



# **NATIONAL FINANCIAL SERVICES FEDERATION**

## **Comment on the Exposure Drafts:**

### **Consumer Credit Code Amendment Bill 2007 Consumer Credit Amendment Regulation 2007**

**September 2007**

To the  
Ministerial Council on Consumer Affairs  
C/- Fringe Credit Project  
Queensland Department of Justice,  
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## INDEX

| <b>Section</b>   | <b>Page No.</b> |
|--|-----------------|
| Introduction   | 2               |
| Consumer Credit Amendment Regulation 2007  | 3               |
| Proposed New Section 7(1A)   | 6               |
| Amendment of Section 11 (Presumptions relating to application of Code)                       | 9               |
| Amendment of Section 15 (Matters that must be in contract document - annual percentage rate) | 11              |
| Amendment of Section 46 (Prohibited securities)  | 17              |
| Replacement of Section 72 (Court may review unconscionable interest and other charges)       | 20              |
| New Office of Fair Trading Powers  | 24              |
| The Issue of Retrospective Powers  | 25              |
| Conclusion   | 25              |

## INTRODUCTION

The National Council of the National Financial Services Federation would like to thank the Ministerial Council on Consumer Affairs for the opportunity to comment on the exposure drafts of the Consumer Credit Code Amendment Bill 2007 and the Consumer Credit Amendment Regulation 2007.

The National Financial Services Federation (the Federation) is a not for profit organisation representing 131 companies, operating 504 trading outlets, being retail, Internet and/or telephone lending services throughout Australia. The majority focus on lending amounts between \$100 and \$5,000, for periods of 2 weeks to 9 months.

Federation members are pleased to conduct their businesses, and would like to continue to conduct their businesses, under the uniform Consumer Credit Code regime.

In 2004, an ANZ Bank survey established that 18% of all adult Australians had a personal loan. The Federation's members provide personal loans to a portion of that 18%. Significantly, within that portion, 88% of the borrowers do not have access to the ANZ, or any other banks, for such personal loans.

Over the last decade, this segment of the lending market has been abandoned by all the banks and other mainstream lenders, because these institutions can make much greater profits, with less risk, concentrating on lending to the big end of town, providing extensive credit card services and home loans with terms over many years.

The Federation believes the impact of the regulatory regime proposed should not be underestimated. The Amendment Bill and Regulation incorporate significant changes that will impact on many aspects of the day to day conduct of the microlending sector of the Australian finance industry.

In 2006, Federation members across Australia provided loans totalling \$220 million. In Queensland alone, Federation members provided loans to 105,000 people and provided 180,000 other financial services.

The legislative and regulatory changes proposed will impact on the economics of doing business, particularly as it can be anticipated more staff time will have to be invested to satisfy an appropriate level of compliance.

## THE CONSUMER CREDIT AMENDMENT REGULATION 2007

The new regulation requiring information to be listed about Direct Debit Arrangements involves:

1. The ability for the customer to cancel the arrangement.
2. The ability for the customer to complain to the bank if they think there's been an incorrect debit.
3. The ability for the customer to contact the Government Consumer Agency for assistance with a complaint.

The Federation believes that this provision is probably appropriate under the auspices of full disclosure and notes that it is to be included, regardless of whether or not the borrower wants to pay by such means.

The Ministers should be aware that members of the Federation, when introducing a customer to the concept of a direct debit facility, currently provide documentation which clearly indicates the ability for a customer to cancel the facility and encourages customer contact with their lender and/or bank.

However, there are a number of issues that require attention to assist in the development of an appropriately balanced relationship between borrower and lender, given that the borrower must also face their responsibilities. These are:

1. The borrower must be required to inform the lender when cancelling.
2. In these circumstances, the borrower must make alternative arrangements for payment.
3. Failure to do either, or both, should constitute an act of default, which may be covered elsewhere in the contract document, but should also be included in the box that is being prescribed, so that the borrowers are left in no doubt as to their obligations.
4. The Ministers should have contact with the banks to review their current Direct Debit Declarations. Some of these will require amendment, to be appropriately compatible with the proposals. For example, while the National Australia and Commonwealth Banks' agreements appear otherwise, the current Westpac Mandatory Direct Debit Service Agreement, under the subheading "*Your rights*", prescribes that, if the customer wants to make changes to the drawing arrangements, the customer is to contact Westpac. In regard to enquiries, it goes on to state "*Direct all enquiries to us, rather than to your financial institution, and these should be made at least... working days prior to the next scheduled drawing date*". There is no provision encouraging the customer to have contact with the recipient of the funds under the direct debit agreement. All banks should prescribe that, in these circumstances, the customer's first contact should be with the lender.

### The Banks

Failure to address the above issues could lead to circumstances where the inclusion of the "*information about direct debit arrangements*", in credit contracts, may encourage borrowers to default, effected by simply cancelling the direct debit arrangement and never attempting to introduce an alternate method of payment.

While, historically, the banks have encouraged their customers to deal with the microlenders in regard to direct debit facilitation, there is no legal requirement for the borrower to do so. That means there should be regulatory recognition

of a requirement that either the banks notify the relevant microlenders, before accepting a cancellation of the direct debit facility, or there is a requirement for the borrower to first contact the microlender, prior to any cancellation.

### Government Consumer Agency Workloads

The Federation notes that any anticipated increase in the numbers of borrowers contacting “*the Government Consumer Agency for assistance in resolving the complaint*”, will be ameliorated with the forthcoming introduction of the external, or alternate, dispute resolution scheme, contemplated by the Federation.

### Customer Reticence to Read Documents - Substantial

Ministers should be conscious of a continuing problem, being the reticence of borrowers to read their loan documentation. In this context, it should not be overlooked that the proposed amendment will be increasing the amount of material intending borrowers are expected to read.

To provide an example of how significant this social phenomenon is, the results of the Federation’s 2007 Survey, in preparation for the Federation’s submission to the Australian Law Reform Commission Inquiry - “*Credit Reporting Provisions of the Commonwealth Privacy Act*”, are worth noting.

460 microlending outlets, from across Australia, responded to the question, “*What percentage of your customers read the Privacy Protection of Information Statement and Declaration, before they take out their loan?*” Ministers would be aware that this declaration has to be presented to every borrower, under the Commonwealth Privacy Act 1988. The results were as follows:

**65.4% of outlets reported that 5% or less of their customers actually read the document.**

The remainder reported:

|   |   |   |  |
|---|---|---|--|
| 25% outlets reported 10% customers read the document  | 1.1% outlets reported 20% customers read the document | 0.2% outlets reported 40% customers read the document | 0.9% outlets reported 60% customers read the document  |
| 4.4% outlets reported 70% customers read the document | 2.2% outlets reported 80% customers read the document | 0.2% outlets reported 95% customers read the document | 0.6% outlets reported 100% customers read the document |

These figures are mirrored by South Australian statistics, derived from the Federation’s February 2007 Industry Analysis Survey, where responding companies reported that the proportion of their customers who actually carefully read all their loan documentation, was as follows:

|                             |                     |                     |                      |                      |
|-----------------------------|---------------------|---------------------|----------------------|----------------------|
| 64% outlets said 5% or less | 3% outlets said 10% | 6% outlets said 40% | 12% outlets said 60% | 15% outlets said 80% |
|-----------------------------|---------------------|---------------------|----------------------|----------------------|

### Inclusion - Code v Regulation

The Federation notes a request, by the Council, to consider whether this provision should be included in the Consumer Credit Code, rather than in the proposed separate regulation. The Federation is of the view that it is advantageous to contain all regulations that relate to the finance industry in one document. This leads to easier reference and understanding, which leads to greater protection for consumers and greater ease of enforcing compliance. Ideally, the Code should be the comprehensive and all-inclusive direction for

the relevant sectors of the finance industry. Further, it could be argued that the proposed provision, concerning direct debit arrangements, is of equal importance to a number of the provisions already contained in s14 of the Code.

While the preference is to include such a provision in the Code, it must be prescribed as a separate document, in accordance with the suggestion included in the *“Summary of the proposed amendments to the Regulation”*.

That is, by adding a new s14A, prescribing disclosure to be made in writing, where relevant, prior to a credit provider entering into a direct debit arrangement with a borrower.

This also has the advantage of being a provision that applies, whether the borrower enters into the direct debit arrangement at the commencement of the contract term, or sometime thereafter.

### **Recommendation**

That the proposed *“information about direct debit arrangements”* provision, together with ancillary provisions reflecting the Federations’ concerns listed above, should be included as s14A in the Consumer Credit Code. This expanded provision being as follows:

- “1. *If you make direct debit payments under this contract, you have a right to cancel that arrangement at any time. You should contact your lender first to make alternate payment arrangements and then contact your bank or financial institution.*
2. *Cancelling your direct debit arrangement does not free you from your obligations under your loan contract. Please check your loan contract carefully. By cancelling your direct debit arrangement, without making alternate arrangements for payment, you may be committing an act of default.*
3. *If you think a wrongful direct debit has been made from your account, contact your bank or financial institution to request an investigation of the matter and correction, if necessary.*
4. *If you are not satisfied with the outcome of anything referred to in items 1-3 above, you can contact the lender’s external dispute resolution scheme, or the Government Consumer Agency in your state or territory for further assistance”.*

## PROPOSED NEW SECTION 7(1A)

Proposed new Section 7(1A) - prescribing "*credit fees and charges imposed or provided for under the contract are taken to include fees and charges payable by the debtor to anyone else in connection with the provision of the credit, whether or not the fees and charges are payable under the contract*".

This proposal is recognised, by the Federation, as being primarily directed at lending circumstances where there is both a credit provider and a broker. In the interests of clarification, the Federation believes that this should be acknowledged in the sub-section. Therefore, the Federation recommends a slight modification of the current draft.

The proposal appears to reflect the recommendations in the Regulatory Impact Statement that capture any "*referral*" fee, irrespective of whether or not the person being paid that fee is related to the lender.

The Federation notes that the proposal is recommended, irrespective of whether or not the broker, or other person paid the fee or charge, is related to the lender in any way.

The Federation is concerned that the premature introduction of this proposal, prior to the finalisation of the long promised national broking legislation, could introduce contradictory provisions. Further, the Federation has an associated concern that the total impact of this proposal, particularly in regard to its impact on the microlending segment of the finance industry, has not been the subject of appropriate, close scrutiny and/or sufficient public inquiry.

The Federations' concerns are:

1. The proposed inclusion will occur whether or not the amount is in any way referred to in the contract and whether the amount is known to the lender.
2. The Federation notes the result of this proposal is that the description or definition referring to any amount used by lenders or brokers, will be irrelevant. Introduction fees, commissions, anything "*payable...in connection with the provision of the credit*", will become part of the cost of the loan to be included in any calculation of comparison rates.

That means that they will be included in the calculation of the inclusive interest rate (interest plus all fees and charges) used in the current NSW and ACT model, to determine whether the inclusive cap of 48% is satisfied or breached. This consequence introduces a dual impact, under the current NSW and ACT model, where not only will there be disclosure of the full amount but, in addition, there will be exclusion of the opportunity to borrow if that full amount is in excess of 48%.

Because of this second consequence, in NSW and the ACT, and the still to be concluded reviews focussing on the 48% cap, in South Australia and Queensland, it might be useful to reflect on the economic impracticality of the 48% inclusive cap concept, before proceeding with the introduction of this proposal.

As the Ministers would be aware, there are now substantially researched reports emanating from the UK, the USA, Korea, New Zealand and Victoria that clearly indicate the 48% cap, inclusive of all fees and charges, is unworkable.

3. The Federation notes that, under the proposal, it is irrelevant how the brokerage, introduction fee or the like is calculated, or comes into

existence, or whether or not the lender has any control over their existence and/or calculation – they will all be assessed as being “*in connection*” with the contract.

4. The risk arises that, if fees unknown to the lender are captured as proposed, lenders may be placed in a situation of innocently issuing an illegal contract.
5. The proposal provides a dilemma in circumstances where the borrower pays a fee to someone, without the lender knowing, and the lender cannot fulfil the responsibility to fully disclose all costs faced by the borrower, which is imposed by this section.
6. A similar dilemma arises if the fee or charge is solely negotiated between the borrower and the broker, and the credit provider is not party to the negotiations.
7. Clarification is required concerning stamp duty and other government charges payable as a result of the documentation. The Federation regards such charges as being totally outside lenders’ control, not related to “credit” and therefore it is inappropriate to include these the charges in any consideration of the credit provider and broker’s charges to the customer.
8. The practical impact in the ACT and NSW is that nearly 30% of total microloans involving, over recent years, 180,000 borrowers, will not be capable of duplication in future. That means the Ministers will have to reflect on the challenge of where these borrowers, when they seek to borrow again in the future, are going to source their loans.

The Ministers would be interested to know that the percentage of borrowers who indicated that, if the microlending industry was closed down, they would have nowhere else to go, was 65.5% or more, in South Australia, NSW and Queensland, where a Customer Survey of 3,034 respondents was conducted by the Federation between November 2006 and March 2007. The highest state figure was in Queensland, where this was indicated by 81.3% of customers interviewed.

The Ministers are alerted to the fact that the opportunity for these borrowers to turn to no-interest (NILS) and low-interest (LILS) loans is extremely limited. 0.7% of those surveyed in South Australia, 1.5% in NSW and 3.9% of those surveyed in Queensland, indicated that they would turn to Government or charity if the microlending industry was closed down. However, the opportunity for them to do so is hampered by the lack of availability of lending opportunities from these sources.

The existing NILS and LILS schemes would not satisfy the requirements of even 1% of the respondents nationally.

### **Recommendations:**

1. That Section 7(1A), as proposed or as amended (see following), not be introduced until a full investigation and realistic resolution of the 48% inclusive of fees and charges cap issue has been achieved.
2. That Section 7(1A), as proposed or as amended (see following), not be introduced until the long promised national broking legislation has been formulated and is ready for introduction. This to avoid inconsistency between the proposal and the broking legislation and to avoid unintended distortions in the finance industry.

3. Following an appropriate resolution of the above recommendations, that Section 7(1A) be amended to read -

*“For the purposes of subsection (1)(b), credit fees and charges imposed or provided for, under the contract, are taken to include fees and charges known to be payable by the debtor to anyone else including, but not limited to, brokers and excluding government charges. Such being in connection with the provision of the credit, whether or not the fees and charges are payable under the contract.”*

## **AMENDMENT OF SECTION 11 (Presumptions relating to application of Code)**

Section 11(2) - the credit provider will have to make enquiries about the purpose of the credit.

As a result of those enquiries, the credit provider obtains information by, or on behalf of the debtor, that the purpose of the loan was wholly, or predominantly, for either or both business or investment purposes, thereby establishing a position contrary to the assumption, in s11(1), that the loan is for personal or domestic purposes and, therefore, the Code applies.

The Federation has the following concerns:

1. Arguably, the proposal places the burden for establishing the purpose of the loan on the credit provider. This is a significant change and an unfair impost, when one considers that, in all other areas of business, it is ultimately the responsibility of the purchaser to assess his or her need and purchase in accordance with that assessment.
2. This circumstance could place the lender in an invidious position - balancing the weight of the assertion made by the borrower, that the loan is for business and investment purposes, with indications to the contrary provided by other sources of information, as would be facilitated by the proposed s11(2)(a).
3. The Federation notes, in this proposed subsection, that there is no inhibition as to where the enquiries might be made. This invites possible conflict with the Commonwealth Privacy Act 1988.
4. There is a further concern with subsection (2)(a). This is the issue of what exactly constitutes the evidentiary burden, as there is no guidance in the proposed subsection. Subsection (2)(a) simply provides for the credit provider to "*make inquiries about the purpose of the credit provided*". This is of no assistance to the credit provider because there are no guidelines specified as to what constitutes an acceptable attempt to obey the subsection.
5. The use of the term "*and*" at the conclusion of s11(2)(a) imports the provision of s11(2)(a) into the circumstances associated with s11(2)(b). This introduces a substantial problem for lenders. How do they balance the information provided in subsection (2)(a), with contrary evidence supplied under subsection (2)(b).
6. The inclusion of the word "identified" in s11(2)(b) is either redundant, on the basis that a business purpose is a business purpose, or an exhaustive list of what is recognised as business or investment purposes will have to be created. It is noted that, to attempt an exhaustive list is to introduce the risk of excluding innovation.
7. s11(2)(b) provides that "*the credit provider was given information*", without any identification as to the relevance of the substance of the information, as well as providing no guidelines concerning when the credit provider should accept such information.
8. Confusion is also introduced if you take the phrase "*as a result of the inquiries, the credit provider was given information by or on behalf of the debtor*". Arguably, this limits the scope of enquiry undertaken under subsection (2)(a), to being only that of making enquiries of the debtor. If this interpretation is accepted, then it must be asked why there is a need to make any changes to the current Section 11.

The current s11(2) provides the opportunity for the debtor to make a declaration as to purpose and that declaration is accepted as applicable, for the purposes of the Code (unless, in accordance with s11(3) “*(the credit provider) knew, or had reason to believe, at the time the declaration was made that the credit was in fact to be applied wholly, or predominantly for personal, domestic or household purposes*”.

9. There is the practical issue of how much time a lender's staff member will be required to allocate to making sufficient enquiry. We remind the Ministers that many of the loans associated with this provision will be for relatively short terms and involve the borrowing of no more than a few hundred dollars. That means the potential gross profit provides limited flexibility to cover a substantial increase in the amount of time required to comply with this proposal.
10. In this context, it must be remembered that lender counter staff are not trained and have no authority to act in a manner more akin to a police officer or private investigator. There is, therefore, a very practical limit on the extent of enquiry that can be achieved. As noted above, there is also the issue of the Commonwealth Privacy Act 1988.
11. It is noted, in the “*Summary of proposed amendments to the Code*” provided, that it is not intended to prohibit credit providers obtaining a statement about purpose, but such will no longer have any special evidentiary purpose. It will be appropriate to seek clarification from the Ministers on whether a business purposes declaration and/or form will still have utility as part of this process.

Given the above concerns and the central fact that the proposal continues to provide an opportunity for the only source of information to be the debtor, the Federation is not convinced that the proposal provides any net benefit while, at the same time, the Federation is convinced that there are serious compliance assessment issues introduced by the new proposal.

**Recommendation:**

That, unless a substantial effort is employed to address the above negative aspects of the proposed s11(2), that the current Section 11 remain.

## **AMENDMENT OF SECTION 15 (Matters that must be in contract document - annual percentage rate)**

Section 15(2) and Section 15(3) - annual percentage rate calculated on the basis of the total charges that are in the nature of interest charges, whether or not they are called that.

The Federation notes that the “*Summary of proposed amendments to the Code*” makes it clear that the intention here was to follow the NSW regulatory regime.

The Federation’s concerns are both specific and general. The substance of this proposal is, in effect, the introduction of a comparison rate, via s15. It is useful to remember that this concept is still the subject of a sunset clause in some jurisdictions and its inclusion amongst the proposals, without a similar sunset clause, is a conflict of intention. The specific concerns relate to the implementation of what is proposed in the two subsections.

1. We draw the Ministers’ attention to the vexed question of what constitutes fees and charges that are “*in the nature of interest charges*”, which raises the following issues:
  - a) Are establishment fees outside this “*in the nature of*” test, as the Victorian Tribunal decided in the *Director of Consumer Affairs Victoria v City Finance Loans and Cash Solutions* case.
 

It must be remembered that the Victorian City Finance case identified that, if a fee was calculated with reference to the amount of credit and the length of the loan (both), then it was in the nature of interest. Consequently, if there is no reference to either the amount of credit and/or the length of the loan, then the fee or charge under review will be outside the proposed subsections.
  - b) Other cases have also examined what constitutes the essential characteristics of interest. In particular, these cases have included the criteria that the payment is in the nature of compensation for deprivation of the use of money and it accrues over time.
 

[See *Re Euro Hotel (Belgravia) Ltd* (1975) 51 TC 293; *Riches v Westminster Bank Limited* (1947) AC 390 at 400 and (1947) 1 All ER 469; *Bennett v Ogston* (1930) 15 TC 374; *Willingale (HM inspector of Taxes) v International Commercial Bank Limited* (1978) 52 TC 242 and (1978) 2 WLR 452; *Chow Yoong Hong v Choong Fah Rubber Manufactory* (1961) 3 All 1163 and (1962) AC 209].
  - c) A third possible interpretation of the proposal is to adopt s128A(1)(a) of the *Income Tax Assessment Act 1936 (Cth)* approach, which includes interest, for the purposes of taxation, as that which is in the nature of interest and then provides potential guidance by prescribing:
 

“or

(b) to the extent that it could reasonably be regarded as having been converted into a form that is a substitute for interest; or

(c) to the extent that it could reasonably be regarded as having been received in exchange for interest...”
  - d) Therefore, there are three potential interpretations that could be applied to the proposal. To avoid confusion and to facilitate certainty, it would

be useful for the Ministers to be more prescriptive with their requirement.

- e) With fees already separately identified in the Financial Table, being the pre-contractual information provided to the borrower, there is a substantial chance that there will be confusion, in many borrowers' minds, when they are rolled into one interest rate calculation.

In this context, the Ministers might be interested to know that, in April 2006, the Federation undertook a Comparison Rates Survey. 65% of the 276 microlending outlets represented in this survey, in response to the question "What percentage of your customers do you think understand what a comparison rate is", reported that their assessment was nil and 33% of the responding outlets reported that fewer than 1% of their customers understood the concept.

- f) There is no opportunity, in the proposal, to distinguish between fees paid up front and those financed by the credit contract. This provides substantial challenges for, and the opportunity for inaccuracy in, the calculation of an holistic percentage rate.
  - g) Similar calculation challenges arise when there are specific and irregular or one off fees and charges, incurred during the period of the loan. The challenge of accurate calculation arises when traditional interest, accruing over a period, is summed with a fee due at one particular time, and the total is then used to calculate an interest rate.
2. The Federation's general concerns relate to the utility of attempting to impose a calculation, such as the all-inclusive annual percentage rate, with the intended purpose that it assist borrowers to accurately assess the cost of a potential loan. Providing such a comparison rate should be viewed in the light of the following.
3. As revealed in three separate surveys conducted by the Federation 2006 and 2007 and involving over 400 lending outlets across Australia, the microlending industry's attitudes to this impost can be summarised as including:
- (a) The methodology for calculating a comparison rate for small, short term loans, is deficient and poorly understood by regulators and lenders alike.
  - (b) The motivation of finding a simple base of comparison, to assist consumers, is not achieved, because few consumers of microlending products understand the concept and even fewer care. The element of comparison preferred is expressed in dollar amounts.
  - (c) The imposition of the need to display predetermined comparison rates is meaningless, because most of the values included in the mandatory table have no relevance to microlending. The loans are simply too big, in dollar terms, and run for too long a term to be relevant.
  - (d) The ambiguity associated with the inclusion of fees and charges, as opposed to a simple statement of interest rate, generates disinterest amongst customers.
  - (e) For micro-borrowers, the key issue is whether they can service the loan and they simply do not ask for any information concerning comparison rates.

4. The issue of comparison rate methodology misleading and/or confusing customers is significant. On actuarial advice, the Federation notes that, for short term loans for small amounts, the calculated annual percentage rate may appear very high. This may be because the reasonable administration charges relating to such a loan, can represent a significant proportion of the amount borrowed and, even if the interest rate imposed is quite low (or even zero), once the other charges are included, the annual percentage rate becomes high.

While the high, disclosed, annual percentage rate is theoretically correct, many consumers won't have an intuitive understanding of what it means. For example a loan of \$100, repaid by 6 equal weekly instalments, with an interest rate of 10% and an establishment fee of \$20, has an annual percentage rate of nearly 300% pa. Apart from repaying the principal, the borrower only pays back an additional \$20 (the establishment fee), plus interest of just 78 cents (i.e. total repayments of \$120.78).

In this example, an annual percentage rate of 300% pa might appear quite unreasonable to consumers and lead to concern that the terms of the loan are unfair. The consumer is unlikely to understand how an interest rate of 10%, plus a \$20 fee, leads to such a high annual percentage rate. Consequently, disclosing the annual percentage rate to the consumer is unlikely to improve their understanding of the "true" cost of credit.

However, a consumer provided with the total amount of the repayments (in this example \$120.78) is likely to have a much clearer intuitive understanding of the loan to which they are agreeing, i.e. they are borrowing \$100 and, for that service, it is going to cost them \$20.78.

5. Using the formula proposed, the following provides some examples of relatively modest charges, leading to very high annual percentage rates, on small and/or short term loans. In each of the examples below, the borrower is lent \$1,000.
- (a) A simple loan - an interest rate of 10% applies, there are no fees and charges and the loan is to be repaid in exactly 1 year, with a single repayment of \$1,100. In this case, applying the formula produces an annual percentage rate of 10%.
  - (b) A second loan - no interest payable, but a charge of \$100 is applied. Again, the loan is to be repaid in exactly 1 year, with a single repayment of \$1,100, the formula producing an annual percentage rate of 10% - the financial obligations on the borrower are, in practice, the same as (a) above.
  - (c) Then we consider a loan which is to be repaid in 26 equal instalments, over about 1 year. In this case there is no interest payable, but a charge of \$100 is levied. The repayments are \$42.31 per fortnight and the total dollar amount the borrower must repay is \$1,100 (26 x \$42.31). This loan has the same dollar cost as in the previous examples. However, in this case, the annual percentage rate is 18.78%.
  - (d) Finally, consider a loan which will be repaid faster, with 13 equal weekly instalments. Again, there is no interest payable, but a charge of \$100 is levied. The repayments are \$84.62 per week and the total dollar amount the borrower must repay is \$1,100 (13 x 84.62), as before. Interestingly, the annual percentage rate for this loan is much higher, at 72.58%.

Each consumer in the above examples is making the same gross repayment to borrow the same amount of money, but the annual percentage rate differs according to the structure of the loan.

6. The industry's attitudes have substantial independent support, including independent researchers Scott Ewing and Ivan Zwart, from the Institute for Social Research, Swinburne Institute for Technology, Melbourne, in their 2005 *The Effectiveness of Mandatory Comparison Rates: Information, capacity and choice - Consumer Research Issues Paper*, found that, while 37% of their interviewees claim to recognise the term, only 12.6% knew what it was or could accurately define it.
7. The Victorian Government is critical of the term. Consumer Affairs Victoria, in its Fact Sheet on Financial Services, *Comparison Rates Decoded*, FS-06-01, October 2003, highlights the fundamental problems as to why micro-borrowers are not enthusiastic about comparison rates. The fact sheet includes the list of standard amounts and terms to be included in comparison rate schedules, which lenders must provide to borrowers for their consideration. In the group of 21 amounts and terms prescribed, only three amounts are for \$1,000 or less and these three provide terms of 2, 8 and 24 months. Most microloans are not for the amounts indicated and not for the terms indicated, so the customer cannot make an immediate comparison and would have to seek advice from the lender. However, this necessity to seek advice is not encouraged, nor is the relevance of the comparison rate, to the consumer, enhanced when one considers the totality of the fact sheet's three areas, included under the sub-heading:

*"Points to remember:*

1. *Different loan amounts and terms produce different comparison rates and the comparison rate schedule does not include all combinations of amounts and terms.*

*This means the comparison rate for your particular loan may not be included in the comparison rate schedule.*

*You can always ask a credit provider to calculate the comparison rate for the particular amount and term you are seeking, however, credit providers are not legally obliged to provide this information.*

2. *The comparison rate does not include government fees and charges, fees you incur separately, or fees and charges that can't be known in advance. Therefore, a comparison rate may not provide a complete picture of the total cost of a loan.*

3. *The comparison rate is a useful tool for comparing the cost of loans, but the loan with the lower comparison rate doesn't necessarily represent better value for money.*

*You need to consider the terms and conditions of the loan, such as whether you are able to make additional repayments, whether you can access these additional repayments at a later date and whether the loan is portable.*

*A comparison rate also does not take into account some factors which may make a loan more attractive, such as fee-free banking, or flexible repayment arrangements.*

*You should give careful consideration to whether these features are important to you and the effect they will have on the cost of the loan".*

8. One of the three surveys, referred to above, conducted in early 2006, involved responses from the senior management of 276 microlending outlets and agencies across Australia. The relevant results were as follows:
- Percentage of customers who have demonstrated awareness of the term “*comparison rate*” - 43.5% of respondents reported ‘nil’ and 33.4% reported 1% of customers or less, with 22% of respondents reporting less than 2% of customers. One lender commented that none of their staff have ever been questioned about the comparison rate.
  - Percentage of customers understanding what a comparison rate is - 65% of respondents reported ‘nil’ and 33% reported ‘1% or less’.
  - When asked how difficult it was to explain the comparison rate to customers, 57% said it was ‘extremely / very difficult / confusing’ and, not surprisingly, 38% said ‘customers never ask’.
  - 99% of respondents believed none of their customers consider comparison rates when making their decision to borrow from their outlet, with one comment being “*Not once in over 60,000 loans since comparison rates were introduced*”.
  - 100% of respondents reported ‘repayment amount/s’ as the primary information on which borrowers base their decision making.
  - When asked for other categories of information borrowers used to make their decision, 75% of respondents reported ‘how much they can borrow’, 25% said ‘the term’ and 3% said ‘on the reputation, professionalism and profile of the lender’.
  - 97.5% of respondents reported that they, themselves, do not find it easy to calculate the comparison rate. One respondent, the CEO of a respected medium-sized franchise group, who described himself as having had many years experience programming mathematical solutions, said “*I could not work or create a formula for us. We had to contract out to (an actuarial firm) which cost thousands of dollars to get it right*”.

The second survey conducted for the Federation, in early 2006, included a number of questions to explore what motivates customers in their decision making process.

35 owners, responding on behalf of their companies, which varied from 1 outlet to 105 outlet concerns in 5 states (only Tasmania was not represented), the following question was asked:

*In YOUR experience with borrowers, how would you rate the following - from 1 - very important; to 5 - least important for your “average” customer:*

| <b>Question</b>                   | <b>Average Rating</b> |
|-----------------------------------|-----------------------|
| <i>Total cost of loan</i>         | 1.6                   |
| <i>Amount of each repayment</i>   | 1.8                   |
| <i>Length of repayment period</i> | 2.7                   |
| <i>Repayment intervals</i>        | 3.1                   |
| <i>Interest rate</i>              | 3.5                   |

In other words, the customers’ concern and understanding in regard to interest rates was well down the list of concerns at No. 5. The major interests of borrowers are the total cost of the loan and the instalment amount they will have to pay.

For these reasons, the Federation does not support any proposal to include an annual percentage rate.

This approach is strongly supported by the provisional findings report of the UK Competition Commission's 2006 "*Home Credit Market Inquiry*", at 3.14, where it noted,

*"...the TCC (Total Charge for Credit) appears to us to be a more appropriate basis for comparison ...it is readily comprehensible. It is less sensitive than APR to small differences in the period over which the loan is offered. And over the relatively short period ...of most (small) ...credit loans, it approximates, to the net present value, of a loan to the borrower."*

To that end, the Federation would argue that the average consumer is not comfortable calculating a percentage to cost ratio, but that same group of consumers knows how to compare a cost of \$5, as opposed to a cost of \$6, and make a decision in an instant.

Interestingly, in the UK Competition Commission report, the Commission noted that because the APR is hard, if not impossible, to calculate from the percentage to real dollar cost for consumers, those consumers suffer restricted consumer choice. They feel comfortable with their current lender because they don't understand how to compare the loans.

The UK Commission regards this as restricting the market and consumer choice.

The UK Competition Commission, 2006 Report, Item 6:

*"we consider the total charge for credit (TCC) to be a better price measure for home credit loans (small personal loans) than the APR, especially for loans of less than a year. We found that the prices of home credit loans, however measured, were high by comparison with the prices of other credit products (though, given the differences in the product offerings, that does not necessarily imply that a home credit loan represents worse value for money."*

**Recommendation:**

That the proposed s15(2) and s15(3) not be proceeded with and the Ministers look to provisions that will focus on the actual cost of credit, as this is the comparison understood and used by most borrowers.

## AMENDMENT OF SECTION 46 (Prohibited securities)

Section 46(3) - abolition of household chattels as security. Includes household property, as prescribed under the Commonwealth Bankruptcy Act and its regulations.

Not including antique items, where a substantial part of their market value is attributable to their age or historic significance.

In March/April 2007, the Federation, in its preparation for a submission to the Standing Committee of Attorneys General, in regard to that Committee's Personal Property Securities Review, undertook a survey of 368 lending outlets across Australia. 81.52% of these outlets use security on at least some of their personal loans.

Concerning the outlets that did use security, the proportion of total personal loans involved were as follows:

|                 |                 |                    |
|-----------------|-----------------|--------------------|
| 5.33% said 100% | 1.33% said 95%  | 4.33% said 90%     |
| 0.33% said 85%  | 48.33% said 70% | 32.67% said 60-69% |
| 1% said 50%     | 2.67% said 30%  | 4% said below 30%  |

However, the majority of the security items involved in the above table were motor vehicles. A further question, in the same survey, asking what proportion of their company's secured personal loans were secured by general household items, revealed the following:

|                |                 |                |
|----------------|-----------------|----------------|
| 77.42% said 0  | 0.33% said 2%   | 0.66% said 20% |
| 0.66% said 45% | 18.37% said 55% | 2.66% said 60% |

Therefore, the security that is the subject of this proposal, has some relevance to 22.35% of the lenders that responded, i.e. lenders where 20% or more of their loans are guaranteed by household chattels.

In regard to "*essential household property*", the Federation supports the proposed amendment to s46, insofar as it attempts a definition referable to the Bankruptcy Act. There must be the opportunity for as much certainty as possible, associated with any amendment to s46.

The Federation does not support the proposal to include a further opportunity for definition, being that of prescription under a regulation, made under the Code [s46(4)(b)]. The Federation regards this as introducing an unnecessary uncertainty.

The Federation notes that second or more fridges, stereo's, televisions and other electrical goods are available for the lender to use as security.

One challenge is the possible difference between the circumstances that applied when the security was first given and the date of repossession, e.g. a second television became the only television during the term of the loan. This dilemma can only be resolved by adopting the general principles of the Consumer Credit Code. On that basis, the relevance status of the chattel must be at the time of entering into the credit contract.

Another challenge associated with this proposal is the issue of using security over items that are surplus to those set out. In reality, there is very little to stop borrowers getting rid of these surplus items to avoid repossession. While many items have serial numbers and there is some capability of registration of

an interest, such are ineffective in stopping the disposal of the item, as it is nearly impossible to trace them.

### **Sham Sales and Leasebacks**

It is noted that the amendment proposed for s70, being a new subsection, s70(2)(n) and the amendments to s70(6) make it clear that sham sales and leaseback arrangements will not be tolerated. The Federation strongly supports the Ministers in regard to this aspect of the proposals.

### **Pawnbroking**

The Ministers should be aware that, because there is no provision to ban the pawning of household items, borrowers may increasingly move from credit providers to pawnbrokers to source their immediate loan needs.

That means, for the proposal to be effective, the Ministers will have to introduce legislation banning the pawning of essential household chattels.

With the above in mind, the Federation recommends an adaptation of the bankruptcy provisions.

### **Recommendation:**

That the proposed amendment to s46 be revised, insofar as to introduce certainty as to the property referred to and its status at the relevant identified time. Such property to be the following items;

#### Household property

Household property is property that can be considered reasonably necessary for the domestic use of the borrower's household, having regard to current social standards.

This property to include:

- (a) in the case of kitchen equipment - cutlery, crockery, foodstuffs, heating equipment, cooling equipment, telephone equipment, fire detectors and extinguishers, anti-burglar devices, bedding, linen, towels and other household effects;
- (b) sufficient household furniture for daily living;
- (c) sufficient beds for all members of the household;
- (d) 1 television set;
- (e) 1 video recorder.
- (f) 1 set of stereo equipment;
- (g) 1 radio;
- (h) 1 washing machine and 1 clothes drier, or 1 combined washing machine and clothes drier;
- (i) 1 refrigerator and 1 freezer, or 1 combination refrigerator/freezer;
- (j) 1 generator, if needed to supply electrical power to the household; and
- (k) 1 telephone appliance.

#### Personal property

Such to include:

Educational, sporting or recreational items (including books) that are wholly or mainly for the use of children or students in the household;

Sporting, cultural, military or academic awards given to a member of the household;

General recreational and sports equipment.

The status of all such chattels being established at the time the credit contract is entered into.

### **In Regard to Antiques**

The Federation cautions the Ministers as to possible practical problems:

1. with attributing a value to the age of the item; and/or
2. attributing historic significance to the item; and/or
3. assessing what is “*a substantial part of its market value*”.

This proposal introduces potentially substantial evidentiary problems and includes a number of criteria demanding a high level of expertise.

Most microlenders do not have appropriate experience with antiques and are therefore highly reliant on the claims of the borrowers, when it comes to the use of such as security.

### **Recommendation:**

That the proposed clause, in s46(3), relating to antiques, should be amended to read:

*“Not including antique items, where the owner asserts that a substantial part of the antique’s market value is attributable to its age or historic significance”.*

## **REPLACEMENT OF SECTION 72 (Court may review unconscionable interest and other charges)**

Section 72(1), (2), (3), (4) and (6), where the annual percentage rate, establishment fee, early termination fee, pre-payment fee, default fee, or any other fee or charge associated with a credit contract, may be assessed as unreasonable by a Court.

The Federation notes that, in large part, this section will replace “*unconscionable*” as a test for Court interpretation, with “*unreasonable*”.

Overall, the proposals invest the power of commercial determination in Judges, when many Judges have no business experience and even fewer have had business training.

This provision raises the following problems:

1. For the borrower - “*unreasonable*” is a lot easier to justify than “*unconscionable*”. This means that the lender is under a far greater threat of successful prosecution, in circumstances which may be unjust, as the following indicates.
2. The courts will have the opportunity to define “*unreasonable*” and will no longer be constrained, as was the Victorian Tribunal in the City Finance Case, with having to apply traditional common law notions of “*unconscionability*”. This could be untenable for lenders.
3. The summary section advocates the new test will be “*more apt, broad and flexible*”. If the Courts take this view, the lenders will have no certainty in their attempts to comply, before any Court decision considers their exact circumstances.
4. The inclusion of subsections that refer to specific fees and charges is of concern because, within the current proposals, there is no opportunity provided for the Court to consider all the fees and charges as a whole, including annual percentage rates.

As the proposal is currently drafted, a lender could be found guilty of imposing an “*unreasonable*” fee or charge, in circumstances where all the other fees and charges, faced by the same borrower, are more than reasonable and/or the aggregated amount of such fees and charges would, in total, have been found to be “*reasonable*”.

### **General Considerations**

1. Throughout the proposed section, there is no recognition of the following commercial realities:
  - (a) It is extremely difficult to develop any benchmarks for “*reasonable costs*”, because all lenders’ costs are different. Premises rental values alone will demonstrate dramatic diversity. As an example of the dilemma facing assessment on a “reasonable cost” basis. It is useful to consider the role of the NAB, in the 1990s, when income/expense ratios were enthusiastically embraced. The NAB provided the industry benchmark when it came to measurement of these ratios. This bank was 10% better (lower ratio) than their competitors, yet their fees were at the top of the range offered by the banks as a whole. At the same time, the NAB annual profits were also setting new records. During the 1990s, the NAB loan book was amongst the most conservative of the banks, as was evidenced when most of the other banks lost millions of

dollars. Consequently, the bank with the lowest cost, greatest profits and lowest risk charged the most.

The Ministers might reflect on whether this was unconscionable, or unreasonable, or was it simply good business, because the NAB was a publicly listed company. Then, as now, the small businesses supporting the NAB's rejected borrowers are attacked by some regulators and a number of, so called, stakeholders.

- (a) The opportunity to find documentary evidence, to satisfy evidentiary rules of the Courts, is not always available because a substantial amount of business to business activity is without formal contract.
- (b) Often there is the issue of cross-subsidisation. One charge may be higher to subsidise, or offset, an artificially lowered charge.
- (c) Calculation of cost (and profit) may be nearly impossible, until after the conclusion of the relevant financial year.
- (d) Cost figures may vary dramatically from one year to the next and the proposal introduces a danger that inappropriate analysis and comparisons could be made, by the Court, in such circumstances.
- (e) There may be a failure to recognise the necessary risk taking associated with microlending. Most contracts are either without security or, despite an attempt to use security, effectively without security.
- (f) It could be argued that the proposals are drafted without reflecting on the fact that there is a proportion of microlending customers who are dishonest. The proposals make it easier for them to misuse the Court system, to avoid fulfilling their obligations. Dishonest borrowers and serial defaulters, particularly those who are skilled in manipulating the welfare and Court systems, are well known to the microlending industry.

In this context, the Ministers should be aware that one of the major microlenders, operating nationally, experiences audited average losses of approximately 10% of the capital exposed, in any one year. In addition, the Federation's 2006 Industry Analysis Survey, Part 2, of 32 lending companies, representing 73 outlets and lending offices across Australia indicated that, on average, 6.9% of all loans became bad debts.

To provide a statutory window of further opportunity to increase these losses, would substantially threaten all these business's viability.

2. These sections, in providing for the court to consider standards of commercial practice generally and the annual percentage rate, or rates, payable under comparable credit contracts, allows for highly subjective interpretation. This is because it implies that there are benchmark standards of commercial practice available generally. Different industries, and different parts of an industry, have different practices.

The relevant consideration is to look at industry practices within the microlending sector of the finance industry.

### **Specific Considerations**

1. It is noted that, in regard to any changes to the interest rate calculation or application under a credit contract, such change will be assessed [s72(2)] as unreasonable by reference to:

- (a) Any advertised rate or representation made by the credit provider before, or at the time, credit was entered into.

The Federation supports this provision;

- (b) Any other consideration the court thinks relevant.

The Federation cannot support this provision, because it provides the opportunity for the Court to choose the criteria to be considered. This puts the lender at a huge disadvantage, because the lender cannot be sure of the criteria that will be applied and cannot adopt an appropriate compliance strategy to avoid prosecution;

- (c) If the change discriminates unjustifiably against the debtor, compared to other debtors.

The Federation supports this provision, provided it is clarified, so that the comparison is made with "*other debtors*" of the same lender.

2. It is noted that s72(3) provides for the Court to be able to assess whether an establishment fee is unreasonable, applying the criteria - if the amount is more than the credit provider's reasonable costs. The Federation is concerned that such a restriction fails to recognise that:

- (a) it may be appropriate for the credit provider to include some portion for profit, in addition to recovery of reasonable costs;
- (b) included in an establishment fee may be a portion to cover, not only the costs associated with that particular loan's establishment, but also to cover the costs associated with other loans that did not proceed.

In the latter circumstances, the lender may have expended exactly the same resources with loans that did not proceed, as he or she has done with the loan that did proceed and that is under consideration by the Court.

The Federation emphasises that this cost recovery dynamic is a profound one. If the Ministers want lenders to take a responsible attitude to lending and, concurrently, obey the Code's requirement of due care and diligence in lending practices, the Ministers cannot introduce legislation which makes such compliance economically impossible.

The Federation's 2006 Industry Analysis Survey, Part 1, discovered that its members reject from 10-90% of all applications for loans and the average for all companies was 46.58%, with 70.77% of all outlets rejecting 50% or more of total loan applications.

3. It is noted that s72(4), provides for a charge for early termination to be assessed as unreasonable, if the charge is more than a reasonable estimate of the credit provider's loss arising from the early termination.

The concerns here mirror those listed above, for s72(3) and also include a concern as to the interpretation of "loss". In particular, whether such should reflect opportunity costs.

4. It is noted that s72(6) provides for any other fee or charge, again, to be assessed as unreasonable, if it is more than the credit provider's reasonable underlying costs or losses that give rise to the fee. The Federation notes that this provision attracts similar concerns to those outlined for s72(3) and s72(4) above.

5. The Federation notes that s72(7) again provides substantial opportunity for highly subjective assessment.

6. The Federation notes s72(8), which provides an opportunity for a Court to compare the various costs of the credit contract under review, with those costs “*under comparable credit contracts*”.

The Federation accepts this as a reasonable provision, but recognises that the term “*comparable*” must mean comparison with other microlenders’ contracts of similar amount, term and involving borrowers with similar risk profiles, from the same socio-economic and geographic area.

Given the above difficulties, the Federation believes that this element of the proposals is inappropriate and judicially dangerous.

**Recommendation:**

In view of the new Office of Fair Trading powers, incorporated in the proposed s72A and the difficulties of introducing an “*unreasonable*” test, it is recommended that the proposed s72 not be proceeded with.

## NEW OFFICE OF FAIR TRADING POWERS

Section 72A -

- a) Power to make application to the Court in the public interest.
- b) Power to represent one or more credit contractors, or all or any class of credit contractors, in Court proceedings.

The Federation welcomes the increase in Office of Fair Trading powers, to provide a necessary complement to the current regulatory regime.

It is recognised that there is asymmetry in the power of the individual borrower and the power of the larger lenders. An attempt to place this relationship on a more equitable footing is equitable, understandable and welcomed.

The Federation has no interest in protecting unscrupulous lenders and accepts the need for a wide opportunity for self-initiated action by the Office of Fair Trading (or equivalent Government Agency in other states and territories).

The proposed s72A will allow the Office to be able to act in the public interest whether it is a group of borrowers, or an individual borrower, that has been disadvantaged.

However, to introduce the proposed s72, as discussed above, as well as s72A, would introduce the potential for great injustice and tip the balance of power too far in the opposite direction.

### **Recommendation:**

That the proposed s72A be adopted, providing the proposed s72 is not proceeded with.

## THE ISSUE OF RETROSPECTIVE POWERS

A request that such be included in Division 3, Transitional provision for Consumer Credit Code Amendment Act 2007.

There are at least two issues of concern to the Federation in this regard and the proposed (earlier) s70 is of no assistance. The first issue has been contemplated in the proposals, the second has not.

1. In the proposed Section 187, the problem of where a Court case is undecided, or an application has been made to a Court, but no final judgement has been reached before the new legislation comes into force, is addressed.

The Federation appreciates that s187 provides that the court would proceed as if the new legislation had not been enacted.

2. The situation where a contract has been entered into under the old legislation and continues for a period, after the new legislation comes into force, has not been recognised. This could leave the door open to an unconscionable retrospective impost. It cannot be appropriate to require lenders to conduct their businesses, not only according to the law in force at the time, but according to their best guess at what might be included in future regulatory amendment.

In other words, a lender enters into a contract legally but, because of a change in the law, commits an offence (say) halfway through the term of the loan.

3. Such a retrospective impost is particularly onerous, given the Consumer Credit Code restrictions on the lender unilaterally changing the contract during its term. A situation could emerge where a borrower refuses to agree to changing a pre-existing contract, thereby forcing the lender into a breach of the subsequently introduced law, enabling the borrower to avoid their obligations under the credit contract.
4. It is noted that s70, in providing an opportunity for the Court to reopen a contract, has an unjust potency, if retrospectivity is allowed.
5. Finally, if lenders face the threat of retrospective implementation of the proposals, they will be faced with a legally and practically impossible task. The task will require the revision of all existing loans and restructuring of the interrelated complex matrix that was applied to determine the previous interest rate, fees and charges. Such a task would force many lenders into insolvency, despite the fact that they had been totally law abiding when structuring the original loan arrangements.

### **Recommendation:**

That s187 include a new subsection (3), to provide for a continuation of the old provisions, where a contract term spans the date of the enactment of the proposals.

## CONCLUSION

The National Council of the National Financial Services Federation thanks the Ministerial Council for the opportunity to comment on the various proposals and hopes that the suggestions included in this Comment paper are of value to their considerations.