealth. If that is not possible, then the Commonwealth should commit to implementing the reforms within 12 months as part of the transfer of the UCCC to the Commonwealth. If that cannot be done then the Commonwealth should commit to pursuing further work based on the work done to date. This ongoing work will benefit from the continued involvement of the State policy personnel who have current carriage of these matters.

1.7 Unfair contract terms

The Productivity Commission has recommended the introduction of unfair contract terms legislation as part of a proposed generic consumer law to be enacted by the Commonwealth and the States and Territories. We understand that this recommendation is being considered by the Commonwealth and the Ministerial Council on Consumer Affairs and that in principle support is likely. An inquiry by the Victorian government has recommended that Victorian Unfair Contracts legislation should be extended to apply to credit contracts in financial services[24]. The NSW Legislative Council has recommended introduction of unfair contracts terms legislation in NSW.

Unfair contract terms legislation applicable to consumer credit is required to supplement the proposed national law on consumer credit. Introducing unfair contracts terms legislation may enable some prescriptive provisions that would otherwise warrant additional industry-specific laws (for example regulation of default charges on credit cards). Application of unfair contract terms legislation to consumer credit contracts should be achieved through simultaneous or prior enactment of the generic law including unfair contracts terms provisions or through inclusion of similar provision in the national consumer credit code.

Recommendations

1.1 The Commonwealth should take responsibility for regulating all consumer credit including mortgages.
1.2 The national consumer credit legislation should exactly mirror the current Uniform Consumer Credit Code as agreed to be amended by MCCA[25] with the addition of the following
a. interest rate caps as currently apply in some States
b. a requirement for responsible lending as currently applies in the ACT
c. provisions regulating finance brokers based on the draft bill prepared by NSW
d. provisions developed through building on current policy development processes being undertaken by the UCCC Management Committee on fringe lending, fees and charges, and reverse mortgage products.

1.3 Commonwealth regulation of consumer credit should include a requirement that all credit providers are members of an ASIC approved external dispute resolution scheme. This will best be done through a licensing scheme, where membership of an EDR is a condition of the license.
1.4 The EDR requirements for financial services should be amended as follows
a. requirement or incentives for there to be only one EDR scheme for financial services
b. requirement that EDR is able to deal with any matter arising under the national consumer credit law including determining hardship variations and review of fees and charges where competition is not effective
c. requirement that EDR schemes ensure they are accessible to all consumers with consumer credit dispute or potential disputes.
1.5 The Commonwealth should ensure that there is sufficient access to information and advice services (such as those currently and possibly in the future provided by State and

[24] J Merlino *The Report of the Consumer Credit Review* (2006) Consumer Affairs Victoria.
[25] Productivity Commission *Report* Appendix E p 454.

Territory Offices of Fair Trading), financial counselling services and legal aid services in relation to consumer credit matters.
1.6 The Commonwealth should consider ways to ensure access to accessible Tribunal services where a matter can better be dealt with by a Tribunal than an EDR scheme (for example matters with complex legal or evidentiary points and matters involving civil penalties).
1.7 ASIC should take primary responsibility for the enforcement of the national consumer credit regime and should be provided with sufficient resources to do so.
1.8 Arrangements for future policy development should ensure that the Commonwealth has access to the expertise currently possessed by policy development staff in the State Offices of Fair Trading and implements formal processes to ensure that policy development is adequately informed by the experience of the regulator (ASIC).
1.9 Unfair contracts terms legislation similar to that currently in force in Victoria should apply to consumer credit contracts.

2. Regulation of Sub Prime Loans

The Green Paper correctly notes that the US sub-prime crisis was at least in part caused by inadequate regulator framework and identifies media reports of brokers encouraging borrowers to take out high cost sub prime loans where they qualified for prime loans.

We refer you to a paper by Kathleen C. Engel and Patricia A. McCoy *Turning a Blind Eye: Wall Street finance of predatory lending*[26] a copy of which is enclosed. The paper covers a range of factors that contributed to the sub-prime crisis, with a focus on problems caused within the securitization system. However the paper also clearly documents the contribution of inadequate regulation of lending practices to the crisis. It cites evidence that the states of the USA that prohibited certain lending practices *and* provided recourse against assignees for breach of those prohibitions produced far fewer failing sub-prime loans than other states. This suggests that the failure to adequately protect consumers from those practices was a significant causal element in the crisis.

The lesson for Australia is that credit law should include a requirement that a credit provider be satisfied of a borrower's ability to repay credit before lending.

Recommendation

2.1 National credit law should include a requirement that a credit provider be satisfied of a borrower's ability to repay credit before lending.

3. Debentures and Promissory Notes

We support the proposals to simplify the regulation of debentures and extend the licensing requirements. However there are two other issues raised by the promotion of debentures as investment options including for unsophisticated consumers.

The Commonwealth has recently announced a scheme to protect investments made into ADIs. CHOICE continues to see fixed interest products marketed as safe - using terms such as 'warranted' - in such a way that less experienced consumers may conclude that these investments are similar to low risk bank accounts.

[26] (2007) 75 *Fordham Law Review* 2039.

It is very important to now take advantage of the introduction of the depositor protection scheme to clearly communicate to consumers the difference between 'guaranteed' and non-guaranteed fixed interest products. Our submission to ASIC of October 2007 date is attached.

As recent financial collapses show, consumers do not have access to adequate compensation arrangements where they have invested in financial products based on negligent or fraudulent advice. Investments in unlisted unrated debentures are only one of several areas of concern – see our comments on the need for an adequate investor compensation scheme set out below.

Recommendation

3.1 The government should proceed with the proposals in the Green Paper on Debentures and Promissory Notes.

4. Property advice

Consumers are lured in by advertising which suggests they can become rich through property investment after attending free "education" seminars. In fact these turn out to be high pressure selling events for investment property in far off locations where consumers have no idea of the true market value of the property. Or consumers are persuaded to pay for expensive wealth creation seminars – for example $9,000 for a 3 day seminar, which in turn promotes other dubious property investments.

Other problems include:

- poor quality advice
- failure to disclose commissions and the relationships promoters have with property developments
- misrepresentations that proposed investment strategies are risk free or low risk
- failure to provide promised refunds on seminars and courses
- difficulties consumers experience in obtaining redress.

Of course property can be a sensible investment option. But property investment is not regulated in the same way as other classes of investment. Unlike stock broking or financial planning, you don't need to be licensed to give property investment advice, and there's no easy way to pursue a complaint – there's no Ombudsman scheme like there is for other investments.

CHOICE has campaigned for nationally consistent regulation of property investment advice. We were pleased to see that the Commonwealth Joint Committee on Corporations and Financial Services recommended just that.

We think the Commonwealth should adopt the Committee's recommendation to treat property investment advice like all other financial advice. Advisers should be required to hold a licence and belong to an external dispute resolution scheme. ASIC should have clear powers to take action against any misleading or unfair tactics, and ASIC should be adequately funded to regulate the industry. This may require State governments to provide some of their tax take from property transactions for this purpose.

Accordingly we do not support leaving the regulation of property spruikers to the current MCCA process as suggested in the Green Paper, rather the Commonwealth should implement the recommendations of the Joint Committee on Corporations and Financial Services.

A further matter in relation to property advice is that many of the problems in this sector relate to or are contributed to by the finance arrangements underlying the investments. Credit for investment purposes is not regulated by the UCCC. We think that credit for investment purposes by individuals should be regulated. A much greater number of Australians are borrowing to invest in 2008 than were doing so when the UCCC was first developed. The assumption that they are all sophisticated investors is no longer true (if it ever was).

Recommendations

4.1 The Commonwealth should implement the recommendations of the Joint Committee on Corporations and Financial Services in relation to property spruikers.

4.2 The proposed National Consumer Credit law should apply to investment credit granted to individuals.

5. Compensation for Loss

This is a matter not covered in the Green Paper and one that the Commonwealth has power to address.

As noted above, current compensation arrangements are inadequate. The following summarises the argument in our submission of 2007 to the then Parliamentary Secretary for Financial Services on this matter, a copy of which is attached.

1. Where a licensee is solvent, the ASIC approved external dispute resolution schemes such as the Financial Industry Complaints Scheme should be the main compensation mechanism. These schemes are generally effective in compensating consumers, so long as the claim is less than the maximum amount the scheme can award. Provided the maximum limits are high enough, it is reasonable to expect consumers to take larger claims to court.

2. Where a licensee is insolvent or unable to pay, a broad compensation scheme like the stock exchange's National Guarantee Fund should apply. That scheme should include:

    - A broad ability to hear claims
    - A "reasonable grounds to believe" misconduct test
    - Subrogation of rights in order to recover some funds

3. Mandatory professional indemnity insurance should underpin EDR determinations, court judgments and in some cases recoveries by the compensation scheme.

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Mandatory professional indemnity insurance

Arrangement put in place after more than four years of inertia by the previous government are limited to requiring licensed financial advisers to take out Professional Indemnity Insurance (PII). We don't think this is enough but in any case for PII to work as a compensation mechanism, the following is required:

- Consumers must have a right to know the name of the insurer and the terms of the policy. At present consumers can spend tens of thousands of dollars in legal fees just to get this information.
- Licensees must be required to provide the name of their insurer and the general terms of the policy in their Financial Services Guide. This should be in a standard format to be settled by ASIC.
- Government and ASIC must tightly prescribe the terms of mandatory PII to stop insurers trying to "screw down" contract terms to limit their liability.
- A broad form civil liability policy with mandatory fraud and fidelity extensions is necessary to meet the needs of both licensees and consumers, rather than the typical narrow negligence policy commonly in use at the moment.

Insurance is not enough – we need a compensation fund

Even with the changes recommended above, Professional Indemnity Insurance will not cover all losses. Insurers regularly deny claims where a licensee has been acting outside license conditions or selling non approved products, as has happened in Westpoint. A last resort compensation fund is an essential element of the compensation regime. Such a fund would not be designed to compensate consumer for poor performing investments. It would compensate consumers where licensees have breached their license conditions and are otherwise unable to compensate consumers.

We were very pleased when the Rudd Government announced the Financial Claims Scheme to provide consumers of failed ADIs with timely access to their funds and to provide compensation to policyholders of failed general insurers. This extends the compensation regime and adds to that provided by the National Guarantee Fund and the Superannuation Industry Supervisory Act.

This missing link in compensation arrangements policy is any form of compensation for consumers of investment products, where licensees have breached license conditions and been unable to pay such as occurred in the recent Westpoint, Fincorp, ACR collapses.

We understand that the Financial Industry Complaints Service has developed a model (similar to the UK scheme) to provide compensation to such consumers. FICS is the mechanism through which consumers can seek compensation when dealing with solvent licensees but following Westpoint a large number of its awards have gone unpaid following the liquidation of licensees. In many cases the very same individuals have obtained a new licensee and continued operating in some instances from the very same premises as under the old license.

Recommendation

5.1 The Commonwealth should supplement the compensation schemes for ADIs, stock exchange investors and superannuation to consumers of investment products.

6. Conflicts of Interests in Financial Advice

This matter is not addressed in the Green Paper but which the Commonwealth has power to act on.

Structural conflicts of interest are endemic in Australia's financial services sector. They clearly have a negative impact on the quality of advice and products provided to consumers.

The UK Government has embarked upon a major review not of disclosure but of financial services *distribution*. In the words of UK Financial Services Authority (FSA) Chairman Callum McCarthy, 'We have a business model for the retail distribution of financial services…which has so many unattractive features that many regard it as broken.'[27]

The main feature McCarthy points to is conflicts of interest between firms and consumers. He confesses that the regulatory response has been ineffective, in part because it has produced – you guessed it – 'excessive paperwork' for investors. The similarities with Australia are obvious. However, the UK FSA has realised that tinkering with disclosure is not going to solve this problem.

Instead of asking how we can better disclose commissions, perhaps it's time we asked the sorts of questions that McCarthy has put to the UK financial services industry. 'Is it really in the interest of product producers, who have so much riding on their brand reputation, to continue to use commissions as an incentive when it so clearly risks inappropriate consequences?'

Economic research from the US by George Loewenstein from Carnegie Mellon University has demonstrated that not only is disclosure a poor response to conflicts of interest in retail markets, it can actually exacerbate their negative impact. Disclosure of conflicts can lead consumers to place more rather than less trust in advisers. And disclosure entrenches the bias of advisers, allowing them to feel they've 'done the right thing' while keeping the conflicts in place.

Disclosure is also a poor solution to conflicts because it generates information that consumers cannot use. For example, should a consumer apply a greater discount to the value of financial advice if faced with an upfront commission, a trail commission, or a buyer-of-last-resort arrangement? What combinations of these conflicts might produce the most bias? What does it actually mean, in dollar terms, to apply a discount to advice in this way? The answer to these questions is not contained in a disclosure document.

[27] Is The Present Business Model Bust? - Speech By Callum McCarthy, Chairman, Financial Services Authority, Gleneagles Savings & Pensions Industry Leaders' Summit, 16 September 2006 http://www.exchange-handbook.co.uk/index.cfm?section=news&action=detail&id=61995.

One major reason we have lengthy disclosure documents is because of the need to disclose complicated conflicts. If these were not embedded into business models then the disclosure compliance costs could be reduced.

There's too much at stake in the savings of Australian consumers to persist with a policy approach that treats symptoms, not causes. The First Home Saver Account provides an opportunity to focus on the design of products and remuneration rather than just another opportunity to say 'anything goes, as long as you disclose'.

Simpler disclosure documents won't emerge when products and remuneration are *increasing* in complexity. It's time to go beyond disclosure, and start eliminating conflicts of interest.

Recommendation

6.1 The Commonwealth should develop responses to conflicts of interest in financial advice that do not rely on disclosure of the conflict. Such a response should include the ability for the regulator to rule that particular types of conflicts are not permissible.