consumer action law centre

Thus in reality, pre-screening's main purpose is to enhance direct marketing strategies, as it enables lenders to avoid embarrassing events (such as sending offers to children or pets, or having to reject an application from someone who received a "special offer") and allows them to target a wider range of profiles (for example big spenders or financially stressed), knowing that there will be some filtering of these offers. The ALRC was right when it said that 'pre-screening' should be prohibited.[5]

How can we ensure more responsible lending?

The Federal Government has now committed to include responsible lending obligations as part of the new licensing regime for consumer credit providers. This should require lenders to:

- only lend to a borrower who has a capacity to service the loan repayments, and do so without substantial hardship; and
- provide credit products that are suitable for the borrower's circumstances.

Government should accept the ALRC's recommendation to prohibit pre-screening and should ensure that strict definitions are placed around access to credit reports to "manage accounts".

The Government needs to commit to closely monitoring the impact of any changes to the credit reporting system on lending and marketing practices, in case further reforms are required to credit laws to address unforeseen outcomes.

We look forward to having input into the Federal Government's review of credit card limit extension offers and other irresponsible credit marketing practices as part of phase 2 of the transfer of Australia's consumer credit regulation to the Commonwealth. These processes must be worked through before Australia has an effective responsible lending framework.

December 2008

5 We understand that lenders already engage in 'prescreening' even though there is some doubt about whether it is permitted under current law.

Credit reporting and responsible lending

The Australian Law Reform Commission (ALRC) recently recommended that some additional types of information should be allowed on individual credit reports, but that repayment history information should only be allowed once Government has implemented responsible lending obligations in law.

Extending access to personal financial information on credit reports provides lenders with a powerful tool. However, whether this tool improves lending practices or worsens debt stress depends on how it is used by lenders. The same information could be used to lend more responsibly – but also for determining "up-sell" amounts, profiling borrowers for marketing and giving faster approval for "impulse" credit products.

This is why the ALRC understood that a responsible lending framework must be in place before lenders have access to more personal information. It came to this recommendation after a comprehensive, 2 ½ year long inquiry process involving consultation with hundreds of government, industry and community stakeholders and individuals.

Background – Credit Reporting and Responsible Lending

Australia currently allows only certain information to be kept on a person's credit report, such as current credit providers, debts that are over 60 days in default, dishonoured cheques over $100, court judgments and bankruptcy orders.

The ALRC has recently recommended the expansion of information allowed to be included on credit reports to include:

- Open and closed accounts (and dates)
- Credit types (eg, mortgage, personal loan, credit card)
- Current limits for each open credit account.[1]

The ALRC also recommended the inclusion of repayment performance history on credit reports, subject to the Australian Government implementing an adequate legal framework for responsible lending. Repayment peformance history would indicate, for example, whether an individual was on time, or 30, 60 or 90 days late, in making a payment due under a credit card or other credit account.

The Federal Government has also recently announced that it will assume responsibility for regulating consumer credit from the states. As part of this, it will establish a licensing regime for credit providers, requiring licensees to observe a number of general conduct requirements including responsible lending practices.[2]

1 Australian Law Reform Commission, For Your Information: Privacy Law & Practice (Report 108), August 2008.

2 Federal Treasury, National Consumer Credit Action Plan: Single, standard, national regulation of consumer credit for Australia, October 2008

The danger is that if the changes to the credit reporting system go through before effective responsible lending regulation is in place, the changes could lead to an increase in irresponsible lending.

What are the risks in allowing comprehensive credit reporting before we have responsible lending obligations?

Industry only gives one side of the comprehensive credit reporting picture

Lenders and credit reporting agencies (like Veda Advantage and Dun & Bradstreet) have been arguing strongly for comprehensive credit reporting but do not draw attention to the fact that they will obtain significant financial benefits from it – whether or not it leads to more responsible lending practices.

They argue that more information would enable lenders to improve the accuracy of risk assessment, reduce defaults and debt over-commitment, and provide credit to those who cannot currently prove their creditworthiness. It would also lead to an overall increase in consumer debt levels and a related increase in consumer spending.[3]

What will happen in reality?

The claims by lenders and credit reporting agencies are only possible outcomes, not certain ones. More importantly, whether or not they occur does not depend on random factors but will be the direct result of how lenders choose to use the additional information.

This is because the additional information can be used to reduce default rates or increase lending – and there must inevitably be a compromise between these two goals. While it is possible to achieve some level of both objectives, lenders are likely to take advantage of being able to lend more, while keeping default rates to a level acceptable to the lenders.

One of the leading reports on comprehensive credit reporting found that based on their own research and the US experience, the benefits included 'dramatic penetration of lending into lower socio-economic groups, making a variety of consumer loans available across the income spectrum' and a 'reduction in loan losses that would have accompanied such market penetration in the past'.[4]

What this means is that even if comprehensive credit reporting has a positive impact on default rates in Australia (and we are not convinced that it would), this would be in an environment in which lending is dramatically increased, thereby increasing the overall number of consumers in default - and increasing debt stress substantially.

> *"The recent subprime crisis in the United States was caused, at least in part, by very irresponsible lending practices."*

What types of credit will increase?

Lenders assert that any increase in lending benefits consumers and the community.

In fact, there is a big difference between lending for housing or investment and lending to increase spending. Some examples of the latter are:

- Credit cards (72% of the $44.6 billion overall debt owing on credit cards as at September 2008 is accruing interest);
- Credit with an initial interest-free period that traps those who don't pay into excessively expensive debt (often about 28%);
- Pre-approved credit, where the individual hasn't expressed a need for the credit. This includes credit limit increases and overdrafts;
- High-cost debt consolidation loans to refinance consumers in debt stress (which may only resolve debt problems in the short term).

The recent subprime crisis in the United States was caused, at least in part, by very irresponsible lending practices. Lenders in the United States have access to a wide range of personal information from credit-reporting agencies, yet this access does not appear to have reigned in poor lending practices and actually increased levels of lending to at-risk borrowers.

Expanded credit reporting enhances credit marketing and selling

Lenders say they don't want to use credit reporting information for marketing purposes, but there are at least three ways that credit reporting information can be used in such a way.

Upselling

Lenders already use credit reporting information to enhance marketing strategies such as "upselling". For example, when borrowers apply for small interest-free loans in stores, lenders assess them for thousands of dollars of additional high cost credit as part of the deal.

Marketing to Current Customers

The ALRC recommended that access to credit reports be permitted for the management of existing accounts but this is likely to see lenders using credit reports of their current customers for a range of marketing purposes justified as "managing" an account, including offering pre-approved limit increases, "special deals" to customers about to finalise their account or debt consolidation or refinancing deals where the customer has a number of accounts on their credit report. We think the Government should consider the potential marketing impact before allowing access for "management" purposes and instead include a list of specific permitted purposes for accessing individuals' credit reports in the updated privacy laws.

> *"..when borrowers apply for small interest-free loans in stores, lenders assess them for thousands of dollars of additional high cost credit as part of the deal."*

Pre-screening

The ALRC recommended that the use of consumer credit reports for direct marketing purposes be prohibited, including the use of information for pre-screening. This means that lenders cannot access credit reports – which contain personal information that should otherwise be subject to privacy constraints - to screen names for marketing rather than for genuine credit assessment purposes.

Lenders argue that 'prescreening', where lenders use credit reports to 'exclude' individuals from direct marketing offers, should be allowed because it is not marketing but enables them to withhold marketing offers from those whose applications for credit would be refused.

3 Access Economics (for Veda Advantage), The Benefits of Broadening Access to Credit via Comprehensive Credit Reporting, July 2008.

4 Professor John M. Barron & Professor Michael Staten, The Value of Comprehensive Credit Reports: Lessons from the US Experience, 2000, 28.