consumer action law centre

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Submitted via fsi.gov.au

Dear Panel Members

Financial Systems Inquiry Terms of Reference

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to contribute to the Financial Systems Inquiry. The submission below responds to the Inquiry's terms of reference released on 20 December 2013.

The submission has three parts:

- Part 1, which considers developments since the 1997 Wallis inquiry, including:
  - effective and positive aspects of the financial system, including consumer redress and dispute resolution, responsible lending in consumer credit, and the effect of standards of fairness in consumer contracts; and
  - gaps and areas which need closer consideration, such as insurance, fringe lending and newer business models purporting to ‘assist’ consumers experiencing financial difficulties.
- Part 2, which considers essential underpinnings of a well-functioning financial system, including:
  - the role of empowered consumers in driving efficient market outcomes;
  - the role of innovation in meeting consumer needs and wellbeing;
  - effective financial sector regulation, particularly when it is based on a proper understanding of consumer behaviour; and
  - the role, approach and responsiveness of regulators.
- Part 3, which considers emerging opportunities and risks, and particularly the rise of “big data”, including:
  - the way in which consumer data is used to improve business profitability, and the risks this creates for consumers;
  - the possibilities of consumers accessing their own data, so it can help them make product choices aligned with their needs, sending better signals to suppliers; and
  - reforms to payments systems, and the need to focus on end-users.

Our comments are detailed more fully below.

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About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action offers free legal advice, pursues consumer litigation and provides financial counselling to vulnerable and disadvantaged consumers across Victoria. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

PART 1: Developments since the 1997 Wallis Inquiry—Safety, Availability and Access

This section responds to Term of Reference 1. It argues that there have been some positive developments in the cost, quality, safety and availability of credit and financial services since 1997, and discusses gaps which still exist.

1.1 Improvements since the 1997 Wallis Inquiry

Since 1997, there has been a significant increase in the amount and type of financial service providers and products, and in many ways this has benefited consumers. Increased competition, availability and choice have been features in the growth of the financial services sector, but whether such changes were attributable to the Wallis Inquiry, we cannot say. Despite increasing levels of choice, there remains however the problem of financial exclusion—that is, not all consumers are accessing products and services available to improve their wellbeing and that of the economy generally. This impacts particularly vulnerable groups who, because of their financial situation, are pushed to fringe or exploitative products. More generally, growth has brought with it increased risks for consumers, and in the next section we outline some particular gaps that we believe the inquiry should consider. That said, there have been a number of reforms as a result of, and since, the Wallis Inquiry that we believe has improved the operation of the financial system from an end-user perspective. These include industry external dispute resolution, responsible lending reforms in credit, and unfair contract term provisions.

(a) Industry External Dispute Resolution

The Wallis Inquiry recognised that effective redress systems for consumers, particularly through industry External Dispute Resolution (**EDR**) schemes, are an important customer need in the complex financial services market. It is our view that the accessibility, coverage and operation of these schemes is perhaps one of the most significant and important developments in credit and financial services regulation in recent times.

Briefly, credit or financial services providers are required as a condition of their license to have an internal dispute resolution (**IDR**) process that meets certain standards, and also to be a member of an ASIC-approved EDR scheme. If a consumer has a dispute with the business which is not settled through the internal process, they may apply to have it resolved through EDR. The process is free for consumers and, though funded by the industry, determines disputes independently.

It is hard to overstate how important EDR is in producing just outcomes in the credit and financial services industry:

- EDR has created access to dispute resolution for many thousands of consumers who could simply never have taken their dispute through the courts because of the complexity, cost, and cost risks involved in doing so. The case study below demonstrates the ability of EDR (in this case, the Financial Ombudsman Service) to create a just outcome for a consumer who probably could not have presented a case in an adversarial setting like a court or tribunal;

- Accessible, high quality dispute resolution increases the likelihood that misconduct will be challenged, reducing the incentives for poor conduct. This benefits individual consumers but also improves the efficiency of markets generally—where consumers cannot easily complain about poor treatment and seek redress, dishonest traders hold a competitive advantage over more responsible traders;

- Better access to external dispute resolution also boosts incentives for business to have better internal dispute resolution. Business pays a fee each time a complaint reaches EDR, creating a tangible and immediate disincentive for substandard IDR. As IDR improves, disputes cost business less and both the trader and consumers benefit.

- EDR schemes are in an excellent position to identify systemic issues within an industry and take steps to resolve them, either by working directly with members or by reporting to regulators. This amplifies the benefits of EDR and extends reach to consumers who have a meritorious complaint but, for whatever reason, do not pursue them.[1]

> **Case study**
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> A client of Consumer Action Law Centre entered into two loans with an FSP totalling around $150,000. At the time of entering into the loans, our client was working only intermittently and was suffering from mental health problems. He alleges he was placed under undue pressure by a relative to take out the loans, using his home as security. The bank did not make appropriate inquiries into the adequacy of our client's income. Eventually he ran out of loan funds to service the loans, and the FSP threatened to repossess his home.
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> Throughout the process the relevant case managers showed an awareness of the fact that the client's mental illness made him more vulnerable to the pressure applied by his relative to enter the loan and the failures by the FSP to properly assess his capacity to pay. There was also appropriate consideration given to the present vulnerability of the client and his children, for whom he is the sole carer, when seeking a fair outcome.
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> The settlement reached allowed the client and his children will be able to stay in his home and make affordable repayments on the loan. The total loan amount over the life of the loan was reduced considerably, saving the client around $100,000.

[1] For example, in 2006, Consumer Affairs Victoria (CAV) reported that approximately four per cent of revealed consumer detriment in Victoria is reported to it and smaller percentages are reported to other agencies, such as ombudsman. Consumer Affairs Victoria, *Consumer detriment in Victoria: a survey of its nature, costs and implications*, October 2006.

The Commonwealth Consumer Affairs Advisory Council (**CCAAC**) is currently reviewing the benchmarks for industry-dispute resolution schemes. These benchmarks—accessibility, independence, fairness, accountability, efficiency and effectiveness—are adopted by ASIC in its oversight of the schemes in the finance sector and, in our view, have served the development of dispute resolution services well.

In our submission to the CCAAC inquiry, we supported the position of the Australian and New Zealand Ombudsman Association that it is not desirable to have multiple ombudsman schemes operating in the same industry area.[2] In the finance sector, there are two schemes operating: the Financial Ombudsman Service (**FOS**) and the Credit Ombudsman Service. We do not see that competition among ombudsman services in the one industry sector operates in the interests of consumers or efficient market outcomes. Rather than creating incentives for schemes to provide better service for consumers (that is, complainants), EDR schemes will be competing for the business of industry members who will be interested in paying lower fees (which may reduce resources available per compliant received) and more industry-friendly processes.

(b) Responsible lending

The enactment of the *National Consumer Credit Protection Act 2009* (**NCCP Act**) included new responsible lending obligations for credit providers and those that provide credit assistance (commonly brokers). These laws provide that a lender or broker must not suggest, assist with, or provide a credit product to a consumer unless they assess it is 'not unsuitable' for that consumer. One of the situations in which a loan will be unsuitable is if the debtor could not repay it, or could only repay it with substantial hardship.[3]

Prior to these laws, there were limited legal avenues available for debtors who had been provided a loan that was irresponsible or predatory. Banks that were signatories to an industry code of conduct could be challenged for 'maladministration' in lending, but borrowers of other lenders had far lesser access to remedies (for example, unconscionable conduct or unjustness under credit laws). Further, vulnerable borrowers often had to challenge the loan in a court or tribunal, as not all lenders were members of an EDR scheme. Even if there was a legal remedy, the individual nature of any challenge could not provide any systemic response to widespread problems.

> **Case study**
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> Mr S was a self-employed masseur who has not earned more than $1,000 per month from his business for the past 4 years. He cared for his ex-wife who has schizophrenia and their young child who is twelve years old. In 2006, Mr S approached Consumer Action after he was served with a writ for possession of his house by his mortgagee, an individual who had lent our client money as a result of a solicitor loan through a law firm. The loan contract the subject of the writ was entered into in order to refinance a previous loan contract which was also a refinance in

[2] ANZOA, *Competition Among Ombudsman Offices,* September 2011, http://www.anzoa.com.au/ANZOA_Policy-Statement_Competition-among-Ombudsman-offices_Sept2011.pdf.

[3] The laws also require licensees to take reasonable inquiries of the consumer about their requirements and objectives in relation to the credit and to take reasonable steps to verify the consumer's financial situation: see Chapter 3 of the NCCP Act.

> itself of a loan that was obtained some four years earlier.
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> Four years prior, Mr S had a loan secured by his house with NAB, the balance of which was $39,000. However, he was falling into financial difficulty as he also had some other debts that needed to be paid, and he needed to purchase a motor vehicle. During this time, he received a letter in the post apparently addressed to him from a company called "Mortgage Masters". The letter had words to the effect: "Having money problems? We'll say yes, when the banks say 'no'". Mr S contacted this company and arranged an appointment with them. This company signed Mr S up to a loan for one year on interest only terms with a non-bank lender, with assurances from the broker that "this year we will just get you a loan for the year because you are in a hurry for the money but next year you will get a loan that you can work with". For Mr S, this meant a normal principal and interest loan. The total of the credit provided under the first loan was $70,000. $39,000 went to paying out the loan to NAB and the Mr S received approximately $16,000 after fees and charges were deducted. Mr S thought that he could cope with the repayments but soon discovered he was struggling to make the required payments and he ultimately fell into default.
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> Mr S sought a further refinance through Mortgage Masters to pay out the previous loan. This loan was also for a year and was also interest only. He thought that he only had to pay $2,500 for procuring the loan, but he discovered that he was also charged with fees for going through another broker, being the law firm. He was required to pay the law firm approximately $4,500 in fees. The second loan was through the law firm and the creditor was an individual. The loan was for $90,000.
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> When the year was up for the second loan, Mr S could not repay the principal and had to obtain a further refinance. He obtained another interest only loan through the law firm, this time for $120,000. All but $6,000 of this loan went towards paying out the second refinance, despite Mr S believing that he would get at least $13,000 out of these loan proceeds. The repayments for the third loan were $900 per month which constitutes most of Mr S's monthly income. He quickly fell into default.
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> Mr S lost his house, which was worth approximately $250,000. At the time he originally fell into financial difficulties, the loan amount outstanding against his home was $39,000.

The NCCP Act provided for a level playing field by setting a standard for all consumer lending. By doing so, it also improved competition by ensuring that lenders were not disadvantaged by choosing to be a signatory of an industry code or a member of an EDR scheme. In the case of Mr S, above, the NCCP Act would have required 'Mortgage Masters' to be a member of an EDR scheme and for both it and the non-bank lender to comply with responsible lending obligations.

A particular advantage of the NCCP Act regime is that it creates upfront requirements for lenders to have systems in place to support responsible lending and to use those systems for each loan. This gives the regulator, ASIC, the opportunity to investigate and respond to poor practices by individual lenders without relying on a consumer to bring an action. It also allows ASIC to investigate segments of the credit market to assess compliance with the law and send messages for what should be improved—ASIC has done this in respect to riskier aspects of lending, such as 'low doc' home loans and debt consolidation loans.[4] This proactive compliance

[4] For example, see ASIC Report 262 (Review of credit assistance providers' responsible lending conduct, focusing on 'low doc' home loans); Report 264 (Review of micro lenders' responsible lending conduct and

approach assists businesses by helping them understand the requirements of the law, while reducing the need for more expensive court enforcement proceedings.

These reforms also appear to have contributed to a change in culture of institutions that aim for best practice and an apparent reduction in the use of 'low doc' loans. They have also contributed to improved practices by finance brokers. Since their introduction, the level of complaints to Consumer Action about predatory asset lending as reduced to almost nil.

(c) Unfair Contract Terms provisions

The realities of modern consumer contracting are very different from when contract law was first developed. The idea of a bargain negotiated between two parties on a more or less equal footing has given way in consumer contracts to the standard form contract: a mass-marketed agreement framed entirely by the business party that may be long, densely worded and incomprehensible to even well-educated consumers. More significantly, these contracts permit no bargaining or negotiation. They are presented to consumers on a take-it-or-leave-it basis.

It is acknowledged that mass-marketed contracts offer efficiency for businesses, reducing costs for consumers. Businesses offer these contracts because it is cheaper than entering a new contract with every customer, and almost all consumers accept them because to do so is a necessary part of participating in the modern economy. However, unfair terms which are often hidden in contract legalese can cause serious detriment for consumers.

In 2010, following recommendations from a Productivity Commission inquiry into consumer policy,[5] unfair contract terms provisions were enacted as part of the Australian Consumer Law and amendments to the ASIC Act. Like responsible lending in credit, these unfair contract term laws contribute to the safety of products by providing for balanced standards in contract terms. These provisions allow a court to void any term which is 'unfair' as defined by the legislation, that is:

- they create an imbalance between the parties (typically that one party is given unilateral powers, and the other party has nothing as quid pro quo);
- the term in question is not necessary to protect the legitimate interests of the party seeking to rely on it; and
- the party claiming the unfairness has suffered detriment.[6]

The unfair terms provisions create a limited exception to the traditional expectation that parties should be bound to contract terms by recognising that a consumer party to a standard form contract has no ability to vary terms they find to be unfair. It is a limited exception because it only invalidates a term for which there is no legitimate commercial basis—a term the parties could not have been expected to agree upon if there was an opportunity for negotiation. It is an example of the law adapting to meet modern business practices and protecting consumers without burdening business.

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disclosure obligations); and Report 358 (Review of credit assistance providers' responsible lending conduct relating to debt consolidation).

[5] Productivity Commission, *Review of Australia's Consumer Policy Framework,* May 2008, available at: http://www.pc.gov.au/projects/inquiry/consumer/docs/finalreport.

[6] See *Australian Securities & Investments Act 2001* (Cth), Division 2, Subdivision BA.

Case study

In 2008, Consumer Action launched test case litigation against RHG Mortgage Corporation (formerly RAMS Mortgage Corporation). Our client, Ms H, faced an excessive early termination fee to switch her home loan (over $12,000), despite RHG imposing interest rate rises well in excess of the market.

Ms H had chosen a RAMS low-doc loan after considering her options and reading advertising promising that the loan was market leading, that she would not pay 'non-conforming' interest rates, and that the interest rates would be competitive. After she entered into the loan, RAMS (later RHG) started raising her interest rate to a point where her rate was 0.99% higher than when she signed, despite the RBA cash rate decreasing 2 percentage points over the same period.

The case settled before a court determination.

The litigation in the above case study was launched prior to the unfair terms provisions being introduced to the ASIC Act, limiting a more systemic outcome. Nevertheless, in 2012, following the introduction of those laws, ASIC obtained a refund of more than $3.3 million for RHG customers.[7] ASIC also released regulatory guidance which provided that exit fees should only reflect reasonable costs directly arising from any early termination.

Unfair contract terms provisions not only provide for product safety by ensuring terms of contracts are balanced, but are also pro-competitive. The provisions are a type of consumer protection that empowers consumers to participate in the market. The example above is a case in point—the imposition of a significant exit fee inhibited the consumer from shopping around, exercising her market power. The provisions also deal with competition problems relating to fine print—there is little competition on fair contract terms given consumers attention is directed to the central elements of the product, such as the price, not hidden fine print.

It is worth noting that the Government ultimately banned exit fees from residential mortgages from 2012.[8] Again, this was largely because of the anti-competitive effect of such fees—not merely because of consumer protection. Exit fees were seen to be anti-competitive not only because they created a disincentive to switch, but:

- they conceal the true cost of a mortgage by expressing a cost as a contingent fee when in fact a typical borrower will end up paying it—independent research has shown that the average mortgage is terminated or refinanced within approximately three years, while exit fees are typically charged in the first five years;[9]
- they allowed lenders to 'back-end' some of their fees where they are less visible and so less open to competitive pressure.

[7] ASIC, Media Release: RHG Customers Refunded over $3.3 million, 19 July 2012, available at: http://www.asic.gov.au/asic/asic.nsf/byheadline/12-169MR+RHG+customers+refunded+over+$3.3+million. Note as most RHG contracts were entered into prior to the unfair contract term laws, this action relied on other provisions of credit laws.

[8] National Consumer Credit Protection Amendment Regulations 2011 (No 2)

[9] Fujitsu Consulting & JP Morgan (2006), Australian Mortgage Industry Volume 3, 'Mortgage Industry Efficiency Reviewed' cited in ASIC (2008) Report 125: *Review of Mortgage Entry and Exit Fees*, p 2.

1.2 Gaps remaining: cost, quality, safety and availability of financial services

Despite the advances in safety and availability since 1997, significant gaps remain, including:

- large numbers of consumers remain excluded from adequate insurance;
- fringe lenders are issuing unsafe credit products which cause harm to low income and vulnerable consumers; and
- there is an apparently growing industry of businesses offering high priced financial difficulty 'solutions' which are exacerbating the financial hardship of many consumers.

(a) Insurance

The 2013 *Measuring Financial Exclusion in Australia* report from Centre for Social Impact and NAB found that 19.5 per cent of Australians are excluded from access to insurance, with that number 'increasing dramatically' for young people and those born in a non-English speaking country. [10]

A survey commissioned for the report of 1500 consumers found that 18.2 per cent of respondents identified that they wanted greater insurance cover, representing a significant under-served market. When asked why they had not purchased insurance, affordability was the biggest problem, followed by problems with the complexity of insurance products and documentation.

Reducing the Risks, an earlier report from the Brotherhood of St Laurence, similarly found that low income Australians are much more likely to not have insurance, and that price is the key barrier.[11] The insurance industry has also considered the problem of exclusion from insurance in depth[12] and is making efforts to improve consumer education about insurance.[13]

Despite a growing awareness in the industry of consumer concerns and consumer protection reforms in recent years, there remain a number of serious consumer problems in insurance. We hope this inquiry is an opportunity to reinvigorate improvements in the following areas:

- Lack of access and affordability for low-income earners—insurers should develop renters policies that are focused on the needs of tenants rather than merely offering ‘stripped-back’ or ‘no-frills’ home building and contents insurance, and insurers should allow payment of premiums fortnightly through Centrepay to assist with budgeting;[14]

- Problems caused by flood insurance—following widespread flooding in 2011 and 2012, reforms did occur to provide for a standard definition of ‘flood’. While many more policies now include flood cover as standard, this has created an affordability problem for some

[10] C Connolly (2013) *Measuring Financial Exclusion in Australia*, Centre for Social Impact (CSI) – University of New South Wales, for National Australia Bank, p 44.
[11] Dominic Collins (2011), *Reducing the Risks: Improving Access to Home Contents and Vehicle Insurance for Low Income Australians*, Brotherhood of St Laurence, p v.
[12] R Tooth & G Barker (2007), *The non-insured: who, why and trends,* Insurance Council of Australia.
[13] See www.understandinginsurance.com.au.
[14] Collins, above n 11.

living in high-flood risk areas. Where policies allow for consumers to opt-out of flood coverage, some are doing that without understanding the risk.[15]

In 2012, the Natural Disaster Insurance Review (**NDIR**) recommended the establishment of a national agency to manage the national coordination of flood risk management and to operate a system of premium discounts and a flood risk reinsurance facility.[16] Together with mandatory flood cover, this would ensure consumers buying home building insurance have access to flood cover without being priced out of coverage all together. The reinsurance pool also has the potential to provide incentives for insurers and governments to mitigate against flood risk (consumers who have already purchased property in high-risk areas, often without realising it, have little ability to mitigate their own risk other than through insurance).

We strongly endorse this proposal and suggest that without government and industry cooperation on disaster insurance, greater numbers of Australians will opt-out of coverage altogether;

- Underinsurance, particularly due to the lack of availability of total replacement insurance and complexity around what insurance policies do or do not cover.

  Replacement cover is a far superior coverage for home building insurance compared to sum insured cover, however unfortunately it is becoming less and less common. Sum insured policies are in fact a leading cause of under-insurance in Australia, as most consumers have not estimated the correct sum, particularly in the case of a disaster situation. Estimating replacement cost is a technical ask and may require building industry expertise to be done properly. Although insurers provide online valuation calculators to assist homeowners to assess an appropriate sum insured value, the calculators have their limitations. A particular problem is that following a disaster the cost of a rebuild might be inflated due to higher demand for tradespeople and building materials.

  Recognising this problem, the NDIR recommended that all home building insurance policies offering sum insured cover be modified so as to offer full replacement cover in the event of total loss of the home. We strongly endorse this recommendation.

- The continued exemption of insurance contracts from otherwise economy-wide Unfair Contract Terms provisions.

  As noted above, insurance policies are the only type of consumer contracts that are exempted from unfair contract term laws. No less than four inquiries have recommended

[15] Behavioural economics has demonstrated that consumers have a tendency to discount the likelihood of future risks. Faced with a choice between paying what seems like a 'big bill' now and mitigating a possible future risk, many consumers attempt to cut costs by opting out of flood. This can occur even if the premium imposed is not significant.
[16] Natural Disaster Insurance Review Panel (2011), *Inquiry into Flood Insurance and Related Matters*, available at www.ndir.gov.au.

that this exemption be remedied.[17] Following extensive consultation with consumer and industry representatives, a proposal to apply unfair terms protections to insurance gained uniform support. This proposal became the Insurance Contracts Amendment (Unfair Terms) Bill 2013 which was introduced to Parliament but lapsed with the calling of the recent election.

Case study

Consumer Action's client Ben insured his caravan by purchasing a product described as 'fully comprehensive cover' from an insurer who claims to be a specialist caravan insurer. Towards the front of the PDS, a table named 'Summary of Features and Benefits' claimed that the policy covered "Loss or damage to other people's property". Section 3 of the PDS stated that the policy provided cover if:

... *an Australian court or other judicial body finds, or we accept in writing, that as a result of an accident, you, or another person using your caravan with your permission, is legally responsible to pay compensation for:*

- *Loss or damage to property owned or controlled by someone else.*
- *The death of, or bodily injury to, another person.*

After purchasing this policy, Ben was involved in an accident in which he was at fault. Ben's caravan came into contact with a parked car, causing damage to the caravan and $6,000 of damage the other vehicle.

Ben says that in an initial telephone call with the insurer, he was informed that his insurance would cover claims for both the damage to his caravan and the damage caused to the other vehicle. However, Ben later received correspondence from the insurer advising that the damage to his caravan was covered by his policy but the damage to the other vehicle was not.

In rejecting this claim, the insurer relied on a clause within Section 3 of the PDS which says that they "will not pay" for third party property damage:

if at the time of the accident, or immediately before the accident, your caravan was attached to a registered vehicle.

It would be reasonable for consumers to wonder which incidents causing damage to third parties would be covered by a caravan insurance policy if not those which occurred when the caravan was attached to a vehicle. This exclusion appears to rule out cover for almost every situation where an accident involving the caravan caused harm to a third party.

Ben applied to have the rejection of his claim internally reviewed by the insurer.

[17] Senate Economics Legislation Committee report into the *Trade Practices Amendment (Australian Consumer Law) Bill 2009* (2009), at paragraph 10.13; Natural Disaster Insurance Review inquiry into flood insurance and related matters (2011), at recommendation 37; House of Representatives Committee on Social Policy and Legal Affairs inquiry into the operation of the insurance industry during disaster events (2012), at paragraph 7.22; and the draft report of the Productivity Commission into Barriers to Effective Climate Change Adaptation (2012) at pp 242-3. The final report of this Productivity Commission enquiry also spoke favourably about extending unfair contract terms protections to general insurance though did not specifically recommend it, presumably because the report assumes this reform is already underway: pp 318-9 and also 312, 315.

As the above case study demonstrates, unreasonable exclusions can have a significant impact on the safety of an insurance policy. The 2013 bill provided for a balanced outcome, providing that a term would not be unfair where it reasonably reflects the underwriting risk accepted by an insurer. We endorse this approach and suggest that unfair term protections.

Insurance is an important product that helps consumers manage their financial risks. It is integral that the product perform as consumers expect it to. While we recognise that insurance affordability is a challenging issue both for the industry and government, it would be a poor outcome if policies reduced protection or only provided very limited protection, carving out key risks or including wide exclusions that are not in accordance with the insurer's legitimate business needs.

There also appears to be problems with the effectiveness of competition in insurance, particularly with the participation of consumers. Data form the Victorian Fire Services Levy Monitor[18] demonstrates that there are broad price variations for very similar risks—the table below is quotes for home building insurance for four properties identical in every way except for their physical address, obtained in February 2014.

Figure A – Home building insurance quotes (Source: Fire Services Levy Monitor)

Property location [$300,000 sum insured]	A A M I	Allianz	A P I A	Comm Insure	Q B E	R A C V	Bankwest	Coles	*Range*	*Low as percentage of high*
Bendigo	$366	$415	$399	$453	$786	$466	$600	$490	*$420*	*47%*
Glen Iris	$449	$449	$489	$443	$588	$681	$658	$581	*$238*	*65%*
Echuca	$349	$408	$389	$422	$634	n/a	$578	$1,182	*$833*	*29%*
Surrey Hills	$501	$437	$543	$453	$588	$510	$707	$547	*$269*	*62%*

While there are some minor variations in the levels of cover (for example, they all offer flood insurance as standard except QBE), the policies are each marketed as offering standard home building cover. The range in premium amounts is stark. While we note that recent analysis from the ACCC suggests that there are sufficient insurers in the marketplace to drive competition,[19] consumers appear not to be shopping around to such an extent to drive prices to efficient levels. In part, this could be because of insurer practices, including price discrimination between new and renewing customers.[20] Recent data from the Reserve Bank of Australia about the profitability of insurers (despite concerns about the impact of natural disasters) may also suggest that competition is not operating to keep prices as low as possible.[21]

Finally, as outlined further below, there are also problems with some 'add on' and similar insurance problems, where it appears consumers are paying significant amounts for what are

[18] Fire Services Levy Monitor, available at: http://www.firelevymonitor.vic.gov.au/home/consumers/.
[19] ACCC, *Media Release: ACCC does not oppose IAGs insurance acquisition,* available at: http://accc.gov.au/media-release/accc-does-not-oppose-iags-insurance-acquisition.
[20] Karen Collier, 'Insurance Companies Soak Loyal Clients in Cost to Chase New Business', Herald Sun, 18 February 2014, available at: http://www.heraldsun.com.au/news/victoria/insurance-companies-soak-loyal-clients-in-costs-to-chase-new-business/story-fni0fit3-1226829782212.
[21] Reserve Bank of Australia, 'The Australian Financial System', Financial Stability Review, March 2014, available at: http://www.rba.gov.au/publications/fsr/2014/mar/pdf/aus-fin-sys.pdf

relatively small risks. This again demonstrates problems with the operation of the demand side of insurance markets.

(b) Fringe lending

While we welcomed the introduction of responsible lending obligations (discussed above) and the additional obligations on payday lenders introduced in 2013,[22] we do not think either of these reforms is capable of addressing the harm caused by fringe lending.

Payday loans, often described as 'fringe finance', or 'cash advances' are essentially short-term, high cost and unsecured loans for small amounts of cash. A typical payday loan is for $100-$300 and a term of 16 days to one month. There are also larger loans up to $2,000 for longer periods up to twelve months, which are also considered payday loans. They are called payday loans because repayments are made, usually via a direct debit authority provided when the loan was established, on a borrower's payday—whether that is wage or government income. The direct debit ensures repayments are made even if they are unaffordable for the borrower. The typical borrower is on a very low income and loans are usually used to pay recurrent, essential expenses rather than one-off purchases.[23]

Rather than help borrowers through a financial problem, payday loans tend to create more problems. A typical payday loan of $300 repaid over two fortnights will require $186 per fortnight in repayments.[24] A borrower who is already struggling to make ends meet will find it very difficult to continue to cover their essential expenses after losing nearly $200 in loan repayments on their payday. The direct debit arrangement prevents them from defaulting on the payday loan, but likely leaves them short when they need to pay rent, bills, or buy groceries. This can start a cycle of lending—the borrower returns to the lender for another loan which again provides short term relief but compounds their problems in the longer term.

> **Case study**
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> Consumer Action's client, a 44 year old disability support pensioner, entered into 64 short term, high cost loans with a payday lender over the three years to 2010. He paid total fees and charges to of over $5,000. Apart from requesting his bank statements, the lender made no further enquiries as part of the loan application process regarding his ability to afford and repay the loans.
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> Generally our client would pay the loan every fortnight and would have no money left for food and other basic necessities including medicine which meant that he was forced to go back to the lender to obtain another loan to survive.

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[22] The Small Amount Credit Contract provisions of the *Consumer Credit Legislation Amendment (Enhancements) Act 2012*.

[23] Consumer Action, *Payday Loans—Helping Hand of Quicksand,* May 2010, available at: http://consumeraction.org.au/report-payday-loans-helping-hand-or-quicksand/; RMIT/UQ/QUT/NAB/Good Shepherd Microfinance, *Caught Short: Exploring the Role of Small Short Term Loans in Lives of Australians,* August 2012, available at: http://consumeraction.org.au/report-payday-loans-helping-hand-or-quicksand/.

[24] The National Credit Code provides that the most a lender can charge on a $300 loan with a term of less than one month is $72 (a $60 establishment fee and a $12 monthly fee). This creates a total of $372 to repay, or $186 per fortnight.

We have similar concerns about consumer leases, another credit product targeted at low income households that are excluded from mainstream finance. The products, and the problems they cause consumers, are described further below in this submission.

A response to fringe lending products needs be informed by a detailed understanding of who uses them, why they use them and what happens when they do. It is not sufficient to rely on default responses (like improved disclosure) or expecting a mainstream solution (general responsible lending obligations) to work on a fringe product.

The general NCCP Act protections are not well-adapted to deal with problems in fringe lending sector for a number of reasons:

- the small amounts lent out as high-cost short-term loans, at least when assessed in isolation, are unlikely to fail the test imposed to meet responsible lending requirements—that they are 'not unsuitable' for the borrower;

- the dynamics of the high-cost short-term lending industry—where the majority of consumers are driven by financial desperation and borrow to meet basic needs—greatly increases the probability that borrowers will mislead lenders in order to obtain a loan (and lenders may be unusually inclined to be misled); and

- the reforms rely on individual complaints and a case by case approach by the regulator. It is also likely that few high-cost short-term loan consumers will lodge complaints, with the sum of any one loan unlikely to justify the time and effort required by the consumer to pursue a dispute. This rational inertia may be exacerbated by a disadvantaged background and the need to deal with other financial and life pressures and difficulties.

Regulation needs to focus on addressing the harm, which in this case means stopping repeat lending. The provisions introduced in 2013 were a step forward, but we do not think they will be capable of arresting problematic repeat lending. The option proposed by consumer advocates was a cap on costs which would be low enough to make short term loans unviable, driving lenders to provide loans of longer terms, with more repayments of a lower amount per repayment. A cap on costs was introduced in 2013, but it was not low enough to drive this kind of change.

The fringe lending market will continue to evolve and continue to create problems for borrowers. These problems will only be solved if Government is committed to understanding how these products operate (requiring resourcing for ongoing research and assessment into the market) and a willingness to tailor regulation to the problem.

(c) For profit financial difficulty businesses

Since the Wallis inquiry we have seen the emergence of a growing industry of businesses claiming to assist consumers in financial hardship. The types of businesses and products are varied, and include debt consolidation, credit repair, budgeting services, bankruptcy services, debt agreement administration.

Case study – budgeting services

Ms H was referred to Consumer Action's MoneyHelp service by a debt agreement administrator, who she had found on a Google search when wanting to deal with her debts. Ms H lives in private rental, shared with her partner, her 20 year old daughter and her daughter's boyfriend. Ms H works full time, and earns a low-to-moderate income of $50,000 per annum. Due to expenses in obtaining a visa for her partner, Ms H turned to a finance company to borrow $14,000. When she came to us she was 3 to 4 months behind in repayments, and had taken out a number of payday loans to assist her access cash. She had a $3,000 loan, a $2,500 loan, and a $500 loan with three different payday lenders. Ms H had another personal loan of about $4,000. She didn't realise this was secured against her partner's car until she was in an accident, and the lender told her that she would need to purchase another car so they could obtain a security interest over it. Before contacting the debt agreement administrators, Ms H had contacted a budgeting service. The budgeting service charged her a fee of $1,300 but it appears that the service did nothing to assist her manage her money, nor refer her to any independent advice service about her current debts or consider contesting liability for debts (for example, under responsible lending legislation).

Case study – credit repair

M is 23 years old. He came to Australia in 2008 from India to study. In August 2012, M wanted to get a copy of his credit report, and googled 'Veda Credit Report'. A credit repair business came up in the results of his search, and he contacted the under the misunderstanding that he was contacting Veda to get a copy of his credit report. The credit repair business offered to help M 'clear his credit history' and obtained M's authority over the phone.

M entered into a contract with the business which gave M a copy of a credit report showing that there were defaults on his record. There were mistakes on the report, including the fact that the name on the credit report was not M's name. M didn't understand the terms of the contract he signed onto, or that he'd agreed to pay to have the defaults removed. When the credit repair business sent M an invoice for $990 to remove each default that was listed, M tried to end the agreement. The business then charged him a $990 cancellation fee, relying on a provision of the contract. The credit repair business began chasing M for the cancellation fee, emailing him and texting every week.

Case study – credit repair

Simon incurred a default judgment for a debt to a finance company in the Magistrates' Court in 2008, and this judgment was listed on his credit file at that date. In 2012, Simon paid the judgment debt. In late 2012, Simon applied and was approved for a home loan, but was charged a very high rate because of the listing.

Simon's wife visited the website of a credit repair business, which she found through a web search. The business made the following representations on its website:
"Remove court judgements...
Instant approval for finance
Save thousands on interest repayments
Improving the quality of your lifestyle"

Simon's wife contacted the business to enquire about the removal of the judgment listed on Simon's credit file. The representative said that if they followed his advice, the listing would be removed by requesting the finance company to sign a notice to set aside the judgment. Simon's wife agreed to the service, and paid the business $1,095 by direct transfer.

> Simon completed the notice provided by the credit repair business and submitted it to the finance company. However, the finance company refused to sign or lodge the notice, saying the listing had been correctly made.
>
> Simon contacted the credit repair business. He was advised he could seek to have the judgment set aside by going to the Magistrates Court and seeking a rehearing on the basis that the judgment debt had been paid out and that its continued credit listing was causing him financial hardship. Simon was not advised to seek legal advice about making this application.
>
> Simon did seek legal advice and was advised that if he was unsuccessful it is likely that he would have to pay the finance company's legal costs, which could amount to thousands of dollars.

Customers attracted to these businesses will often be in considerable financial difficulty, and have little understanding of their legal options, making them extremely vulnerable. In our experience, advertisements for these services may raise unrealistic expectations about what the service can achieve for clients[25] or may be plainly misleading. Consumers receiving these services invariably pay significant fees for services they could access for free themselves (for example, through an external dispute resolution scheme) or with the support of a financial counsellor.

Consumer advocates, the credit industry and regulators have all expressed concern about these businesses. However, efforts to respond on any systemic level are complicated by insufficient regulation. Some businesses that promote these services have an Australian Credit Licence, but products and services may not necessarily be regulated by consumer credit or financial services legislation—for example, credit repair or debt negotiation services are not 'credit assistance services' as defined by the NCCP Act, and debt agreement administrators are specifically exempt from ASIC's jurisdiction (there is some oversight by the Australian Financial Security Authority, but this is not comprehensive). Making decisions about which law applies and which regulator has jurisdiction drains resources, deters enforcement and ultimately indicates an inability of current regulation to keep pace with emerging problems.

We submit that one regulator (most relevantly, ASIC) should be empowered to regulate any business purporting to provide solutions to consumer credit, debt, insolvency and credit reporting problems. As described further below, the regulator should also be empowered to respond to emerging problems in credit and financial services, and not be delayed by limitations in regulatory power.

(d) An unfair trading prohibition: responding to exploitative business models

Consumer advocates have for some years been concerned about particular exploitative business models that take advantage of vulnerable and disadvantaged consumers. Many of these business models are targeted at low-income earners, or those excluded from mainstream finance due to adverse credit histories or low incomes and profitability depends upon the exploitation of these groups.

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[25] See for example our April 2013 report *Fresh Start or False Hope: A look at the website advertising claims of Debt Agreement Administrators*, http://consumeraction.org.au/wp-content/uploads/2013/05/Fresh-start-or-false-hope-April-2013.pdf.

Consumer Action's experience indicates that there are a number of business models that create a disproportionate number of consumer complaints, for example:

- motor vehicle leasing;
- payday lending;
- 'vendor terms' or rent-to-buy home ownership schemes;
- consumer credit insurance; and
- funeral insurance.

The consumer detriment related to these businesses is not caused merely by individual contract terms, sales techniques or marketing messages. Instead it is that the business model as a whole is designed to target a particular consumer vulnerability and exploit it.

Despite clear consumer detriment, legal action and efforts of regulators, some of these business models persist and are able to continue operating. Existing consumer law protections such as the prohibitions against misleading or deceptive conduct and unconscionable conduct are not easily adapted to address these models on a systemic level. In particular, the prohibition against unconscionable conduct generally targets individual transactions and not systemic business practices. Unconscionable conduct has traditionally required a very high standard of wrongdoing, with courts finding that unconscionable conduct 'requires a high level of moral obloquy' or conduct which is 'highly unethical', and that it is not sufficient that the conduct was 'unfair, unjust, wrong or unreasonable'.[26]

The most recent formulations of statutory unconscionable conduct make it clear that the prohibition is capable of applying to a system of conduct, and that the standard of wrongdoing need not be as high as the common law has required. However, courts can still tend to apply the more stringent tests (with the exception of *ACCC v Lux*[27]).

An unfair trading prohibition could fill this gap by allowing regulators to respond to business models which when assessed as a whole are clearly unfair or unreasonable, even if the constituent parts of the transaction (marketing, contract terms) may not be unlawful in isolation. An example of how this could work is the European Union's 'Unfair Commercial Practices Directive' which creates a general prohibition on 'unfair commercial practices': practices which don't meet a reasonable standard of skill, care, honesty and good faith; and materially distort or are likely to materially distort an average consumer's economic behaviour. As well as the general prohibition, the EU directive creates a 'black list' of practices which are banned in all situations.

An Australian unfair trading prohibition may allow regulators to better address the systemic problems created by unfair trading models (and so create benefits for a broader range of consumers) rather than only being able to respond to one transaction at a time. A general unfair trading prohibition would also allow the law to flexibly adapt to new unfair business models as they are developed. Compare this to regulation designed to address a single unfair business model, for example the law focused on unsolicited sales or payday lending. While these protections are welcome, they will encourage some traders to amend their practice slightly to

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[26] Director of Consumer Affairs Victoria v Scully & Anor [2013] VSCA 292 (18 October 2013).
[27] [2013] FCAFC 90.

avoid the application of the law but otherwise continue an unfair business model. Responding to this conduct may require many more years to prove misconduct is occurring and amend the law to capture it—an inefficient approach to regulation.

Recommendations

When considering developments in the Australian financial system since the 1997 inquiry under Term of Reference 1, we recommend the panel should direct its attention to the current cost, quality, safety and availability of:

- insurance;
- fringe lending; and
- financial difficulty businesses.

When making recommendations under Term of Reference 4 regarding the capacity of the financial system to meet the needs of users, we encourage the panel to recommend that:

- the Government implement the NDIR's recommendations regarding flood insurance availability;
- the Government implement the NDIR's recommendations regarding total replacement cover;
- the unfair contract terms regime should be extended to consumer insurance contracts;
- the Government make an ongoing commitment to understanding how the fringe lending market operates (including resourcing for ongoing research and assessment into the market) and be willing to tailor regulation to the problem;
- one regulator (most relevantly, ASIC) should be empowered to regulate any business purporting to provide solutions to consumer credit, debt, insolvency and credit reporting problems; and
- the Government consider the merits of a general unfair trading prohibition.

PART 2: The underpinnings of a well-functioning financial system

This section responds to Term of Reference 2. It argues that:

- consumer benefit or consumer protection objectives should not come at the expense of competition, innovation, efficiency or stability. A financial system which is focused on meeting the needs of consumers will be one that values competition, innovation, efficiency and stability;
- innovation is not always productive. Innovation is only useful if it promotes longer term productive outcomes and consumer wellbeing;
- financial sector regulation will only be effective if it is informed by a proper understanding of consumer behaviour and of which problems disclosure can and cannot solve;
- an effective regulator will be willing and able to take frequent enforcement action, and should adopt a 'campaign' approach to misconduct. Regulators shouldn't be expected to be successful every time; and

- the UK's Financial Conduct Authority provides a model for improving ASIC's ability to respond quickly and flexibly to emerging issues.

2.1 Objectives of the financial system

A well-functioning financial system will ultimately be one which is focused on meeting the needs of consumers and, more broadly, contribute to Australia's wellbeing. Competition, innovation, efficiency and stability are all worthwhile objectives, but they are not ends in themselves. They are only desirable to the extent that that they promote longer-term productive outcomes and consumer benefit.

There is a tendency in the financial services industry to see secondary objectives as ends in themselves, the following quote (referring to this inquiry) being just one example:

> Major-bank chiefs have already said the panel should not be diverted by the minutiae of banking, such as the treatment of customers, which has been scrutinised in Senate inquiries. Instead, with a chronic shortage of domestic savings, it should examine the capacity of the financial system to fund a growing economy, minimising a potentially destabilising reliance on offshore savings and capital.[28]

The need to 'fund a growing economy' is not separate from questions of how customers are treated—consumer protection and efficient markets are mutually reinforcing. Consumers who are informed and engaged will promote competition and efficiency in markets. The Productivity Commission has stated that:

> As a general rule, competition works best when the bulk of consumers are reasonably well-informed and willing to act on information. To this end, a key goal of consumer protection is to overcome significant information failures that can hinder effective competition. … It is also important to note that good consumer protection benefits goods businesses (and their shareholders) as well as consumers.[29]

This recognises that in determining whether markets are working, the focus should not be only on the supply side but also the demand side. In her 2006 lecture, ‘The interface between consumer policy and competition policy’, Louise Sylvan discussed ‘the category of consumer protection that might be best described as consumer empowerment’. She stated:

> It is the analysis that addresses not the question of ‘what does competition do for consumers?’ but the equally crucial question of ‘what do consumers do for competition?’ I call this area of inquiry ‘economics for the demand side’. Competition policy is concerned with the supply side structure of markets and the behaviours of firms. Consumer policy starts from the position that the structural soundness of markets should be being properly attended to, and focuses on a well-informed understanding of what’s happening on the demand side.
>
> We have all observed markets where consumers seem entirely capable of driving competition, while in other markets, consumers appear to have serious difficulty or some consumers appear to have difficulty. I take it as a given that without consumers activating competition, you don’t have

[28] Richard Gluyas, 'Financial Inquiry Starts to Take Shape', *The Australian*, 7 October 2013.
[29] Productivity Commission, *Review of Australia’s Consumer Policy Framework, Inquiry Report No 45,* April 2008, p 28.

> competition. As Ron Bannerman has put it so concisely 'Consumers not only benefit from competition, they activate it, and one of the purposes of consumer protection law is to ensure they are in position to do so.'[30]

A focus on consumer empowerment in financial sector regulation will also encourage resilience and stability. Australia's experience of the global financial crisis is that it has not been as damaging as the experience in many overseas advanced, developed economies. The strong prudential framework for our banks and key financial institutions has been attributed as a key factor supporting our financial system's resilience. Timely reforms to consumer credit laws also meant that irresponsible lending encouraged by short-termism in sales returns and some mortgage securitisation practices has not been the problem it has been here in the United States.

2.2 Innovation and Risk

Innovation will not always be productive for the economy. While innovation can fuel competition, it should not be pursued at the expense of security and consumer welfare. It appears to us that the term 'innovation' is as often as not used in credit and financial services as a euphemism for chicanery and regulatory avoidance.

One well-worn example of this type of innovation is the complex investment products marketed to ordinary investors which caused so much harm at the outbreak of the global financial crisis. More recently, mis-selling of payment protection insurance in the UK has created a widespread scandal in the UK finance sector prompting billions of pounds in refunds to consumers. The experience in Australia is that the Consumer Credit Insurance market is also geared towards products which make short term profits for insurers and lenders while creating little if any benefit for consumers. The claims ratios of these products speak for themselves—APRA figures show that in the twelve months to June 2013, Australians spent $330 million on Consumer Credit Insurance, yet only 23 cents in every dollar spent was paid out in claims.[31] This means the product is exceptionally profitable for insurers and lenders who sell it, but casts doubt on whether policy holders are getting value for their money.

A particular problem in this sector, and in the sales of other forms of "add-on" insurance often sold with motor vehicle finance, is that consumers purchase the product on the back of another purchase—i.e. when they're purchasing a motor car, or even a credit card. This sales format means that consumers are generally presented with one "add-on" offer, are not given the opportunity to shop around and consider alternatives, and may experience some form of pressure incentivised by commission arrangements. This sort of sales arrangements limits the effective operation of competition—consumers are limited in their capacity to consider the value of the product when their primary focus is the initial purchase.

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[30] Louise Sylvan, Deputy Chair, Australian Competition and Consumer Commission, Consumer Affairs Victoria Lecture, 2006, available at: https://www.accc.gov.au/system/files/The%20interface%20between%20consumer%20policy%20and%20competition%20policy.pdf

[31] *The Numbers show Consumer Credit Insurance is a poor deal for consumers,* Consumer Action Law Centre media release, 27 November 2013, http://consumeraction.org.au/media-release-the-numbers-show-consumer-credit-insurance-is-a-poor-deal-for-consumers.

Case study

We acted for two unrelated clients who sought loans from the same payday lender in 2011. At the time of the loan applications, the sole income of both clients was social security benefits. Both clients had mental health issues and were highly vulnerable at the time of entering the loan. Along with the loans, our clients paid for income protection insurance—purportedly to cover the customer's loan repayments in the event that they lose their income. This product was completely redundant for our clients, as they were in no danger of losing their income.

Case Study

Our client purchased a used motor vehicle in 2012 with finance provided with the assistance of a financial services provider representative. The ticket price of the vehicle was $10,000. The client informed the representative that his English skills were limited, and he would not be able to fully understand the contract. Basic information concerning interest and repayments was given but the client was not notified of the total amount payable. Nor was he notified that the vehicle was covered by an extended warranty (at a cost of $1695) and that he had been entered into gap insurance (at a cost of $995). The representative of the financial services provider also failed to disclose that he may be receiving a commission of up to 67% of the retail price of the extended warranty and up to 55% of the premium paid on the gap insurance.

Our client was only advised of the existence of the extended warranty and the gap cover after 10 months of repayments when he asked for a payout figure. At that point he asked for a refund on the extended warranty and was refused. He was also told he would be refused cover under the warranty because he had failed to properly service the vehicle under the terms of the warranty.

A similar 'innovation' that has arisen over more recent years is funeral insurance.[32] It can be very difficult for consumers to assess the real value of funeral insurance, and compare it to other products that might help manage the costs of a funeral (e.g. savings accounts). Premiums can be expensive and policies have commonly paid out amounts significantly less than the total amount paid over the insured period, which may be years or decades. Marketing and promotion often fails to disclose the true cost of the product but rather a seemingly low 'weekly' amount, and it does not warn about the steep price rises that sometimes apply as the policy holder ages. Commonly, the promotion of some funeral products target anxieties—the fear of outliving one's savings, the fear of being a financial burden on loved ones, or the fear of losing one's financial independence. Particular groups within the community, such as the elderly and Aboriginal communities, are key markets for these products.

Case study

Our client, a 70 year old resident in a nursing home, contacted us about his funeral insurance policy. His sole income was a government pension and has been for approximately 20 years. In around August 2006, our client saw an television advertisement which offered a funeral insurance product with premiums of approximately $10 per fortnight and a payout figure of

[32] In 2013, eleven consumer organisations banded together to release a Consumer Strategy for a Fairer Deal in Funeral Insurance: http://consumeraction.org.au/wp-content/uploads/2013/08/Funeral-insurance-13-point-plan-FINAL-190813.pdf. ASIC has taken action in relation to a number of funeral insurance providers, forcing changes in advertising and product attributes. See ASIC, *Media Release—ASIC continues to focus on funeral insurance,* 14 January 2014: *https://www.asic.gov.au/asic/asic.nsf/byheadline/14-007MR+ASIC+continues+to+focus+on+funeral+insurance?openDocument*

> $15,000. This funeral plan appealed to him as he was unwell at the time—he had experience a heart attack and stroke, losing a kidney and was on dialysis. Our client did not want to burden his children with funeral costs in the future. He telephoned the insurer to enquire about the advertisement and the representative reiterated the claims made in the television advertisement. The representative also advised that the plan was very affordable and that premiums would not increase. Our client subsequently purchased the policy on the understanding that the premiums would not increase, and would not have otherwise.
>
> The premiums for the funeral plan increased annually. On each occasion, our client contacted the insurer and advised the representative that premium increases were not part of the agreement. On each occasion he was advised that the increases were a result of an increased cost of living. Our client continued to make payments as he felt that he had no other option but to do so. In 2013, our client received a letter from the insurer stating that as he had moved into the next age band his premium would increase from $153 to $202 per month. He could not afford this premium and contacted Consumer Action. Consumer Action negotiated on his behalf with the insurer.

Innovations in fringe lending commonly involve the establishment of business models and drafting of contracts that seek to avoid legislative protections. The techniques used by Fast Action Finance to apparently avoid the application of the credit law (ASIC alleges that Fast Action Finance structured small amount loans as transactions to buy and sell diamonds)[33] are one of many examples.

> **Case study**
>
> A recent determination by the Credit Ombudsman Service provides an example of apparently related businesses (a lender and a broker/service provider) which claim that its contracts are drafted in such a way so as not to come within the purview national credit laws.[34] This is despite its service being the provision of cash into a customer's bank account and the charging of significant fees—higher than the minimum allowed under the national credit laws. While the determination was that the credit laws apply, it appears that the business is still operating in the same manner. Further, it appears that the some aspects of the decision implied that the arrangement may have successfully avoided the application of credit laws had the contractual arrangements and correspondence been more carefully drafted. If this is correct, it may inhibit the regulator taking action.

Another 'innovation' is the scores of 'vendor terms' and rent-to-buy real estate entrepreneurs who use a complex series of transactions to facilitate the sale of a home by financially distressed vendors to prospective buyers who cannot access mainstream finance. Vendors and buyers are unlikely to understand the real nature of the deal or the great deal of risk to which they are exposed. This ignorance will be partly because of the complexity of the arrangement, misleading representations made by the intermediary[35] and a lack of access to advice. In many cases the intermediary's business model may breach either the credit or real estate law, though

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[33] *13-205MR ASIC commences legal action against Fast Access Finance*, ASIC Media Release, 7 August 2013.

[34] Credit Ombudsman, Determination 21, 27 February 2014, http://www.cosl.com.au/cases/determinations-made/determination-021/

[35] See for example *Penalty and injunctions for rent to buy property promoters (Patricia and Bryan Susilo)*, Media Release, Department of Commerce Western Australia, 5 March 2014.

this is rarely clear cut. It is often difficult to even identify which Commonwealth or state regulator has jurisdiction, such is the success of this business model in skirting existing regulation.[36]

> **Case study**
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> Our client, a single mother with two children reliant on Centrelink payments, entered into a 'vendor terms' contract in May 2011. The firms our client contracted with carry on business of providing homes to consumers by way of vendor terms contracts.
>
> The arrangement required our client to pay:
> - an application fee of around $1000;
> - 156 (3 years) of weekly instalments of around $500;
> - a final payment of around $300,000; and
> - her $7000 first home owners grant.
>
> Our client entered the contract following representations made to her that:
> - she would be able to own the Property if she were to meet the requirements above;
> - the vendor terms businesses would assist her to obtain finance to cover the $300,000 final payment; and
> - she would be able to, or reasonably likely to, obtain that finance.
>
> To obtain the required finance, our client would have had to borrow close to 100% of the value of the property, despite being of low income and reliant on Centrelink payments.
>
> Our client made the required payments for around two years despite them causing her financial hardship—she incurred over $237.50 in bank dishonour and overdrawn account fees in making the payments. Our client became unable to keep up repayments when the Commonwealth Government changed the amount paid to single mothers in March 2013.

Vendor terms and rent to buy promoters may be better dealt with by ensuring property advice is regulated in a similar way to financial advice, as has been recommended by the Victorian Parliament Law Reform Committee,[37] or by extending national credit laws.

Further 'innovations' include the techniques used by consumer lease providers to ensure their 'rent to own' transactions do not give consumers a 'right or obligation to purchase the goods'. If contracts provide such a right or obligation, the transaction becomes treated as a 'credit contract' rather than a 'consumer lease', and is then subject to the more comprehensive regulatory requirements (which include requirements such as disclosing the cost of credit).[38] One technique used by a well-known lessor is to provide a right to purchase 'similar' goods to those being rented after the consumer makes the minimum required rental payments. Another technique is to give the consumer a right to instruct the lessor to give the rented goods as a gift to any person nominated by the consumer—the consumer's spouse, for example.

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[36] Carolyn Bond, former Co-CEO of Consumer Action Law Centre, explains the risks in more detail at http://thenaysayer.net/2013/09/11/16/.

[37] Victorian Parliament Law Reform Committee, Inquiry into Property Investment Advisers and Marketeers, 10 April 2008, available at: http://www.parliament.vic.gov.au/lawreform/inquiries/article/1172.

[38] *National Consumer Credit Protection Act 2009,* Schedule 1, *section* 169.

> **Case study**
>
> Our client approached a firm seeking a loan of $600. The firm agreed to provide the loan with the requirement that it be repaid over 6 months in equal fortnightly instalments totalling around $1000. The firm also required that the loan be secured by our client's white goods.
>
> In reality, the contract our client signed purported to be a consumer lease for the whitegoods that the consumer already owned. The fortnightly payments were made from the Client's Centrelink payment via Centrepay. Note that consumer leases for basic household goods are permitted to be paid via Centrepay, but credit contracts of this type are not.
>
> With our assistance, the client wrote to the trader alleging that it had breached provisions in the National Credit Code which prevent security being taken over essential household goods; that it had engaged in misleading or deceptive conduct, and that the transaction was unjust.

In each example above, the 'innovation' takes the form of a complex product marketed to consumers who are unlikely to understand the true nature and cost of the transaction, or the risks involved. They will invariably be promoted as giving consumers choices they did not have before, but the 'choice' is illusory. Consumers buying these products are usually only doing so after being drawn in by marketing which makes these products appear to be something they are not. When these products cause harm, many consumers will usually suffer detriment over the course of many years before regulators or legislators are able to respond.

Consumer Action recognises that the financial system should include incentives to encourage innovation that benefits consumers and that consumers have benefited from many innovations in the financial sector. However, when making recommendations regarding the financial system's capacity for innovation we urge Panel members to be clear that innovation is only beneficial to the extent that it improves consumer welfare. We also direct the Panel to the discussion below regarding the powers of regulators to respond more quickly and flexibly to emerging market problems.

2.3 Consumer behaviour and effective financial sector regulation

(a) Regulation which empowers consumers

Louise Sylvan's comments above spoke of the role of consumers in activating competition, and that consumers are more successful in activating competition in some markets than others.

Martin Wheatley, Chief Executive of the UK Financial Conduct Authority spoke in similar terms recently when discussing his agency's attempts to use behavioural economics principles to make it easier for consumers to engage in markets

> For the first time, we're seriously considering how we can support consumers to discipline markets more effectively, rather than attempting to reverse engineer market outcomes.[39]

The term 'consumer protection' suggests that the law is protecting consumers from the normal activities of the market which then creates the impression that consumer protection law distorts

[39] *Making Competition King - the Rise of Behavioural Economics at the FCA*, speech to the ASIC Forum, 25 March 2014. Accessed from http://www.fca.org.uk/news/making-competition-king

markets. However, the real purpose of consumer protection legislation is to empower consumers: to permit them to participate effectively in markets and encourage efficiency by making informed choices. This is the principle that informs our comments below on effective financial regulation. Regulation should be informed by an understanding of how consumers realistically react in markets, and should ensure as far as possible that consumers to make decisions in their best interests.

The banning of mortgage exit fees, outlined above, is an example of a 'consumer empowerment' regulation. This reform did not disadvantage lenders in any real sense: lenders are still able to recover the costs through up-front application fees, monthly fees and, of course, interest rates. For consumers, these costs are much more transparent and top-of-mind, influencing a decision about which product to purchase. Exit fees, by contrast, were largely hidden from consumers due to their contingent nature so could only play a limited role in driving consumer behaviour—indeed, being hidden and not top-of-mind allowed lenders to hide up-front costs in exit fees, making a product appear cheaper than it was in reality.

The credit card reforms, which were enacted in 2012, are another example of 'consumer empowerment' regulation. These reforms required lenders to provide warnings on credit card statements about the implications of only making minimum repayments on their credit card, and required interest charges to be applied consistently among lenders (particularly by ensuring repayments were applied to the highest interest bearing balance first).[40]

The benefit of the minimum repayment warning wasn't simply to provide information to the consumer about their current circumstances, but to counteract some consumer behaviour that can arise from the lender's action in placing a very small minimum monthly payment requirement on the statement. The warning reminds consumers that while the required payment was small, the overall cost of the credit could be expensive. This has proven to be a useful reminder to consumers who are considering applying for a credit limit increase, are tempted to reduce the level of their monthly payment, or are considering entering into another commitment based on making lower credit card payments.

Since these reforms were enacted, the overall level of credit card balances that is interest bearing has stabilised and reduced (at around $35 billion) after virtually uninterrupted growth previously. Credit limits, by contrast, have continued to increase (raising $8 billion to $142 billion between January 2012 and January 2014).[41] This would suggest that the reforms have contributed to consumers managing their credit cards better.

There have been some reforms that have intended to empower consumers that have been less successful. The 'account switching' reforms, implemented from July 2012, were designed to make it easier to move banking from one financial institution to another.[42] The reforms allowed consumers to authorise a new financial institution to contact a consumer's previous institution to obtain a list of all regular direct debits and credits, and to provide all relevant organisations with

[40] *National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011* (Cth).
[41] Reserve Bank of Australia, Credit and Charge Card Statistics – C1, available at: http://www.rba.gov.au/statistics/tables/index.html.
[42] See www.bankingreforms.gov.au.

the customer's new account details. However, available data suggests that the service has not been widely used by customers.[43]

While independent analysis would be required to determine the reasons for this failure, it would appear that the reform failed to deal with some of the underlying reasons why consumers find it difficult to switch banks. In addition to the problem of direct debits and credits, difficulties arise due to the practice of 'bundling' used by most financial institutions. Rather than provide a customer with just one product, banks generally tie different products together, particularly when a mortgage is taken out (for example, a banking package is likely to tie a mortgage, credit card and transaction account). The account switching reforms, applying only to transaction accounts, failed to deal with the way in which products are tied, and also the way in which direct debits are often used in relation to credit card accounts, not just transaction accounts.

(b) The limitations of a regulatory framework focused on disclosure

It is now broadly accepted that disclosure is at best an imperfect response to consumer protection problems in financial products and services.

Chair of this inquiry, David Murray, recently said that:

> The effects of the [financial] crisis were also felt by many Australian retail investors who suffered substantial losses associated with the failures of financial firms or misselling of financial products. These consequences have called into question whether disclosure is effective.[44]

Also recently, ASIC Chair Greg Medcraft said:

> We have witnessed the harm caused by regulations that assume all investors and financial consumers will act rationally. Disclosure, the way it has been done in the past, is not the disinfectant it was once thought to be.[45]

While there is a place for disclosure requirements, disclosure alone will fail to protect consumers in many situations.

Two broad forces seem to drive disclosure-based responses to consumer protection problems. The first is a number of assumptions attributed to classical economic and classical contract theory which together promote the view that consumers necessarily act rationally, are free to negotiate terms and, assuming they are well informed about the nature and terms of a product, they will only make a purchase if it is in their best interests to do so. This line of reasoning is troubled by a number of considerations:

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[43] 'Reforms fails to get customers to switch banks', News.com.au, 29 April 2013, available at: http://www.news.com.au/finance/money/reform-fails-to-get-customers-to-switch-banks/story-e6frfmcr-1226631684082.

[44] *Conduct of the Financial System Inquiry,* Keynote address to Economic and Political Overview Conference, Sydney, 14 February 2014. Accessed from http://fsi.gov.au/2014/02/14/keynote-address-by-david-murray-chairman-ceda/.

[45] *Regulating for Real People, Markets and Globalisation*, Opening address, ASIC Forum 2014, 24 March 2014. Accessed from https://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC-Forum-2014--Regulating-for-real-people-markets-and-globalisation?openDocument.

- people do not necessarily choose between products 'rationally', they make quick decisions using mental shortcuts when dealing with unfamiliar topics or when limited by time. Available research suggests that this may be a particular problem for financial products and services, which many consumers consider essential to purchase, but take a limited interest in.[46] For example, research by the UK Office of Fair Trading has found that 70 per cent of consumers did not shop around for the best credit card deal.[47]

- credit and financial products are extremely complex and non-experts will frequently misunderstand even the most important elements: take for example the widespread surprise and anger among insurance policy-holders affected by the 2011 Queensland floods when informed that their policies covered 'storm' but not 'flood' damage;

- inaccessible disclosure can be as useless as non-disclosure: for example, few consumers ever read any of the numerous product disclosure statements they will receive in their lifetime and it is more or less expected that consumers will sign standard form contracts without really reading them (consider, for example, insisting on reading a rental car contract at an airport counter and taking the time to ask questions about things you don't understand while a queue of other customers grows behind you);

- poorly designed disclosure does not assist consumers to shop around: even if consumers read and understand their PDS, it is of very limited use as a comparison tool because key points of comparison may be hard to find, and statements provided by different businesses will be structured differently and use different terms.

These factors affect all consumers, but even more difficulties arise for disadvantaged or vulnerable consumers. For example, consumers with low levels of literacy or those who speak English as a second language will find it extremely difficult to understand the main features of an insurance policy, or shop around for a credit product (despite needing insurance and credit as much as any other consumer).

The second driver for using disclosure as a regulatory tool is political expediency and cost. A Government responding to a consumer protection issue will likely have a number of options: doing nothing (unlikely if there is already popular support for action); interventionist options which force businesses to change their practices (likely to be fiercely opposed by industry); or half measures such as improving disclosure or 'consumer education'. The attraction of the disclosure / education option is that is appears relatively cheap and encounters less resistance. The reality is likely to be that this model is in fact the costliest option, because it adds extra costs (the disclosure requirements) but fails to solve the problem because more disclosure is simply not an appropriate response to most consumer protection problems.

(c) Shifting away from using disclosure as a default setting

In recent years we have seen the beginnings of a move away from a disclosure focus. For example, recent reforms to the obligations of payday lenders and financial advisers were based

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[46] Aldlanigan and Buttle 2001; Beckett et al 2000, cited in *Profiling for Profit* p 41.
[47] Office of Fair Trading (UK), (2008) *Credit Card Comparisons: A report by the Office of Fair Trading.* Accessed from http://www.oft.gov.uk/shared_oft/reports/financial_products/oft978.pdf.

on the understanding that the desired consumer protection outcomes were best achieved by focusing on unfair practices themselves rather than disclosure. Further, as outlined above, since 2011 ASIC has had power in relation to unfair terms in consumer contracts—these powers can enable the regulator to seek changes to terms in consumer contracts that are both unfair and not commercially necessary.

If we are to see further improvement to consumer protection in financial system—and, we would argue, greater resilience in a future crisis—we need a continued commitment to step away from using disclosure as a default option. Disclosure should remain in the toolkit, but it should only be used when we are confident it is the best tool for the job.

For example, one of our concerns with consumer leases (especially 'rent to buy' arrangements) is that consumers are not aware of the cost of these contracts because businesses are permitted to give what we would argue are misleading impressions about cost in their advertisements.[48] Better disclosure could solve that problem because it is primarily caused by lessors choosing to provide incomplete disclosure in the first place. However, no amount of disclosure can solve other problems which arise in the consumer leases industry which are created by predatory business models.[49]

> **Case study**
>
> In 2011, a community legal centre in Mildura identified a number of financial counselling clients with 'rent to buy' contracts with Zaam rentals. Zaam offered consumer leases for the purchase of furniture, TVs, white goods, computers, game consoles and outdoor equipment like lawnmowers. Zaam targeted Indigenous families in northern Victoria through unsolicited sales.
>
> In a number of cases, Zaam rentals signed up the consumer to multiple contracts without assessing whether the contract was suitable or whether it would cause substantial hardship. Zaam rentals would commonly secure repayment by requiring the consumer to sign a Centrepay deduction, so that it would be paid directly from Centrelink benefits.
>
> Consumer Action assisted the financial counsellors lodge complaints with the Financial Ombudsman Service and ASIC. In February 2013, FOS made a determination that the rental company had breached a number of credit laws, including responsible lending obligations. ASIC subsequently cancelled its credit licence and banned its directors for engaging in credit activities for a number of years.

Where consumer detriment is caused by dishonest, unfair or unconscionable business practice, regulation should be focused on the business or the conduct, not on the consumer. Suggesting that these kinds of problems can be fixed with better disclosure or consumer education is blaming the victim—it suggests that consumers would not fall victim to unreasonable conduct if only they were better at looking after themselves.

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[48] Consumer lease providers typically advertise the price of their products with a per-week rate, but fail to properly disclose that this price is only available over a minimum number of repayments, often three years. No lessors that we are aware of include the total cost of the lease in their advertisements. Our research found that consumers should expect the total cost of such a lease to be at least two or three times retail price and possibly more: *The Hidden Cost of Rent to Own*, September 2013, http://consumeraction.org.au/report-the-hidden-cost-of-rent-to-own.

[49] See for example ASIC media releases relating to Zaam Rentals (Media Release 13-021, 11 February 2013), and Mr Rental Port Augusta (Media Release 13-288, 24 October 2013).

(d) Using disclosure effectively

There will be situations where disclosure is the best tool for the job, but even in these cases, it will only be effective if the disclosure is designed with consumers in mind.

The ‘product disclosure statement’ model of disclosure, where every notable feature of a product is disclosed at once, may work well for 'professional' consumers who are engaged and interested in financial services and are able to commit the time to comparing one PDS with others. However, more thought needs to go into the design of disclosure targeted at average consumers, or consumers who are known to be vulnerable.

An example of where this has been done well is Paul O'Shea's research conducted for the Standing Committee of Officials of Consumer Affairs on simplification of consumer credit disclosure.[50] O'Shea's work began by testing the level of comprehension of existing disclosure required by the credit code, finding serious shortcomings:

- only 6 per cent of participants understood the true cost of a home loan;
- 15 per cent understood how long it would take to pay off a credit card if only making minimum repayments and 10 per cent could estimate how much interest that would cost;
- 29 per cent understood the total cost of interest on a car loan, but only 3 per cent could find the restriction on repossession explained in a statutory information statement.[51]

After two rounds of redesigning and consumer testing, O'Shea's final disclosure documents achieved almost 100 per cent comprehension on most questions. On the questions regarding cost of credit, this represented an improvement of between 400 and 1800 per cent.[52] Paul O'Shea's research informed the Key Facts Sheets recently designed for home loans and insurance products.

2.4 The role and objectives and powers of financial regulators

(a) Role of Regulators

Effective regulators are essential for a well-functioning finance system, and their enforcement role is perhaps most critical. Consumers can, at least in principle, use the legal system to enforce their rights against businesses that have breached consumer protection laws. However, the financial and other barriers to consumers doing so in practice are significant. Individual consumers often lack the resources or capability to take action, meaning that misconduct can go un-remedied. In mass marketed financial services, consumer detriment may only amount to a small amount individually, but can add up to many millions across the market—bank penalty fees is an example. While consumer legal services, such as Consumer Action Law Centre, provide resources to assist with individual enforcement against businesses, demand for such services outstrips supply.

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[50] Paul O'Shea (2010) *Simplification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign - Final Report*, UniQuest Pty Ltd.
[51] O'Shea (2010), page 4.
[52] O'Shea (2010), page 7.

Non-compliance with consumer laws may also contribute to anti-competitive outcomes—some businesses may comply with the law, but others will not in the knowledge that the risk of being found in breach is low. Robust enforcement by consumer regulators can protect individual consumers as well as to contribute to fairness within markets.

Further, consumer protection law often needs to be tested before the courts to determine its meaning and extent. This is a key role for regulators. Sometimes law reform is argued for in circumstances where the existing law has not been fully tested. The majority of individual complaints against businesses are settled without any legal finding being made and thus do not have any wider impact on market misconduct. For laws to be fully tested, consumer regulators need to take enforcement action, including in matters where the outcome may not be certain.

We acknowledge that responsibilities of regulators beyond enforcement are also critical, such as trader and consumer education as well as standard-setting. However, we believe attention should be particularly applied to regulators' enforcement role because it is a key function of a regulator's toolkit, and also because regulators can face disincentives to use it as much as is needed. For example, enforcement activities can be more expensive, more time and resource intensive, and regulators can face the risk of public criticism should enforcement activities not be successful before the courts.

In our view, the enforcement activities of a regulator should particularly respond to systemic problems and the most serious misconduct.

- *Systemic Problems*
  A systemic issue by definition affects a number of consumers. As noted above, while services like ours can assist individual members of that group through legal and financial counselling casework, this is at best a partial solution. We could not possibly assist every consumer who comes to us for assistance and indeed most consumers (particularly the most vulnerable) will not even seek help.[53]

  Even if every consumer with a problem received assistance with their dispute, this would still not provide a systemic solution. These disputes are usually settled between the parties (often with a confidentiality requirement) and a trader engaging in systemic misconduct will not necessarily be under any pressure to reform their approach to prevent the problem happening again.

  Again, a service like ours can try to apply pressure on a problem trader through the media or (where poor conduct extends across an industry) by lobbying for law reform. But a regulator with appropriate powers to investigate and sanction breaches of the law has far more influence over business and is better placed to respond to systemic problems.

[53] For example, in 2006, Consumer Affairs Victoria (CAV) reported that approximately four per cent of revealed consumer detriment in Victoria is reported to it and smaller percentages are reported to other agencies, such as ombudsman. Consumer Affairs Victoria, *Consumer detriment in Victoria: a survey of its nature, costs and implications*, October 2006.

- *Serious misconduct*
  Similarly, our service can assist individual clients who have suffered loss because of serious misconduct, but we cannot seek penalties that are commensurate to the level of misconduct and send a message to the broader industry that similar conduct will not be tolerated in future.

Given their essential role, regulators must be funded sufficiently to enable them to do their job. We encourage the Panel to consider whether ASIC in particular should receive greater funding from the businesses it regulates—more of a 'user pays' model. We note that UK's new Financial Conduct Authority (described further below) is funded entirely from the financial services firms it regulates.[54] Such an approach might reduce ASIC's reliance on consolidated revenue and provide more flexibility for the regulator to increase or decrease is resourcing depending on the scope of its required activities.

We also support calls to ensure penalties are sufficient to have the desired deterrent effect. In other industries (for example, the national energy market and its rebidding offences), maximum penalty are set by reference to a multiple of three times the gains derived from a contravention. We support such an approach in financial services.

(b) One conduct and product regulator

Consumer Action supports there being one regulator across the entire finance system, regulating the conduct and products of financial service providers. That is, we submit that the Panel should not adopt calls to split ASIC's roles in regulating financial service providers—we are aware of calls to carve off particular types of financial service businesses from ASIC's responsibility, for example, superannuation.

It is our experience that multiple regulators contribute to gaps in regulatory responsibility. Due to different regulators having different levels of responsibility, there can be confusion and a tendency of regulators to 'vacate the space'. In the sections above, we referred to the growth of for-profit financial difficulty businesses—these businesses have been able to grow partly due to the confusion and limitations about which regulator is responsible. In relation to these businesses, ASIC will not have responsibility unless they are engaged in credit assistance activities (debt negotiation or credit repair are not defined as such). The Australian Financial Services Authority is responsible for debt agreement administrators, but its power is limited and does not extend to the advertising and promotion activities of administrators. General consumer protection regulators, such as the ACCC, will have responsibility in relation to the Australian Consumer Law, but given these services have a flavour of 'financial services', it is our experience that such regulators will not see concerns as a priority.

There is a similar problem in relation to vendor terms or 'rent to buy' schemes and promoters, also described above. Depending on the contractual arrangement, very different laws might apply—and one or more of a number of regulators might be responsible. This may include tenancy regulators, the credit regulator, and general consumer protection regulators. The result is that there can be a challenge in coordinating many regulators, each with different priorities.

[54] Financial Conduct Authority, 'How we are funded', available at: http://www.fca.org.uk/about/how-we-are-funded

Such a regulatory environment can allow a harmful practice or product to get a foothold and contribute to widespread consumer detriment.

(c) Effective enforcement—the 'Campaign approach'

We acknowledge that a regulator cannot respond to all misconduct that comes to its attention (or even all serious or systemic matters). Given this, we submit that regulators must be proactive, by regularly signalling to the market that it intends to focus its resources on particular areas. This serves a number of purposes, including putting relevant businesses on notice that their practice may be under greater scrutiny (and so encouraging them to improve their practice) and making consumers and the media more aware of problems in certain markets. Most importantly, it creates guidelines for distributing enforcement resources between competing demands. It becomes both a public commitment to investigate problems in stated priority areas as well as a license of sorts to decline to investigate problems in other areas given limited resources. We note that the ACCC publicly declares a list of priority areas each year, after consulting with stakeholders.

Once its priorities are established, a regulator can be effective by adopting a 'campaign approach' to market risks[55]—that is, undertake a coherent and planned series of actions which are together designed to achieve an overall aim and objectives. This approach recognises the limitations facing regulators in relation to access to resources, particularly in response to potentially prolific breaches of the law. It also looks at an issue more holistically, including business and consumer educational initiatives combined with targeted enforcement.

Such an approach, we submit, may assist the regulator respond to complaints about timeliness in its response to market issues.

(d) Powers of the regulator—the example of the UK Financial Conduct Authority

A regulator will be most effective when:

- the regulatory framework uses the right tools to address identified problems; and
- regulators have the necessary powers and resources to respond to problems as they arise.

The first of these points is discussed above. Regarding the second point, we recommend the Panel consider powers available to the new UK Financial Conduct Authority to suspend or ban potentially harmful products.

While the Financial Conduct Authority's powers are new, they propose a model to allow a financial services regulator to respond quickly to problematic conduct before extensive harm can occur. Indeed, a media report from March this year suggested that the new powers were driven by dissatisfaction with the time it took its predecessor Financial Services Authority to

[55] For further information about this approach, see Consumer Action Law Centre, *Regulator Watch: The enforcement performance of Australia's consumer protection regulators,* March 2013, available at: http://consumeraction.org.au/new-report-regulator-watch/.

investigate and respond to problems in the Payment Protection Insurance industry.[56] The new powers are designed to allow the regulator to suspend a product for up to one year while it investigates.[57]

This approach contrasts with the powers of ASIC—it has powers over the conduct of licensees. Commonly, new business models can adapt that fall outside the licensing requirements. While intuitively involving financial services, technically ASIC has no or very limited power to take action. For-profit financial difficulty businesses, described above, are an example.

By contrast, as we understand it, the Financial Conduct Authority is empowered to regulate financial and credit product themselves, including by identifying and investigating new types of products and imposing rules. In our view this approach gives a regulator more power to respond quickly to emerging problems before widespread consumer detriment occurs.

To do this sort of work effectively, the regulator needs to have resources to conduct and foster research, and undertake analysis to identify consumer harm and gaps in regulation. We are aware of calls from some quarters that the regulator, ASIC, should not be involved in 'policy' work but leave this for the relevant government departments. We oppose such an approach. If taken, it will mean that the regulator is on the back foot, unable to respond to market developments.

(e) Powers of the regulator—a general anti-avoidance provision

The Panel should also consider the merits of a general anti-avoidance provisions in financial regulation.

A general anti-avoidance provision would be designed to allow ASIC or other regulators to take enforcement action if it detected a scheme by a trader which was designed to avoid financial regulations. The draft National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012 (drafted in 2013 but discontinued after the 2013 election) included such a provision at clause 323A. We were in favour of this provision because (among other things) it would better target the avoidance techniques used by payday lenders.

The benefit of this approach is that it enables courts and regulators to identify and react to avoidance schemes before consumer detriment occurs. Currently a consumer (and usually a large number of consumers) must suffer detriment before a complaint can reach courts or regulators and it can take a significant period of time before particular business models can be addressed. A general anti-avoidance provision would enhance ASIC's ability to respond to avoidance as it occurs, rather than waiting for Parliament to change law or regulation.

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[56] 'Financial Conduct Authority may ban harmful products', *The Guardian* (UK), 26 March 2013. Accessed 16 October 2013 from http://www.theguardian.com/business/2013/mar/25/fca-ban-financial-products.

[57] 'The Financial Conduct Authority: what it does and who is charge', *The Telegraph* (UK), 8 November 2011. Accessed 16 October 2013 from http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8874588/The-Financial-Conduct-Authority-what-it-does-and-who-is-charge.html.

Recommendations

We recommend that the Panel's report under Term of Reference 2 should:

- note the extent to which objectives of consumer protection, competition, innovation, efficiency and stability can be mutually reinforcing;
- be clear that innovation is only beneficial to the extent that it improves consumer welfare;
- consider whether there are advantages in ASIC:
    - receiving greater funding from the businesses it regulates;
    - having extended powers of the kind held by the UK Financial Conduct Authority;
- consider the merits of a general anti-avoidance provision in credit and financial services regulation

PART 3: Emerging opportunities and challenges—use of consumer data

This section responds to Term of Reference 3. It argues that:

- improvements in information technology have allowed credit providers to collect and use customer data to target the most profitable customers. This development has coincided with—and appears at least partially responsible for—a huge increase in levels of credit card debt which disproportionately burdens those on lower incomes; however
- where data is accessible to consumers it can help them make product choices aligned with their needs, sending better signals to suppliers.

It also discusses reforms in payments systems, and suggests there is a need to retain a focus on end-users in any future reforms.

3.1 Use of customer data—risks to consumers

Target marketing of products to particular groups of consumers is not new. However, advances in information technology permit businesses to access consumers' personal information and use complex systems to predict an individual's behaviour. In consumer lending, this technology can be used to identify consumers who are likely to be profitable, tailor and price products that the most profitable customers are likely to accept, and develop strategies to reduce the likelihood that the most profitable customers will close their accounts.[58]

It is often argued that this technology creates a win-win: consumers get access to products they want, and business can target their marketing and increase profits. However, the increased use of customer information has coincided with a sharp increase in levels of consumer debt. Over the last 20 years, the level of credit and charge card debt in Australia has increased from a total

[58] Paul Harrison, Charles Ti Gray and Consumer Action Law Centre (2012) *Profiling for Profit: A Report on Target Marketing and Profiling Practices in the Credit Industry*, Deakin University and Consumer Action Law Centre, pp 5-6.

of around $5 billion to almost $50 billion. Over 70 per cent of this balance—$35 billion—is accruing interest.[59]

Our report *Profiling for Profit: A Report on Target Marketing and Profiling Practices in the Credit Industry* produced with Deakin University presented evidence that the two trends are linked. For example, research regarding the US economy found that "the drop in information costs alone explains 37 per cent of the rise in the bankruptcy rate between the years 1983 and 2004".[60] The report draws on the limited public information about customer management systems, but describes how banks use sophisticated systems to glean intimate personal details, using information gathered from spending patterns, call centres, product registration and point-of-sale transactions, in order to predict an individual's behaviour.

It is not in the interests of lenders to extend credit to people who are unable to repay. However, it is well known to our caseworkers (and, we would suggest, to the credit industry) that there are large numbers of consumers who struggle for years at a time to make repayments to their credit accounts without ever reaching the point of default. These customers will be very profitable for lenders, despite the fact that these contracts cause financial hardship.

Banks and credit providers are increasingly able to use consumer data and technology to better target particular financial services offers to 'profitable' consumers. Recent credit reporting reforms which provide lenders with greater levels of personal information are designed to help lenders better assess credit risks. These reforms are likely to lead to an increased use of 'risk-based pricing', and may result in some lenders targeting 'riskier' borrowers with higher interest rates. It appears to us that some lenders already engage in this conduct, causing consumer detriment.

Case study

Consumer Action recently assisted in a matter where a consumer sought a loan for $6,250 from GE Money for the purpose of consolidating her debts. According to the loan documents, approximately $1,280 was for small debts, and an additional $4,700 was for 'debt consolidation'. The documents showed that $4,700 was in fact used to pay off a single credit card debt with a major bank, which the client then closed.

Loan documents show that GE Money gave the consumer a 5 year loan at an exorbitant 34.95% per annum interest—meaning she was repaying over $14,000 (including interest, fees and charges) for consolidating debts worth approximately $6,000. Given that credit card interest rates are commonly in the vicinity of 20%, it's likely the GE Money loan put the client into a worse, not better, financial position.

We looked at GE's Money's website in October 2013 to see what interest rates were being advertised.[61] Both personal and debt consolidation loans were being advertised as being from 17.49% p.a. for loan amounts less than $20,000. On closer inspection, these rates were

[59] Reserve Bank of Australia, Credit and Charge Card Statistics, (as updated January 2014). Accessed via http://www.rba.gov.au/statistics/by-subject.html.

[60] Sanchez, J M (2009) *The Role of Information in Consumer Debt and Bankruptcies.* Working Paper Number 09-04, The Federal Reserve Bank of Richmond.

[61] See: http://www.gemoney.com.au/loans/personal-loans.html and http://www.gemoney.com.au/loans/debt-consolidation-loans.html.

> asterisked with the fine print stating that these rates were only available to approved customers and subject to lending and approval criteria.

We see similar problems in the credit card industry—banks would prefer to send credit card offers to those who don't pay back their full balance within the interest-free period. Known as 'revolvers', such credit card users are highly profitable compared to 'transactors' or 'convenience users', who generally do not incur interest on purchases.

The group of consumers who have trouble paying off credit card debt may be very large. ASIC recently reported that 27 per cent of personal credit card holders (being around 2 million people) do not pay off their personal credit card debt in full each month.[62] This finding is supported by a 2002 report by Visa International, *The Credit Card Report: Credit card spending in perspective*, which found that 64% of all households with credit cards in use did not pay credit card interest.

Failing to repay credit card balance every month will not always be an indicator of financial hardship. However, it should be a cause for concern because those on lower incomes are disproportionately burdened with credit card debt. Australian Bureau of Statistics figures show that households in the second lowest household net worth quintile hold considerably more credit card debt ($3,100) than the average ($2,700), being about the same level of debt as the wealthiest quintile ($3,200 of debt). The second quintile holds more debt than the third and fourth quintiles ($2,800 and $2,400 respectively).[63]

The second household net worth quintile bears the same amount of debt as the highest quintile, despite having less than one third of the disposable income ($552 per week compared to $1797). The second quintile has a little less than two thirds of the disposable income of the 'all households' average ($894 per week), while on average bearing more debt. More disturbing is that the credit card debt held by the second quintile is nearly four times the weekly *gross* income of those households ($821).[64]

In a similar vein to credit card marketing, particular mortgage borrowers can be encouraged to redraw additional funds, or to otherwise refinance or increase the amount of their mortgage. We do not mean to say that this is in any way unlawful—the competitive need of corporations to increase their profitability and return to shareholders unsurprisingly drives them to use personal information and new technologies for their ends, rather than to help consumers access the most appropriate products for their needs.

However, this kind of conduct should be a matter for regulation if it creates risks for consumers and the financial system. We encourage the Panel to consider in more depth the techniques being used to target marketing of credit, and whether existing regulation is adequate to counter the risks it creates. Regulatory responses should be informed by an understanding of how marketing is used and how it is received by consumers.

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[62] *Smart people not so smart with their money,* ASIC Media Release 14-041, Wednesday 12 March 2014. Accessed 20 March 2014 from asic.gov.au.

[63] Australian Bureau of Statistics (2013) *2011-12 Household Wealth and Wealth Distribution, 6554.0,* Table 6. Accessed 21 March 2014 from http://www.ausstats.abs.gov.au

[64] Australian Bureau of Statistics (2013) *2011-12 Household Wealth and Wealth Distribution, 6554.0,* Table 1.

An example may be the 2011 reforms prohibiting unsolicited credit limit increase offers, unless the customer has consented to receiving such offers.[65] These provisions were designed to address the significant consumer harm caused by the impact on many consumers who are coerced into increasing their levels of debt. Vulnerability to this sort of marketing was described in depth in our 2008 research report, *Congratulations, You're Pre-Approved.*[66]

3.2 Use of customer data—benefits to consumers

Use of aggregated customer data also has the potential to create benefits for consumers. Where consumers have access to this data in a useable format it can provide information which helps consumers choose financial products and services which best meet their needs.

One example where this is currently working is in the energy market. The mandatory rollout of smart meters across Victoria has allowed consumers to access their electricity usage data from their energy distributor or retailer. This creates opportunities for consumers to quickly identify where they might be able to save money by reducing electricity use (for example, by quantifying how much power is being used by appliances on standby overnight) or by shifting demand (by moving more use to off peak times). Through comparison services that "read" the consumers data, consumers are able to compare different 'flexible' energy tariffs (which charge different rates for energy at different times of the day) based on objective data about when they use energy the most.

We submit that similar reforms in the financial services sector—for example, data about credit card usage or insurance claims history, if standardised and accessible, could assist consumers choose between providers and contribute to more effective competition.

3.3 Payments reforms—focus on end-users

New technologies are disrupting the traditional financial system, and payments reform is perhaps the key area of change for consumers. In many respects, reforms have benefited consumers by allowing faster, more convenient payments. The payments system does create risks for consumers, however, and we submit that insufficient attention has been paid to these risks as reforms have been implemented.

To date, the focus of payments reforms has been on efficiency and competition—the role of the Reserve Bank of Australia's (**RBA**) Payments Systems Board is to promote efficiency and competition in the system. Many of its reforms have been positive for consumers. For example, direct charging at foreign ATMs has increased transparency of fees for consumers, and has contributed to significant behaviour change meaning consumers are taking steps to avoid banks fees.[67] This was difficult previously, as the costs of using foreign ATMs were hidden from consumers.

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[65] National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011.
[66] Paul Harrison and Marta Massi (2008), *Congratulations, You're Pre-approved: An analysis of credit limit upselling offers,* available at: http://consumeraction.org.au/policy-report-an-analysis-of-credit-limit-upselling-letters/.
[67] Clare Noone (2012) found that there was a 'sharp and sustained shift away from using foreign ATMs' after the direct charging reforms (which required ATMs to disclose that a foreign fee would apply and

Drawing on lessons from consumer behavioural studies, we submit that these reforms could be improved by requiring ATM providers to place prominent, clear warnings on the outside of their machines telling consumers how much foreign transactions will cost. While notice about fees on ATM screens have affected consumer behaviour, the warning does not appear until consumers are part way through the transaction, meaning that many are unlikely to reject the transaction proceeding due to the presence of the fee. The RBA's focus on supply-side efficiency and competition has meant that the possibility of further consumer benefit has been over-looked.

There are still questions about the effectiveness of competition in the ATM system, and whether the reforms are meaning that consumers are paying no more than is economically efficient. For example, consumers generally pay between $2 and $3 for foreign-ATM transactions, when the available evidence suggests the cost of providing the service for large banks is as little as 54c.[68]

Moreover, by only focusing on efficiency and competition, the payments system has been able to develop in a way that has not adequately considered the end-user. An example is direct-debits. Direct debits enable businesses to obtain payment very efficiently, and direct debits can be very useful for important long-term payments (such as mortgage repayments). However, the extent of the use of direct debit raises problems for consumers.

Our casework experience is that consumers are coerced into using direct debit arrangements when the trader does not offer a suitable alternative payment option and when the trader charges a surcharge for payment by another payment system. More exploitative businesses—for example, fringe lenders, funeral insurance providers, and others—rely on the direct debit system to provide security for their business.

> **Case study**
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> In November 2005, Harold entered into a contract with a consumer lease provider for the lease of electronic equipment over a four year term. He signed a direct debit form that allowed the lease payments to be debited from his bank account. One of the terms of that lease contract allowed for automatic holding over of the contract at the end of its initial term, on a month by month basis, until the leased goods were returned to the lesor, or some other arrangement was reached between the parties. The terms of the contract are written in very small, size 6 font.
>
> At the end of 2009, Harold, who lived in a regional area, undertook volunteer work in response to the Black Saturday Bushfires, and saw many of his friends die as part of this work. As a result of this he developed Post Traumatic Stress Disorder (**PTSD**), which affected his memory and his ability to undertake his every day affairs. As a result, Harold didn't realise that the direct debit payments for the lease continued after 2009. Harold also lost track of where the goods had gotten to, and may have lost them in the bushfires.
>
> Only in June 2013, when he had a financial counsellor assess his bank statements, was he

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allowed consumers to cancel) 'despite there being no change in price'. *ATM Fees, Pricing and Consumer Behaviour: An Analysis of ATM Network Reform in Australia*, Reserve Bank of Australia, p 23.

[68] Flood et al (2011) reported that the average direct charge at an ATM run by a financial institution was $1.94 for withdrawals and $1.68 for balance enquiries, compared to $2.15 and $1.96 respectively for independent ATMs. Edgar, Dunn & Company (2010), cited in Flood et al, estimate a cost per ATM transaction of 54 cents for large banks and $1.12 for independent owners. Flood, D., Hancock, J. and Smith, S. (2011) 'The ATM Reforms—New Evidence from Survey and Market Data', *RBA Bulletin*, March Quarter 2011, pp 47-48.

aware that the consumer lease payments had continued to come out of his account. At that point his financial counsellor cancelled the direct debit payments. However, at June 2013 the client had paid $32,669 to the lessor under the lease contract, and had paid approximately $17,390 over the amount required over the initial four-year term.

One problem with this is the way in which direct debits remove control over payment transactions from consumers. While consumers are able to cancel direct debit arrangements with their bank (there is a requirement for a bank to process a request to cancel a direct debit from a transaction account at clause 21 of the Code of Banking Practice), this is limited. First, despite this right, consumers are regularly told that the bank is unable to process the request to cancel. Even worse is that some banks impose a charge for stopping a direct debit.[69]

Second, this right is limited to direct debit arrangements connected to the Bulk Electronic Clearing (**BECS**) system, which covers direct entry payments. Increasingly, consumers are establishing recurrent payment arrangements using credit card accounts or scheme debit cards. For such payment arrangements, banks are unable and unwilling to process a request to cancel.[70] Instead, a consumer must deal with directly with the merchant who commonly also reject request to cancel payments, leaving consumers paying amounts needlessly. For low-income consumers, this can mean that direct debit repayments risk them having insufficient income to cover their living expenses. While banks are aware of this problem, they have done little to provide a solution.

Most recently, consumers have benefited from the growth in contactless cards. For many consumers, such cards have been a time saver and have resulted in increased convenience. However, they have also created increased risks for consumers, particularly around fraud. Consumer Action regularly receives complaints from consumers about the inability for the contactless payment function to be disabled. The Victorian Police has also indicated that these cards are causing significant consumer fraud issues, which have been overlooked in their development and implementation.[71]

We recognise that the payments system will continue to innovate and develop, and there is the potential for significant consumer benefit. It appears likely that payments and communications technologies will further converge, with consumers increasingly making payments using smart phones or similar technology. Our submission is that these further innovations must be implemented with a focus on the end-user. The RBA and the Australian Payments Clearing Association have recently announced the establishment of a new payments industry coordination body, the Australian Payments Council[72]. For payments innovations and reforms to

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[69]Code Compliance Monitoring Committee, cited in Uta Mihm (31 May 2013), *Banking Code Exposed*, http://www.choice.com.au/reviews-and-tests/money/banking/saving-money/banking-code-revised.aspx

[70] Note that direct debits attached to a credit card are exempted from the general requirement that direct debits be cancelled promptly upon request: clause 21.3 of the Code of Banking Practice.

[71] Jon Kaila and Karen Collier 'Police want ban on tap and go technology, saying sloppy practices can promote crime', *Herald Sun*, 27 November 2013. Accessed from http://www.heraldsun.com.au/news/law-order/police-want-ban-on-tap-and-go-technology-saying-sloppy-practices-can-promote-crime/story-fni0fee2-1226769029022

[72] 'Proposed Establishment of an Australian Payments Council and User Consultation Group', Reserve Bank of Australia Media Release, 21 October 2013, accessed from http://www.rba.gov.au/media-releases/2013/mr-13-22.html

benefit consumers, this body (or anything similar) must include representation of consumer interests.

Recommendation We recommend that the Panel's report on Term of Reference 3 consider: • the use of customer data to target marketing of credit and whether existing regulation is adequate to manage the risks this creates; • how improving access by consumers to this data could assist better consumer decision making in credit and financial services. We encourage the panel to make recommendations under Term of Reference 4 regarding: • how access by consumers to their data could be improved; and • the involvement of consumer representatives in payments policy development.

Please contact David Leermakers on 03 9670 5088 or at david@consumeraction.org.au if you have any questions about this submission.

Yours sincerely
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