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FOREWORD

1 July 2010 marks the beginning of a new regulatory landscape for consumer credit in Australia. The National Consumer Credit Protection (NCCP) laws, which come into force on that date, replace the State- and Territory-administered Uniform Consumer Credit Code (UCCC), and deliver on the first phase of the historic agreement by the Council of Australian Governments (COAG) on October 2008 to transfer responsibility for consumer credit regulation to the Australian Government.

All Australian governments have acknowledged that consumer credit law reform will bring substantial long-term benefits to the Australian economy. The extent of financial market integration and credit flows, as well as changes in the credit market and practice has meant indisputably that a seamless national scheme is long overdue.

A nationally consistent consumer credit framework marks a generational change that will significantly improve the effectiveness of consumer protection and reduce the cost of doing business across eight different jurisdictions.

To ease the transition burden for industry and consumers from the transfer of credit regulation to the Commonwealth Government, COAG endorsed a two-stage implementation plan to develop a national credit regulatory framework. The decision for the credit reforms to proceed in stages allowed the first phase to focus on closing the systemic and regulatory gaps which jurisdictions have long sought to address.

The NCCP regime established in Phase One offers consumers a further level of protection through better dispute resolution mechanisms, national rules on consumer credit, and a national credit licensing system with enhanced enforcement powers administered by ASIC as a single national regulator. In addition to specific protections governing consumer credit contracts, licensed credit service providers will need to meet responsible lending requirements, which over time will lift industry-wide lending standards and further enhance consumer protection.

The Government intends to build on those reforms in Phase Two to consider further enhancements in three key areas:

(i) the range of reforms proposed by the Ministerial Council of Consumer Affairs relating to credit card practices, reverse mortgage and equity release products and disclosure that were paused in 2008 to allow work on the COAG reform agenda to proceed;

(ii) specific conduct obligations in the credit law to stem unfavourable lending practices and enhancements to improve the coverage and operation of the national credit scheme; and

(iii) possible extension of the new national credit scheme beyond just consumers to the provision of credit for small business lending and investment loans — where there are clear net benefits to the Australian community.

This Green Paper provides a high level assessment of those key areas where potential gaps have been identified in the existing credit regulation, and an important opportunity to canvass broader community views to test potential options to address some of these gaps. The paper is intended to initiate the next stage of consultation on the credit reform and suggests a way forward for considering action to address those regulatory gaps. The analysis is based on consultation undertaken through discussions with industry stakeholders and States and Territories.

The policy rationale is to provide a consistent national credit regime in areas where there are conflicts or gaps in the existing regulatory framework and where there is evidence of significant detriment to consumers because of regulatory gaps or market failure. The paper invites community views and information to better inform consideration of the need for further reform, having regard in all cases to whether regulatory intervention or other alternatives would better address those shortcomings, and the likely costs and risks associated with such action.

Feedback from the Green Paper will assist development of relevant regulatory options and a Regulation Impact Statement for consideration by Government and COAG endorsement. In that regard, the Government looks forward to continue working with industry, the community and the States and Territories in the development of the next phase of these important credit reforms.

The Government's vision for financial services and credit reform is to reduce the regulatory burden on business, better protect the interests of consumers and ensure the Australian credit market remains both fair and competitive. The proposals contained in this Green Paper further contribute to these critical objectives.

The Hon Chris Bowen MP
Minister for Financial Services, Superannuation and Corporate Law

Contents

REQUEST FOR COMMENT

Treasury is calling for public and stakeholder comments on each of the proposals set out in this Green Paper (July 2010).

In order to better understand the financial or other implications of the Green Paper proposals, please provide information in relation to the likely compliance costs, impacts on competition and any other costs or benefits.

This information will be considered in the preparation of a Regulation Impact Statement and any other necessary regulatory documents.

Comments are requested by COB Friday, 6 August, 2010 and can be submitted to consumercreditgreenpaper@treasury.gov.au.

Or

National Credit Reform Green Paper
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Confidentiality

It will be assumed that submissions are not confidential and may be made publicly available. If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly. A request made under the *Freedom of Information Act 1982 (Cth)* for a submission marked confidential to be made available will be determined in accordance with that Act.

CHAPTER 1: CREDIT FOR SMALL BUSINESS

Objectives

The scope of the Phase Two Action Plan for the national regulation of consumer credit included consideration of the need to extend regulations to the provision of credit for small business. As a starting point, the analysis will focus on issues from the small business borrowers' perspective and from the industry perspective. This will enable both consumer protection issues and industry issues to be considered.

The reasons put forward in support of small business borrowers being afforded the same degree of protection as consumers include:

- similarities in the types of securities used for small business loans (such as the primary residence); and
- similarities in the level of sophistication of small business borrowers' understanding of credit contracts and credit products.

However, it is difficult to assess the significance of these issues due to the diversity of the small business sector and the relatively small number of small business complaints reported compared with complaints from individuals. Despite this, there is merit in examining whether small business borrowers would benefit from some statutory protections. In that assessment this chapter will examine the following issues:

- current regulatory arrangements in relation to lending to small business;
- the types and extent of problems faced by small business in relation to credit contracts, and the nature of these problems;
- the nature of lending and assisting small business; and
- whether the benefits of potentially extending regulatory protection to small business borrowers would be proportionate to the potential costs involved.

Although this chapter provides a brief overview of trends in small business access to finance, it will not explore issues specific to small business access to finance. These issues were considered as part of the Senate Inquiry into Access of Small Business to Finance. Treasury's view is outlined in its 23 April 2010 submission to that inquiry.

There are also conceptual linkages with other chapters in this Green Paper, such as investment lending where small business may take out credit for investment. However, for the purposes of this chapter, the focus will remain on analysing small business in relation to general credit issues, as opposed to focusing on how small business and credit issues interact with other issues examined in this Green Paper.

A. Background

i. Definition of small business

It should be noted that the definition of small business can set the scope of regulatory cover.[1] For example, the scope of small business coverage under the definition of small business already in use by the industry and in legislation could potentially be broad, capturing small businesses that do not necessarily share the same level of sophistication. An alternative definition of small business could narrow the regulatory scope, but this could potentially exclude businesses that operate on the margins.[2] A tailored definition may be more appropriate in the context of credit and small business lending. However, a greater understanding of how small businesses use credit is required before settling on a tailored definition of small business for credit regulation. An assessment of how the tailored definition would interact with compliance requirements and interact with other definitions would be required.

For the purposes of the analysis in this chapter, it is proposed to use the definition of small business already in use by industry and in legislation through the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001* (ASIC Act).[3]

ii. Small business and credit

There are approximately 1.93 million active small businesses in Australia, which represent 96 per cent of all businesses. Approximately 6.75 per cent of all of small businesses are home-based (defined as either operating from home or at home).[4] In 2008 the most common forms of finance accessed by small business were[5]:

- credit cards;
- leasing;
- overdrafts; and
- hire purchase.

Other forms of loans include lines of credit (generally secured by a registered mortgage secured over a property), cash flow lending, debtor finance (factoring, business growth finance, working capital finance), full drawn advance credit, mortgage equity loans, interest-only loans and chattel mortgage.[6]

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1 *Australian Financial Review*, Pizzacella, M 'Definition of SMEs is no small matter' 25 August 2009 p 49.
2 For example, the draft NSW Finance Brokers Bill 2007 also included the exemption for businesses that, although defined as small by the number of employees, borrowed more than $2 million, National Finance Broking Regulation, Regulatory Impact Statement, Discussion Paper, 2005, p 16.
3 The Corporations Act and the ASIC Act define a small business as a business that employs less than (a) if the business is or includes the manufacture of goods — 100 people' or (b) otherwise — 20 people. Voluntary industry codes of conduct also use the definition and http://www.abs.gov.au/Ausstats/abs@.nsf/0/97452F3932F44031CA256C5B00027F19?Open
4 http://www.innovation.gov.au/Section/AboutDIISR/FactSheets/Pages/SmallBusinessFactSheet.aspx.
5 *CPA Australia Small Business Survey August – Financial Management of Small Business 2008*.
6 Surveys indicate that small businesses do not appear to be as familiar with alternative forms of finance, such as international trade finance, inventory financing and vendor and debtor financing, *CPA Australia Small Business Survey August — Financial Management of Small Business 2008*.

When accessing credit, there are different types of securities that can be used, such as:[7]

- covenants, which are agreements between the parties to certain actions in relation to that credit contract. Covenants could include provisions of financial information to the lender or an agreement that the loan to value ratio (LVR) will not exceed a certain limit;[8]
- business assets, which could incur higher interest rates compared to loans secured over the primary residence; and/or
- the primary residence, which enables small business borrowers to draw on the equity in the primary residence. Using the primary residence as security enables small businesses to fund ventures that otherwise might not receive finance, or to fund ventures at a lower cost.

Lenders mortgage insurance (LMI) is another form of protection for the lender, which is payable by the small business borrower. LMI protects the lender when the LVR exceeds a certain percentage. When the LVR limit is exceeded, the borrower is then required to pay a one-off premium to the lender.

According to the 2009 CPA Australia Survey, small businesses were less likely to access additional funds from a bank in 2009 (59 per cent) compared with 2008 (68 per cent).[9] The survey indicated that in 2009, small businesses were more likely to access finance by selling business assets or by borrowing from family and friends.

The overall growth since the 1990s in the volume of residentially secured financing for small business could indicate that there is a growing proportion of small business borrowers who use their primary residence as security.[10] It is common for banks to offer both residentially secured and non-residentially secured small business loan products.

These products are priced differently because of the cost of funds and the credit risk assumed by the bank and, to some extent, the prudential capital adequacy requirements on the bank. Recent reports by insolvency practitioners[11] indicate that company failures are near record highs and that this may increase as interest rates and tax office collections hit small businesses.[12]

B. Current arrangements

i. Regulatory arrangements

Credit regulation for small business is a combination of legislation and self regulation (see Table 1). Business loans were not covered under the Uniform Consumer Credit Code (UCCC), which was a deliberate policy decision. The 1999 review of the UCCC opted not to extend coverage to small business lending as the small business sector was considered to be relatively diverse and there was a concern that this could dilute the UCCC consumer

7 Australian Business Association, *Fact Sheet: Small Business and Dealing with Debt*, May 2009.
8 Australian Business Association, *Fact Sheet: Small Business and Dealing with Debt*, May 2009.
9 CPA Australia, *Small Business Survey – Asia Pacific Small Business Survey 2009*, Australia, Hong Kong, Malaysia and Singapore, p 18.
10 Reserve Bank of Australia, 1999, *Recent Developments in Interest Rates on Bank Lending*.
11 *Australian Financial Review,* 6 May 2010, 'Collapses near record high: ASIC'.
12 *Australian Financial Review,* 6 May 2010, 'Collapses near record high: ASIC'.

protection provisions.[13] This decision, in effect, reduced the scope of coverage compared with earlier Credit Acts.[14]

Reflecting the scope of the UCCC, the National Credit Code (the Code) only covers credit provided to natural persons or strata corporations for personal, domestic or household use. As part of Phase One of the credit reforms, coverage was extended to also include investment in residential property. The Code only covers credit provided for personal, domestic or household purposes, or to purchase, renovate or improve residential property for investment purposes. This means that if a small business enters into a credit contract, that contract is not covered by the Code.

The ASIC Act has a relatively broad jurisdiction over credit, which extends to small business and consumers, with the main prohibitions relating to remedies to address misleading and deceptive conduct and unconscionable conduct.[15]

The *Finance Brokers Control Act (1975) (WA)* adopts a more comprehensive approach and covers small business credit.[16] Western Australia's combination of probity checks and licensing requirements for brokers has appeared to reduce instances of exploitative broker practices.[17] There are also various state statutes that cover farm debt and hire purchase equipments, such as the *Farm Debt Mediation Act (1994) (NSW)*. In most cases, the borrowers in these contexts could be considered to be a small business. The hardship provisions provide debtors with mediation options and, in some cases, prevent the debtor from entering into further hardship in the short run.

ii. Voluntary codes of industry practice

Various industry codes of practice (industry codes) such as the Code of Banking Practice, the Mortgage and Finance Association of Australia Code of Practice and the Mutual Banking Code of Practice cover small business lending (see Table 1).

The industry codes provide a useful benchmark for service and conduct in relation to small business lending. These codes are voluntary and legally binding only if the entity is a signatory. It is difficult to ascertain whether there is uniform adherence to the standards of industry codes in relation to small business lending. However, there are some codes that have independent compliance monitoring mechanisms, for example the Code of Banking Practice Code Compliance Monitoring Committee (CCMC). For lenders, a breach of the Code of Banking Practice is a contractual breach, against which the small business borrowers can make a claim for damages which can only be awarded through the Court or through an external dispute resolution scheme (such as the Financial Ombudsman Service). If a lender breaches the Code of Banking Practice, CCMC may report on the breach by identifying a non-compliant bank in its publicly available annual report. As such, there are no formal penalties applicable beyond a reputational risk.

13 1999 UCCC Post Implementation Review.

14 For example, earlier Credit Acts applied to some lending to farming or trucking businesses, where the credit was secured by a mortgage relating to either farm machinery or a commercial vehicle.

15 Section 12BC(1)(c) ASIC Act.

16 The NSW Draft Finance Brokers Bill would have provided partial coverage for small business such as providing access to remedies, external dispute resolution schemes and licensing of brokers who engaged in broking to small business. The broad definition of broker meant that most types of credit would have been covered.

17 National Finance Broking Regulation, Decision Making Regulatory Impact Statements, August 2006, p 33.

External dispute resolution (EDR) schemes have some jurisdiction to consider small business claims, determined according to their terms of reference (see Table 1). Depending on the monetary threshold of the claim, the dispute and the circumstances, small business borrowers have some coverage.

The Financial Ombudsman Service (FOS) can consider disputes lodged before 1 January 2010 under the Banking and Finance Terms of Reference (ToR). Under the Banking and Finance ToRs, FOS is unable to consider a dispute where the claim exceeds $280,000.[18] After 1 January 2010, the current FOS ToRs apply and the Service can consider claims up to $500,000 with the maximum compensation of $280,000.[19] Similarly, the Consumer Ombudsman Service Ltd (COSL) can consider complaints from consumers not claiming loss of more than $500,000. Any compensation awarded cannot exceed the monetary compensation limit, which is $250,000.[20] If the claim is for more than $250,000 in compensation, then the case cannot be considered unless the complainant accepts compensation not exceeding $250,000. The scope of EDR coverage of small business claims may vary between EDR schemes and scheme membership can also vary.

Further consideration should be given as to whether current voluntary codes of conduct operate satisfactorily and whether, under the best practice regulation principles, they could serve as appropriate regulatory models for small business lending in the industry.

C. Current issues

This section examines issues identified through EDR scheme providers, industry consultations and consumer advocates related to small business borrowing.

i. Access to credit

Recent Reserve Bank of Australia analysis suggests that lending to small business grew steadily between 1998 to 2009. During the recent economic downturn the rate of credit growth slowed, reflecting both reduced demand from small businesses for credit and some tightening of lending standards and terms by financial intermediaries.[21]

This tightening reflects a combination of increased cyclical risk of business loans and the global repricing of risk more generally. Further, a number of financial intermediaries scaled back their lending to small business during the global financial crisis, due to a combination of factors including rising funding costs resulting from the dislocation in financial markets and weaker conditions in foreign lenders' home economies. This placed additional pressure on credit conditions.

Overall, as discussed in Treasury's submission to the Senate Inquiry into the Access of Small Business to Finance, it appears that the majority of small businesses have had continued access to credit through the economic downturn, albeit at less favourable terms

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18 Clauses 3.1 and 3.2 and Schedule 1 of FOS Terms of Reference, *FOS Circular, Dealing with customers in financial difficulty: small business*, Issue 2 April 2010.

19 FOS Circular, Dealing with customers in financial difficulty: small business, Issue 2 April 2010.

20 Clauses 9.1 and 9.2, definitions 44.1 in COSL Rules (March 2010 version). The monetary compensation limit will increase to $280,000 on and from 1 January 2012 and will be adjusted thereafter every three years using the higher of the increase in the MTAWE or CPI (COSL Member Alert, 8 September 2009).

21 Reserve Bank of Australia, *Submission to the Inquiry into Access of Small Business to Finance*, 24 March 2010.

than existed prior to the financial crisis.[22] In addition, small businesses continue to have access to a range of loan providers and products.[23]

It is expected that, as Australia's economy improves and cyclical business risk declines, some of the pressures on small business credit terms and conditions will ease. In addition, the Reserve Bank of Australia suggests that, as Australia's economy improves, competitive pressures in the market for small business loans are likely to increase.[24] This would further support downward pressure on prices and ongoing access to credit for small businesses over the longer term.

ii. Use of credit

Compared to credit access, there is relatively little information on how small businesses use credit. Consequently, it is difficult to make a definitive assessment of difficulties facing small business borrowers due to the diversity of the small business sector and the relative lack of information about credit use. However, EDR schemes offer some insight into issues faced by small businesses. Chart 1.1 shows selected reported small business case issues received by COSL and suggests that small businesses and consumers share similar credit issues.

Chart 1.1: Selected small business case issues (COSL, 2009)

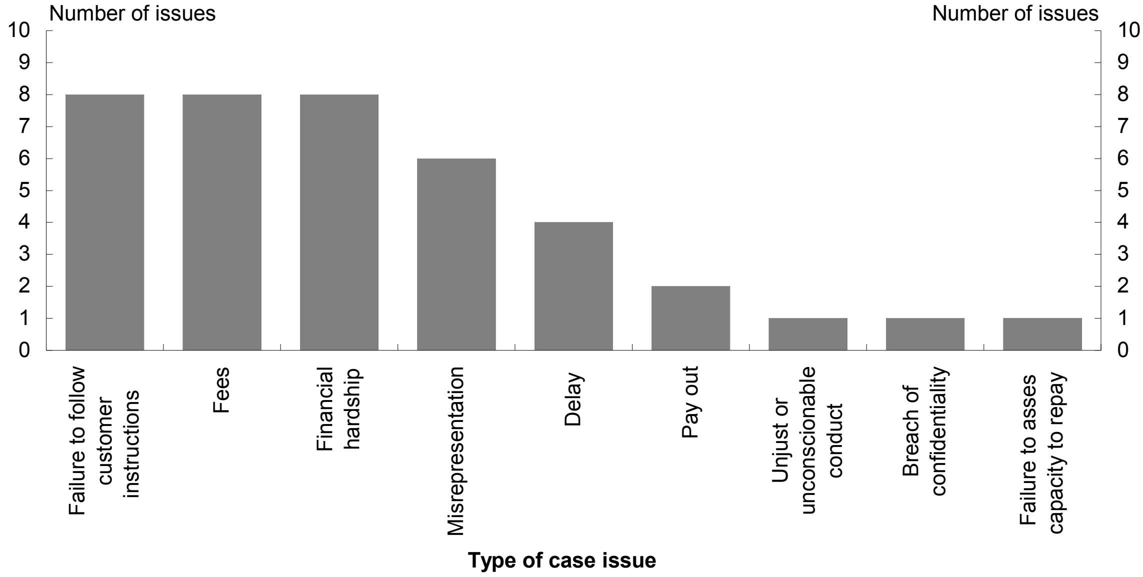
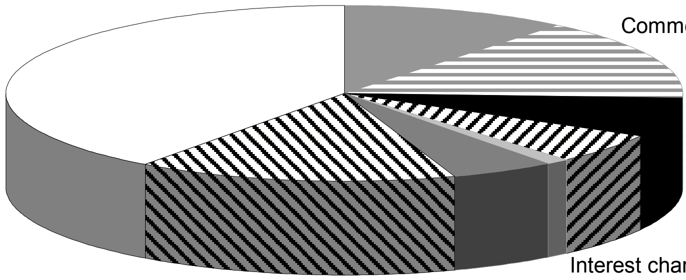


Chart 1.2 shows the number of reported small business complaints received by FOS according to the type of dispute. The chart indicates that small businesses potentially face similar disputes to consumers in relation to financial services. It should be noted that the share of small business complaints received by FOS was seven per cent of the total number of complaints received in 2009.

22 Treasury, *Submission to the Inquiry into Access of Small Business to Finance*, 23 Aril 2010.
23 Reserve Bank of Australia, *Submission to the Inquiry into Access of Small Business to Finance*, 24 March 2010.
24 Reserve Bank of Australia, *Submission to the Inquiry into Access of Small Business to Finance*, 24 March 2010.

Chart 1.2: Small business complaints by type (FOS, 2009)



Source: Banking and Financial Services Ombudsman

While the above information provides insights into difficulties faced by small business, the charts represent only a small number of the total number of small business in Australia. It is unclear whether difficulties faced by small business are a widespread issue. Alternatively, the small number of reported issues could be because small business borrowers are not covered by EDR, that the small business may not have substantive rights or the time to pursue a claim, or that the small business may be unaware that they have access to EDR.

Based on this information, it is difficult to distinguish between problems arising from lenders' practices or whether it is from small business borrowers' understanding of credit. However, there is some evidence that suggests further investigation of small business borrowers understanding of credit may be warranted.

For example, the CPA Australia 2009 survey indicates that small businesses may not have a good understanding of financial services and could be as unsophisticated as individual consumers in their dealings with credit providers.[25] Nearly 24 per cent of the small businesses surveyed did not have a good understanding of the interest rate on their borrowings and a further 15 per cent had a limited understanding.[26]

For small businesses, residentially secured finance may be preferable to unsecured loans, which can be more expensive. It is suggested that the borrower's primary residence is often used as the security for loans, which could place the borrower's primary residence at risk in the event of default.[27] Other difficulties may arise from how certain types of credit are used for different purposes. US studies show that family-owned small businesses may also mix family and business finances, so that families can use their business funds and vice-versa.[28]

The small business sector is also varied, and can include microenterprises and start-ups to more mature small businesses. To accommodate the growth of small businesses, lenders

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25 Council of Small Business of Australia (COSBOA): http://www.cosboa.org/About-Us/Goals-and-objectives.aspx.
26 CPA Australia, *Small Business Survey – Asia Pacific Small Business Survey 2009* Australia, Hong Kong, Malaysia and Singapore, pg 28.
27 ASIC Submission to the Senate Inquiry into Access of Small Business to Finance, March 2010, p 3.
28 Yilmazer and Schrank 'Financial Intermingling in Small Family Business' in *Journal of Business Venturing*, 2006 Vol 21 and Haynes and Avery 'Family businesses: Can the family and the business finances be separated?', *Journal of Entrepreneurial and Small Business Finance*, 1997 Vol. 5.

have different categories of small business for lending purposes. Depending on the development of the small business, some businesses will migrate between these categories and therefore market maturity of the small business may be a factor in credit use. It could also indicate that some scalability of coverage for small business needs to be considered. For example, it may be more important to set standards for dealing with smaller business versus mature and relatively more sophisticated small businesses.

Without a clear understanding of how small businesses use credit, it is difficult to assess whether and what type of regulatory intervention is merited. As such, further information is required as to how small businesses use credit, particularly in relation to:

- the size of the small business;
- the maturity of the small business (for example, start-ups versus well established small business);
- what types of credit are used predominantly, and the purpose of the credit (for example, short term sources of credit such as overdrafts used to fund longer term projects); and
- whether the location of small business (rural or metropolitan) leads to different discernable patterns of credit use.[29]

Further information regarding these issues would provide a better understanding of credit use by small business along the spectrum of small business borrowers.

1. Are there any differences in how small business borrowers use credit compared to individuals? If so, what are they? Please provide reasons for these differences.

iii. Options available to small business when facing financial difficulty

The options available to small business borrowers in financial distress will depend on the specific circumstances of the small business, the security of the credit contract, and the lender's assistance processes (see Table 1). The options available to small business borrowers are based on a combination of legislation and solutions provided by lenders.

There are hardship provisions for specific types of business owners as well as for different types of loans. For example, under Section 3 of the *Farm Debt Mediation Act (NSW) 1994*, a creditor must give at least 21 days notice to a farmer with notice of intended enforcement action and the availability of mediation under the Act. Within 21 days after such notice is given, a farmer may notify the creditor requesting mediation. Under the *Hire Purchase Act 1959 (Qld)* farmers who hire farming goods under a hire purchase agreement can also apply for a moratorium against the repossession of goods. Under these laws, the mediation and temporary suspension of payments can offer the borrower time to consider how to negotiate a change to their repayment schedules, thus avoiding the risk of placing the small business in further hardship.

In early 2009 the banks announced additional initiatives to support small business through the global financial crisis. These initiatives included forums to provide advice to small

29 Rural small business borrowers apply for additional finance it tends for critical cash flow reasons as opposed to growth, *CPA Small Business Survey Financial Management of small business* August 2008, p 12.

businesses, discounted interest rates, improvements to e-commerce, employment of additional small business experts and relationship managers.[30]

Small business borrowers in financial difficulty or hardship may find it difficult to pursue options for several reasons:

- Some lenders require small business borrowers to rectify defaults within a specific timeframe, which can range from two to seven days, depending on the lender.

- The information required by lender when considering a renegotiation of a repayment schedule is rigorous. Generally there is an expectation that small business borrowers will demonstrate that the lender made an incorrect assumption about the information (for example, cash flows or assets).[31]

- Anecdotal evidence also suggests that small business borrowers are less inclined to seek redress under the hardship procedures until business conditions have substantially deteriorated, which significantly affects the scope of assistance.

- Anecdotal evidence also suggests that there is some risk that the expense of the mediation process can be passed onto the unsuccessful party.[32]

From the lender's perspective, assisting a small business borrower to address a default may be difficult because:[33]

- the cause of the business' financial distress may not be temporary;

- the process for understanding the cash flow and working out a repayment plan is complex and, in some cases, a specialist team is required to make the assessment;

- it may be that an agreement cannot be reached between the small business borrower and the lender and, as such, there may be no other option for the lender but to ask the small business to repay the loan in full, or to commence default proceedings;

- the business may be inadequately capitalised and need an injection of further equity rather than short-term cash flow;

- the commercial decisions involve the lender having to make the assessment that the value of the security over the business' assets may be deteriorating, which increases the probability of loss for the lender;

- due to interactions with insolvency law. The small business may be forced to cease trading or go into voluntary administration to avoid non-compliance with insolvent trading law; or

- due to interactions between hardship variations and insolvency law. For example, how does a lender balance their rights as a creditor against their legal obligations to consider hardship applications? Alternatively, the small business may be forced to cease trading or go into voluntary administration to avoid the non-compliance with insolvent trading law.

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30 Treasury submission to Inquiry into Access of Small Business to Finance, 23 April 2010, p 12.
31 FOS Circular, *Dealing with customers in financial difficulty: small business*, Issue 2 April 2010.
32 Rural ABC, Claughton, D 'Challenging times for agriculture', 1 November 2009.
33 Australian Business Association, *Fact Sheet: Small Business and Dealing with Debt*, May 2009.

2. How does insolvency law impact on and interact with a lenders' provision of assistance to small business? For example, how would a lender balance their rights as a creditor against any obligations to consider financial hardship?

3. Do lenders face any other difficulties not identified in relation to hardship provisions or repayment negotiations? If so, what are they?

iv. Role of credit providers

Many small business borrowers interact closely with their lender and, as such, the relationship between lender and small business borrower reflects elements of credit assistance. However, there are some differences due to the underlying risk of the loan. Lenders generally regard small business lending as a riskier loan proposition compared with lending to individuals. Additionally, lending to small business is generally more complex because:[34]

- there can be multiple transactions related to a single business credit contract and these transactions generally need to be conducted quickly;
- small businesses may not be viable and could fail relatively easily;
- the small business' cash flow can change dramatically, whether it is impacted by non payment of an invoice by a debtor or by other factors; or
- small businesses borrowers may contact their lender only when credit is needed and this may occur generally within a short timeframe.

Lenders may also introduce covenant requirements into the credit contract, which may add to the complexity of the small business lending process. Some anecdotal evidence suggests that many small business borrowers do not know that they have breached the covenants until the lender decides what action may be necessary as a consequence of the breach.

Many lenders also make the commercial decision to help small businesses grow and develop. This can also create additional complexity in the relationship between the creditor and small business borrowers. Lenders may also provide different services (such as a dedicated source of assistance) for mature small businesses versus a start-up small business.[35]

More information is needed about the nature of small business lending in order to assess the adequacy of current lending arrangements.

4. What are the main differences and similarities between lending and providing credit service assistance to small business borrowers? Please provide details.

5. What are the main practices by lenders in assisting mature small businesses versus newer start-ups? Please provide details.

6. To what extent have industry conduct standards assisted small business borrowers to date? Please provide details.

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34 Australian Bankers Association, *Submission into the Inquiry into Access of Small Business to Finance*, 31 March 2010, p 8.
35 ANZ Submission *Inquiry into Access of Small Business to Finance* 31 March 2010, p 5.

v. Role of credit service providers

Due to the growth in the number of credit products in recent years, small business borrowers have increasingly used brokers to assist with credit contracts because the broker:[36]

- may have had previous broking relationship with small business via a home loan;
- filled a gap in the market left by the closure of regional bank branches; or
- had more experience in certain types of credit, such as broking for equipment leasing.

Broking for small business lending may be more complex due to financial information requirements, restricted timeframes in which to complete transactions as well as the on going nature of the relationship.[37] To make any firm assessment of how small business lending occurs from the perspective of the broker, more information is needed about the nature of how service assistance occurs.

7. What are the main differences and similarities between lending and providing credit service assistance to small business borrowers?

8. Are there any significant differences in the cost of providing credit assistance to small business compared to individuals? Please provide details.

9. How have industry conduct standards assisted small business borrowers to date? Please provide details.

vi. Other sources of advice and assistance for small business borrowers

Small business borrowers also receive advice relating to credit from other sources, such as accountants. In these situations, the borrower may not have the time or knowledge to gather and present the information required for loan applications and may use the services of an accountant to help them prepare the loan application.[38] The relationship between the small business and the accountant can also be of an ongoing nature as small business borrowers with an existing facility may require assistance in presenting information for regular business reporting to their credit provider.

Additionally, accountants may also provide general advice on the types of credit available, as opposed to recommending a specific credit product, or recommending that a small business borrower enter into a specific credit contract.

10. Do small business borrowers use other sources of advice and/or assistance not identified in relation to credit contracts?

11. What is the nature of this advice and/or assistance? Please provide details.

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36 *National Finance Broking Decision Making Regulatory Impact Statement* August 2006, p 16.

38 CPA Australia, *Submission to Inquiry into Access of Small Business to Finance*, 9 April 2010, p 8.

D. Reform

This paper seeks to examine issues in the current environment that affect small business and credit. The evidence suggests that there is merit in further investigating these issues, with a focus on small business credit use, and the nature of small business lending and broking, before deciding on whether further regulatory action is warranted.

If further investigation confirms the case for maintaining the status quo, this would involve no change to the current regulatory approach. The benefit of maintaining the status quo is that there would be no additional costs compared with implementing a new regulatory framework for small business lending. However, the same degree of regulatory variation (a combination of legal regulation and self-regulation) under the current system would remain for small business borrowers and for industry. More generally, industry would continue to shoulder the costs and resources involved in the development and administration of industry-based codes of conduct.

Should the evidence point to a need for regulatory action, further options for reform may be explored.

Careful consideration must be given to the relative merits of any proposed regulatory model with focus on the likely compliance burden for industry and for small business borrowers, noting that such reforms could potentially increase the cost of credit provision to small business and may impact on the access of credit by small business.

Option One: Limited application of consumer credit protection regulations

This option would extend basic protections and obligations under the Credit Act and the National Credit Code to small business lending. The obligations could include mandatory EDR scheme membership, responsible lending disclosure requirements and licensing requirements. Under this option, the credit product monetary limits for consideration by ombudsman services would remain unchanged.

As industry would already be complying with the Credit Act licensing and EDR requirements, the benefit of this approach would be that it may reduce credit regime transition and training costs for industry compared with a new regulation system. Minimum standards of conduct and competencies could also be developed for small business lending. The standards could be based on current industry codes of practice.

There may be documentation, procedural and education costs for industry associated with transitioning to a model with limited coverage of small business lending. For small business borrowers, developing an understanding of a new credit regulation framework may involve education costs.

The limited application of regulations may also give rise to regulatory gaps that are less effective in delivering an optimal level of regulation for small business. For example, the current monetary threshold for applications of hardship variations or stays of enforcement may not be, in practice, the most appropriate threshold for small business borrowers facing hardship.

12. Are the Credit Act and National Credit Code a useful framework for extending regulatory coverage to small business lending?

13. Are there any provisions in the Credit Act or National Credit Code that either should or should not apply to small business?

14. Are there any potential regulatory gaps under a model of limited application of the Credit Act?

Option Two: Full application of consumer credit protections regulations

Under this approach, full application of the Credit Act and the Code would be fully applied to small business. This would include application of the full suite of responsible lending conduct obligations and licensing obligations. A nationally consistent coverage of credit regulation applicable to both consumer and small business lending could potentially reduce compliance complexity as industry would have the same standards to meet for both consumers and small business borrowers. A prescriptive approach may also reduce the costs and resources devoted to developing and administering codes of conduct.

However, the costs for industry could potentially be significant. For small business borrowers, the same cost associated with dealing with a new credit regulatory system would apply. There may also be other costs associated with the application of some provisions, specifically the responsible lending conduct obligations.

The full application of the responsible lending conduct unsuitability test and capacity to repay requirements could lead lenders to undertake a more intensive assessment of the credit contract's suitability for the small business borrower than currently exist.[39] Similarly, the capacity to repay test could require small business borrowers to provide information which the small business does not have, for example, a speculative business plan may not have information on cash flow. This could potentially add complexity to the process of small business borrowing.

Further information from industry would be required to gain a better understanding of the costs involved in a full application of consumer credit protections.

15. Are the Credit Act and the Code the most effective mechanism for extending regulation to small business lending?

16. What specific provisions in the Credit Act or the Code should or should not apply to small business?

17. If the Credit Act was applied in full to small business lending, what would be the costs and benefits for small business borrowers and industry? Please provide details.

Option Three: Development of tailored regulations for small business lending

This option addresses identified regulatory gaps through a specific set of industry standards of conduct for small business. The voluntary industry codes of practice could provide a

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39 The unsuitability assessment requires holders of an Australian credit license to assess the credit contract against two criteria: (a) whether the contract meets the consumer's needs/objectives, and (b) whether the consumer can comply with the obligations under the contract/or could only comply with substantial hardship.

useful starting point and could be enacted as statutory requirements. A specific definition of small business may also be considered under this option. Under this option, industry could benefit from a tailored regulatory approach as there would be scope to more closely reflect their lending and credit services practices to small business.

This option would entail some costs for both small business borrowers and industry. For industry, there could be increased compliance costs stemming from increased educational and record-keeping costs as there could be different prescribed forms, regulatory guidance and competency standards that are relevant for small business lending. Small business borrowers would also have to adjust to a new framework for credit. Additionally, different regulatory frameworks may also be considered to determine how best to achieve the outcomes and whether this could be effected through:

- legal regulations, where government develops and enforces the legislation; or
- quasi-regulation, where standards and instruments are developed by government and industry, but do not form explicit government regulation.

These approaches have associated costs, both for industry and small business borrowers. If this option were progressed, the type of regulatory framework would need to be considered further. Further information from industry about small business lending processes and practices would be required to provide a better understanding of the costs involved in developing a tailored regulatory approach for small business lending.

18. What are the likely costs and benefits for small business borrowers and industry with a tailored approach? Please provide details.

Table 1: Regulatory context for small business and credit

Type of coverage	Outline of provision/clause/rule
Credit coverage	**Uniform Consumer Credit Code:** The UCCC only considered credit where the credit was provided or intended to be provided wholly or predominantly for domestic or household purposes (paragraph 6 (1)(b)), or where the debtor was a natural person (paragraph 6(1)(a)). **National Consumer Credit Protection Act 2009:** Credit is provided under a contract if: a) payment of a debt owed by one person (the *debtor*) to another (the *credit provider*) is deferred; or one person (the *debtor)* incurs a deferred debt to another (the *credit provider*) (Section 3(1) of the Code) which is defined as a natural person or a strata corporation (section 5 of the Credit Act). **Australian Investments and Securities Commission Act 2001:** Relatively broad jurisdiction over credit, which extends to small business and consumers (Section 12BC(1)(c)). The main prohibitions related to small business lending focus on misleading and deceptive conduct and unconscionable conduct (Sections 12DA, 12CB and 12CC).
State-based credit Acts	**States Hire Purchase Act:** There are a range of hire purchase acts, with different levels of coverage across States and Territories. In Queensland, Victoria and Western Australia, hire purchase legislation applies to transactions for farmers and small business transactions that fall outside of the credit legislation. In the ACT, New South Wales and South Australia, hire purchase transactions are subject to general credit laws. They are regulated by specific legislation. Tasmania and the Northern Territory have regulations in place for both consumer and commercial purposes. **Finance Brokers Control Act 1975 (WA):** Coverage of small and big business, no restriction for the type of credit. **Queensland (Rural Finance) Act 1996 (QLD):** Introduced to coincide with the UCCC commencement to cover farmers entering into new credit contracts for farming equipment. The Act provides a moratorium of up to 12 months before farm machinery can be repossessed by a mortgagee (Section 116). **NSW Farm Debt Mediation Act 1994:** According to section 3 of the *Farm Debt Mediation Act,* a creditor must give at least 21 days notice to a farmer with notice of intended enforcement action and the availability of mediation under the Act. Within 21 days after such notice is given, a farmer may notify the creditor requesting mediation.
Industry code of practice	**Banking Code of Practice:** The Banking Code of Practice is a voluntary binding code and sets out standards of good conduct for the banking industry, and applies to personal and small business bank customers and guarantors (Clause 1.1). The Banking Code of Practice also has requirements for credit providers to work with consumer's facing financial difficulties to negotiate a repayment plan in the event that the credit contract is not covered by the UCCC (Clause 25.2). **Mortgage and Finance Association of Australia Code of Practice:** The MFAA Code is voluntary binding code and requires members to meet standards of good practice and fair dealings with customers. Small business is not included in the definition of consumer but is mentioned in the definition of a borrower, where a borrower is defined as a natural person or small business as defined by the Corporations Act (Clause 65). The MFAA Code specifies that small businesses in financial difficulty may request a non-credit provider or a credit provider to vary payment terms (Clause 67).

Table 1: Regulatory context for small business and credit (continued)

Industry code of practice (continued)	**Mutual Banking Code of Practice**: The Code covers small business according to the ABS definition of small business. The MBCOP requires members to work constructively with small business if they are experiencing financial difficulties and will do this whether or not the small business has the right to seek hardship variation or change under consumer credit laws (Clauses 24.1 and 24.2 MBCOP).
External dispute resolution providers	**The Financial Ombudsman Service:** Under the Banking and Finance Terms of Reference which apply to disputes lodged before 1 January 2010, the FOS can only consider disputes up to $280,000 (Clause 2.5 BFSO TOR). After 1 January 2010, claims for losses of up to $500,000 can be considered and maximum compensation is capped at $280,000 (Clauses 3.1 and 3.2 and Schedule 1 FOS Terms of Reference). If a guarantor is disputing their liability for amounts of less than $500,000 FOS can only award compensation up to $280,000. If the guarantor is seeking a guarantee in full the amount must be less than $280,000. **Credit Ombudsman Service Limited:** COSL can consider consumer complaints about MFAA Code breaches up to a limit of $250,000 (Clauses 9.1 and 9.2 COSL Rules March 2010). If the claim is for more than $250,000 in compensation, the case cannot be considered unless the complainant accepts compensation not exceeding $250,000.

CHAPTER 2: REGULATION OF CREDIT CARDS

Objectives

The objectives of this project are to consider:

- whether the current scope of regulation of credit is appropriate for a competitive market and healthy access to credit;
- the need for further regulatory action as part of the Phase Two credit reform agenda to address the concerns canvassed by the Ministerial Council on Consumer Affairs (MCCA); and
- the need for further regulatory action relating to credit card lending practices.

A. Background

The scope of Phase Two of the National Consumer Credit Protection reforms includes an examination of State and Territory reform projects including the work progressed by MCCA relating to credit cards which were paused at the time of the COAG agreement to transfer the regulation of consumer credit to the Commonwealth. In meeting that commitment, consideration will be given to assess the extent to which the reforms implemented during Phase One of the credit reforms address the concerns raised by MCCA and whether any further enhancements in relation to credit cards are required.

This chapter considers the need for further regulatory action to reduce the incidence and impact of unmanageable debt on consumers while maintaining appropriate access to such credit. For the purposes of this chapter, unmanageable debt in the context of credit cards refers to situations where consumers do not have the capacity to repay the debt in a reasonable amount of time without financial hardship. Due to their circumstances borrowers make small repayments and incur interest charges and fees which can perpetuate their debt.

Concerns have also been raised that some fee, and interest rate charges may be excessive, thereby increasing the costs of using credit cards, even for those consumers who do manage their credit affairs effectively.[1] Discussion of these issues and any further regulatory approaches will need to be considered on the potential impacts on consumers and lenders, including compliance costs, as well as their effects on competition within the credit card market.

The scope of this chapter relates to credit cards, including store cards, where access to credit is provided through a revolving line of credit. It does not cover charge cards, debit cards or gift cards purchased from retailers.[2]

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1 Choice, *Card Games* October 2006 and *Which Credit Card for You,* January 2010.

2 Debit cards provide access to consumers' own funds Store gift cards are purchased up to a certain value and do not provide access to credit. Charge cards differ from credit cards in that balances owed must be repaid in full at the end of the billing term. Charge cards are not covered by the National Credit Code and therefore are not within the scope of this paper

i. MCCA project relating to credit cards

Work undertaken on behalf of MCCA on issues relating to credit card lending resulted in the issue of the Regulation Impact Statement *Responsible Lending Practices in Relation to Consumer Credit Cards*[3] in August 2008. This report saw a role for government intervention to:

- facilitate improved consumer choice through competitively priced credit card products;
- adequately protect consumers, especially vulnerable or disadvantaged consumers, from revolving debt levels that cannot be repaid without substantial hardship; and
- minimise the effect on consumers who manage their cards satisfactorily.

The report identified factors that contribute to problematic levels of consumer credit card debt such as:

- essential information being received at a time when it is unlikely to be useful;
- credit providers' assessment practices that maximise the amount of credit granted;
- minimum repayment percentages that are set at a very low level; and
- the legislative requirements are remedial, not preventative, with consumers most in need of assistance being the least likely to be able to negotiate the largely self-help process.

The report suggested that regulation had failed to prevent card issuers from granting inappropriate levels of credit and failed to ensure that consumers were provided with pre-contractual information at crucial time points to inform the consumer of the costs and features of the card. The report also noted that the legislation at the time did not address the level of minimum repayment and its effect on long term indebtedness. To address these gaps, the report put forward six options:

1. Change the timing of essential information.
2. Require credit providers to allow consumers to nominate the credit limit sought.
3. Prohibit the card issuer from providing more credit than the consumer can repay from their income without substantial hardship.
4. Provide relief for consumers by making the debt unenforceable to the extent that it exceeds an amount granted in accordance with Option 3.
5. Require card issuers to warn consumers about the effect of paying only the minimum repayments.
6. Require card issuers to increase the minimum repayment percentage for new credit card contracts and for offers of increased credit limits on current cards.

These options were not intended to be mutually exclusive. Responses to the report were received from the credit industry, consumer advocates and individual consumers. Generally, industry indicated that there was little need for change pointing to the banks' own credit

3 The Regulation Impact Statement was prepared by the NSW Office of Fair Trading.

scoring practices as superior to any additional legislative requirements in assessing a consumer's capacity to repay, which would be significantly improved with the pending introduction of positive credit reporting.[4] Some lenders also noted that consumers' credit card problems arise following life-changing events — such as unemployment, divorce or separation — rather than poor assessment practices.

Consumer groups were generally supportive of the options, however they considered disclosure to have only a limited effect and suggested that consumer warnings would have greater effect if they were more personalised to the consumer's circumstances. Consumer groups suggested that fees and charges should also be addressed, and were generally keen to prohibit unsolicited credit limit increases or make such increases subject to full assessment processes. Inappropriate credit card offers were also raised as an issue of concern.

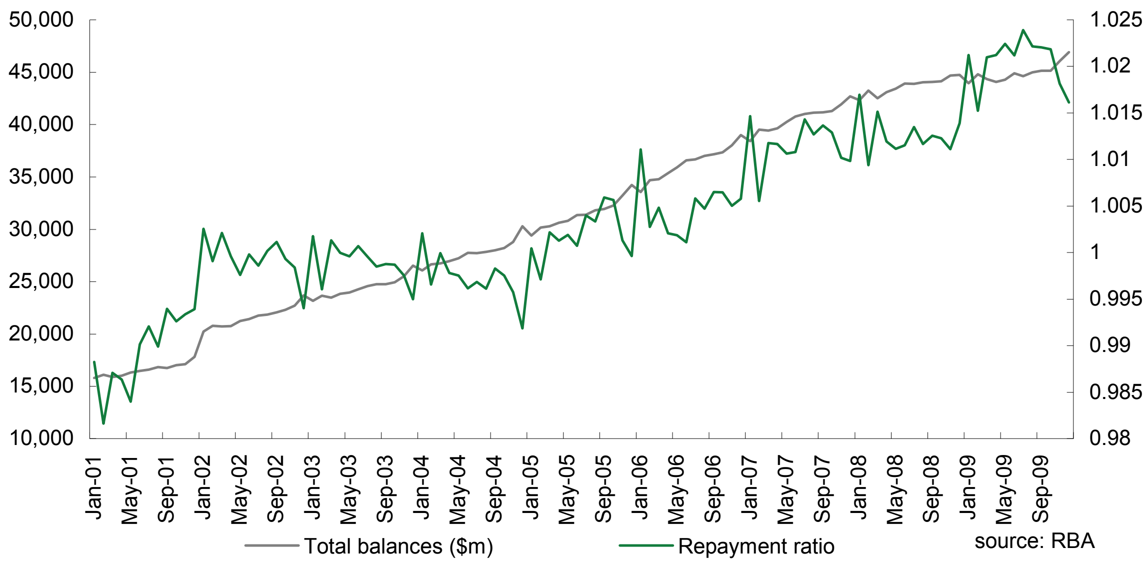
ii. Credit card usage in Australia

As at February 2010, Australians owed $47.1 billion in debt on their credit cards ($34.0 billion of which accrued interest). This represents an increase of 5.1 per cent from one year ago (when $44.8 billion was owed), and over three times more than 10 years ago (when $12.9 billion was owed). As at February 2010, there were 14.5 million cards on issue, which amounts to $3250 owed on each credit card

In 2009, Australians added, on average, $18.8 billion onto their credit cards from transactions each month. Average monthly repayments in 2009 exceeded this and averaged $19.1 billion each month.[5] In 2009, consumers made $225.8 billion in credit card transactions and repaid $229.3 billion in repayments. That is, consumers repaid $3.6 billion more than they spent over that 12-month period.

As shown by the chart 2.1, while credit card repayments have increasingly exceeded transactions in recent years, total credit card balances have continued to grow.

Chart 2.1: total credit card balances vs repayments and transactions ratio



Source: RBA

4 See Current Arrangements section.
5 RBA Credit and charge card statistics (series C1).

Credit card users are generally recognised to fall into two broad categories — transactors and revolvers.[6] Transactors pay their outstanding balances on time and therefore incur no interest charges. Revolvers tend to carry (or revolve) debt, making minimum repayments or slightly more, and thus maintain a level of continuing debt. Due to their outstanding balances and repayment habits, revolvers pay more interest, and tend to have higher default rates.

As at November 2009, 278 different cards from 69 institutions were available to consumers in Australia.[7] Interest rates on credit cards range from 9.9 per cent to over 20 per cent, which is substantially greater than the average variable home loan rate (currently about six to eight per cent).[8] This reflects the unsecured nature of credit card products which represent a higher risk to the lender.

B. Current arrangements

i. Regulatory arrangements

The National Consumer Credit Protection Act 2009 (Credit Act)

The law applying to consumer credit has been strengthened as part of the transfer of the regulation of consumer credit from the States to the Commonwealth. The Credit Act commenced on 1 July 2010 and contains provisions that have particular relevance for the regulation of credit cards.

Under the responsible lending conduct obligations outlined in Chapter 3 before a credit card can be approved, credit card issuers will need to undertake reasonable enquiries as to the applicant's requirements and their financial situation (for example, the customer's income and expenses) in order to make an assessment that the credit is not unsuitable for the consumer and that they have the capacity to repay without substantial hardship.

The National Credit Code

The National Credit Code regulates many aspects of the provision of certain types of credit, including upfront and ongoing disclosure obligations, changes to credit contracts, advertising and marketing requirements, termination of the credit contract and penalties and remedies.[9]

Australian Securities and Investments Commission Act 2001 (ASIC Act)

The ASIC Act provides the functions and powers of ASIC in facilitating the performance of the financial system. Subdivision D of Division 2 of Part 2 of the ASIC Act relates to consumer protection and prohibits misleading or deceptive conduct, and harassment and coercion.

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6 *Are you a revolver or transactor?*, Money Magazine, July 2004.
7 As listed on financial product website www.canstar.com.au
8 As listed on financial product website www.canstar.com.au
9 In particular, Division 1 of Part 2 regulates credit contracts and outlines matters that must be included in a credit contract including the amount of credit, annual percentage rates, calculation of interest charges, and credit fees and charges Division 3 and 4 of Part 2 relates to interest charges and fees and charges respectively Division 5 of Part 2 outlines the credit provider's obligation to account including the contents and frequency of account statements.

The new national consumer protection laws against unfair contract terms[10], which commenced in 2010, will be inserted into the ASIC Act and apply to credit card contracts. Under the new laws, a term in a consumer contract will be unfair if:

- it would cause a significant imbalance in the parties' rights and obligations arising under the contract;
- it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on; and
- the term is not reasonably necessary to protect the legitimate interests of the party, who would be advantaged by the term.

The effect of the unfair contract terms provisions would be to void the unfair term within a consumer contract.

Privacy Act 1988 (Privacy Act) and Positive Credit Reporting

The Government has proposed changes to the Privacy Act to accommodate positive credit reporting. Currently, credit reports can only contain 'negative' information, such as payment defaults on credit accounts. Changes to the Privacy Act will add five additional categories of 'positive' information to an individual's credit file. These categories include:

(a) the type of each credit account opened;

(b) the date on which each credit account was opened;

(c) the current limit of each open credit account;

(d) the date on which each credit account was closed; and

(e) the individual's repayment history for these accounts for the previous two years.

This additional information will give credit providers an additional tool to ascertain a customer's ability to repay the debt and more information to assess whether a consumer's application for credit is unsuitable.

The Fair Trading Act 1992 (ACT)

The *Fair Trading Act 1992* of the Australian Capital Territory regulates trading practices within the ACT and imposes additional requirements on credit providers when issuing credit. Section 28A of the Fair Trading Act regulates credit card contracts and increases in credit card limits. It requires credit providers to carry out an assessment of the debtor's financial situation to ensure that they have a reasonable ability to repay the amount of credit provided or to be provided. A satisfactory assessment process includes asking the debtor for a statement of income, all credit accounts and applicable limits and balances, and repayment commitments

However, an Australian Bankers' Association (ABA) survey of member banks established that default rates in the ACT after amending its Fair Trading act were in line with national

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10 The *Trade Practices Amendment (Australian Consumer Law) Act (No.1) 2010* took effect from 1 July 2010.

default rates. The ACT is the only jurisdiction to have introduced this additional requirement on credit card contracts and increases in credit card limits.

ii. Industry self-regulation

Credit issuers may be subject to their own industry Codes of Practice. Adherence to industry codes is voluntary, however, financial institutions that are signatories to these codes are bound by their obligations

Code of Banking Practice

The ABA has published its own voluntary code of conduct, which sets standards of banking practice for banks in dealing with their customers. It includes industry standard requirements to apply credit assessment methods in forming a customer's ability to repay, providing assistance if customers encounter financial difficulties, compliance within relevant guidelines and legislation governing debt collection, internal and external dispute resolution, and disclosures and other principles of conduct.

Banking industry best practice principles on credit card lending practices

In addition, in 2006 the ABA and its member banks released draft best practice principles on credit card lending practices, which guide banking practice when deciding whether to approach a customer to offer a credit card limit increase. Under these principles, matters which the banks will take into account when approaching customers to extend credit card limits include: the cardholder's repayment history (including missed and late payments); the cardholder's income; the cardholder's recent credit card activity; and other products the bank may have.

In 2004, in response to community concerns, the ABA announced a range of initiatives designed to provide improved services to its customers in relation to credit cards. These initiatives included information on additional repayments when sending credit limit increase offers, advice in marketing material for customers whose personal circumstances may have changed, and the capacity for people to opt for a lower credit card limit, or reduce their credit card limit.

Mutual Banking Code of Practice

The Mutual Banking Code of Practice applicable to credit unions and mutual building societies has applied since 1 July 2009, and establishes principles and values that apply in their dealings with customers. It includes policies in relation to information disclosure; responsible lending practices (including only lending amounts that the bank believes customers can reasonably afford to pay); and credit limit increase offers (including not sending unsolicited credit increase offers to consumers with a recent poor repayment history).

C. Current issues

i. Debt stress and default

A 2005 study by the ANZ Bank and AC Nielsen identified three core factors which caused people to fall into financial difficulty:

- ‘unhealthy’ ways of thinking about finances;
- circumstances or events outside a person’s control; and
- lack of financial skills and knowledge.[11]

‘Unhealthy’ ways of thinking about finances include consumers who take on debt without considering the future consequences of that debt, or consumers who have little interest in managing their financial affairs. This can lead to over-commitment as consumers purchase goods and services on credit card debt and subsequently find it difficult to repay the debt.

Circumstances beyond the control of the consumer include life changing events such as loss of employment, illness, injury, divorce and separation. The unpredictable nature of these events make policy responses to address these sources of hardship more difficult.

A smaller group of people experienced financial difficulty due to their low level of financial literacy. This is compounded by their susceptibility to poor advice from lenders and salespersons to take on more debt than they can effectively manage.[12]

A recent Australian Debt Study report conducted by Galaxy Research for Veda Advantage found that 67 per cent of the adult population hold credit cards. The study, conducted in March 2010, suggests that 19 per cent of Australians with debt are finding it difficult to make repayments or are unsure how they will make their next repayment; and 82 per cent of Australians are worried about their ability to repay their debt over the next 12 months. Eight per cent of respondents said they were likely to apply for a new credit card in the next six months. In relation to missed payments, five per cent had missed a credit card bill in the past three months.[13]

Dun and Bradstreet’s *Consumer Credit Expectations Survey* found that 43 per cent of Australians expected to use credit cards to pay for otherwise unaffordable expenses in the March 2010 quarter.[14]

A 2008 Consumer Action Law Centre study *Congratulations, You’re Pre-Approved*, suggested that banks and credit providers use techniques to entice consumers to increase their credit limits, sometimes against the customer’s best interests. The study puts forward a number of options including a requirement for customers to nominate a desired credit limit, and a requirement that customers provide current income, expenditure and debt commitments when responding to credit limit increase offers.

1. To what extent is credit card debt causing financial hardship?

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11 ANZ Bank, *Understanding Personal Debt & Financial Difficulty in Australia*, November 2005.
12 ANZ Bank, *Understanding Personal Debt & Financial Difficulty in Australia*, November 2005.
13 Galaxy Research, *Australian Debt Study Report*, March 2010.
14 Dun and Bradstreet (Australia) Pty Ltd, *Consumer Credit Expectations Survey*, March 2010.

ii. Credit card practices

Bank fees and interest rates receive widespread consumer interest and media coverage. In addition, media reports of recent reforms adopted internationally have placed a focus on some credit card practices that are unfavourable to consumers.

There is a vocal public concern that lenders inflate fees or adopt unfair policies in relation to interest and charges.[15] Changes to bank fees and charges tend to elicit extensive media coverage and consumer response.[16]

A recent study conducted by CoreData[17] suggested that while the majority of Australians (55 per cent) claim to know how many interest free days they have on their card, almost half of them have been charged late payment fees, and a quarter have been charged for not paying enough of their monthly bill.[18]

The consumer advocacy group Choice recently released a study into 'unfair credit card practices'[19], which highlighted a number of practices adopted by some credit card issuers that inflate interest and fees, such as backdated interest, applying interest on an initial balance even though part of the balance has been paid off, and cancellation of an interest-free period for new transactions. In addition, Choice has also recently reported on practices of Australian credit card issuers in comparison to recent UK reforms.[20]

These practices may be attributable to pricing flexibility and competitive pressures within the Australian credit card sector. Regulation setting limits on how interest is calculated or what fees can be charged may be perceived as price fixing and could hinder innovation in the sector. Fixing one element of pricing could drive issuers to recoup losses through other means such as raising interest rates or introducing other fees. In response to new US regulation on credit card lending, banks in that country have raised interest rates and limited credit.[21]

2. What practices in relation to credit cards are perceived to be unfavourable?
3. What is the impact of these practices on consumers?
4. Do these practices reflect the costs to industry of providing these services?

iii. International developments

Recent economic conditions have prompted some countries to adopt stricter and more regulated lending practices to achieve greater stability in their financial markets. In the US, over-indebitedness and the over-availability of debt were viewed as one of the primary causes of the sub-prime housing crisis in that country. Similarly, in the UK, reforms have been pursued to achieve a robust and responsive regulatory system and ensure sustainable financial markets.

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15 Zahos,Effie *Who's stinging customers with unfair fees?*, Money Magazine, November 2008.
16 For example, in relation to overlimit fees: Eric Johnston, 'NAB abolishes fees and puts pressure on rivals', *Sydney Morning Herald*, 16 October 2009.
17 CoreData is the research arm of the market intelligence and consultancy firm, brandmanagement.
18 Croshaw, Perrie, We know card rates, but fees still sting, CoreData 5 July 2009.
19 *Which Credit Card For You?* Choice, 25 January 2010.
20 *Australian Credit Cards Fail UK Standards*, Choice, 22 March 2010.
21 Martin, Andrew and Bergman, Lowell, Squeeze on Customers Ahead of New Rules, NYTimes.com, 10 November 2009.

In both countries, reforms have sought to address certain credit industry practices perceived to be detrimental to consumers and to introduce extra protections for consumers from unfair, deceptive or misleading conduct by credit card issuers. Some of the issues raised in those jurisdictions are already addressed in Australia under existing laws or are not applicable in the Australian context due to differing legal environments.

D. Reform

In its final report on the Inquiry into the Australian Securities and Investments Commission (Fair Bank and Credit Card Fees) Amendment Bill 2008, the Standing Committee on Economics noted concerns about the social effects of default fees on consumers, particularly those on low incomes and welfare. The Committee found that 'there was anecdotal evidence that in some cases at least the impost of high default fees is marginalising people who are already struggling to feel they belong in society.'[22]

Additional fees and interest charges can greatly affect on the wellbeing of consumers and diminish their consumption possibilities that could be otherwise used towards housing, health and education. In some cases, fees and charges can constitute as much as 20 per cent of a family's income.[23]

However, the existence of fees and charges is not necessarily a problem in itself. More relevant issues such as the competitive level of fee-setting and the provision of information to consumers need to be considered in the context of the broader credit market. Well functioning markets will allow credit providers to compete to offer products at the lowest possible price, and enable consumers to make informed decisions about product choices. Within this context, where fees and features are unknown to consumers, there may be a case for intervention to address information asymmetry to achieve better market outcomes.

Consumer campaigns and media scrutiny may, to a certain extent, provide sufficient information to facilitate competition for certain products such as home loan interest rates[24] and may have led to recent reductions in over-limit fees.[25, 26] However, in the absence of effective market adjustments, regulation may be required to address unfavourable practices.

However, limited financial literacy amongst consumers and imperfect information on fees and methods of calculating interest associated with credit products reduce the ability of consumers to understand the practical implications of the lender's pricing policy and to make improved product choices.

Imperfect information may be particularly relevant for lower income consumers who may not be fully aware of the implications of extending their credit limits or paying only minimum repayments.

This may point to a strong case for more effective disclosure requirements of products so that consumers understand the real cost of credit card products. This would result in a more level playing field for credit card products and thus improve competition.

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22 Standing Committee on Economics, *Final Report on Inquiry into the Australian Securities and Investments Commission (Fair Bank and Credit Card Fees) Amendment Bill 2008*.

23 The Smith Family, *Submission to the Inquiry into the Australian Securities and Investments Commission (Fair Bank and Credit Card Fees) Amendment Bill 2008*.

24 For example, Lekakis George, 'National Australia Bank sparks bank war by undercutting Westpac on variable mortgage rates', *Herald-Sun,* 4 December 2009.

25 AAP, *NAB to abolish monthly account fees*, news.com.au 15 October 2009.

26 *People Power: Nab Ditches Penalty Fees*, Consumer Action Law Centre Media Release, 29 July 2009.

i. Issues for consideration

This section considers the options discussed within the MCCA report and their continued relevance in light of the new national consumer credit protection framework introduced in Phase One of the credit reforms.

Consideration of options considered by MCCA

1 **MCCA Option One**: Change the timing of essential information

This option sought to mandate the provision, in a clear and easily understood manner, of a summary of the interest rates, key features and core terms and conditions of credit cards on credit application forms.

Under the Code, items such as the amount of credit, annual percentage rates, calculation of interest charged, repayments, credit fees and charges and other matters related to the credit contract are required to be disclosed in the contract document

While these disclosures may be available in credit contracts, the lengthy and technical nature of most credit card contracts often means that consumers can easily overlook key information. A summary of these key features, prominently displayed on the credit application would draw consumers' attention to the more important terms and conditions before committing to the credit contract.

5. What key information is useful to be disclosed or should be made more prominent? When and how should this information be disclosed?

6. What impact would these disclosures have on consumers and the credit card market more generally?

2 **MCCA Option Two**: Require credit providers to allow consumers to nominate the credit limit sought

This option sought to require credit card issuers to ask consumers to nominate the maximum limit sought on credit card applications. This would safeguard against card issuers from granting credit in excess of that requested by the customer.

Under the responsible lending conduct provisions that apply under the Credit Act, a credit provider must make reasonable inquiries about the consumer's requirements and objectives when suggesting credit or entering a person into credit contract, as well as assess the consumer's capacity to repay the credit.

This means credit card lenders need to assess the consumer's capacity to repay and not to offer more credit than they requested. Where the credit card has a specific initial purpose (such as for the purchase of a computer) the credit issuer needs to take that into account in considering whether the credit contract is unsuitable. Where consumers seek access to a revolving line of credit, it may be reasonable for credit providers to ask the customer the amount of credit sought.

Such inquiries may include the consumer nominating upper and lower credit limits. This may be preferable because it may not be reasonable for credit providers to provide as much credit as the consumer is seeking, under their own lending policies.

7.	Are further measures appropriate or necessary to clarify the responsible lending obligations of lenders in regards to credit cards?

3 **MCCA Option Three**: Prohibit the card issuer from providing more credit than the consumer can repay from income without substantial hardship

This option sought to put the onus on credit card issuers, at the time they enter into a contract, to not provide consumers with more credit than they could repay from income without substantial hardship. Substantial hardship would include a reasonable assessment of current expenses.

Under the responsible lending conduct provisions of the Credit Act, a credit provider must make reasonable inquiries about whether the consumer will be able to comply with the financial obligations under the contract without substantial hardship. For it to be likely the consumer will be able to comply, the credit provider must take a future view of the reasonable foreseeability of that compliance, given the financial obligations that will arise into the future. Therefore, this option has been broadly addressed by the requirement for credit providers to meet the responsible lending conduct obligations under Phase One of the credit reforms

However, a relevant issue in applying the responsible lending conduct obligation is the length of the repayment period against which the capacity to repay is to be assessed in extending a credit limit. This ensures that any credit extended to consumers is repayable within a definable timeframe.

When issuers make an assessment of a consumer's ability to repay a credit card limit, as required under the Credit Act, current practice is to ensure that the consumer has sufficient uncommitted monthly income to be able to meet a monthly payment of six per cent of the total credit limit. This is substantially above most monthly repayments required to service the debt

Consideration may be given to requiring card issuers to assess a consumer's capacity to repay against their ability to repay the debt *within a reasonable amount of time.* For situations where a finite period is associated with the credit provided (such as a 12 month interest-free period on the purchase of whitegoods), it may be reasonable to expect the consumer to be able to repay the purchase within that amount of time. An alternative may be to invite the consumer to nominate a timeframe in which they wish to repay the debt.

8.	What impact would imposing additional requirements on the assessment of a consumer's capacity to repay have on their access to credit?
9.	Are current lending practices sufficient to ensure consumers have a capacity to repay debt within a reasonable amount of time?

4 **MCCA Option Four**: Provide relief for consumers by making the debt unenforceable to the extent that it exceeds an amount granted in accordance with the above option

MCCA Option four suggests that any credit provided, including any interest accrued on that account, if found to be in excess of what should reasonably have been granted, would be unenforceable.

This issue is partly addressed by the responsible lending conduct obligations under the Credit Act. Under the Credit Act a licensee must not enter into a contract with a consumer, or increase the credit limit of a credit contract of a consumer, if the contract is unsuitable for the consumer.[27] Failure to comply with the obligations of credit providers before entering credit contracts, or increasing credit limits, attracts a civil penalty of a maximum of 2,000 penalty units.[28] In addition, the Credit Act imposes a criminal penalty of 100 penalty units or two years imprisonment for a person who engages in conduct that contravenes that requirement.[29]

In addition the Credit Act establishes a civil penalty and consumer remedy framework that promotes strong consumer protections, including a civil enforcement regime and broad civil remedies. It authorises the court to grant a range of remedies, including injunctions, compensation orders and other orders against those who engage in credit activities unlawfully.[30]

The Credit Act, however, stops short of mandating that debt that exceeds an amount that was unsuitable for the consumer is unenforceable. While relief from debt is an option available to the courts, the courts have shown a clear judicial reluctance to relieve a debtor of the obligation to repay a principal, and in most cases, additional interest.[31]

10. Are the remedies within the Credit Act sufficient to addresses the problems caused by consumers being able to access too much credit?

5 **MCCA Option Five**: Require card issuers to warn consumers about the effect of paying only the minimum repayments

This option sought to require a 'health warning' on monthly statements in relation to the time that a consumer could expect to be indebted if paying only the minimum repayments.

Having a prominent and clearly designated information box warning consumers about the implications of making minimum repayments on their credit statements would assist consumers in making decisions relevant to their debt management. Such information should, for example, include the length of repayments and total interest payable.

Division 5 of the Code outlines when credit providers must send statements of account, and information to be contained in statements of account. It does not require the inclusion of information on the time that a consumer could expect to be indebted if paying only the minimum repayments.

An alternative mechanism, which would achieve the same outcome to an ongoing warning on bank statements, is for consumers to be sent a letter separately from their bank statement, reminding consumers of their payment history. The letter could also include projections of the total interest payable and length of time it would take to pay off the debt based on their current repayment patterns, together with avenues of assistance if the customer is experiencing financial difficulties.

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27 Section 133 of the Credit Act.
28 Section 133 of the Credit Act.
29 Section 133 of the Credit Act.
30 Section 176 of the Credit Act.
31 For example, in Esanda Finance Corporation Ltd v Murphy (1989 ASC 55-703) Hunt J at 58,358 expressed 'Where a debtor has received the benefit of the whole sum lent … It is difficult to imagine the circumstances in which the debtor should not be required to repay at least the principal sum which had been lent'.

11. What impact, if any, would these options have on consumer behaviour and default levels?

6 **MCCA Option Six**: Require card issuers to increase the minimum repayment percentage for new credit card contracts and for offers of increased credit limits on current cards

This MCCA option sought to mandate the minimum repayment percentage on credit cards. Paying more than the minimum monthly repayments can have a relatively large impact on the length of time and the total amount of interest paid by the consumer to pay off that debt.

While it may benefit some habitual minimum repayers in the long term, some minimum repayers do so because that is all they can afford.[32] Therefore any potential requirement to meet a higher minimum monthly payments can potentially exacerbate financial difficulties and should therefore apply only to new credit card contracts or increased credit limits. The United Kingdom will introduce a minimum monthly repayment amount with a repayment rate of at least interest plus one per cent off the balance.

12. What percentage of consumers make minimum monthly repayments?

13. What impact would any proposed minimum monthly repayment have on default levels?

14. If mandated, what level should the minimum monthly repayment be set?

Other relevant issues to be considered

The MCCA options were specifically targeted at imposing protections for 'vulnerable or disadvantaged consumers'.[33] As part of Phase Two of the credit reforms the Government committed to reviewing enhancements to specific conduct obligations to stem unfavourable lending practices, such as a review of credit card limit extension offers.[34]

7 Unsolicited credit limit offers

Unsolicited credit limit offers is a method for consumers to potentially access additional debt Such offers have been attributed to enticing consumers to increase their debt levels.[35] Subsection 67(4) of the Code states that credit card limit increases can only occur with the request or written request of the consumer, however, this does not prohibit credit providers from sending credit card limit increase offers to their customers.

Generally, the processes for making offers of credit limit increases are different to the process on an initial application for a credit card facility. For credit limit increases, lenders are likely to rely on information they already have rather than ask for new or updated information in all jurisdictions except the ACT. Under the ACT *Fair Trading Act 1992*, card issuers must carry out an assessment of the debtor's financial situation and ask the debtor for a statement of income, credit accounts, and repayment commitments.

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32 UK Department of Business, Innovation and Skills cites GfK NOP that it is over half of minimum payers, and 37 per cent according to TNS-BMRB.
33 The MCCA Report defines 'disadvantaged' as that group being essentially financially illiterate and unable to manage credit or other financial matters.
34 *National Consumer Credit – Single, standard, national regulation of consumer credit for Australia*, Australian Government.
35 *Congratulations, You're Pre-Approved!* Consumer Action Law Centre, 2008.

15. What is the extent of consumer detriment in receiving these unsolicited credit limit offers?

16. Do unsolicited credit limit offers translate to increased debt levels?

17. What impact has the ACT Fair Trading Act 1992 had on credit card borrowing and default rates in the ACT?

8 Other Issues

The method by which lenders calculate and apply interest on credit card balances and the balances to which they allocate repayments may result in consumers paying more interest than they anticipate.[36] There is no industry standard on how repayments are allocated to balances with differing interest rates (such as on balance transfers, standard purchases and cash advances) with payment allocation policies varying from product to product. Consumers may be unaware that, in many cases, their repayments are used pay off balances attracting the lowest interest rates first, leaving the higher interest balance to attract interest charges.

In relation to interest charges, calculation and limitations on interest rates are regulated by Division 3 of Part 2 of the Code. However, there is no industry standard on how interest is calculated and charged on credit card balances. Therefore, the actual interest paid on some credit products can vary greatly even if the actual interest rate is the same. This is because credit issuers have different approaches in the way they apply interest such as when interest starts accruing, and balances on which they accrue. These differences make it difficult for credit card users to compare the true cost of credit. For example, some banks apply interest from the date of purchase while others only apply interest only from the start of the current statement period.[37]

In addition credit card issuers can adopt different approaches when it comes to calculating the balance on which interest is applied. Some apply interest on the original purchase balance, resulting in interest being charged on amounts that are no longer owed to the issuer. Some card issuers do take into account repayments made and apply interest only on current balances.[38]

Given the different approaches to applying interest as illustrated above, it is sometimes difficult for consumers to ascertain the best value credit card product, with interest rates being only one factor in the cost of the credit card. These varying approaches also make switching between products difficult if consumers must read and understand the different policies applying to each product.

Notification of interest rate changes is regulated by section 64 of the Code. Currently, credit card issuers must provide the consumer with written notice on or before the day the new interest rate takes effect. This gives consumers little time to make appropriate adjustments, to their debt obligations in light of the interest rate increase In addition, this notification may be made by publication in a newspaper, which consumers may not read.

When consumers exceed their credit limits they may be charged a fee for doing so. This allows consumers access to credit they have not been approved for. The additional fee

36 Choice, *Low interest, High Anxiety?* May 2010 and Choice, *Card Games*, October 2006.
37 Choice, *Card Games*, October 2006.
38 Choice, *Which Credit Card For You*, January 2010.

charged when the credit limit is exceeded is seen by some as unfair,[39] particularly for small amounts above the credit limit. Allowing consumers to choose not to exceed their credit limit will enable them to avoid over-limit fees.

18. Should regulations be introduced to specify or standardise the balances to which repayments are to be allocated? What would the cost be to industry if such an approach were adopted?
19. What impact will the protections against unfair contract terms have on the allocation of repayments? Will the unfair contract terms legislation provide sufficient safeguards for consumers?
20. Are consumers aware of how interest is applied on credit card balances?
21. How much do different policies in relation to interest rates impact on the amount of interest paid by consumers?
22. Should the calculation of interest be standardised across the industry?
23. What would be the impact of longer notification periods for interest rate increases on consumers and the industry?
24. What impact does exceeding credit limits have on consumers?

E. Conclusion

Credit cards provide consumers with convenient access to credit for the purchase of goods and services. They allow consumers to enhance their welfare and utility by adjusting their consumption possibilities over time to suit their requirements. In considering the issues discussed in this paper, it is therefore important to consider the impact any additional requirements would have on the availability of credit and ensuring downward competitive pressures on cost of credit.

However, access to debt also has the potential to place consumers in financial difficulty. MCCA developed six regulatory options prior to the transfer of the regulation of consumer credit to the Commonwealth to address this issue. The Phase One credit reforms, already implemented by the Commonwealth, provide a robust mechanism to fully address MCCA Option 3 and to partially address the concerns in Option 4. Further information is sought to assess the impact and consequences of any potential regulatory action flowing from the remaining MCCA options.

This paper also raises additional issues in relation to certain credit card practices that make it difficult for consumers to effectively manage their credit card debt. In addition, practices are applied differently among lenders making it difficult for consumers to compare credit card products, thereby lessening competition in the sector. Further information and evidence is sought on these issues to consider the nature and extent of the problem, and the impact of any possible solutions on consumers, the credit card industry, and the economy as a whole.

39 *NAB abolishes monthly account fees*, Infochoice, October 2009.

CHAPTER 3: REVERSE MORTGAGES

Objectives

This chapter seeks to consider, in light of measures included in Phase One of the credit reforms and Australian consumer law reforms:

- whether the current scope of regulation of reverse mortgages is appropriate for a competitive market;
- whether the unique features of reverse mortgages and the risk exposure for consumers merit specific targeted measures; and
- whether there are any gaps in the regulatory framework for equity release products.

A. Background

As part of Phase Two of the credit reforms, the Government has committed to examining the need for specific enhancements to the regulation and tailored disclosure for reverse mortgages.[1] The scope of the Phase Two reform agenda is in keeping with the Government's commitment that it would continue to progress the projects undertaken by the Ministerial Council on Consumer Affairs (MCCA), which were paused at the time of the COAG agreement to transfer responsibility for the regulation of consumer credit to the Commonwealth.

i. MCCA projects relating to reverse mortgages

In 2007, the MCCA released for public consultation the draft National Finance Brokers Bill 2007, which was intended to ensure that only reputable, skilled brokers transacted with consumers to obtain credit to suit their purposes and that they could afford. This draft Bill included specific disclosure obligations for brokers assisting consumers to apply for a reverse mortgage, such as providing estimates to demonstrate the consumer's future debt in relation to the future value of the mortgaged property for different time periods.

In 2008, a Reverse Mortgage Working Group was formed under the auspices of the MCCA to consider whether the unique features of reverse mortgages merited specific targeted regulation. This working group was comprised of representatives from the Australian Securities and Investments Commission (ASIC), Commonwealth Treasury and State government consumer agencies.

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1 A reverse mortgage is a type of equity release product that allows borrowers to use the equity in their home as security for a loan. The loan principal is often provided as a lump sum, regular payments, line of credit or a combination of these. Interest on the loan amount and on any fees and charges is compounded during the life of the loan, meaning that the total amount owning increases and the borrower's equity in their home may decrease over time. Borrowers retain title over their property, with repayment of the principal and interest generally not required until the borrower dies or sells their home. Most lenders of reverse mortgages require borrowers to be aged 60 years or over.

However, both these MCCA projects were paused at the time of the COAG agreement on the basis that they would be considered as part of Phase Two of the National Consumer Credit Protection reforms.

ASIC reports on reverse mortgages

In addition to MCCA's work on reverse mortgages, ASIC has released two reports identifying a range of regulatory issues specific to reverse mortgages.[2] ASIC reported on borrower experiences with reverse mortgages and concluded that reverse mortgage borrowers had difficulty estimating the long-term costs of the loan and how the loan may affect their capacity to fund their future needs (such as aged care). These reports made recommendations regarding the structure of reverse mortgage products as well as the quality and accessibility of information and advice available to borrowers.

Issues relating to home reversion schemes

Reverse mortgages are one of several types of equity release products currently available on the Australian market. Home reversion schemes, another equity release product, are commonly used by consumers of the same demographic for similar purposes and are therefore often considered by industry and consumers to be a competitive product to a reverse mortgage.

A home reversion scheme allows a consumer to sell a proportion of the equity in their home (usually between 35 and 50 per cent) to a reversion company for a lump sum payment in exchange for a fixed proportion of the future value of the home. As home reversion schemes are not a credit product, they are not subject to the National Credit Code and other statutory provisions governing credit. However, reverse mortgages and home reversion schemes may share some regulatory issues that should be considered concurrently.

1. What evidence is there that borrowers consider home reversion schemes and reverse mortgages to be alternatives?
2. Are there potential detrimental consequences of home reversion schemes and reverse mortgages coming under different regulatory arrangements?

The Australian reverse mortgage market

Reverse mortgages are a relatively small sector of Australia's mortgage market. However, it is anticipated that there will be growth in this market given Australia's aging population.[3] The total value of reverse mortgages in 2004 was estimated to be $459 million.[4] These estimates have risen to $2.7 billion as at 30 December 2009, with approximately 39,000 reverse mortgages currently issued.[5] During the second half of 2009, 50 per cent of borrowers sourced their loans directly from the lender and 50 per cent from brokers and financial planners.

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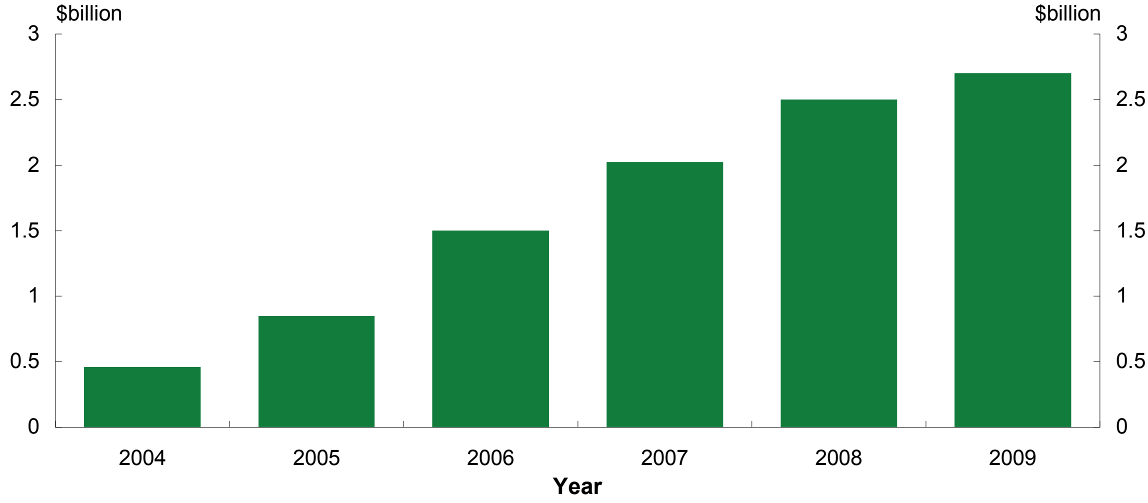
2 Report 59 *Equity release products: An ASIC Report* (November 2005) and Report 109 *All we have is this house: Consumer experiences with reverse mortgages* (November 2007).

3 See for example SEQUAL-RFI Reverse Mortgage Study *'It's on the house' A consumer study into the attitudes and perceptions of Australians aged over 60 years*. See also *Report to Consumer Credit Fund for Credit Preferences and Credit Traps for Older People.* Council of the Ageing (Victoria) (COTA). September 2007.

4 SEQUAL/ Deloitte Reverse Mortgage Survey (October 2006).

5 SEQUAL/ Deloitte Reverse Mortgage Survey (December 2009).

Outstanding reverse mortgages $ billions 2004 — 2009



Source: SEQUAL/ Deloitte Reverse Mortgage Surveys 2004, December 2009. This chart includes only reverse mortgages provided by members of SEQUAL.

B. Current arrangements

i. Government regulation

Reverse mortgage products are regulated as a credit product under the *National Consumer Credit Protection Act 2009* (Credit Act). The Credit Act includes requirements for pre- and post-contractual disclosure and some other conduct requirements relevant to reverse mortgages. However, the Credit Act (including the National Credit Code) does not contain regulation specifically tailored to reverse mortgage products.[6] Further, the application of the Credit Act is limited to reverse mortgages that are provided wholly or predominately for personal use, or are used to purchase, renovate or improve residential property for investment purposes. Reverse mortgages which are used for other investment purposes or business purposes are not covered by the Credit Act.

While consumer credit is currently excluded from the *Corporations Act 2001*, some consumer protection is also afforded through the *Australian Securities and Investments Commission Act 2001*, which prohibits conduct that is misleading or deceptive, or is likely to mislead or deceive, in relation to credit products and services.

The Credit Act will impose a number of additional requirements on reverse mortgage lenders and those who provide credit services such as finance brokers and other intermediaries. For example, the Credit Act creates a uniform licensing regime for lenders and intermediaries under the Australian credit licence (ACL), which includes requirements such as a ‘fit and proper’ test, and membership of an ASIC-approved external dispute resolution provider.[7]

In particular, as part of their licensing obligations, licensees will be required to meet responsible lending conduct obligations. These obligations will require that consumers not

6 As noted by Consumer Affairs Victoria in its report: *The Report of the Consumer Credit Review* (2006), the Uniform Consumer Credit Code (UCCC) was written at a time when reverse mortgage products were not offered in Australia. The Code largely replicates the UCCC and therefore contains no reverse mortgage specific regulation.

7 See sections 37 and 47 of the Credit Act.

be entered into or assisted to apply for a reverse mortgage which is unsuitable for their requirements and that they do not have the capacity to repay.

The first stage of the Australian consumer law reforms includes national unfair contract terms provisions, which will apply to standard reverse mortgage contracts.[8] Although the unfair contract terms legislation does not apply to upfront price and main subject matter, it may provide some further safeguards for reverse mortgage borrowers in regard to contingent fees and unfair default clauses if they are not in the legitimate business interests of the reverse mortgage lender.

ii. Industry self-regulation

Since its establishment in January 2005 the Senior Australians Equity Release Association (SEQUAL) has provided the main source of self-regulation in the equity release market. SEQUAL represents nine lenders estimated to provide 95 per cent of all reverse mortgages in Australia. All members agree to be bound by the organisation's Code of Conduct and Guidelines, which set out requirements regarding the features of the reverse mortgage products they may offer and the process under which borrowers may enter into a reverse mortgage.

SEQUAL also provides equity release accreditation for brokers, financial planners, accountants and lawyers supported by industry bodies such as the Mortgage and Finance Association of Australia, CPA Australia and the Financial Planning Association of Australia. Over 1,500 members of these organisations have completed this SEQUAL accreditation training.[9]

Homesafe Solutions Pty Ltd, currently the only provider of a home reversion product in Australia, is also a SEQUAL member.

C. Current issues

i. Risk of negative equity

Negative equity occurs when the debt repayable under the reverse mortgage exceeds the value of the borrower's property. In such a situation, without intervention, the entire risk of negative equity is borne by the borrower who could be required to pay more than the proceeds from the sale of their property as repayment for the loan.

Negative equity has been identified as a significant risk to borrowers by ASIC and State consumer agencies.[10] For example, a statutory protection against negative equity was included in the draft National Finance Brokers Bill 2007.[11]

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8 *Trade Practices Amendment (Australian Consumer Law) Act (No. 1) 2010.*
9 SEQUAL, *Submission to the Review into the Governance, Efficiency and Operation of Australia's Superannuation System*, February 2010.
10 See ASIC Reports 59 and 109 op cit.
11 The draft bill was not progressed as a result of the decision to transfer the responsibility for regulation of consumer credit to the Commonwealth.

Negative equity has also been indentified as a risk to consumers in the United Kingdom, United States and New Zealand where measures have been introduced to protect borrowers from its effects.[12]

SEQUAL has responded to concerns about the risk of negative equity by including a requirement in its Code of Conduct that its members must include a No Negative Equity Guarantee (NNEG) as part of their reverse mortgage lending policy. This guarantees that the amount the borrower owes on their loan will never exceed the value of their property except in a limited range of circumstances.[13]

The majority of reverse mortgages in Australia are provided by SEQUAL members who offer this NNEG. However, since several reverse mortgage providers are not members of SEQUAL, this requirement is not mandated across the whole of the reverse mortgage industry. This creates several issues for borrowers including:

- varying degrees of protection available to consumers depending on whether their lender's NNEG is in line with the SEQUAL Code of Conduct, or the lender offers its own voluntary negative equity protection;
- a lack of consistency regarding the ways in which a borrower may lose their protection against negative equity;
- a lack of consistency as to the borrower's ability to enforce current negative equity protections and to access options for redress when lenders do not comply with negative equity protections; and
- as membership with SEQUAL is voluntary, there is no requirement for new lenders to include a NNEG as part of their lending policy. There is also no statutory requirement to provide any other form of protection against negative equity.

Under reforms introduced as part of Phase One of the credit reforms, responsible lending conduct obligations will preclude lenders from providing a reverse mortgage to a consumer unless they assess that the product would not be unsuitable for the borrower's requirements. This would require the lender to make reasonable inquiries as to whether the product meets the borrower's requirements and the borrower has the capacity to repay the loan, without incurring substantial hardship.[14]

While the responsible lending conduct requirements under Phase One will provide borrowers with safeguards against being offered a reverse mortgage they can not repay, it will not impose any obligation on lenders to offer any particular protection to consumers against the impacts of negative equity. There is a range of variables (such as changes in housing prices

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12 For example, in the United Kingdom, the industry association for equity release providers, Safe Home Income Plans, requires all its members to offer a no negative equity guarantee. In New Zealand, under the voluntary Equity Release Code of Practice lenders must ensure that a consumer's liability under a reverse mortgage will not exceed the net realisable sale price for the home. A similar obligation also exists in the United States for Home Equity Conversion Mortgages under an arrangement where all lender shortfalls are compensated by the government.

13 SEQUAL members are required to provide a NNEG that guarantees that they will not have recourse to recover amounts in excess of the net sales proceeds of the property, other than if the property is not sold in an arms length transaction and only following the express permission of the lender, or there has been fraud or wilful damage to the property by the borrower which has resulted in the shortfall.

14 If an ACL holder is a provider of credit assistance such as a mortgage broker, they will be required to make a preliminary assessment that the reverse mortgage would not be unsuitable for the consumer's requirements before suggesting the reverse mortgage to the consumer or assisting the consumer to apply for the reverse mortgage.

and movements in interest rates) that will affect the rate at which the borrower's equity in their home depletes that are not necessarily quantifiable at the start of the loan. Because of this, without access to a specific protection against negative equity, borrowers may remain vulnerable to its impacts. Therefore, a protection against negative equity would improve protections for consumers, especially considering many borrowers use their primary or only major asset as security for a reverse mortgage loan.

ii. Provision of advice to consumers

As a reverse mortgage is a major financial undertaking involving new rights and obligations for a borrower, borrowers' access to independent legal and financial advice is considered important for both borrowers and lenders.[15] Current measures and regulation that govern the provision of information and advice to consumers include:

- pre-contractual disclosure requirements under the Credit Act requiring credit providers to disclose relevant information to consumers, such as interest rates, fees and charges;
- ongoing disclosure requirements requiring credit providers to disclose to borrowers every six months information such as interest rates and charges, opening and closing balances, and amounts of credit provided during each statement period;
- industry self-regulation measures.[16] These include requirements that SEQUAL members ensure consumers seek independent legal advice and recommend that they receive independent financial advice before entering into a reverse mortgage contract or home reversion scheme and the SEQUAL requirement that its members provide consumers with its *Key Facts Guideline* and encourage third-party intermediaries to adhere to the Equity Release Proper Process,[17]
- information and resources provided by ASIC,[18]
- information to borrowers provided by services such as the National Information Service on Retirement Investments and State and Territory governments;
- information to borrowers regarding the impact on their entitlements provided by the Centrelink Financial Information Services;
- the practice of some lenders to require borrowers to obtain independent financial advice before taking out a reverse mortgage; and
- responsible lending conduct obligations under the Credit Act.

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15 See, for example, Council on the Aging (Victoria), *Report to Consumer Credit Fund for Credit Preferences and Credit Traps for Older People*, September 2007 . See also ASIC reports 59 and 109, op cit. Many submissions to State Government inquiries such as the Consumer Affairs Victoria Consumer Credit Review in 2005 submitted that borrowers must receive independent legal and financial advice before entering into a reverse mortgage.

16 On SEQUAL members, under the SEQUAL Code of Conduct.

17 The SEQUAL Key Facts Guideline is a 4 p document which provides generic information on the features of a reverse mortgage, potential costs, a consumer checklist and details of where a consumer may go to access further information. The SEQUAL Equity Release Proper Process is a nine stage process undertaken by SEQUAL accredited Reverse Mortgage Consultants when assisting a consumer with their decision to apply for a reverse mortgage.

18 This includes its booklet "Thinking of using the equity in your home" and online reverse mortgage calculator which allows a consumer to assess the potential effects of decisions such as the amount borrowed, whether the loan is taken as an initial lump sum, or regular income payments or a combination of both, etc. It also shows how the borrower's home equity may be affected by future changes in the value of their home.

Despite these measures, there is evidence to suggest that the provision of timely information and advice to potential borrowers remains a challenge.[19] For example, some borrowers, in particular those who consider that they have no reasonable alternative sources of finance, may focus on obtaining funds at the expense of understanding the legal and financial implications of a reverse mortgage. Some borrowers may also enter loans without adequate discussion about loan alternatives with credit providers, brokers and financial planners.[20]

While SEQUAL lenders are required to ensure that borrowers receive independent legal advice before they enter into a reverse mortgage, several barriers to affordable legal and financial advice have been identified.[21] The cost of obtaining legal advice on an average reverse mortgage contract has been estimated at $700 to $1500.[22] Considering that some reverse mortgage borrowers have limited incomes, such a cost may deter borrowers from obtaining legal advice. While some lenders may pay for the cost of borrowers accessing financial advice from the proceeds of the loan this option may not be favourable as the compound interest applied to the loan may inflate the cost of this advice substantially before repayment of the loan is required.

It is also unclear whether professionals who provide advice to reverse mortgage borrowers have adequate knowledge and expertise of reverse mortgage products, and whether adequate numbers of these professionals have undertaken training relevant to equity release products. SEQUAL provides training to members of the Financial Planning Association of Australia, the Mortgage and Finance Association of Australia and CPA Australia, for industry accreditation as an Equity Release Consultant. However, the training is not mandatory and as reverse mortgages represent a small amount of total lending activity, there are likely to be professionals who offer advice to consumers who have not undertaken this accreditation training. This creates a risk that borrowers may receive advice from professionals who are not equipped to identify all the issues consumers face in taking out a reverse mortgage.

Within the legal profession, there are currently no mandatory standards for legal advice specific to reverse mortgages and no accreditation programs offered by the legal representative bodies for reverse mortgage and personal finance specialist lawyers.[23]

Consumers considering entering into a home reversion scheme may experience similar obstacles in accessing quality independent legal and financial advice.

iii. Product features

Minimum age and maximum loan-to-value ratios

Since debt increases during the term of a reverse mortgage, the younger a borrower the more likely they will deplete the equity in their homes to a level which impacts their ability to

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19 For example, see COTA op cit, ASIC report 109 op cit.

20 ASIC Report 109 found that only four out of 29 borrowers interviewed by ASIC reported that they discussed alternatives to reverse mortgages with their advisor. Also a shadow shop conducted by *CHOICE* magazine of 15 mortgage brokers and lenders found that the majority of these did not discuss alternatives to a reverse mortgage, such as downsizing (*CHOICE*, March 2007).

21 COTA op cit, ASIC report 109 opt cit.

22 This estimate is based upon the average small to medium sized firm lawyer billing out two to three hours to provide advice. However, these costs may vary as billable rates vary from region to region and firm to firm.

23 However, the Law Council of Australia and some law societies are progressing plans to implement specific reverse mortgage training, education and guidance materials aimed at improving the quality of legal advice to consumers.

meet future needs, such as medical and aged care.[24] Currently, most credit providers only make reverse mortgages available to applicants aged 60 or over. This recognises that younger borrowers represent higher risks to reverse mortgage providers. While this suggests that the market has determined a suitable age to offer reverse mortgages to borrowers, which minimises the risk of negative equity, this is not a mandatory requirement across the industry and lenders may offer a reverse mortgage to younger borrowers.

Similarly, borrowers who enter a reverse mortgage at maximum loan-to-value ratios (LVRs) risk over-depleting the equity in their home.[25] Latest industry statistics suggest that younger borrowers are using the maximum LVR available.[26]

The responsible lending conduct obligations introduced in Phase One of the credit reforms will provide some safeguards to borrowers against being entered into reverse mortgages that they do not have the capacity to repay, regardless of their age and the LVR they take out. To further assist borrowers to manage this risk, reverse mortgage specific pre-contractual disclosure could include information regarding the risk to borrowers of over-depleting their equity before the end of their life expectancy.

Default clauses

Reverse mortgage contracts contain specific clauses which, if breached, may result in the borrower being in default. Default could have serious implications for a borrower.[27] A number of issues associated with default clauses have been raised, namely that default clauses:

- may be too broadly drafted, creating uncertainty for the borrower about their obligations and what circumstances would trigger a default; and
- may include default triggers involving minor oversights such as failure to pay council rates on time, failure to pay for a property valuation, and failure to inform the provider that another person is living in the house.

Industry self-regulation has been directed to address these issues under the SEQUAL Default Conditions Guideline, which requires members to ensure their loan contract default clauses are fair and reasonable.

Under the Australian Consumer Law reforms, national unfair contract terms provisions will apply to standard reverse mortgage contracts. This may reduce the risk of borrowers being exposed to unfair default clauses. Borrower understanding of default clauses could also be enhanced by reverse mortgage specific pre-contractual disclosure including information regarding default clauses and their potential effects.

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24 The longer the term of the loan, the more compound interest is applied. This means that the borrower may lose a greater proportion of their equity, the longer the term of the loan is. However, the amount of equity borrowers' hold in their home will depend on the rate of growth of the value of the property.

25 LVR is the amount borrowed under a loan contract represented as a percentage of the value of the property offered as security.

26 The SEQUAL/ Deloitte June 2009 Reverse Mortgage Survey reported that on average borrowers aged under 65 years utilised all the LVR available to them.

27 Default may trigger a higher rate of interest payable, loss of any protection against negative equity, the borrower being required to repay the loan, or the provider commencing enforcement action.

Procedure upon default

The Credit Act contains requirements lenders must observe in the event that a borrower defaults.[28] However, these default procedures are not specifically tailored to reverse mortgage borrowers and may not be appropriate to their age. The relatively small size of the reverse mortgage market currently permits the provision of a more personalised standard of service from lenders. For example, current industry practice under the SEQUAL guideline on default conditions contains additional requirements for members including that they personally contact (or make a reasonable attempt to contact) the borrower prior to the expiry date of a default notice and ensure the borrower has received the notice and understands the consequences of not rectifying the default. However, these requirements are not mandated across the industry.

Lack of protection for non-title holding residents

Since most reverse mortgage contracts require repayment at the end of the borrower's life tenancy, a surviving non-title holding resident not listed as a borrower may have no protection against being forced to vacate the property. Some lenders do allow for a non-title holding resident to be added to the loan or be designated as a nominated resident, affording them protection of residency. However, such protection is not uniform across the industry.

3. Is there any need for specific measures to address issues relating to any of the product features discussed above, or any other product features of reverse mortgages?

4. Are any of the issues raised above relevant to the regulation of home reversion schemes?

Responsible lending conduct

Phase One of the credit reforms imposes obligations on holders of an ACL to observe responsible lending conduct obligations.[29] These obligations will apply to reverse mortgage lenders and credit services providers such as finance brokers and other intermediaries.

Responsible lending conduct obligations will prohibit licensees from entering into a credit contract with or suggesting a credit contract to a consumer, or assisting a consumer to apply for a credit contract that would be unsuitable for the consumer's requirements. A contract will be unsuitable where either it does not meet the consumer's requirements and objectives; or the consumer does not have the capacity to repay the loan, either at all or only with substantial hardship. To determine if a loan meets these requirements, licensees will need to make reasonable enquiries as to the consumer's requirements, objectives and financial situation and take reasonable steps to verify the consumer's financial situation.

In its regulatory guidance on responsible lending,[30] ASIC describes the requirement of reasonable inquiries as 'scalable'. In relation to reverse mortgages, ASIC expects a high

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28 Lender default procedures include requirements such as written notification to the borrower of the default, and allowing 30 days for rectification.

29 Credit licensees must comply with the responsible lending conduct obligations in Chapter 3 of the *National Consumer Credit Protection Act 2009*.

30 Australian Securities and Investments Commission. *Regulatory Guide 209: Credit licensing: Responsible lending conduct.* February 2010.

standard of investigation and verification by licensees as to the consumer's understanding of the loan and its possible consequences.[31]

As part of Phase Two, one option may be to consider the need for responsible lending conduct obligations tailored to the features of reverse mortgages, for example, stipulating that:

- the licensee's assessment of the borrower's capacity to repay the loan must include explicit consideration of the borrower's capacity to repay any potential negative equity or fixed interest loan break fee; and
- the licensee's assessment of whether the product meets the borrower's requirements must include:
  - consideration of alternatives to a reverse mortgage (such as downsizing);
  - whether the type and amount of the loan reflects the borrower's purpose for its use;[32]
  - how the loan may affect their entitlement to any pensions or benefits; and
  - information relevant to the borrowers' future costs and needs in relation, for example, to health and aged care.

5. Is there a need for specific responsible lending conduct obligations applicable to reverse mortgage providers and other intermediaries such as brokers?
6. Are the examples of possible mandatory reverse mortgage-specific responsible lending enquiries and assessments listed above appropriate?
7. Are there additional requirements that should be imposed on licensees in relation to responsible lending for reverse mortgages?
8. Are any of the issues and options raised above relevant to home reversion schemes?

D. Reform

The issues surrounding reverse mortgage products that prompted consideration of the regulatory arrangements in Phase Two include a higher than usual risk associated with older borrowers using what is typically their most significant asset, and often without a significant income stream.

In light of the risks of borrowers entering reverse mortgages without adequate comprehension of its terms and implications, there is a concern to ensure there are sufficient safeguards for consumers considering entering reverse mortgage products.

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31 Ibid. p.11.

32 For example, a borrower who wishes to use their reverse mortgage to supplement their fortnightly income may wish to receive the loan as a regular fortnightly payment rather than as a lump sum.

i. Protection against negative equity

Two broad approaches may be taken to address the risk of negative equity:

Option One: Maintain status quo

This option would involve continuing to rely on measures in place under industry self-regulation. As this option would involve no change to current arrangements it would have no significant impacts on consumers and business.

With the commencement of the Phase One responsible lending conduct requirements, consumers will be protected by the requirement for lenders and other credit service providers such as brokers to not provide or assist a borrower to apply for a reverse mortgage unless they assess that the borrower can repay the loan without incurring substantial hardship. However, these responsible lending conduct requirements will not impose a discrete obligation on lenders to offer any guarantee that borrowers will not incur negative equity.

Also, while industry self-regulation and practice may provide important protections to consumers it does not provide uniform protection and industry-wide compliance.

Option Two: Statutory protection against negative equity

This option would involve the introduction of a statutory requirement that lenders not seek to recover amounts from the borrower which exceed the value of the property (except under limited circumstances). A mandated statutory protection would provide a uniform approach which enhances certainty for borrowers, and ensures that borrowers are universally protected regardless of whether their lender voluntarily provides a no negative equity guarantee or not. Importantly, this option would also offer enforceability with appropriate penalties and sanctions. Options for consumer redress could also be attached to support such a statutory requirement.

Since most reverse mortgage providers already include no negative equity guarantees as part of their lending policy, it is expected that a statutory protection against negative equity will have a limited impact on lenders.

This option would also clarify for both borrowers and lenders the circumstances in which the protection against negative equity would not apply. This recognises that there are legitimate circumstances under which lenders should be able to protect their security in the mortgaged property. Such conditions would only result in the recoverability of negative equity to the shortfall the breach of such a condition has caused, rather than allowing lenders to recover the full amount of accumulated negative equity. For example, if the property was not sold at arms-length and the sale price was under market value, the negative equity the lender could recover may be limited to the difference that would have been achieved had the sale been at market value.

The current Australian industry best practice and international regulation provide examples of the circumstances which may invalidate a negative equity guarantee.[33] These include:

- sale of the property in a non arms-length transaction or other transaction not based on commercial terms;

33 Forms of no negative equity guarantees are in place in the UK and US and are part of the voluntary Code in New Zealand.

- fraud or misrepresentation by the borrower at the time they enter into the contract or relating to the terms and conditions of the loan; or
- significant wilful damage to the property by the borrower.

9. Which of the above regulatory approaches is preferred and why? Are there other options which should be considered?
10. If Option 2 is preferred, are the terms mentioned above which may void the statutory protection against negative equity appropriate? Are there others that should be considered?

ii. Provision of advice to consumers

Two broad approaches may be taken to strengthen the quality of information on reverse mortgages and the provision of advice to consumers generally:

Option One: Requirement for consumers to obtain independent legal and/or financial advice

Under this option, consumers would be required to obtain independent legal and/or financial advice before entering into a reverse mortgage. This could be achieved by borrowers accessing such advice from a provider of their choice, or from a one-stop-shop for the provision of all legal and financial advice to consumers.

The advantages of this approach include:

- increasing the level of current pre-contractual advice to consumers beyond that currently required by the Credit Act and industry self-regulation; [34]
- specific requirements relating to education, training, and standards of advice could be created for professionals providing such independent legal and/or financial advice; and
- a one-stop-shop advice provider would create uniformity of advice so that all borrowers are provided the same quality of advice.

However, without improvements to the quality of education regarding reverse mortgages to the advice professions, there is no guarantee that there will be adequate numbers of lawyers, brokers and planners with sufficient expertise to provide consumers quality advice regarding the legal and financial implications of an equity release product.

Other potential impacts include:

- the cost of entering into a reverse mortgage could increase as the expense of obtaining legal and/or financial advice would be either paid directly or indirectly by consumers;
- if the cost of advice is borne by lenders, or borrowers, this may potentially cross-subsidise the cost of advice to consumers who decide not to enter into a reverse mortgage;

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34 The SEQUAL Code of Conduct does require lenders to ensure borrower receive legal advice and recommend borrowers obtain independent financial advice. Some lenders also require potential borrowers obtain independent financial advice.

- if the cost of advice is paid for by a user pays method, consumers who decide not to enter into a reverse mortgage after obtaining advice may still need to pay for the advice service;
- the demand for advice regarding reverse mortgages and home reversion schemes may exceed its supply, creating a bottleneck for consumers wanting to apply for a reverse mortgage; and
- a legal and/or financial advice provider of the consumer's choice may provide advice tailored to the consumer's personal circumstances. A centralised provider of advice may not be able to achieve such personalised advice.

Option Two: Improve pre and post-contractual generic advice to consumers

Under this option, lenders and intermediaries such as brokers would be required to provide borrowers with reverse mortgage specific forms of pre and/or post-contractual disclosure. For example, pre-contractual disclosure could be provided in the form of a prescribed Information Statement containing generic information regarding the key features and implications of a reverse mortgage. Such a prescribed information statement may need to be provided to the consumer with sufficient time for them to adequately consider it before gaining further legal and/or financial advice and before entering the contract (for example, upon first contact with the lender or intermediary, such as a broker). Content could cover issues such as:

- the features of a reverse mortgage;
- what compound interest is and how it affects the amount repayable under the loan;
- explicit cautions about potential risks such as over-depleting equity or possible implications for pension entitlements;
- indicative illustrations of how taking out a reverse mortgage as a lump sum, line of credit or regular payment affects the amount repayable under the loan;
- indicative illustrations of the potential break fees which may be incurred under a fixed interest loan;
- indicative illustrations of how a reverse mortgage can affect the equity in a borrower's home, with different scenarios regarding changes in interest rates and house prices;
- generic information regarding the rights and obligations of a borrower under a reverse mortgage such as property maintenance and the rights of other residents of the property or non-title holding partners;
- sources of further advice; and
- a checklist for consumers including possible questions they should ask their advisors.

Additional ongoing disclosure could assist borrowers' understanding of the ongoing cost of their loan and how it may affect their current and future financial needs. Content could cover issues such as:

- the compounded interest accumulated on the loan since the previous statement;

- ongoing obligations of the borrower under the contract such as property maintenance, property valuations, and especially those obligations that trigger default or void any no negative equity protection; and
- indicative illustrations of the borrower's remaining equity in their home.

Improving existing pre and post-contractual disclosure in these ways could provide a relatively simple but effective way of ensuring simplified but comprehensive information is provided uniformly to all borrowers.

Improving current disclosure requirements to consumers will increase the costs for lenders providing this disclosure. Such additional costs may ultimately be passed onto borrowers.

11. Which of the above regulatory approaches is preferred and why? Are there other options which should be considered?

12. Would there be merit in considering both options?

13. What advice could be usefully provided pre-contractually and which post-contractually?

14. Would there be any merit in the options raised above being applied to home reversion schemes?

iii. Product features

Broad approaches to improve consumer protections surrounding minimum age and maximum LVR requirements, default clauses, and non title-holding resident protections are discussed above.

There are two broad regulatory options for default procedures:

Option One: Maintain status quo

Under this option, lenders would continue to operate under the default procedure obligations under the Credit Act. However, these default procedures are not specifically tailored to reverse mortgage borrowers and may not be appropriate to their age. The SEQUAL Guideline on default conditions contains additional requirements, which are tailored to elderly borrowers. However, this is not a requirement across the whole industry.

Option Two: A reverse mortgage specific default procedure

Under this option, a uniform default procedure would be mandated across the entire reverse mortgage industry. Such a procedure could have requirements more appropriate to the age of reverse mortgage borrowers such as requiring the lender to make personal contact with the borrower.

15. Are current arrangements provided under the Code and industry practice adequate, or are other measures required? Please provide details.

16. If a reverse mortgage specific default procedure is required, what could this involve (for example, a requirement for lenders to make personal contact with borrowers, prior to the expiry of a default notice)?

Appendix

Reverse mortgage industry statistics

Market	**Payment type (last 6 months to June 2009)**
• Over 38,000 reverse mortgages on issue • Total of $2.6 billion • Average loan size is $68,500	• 97 per cent taken as a lump sum • 3 per cent taken as an income stream
Interest rate type	**Growth rates**
• 85 per cent variable • 15 per cent fixed	• 5 per cent in the first half of 2009 • 13 per cent in the second half of 2008
Loan-to-Valuation Ratio (LVR)	**Borrowers**
• Borrowers aged under 65 — use an average of 15 per cent LVR (this is the maximum) • Borrowers aged between 70-74 — use an average of 17 per cent LVR (the maximum is approx 24 per cent) • Borrowers aged over 80 — use an average of 24 per cent LVR (the maximum is approx 40 per cent)	• 41 per cent couples • 43 per cent single women • 19 per cent single men • Average age of existing borrowers is 74 years • Average age of new borrowers is 73 years
Loan use (new loans in last 6 months to June 2009)	**Credit providers**
• Regular income approx 18 per cent • Home improvement approx 17 per cent • Debt repayment approx 14 per cent	• Core credit providers include Commonwealth Bank of Australia, St. George, Bankwest and previously Royal Bank of Scotland • Several credit providers have exited the market over the past 24 months
Distribution channel (last 6 months to June 2009)	**Geographic split**
• Direct from credit provider approx 53 per cent • Brokers approx 45 per cent • Financial planners approx 2 per cent	• NSW — 33 per cent • Qld — 16 per cent • VIC, SA, WA approx 16 per cent each

Source: SEQUAL/ Deloitte Reverse Mortgage Survey June 2009.

Chapter 4: Regulation of investment lending

Objectives

This chapter seeks to consider the issues below.

- Do investment loans (other than mortgages for residential investment properties and margin loans) raise significant concerns about irresponsible lending and borrowing to justify regulatory intervention?[1]

- If there are significant concerns, should Commonwealth regulation be introduced to address those concerns? If so should it be via the *National Consumer Credit Protection Act 2009* (Credit Act) or the *Corporations Act 2001* (Corporations Act)?

- If Commonwealth regulation is required, should it seek to only cover borrowers who are natural persons or should it include borrowers that are corporate entities?

A. Background

i. Context

In Australia the borrowing of money to invest in shares, securities and managed investments could reasonably be characterised as 'mainstream' as an increasing number of people have, in recent years, been borrowing to invest in these products in the course of managing their domestic finances.

In October 2008, the Council of Australian Governments (COAG) identified the provision of investment loans in Australia (other than mortgages for residential investment properties and margin lending) as potentially requiring Commonwealth regulation and agreed that it be examined as part of Phase Two of the COAG credit reform agenda.

Investment loans were not part of Phase One of the COAG credit reform agenda. This was because the issues that had to be assessed in establishing whether there was sufficient justification for regulatory intervention were considered to be quite complex.

These issues require consultation with a broader range of stakeholders to ensure that the most satisfactory outcome is reached in relation to consumer safeguards, consumer choice and the maintenance of efficient and fair markets.

ii. Focus

This Phase Two review will focus on whether the current limited regulation of investment lending ensures efficient and fair market outcomes for lenders and borrowers, and, if not, to consider options to address these concerns. For example, it will seek to explore how

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1 The chapter discusses (i) unsecured personal loans to borrowers who intend to invest in shares; (ii) home equity loans to invest in shares or managed investment schemes (MIS); and (iii) credit card advances to fund share purchases. However, other relevant products will be examined as part of this Phase Two project.

consumer choice could best be enhanced, including by assessing the extent to which consumers find investment loans to be sufficiently transparent and understandable.

Further, the examination will consider appropriate ways to improve innovation and risk taking by lenders and brokers; facilitate competition between them; and where necessary, provide appropriate consumer safeguards.

B. Current arrangements

There is limited regulation of investment lending under current arrangements. Residential investment property loans are covered by the Credit Act and margin loans are covered by Chapter 7 of the Corporations Act.

i. Credit Act

The Credit Act imposes an obligation on lenders and intermediaries to not provide or arrange unsuitable loans for borrowers. A loan will be unsuitable if, for example, at the time the loan is assessed, it is likely that the borrower could only make repayments with substantial hardship. The Act provides that there will be heavy penalties for lenders and intermediaries who place consumers in these loans.

The Credit Act regulates investment loans only where the borrower is a natural person or a strata corporation and where the loan is meant predominantly to purchase, renovate or improve residential property for investment purposes or to refinance an existing investment loan.

Residential property is defined in the Credit Act to include such matters as land that contains or will contain a dwelling; aged care homes or dwellings in a retirement village; or an equity of redemption in land that contains or will contain a dwelling.

ii. Chapter 7 of Corporations Act (Margin loans)

Following the enactment of the *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009* (Modernisation Act), margin loans to retail clients are now regulated under Chapter 7 of the Corporations Act and are subject to supervision and enforcement action by the Australian Securities and Investments Commission (ASIC).

A person who holds an Australian Financial Services Licence (AFS licensee) now has an obligation to lend responsibly to the borrower. This requires the AFS licensee to not provide an unsuitable loan to the borrower. A loan will be unsuitable if, for example, at the time it is being assessed, it is likely that the borrower could only make repayments with substantial hardship.

A margin loan allows a person to borrow money to invest in shares (or other financial products) and use the latter as security for the loan. The lender has the right in specified circumstances to compel sale of the shares, for example, where the value of the shares fall below a required minimum and the borrower is unable to make relevant payments to the lender.

iii. *Australian Securities and Investments Commission Act 2001* (ASIC Act)

The ASIC Act regulates the conduct of investment lending. In addition, at the Commonwealth, and State and Territory levels there is a range of remedies in respect of unfair conduct generally (for example, conduct that is unconscionable or misleading or deceptive).

The ASIC Act prohibits conduct that is misleading or deceptive — or is likely to mislead or deceive — in relation to the supply of credit products and services (including financial services). It also prohibits other market misconduct including: misleading advertising and marketing, including 'bait' advertising; misleading statements made by finance brokers and sales representatives among others; undue harassment and coercion at the point of sale and in debt collection; referral selling and pyramid selling; sending unsolicited credit cards or asserting a right to payment for other unsolicited financial services; and unconscionable conduct.

C. Current issues

i. Borrowing to invest — and financial advice

The objective of this examination of investment lending is to determine whether there are sufficient grounds to warrant its regulation at the Commonwealth level. It is expected that comments in response to questions posed in this chapter would assist this objective by providing a basis for further analysis of whether or not regulation may be required.

Unsecured personal loans to invest in shares

It is not uncommon for the provision of credit for investments in shares, especially where the amounts being borrowed are relatively small (that is between $10,000-$50,000), to be done in circumstances where the borrower has not received financial advice as small investments in direct shares are unlikely to provide sufficient remuneration to justify a financial adviser's involvement.

Further, there are concerns within industry that many people taking out personal loans may not wish to pay fee-for-service to an adviser when all they want to do is invest in the stock market. These people may use electronic stock trading tools to determine what stocks they should invest in and many of them are unlikely to seek financial advice.

Credit card advances to finance share purchases

Another example of investment lending involves borrowers with large credit card limits, particularly those on low honeymoon rates, who use the cards to fund direct purchases of shares through share trading sites. Shares are often held for only a short term. When the credit card honeymoon rate is nearly up, these borrowers swap their balance over to a new card to take advantage of its honeymoon rate. With the huge range of credit card offerings available, this cycle may continue indefinitely. This form of investing is understood to be done regularly without financial advice.

Home equity loans to invest in direct shares or MIS

There are some concerns within industry groups that many borrowers who engage in this conduct are older and they use the equity in their home to fund share purchases or investments in a managed investment scheme. It is possible that investments in direct shares would be done without financial advice.

A managed investment scheme in this context refers to an investment in a scheme such as the development of a winery or plantation where the consumer will be able to obtain significant taxation advantages, and often finances the purchase of the investment through a loan (in order to maximise those advantages).

These types of schemes have been subject to criticism on the grounds that they are marketed through intermediaries who can receive high commissions. This can result both in inappropriate sales and increased risk in respect of the potential return on the investment. For example, if the intermediary earns an immediate upfront commission of 10 per cent of the investment the anticipated return must be generated from 90 per cent of the funds invested, in effect, increasing the risk to the consumer.

Investments through the Westpoint companies are another example of where people were encouraged to use their home equity to fund investments. The risks for consumers were increased where they increased the amount of their investment through a loan (using the equity in the family home for security). This left them exposed to the potential risk of having the investment fail and still being liable to meet the repayments on such a loan.

When regulation might be appropriate

It is worth noting that even if the above were to suggest the existence of a regulatory gap, it would not necessarily justify regulatory intervention. Intervention will only be justified if the occurrence was widespread enough to be having a significant impact on consumer choice and safeguards and where it was considered that a non-interventionary approach would be unlikely to rectify the relevant market failure.

Having said this, it is also likely that some borrowing to invest, whether in shares, managed investment schemes or commercial property, is done with the benefit of financial advice and this may provide a reason to exercise caution when considering whether to intervene in relevant markets.

1. Do borrowers who invest in shares, securities and managed investment schemes require the protections (for example, responsible lending requirements) that are provided in the Credit Act and in Chapter 7 of the Corporations Act? If so, please explain why.

2. Is lending for an investment purpose inherently different to lending for a personal or domestic purpose? If so, what are the reasons for this? Please explain the circumstances under which you consider that any differences might support the case for the regulation or non-regulation of investment lending.

3. In the absence of regulation under the Credit Act or Chapter 7 of the Corporations Act, does current market practice, including industry self-regulation (if any), provide sufficient safeguards for borrowers? If so, please explain how these occur.

4. Given that borrowers of margin loans and loans for residential investment property are protected by responsible lending obligations imposed on lenders, is there any reason why similar protection should not be given to those who borrow to invest in other financial and investment products?

5. Are there any other investment products, besides those mentioned in this section of the chapter, that potentially raise concerns about irresponsible lending practices? If so, please explain what they are and the circumstances under which any identified problems might arise.

6. Alternatively are there any circumstances surrounding the provision of loans for investment purposes that suggest that regulatory intervention may not be required?

ii. Recent developments — Ripoll inquiry report

The November 2009 report of the Parliamentary Joint Committee on Corporations and Financial Services titled *Inquiry into financial products and services in Australia* (Ripoll report), contained an examination of key issues associated with the collapse of some financial services providers, such as Storm Financial and Opes Prime.

The Ripoll report reviewed borrowers' motivations in investing, and the incentives for lenders and intermediaries. The conduct examined in the report highlights the limitations of disclosure in decision-making by consumers. Generally, consumers do not 'shop around' to compare the costs of financial advice. Further, only a small percentage of consumers know that they are being charged commissions or understand the potential impact of the commissions on the advice provided.

These observations in the Ripoll report would appear to give credence to the view that borrowers of investment loans are not necessarily more sophisticated than those who borrow for domestic purposes and that the motivations and incentives of intermediaries and lenders have the potential to reduce lending standards.

Moreover, it is becoming apparent that family homes are being put at risk where the equity in the home is used to secure a loan for investment purposes. The Government has announced its response to the Ripoll report, which is called 'The Future of Financial Advice'.[2]

The Government also announced that there will be a review of other measures, including the appropriateness of the current method of classifying unsophisticated and sophisticated investors (i.e. retail and wholesale clients). This classification has not been reviewed since its introduction almost 10 years ago.

2 Minister for Financial Services, Superannuation and Corporate Law Media Release 26 April 2010.

D. Possible outcome

Options

The consideration of these issues may lead to the following options:

- maintain the status quo; or
- introduce relevant Commonwealth regulation.

Option One: Status Quo

Under this option, there would be no changes to the current regulatory arrangements in relation to borrowing to invest. This may suggest that there is no market failure and that the case for a sufficient justification to intervene has not been made.

Option Two: Commonwealth regulation

The key issue here is about finding an appropriate form of regulation, assuming that there is sufficient justification to intervene.

Another issue relates to whether regulation should focus on natural persons or corporate entities.

A further issue concerns the type of *investment product* that should be regulated.

Making judgments on these issues would be relevant in forming a view about whether to intervene and if so what the best approach to intervention should be. For example, it will assist in deciding on whether regulation should occur under the Credit Act or under Chapter 7 of the Corporations Act.

Natural persons or corporate entities

In the Credit Act the responsible lending obligations apply only when the borrower is a natural person and in Chapter 7 of the Corporations Act (in respect of margin loans) similar obligations apply only when the borrower is a retail client.

This raises the question whether any regulation of loans that are meant to be invested in shares, securities and managed investments should be limited to natural persons or be extended to corporate entities.

The key concern here is that if lending for investment (other than margin loans) were to be regulated under the Chapter 7 provisions, a failure to regulate corporate vehicles would potentially create an avoidance mechanism. This could occur because the non-regulation of companies would provide an incentive for some lenders to avoid the regulation by structuring their loans to ensure that they are supplied to borrowers that are companies. This risk might not exist if general investment lending were to be regulated under the Credit Act (on the basis that the scope of the Act was limited to natural persons).

On the other hand, extending the Chapter 7 provisions to companies would, for example, mean that a wide range of business lending would be captured and commercial credit will then be regulated under Chapter 7. Extending the Credit Act to companies will raise similar issues.

Retail and sophisticated/wholesale investors

The recently announced package on the future of financial advice includes a proposal to review the appropriateness of current methods of classifying retail and wholesale investors.

The Corporations Act provides retail investors with greater protections in recognition of their growing participation and interests in markets. Wholesale investors face less protection given their expertise and experience.

The distinction between retail and wholesale clients is important in the regulation of financial services. The obligations placed on financial services providers in relation to retail clients are far more onerous while wholesale investors are assumed to be financially sophisticated and able to protect their investment interests in an optimal fashion without regulatory interference.

Nature of underlying investment

It would be worth considering whether the regulatory approach should be driven by the nature of the underlying investment that is the subject of a loan. If so, this will require an examination of the nature of various investment products and conclusions to be drawn on their similarities and differences.

There is a view that the coverage of margin loans in Chapter 7 should provide ample support for the same regulatory approach to shares, securities and MIS. However, it is arguable whether this view necessarily gives credence to regulating such investments under Chapter 7. This is because a margin loan is usually provided in the context of other financial advice or services. A margin loan is a very specific financial product where the credit is intrinsically linked to the securities it is invested in and secured against. Although other credit products can be used for buying securities, the interrelationship between the loan, and the investment, which is also the security for the loan, will be far less.

On the other hand, although this might suggest good grounds for considering whether to extend the coverage of the Credit Act to general investment lending, issues regarding whether to limit any potential coverage to natural persons or to include corporate entities would have to be looked at carefully.

A further view in support of coverage under Chapter 7 is that if the investment is provided predominantly to acquire a financial product, like a share, unit in an MIS or derivative, then the regulation of the credit service would naturally sit within the financial services provisions of the Corporations Act. This approach would effectively create a new type of financial service, being ‘the provision of an investment lending facility’. Further, it would harmonise ongoing disclosures such as periodic statements, simplify offer documents and reduce compliance costs.

The advantage of this approach would be that the regulation of investment lending could then be harmonised with the recent regulation of margin lending (that is, if margin lending is considered to be a comparable financial product). This approach will also bring such contracts within the unfair contract terms regime (that is, via the ASIC Act).

That being the case, it would appear that other non-financial product lending could be regulated under the Credit Act.

7. In light of the discussion under *Option 2: Commonwealth regulation*, do you have a view on the approach that any potential regulation should take? In particular, would you prefer that investment lending be regulated under the Credit Act or in Chapter 7 of the Corporations Act?

8. Please provide answers (with explanations) in relation to:

   (i) whether regulation should cover natural persons or corporate entities; retail or sophisticated investors; and

   (ii) whether considerations for regulation should be driven by the type of investment product.

CHAPTER 5: REGULATION OF SHORT-TERM SMALL-AMOUNT LENDING

Objectives

- Examine State and Territory approaches to interest rate caps.
- Consider the need for further intervention in relation to high-cost short-term small-amount loans as a contributor to over-indebtedness.

A. Background

i. Overview of for-profit small-amount short-term lending market

There are no standard terms on which short term, small amount loans are offered. Lenders generally offer amounts from $100 to $5,000 with repayment periods ranging from a week to two years. Interest rates vary (in extreme cases, they can be over 1,000 per cent per annum) and a range of fees may be charged in addition to interest.

1. Please provide information on the average size and number of short-term, small-amount loans that you offer.

2. Please provide information on the terms of the loans that you offer or that are available in the market.

3. Please provide information on the profile of consumers who access these loans (for example, income (including source) and expenses, dependents and other sources of credit used) and the purpose for which this type of credit is sought.

4. Please provide information on the number of loans that customers apply from an individual lender over a 12 month period.

5. Please provide information on the amount of capital lost as a result of defaults.

6. Please provide information on why these consumers use this type of credit in preference to other forms of credit.

7. What is the average cost to the lender of providing short-term, small-amount loans, (for example, administration costs, profit margins, risk)? Are these costs standard? Are there any factors that are likely to result in significant variation among lenders? Does the interest rate vary to reflect the risk to the lender, particularly in those jurisdictions where there is no interest rate cap?

8. What is the breakdown of profit on loans, for example, interest, fees and charges?

9. Please provide information on the size of your loan book/volume of capital.

ii. Microfinance offered by mainstream lenders in conjunction with community organisations

Generally, microfinance programs offered by mainstream lenders in conjunction with community organisations and government provide no or low-cost short-term, small-amount loans to low income consumers who are excluded from mainstream credit. Supply of these loans is not necessarily sufficient to meet the demand of everyone in the community and eligibility requirements are usually restricted.

Microfinance programs are generally directed to assisting borrowers to buy assets or make the transition to mainstream lending, rather than to pay for standard living expenses. On the other hand, high-cost, small-amount, short-term loans are often used for purposes such as the payment of household bills, rent and living expenses.

In October 2009, the Government announced a $50 million investment over two years to fund innovative projects to help build the financial capacity of people on very low incomes, including the unemployed. As part of this program, funding will be available to church, charitable and community organisations to provide No Interest Loan Schemes (NILS) and dollar-for-dollar matched savings accounts for low-income earners. Funding will also be provided to further develop and explore the potential of a community development financial institution (CDFI) sector, which would seek to provide Australians currently excluded from mainstream banks and financial services with greater access to fair and appropriate financial products.

In support of community microfinance programs, the National Consumer Credit Protection Regulations 2010 minimise the regulatory requirements by means of an exemption from licensing obligations (under the Credit Act) for charities and other organisations that provide microfinance credit services in conjunction with licensed credit providers.[1] Generally, these services are provided to low income consumers who would not normally qualify for other credit products from mainstream lenders.

iii. Alternatives to short-term, small-amount lending

Credit products offered by 'mainstream' credit providers may provide alternatives to high-cost, short-term, small-amount loans. However, these types of products are not available as alternatives to all borrowers. Some borrowers with unrepaid mainstream loans may not qualify for higher levels of mainstream debt. Others may simply not meet lending criteria for mainstream loans. In many cases, mainstream lenders do not offer small amount loans.

Consumers who do access mainstream credit by using a credit card or redrawing from a home loan, for example, may then carry debt and incur associated interest and other charges over a longer term.

Some consumers may choose to make payments late. This may, in turn, result in further financial detriment through the imposition of default fees for late payment. Some individuals may resort to using pawnbrokers, which may deprive them of the possession and use of necessary items.

In the absence of any legitimate short-term loan options, borrowers may resort to using unregulated lending sources. Others may rely on family or friends, either as a source of

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1 Subregulation 20(12) of the National Consumer Credit Protection Regulations, 2010.

loans or to act as guarantors for loans. This may extend financial pressures to other parties or contribute to the breakdown of relationships.

10. Are there alternatives to high-cost loans in addition to those listed above?

11. What are the main obstacles to consumers accessing alternatives to short-term, small-amount loans?

12. What are the main costs and risks associated with use of these alternatives?

iv. Government programs

To assist those in financial hardship, State, Territory and Commonwealth Governments fund and administer a number of initiatives to provide consumers with advice and support on budgeting and financial management issues.

Financial assistance available in relation to utility bills

People who experience severe financial difficulty may be eligible for State-funded support under the Utility Financial Assistance Programs.[2]

Advance payments of income support

Income support recipients may receive a portion of their future income support entitlement as a lump sum to assist them to budget for major expenses (advance payment). Changes to the law will increase the maximum advance payment and allow pension recipients to obtain up to six advance payments in a year from 1 July 2010.[3] Income support recipients can access advance payments of both income support and Family Tax Benefit payments.

Financial education and information

ASIC, through the Financial Literacy Foundation, and State and Territory consumer agencies, provides information to consumers on issues such as budgeting, saving, debt management and investment.

The Department of Families, Housing, Community Services and Indigenous Affairs administers programs for the provision of free financial counselling services in the form of the Financial Management Program and the Commonwealth Financial Counselling (CFC). The CFC funds community and local government organisations to provide free counselling services focussed on low-income groups.

Centrelink administers the Financial Information Service, a free education and information service available to everyone in the community, which is designed to help people make informed decisions about investment and financial issues.

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2 These include the Utility Relief Grant Scheme (VIC), the Emergency Energy Payment Scheme (SA), the Hardship Utility Grant Scheme (WA) and the Emergency Accounts Payment Assistance Scheme (NSW).

3 www.jennymacklin.fahcsia.gov.au/internet/jennymacklin.nsf/content/flexible_pension_system_12may2009.htm. The maximum amount will be $1,000 for full-rate pension recipients ($1,500 for couples) in each 13 fortnight period, accessible as a single advance payment, or by two or three advance payments in the 13 fortnight period.

State and Territory Governments also contribute funding to community and local government organisations to provide free financial counselling services.

13. Are borrowers aware of the availability of Utility Financial Assistance Programs? What proportion of short-term small-amount loans are used to pay utility bills?

14. What proportion of users of short-term, small-amount loans are benefit recipients? Are these users aware of the availability of advances on income support payments? What are income support recipients using the advance payments for?

15. Do users of short-term, small-amount loans know of and use budgeting/debt management services?

B. Current arrangements

i. Commonwealth regulation

In 2008 the Council of Australian Governments (COAG) agreed that the Australian Government would assume responsibility for regulating consumer credit and related services from the States and Territories.

Phase One of the National Consumer Credit Protection reforms commenced on 1 July 2010. The reforms include a number of measures to improve consumer protection and deter predatory lending practices, and incorporate a number of reforms considered by State and Territory governments prior to the Australian Government assuming responsibility for credit regulation.

- **Licensing:** introduces upfront entry and ongoing conduct requirements (to exclude persons who are not fit and proper, promote competency and guard against conflicts of interest) and provides access to external dispute resolution (EDR) mechanisms.
- **Responsible lending conduct:** requires lenders to conduct an assessment that the credit contract or lease is not unsuitable for the consumer.
  - A contract will be unsuitable where either it does not meet the consumer's requirements and objectives; or the consumer will be unable to meet the repayments, either at all or only with substantial hardship. In undertaking the assessment the lender must make reasonable inquiries about both the consumer's requirements and objectives and their financial situation, and take reasonable steps to verify the consumer's financial situation.
  - This will limit the provision of loans to consumers who are, or are at risk of being over-indebted. Responsible lending conduct obligations will limit the provision of loans to cases where the consumer can reasonably be expected to be able to comply with their financial obligations under the contract without substantial hardship, thereby reducing the provision of further credit which could contribute to debt spirals.
- **National Credit Code:** largely replicates the State-based Uniform Consumer Credit Code and includes:
  - enhancements to close known loopholes, such as tightened exemptions for pawnbroking and low-cost, short-term credit;

- improved operation of the business purpose declaration;
- information statements and notices which require lenders to inform consumers about their rights to apply for hardship variations and stays of enforcement, access to external dispute resolution mechanisms, and the existence of financial counsellors and legal aid; and
- power for the court to re-open unjust contracts and review unconscionable interest and other charges.

• **Strong national regulator:** ASIC will be able to ban people from the industry and impose a range of penalties in enforcing the regime. ASIC will also have standing to make an application to the Court to re-open an unjust transaction or challenge unconscionable interest or certain charges where it is in the public interest.

The *Trade Practices Amendment (Australian Consumer Law) Act 2010*, which implements the national unfair contract terms reforms, commenced on 1 July 2010. Although the national unfair contract terms provisions included in this legislation will not apply to upfront fees and interest rates, they do provide some further safeguards in the area of high-cost credit as far as they cover contingent fees, such as default fees.

The Government has also agreed to implement the Australian Law Reform Commission's recommendation to move to a more comprehensive credit reporting regime.[4] The Commission's rationale was that increasing the range of information that credit reporting agencies are able to collect may encourage improved lending practices and make it easier for some people on low incomes to obtain finance.[5]

ii. State and Territory regulation

Some States and Territories have unilaterally put in place mechanisms to regulate consumer credit in addition to the Uniform Consumer Credit Code. These include interest rate caps and registration or licensing of lenders. For example, New South Wales, Queensland, Victoria and the Australian Capital Territory have enacted interest rate caps.

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4 Australian Government Response to the Australian Law Reform Commission Report 108: *For Your Information Australian Privacy Law and Practice.*

5 ALRC Media Release *ALRC proposes a more comprehensive credit reporting regime* www.alrc.gov.au/media/2007/mr1207_credit.html, 12 September, 2007.

A summary of State and Territory regulation is included in the attachment at Table 1.

16. How effective have interest rates caps been at restricting the cost of credit to borrowers?

17. How do the different regulatory approaches among the jurisdictions affect the short-term small-amount lending market including the availability of credit, the terms on which it is offered and the number of credit providers?

18. In those jurisdictions with a cap, how have lenders responded (for example, have they exited the market, revised prices, changed business structures or resorted to avoidance techniques)?

19. Is there evidence of an increase in avoidance or unlawful lending in jurisdictions that have introduced a cap?

iii. Industry self-regulation

The National Financial Services Federation (NFSF) is an industry association representing the for-profit, short-term, small-amount lending industry. NFSF members are subject to an industry code of conduct and its membership is obliged to adhere to an industry code of practice. The Code of Practice requires lenders to make full disclosure of interest fees and charges.[6] NFSF also has internal dispute resolution processes and undertakes to arrange for counselling to assist customers with financial management on request.

20. What proportion of borrowers makes use of available internal dispute resolution processes? How effective are they in resolving disputes?

C. Current issues

The Government has committed to an examination of State and Territory approaches to interest rate caps during Phase Two of the national credit reforms and has agreed that those jurisdictions with caps can retain them, pending the outcome of the review.

Some interested parties have expressed concern that the measures put in place in Phase One of the national credit reforms do not provide sufficient consumer protections to prevent indebtedness as a result of using high-cost, small-amount, short-term loans.

Concern has been expressed about the lack of availability of appropriate 'mainstream' alternatives to short-term, small-amount loans. A reduction in the number of available short-term, small-amount loans may exacerbate this.

21. What will be the impact of licensing and responsible lending obligations on short-term, small-amount lending?

22. Is there evidence of a need for further Government intervention to address specific issues with high-cost lending?

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6 www.nfsf.org.au/code-of-practice.htm.

D. Reform

During the consultation process for Phase One of the consumer credit reforms, the issue of interest rate caps met with conflicting views among stakeholders. In recognition of this, under Phase One of the COAG reform process, it was agreed that jurisdictions with interest rate caps in place would retain them, and those without caps would not introduce them.

Under this arrangement, the Commonwealth undertook to consider the issue of interest rate caps during the course of Phase Two.

Option One: Maintain the status quo (No further Commonwealth intervention)

Under this option, the Commonwealth Government would not impose further regulation at this time.

There may be benefit in deferring consideration of the need for further intervention to allow additional time after the implementation of Phase One of the national credit reforms to observe whether the responsible lending conduct requirements are sufficient to provide consumer protection. If at a later stage the need for further invention is warranted it may not be in the form of an interest rate cap.

If it is decided that no further intervention is warranted at this time, jurisdictions with an interest rate cap may choose to maintain them, and those without may choose to implement one. This would be allowed under the intergovernmental agreement.

If this were the outcome, it would undermine the spirit of the COAG credit reform objective of nationally consistent regulation of consumer credit as States and Territories may not necessarily impose uniform caps.

Option Two: Implement a national interest rate cap

Under this option, the Commonwealth Government would implement a national interest rate cap. If this option were to be adopted it would be necessary to establish a basis for the rate at which the cap would be set and which fees and charges (if any) should be included.

An interest rate cap inclusive of fees and charges restricts the overall cost of credit a provider can legally charge. A cap exclusive of fees and charges does not strictly limit the overall cost of credit as costs may be moved from the interest rate to upfront fees and charges.

Each jurisdiction in Australia with an interest rate cap has determined the level of its cap on the basis of different criteria. To implement a national interest rate cap, it would be necessary to consider several factors, such as the costs, risks and profitability and community expectations about what may be a reasonable interest rate. The risk of an interest rate cap making such products unviable and therefore being withdrawn from the market has been raised repeatedly.

A number of Australian jurisdictions have found that lenders have circumvented the cap.

Below is a summary of some of the key arguments that have been raised repeatedly in debate and submissions on the topic of interest rate caps.

Arguments raised in favour of interest rate caps

- Failure to implement a national cap would result in a loss of protection for consumers in jurisdictions with a cap.
- The presence of a cap makes it easier to seek remedies as proof of breach of a cap is relatively easy (that is, it is not necessary to prove that the interest rate is unconscionable).
  - However, there is evidence that lenders in jurisdictions that have caps in place have sought to avoid the cap, or the Code altogether.
- Disclosure of costs is not sufficient protection for vulnerable, desperate consumers who will take up credit irrespective of the cost.
- Competition is not an effective price control mechanism in this market. Annualised interest rates in excess of 1,000 per cent have been seen in jurisdictions without an interest rate cap.

Arguments raised in opposition to interest rate caps

- Not adopting a cap at this time would be in line with the recommendation in Consumer Affairs Victoria's *Small Amount Lending Inquiry 2008*[7] recommendation that a cap be introduced only after other alternatives were trialled.
  - The inquiry recommended establishing an Industry Code of Practice, mandating compulsory membership of an EDR scheme, and applying unfair contract terms to credit contracts.
  - Mandatory EDR membership will be mandated in Phase One of the national credit reforms and the Australian consumer law reforms will apply unfair contract terms to credit. Further measures, canvassed by Consumer Affairs Victoria in a draft Industry Code of Practice, are raised as Options 3 to 5.
- The fixed costs and risk associated with small-amount, short-term loans are higher than other forms of credit, therefore it is appropriate that the interest rates are higher. Limiting the cost that can be passed on to the consumer may discourage lenders from offering the product as they are not viable.
  - However, short-term, small-amount loans are still offered in jurisdictions that have introduced caps which may suggest that these products remain viable.
  - Low default rates do not seem to justify the risk premium and it is suggested that the reliance on direct debit facilities reduces the default risk.
- It is recognised that an annualised percentage rate may not appropriately reflect the cost of a short-term loan.
  - Mandatory comparison rate schedules were not retained in the National Credit Code. Further consideration of the mandatory comparison rate regime will occur during Phase Two.

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7 Department of Justice, Consumer Affairs Victoria *Small Amount Lending Inquiry 2008,* 17 December 2008.

- Introducing an interest rate cap may see lenders of short-term, small-amount loans leave the market. This would reduce the supply of these products and could result in the exclusion from the credit market of low-income earners or those with poor credit ratings. As a result, they may resort to other sources of credit, including unregulated sources.
  - The National Australia Bank (NAB) Small Loans Pilot, initiated in 2008 to examine issues associated with the provision of small loans outside the mainstream credit market found that for loans between $1,000 and $5,000 an annual percentage rate of 32.8 per cent (or $18.70 per $100) was the minimum required to enable the lender to break even. In its report, the National Australia Bank observed that the breakeven rate would be likely to be higher for smaller loans due to the need to recoup fixed administration costs and that for small loan portfolios and smaller loans it would be not be possible for lenders to operate legally within a 48 per cent cap.[8]
- Consumers with access to mainstream credit may resort to longer-term options or continuing credit which incurs interest and charges over a longer period.
  - Some research suggests that some users of these products are not low-income earners or would qualify for credit with mainstream providers.
  - High-cost credit is rarely used for 'capacity building' and often contributes to debt spiral. It is counterproductive to ensure access to a product that exacerbates or perpetuates debt and disadvantage. In the case that borrowers are not able to afford essential goods and services, accumulating debt serves only to reduce income over an extended period.

Other possible forms of intervention

The following options, canvassed in a draft *Code of Practice for Short Term Loans* proposed by Consumer Affairs Victoria and developed with industry in 2008, may be implemented to address the concerns associated with this type of lending as an alternative to a national interest rate cap.

Option Three: Warnings on high-cost products (enhanced disclosure)

A stark warning may assist to draw borrowers' attention to the potential risks and costs associated with the product and provide information on other possible alternatives.

- This could include a requirement for lenders to inform consumers about their right to apply for hardship variations, payment options for utility bills, advances of welfare payments and information about services offered by welfare groups/community organisations.

Option Four: Prohibition on rollovers

A prohibition on extensions of outstanding loans, or advancing new loans prior to the repayment of existing loans, may protect consumers from the risk of entering a debt spiral. Alternatively, outstanding short-term, small-amount loans could be a statutory presumption against a person's capacity to repay.

- Limitations on this option were acknowledged when it was canvassed by the South Australian Office of Consumer and Business Affairs during its deliberations over options to provide increased protection for payday lending customers. For example, it would not be

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8 National Australia Bank *Do you really want to hurt me? Exploring the costs of fringe lending* March 2010, p 14.

easy to prevent a borrower from obtaining a loan from a different lender to repay an outstanding loan.[9]

- However, the new responsible lending conduct requirements (which require lenders to make inquiries about the purpose of the loan and the consumer's capacity to repay) and the impending move to comprehensive credit reporting will resolve some of these issues.

Option Five: Restrictions on fees or charges

Restrictions on late payment fees and other fees or charges, particularly those applying after a consumer has defaulted, may assist to limit debt escalation/spirals.

- The requirement on credit providers to issue a direct debit default notice from 1 July 2010 may serve to reduce the repeated imposition of fees resulting for the incorrect establishment of direct debits.

- Unfair contract terms may also apply to contingent default fees charged under a credit contract from 1 July 2010. A consumer may obtain a remedy under this regime by means of court intervention.

23. Which option(s) do you consider would be effective at addressing the concerns associated with high-cost credit?

24. Are there other mechanisms which should be considered?

9 The Office of Consumers and Business Affairs discussion paper, *Payday lending in South Australia – options to increase consumer protection,* October 2006. www.ocba.sa.gov.au/assets/files/Discussion_Payday_Ar.pdf pp 19-20.

Table 1: Regulation in the States and Territories

Jurisdiction	Regulation
ACT	• A maximum cap of 48 per cent per annum, inclusive of fees and charges. • Credit providers are required to be registered. • Responsible lending obligations apply to credit card providers. • The ACT Government has not made an announcement about the future of its interest rate cap.
New South Wales	• A maximum cap of 48 per cent per annum, inclusive of interest, fees and charges commenced in March 2006. • In March 2010 NSW enacted legislation which continues, until 1 July 2011, its interest rate cap with amendments to expand the definition of credit fees and charges included in the calculation.
Northern Territory	• No interest rate cap or licensing/registration requirements.
Queensland	• A maximum cap of per cent per annum, inclusive of interest, fees and charges. Current arrangements commenced on 31 July 2008. • Queensland has retained its interest rate cap.
South Australia	• No interest rate cap. However, following the release of a discussion paper in October 2006, South Australia developed legislation to introduce an interest rate cap which was put on hold in light of the impending transfer to the Commonwealth.
Tasmania	• No interest rate cap or licensing/registration requirements. • Introduced, but did not enact, legislation to restrict advertising of credit products where the total cost of credit exceeded 40 per cent per annum.
Victoria	• A maximum cap of 48 per cent per annum for unsecured credit and 30 per cent per annum for secured credit, exclusive of fees and charges. • Victoria has enacted legislation which continues its cap until 1 July 2011. • Credit providers are required to be registered. • Unfair contract terms have applied to credit contracts since mid-2009. • Mandatory EDR membership since March 2009.
Western Australia	• No interest rate cap. • Credit providers (except authorised deposit-taking institutions (ADIs)) must be licensed.

CHAPTER 6: REGULATION OF CONSUMER LEASES

Objectives

This chapter:

- examines the different treatment of leases and consumer credit contracts under the National Credit Code (the Code); and
- assesses whether there is a need to improve regulation of consumer leases by the Code.

A. Background

i. Context and focus

The Code currently provides a reduced level of regulation of consumer leases compared with consumer credit contracts. Some commentators, competitors and consumer bodies consider that the different treatment of consumer credit and consumer leases creates opportunities for regulatory arbitrage, with consequent reduction in consumer rights and adverse competitive impacts on suppliers of credit contracts relative to suppliers of leases.

Some of these concerns were identified during the development of Phase One of the National Consumer Credit Protection reforms. Consumer leasing was subsequently endorsed by the Council of Australian Governments (COAG) as an area to be examined under Phase Two of the credit reforms.

In assessing whether there are sufficient grounds to warrant regulatory reform, consideration of the following key issues are necessary:

- identifying the differences in the application of the Code between credit contracts and consumer leases, and the potential for these differences to provide a market advantage to lessors relative to providers of credit contracts;
- whether the differences between consumer leases and credit contracts raises particular issues in relation to the circumstances under which a consumer would choose a lease and not a credit contract; and
- considering whether any concerns identified as a result of this analysis would be addressed by or are sufficient to justify extending provisions in the Code applying to credit contracts to leases (including in a modified form where this is warranted by the different structures of a product).

In 2007, the Micah Law Centre released a report into consumer leases, titled *A Loan in Lease Clothing: Problems identified with instalment based rent/purchase contracts for household goods* (Micah report).[1] The report identified the following key issues:

- the use of lease agreements instead of loan agreements by financiers as a means to avoid the stricter obligations that apply to credit contracts;
- complex or misleading clauses relating to final ownership of the goods;
- misleading and confusing marketing of lease agreements in stores;
- relatively high cost of lease agreements; and
- the impact of the marketing of these contracts to low-income consumers.

B. Current arrangements

i. Implementation of Phase One of the Credit Reforms

The implementation of Phase One of the credit reforms will not create any significant changes in respect of the statutory provisions applying to leases under the Code relative to the Uniform Consumer Credit Code (UCCC).

The UCCC applied different requirements according to the type of lease being provided:

- contracts in which the consumer had a right or obligation to purchase the goods being leased. These were treated as a sale by instalments with the lessor required to meet the disclosure requirements applying to credit contracts, where the charge for hiring the goods exceeded the market value of the goods;
- contracts for the hire of goods in which the lessee did not have any such right or obligation to purchase the goods being leased (other than excluded leases). These were subject to a reduced level of regulation (under Part 10 of the UCCC); and
- excluded leases were defined as the following types of leases — leases for a fixed period of four months or less, leases for an indefinite period, and employment-related leases. These leases are completely excluded from the UCCC.

The rationale for this approach was that, at the time the UCCC was introduced, leases commonly gave the consumer a right or obligation to purchase the leased goods, so they could obtain ownership by buying them at a discounted price at the end of the term. The UCCC acknowledged that these types of leases were functionally similar to a sale of goods by instalments and therefore treated them in an equivalent way, from a regulatory point of view (including imposing disclosure requirements that allowed consumers to compare the cost).

It has been suggested that the jurisdiction of the UCCC was extended to contracts in the second category, for the simple hiring of goods, to ensure that leases would be subject to the

1 http://www.consumer.vic.gov.au/CA256902000FE154/Lookup/CAV_Credit_Grant_Resources/$file/credit_grant_resources_micah_law_centre_consumer_leases_project.pdf.

Code, whether as a sale by instalments or a consumer leases, in order to discourage the use of consumer finance leases as a way of avoiding regulation.[2]

Table A sets out a comparison of the disclosure requirements under the Code between credit contracts, a lease where the consumer has a right or obligation to purchase the leased goods, deemed to be a sale by instalments pursuant to section 9 of the Code (section 9 leases), and consumer leases regulated by Part 11 of the Code.

The effect of the Code on the different types of contracts, as set out in Table A, is that:

- identical requirements apply to a credit contract and a lease where the consumer has a right or obligation to purchase the leased goods. For example, the consumer can readily compare the cost of different contracts; and
- the level of obligations applying to leases where the consumer has no right or obligation to purchase the leased goods is significantly lower.

It would appear that the effect of the regulatory approach adopted in the UCCC, and maintained in the Code, has been to increased the use of leases where the consumer has no right or obligation to purchase the leased goods, because of the lower regulatory burden. This has necessarily resulted in consumers obtaining goods through products where they do not own those goods at the termination of the lease. The increased use of these types of leases has arguably been the cause of some of the problems experienced by consumers, as identified in the Micah report.

ii What is a consumer lease?

The Code defines a consumer lease as a contract for the hiring of goods by a natural person or a strata corporation wholly or predominantly for personal, domestic or household purposes under which that person or corporation does not have a right or obligation to purchase the goods (section 169). The Code does not regulate leasing transactions that are made wholly or predominantly for business or investment purposes, for example, transactions made with incorporated customers, partnerships or sole traders.

The application of the Code is limited to consumer leases as defined in section 170, that is, to contracts where:

- the goods hired by the natural person or strata corporation are hired wholly or predominantly for personal, domestic or household purposes;
- a charge is, or may be, made for the hiring of the goods;
- the charge, together with any other amount payable under the consumer lease, exceeds the cash price of the goods; and
- the lessor hires the goods as part of a business carried on in Australia.

The Code, pursuant to section 171, specifically does not apply to:

- short term leases, that is, leases for a fixed period of four months or less;

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2 A. Duggan and E. Lanyon, Consumer Credit Law, 1999, Reed International Books Australia Pty Ltd, paragraph [13.1.6], p 511.

- leases for an indefinite period; and
- employment-related leases.

iii Treatment of leases and credit contracts under the Code

The following provisions of the Code that apply to credit contracts are extended to consumer leases:

- changes to credit contracts on the grounds of hardship and unjust transactions in Division 3 of Part 4 (except for section 78, which relates to unconscionable interest and other charges 4);
- orders by the Court for entry and repossession (sections 98 to 101); and
- miscellaneous matters such as tolerances and assumptions (Part 12).

The Code imposes a number of obligations on lessors that are similar to obligations imposed on credit providers. These primarily relate to disclosure and notice requirements on lessors at key points in the life of the lease, for example, on termination of the lease or before repossession of goods supplied under the lease).

There are some significant differences in coverage between leases and credit contracts under the Code including that:

- the content of the disclosure requirements is reduced for lessors;
- lessors are not required to provide a pre-contractual information statement;
- the provisions in respect of mortgagors and guarantors apply only where the mortgage or guarantee secures obligations under a credit contract (and not under a lease);
- the provisions in relation to liability for conduct such as false and misleading representations in sections 128 and 154 of the Code apply only to credit contracts; and
- a lessor is not subject to penalties for breach of a key disclosure requirement provision.

C. Current issues

i. Regulatory arbitrage in relation to consumer leases

The experience under the UCCC has identified the following three issues in relation to the way in which consumer leases are regulated:

1 some providers of leases are offering a product where the consumer has no right or obligation to purchase the leased goods (rather than a credit contract or a lease where the consumer has this right or obligation), because of the lower regulatory burden under the Code;

2 consumers are being misled about whether or not they will own the goods, or have a right to purchase them, under the lease; and

3 the exclusion from the Code of short-term or indefinite leases results in some providers being able to avoid the Code entirely.

In the discussion below, the term ‘credit contracts’ is used to describe both traditional credit contracts and consumer leases where the consumer has a right or obligation to purchase the leased goods.

Issue 1

There may be a risk that the different treatment under the Code could encourage both financiers and intermediaries to offer leases to consumers instead of consumer credit, for the purpose of avoiding some of the requirements that apply to credit contracts. This could place credit providers at a competitive disadvantage.

It can also have adverse impacts on consumers where a lease is arranged for a consumer because of the commercial interests of the financier or intermediary, rather than because the consumer elects to do so on an informed basis.

State and Territory regulators and ASIC are aware of specific instances where business models have utilised leases for this reason; this has limited the rights of consumers or their capacity to obtain remedies from those providers.

This issue needs to be considered in the context of an examination of whether obligations attaching to credit contracts should also be extended to consumer leases, as discussed below.

Issue 2

This issue concerns the supply of a product, which meets the legal definition of a lease but is functionally similar to a credit contract. The gap exists because lessors can readily avoid the provision in the Code that requires a lease to not include ‘a right or obligation to purchase the goods’.

Lenders can avoid this provision by allowing the consumer to purchase an item that is similar to the goods originally hired by the consumer, or by allowing the consumer to sell the goods as the lender’s agent, and to retain all but a nominal amount as sales commission.

Although the consumer is not necessarily being disadvantaged in relation to ownership of the goods, they may be disadvantaged in other ways, given that they will have fewer rights under the transaction than if it had been documented as a credit contract.

There is a variation of this scenario where the consumer may be encouraged to enter into consumer leases in circumstances where they believe they will be the owners of the goods. These are known as ‘nod and wink’ leases, and were regulated under the former State-based Credit Acts.

In some instances the goods being hired are low-value household items, such as beds or tables, where at the end of the lease:

- the item is unlikely to have any resale or market value to the lessor; and
- there is little benefit to the consumer in having obtained finance through a lease if they are required to return the goods to the lessor.

Currently contracts of this type will not be deemed to be a credit contract, as the consumer may only have an expectation that they will be able to own the goods at the conclusion of the lease, rather than a right or obligation to purchase them.

Issue 3

The definition of consumer leases excludes both short-term (leases for a fixed period of four months or less) and indefinite leases. It would appear the intention of this exclusion was to avoid the application of the Code to pure hire contracts (such as renting a car). In practice these types of hire contracts would usually be excluded under paragraph 170(1)(c) of the Code, which excludes leases where the cost of hiring and other charges under the contract does not exceed the cash price of the goods.

The way the Code defines the type of leases subject to its jurisdiction allows a provider to utilise a specific structure for the purpose of avoiding the Code entirely (rather than for meeting the needs of consumers). In this situation the regulatory outcome is different from that in Issue 2 above, in that lessors have no obligations under the Code, rather than having to meet a reduced level of obligation relative to a provider of credit contracts.

The potential regulatory gap is similar in that there is a risk these leases will be used in circumstances where the consumer may expect or be confused as to ownership of the goods, but have no remedy under the Code.

1. Are there any businesses that only offer short-term or indefinite term leases where the cost of hiring and other charges under the contract exceeds the cash price of the goods?

2. If so, in what circumstances are consumers being provided with these types of leases?

ii. Different treatment of leases and credit contracts: disclosure requirements

Examining the effectiveness of disclosure requirements in lease contracts will be relevant in establishing whether the existing safeguards for consumers are adequate, and whether providers of consumer leases are likely to have a competitive advantage over suppliers of consumer credit in relevant markets.

Table A sets out a comparison of the disclosure requirements under the Code between credit contracts, including leases where the consumer has a right or obligation to purchase the leased goods (in section 17), and consumer leases (in section 174).

Some of the key differences in relation to disclosure are:

- A credit provider is required to assist a consumer to identify the true cost of credit offered by disclosing an annual percentage rate (subsection 17(4)). There is no equivalent obligation on providers of consumer leases (as defined in Part 11), which means that consumers are not readily able to compare costs between credit contracts and consumer leases.

- A credit provider is required to disclose commissions that are payable in relation to their contracts, so that consumers are better able to assess the effect of such payments on the transaction. However, the Code does not impose similar obligations in relation to consumer leases.

- Where the cost of the commissions is passed on to the consumer in higher charges, the lack of comparability between products means the consumer cannot easily discern this.

3. To what extent are consumer leases and credit contracts directly competitive products? Please provide examples of any circumstances where leases and credit contracts may be directly competitive.

4. To the extent that these products are directly competitive, which differences in regulation should be addressed?

5. To the extent that these are not directly competitive products, would it be desirable to extend provisions regulating credit contracts to consumer leases?

6. If so, what elements applying to the regulation of credit contracts should be extended to the regulation of leases? Will any such extension enhance consumer protection?

The Code currently has a mechanism in which persons providing section 9 leases (where the consumer has the right or obligation to purchase the goods) must meet the same disclosure requirements as persons offering credit contracts. This includes disclosure of an interest rate and other information to enable consumers to compare the cost of credit between credit contracts and section 9 leases.

The only relevant difference between a section 9 lease and a consumer lease is whether or not the consumer has the right or obligation to purchase the goods, and whether or not there is a cost attached to this right. The existence of this right affects disclosure only by requiring the provider to include the cost to the consumer in relation to exercising this right in calculating this right. The existing model would therefore appear to be applicable to consumer leases.

7. To what extent does the absence of a right or obligation to purchase the hired goods affect disclosure of the cost of a consumer lease relative to a section 9 lease?

iii. Different treatment of leases and credit contracts: other requirements

As noted above, there are significant differences in the treatment of consumer leases and credit contracts. In some instances a difference in treatment may be warranted because of the different nature of these products. However, there would not appear to be any reason for a variation in respect of at least some of the obligations in the Code. For example, the provisions in relation to mortgagors and guarantors only apply where the mortgage or guarantee secures obligations under a credit contract and not under a lease, and would therefore not apply where the lease is secured by a mortgage over real property.

The linked credit provider provisions in Part 7 of the Code do not apply to leases. These provisions only apply to the sale of goods or the supply of services that are financed through credit contracts. The intention of the linked credit provider provisions is to make the lender liable in some situations for conduct of the supplier. The linked credit provider provisions therefore do not appear to be directly applicable to a lease transaction, given that the lessor both provides the finance and supplies the goods.

Nevertheless, it is noted that the linked credit provider provisions in the Australian Consumer Law do apply to leases, raising the question as to whether the provisions in the Code should also be extended to leases.

8. Which requirements applying to credit contracts but not to consumer leases could be extended to leases?

9. Which requirements applying to credit contracts would raise practical difficulties if they were extended to leases?

10. What are the implications of extending the linked credit provisions to consumer leases?

D. Reform

i. Options for reform

The consideration of these issues may give rise to two options:

- no further regulatory intervention; or
- further regulation

Option One: No further regulatory intervention

Differences in regulatory framework do not in themselves necessarily imply a reduction in consumer protection or lead to competitive disadvantages in relevant markets. This option reflects the possibility that consultations with industry and other stakeholders, and Treasury's examination of the issue, could lead to the view that intervention might not be necessary.

Option Two: Further regulatory intervention

Where changes to the regulatory framework are warranted, a number of responses may be considered.

Firstly, the scope of the consumer lease definition could be broadened to ensure that the Code applies as consistently as possible to products that are similar in nature, to ensure effective protection for consumers. This will involve consideration of the following issues:

- whether or not the distinction between leases where the consumer has a right or obligation to purchase goods, and leases where they have not such right or obligation is still relevant in determining the regulatory requirements that should apply;
- whether or not the circumstances in which a consumer is regarded as having a right or obligation to purchase goods be amended to cover situations such as 'nod and wink' leases where the parties understand the consumer will retain ownership of the goods at the end of the lease; and
- whether or not the definition of consumer leases should be extended to cover indefinite or short-term leases.

Secondly, the issue of whether or not consumers would benefit from enhanced precontractual disclosure in respect of consumer leases could also be considered. The following issues arise for consideration:

- whether consumers need to be better informed about the features of the product before entering into a consumer lease;
- whether consumers need information to be presented in a way that would enable them to better compare consumer leases to credit contracts; and
- whether any additional disclosure is required in relation to consumer leases to address the risk of consumers being confused as to whether or not they own goods under a lease at the end of the contract period.

11. Is there a need to broaden the scope of the definition of consumer leases in the Code?
12. If lessors become subject to a broader range of requirements under the Code, will this reduce the incentive for persons to provide consumer leases?
13. Is there a need to change the disclosure requirements applying to consumer leases? If so, what factors should be taken into account in changing the requirements?

Table A: Comparison of disclosure requirements between credit contracts, deemed sales by instalments and consumer leases

Credit contracts	Section 9 credit contracts	Consumer leases
Subsection 17(2) — Credit provider's name.	Equivalent requirement applies. Paragraph 9(3)(b) provides that the credit provider is the person who receives payments.	No equivalent.
Subsection 17(3) — Information in relation to the amount of credit.	Equivalent requirement applies. Paragraph 9(3)(e) provides that the amount of credit advanced is the cash price of the goods (as defined in subsection 204(1) of the Code).	No equivalent.
Subsection 17(4) — Information in relation to the annual percentage rate (APR) or rates.	Equivalent requirement applies.	No equivalent.
Subsections 17(5) and (6) — Information in relation to the method of calculation and, in specified circumstances, the amount of the credit charges.	Equivalent requirement applies.	No equivalent.
Subsection 17(7) — Information in relation to repayments including, if ascertainable, number, amount and timing of repayments, and the total amount of the repayments.	Equivalent requirement applies. Paragraph 9(3)(a) provides that amounts payable under the contract are the instalments.	Paragraphs 174(1)(e) and (f) — Information in relation to the amount, date and number of repayments, and the total amount of rental payable under the lease.
Subsection 17(8) — (a) A statement of the credit fees and charges that are, or may become, payable under the contract, and when each such fee or charge is payable, if ascertainable; (b) the amount of any such fee or charge if ascertainable, but, if not, the method of calculation of the fee or charge, if ascertainable; and (c) the total amount of credit fees and charges payable under the contract to the extent that it is ascertainable.	Equivalent requirement applies. Paragraph 9(3)(e) provides that the charge for providing credit is calculated as: (a) the sum of: (i) the charge for hiring the goods; and (ii) any other amount payable under the contract (as defined in subsection 9(4)); (b) minus the cash price of the goods.	Paragraph 174(1)(d) — The amount of any other charges not included in the rental payable under the lease, and a description of those charges. Paragraph 174(1)(e) — The amount of any stamp duty or other government charge (other than on receipts or withdrawals) payable by the lessee in respect of the lease.
Subsection 17(9) — Changes affecting interest and credit fees and charges.	Equivalent requirement applies.	No equivalent.
Subsection 17(10) — Frequency for sending statements of account.	Equivalent requirement applies.	No equivalent.
Subsection 17(11) — Information in relation to the default rate of interest.	Equivalent requirement applies.	No equivalent.

Table A: Comparison of disclosure requirements between credit contracts, deemed sales by instalments and consumer leases (continued)

Credit contracts	Section 9 credit contracts	Consumer leases
Subsection 17(12) — Statement as to when enforcement expenses may become payable.	Equivalent requirement applies.	No equivalent.
Subsection 17(13) — Statements in relation to any mortgage or guarantee is to be or has been taken by the credit provider.	Equivalent requirement applies. Paragraphs 9(3)(d) and (f) provide for property in the goods to pass to the debtor, and for the creation of a mortgage in favour of the credit provider/lessor.	No equivalent.
Subsection 17(14) — Statement in relation to any commission that is to be paid by or to the credit provider.	Equivalent requirement applies.	No equivalent.
Subsection 17(15) — Disclosure in relation to credit-related insurance contracts.	Equivalent requirement applies.	No equivalent.

CHAPTER 7: ENHANCEMENTS TO THE NATIONAL CONSUMER CREDIT PROTECTION REGIME

Objectives

During the course of Phase One of the National Consumer Credit Protection reforms, concerns were raised by various stakeholders about some of the previous arrangements under the Uniform Consumer Credit Code (UCCC). These issues included whether there:

- should be further enhancements to the hardship variation provisions;
- should be further enhancements to the stay of enforcement provisions;
- should be a remedy for consumers for unjust conduct by providers of credit services;
- is a need to restrict the use of certain words or expressions used by industry participants; and
- is a need to broaden the prohibition concerning canvassing of consumer credit at home.

A. Background to chapter

As part of the transitional arrangements agreed between the Commonwealth, State and Territory Governments and industry, minimal changes were made in replicating the UCCC as the National Credit Code (the Code) on the basis that these issues would be given further consideration during Phase Two.

B. Enhancements to the hardship variation provisions

i. Background

A statutory right for consumers to request a variation to their contract where they are unable reasonably, due to illness, unemployment or other reasonable cause to meet their obligations was incorporated into the UCCC in 1996 for contracts under $125,000.

In recognition that the threshold had not kept pace with the increasing value of home mortgages, changes to the State regulations between November 2004 and July 2005 resulted in the introduction of a floating threshold linked to equal to 110 per cent of the average loan size for the purchase of new owner occupied dwellings in New South Wales. The threshold changes monthly, and has ranged from $295,790 to $368,610. Since July 2009, the threshold for these contracts has been around $350,000.

ii. Current arrangements

Government regulation

A significant enhancement to the Code was the dramatic increase in the monetary threshold to $500,000 for contracts entered into after 1 July 2010. For Constitutional reasons, the threshold for contracts entered into before 1 July 2010 could not be increased and continues to be floating.

The Code currently specifies that the variation requested under the hardship provisions can involve:

- extending the period of the contract, and reducing repayments accordingly;
- a repayment holiday (without extending the period of the contract); or
- a repayment holiday and extending the period of the contract.

From 1 July 2010, credit providers will be required to respond to a hardship variation request in writing within 21 days and to provide reasons if they refuse a borrower's variation request.

A debtor can apply to the court to change the contract if the credit provider refuses to consider a hardship request. If successful, a court has power to order a range of variations.[1] Consumers may also apply to the credit provider's external dispute resolution scheme (EDR) to reconsider a request for a hardship variation. EDRs provide consumers with an independent, informal and no cost alternative to going to court. Australian credit licensees are required to be EDR members and are bound by their decisions. Consumers retain their right to access the courts following a decision or outcome by an EDR.

In addition to the specific arrangements for variation on the basis of hardship, the Code allows changes to be made to contracts by agreement of the parties.[2] There are no monetary thresholds or limitations on what changes can be made under this provision. However, if agreement to amend (outside of the hardship provisions) is refused, there is no statutory recourse to a court for review.

Industry self-regulation

The Australian Bankers' Association Code of Banking Practice goes further than the rights to hardship variations provided by the UCCC or the Code. It stipulates that, with the debtor's agreement, signatories will try to help individual and small business debtors overcome their financial difficulties with any credit facility they have. It also provides that, if at the time, the hardship variation provisions could apply to the debtor's circumstances, signatories will inform the debtor about them.[3]

The Mutual Banking Code of Practice also goes further than the rights to hardship variations provided by the UCCC or the Code. It stipulates that members will work with debtors in a constructive way if they experience genuine difficulties in meeting their financial commitments. With the debtor's agreement and commitment, members will try to assist

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1 Section 74 of the Code.
2 Section 71 of the Code.
3 www.bankers.asn.au/ArticleDocuments/20040526%20FINAL%20CODE%20MODIFIED%20WORD%20DOCUMENT.doc

debtors to overcome those difficulties. Members will do this whether or not the debtor has a right to seek a hardship variation or change under consumer credit laws.[4]

Voluntary co-regulation

In April 2009, the Treasurer announced an agreement between the Government and the four major banks, to assist borrowers who are experiencing financial difficulty as a result of the global financial crisis by temporarily adopting expanded principles on hardship.[5] By June 2009, all 144 retail banks, building societies and credit unions had agreed to adopt the expanded principles.[6] Under the expanded principles, these institutions will work with borrowers, irrespective of the value of their loan, to determine the most appropriate assistance option.

iii. Current issues

The limited range of variations that can be requested on the basis of financial hardship may lack sufficient flexibility to enable the most mutually beneficial outcomes for both lenders and consumers. Furthermore, having a monetary threshold above which a consumer does not have a right to request a variation applies an arbitrary limitation. Neither of these restrictions are entrenched in the industry codes of conduct.

In most situations it is likely to be advantageous to both lenders and consumers to keep a credit contract out of default, provided that the consumer can reasonably be expected to meet their commitments following a variation and the lender is able to receive repayment within a reasonable timeframe.

Between March 2000 and March 2010, total outstanding consumer credit (owner-occupied housing credit and other personal credit) increased from $277.2 billion to $913.5 billion. This equates to an average annual growth rate of 12.7 per cent. Total outstanding credit in the economy, which includes consumer credit, grew at an average rate of 11.1 per cent over the same period.[7]

Along with the growth of consumer credit, there is evidence of increasing levels of debt stress amongst Australian households and people are increasingly applying for variations to their credit contracts on the grounds of financial hardship.[8]

iv. Reform

Issue one — Types of hardship variations that can be requested

1.1 Option One: Maintain the status quo

Under this option, there would be no changes to the existing regulatory arrangements for hardship variations. This presupposes that the existing types of variations provide

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4 http://www.bankers.asn.au/ArticleDocuments/20040526%20FINAL%20CODE%20MODIFIED%20WORD%20DOCUMENT.doc

5 www.abacus.org.au/media_a_resources/publications/mbcop

6 www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/077.htm&pageID=003&min=wms&Year=2009&DocType=0

7 Reserve Bank of Australia, *Financial Aggregates,* March 2010.

8 www.vedaadvantage.com/news-and-media/article.dot?id=509973; www.couriermail.com.au/money/banking/families-gripped-by-financial-hardship/story-e6freqox-1225767439923; http://www.rba.gov.au/speeches/2010/sp-ag-300310.html

sufficiently flexible options to amend contracts when consumers find themselves in financial hardship.

1.2 Option Two: Broaden the types of variations that can be requested

Under this option, the type of variation that can be requested by a borrower could be broadened by specifying additional types of variation that can be requested. This could include codifying aspects of the ABA and/or ABACUS Codes of Practice and/or the expanded hardship principles adopted by many financial institutions following the global financial crisis.

Alternatively, there could be no limit to the type of variation that can be requested, given that it may be difficult to articulate a comprehensive range of variations that would be useful to consumers.

1. Should the range of variations available under hardship provisions be expanded?
2. If so, what additional types of variations should be available?

Issue Two — Monetary threshold above which a consumer can not request a hardship variation

2.2 Option One: Maintain the status quo

Instead of amending the existing hardship variation provisions, consumers with contracts that exceed the threshold can continue to make use of the arrangements in the Code for parties to amend credit contracts by agreement or rely on the relevant industry Code of Conduct.

2.2 Option Two: Increase, or remove, the threshold under which a consumer has a statutory right to request a hardship variation

Under this option, the threshold would be increased. Alternatively, the threshold could be removed altogether.

Consideration would need to given to the interaction with the 'sophisticated investor' for the purposes of Chapter 6D of the Corporations Act (if they are offered debt or shares) or 'wholesale client' for the purposes of Chapter 7 of the Corporations Act (if they are offered a financial product, other than insurance, superannuation or a retirement savings account product or service) and the financial product is not used in connection with a business.

3. Should there be any monetary threshold above which a statutory right to apply for a variation for hardship does not exist?

4. If so:
   - what proportion of consumers do not have a statutory right under the existing $500,000 threshold?
   - should the threshold be subject to regular indexation?

5. What are the implications for lenders, that is, prudential concerns or compliance costs?

C. Enhancements to the stay of enforcement provisions

i. Current arrangements

A credit provider can generally commence proceedings where a consumer is in default and the credit provider has served the borrower a notice specifying the nature of the default by the borrower, and allowing them an opportunity to rectify the default.[9]

The current arrangements in the Code allow a credit provider to commence enforcement proceedings without having to consider whether the consumer could continue to meet their repayment obligations if the amount, number or frequency of repayments under the contract were varied.

ii. Current issues

Financial hardship is a major reason for consumer credit contracts going into default. In most cases it would be in both the lender's and consumer's interests to defer enforcement proceedings, provided that the lender is able to receive repayment within a reasonable timeframe and the consumer can reasonably be expected to meet their commitments following a variation.

Enhancing the stay of enforcement provisions may assist in reducing the number of defaults that result in court action. However, it could encourage credit providers to consider commencing proceedings earlier, to compensate for any perceived risk of delay where the consumer seeks a stay.

If proceedings have already commenced then the lender will have incurred legal costs (and may continue to do so while any request for a stay is being considered). Under usual court rules the borrower would be liable for these costs. On this basis any variation of the repayments due under the credit contract would need to also address payment of this amount.

Option One: maintain the status quo

Instead of imposing an additional obligation on lenders, the existing Commonwealth regulatory arrangements would continue. This assumes that the current agreement provide

9 Section 88 of the Code.

an appropriate balance between providing mechanisms to consumers to prevent and rectify defaults and allowing lenders to enforce their right to collect repayments.

Option Two: consider enhancements to stay of enforcement provisions

Consideration could be given to:

- requiring the lender to only commence court proceedings only once they have considered (and rejected) the possibility of a hardship variation (including initiating the process);
- preventing the lender from commencing or continuing court proceedings while a request for a hardship variation is being considered;
- preventing the lender from commencing or continuing court proceedings for a specified period after the lender has refused a request for a hardship variation. For example, the stay could continue for 14 days from the date of a written response by the lender,[10] to give the borrower time to consider the response and take further action (for example, request review from an EDR scheme) as appropriate; and
- preventing the listing of a default while considering a hardship application.

Any such proposal would need to be subject to exemptions similar to those already in the Code in relation to situations where a default notice is not required as set out in subsection 88(5) of the Code (for example, where the borrower cannot be located).

6. Should it be compulsory to consider a hardship variation before commencing default proceedings? If so, should there be any exceptions to this rule?
7. Should there be an automatic stay of proceedings where a request for hardship variation has been made? If so, should there be any exceptions to this rule?
8. Should there be any specific provisions in respect of payment of legal costs incurred by the lender before any stay of proceedings?
9. Should the credit provider be prevented from listing a default while considering a hardship variation?

D. Extension of the remedies for unjust conduct to credit service providers

i. Current arrangements

The implementation of Phase One of the National Consumer Credit Protection reforms has maintained, at a Commonwealth level, the right for consumers to be able to have a credit contract, consumer lease, mortgage or guarantee reopened on the grounds that it is unjust. However, as the remedy is located in the Code, and the Code only regulates conduct in relation to credit contracts and consumer leases, there is no equivalent remedy in relation to providers of credit services, such as brokers or intermediaries.

10 Subsection 72(2) of the Code.

The provision of a specific remedy of this type has been a consistent feature of legislation regulating credit, with the unjust conduct provisions being based on similar provisions that can be traced through the various Credit Acts to money-lending legislation.

ii. Current issues

The remedy for unjust conduct in the Code is based on provisions in the UCCC. It operates to provide a remedy to the consumer against a credit provider, lessor, mortgagor or beneficiary of a guarantee, through a rewriting of the contract between them, including adjusting the amounts payable between the parties to the contract.

The draft National Finance Broking Bill 2007 (NSW), which was developed before the transfer of responsibility of credit to the Commonwealth, proposed a specific remedy for unjust conduct by brokers.

Consumers currently have remedies in relation to the conduct of providers of credit services under the Credit Act and under the *Australian Securities and Investments Commission Act 2001* (ASIC Act). However, the concept of unjust conduct in the Code is broader as it provides remedies for conduct which is harsh or oppressive (as well as for unconscionable conduct) as well as for conduct which is unjust, without necessarily falling into any of the other categories of conduct that allow for relief.[11]

Where a provider of credit services engages in unjust conduct there are two possible outcomes. Firstly, the credit provider, lessor, mortgagor or beneficiary of a guarantee (the contracting person) is responsible or accountable for the conduct by the provider of credit services. This will therefore result in the consumer being able to obtain a remedy against the contracting person for the conduct of a third party (with the contracting party then possibly able to be indemnified by the provider of credit services, pursuant to any commercial arrangements between them).

The second situation is where the contracting person is not accountable for the conduct by the provider of credit services. The consumer will therefore not be able to obtain a remedy against the contracting person, or have the contract declared unjust and their obligations under it adjusted. The consumer may also not be able to obtain any remedy at all against the provider of credit services (given that the unjust contract provisions are currently limited to credit providers, lessors, mortgagors or beneficiaries of a guarantee and are broader than other statutory remedies).

It follows that whether or not the consumer can obtain a remedy may ultimately depend on the identity of the person engaging in the conduct and not the type of conduct that occurred. This disparity was utilised by some lenders engaging in equity stripping to insulate themselves from any misconduct by third parties dealing with the consumer in arranging the loan).

Creating a remedy for unjust conduct in relation to providers of credit services would have the following consequences. Firstly, it would allow relief to be allocated against the appropriate person, and, secondly, it would provide similar remedies for similar conduct (rather than this depending on the character of the person engaging in the conduct).

11 It also provides a remedy that operates in different circumstances from unfair contract terms legislation (whether at a State or Commonwealth level).

iii. Reform

Option One: maintain the status quo

Under this option there would be no change to the current regulatory arrangements for unjust conduct in relation to credit contracts, consumer leases, mortgages and guarantees. This option would be based on a conclusion that the existing remedies are adequate for consumers.

Option Two: provide a remedy for unjust conduct by providers of credit services

There are two broad approaches available under this option:

(a) Extend the existing remedy enabling an unjust contract to be reopened to specifically allow a remedy to be provided against any person (so that it can apply to both brokers and lenders, individually or jointly). This would entail a change to the procedural aspects of the existing provisions, to allow consumers to also obtain a remedy directly from a provider of credit services.

(b) Create a new and separate remedy for unjust conduct by providers of credit services. This would allow the remedy to be specifically tailored to address the role of third parties who are not the credit provider or lessor.

10. What considerations should be taken into account in deciding whether or not to extend the remedy for unjust conduct to providers of credit services?

11. If the remedy for unjust conduct is to be extended to providers of credit services, what considerations should be taken into account in deciding whether to extend the existing unjust conduct provisions or creating a new remedy specifically for providers of credit services?

E. Restricting the use of certain words or expressions

i. Current arrangements

There are no restrictions on the use of certain words or expressions by licensees or registered person (for example, words such as 'independent' or 'impartial') in the Credit Act.

Under the financial services regime, section 923A of the *Corporations Act 2001* (Corporations Act) restricts the use of the words independent, impartial or unbiased. Further, Section 923B restricts the use of certain other words or expressions, for example, insurance broker or stockbroker.

The use of certain words or phrases may, depending on the context, infringe the prohibition in Section 12DA of the ASIC Act against conduct that is misleading or deceptive.

ii. Current issues

The use of certain words or expressions in the context of credit and credit services may be intentionally or inadvertently misleading. Limiting the use of those terms would encourage consistency in meaning and mitigate the risk of confusion by consumers.

A person who is both the holder of an Australian financial services licence and an Australian credit licence would be subject to a restriction in respect of the financial services part of their business but not in relation to credit activities.

There are a number of key words or phrases that might need to be considered:

- ‘pre-approved’, where there has been no analysis of the proposed credit contract in relation to the responsible lending conduct obligations;[12]
- ‘independent, impartial or unbiased, not-for-profit, free’, where the provider does not have those characteristics;
- ‘reverse mortgage’, where it does not meet a specific definition; and
- ‘financial counselling/financial counsellor’, unless accredited by the relevant professional association.

iii. Reform

Option One: maintain the status quo

Under this option, there would be no restrictions on the use of certain words and expressions. This suggests existing prohibition and remedies available under the ASIC Act are sufficient.

Option Two: restrict the use of certain words or expressions

Under this option, the use of certain words or expressions would be restricted on the basis that their use in certain circumstance can intentionally or inadvertently mislead consumers.

12. Should the use of certain words or expressions be restricted?
13. If so, do you agree with the examples above? Are there other words or expressions that should be restricted?

F. Canvassing of consumer credit at home

i. Current arrangements

Section 156 of the Code provides that a credit provider (including their agents or employees) must not visit a person’s home to induce the resident to obtain credit (hawking), except by prior agreement. However, the prohibition does not apply where the credit is offered incidentally to the unsolicited sale of goods and services (linked credit arrangements), and this is regulated by State and Territory fair trading laws.

There is no specific remedy for a breach of the provision.

12 For example, the assessment of unsuitability required under section 115 or 128 of the Credit Act.

ii. Current issues

The practice of selling and marketing credit has evolved since the introduction of this prohibition and there has been some concern about the limitation of these provisions in relation to telemarketing[13] and forms of unsolicited contact by means other than by a personal visit, and in the 'door-to-door' sale of linked credit arrangements.

Consideration also needs to be given as to whether the law should be consistent with other Commonwealth laws and policy seeking to address unsolicited sales practices. In particular, Sections 736, 992A and 992AA of the Corporations Act prohibit the offering of financial products[14] via unsolicited phone calls and meetings. These hawking prohibitions do not prevent an offeror using other communication methods outside of certain hours where such conduct was not in breach of a 'Do Not Call' request.[15] These hawking prohibitions were introduced to prevent the pressure selling of financial products (for example, 'badgering' and 'boiler room' practices). These prohibitions are broader than the provision in the Code, as it is not limited to soliciting credit 'door to door'.

On 4 December 2009, the Ministerial Council on Consumer Affairs agreed that the Australian Consumer Law (ACL) will include a single national law covering unsolicited sales practices, including door to door selling, telephone sales — to the extent not already covered by the *Do Not Call Register Act 2006* — and other forms of direct selling which do not take place in a retail context. The unsolicited selling provisions in the ACL will replace the current State and Territory regulatory regimes that apply to unsolicited sales with a single national law which will apply as a law of the Commonwealth as well as of the States and Territories.

The Trade Practices Amendment (Australian Consumer Law) Bill (No. 2) 2010, which was introduced into the House of Representatives on 17 March 2010, is the second Bill to implement the ACL. Chapter 3, Part 3-2, Division 2 of the ACL will regulate the making of unsolicited offers to supply goods and services to a consumer and the agreements arising from such offers. The provisions of the ACL will not apply to the supply of financial products or services.[16]

Clauses 3.2 and 5 of the Intergovernmental Agreement for the Australian Consumer Law[17] require the Australian Government to ensure that the provisions of existing or new Commonwealth sector-specific consumer legislation is not inconsistent with or does not alter the effect of the ACL. However, this does not preclude the use of sector-specific regulation where appropriate, provided it does not conflict with the generic approach.

iii. Reform

Option One: maintain the status quo

Under this option, there would be no change to the current regulatory arrangements.

Option Two: consider the need to amend the current regulatory arrangements

Under this option, there would be consideration of the need to amend the current regulatory arrangements.

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13 www.fairtrading.nsw.gov.au/pdfs/About_us/telemarketingoptionspaper05.pdf
14 'Financial product' as defined in the Corporations Act generally excludes 'credit'.
15 See generally, ASIC Regulatory Guide 38, *The Hawking Prohibitions*.
16 See new section 131A to be inserted into the renamed *Competition and Consumer Act 2010* (Schedule 2, item 1 (p 259) of the Trade Practices Amendment (Australian Consumer Law) Bill (No.2) 2010).
17 www.coag.gov.au/coag_meeting_outcomes/2009-07-02/docs/IGA_australian_consumer_law.pdf

14. Are the limitations to the hawking provisions of the Code justified?

15. Should the sale of credit sold 'door-to-door' to finance the sale of goods or services be prohibited or further regulated?

16. Would some or all of the Corporations Act provisions be appropriate if applied in the context of credit?

17. How do the Code provisions compare with and operate in the context of other Commonwealth, State and Territory laws (that is, State and Territory fair trading laws, the *Trade Practices Act 1974*, telecommunication laws) and the development of the ACL?

CHAPTER 8: COVERAGE OF CREDIT UNDER THE *NATIONAL CONSUMER CREDIT PROTECTION ACT 2009* AND AVOIDANCE PRACTICES

Objectives

This chapter examines whether or not there is a need to expand the jurisdiction of the *National Consumer Credit Protection Act 2009* (the Credit Act):

- to address avoidance of the Code by the use of legal structures to fall outside the scope of its definitions of credit and regulated credit; and
- to cover some structured and organised forms of private lending by individuals (including peer-to-peer lending).

A. Background

The Code will regulate a transaction where it satisfies the definitions of both *credit* (section 3) and *regulated credit* (section 5). The same definitions have been carried over into the Code as were previously used in the Uniform Consumer Credit Code (UCCC) (apart from a specific expansion of jurisdiction to cover credit in relation to residential investment properties).

It is noted that issues of avoidance arise in other contexts (for example, consumer leases) and the analysis in this Chapter is also relevant to those topics.

i. Previous changes to the scope of credit regulation

Since the UCCC came into force in 1996, lenders have offered products that were not regulated by the UCCC, and the States and Territories have responded by amending the UCCC to bring some of these forms of lending within its ambit. The process is ongoing in the sense that new types of product are constantly being developed and offered that are outside the Code, and need to be examined to determine whether this is the appropriate regulatory outcome.

Some of the key amendments to the definitions of credit and regulated credit in the UCCC were:

- Amending the initial exemption in subsection 7(1) of the UCCC, which excluded all contracts of less than 62 days duration. The exemption was amended in 2001 so that short term finance would only be exempt where the cost of the credit (through fees or interest) did not exceed specified limits. This exemption was relied on by short-term lenders to completely avoid the Code.
- Further amending the exemption for short-term lending in subsection 7(1) so that fees payable to third parties could be taken into account in determining whether or not the exemption applied. Lenders continued to avoid the Code (either in full or in part) by instituting arrangements in which the consumer was charged a fee payable to a third party

who had an ongoing commercial relationship with the lender or substantially acted on their behalf. The Code did not include these fees in determining whether the cost of credit exceeded the limits introduced by the 2001 amendments.

- Amending the exemption in subsection 7(5) for bills of exchange and promissory notes, so that these transactions are now only exempt where the bill of exchange or promissory note is provided by an authorised deposit-taking institution (and not by any lender).

- Clarifying the application of the Code to vendor terms sales of real property, and to sales of goods by instalments, where the price of the goods or land was inflated beyond the market price.[1] The difference between the market value of the item being purchased and the amount payable by the consumer is treated as the cost of the credit. In some business models the financier and the supplier are related companies. The financier can promote the credit as 'interest-free' lending, when the cost of providing credit is charged to the consumer by the supplier inflating the price of the goods.

Some changes in jurisdiction were introduced only in the Code itself, in response to practices identified by the States and Territories prior to the transfer of responsibility for credit to the Commonwealth. These changes are:

- Amending the effect of a business or investment purposes declaration, so that the declaration would not be conclusive but could only be relied on only where the lender or other persons involved in arranging the credit had made reasonable inquiries into the borrower's purpose. The use of a false declaration was particularly relied on in 'equity stripping' scams.[2]

- Restricting the scope of the pawnbroker exemption, so that it applies only where the pawnbroker's only recourse, should the debtor be in default, is against the goods provided as security for the credit. Again, this was introduced in the Code in response to concerns identified by the States and Territories.

B. Current arrangements

i. Definitions

The definitions of credit and regulated credit in the Code adopt the same definitions used in the UCCC (apart from the extension of coverage in respect of credit for residential investment properties, which is not relevant to this discussion).

Credit is defined in subsection 3(1) of the Code as follows:

- payment of a debt owed by one person (the debtor) to another (the credit provider) is deferred; or

- one person (the debtor) incurs a deferred debt to another (the credit provider).

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1 This practice has a long pedigree and legislation prohibiting it was enacted as early as 1545 in England (37 Hen VIII c 9).

2 See ASIC's 2008 report *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress*. The report analysed three refinances in detail. It found that for these three borrowers, the refinance cost them on average 27 per cent of the equity they had accumulated in their home, and a minimum of $20,120 in fees and charges. The role brokers played in actively mis-describing the proposed purpose of the credit in order to avoid the UCCC is discussed at ps 29-30.

Whether or not credit will be regulated by the Code involves a consideration of the following criteria in Section 5:

- characteristics of the debtor – they must be either a natural person or a strata corporation;
- purpose of the credit – it must be provided wholly or predominantly for personal, domestic or household purposes, or to purchase, renovate or improve residential property for investment purposes (or to refinance credit provided for such a purpose);
- cost of the credit — a charge is or may be made for providing the credit; and
- characteristics of the lender — the credit provider must provide the credit either in the course of a business of providing credit, or as part of or incidentally to any other business they carry on.

There are also exemptions to the Code, specifying particular persons or circumstances in which the Code will not apply. Some people have taken advantage of an exemption to avoid the Code by repackaging their business or products, when it was introduced to exempt other arrangements.[3]

ii. Effect of the National Consumer Credit Protection Reform Package

The implementation of the National Consumer Credit Protection Reform Package has had the following consequences in relation to the jurisdiction of the Code, and the operation of persons in this industry.

- The effect of business purpose declarations has been changed in the Code, to mitigate the risk of avoidance. From 1 July 2010 declarations will no longer be automatically conclusive, but can be relied on only where the lender or other persons involved in arranging the credit will have made reasonable inquiries into the borrower's purpose and ascertained that it was not for personal use.
- The National Consumer Credit Protection Reform Package has introduced the following requirements for persons engaging in credit activities in relation to regulated credit:
  - responsible lending conduct requirements, so that, credit must be not be provided where it is assessed as unsuitable; and
  - lenders and intermediaries must hold an Australian credit licence.

The introduction of these additional requirements on persons providing credit prima facie increases the competitive advantage of those players who provide a product that is not credit, relative to those who do (notwithstanding that it may be functionally similar).

Where a person provides or arranges credit that is not regulated by the Code, this will have the following consequences:

- They are not required to comply with the Code or the responsible lending requirements, or to obtain an Australian credit licence (ACL).

3 The need to narrowing the pawnbroker exemption was a response to such conduct.

- Where they otherwise hold an ACL, consumers may presume that the obligations and standards attaching to regulated credit apply to all products arranged or provided by these persons.
- Where the person is engaging in credit activities by providing credit assistance (that is, suggesting or assisting in relation to a particular product) they can select an unregulated product over a regulated product without having to conduct an assessment that the product is not unsuitable. This assessment is required where they are selecting one regulated product over another.
- ASIC cannot take action to stop the lender from operating or prevent particular individuals from being involved in avoidance practices, as they are not engaging in credit activities within the meaning of the Code.
- ASIC can take action only under the *Australian Securities and Investments Commission Act 2001*, and generally only when a person has engaged in conduct that may infringe that Act, for example, where their conduct has been unconscionable.

1. Does the introduction of licensing and responsible lending requirements to persons who provide or arrange regulated credit increase the incentives to avoid the Code?

C. Current issues

i. Avoidance of the Code

As discussed above the history of the UCCC has been marked by changes in the scope of when credit will be regulated. There are two distinct types of avoidance:

- where the form of the product is the result of commercial or market-driven factors (for example, innovations in respect of lending design); and
- where the form of the transaction is dictated by the desire to avoid regulation and where, therefore, the provider is able to develop an adaptive response to any changes in definition in order to maintain this outcome. These persons can be labelled as *serial self-exempters*.

Serial self-exempters may be motivated either to avoid the Code in its entirety, or to only avoid specific provisions that are particularly onerous, but whose impact can only be circumnavigated by excluding the Code. The most problematic scenarios involve persons who are targeting a vulnerable class of consumers and engaging in predatory lending practices which would not be permitted under the Code, or would create a greater risk of the consumer being able to obtain a remedy.

The incentives or advantages for these persons in continuing to avoid the Code are therefore significant. This increases the likelihood that they will routinely assess any new attempts to control or regulate their conduct, and develop responses that are both adaptive and unpredictable.

The self-exempting models generally can be characterised as follows:

- The form of lending can be sophisticated in its approach to avoid the Code, and use methods that are both confusing to consumers (except that the outcome is similar in that they receive a sum which they must repay over time), and have no counterpart in the mainstream industry.

- The lending can be combined with high-risk or predatory practices, targeting potentially vulnerable consumers. Equity stripping, for example, exploits the desire of borrowers to avoid having to sell the family home. For these borrowers, social and emotional considerations can override prudent decision-making, and make them susceptible to expensive refinances that only defer rather than prevent the sale of their home.

- Some models will become widespread as they become known to, and replicated by, different players. Competition between regulated and unregulated products on the fringes may require some players to mimic avoidance techniques used by others in order to maintain their market share.

- Some methods of avoiding the Code can be absolute and beyond legal challenge. Other methods may be regulated depending on the interpretation of the Code, with the situation ultimately able to be resolved only by a definitive judicial decision). A serial self-exempter can avoid litigating a matter where this would affect their business model generally, for example, by settling the case where there is a risk of an adverse result.

  – The practical consequence is that a model can continue to avoid the Code until its scope is amended. This analysis suggests that the most effective way of establishing whether the Code applies to a particular lending model is to extend the scope of the legislation, rather than seeking to litigate the matter.

- In some circumstances lenders rely, exclusively or extensively, on third parties to distribute their products. For example, the role of brokers has been significant in the following areas:

  – Equity stripping — ASIC's 2006 report found that brokers protected lenders by actively mis-describing the proposed purpose of the credit in order to avoid the UCCC. Brokers could benefit by charging the consumers substantial fees; for example, in one case reviewed by ASIC the broker charged borrowers a fee that was on average 21.6 per cent of the value of the equity in the borrower's home.

  – Third parties charging fees on short-term loans — some persons avoided the application of the UCCC (where it depended on the level of fees charged by the credit provider) by having arrangements for a broker associated with the lender to charge a fee. The broker would ordinarily only refer consumers to the one lender.

- Consumers will have a significant difference in terms of their rights according to whether or not the transaction is subject to the Code, and the lender is required to comply with the Credit Act. This is more relevant where the avoidance techniques are linked to practices that are predatory or where the target market for the product is particularly vulnerable (rather than where avoidance is an incidental outcome of product design, rather than the primary motivation).

Stakeholders have suggested that new methods of avoiding the Code are already being developed. The continuation of avoidance practices in the credit market has the potential to be anti-competitive, and to undermine the integrity of the market and the confidence of consumers. Lenders who are compliant with the Credit Act would prima facie be disadvantaged in that they will be more closely regulated in the way in which they must interact with their borrowers. For example, the disclosure requirements, which ensure competitive neutrality between providers of regulated credit, can result in a disadvantage where the comparison is between regulated and unregulated products.

2. What current practices are being used to provide credit without the transaction being regulated by the Code?

3. How widespread are these practices?

4. Are these practices being targeted at particular classes of consumers, and what are the consequences for consumers?

5. What are the consequences for lenders and brokers who are complying with the Credit Act?

ii. Intermediaries arranging credit from private lenders

The effect of paragraph 5(1)(d) of the Code (and previously section 6(1)(d) of the UCCC) is that a credit contract will be regulated only where the lender provides credit as part of, or incidental to, a business. A transaction will therefore not be regulated by the Code where the individual who is the lender is not in the business of providing credit, or does not provide the credit incidentally to another business.

Whether or not a private individual providing a loan is doing so in the course of a business may not be readily discernible, with the case law on this issue treating each situation on its facts. For example, simply because a person has made only one loan does not prevent them being characterised as being in the business of providing credit. It means there is uncertainty as to whether the Code applies, which may ultimately be able to be resolved only by a court.

The issue is being considered here as there are two specific lending models in which intermediaries are acting to arrange loans between a private lender and a borrower, in a sophisticated and structured commercial arrangement. The features of these two situations are:

- Mortgage Lending, used to describe a form of lending that is relatively short-term and secured by mortgages over real property (typically the borrower's family home).[4]
  - The intermediary is usually a managed investment scheme, regulated by the *Corporations Act 2001*. This Act regulates the scheme in order to protect the lender as an investor, in their relationship with the intermediary.
  - These loans can be arranged by mortgage brokers. Often these loans are arranged where the borrower may not satisfy the lending criteria of a mainstream lender.
- Peer-to-peer lending, in which an intermediary, commonly through the internet, introduces a person who has funds available to lend to potential borrowers.
  - The lending can occur in two ways according to whether the intermediary is lending in their own name (and has simply raised capital from private individuals) or has arranged

4 Intermediaries arranging this type of credit in Western Australia are required to comply with the *Finance Brokers Control Act 1975* (WA) and the *Finance Brokers Control (Code of Conduct) Regulations 2007*, as this legislation was not limited to credit regulated by the UCCC.

credit by matching a borrower in need with a private lender. In the first situation the intermediary is also a lender and will therefore need to hold an ACL and comply with the Credit Act in their own right as the credit provider under the contract. It is understood this is the structure commonly used in peer-to-peer lending. These loans can range from small unsecured loans to larger secured loans.

It is noted that the terms ‘mortgage lending’ and ‘peer-to-peer lending’ do not reflect any formal definitions, and there may be some overlap between the two.

It has been suggested that the exemption in paragraph 5(1)(d) of the Code was introduced as it would be too burdensome to require a person to comply with the Code where they provide credit only on a casual or occasional basis.[5] This rationale does not seem directly applicable to a scenario where the lender provides funds and a third party intermediary assumes or can assume responsibility for compliance with the law. In other words, a model in which a third party is intrinsically involved in arranging loans on a regular basis is prima facie inconsistent with the rationale for exempting loans, as it can no longer be readily characterised as casual or informal lending.

As with all forms of avoidance, it is appropriate to consider the effects of these structures on both competition and consumers. It is possible to identify these in some detail given that particular models are being considered.

- The effects on *competition* — the products being offered through these intermediaries are similar to and directly competing with, products offered by lenders who are complying with the Code (with apparent disadvantage to these lenders in terms of compliance costs, meeting and maintaining the requirements to hold an ACL and regulation of their interaction with consumers).
  - ASIC’s 2006 report, *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress*, found that the interest rates disclosed by exempt mortgage lenders could be as low as 9.5 per cent, when they would be 15.3 per cent if calculated in accordance with the Code.[6]
- The effects on *consumers* – a consumer is dealing with an intermediary who is in the business of arranging credit, and, as a result, there is little difference for them relative to dealing with a lender subject to the Code. However, where the credit is not regulated by the Code, the consumer will have more limited rights (for example, in relation to pre-contractual disclosure, enforcement procedures, access to hardship variations and requirement for the person to be a member of an EDR scheme).

6. Should this type of lending be regulated by the Code, and what issues should be taken into account in considering this question?

7. If it is to be regulated should the lender be required to hold a licence or should they be exempt provided the intermediary is licensed?

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5 A. Duggan and E. Lanyon, Consumer Credit Law, 1999, Reed International Books Australia Pty Ltd, paragraph [2.4.13], p 66.
6 Table 9 in the report at p 29.

iii. Examination of solicitor lending by the Ministerial Council of Consumer Affairs

The issue of solicitor lending was examined by the Ministerial Council of Consumer Affairs (MCCA) prior to the transfer of responsibility of credit to the Commonwealth. It only considered private lending where the intermediary between the lender and the borrower was a solicitor. The following summary of MCCA's examination of the issue is provided as it identifies some of the relevant policy considerations.

MCCA released an exposure draft Bill to amend the UCCC and accompanying Explanatory Paper for public consultation in October 2005. The Bill and Paper explored options for bringing this type of lending within the Code where the credit was provided, in general terms, as a result of the law practice acting as an intermediary.

Two options were identified to bring this type of lending within the UCCC:

- deeming the solicitor to be the credit provider; or
- treating the lender as a regulated credit provider (even though they did not provide credit in the course of a lending business or incidentally to another business).

MCCA decided not to proceed with amendments as issues identified during the consultation process required further consideration to determine the appropriate response. These issues were:

- the deeming provisions created technical difficulties as it would allow, for example, both the investor/credit provider and the solicitor/deemed credit provider to exercise the right to receive payments by the borrower;
- requiring the individual lender to be licensed would raise questions about whether they would have the resources to be able to themselves comply with the UCCC (or whether the law practice would be accountable to the lender for any non-compliance);
- the undesirability of limiting any extension of the UCCC only to law practices only, given that other types of intermediaries are also engaged in this type of conduct, and the proposed extension could be avoided easily by a law practice forming a separate entity to conduct the lending; and
- concerns about defining the arrangements to be regulated in a way that did not include conduct such as solicitors acting as agents or under a power of attorney.

The development of the National Consumer Credit Protection Reform Package has addressed some of these issues in that:

- A model in which the lender is exempt from the need to be licensed on the basis that there is an agreement with a third party who is responsible for compliance with both the Code and the Act has been developed in the regulations to the Credit Act (and could be adapted to address this issue). [7]
- The intermediary will need to hold an ACL (or be registered in the transitional period). The individual lender will therefore be able to protect their interests through an agreement

7 See, for example, the exemption for fund raising special purpose entities and securitisation entities in Credit Regulations 23B and 23C, and the modifications to the Credit Act in Schedule 3 of the Credit Regulations.

with this third party, setting out the terms on which they will act, and will also have access to an external dispute resolution (EDR) scheme to resolve any complaints about its conduct.

- MCCA was only considering the issue only in respect of solicitors lending schemes. However, the issue arises more broadly, and should be addressed in terms of the structure being used, rather than the persons engaging in it.
- There are existing exemptions to the Act for solicitors where they may be engaging in credit activities in the ordinary course of their duties as a solicitor.[8]

D. Reform

There are four options to address these issues:

Option One: No further Commonwealth intervention

Under this option there would be no changes to the definitions and the current methods of avoiding the Code would continue.

Option Two: Broaden the definition of regulated credit

This approach would change the definition of when credit will be regulated in a way that is broad enough to encompass the current identified techniques used to avoid the application of the law, and limit the extent to which future avoidance is possible.

As noted above, whether or not the Code applies is determined by criteria in respect of the characteristics of the transaction, the debtor and the lender, and the purpose and cost of the credit.

There are a variety of different ways in which the Code can be avoided, and the practices discussed above do not avoid the Code in the same way. This means, for example, that a change that was effective in addressing avoidance in relation to one part of the definition of regulated credit may still allow the Code to be avoided in other ways.

A comprehensive approach to changing the Code would therefore need to consider each of the following aspects of the definition and the way in which it operates:

- whether or not to change the definition of credit from a deferral of a debt;[9]
- whether or not to change the characteristics of the transaction, the debtor and the lender;
- whether or not to change the purpose for which the credit is provided;[10]
- whether or not there is a need to clarify when there will be a cost to the provision of credit; and

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8 Subregulation 24(5) of the *National Consumer Credit Protection Regulations 2010* exempts a lawyer from the licensing requirements of the Credit Act in specified circumstances (including where they are acting in the ordinary course of their duties as a lawyer and otherwise meet the requirements for the exemption to operate).

9 It is noted that a definition using the phrase *financial accommodation* is used in the UK and was also utilised in the former Credit Acts.

10 By comparison the draft NSW Draft Finance Brokers Bill initially regulated all credit irrespective of purpose. Where it was established that the credit was provided for a business, the Bill did not apply (in part or in full, according to whether the borrower was a small or big business).

- whether or not any of the exemptions need to be reviewed.

In general terms, this approach may be more difficult to avoid, given that the definition will be broader and capture transactions which are not intended to be regulated and which would need to be exempted, depending on the definition used.

8. Is there a need to amend the definitions of credit or regulated credit in the Code?
9. If any particular elements of the definition need to be changed, what avoidance practices are they intended to prevent, and what mainstream practices might also be covered by any change?
10. Are there different factors to be taken into account in considering whether to extend the definition of regulated credit as it applies to intermediaries and to lenders?

Option Three: Respond to individual practices

This approach is an alternative to Option 2 and would involve the application of the Code being extended on a case by case basis, responding to methods of avoidance as they are identified.

This approach would:

- allow existing methods of avoiding the Code to continue until there was further amendment in response to a demonstrated need; and
- provide certainty to industry in that the definition would be expanded to cover particular practices or models, rather than being changed broadly, which would require consideration of whether transactions fall within or outside the scope of such a definition.

11. What are the advantages and disadvantages of this approach?

Option Four: Adopt other measures

A further approach, which could operate in conjunction with either Option 2 or 3, would be to adopt other mechanisms to address the issue of avoidance. These mechanisms could include:

- an anti-avoidance provision;
  - This would still need to be tied to a definition of regulated credit, and would therefore not assist where the structure used is effective in avoiding that definition.
- a mechanism allowing for a prompt decision on whether or not a particular transaction is regulated by the Code; and
- a specific response to address the conduct of serial self-exempters, who change the structure of their transactions to avoid regulation.
  - This could cover some mechanism so that the products offered by these persons could be made subject to the Code relatively quickly, where the product was functionally similar to credit and the form was adopted to avoid the Code. One option would be a provision allowing specific products or products offered by specific persons (serial self-exempters) to be deemed to be regulated.

11. What issues should be taken into account in considering these options?

12. Which option would be most effective in addressing the issue of avoidance?

13. Are there any other methods of strategies that could be used to address the issue of avoidance?

ANNEX A: BACKGROUND TO CONSUMER CREDIT REFORMS

A. Previous regulatory framework

Until 1 July 2010 credit providers were regulated by the States and Territories by the Uniform Consumer Credit Code (UCCC). Responsibility for enforcing the UCCC lay with various State and Territory Fair Trading Authorities or Consumer Affair Bodies. The focus of the UCCC was on precontractual disclosure requirements aimed at informing the consumer of the full costs of credit. It also prohibited 'unjust' terms in credit contracts, required the provision of 'comparison rates' in certain credit advertising, and covered such matters as default procedures and provision for hardship applications.

There are also a range of ancillary State and Territory credit regulations outside the UCCC, which have developed over time to address perceived gaps in consumer protections. For example, four States have introduced interest rate caps, and Western Australia has a licensing regime for credit providers and finance brokers who advise consumers on the merits of competing credit products.

The Australian Government has limited influence over the regulation of consumer credit through the consumer protection powers given to the Australian Securities and Investments Commission (ASIC) in the *Australian Securities and Investments Commission Act 2001* (ASIC Act). The scope of this power is limited to requiring credit providers to comply with certain provisions mirroring the consumer protection sections of the *Trade Practices Act 1974*. For example, ASIC has powers to investigate and prosecute conduct that is misleading or deceptive, or is likely to mislead or deceive, in relation to credit products and services. Credit providers and many of those providing advice on credit products remain predominately outside ASIC's remit.

B. COAG reform process: Two stage reform process

Phase One

In recognition that there was scope to improve the regulation of consumer credit, in 2008 the Council of Australian Governments (COAG), at its meeting on 2 October 2008, decided that the Commonwealth Government would assume regulatory responsibility for consumer credit under a two phase implementation plan.

Phase One included the transfer of the existing key credit regulation — the UCCC with key enhancements and an expanded scope — the introduction of a robust national licensing regime administered by ASIC as a single national regulator. At the same time, it sought to bolster consumer protection through introducing industry wide responsible lending standards. While the reform timetable was set by COAG, a decision was taken for the reform to proceed in stages and to focus efforts in the first stage on addressing the systemic and regulatory gaps which States have long sought to address — that is licensing and broker legislation.

The *National Consumer Credit Protection Act 2009* (Credit Act) delivers on Phase One of the Reform Package and introduces:

- a comprehensive licensing regime for all providers of consumer credit and credit related brokering and intermediaries in the industry;
- industry wide responsible lending conduct requirements on licensees — not to provide credit products and services that are unsuitable for the consumers' needs and that the consumer does not have the capacity to repay;
- improved sanctions and enhanced enforcement powers for the regulator — ASIC;
- expanded consumer protection through court arrangements, remedies for consumers and penalties for licensee misconduct; and
- a largely replicate UCCC as the National Credit Code (Code) and expand its scope to include credit provided to purchase, renovate or improve residential investment property.

The *National Consumer Credit Protection (Transitional and Consequential Provisions) Act 2009* deals with the treatment of rights and liabilities in respect of certain existing credit contracts; and court proceedings that existed or arose prior to the commencement of the Credit Act. It also establishes a registration process for industry participants, as a precursor to licensing.

Finally, the *National Consumer Credit Protection (Fees) Act 2009* imposes fees for various matters such as the lodgement of documents and the inspection or search of a register kept by ASIC.

Phase Two

Phase Two will encompass consideration of the regulation of small business and investment lending, and areas identified as potentially requiring specific regulation, such as reverse mortgages, payday lending and consideration of remaining Ministerial Council on Consumer Affairs projects. Phase Two also includes issues that have emerged as a result of Phase One.

Given the broad scope of matters to be considered in further regulatory reforms, the Phase Two reform package will be delivered in two tranches. This will enable careful consideration of issues and allow for broad based public consultations. Legislation to give effect to regulation, where warranted, to be in place for some projects by mid-2011 (Part One), and for those which require more consultation to be in place by mid-2012 (Part Two). Consultation on Phase Two, which commenced in December 2009 and will continue throughout will be undertaken through two main groups:

(i) the industry and consumer representative consultative group (which assisted in the development of Phase One of the consumer credit reforms); and

(ii) the Financial Services and Credit Reform Implementation Taskforce comprising State and Territory Government officials.

Special working groups on Phase Two issues have also been convened to allow targeted industry input into those areas. To date, two working groups have been established: the Equity Release Consultation Working Group and the Retail Point of Sale Working Group.

Input from this Green Paper process will assist development of detailed regulatory options and Regulation Impact Statement for consideration by Government, and subsequently, development of a proposal to be submitted for COAG endorsement later this year.

C. Outline of Phase Two issues for government consideration

The Green Paper contains issues that the Government considered further consultation in the medium term. However, the scope of Phase Two of the National Consumer Credit Protection Reforms includes other topics. Below is the full list of topics:

For Part One of Phase Two of the Government will consider the need for:

- enhancements to the regulation of and tailored disclosure for reverse mortgages;
- consideration of the treatment of consumer leases including the disclosure and linked credit requirements;
- regulation of other forms of credit used for personal use including peer to peer lending;
- enhancements to the regulation of credit cards;
- extending unjust conduct provisions to credit service providers; and
- further enhancements to the Code.

For Part Two of Phase Two the Government will consider projects requiring more in depth industry consultation, including:

- the need for regulation of the provision of credit to small business;
- the need for regulation of credit for investment loans other than margin loans and residential property investments;
- examination of mechanisms, including State approaches to interest rate caps, to address predatory or fringe lending;
- an examination of the need for any enhancements to responsible lending conduct obligations;
- a review of the regulation of credit advertising; and
- reform of mandatory comparison rates.

ANNEX B: PRECONTRACTUAL DISCLOSURE IN THE UNIFORM CONSUMER CREDIT CODE

Objectives

Phase Two of the National Consumer Credit Protection Reforms (Credit Reforms) includes consideration of remaining State projects and commitments under the Council of Australian Governments' (COAG) Action Plan. This annex, which considers the report commissioned by the Standing Committee of Officials of Consumer Affairs (SCOCA) on precontractual disclosure in the Uniform Consumer Credit Code (UCCC) (the precontractual disclosure report):

- outlines the key research and proposals from the report; and
- considers the report findings against the *National Consumer Credit Protection Act 2009* (Credit Act) disclosure requirements.

A. Background

i. Overview of precontractual disclosure report

In December 2005 the Uniform Consumer Credit Code Management Committee released a consultation package, *Precontractual disclosure under the Uniform Consumer Credit Code*, which included a Proposed Disclosure Model to replace the Current Disclosure Model in the UCCC. The consultation found that further changes to the existing UCCC precontractual disclosure needed to be determined by consumer testing and consideration of current research into disclosure.

As a result, SCOCA commissioned an independent consultant to conduct research into precontractual disclosure under the UCCC, with the aim of developing an evidence-based disclosure model to meet the information needs of consumers and, where possible, provide consumers with a better understanding of the cost of credit.

Following the COAG decision to transfer responsibility for the regulation of consumer credit to the Commonwealth in 2008, it was agreed that the Commonwealth would consider the finding of the report as part of Phase Two of the credit reforms. The precontractual disclosure report, which was released in mid-May 2010, describes how the research used an evidenced-based approach and tested various precontractual disclosure models by simulation, surveys, focus group discussions, qualitative research and comprehension testing.

Current Disclosure Model (CDM)

The current disclosure model (CDM) is the disclosure document mandated by the UCCC. The CDM can be a separate document, but it is usually a copy of the loan contract which must present certain information in a Financial Table or Schedule. The research indicated that consumers lacked sufficient understanding of the information in the CDM. While it helped consumers to understand the cost of the credit contract, the CDM format can still be a lengthy document which is confusing for consumers.

Proposed Disclosure Model (PDM)

The proposed disclosure model (PDM) is the disclosure model proposed in the 2005 Uniform Consumer Credit Code Management Committee (UCCCMC) consultation package, *Precontractual disclosure under the Uniform Consumer Credit Code*. The PDM consists of a Financial Summary Table (FST), which is the Schumer box, and the statement of other information (SOI), which is information about the core features of the credit contract summarised on two pages.

Overall the PDM model, which incorporated a Schumer box format[1], produced better comprehension results. However, there were only marginal improvements in consumer understanding of the cost of credit and related information for car loans and home loans. As a result further revisions of the design of the PDM was further refined and the research team tested two more re-designed models based on focus group feedback on the PDM model and from further comprehension tests.

Redesigned disclosure models 1 and 2

Redesigned disclosure model 1 RDM(1) is the first re-designed model produced by the researchers. RDM(1) consists of a redesigned FST and SOI. It refers to the credit contract and is accompanied by a contract schedule and a set of standards terms or the loan contract.

RDM(2) is the second tested version and has only a redesigned FST and refers to the contract schedule and includes a set of standards terms or the loan contract. There is no SOI. This is the report's recommended disclosure model.

The redesigned disclosure models focused on providing the key information in a Schumer box format, making minor adjustments for credit cards by including a warning about monthly minimum repayments and for car loans, and consumer rights in relation to repossession. The RDM(2) model prescribes the format for fees and charges, including the components for the calculation to assist in simplifying the process of understanding the cost of the credit.

Consumer testing found that the final redesigned pre disclosure format in RDM(2) was a more meaningful document for consumers in that it explained the cost of credit more clearly and allowed them to refer to the accompanying documentation.[2] The precontractual disclosure report also tested the RDM(2) model for on line applications for credit cards. The study found that there was a high level of comprehension of the content for RDM(2).

Early disclosure model RDM (2.1)

The RDM(2.1) disclosure model is based on variations of the redesigned RDM(2) model but was tested in an early disclosure context. RDM (2.1) uses a modified Schumer box

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1 The Schumer box is a standardised disclosure box that features consistent terms and conditions for credit card offers. The aim of the Schumer box is to allow consumers to compare credit cards in a consistent manner. Specific terms and conditions are required to be spelled out for consumers in conjunction with new account applications.

2 SCOCA Simplification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign — Final Report, 12 March 2010, p 6.

presentation, which summarises the information on one page and is a stand-alone document. Test subjects found the format of RDM(2.1) to be a useful tool for comparing different credit contracts and that it simplified the process of understanding the cost of credit. The RDM(2.1) model proved to be more accessible for consumers, while still enabling the consumer to rely on the contract document for full contractual requirements.

ii. Overview of the Report's key recommendations

The precontractual disclosure report makes several recommendations primarily for the formatting and timing of the precontractual disclosure for four specific transaction types (home loans, car loans, store cards and credit cards). The recommended disclosure model, RDM(2), is based on variations of the redesigned disclosure model, which is adapted from other models tested during research for the precontractual disclosure report.

The precontractual disclosure report notes that the research could benefit from further redesigning and testing to allow for more complex analysis of the data and that there would be some limitations to the early disclosure RDM(2.1) model (such as ensuring that the consumer does read the pre contractual disclosure information). The precontractual disclosure report also notes that the solutions for these limitations are beyond the remit of the research project.

B. Current issues

There are further issues that need to be considered in conjunction with the precontractual disclosure report. Several of these issues were raised during previous discussions about the Credit Act disclosure framework with key stakeholders.

i. Regulatory arrangements

The precontractual disclosure report was conducted in the context of the UCCC as a stand alone State-based law prior to the development of the overarching Commonwealth law. Given that the new Credit Act commences on 1 July 2010, some consideration should be given to how the new credit regulatory frameworks relate to the precontractual disclosure report findings.

The precontractual disclosure report was commissioned to conduct research that could be used to improve the UCCC precontractual disclosure framework. The UCCC provided consumer protection in relation to consumer credit contracts, by requiring the disclosure of interest rates, fees, commissions and other information about contractual provisions, and also provides remedies and enforcement powers. Following the COAG decision to transfer credit regulation to the Commonwealth, the UCCC disclosure approach was largely replicated in the National Credit Code (the Code).

In addition to Code requirements, Chapter 3 of the Credit Act outlines the responsible lending conduct obligations for licensees. The Credit Act disclosure obligations are designed to better inform consumers and prevent the provision of unsuitable credit contracts by:

- providing information about the licensee;
- disclosing key responsible lending conduct obligations;

- providing information about the rights of the consumer and procedures for dealing with a dispute;
- informing the consumer of their right to request a copy of the unsuitability assessment; and
- disclosing quotes for providing assistance.

Chapter 3 prescribes the type of information to be provided in a disclosure document and how the disclosure document will be provided to consumers when a credit contract will be entered into or when credit assistance is provided. Chapter 3 requires any commissions received, either directly, or indirectly, to be fully disclosed as well as any fees incurred by the consumer. New precontractual disclosure for credit service providers was also introduced in Chapter 3 of the Credit Act and the UCCC precontractual disclosure requirements were replicated in Sections 16 and 17 of the Code.

Other objectives include disclosing information at certain points during the lifecycle of the credit contracts to ensure that consumers have access to adequate information about the credit service provided and the credit contract. A further objective is developing the disclosure regulations in such a way that compliance costs for industry are proportionate with the level of protection for consumers.

ii. Effectiveness of disclosure as a tool for promoting consumer awareness

There is some research to suggest that disclosure practices do not necessarily improve understanding of the core features of a credit contract. A 2008 report prepared for the Brotherhood of St. Laurence indicated that the consumer's level of financial literacy shaped their capacity to understand the core features of the credit product and contract.[3] The precontractual disclosure report also indicated that the consumer's need for credit often overrides other considerations when choosing one type of credit product over another or when entering into a credit contract. In particular, the language and length of the document was an issue for consumers in understanding the credit contract.[4]

Similarly the 1999 *UCCC Post-Implementation Review* suggested that while consumers appreciated the additional information, there was still confusion about how the fees and charges would be applied.[5] A 2005 O'Shea and Finn study indicated that financial tables in consumer credit disclosure documents presented some comprehension problems for participants.[6] The precontractual disclosure report testing found that a consumer's previous experience with credit applications was also a significant factor in determining how much of the information they understood.

Overall the literature suggests that there is a range of reasons why consumers have difficulties in understanding credit contracts. Some of these issues are related to the capacity of the consumer to understand the disclosure material, but it is also clear that consumers can

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3 Sheehan, G Wilson, T and Howell, N *Coming to grips with credit contracts — Steps to protect vulnerable borrowers*, Brotherhood of St. Laurence and Griffith University, November 2008, pp 4-5.
4 Sheehan, G Wilson, T and Howell, N *Coming to grips with credit contracts — Steps to protect vulnerable borrowers*, Brotherhood of St. Laurence and Griffith University, November 2008, p 13.
5 Uniform Consumer Credit Code, *Post-Implementation Review Ministerial Council on Consumer Affairs Final Report*, December 1999, p 31.
6 O'Shea, P and Finn, C *Consumer Credit Code disclosure: does it work?* The University of Queensland Legal Research Series, 2005, p 11.

have a better understanding of the credit contract if the disclosure document focuses on core information, has better formatting and if the consumer has enough time to consider the information. These issues are addressed by the precontractual disclosure report.

iii. Credit Act precontractual disclosure requirements

The precontractual disclosure report was prepared before the Credit Act disclosure framework was introduced and the precontractual disclosure report findings were only intended to apply only to precontractual disclosure for credit providers. However, the recommended RDM(2) model and the findings on early disclosure have now been released in the context of the new Credit Act disclosure framework. This section considers some of the issues related to the recommended RDM(2) model against the Credit Act disclosure framework.

Content of Credit Act precontractual disclosure document and RDM(2) model

The Credit Act includes similar precontractual requirements for credit providers in Chapter 3 of the Act and under sections 16 and 17 of the Code. Under sections 16 and 17 of the Code, precontractual disclosure documents provide information about a specific credit contract before the consumer enters into that contract. However, the content for the RDM(2) model and the Code precontractual disclosure documents differ slightly:

- The proposed RDM(2) model for credit provision includes core credit contract information that is formatted for the benefit of consumers. It also provides information on the minimum repayments for the credit contract and where necessary, financial summary tables and important information tables. The precontractual disclosure report found that the RDM(2) model was significantly more meaningful for consumers making an informed choice about the credit contract as they could find the core information.

- The credit provider pre contractual disclosure document under Section 16 and 17 of the Code is less prescriptive in the information required compared with the RDM(2) model and as noted previously there are no prescriptive requirements for formatting of the information. If the pre contractual disclosure is included in the credit contract, then the information is subject to information credit contract information requirements (subsection 16(5) and Section 17 of the Code).

Further consideration needs to be given to the original scope of the precontractual disclosure report and the recommended RDM(2) model against the Credit Act disclosure model.

Timing of provision of precontractual disclosure document and other Credit Act disclosure documents

While not the recommended RDM(2) disclosure model, the early disclosure model RDM(2.1) highlights some issues related to the timing of other Credit Act disclosure documents.[7] The precontractual disclosure report explores timing, comparing comprehension issues under 'early' and 'late disclosure' timeframes against each of the four credit transaction types.[8] Participants considered that the RDM(2.1) model was most useful in the early disclosure

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7 SCOCA S*implification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign: Final Report*, 12 March 2010, p 166.

8 Participants in the early disclosure group were given the precontractual disclosure information in a modified RDM(2) model, the RDM(2.1) model, early in the transaction decision making process.

stage as it assisted them to make an informed choice at the outset of the decision making process.[9]

The precontractual disclosure report concludes that further timing issues beyond the remit of the study may need to be considered, such as mandating early disclosure for precontractual disclosure or a 'cooling-off' period.[10] Under the new Credit Act disclosure framework, triggers for providing disclosure documents to consumers such as suggesting a credit contract, and for providing disclosure documents to consumers could mean that the consumer could be provided with several disclosure documents at once (see Table 1).

Whether or not the RDM(2) or RDM(2.1) model replaces the current precontractual disclosure, timing of the other disclosure documents needs to be considered as it could dilute the effectiveness of the proposed RDM(2) model.

Application of features of the RDM(2) model to credit service provider' precontractual disclosure

For credit service providers, the credit proposal disclosure document is similar to the precontractual disclosure requirements for credit providers.[11] The credit proposal disclosure document includes the requirement to provide an estimate of the commissions that are received and are likely to be received by the credit service provider.

Although the precontractual disclosure report findings were not intended to apply to broker services, it may be that some useful features of the RDM(2) model, such as the warning boxes or information boxes could be applied to the credit proposal disclosure document. This issue could be explored further in the context of the development of guidance for disclosure in line with the responsible lending conduct requirements.

iv. Costs associated with RDM(2) model

The precontractual disclosure report suggests that the recommended RDM(2) model is less costly than the current PDM model as it reduces the number of additional pages. The report notes that there will be some additional administrative and IT systems costs to develop new systems to give effect to the RDM(2) format. Other costs such as consequential changes to staff procedures, and education and training costs may need to be considered when assessing the findings in the precontractual disclosure report.

C. Questions

This annex seeks to canvass broad industry feedback on the precontractual disclosure report recommendations. Feedback is specifically sought on the costs and benefits to both consumers and industry of the findings and recommendations. At this stage it is not proposed to consider reform options.

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9 SCOCA *Simplification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign: Final Report*, 12 March 2010, pp 174-175, p 198.

10 SCOCA *Simplification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign: Final Report*, 12 March 2010, p 241.

11 *National Consumer Credit Protection Act 2009*, sections 121 and 144.

1. How might the findings of the precontractual disclosure report be used to inform further consideration of precontractual disclosure requirements in the Credit Act?

2. Can the report's findings be used to improve the current precontractual disclosure requirements in the Credit Act? Please specify.

3. What are the costs and benefits for consumers and for industry of:

   - the recommended product-specific RDM(2) model?

   - maintaining the precontractual disclosure requirements under the Credit Act (that is, not implementing the RDM(2) model)?

4. Are there other issues not identified in this annex that should be considered in light of the report findings? Please specify.

Table 1: Credit act disclosure obligations relating to documents

Document	Obligation applicable to	Purpose	Overview of obligations
Credit Guide (CG)	Credit providers (CP) Credit assistance providers (CA) Credit representatives (CR)	To provide consumer with preliminary information about the CP, CA and CR. Information that should be provided is conduct obligations of licensee, key rights of the consumer. For CA the information needs to include the possible nature and size of fees and charges that the consumer may incur as well as commissions. Applies to credit leases as well.	For CA the credit guide must be given to the consumer as soon as practicable after it becomes apparent to the CA that they will provide credit assistance to the consumer. It is anticipated that this could occur as early as the first communication. If CA gives the consumer CP CG, there is the expectation that there is no need to provide it to the consumer again. For CP, it is envisaged that precontractual disclosure required as required by the Code. For the CP, it is anticipated that the timing could be as soon as the consumer is likely to enter into a credit contract. For CR, they must give CG to consumer at same time as CG of licensee they represent.
Quote for providing credit assistance (quote)	CA	The quote advises the consumer of maximum cost of the CA's services, also includes estimates incurred by consumer or out of credit contract. Possibility that final quote will be less. Quote clarifies with consumer whether or not the costs will be incurred by consumer regardless of whether the credit is obtained.	The quote must be provided before credit assistance is provided. The quote needs to be signed and date before credit assistance is provided. These requirements also apply to credit leases.
Credit proposal disclosure document (CCPD)	CA	The document provides the consumer with estimates of fees and commissions relating to the credit contract. Applies to credit leases as well.	CA must at the same time as providing credit assistance provide the CPDD.

Table 1: Credit act disclosure obligations relating to documents (continued)

Document	Obligation applicable to	Purpose	Overview of obligations
Precontractual disclosure statement	CP	The document provides the consumer with financial information specified by regulations. Applies to credit leases as well.	The CP must provide the document before the contract is entered into or before the debtor makes an offer to enter into the contract, depending on what comes first. It may be that the pre contractual statement can be the proposed contract document. In this case section 17 information requirements would apply.
Assessment that contract is not unsuitable.	CP and CA	This could be the written preliminary assessment or final assessment that a credit contract is not unsuitable for the consumer.	CA must give the consumer a copy of the assessment if requested by consumer. CP must give the consumer a copy of the final assessment if requested by consumer.

GLOSSARY

Term	Definition
ACL	Australian credit licence, granted under Chapter 2 of the *National Consumer Credit Protection Act 2009*
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
Authorised deposit taking institutions	Authorised deposit taking institutions (ADIs) are corporations which are authorised under the Banking Act 1959. ADIs include banks, building societies and credit unions.
COAG	Council of Australian Governments
COAG agreement	Agreement by COAG that the Commonwealth assume responsibility for regulating consumer credit (including non deposit taking institutions) and advice, including persons and corporations engaged in mortgage broking activities. The agreement also extends to the Commonwealth regulating margin loans.
Code	National Credit Code, which is Schedule 1 to the *National Consumer Credit Protection Act 2009*.
Consumer Credit Protection Reform Package	*National Consumer Credit Protection Act 2009*, the National Consumer Credit Protection (Transitional and Consequential Provisions) Act 2009, and the National Consumer Credit Protection (Fees) Act 2009.

Term	Definition
Credit	For the purposes of the National Credit Code, credit is provided if under a contract for payment of a debt owed by one person (the debtor) to another (the credit provider) is deferred; or one person (the debtor) incurs a deferred debt to another (the credit provider).[1]
Corporations Act	Corporations Act 2001
Credit Act	*National Consumer Credit Protection Act 2009*
Credit contract	For the purposes of the National Credit Code, a credit contract is a contract under which credit is or may be provided, being the provision of credit to which the National Credit Code applies.
EDR scheme	External dispute resolution scheme
Equity stripping	Occurs where some brokers and lenders (typically operating at the fringe of the industry) inappropriately target vulnerable borrowers who are experiencing financial difficulties. The broker refinances the borrower's home loan debt into a new, higher cost loan.[2]
Fees Act	*National Consumer Credit Protection (Fees) Act 2009*
FSR	*Financial Services Reform Act 2001*
Hire purchase	A method of purchasing an item, where the buyer hires it and takes possession of the item and pays regular instalments. Ownership is only transferred on payment of the final amount.

1 Subsection 3(1) of the National Credit Code.
2 Australian Securities and Investments Commission, Submission to the Inquiry into Home Lending Practices and Procedures House of Representatives Standing Committee on Economics, Finance and Public Administration, July 2007.

Term	Definition
Consumer lease	The hiring of goods by a natural person or a strata corporation wholly or predominantly for personal, domestic or household purposes under which that person or corporation does not have a right or option to purchase the goods.[3]
Loan-to-value Ratio (LVR)	LVR is the amount borrowed under a loan contract represented as a percentage of the value of the property offered as security. LVR is calculated as follows: LVR = Loan amount ÷ Property value
MCCA	Ministerial Council on Consumer Affairs
Non-bank lender	A financial institution that provides credit products which does not source any of its funding through deposit taking. Also called non deposit taking institutions in this paper.
Non-deposit taking institution	See non-bank lender.
Overdraft	A loan facility on a customer's current account at a lending institution that permits customer withdrawals and commitments, up to an agreed limit, in excess of their account balance.
Pre-contractual disclosure	The disclosure required by to be provided by lenders under the Code which provides the consumer with estimates of fees and commissions relating to the credit contract.
Reverse mortgage	An arrangement where a borrower uses the equity in their property as security for a loan, commonly provided as a lump sum, regular payment, line of credit or a combination of these. The borrower retains title over the property and grants the lender a mortgage over the property. The principle and interest, as well as any fees and charges under the loan are capitalised and are usually not required to be repaid until the borrower dies or voluntarily vacates.
SCOCA	Standing Committee of Officials of Consumer Affairs.

3 Section 169 of the National Credit Code.

Term	Definition
Small business	Small business is defined as a business having fewer than: a) 100 full time (or equivalent) people if it involves the manufacture of goods; or, b) in any other case, 20 full time (or equivalent) people.
Uniform Consumer Credit Code (UCCC)	Uniform Consumer Credit Code enacted in Queensland by the Consumer Credit (Queensland) Act 1994 (QLD) and applied in States and Territories between 1996 and 1 July 2010.