Joint Submission from the Financial Counselling Sector

The Treasury

Draft Legislation - Consumer Credit Reforms

November 2020

Financial counsellors strongly oppose the Government's proposals to wind back Australia's responsible lending laws. The draft legislation is fundamentally flawed and not capable of amendment to address our concerns.

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About Financial Counselling and the Financial Counselling Sector

Financial counsellors provide advice and support to people with money and debt issues. Working in community organisations, their services are free, confidential and independent.

This is a joint submission from the peak bodies in the financial counselling sector.

- Financial Counselling Australia
- Financial Counsellors ACT
- Financial Counsellors Association of NSW
- Financial Counsellors Association of Queensland
- Financial Counsellors Association of Tasmania
- Financial Counsellors Association of Western Australia
- Financial Counselling Victoria
- South Australian Financial Counsellors Association (also covering the NT)

There are around 950 financial counsellors in Australia.

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1 Context in which these reforms are being made

Financial counsellors work in not-for-profit community organisations. Each year our sector provides advice and support to around 125,000 Australians experiencing various degrees of financial hardship. This means we see at first hand the impact excessive debt has on people and it is this experience that frames this submission.

In this section of the submission, we make some overarching comments about the context in which these regulatory changes are being made. Section 2 of the submission considers the responsible lending reforms. Section 3 of the submission has brief remarks about the proposed reforms to small amount credit contracts and consumer leases.

1.1 Despite the RLOs, irresponsible lending still occurs

Despite the current responsible lending laws, financial counsellors still see too many people where the original lending was irresponsible. The fact that financial counsellors continue to see so many clients with unaffordable debt is the reason the sector is so concerned about the removal of the responsible lending laws. If these laws are repealed, which provide at least some avenue for redress, there is little doubt that more and more people will get in over their heads because of excessive debt.

People want to repay their debts so when they find themselves struggling with an unmanageable level it causes significant stress and anxiety. They will cut down on food, medications and other expenses for example and do what they can to try and make ends meet, often at the expense of their health and relationships. Some people become homeless. But none of that would have happened if loans had been lent in a responsible way in the first place.

1.2 Consumer credit is a special product

While many consumer transactions are straightforward purchases, consumer credit is a complex product and can be dangerous if not used safely.

Credit cards are a good example. While they are a widely accepted product and have been a feature of the Australian marketplace for many years, they can be hard to manage. Many small transactions can quickly accumulate into one large debt at the end of the month. And the payment on that amount may not coincide with a person's income cycle.

Credit card debt is the single most common debt for financial counselling clients. This is consistent with research from ASIC in 2018 showing that around one in six people were struggling with problem credit card debt.[1]

[1] See https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-201mr-asic-s-review-of-credit-cards-reveals-more-than-one-in-six-consumers-struggling-with-credit-card-debt/

Credit cards come with different terms and conditions, different fees and charges, different interest rates and can be marketed with the lure of balance transfers and bundled with reward schemes. It is not surprising that people do not always choose the best credit card for their needs. Research from consumer advocacy group CHOICE found that people chose credit cards based on attributes such as reward schemes, when in reality, for their usage, a lower rate card would be a better option. Similarly, a Reserve Bank Discussion Paper estimated that about 30% of people experienced a net loss with the product.[2]

Importantly, when a person makes a mistake in purchasing a credit product, such as a credit card, personal loan or home loan, the consequences are dire. When people struggle to repay they need to cut back somewhere else, and begin juggling expenses. Some people take on more debt, such as a payday loan, to try and make ends meet. Being unable to pay means that calls from debt collectors start, and a default is usually listed on a person's credit report. Some people lose their assets, such as a car or home. Others may end up bankrupt.

Because credit is a complex product that poses risks for people and potentially significant harm, there is a clear need for strong consumer protections in the way it is marketed and sold. Responsible lending obligations are a crucial component of a consumer protection framework.

1.3 Regulate for the real world

Regulation needs to be grounded in the real world and based on how real people behave. People are not walking abacuses, minutely tracking income and expenditure so that they have an accurate understanding of their current and future financial position. In reality, most people filling out loan applications do not have a clear idea of where exactly they spend their money. In fact, the bank where a person has their transaction account will often have a better insight into the spending behaviour of customers, because of computer systems that extract and aggregate data. Treasury will be well aware of this data analytics capability as the banks have been providing relevant data during the pandemic to Government to assist in understanding what is happening in the economy.

It is also relevant to note that as humans we tend to be overly optimistic about the future, for example, about our ability to cut back on expenditure. Behavioural economists call this optimism bias.

The wind back of the responsible lending laws however is partly based on the heroic and unrealistic assumption that people are rational and consistent, clearly understand their financial position and are clear-eyed about the future. This is not how real people behave, particularly under pressure for example, when considering purchasing credit sitting in the office of a car dealer or in a consumer goods store.

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[2] Mary-Alice Doyle, Consumer Credit Card Choice:Costs, Benefits and Behavioural Biases Research Discussion Paper 2018-11, https://www.rba.gov.au/publications/rdp/2018/pdf/rdp2018-11.pdf

When a bank in particular approves a person for a loan, be it a credit card, personal or home loan, individuals take that as a signal that the bank believes they can comfortably afford the lending. People do not understand that the assessment made by a lender may be based on lending as much as possible, rather than making a loan that a person can comfortably repay. What should happen however, is that a loan application is as an opportunity for a lender and a potential borrower to come to agreed view about an individual's financial capacity to repay. It should not be a one-sided transaction, with all of the downside risk left to the customer – but this will be the effective outcome of the proposed credit reforms.

1.4 It is easy for lenders to take advantage of people who are vulnerable

Following on from the points above about the complexity of a consumer credit transaction and the need to regulate for the real world, it is still far too common, and far too easy, for lenders to take advantage of people who are vulnerable by loading them up with as much debt as possible.

People can be vulnerable for many reasons, including mental health issues, low financial literacy, gambling addictions, or because they are affected by family violence.[3] The key point however is that there are large numbers of people in our community who have vulnerabilities that leave them open to exploitation when it comes to lending.

Financial counsellors assist many people in vulnerable circumstances. If the responsible lending laws are removed it will be even easier for lenders to over-lend and to exploit a person's vulnerability. We are extremely concerned about the way in which people who are vulnerable will be at huge risk of being sold excessive debt in the absence of responsible lending.

1.5 Growing debt levels is a recipe for economic disaster

Excessive debt is already a problem in Australia, with around 2.2 million people living in households of high financial stress. Australia has the second highest level of household debt to income in the world.[4] The most recent data from the Australian Bureau of Statistics shows that nearly one in three housholdes are overindebted when comparing total debt to total income.[5]

The latest figures show that 7% of Austalians are unemployed (960,900 people)[6], even larger numbers are under-employed and Australia is going through one of the most difficult

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[3] The interaction of family violence and the responsible lending laws are canvassed in more depth in the submission from a number of specialist family violence agencies working.

[4] See AAP Fact Check - https://factcheck.aap.com.au/claims/is-australias-household-debt-the-second-highest-in-the-world

[5] See https://www.abs.gov.au/statistics/economy/finance/household-income-and-wealth-australia/latest-release#articles

[6] https://www.abs.gov.au/statistics/labour/employment-and-unemployment/labour-force-australia/latest-release

economic times in its history. Loading people up with more debt is a recipe for economic disaster. In fact, research from the International Monetary Fund confirms that high levels of household debt holds the economy back.[7]

1.6 Lenders will lend the maximum amount possible – this is different to what is affordable

One of the reasons some people argue there is no need for responsible lending laws is that it is not in a lender's interest to lend money that will not be repaid. This is a simplistic position and misunderstands the incentives driving lending behaviour.

The interests of lenders and borrowers are not always aligned. A profit maximising lender wants to lend as much money as possible, within their risk appetite. It is true that they do not want too many borrowers to default, but there is significant profit to be made in pushing borrowers to the edge. This means loading people up with as much debt as possible – not so much that they default, but the lending may nevertheless place people into some degree of financial hardship.

A good example of this is the way lenders were assessing the ability of people to afford a credit card, based on whether they could make the minimum repayments of two or three per cent of the limit. This clearly maximises profits for lenders, increasing the amount borrowed. Eventually the legislature had to step in, passing an amendment to the credit laws requiring lenders to assess credit card limits on whether a person could repay the whole of the limit within three years. Ironically, this provision is one that will be removed under the proposed reforms for Authorised Deposit Taking Institutions (ADIs), as it is tied to the responsible lending obligations. A further example was the explosion in interest only lending on investment and home loans, with 50% of new loans in 2017 in that category. APRA had to step in, limiting bank loan portfolios for interest only lending to a maximum of 30%.[8]

It is also worth noting that staff in banks and other lenders are subject to the same human weaknesses and frailities as the rest of us, and that commission-based selling of debt has not disappeared. People receiving short-term bonuses for increasing loan volumes, or even just knowing that this is what their promotion depends upon, will be strongly motivated to load people up with debt. Financial counsellors frequently see this in point of sale lending at consumer goods stores, where salespeople frequently talk vulnerable people into taking out credit cards with higher limits than they orginally requested.

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[7] See https://www.imf.org/en/Publications/GFSR/Issues/2017/09/27/global-financial-stability-report-october-2017

[8] This was removed at the end of December 2018. See https://www.apra.gov.au/news-and-publications/apra-to-remove-interest-only-benchmark-for-residential-mortgage-lending

1.7 These changes fly in the face of the Financial Services Royal Commission

In the final report of the Financial Services Royal Commission, Commissoner Hayne wrote in relation to the responsible lending laws:

> My conclusions about issues relating to the NCCP Act can be summed up as 'apply the law as it stands'.

At the time of the FSRC, the procedings in the case bought by ASIC against Westpac alleging irresponsible lending were still before the court. Commissioner Hayne's view was that if this case:

> "were to reveal some deficiency in the law to make reasonable inquiries about, and *verify*, the consumer's financial siutation, amending legislation to fill in that gap should be enacted as soon as reasonably practical." (emphasis in the original)

It is not possible to read Commissioner Hayne's comments as anything other than supporting the continuation of the responsible lending obligations. It is disappointing that the Government is proposing to do the exact opposite.

2 Specific Problems with the Proposed Reforms

This section of our submission highlights a number of problems with the proposed changes. The comments are at a principle level rather than addressing specific sections of either the bill, draft regulations or draft standards.

Our associations also endorse the joint consumer group submission coordinated by the Consumer Action Law Centre which does go into more detail about some of the issues with the proposed changes.

2.1 Removing individual rights

The responsible lending laws in the National Consumer Credit Protection Act provide individuals with rights to challenge irresponsible lending in one of two ways: through a court, or through free, independent dispute resolution provided by the Australian Financial Complaints Authority (AFCA).

The ability of a person to access both of these avenues is severely curtailed under the proposed reforms. In relation to access to justice through the courts, borrowers will not be able to rely on the specific obligations set out in the responsible lending laws. The only potential causes of action will rest on unjustness or unconscionability, remedies which are more complex to argue and only available to people with either significant resources or able to access extensive free legal assistance. In a practical sense, court action will effectively be closed as an option for consumers.

In relation to AFCA, it is difficult to see how AFCA will be able to resolve disputes where a person believes the original lending was not responsible. This is because they will not have the same yardstick of responsible lending against which they can make that assessment. We also note that the Banking Code of Practice does not include specific obligations in relation to responsible lending as it is predicated on the existence of these laws. The only "hook" for AFCA in resolving disputes will be to rely on the broad requirement for banks to lend with the skill of a prudent and diligent banker.

The law around responsible lending will be removed altogether for authorised deposit-taking entities (largely banks), leaving standards set out by the Australian Prudential Regulation Authority (APRA) as the only relevant lending laws. These standards apply at a loan portfolio level, rather than providing rights to individual borrowers. Similar standards would be introduced for other lenders, but which also only focus on big picture obligations to put in place systems, policies and processes. Failures would need to be systemic – individual failures would not sustain a penalty or a court case and AFCA and consumers will not know how the systems, policies and processes operate in practice.

The removal of individual rights to redress will make the jobs of financial counsellors much harder. The excerpt on the next page is from a recent opinion piece from the Reverend Chris Jones, the CEO of Anglicare Tasmania and is an example of how responsible lending laws protect people by providing them with rights.

Not only do these laws help to protect people, our financial counsellors use them to find a way forward for people who were still loaned money they are unable to repay. For example, our counsellors have provided support to an elderly Tasmanian with a serious mental illness who, confused and frightened by a scammer's demands, was given a large personal loan and significantly increased limit on a credit card. An appropriate assessment by the lender would have shown she did not have the capacity to repay these debts.[9]

2.2 Limited assessment and verification, requirements and objectives

The removal of responsible lending obligations will also reduce obligations on lenders to verify income and expenditure or consider the requirements and objectives of borrowers. The proposed regime appears designed to place most of the onus on borrowers, as well as allowing lenders to use automated systems to estimate expenses. The Financial Services Royal Commission pointed out the problems with the use of benchmarks, with lenders for example, choosing benchmark levels set at the 25th percentile of discretionary spending. Obviously 75 per cent of people will have a higher level of expenditure.

We outlined in Section 1, how many people are not good at estimating what they can afford to repay, that credit is a complex product and that large numbers of people are in vulnerable circumstances, leaving them at risk of exploitation.

Together these changes will mean that lenders will focus their assessment of a borrower on the risk of default, rather than whether the loan is affordable.

2.3 A reduction in penalties

As noted above, individuals will have fewer rights and this in turn reduces the incentives for lenders to lend responsibly. To make matters worse, the proposed changes to the credit laws actually reduce the penalty regime.

For example, non-ADI lenders will only breach a civil penalty provision where they either:

- have not established, maintained or documented the systems, policies and processes required by the Draft Standards at all;[10] or
- repeatedly fail to implement those systems, policies and processes.[11]

This is a ridiculously low standard.

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[9] The Mercury, November 18, 2020, https://www.themercury.com.au/news/opinion/talking-point-stripping-away-responsible-lending-laws-will-hit-battlers/news-story/e556c8a0ecf11d42c23f21cef76b70d7

[10] Draft Bill, s 133EB.

[11] Draft Bill, s 133EC.

2.4 Dismantling the twin peak model, APRA's role

The proposal dismantles Australia's twin peak model of regulation that has served us well since recommended by the Wallis Inquiry in 1996. Indeed, this model, which separates prudential regulation from conduct regulation, has been picked up by a number of other jurisdictions, including the UK, as it represents best practice.[12]

APRA's focus is on system stability, soundness and the protection of depositers. It is not on consumer protection. For example, APRA's current guidance on mortgage lending refers to how a bank needs to take into account the credit card liabilities of potential borrowers.[13] But in doing this, the guidance suggests that assuming a potential borrower is repaying just 3 per cent of the card limit is appropriate.

APRA's enforcement activity in the past has effectively occurred behind closed doors and will not focus on breaches by lenders where individuals are harmed, unless there are system-wide failures. As noted earlier, consumers and advocacy groups will not know what those systems are. APRA's enforcement review has yet to be finalised and there is no adequate civil penalty regime.

It is also hard to see how this proposal simplifies the regulatory architecture as APRA will now be the conduct and prudential regulator for ADIs, but ASIC will be the regulator for non-ADIs. ASIC will be the regulator for both ADIs and non-ADIs in relation to the product intervention powers and design and distribution obligations. There will also be different obligations between ADIs and non-ADIs in relation to credit cards. We are very concerned about a return to excessive credit card limits as a result. If APRA through their supervision of ADIs observes problematic lender behaviour, in the past they might refer this to ASIC. It is less clear what will happen now. Referring to AFCA for example is unlikely to be much of an option as it not clear what they can do either.

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[12] https://www.lowyinstitute.org/the-interpreter/financial-regulation-australias-twin-peaks-model-successful-export

[13] APS Residential Mortgage Lending 223, February 2017.

3 SACCs and Consumer Leases

The Government's proposals also introduce reforms affecting small amount credit contracts and consumer leases. These proposals are significantly watered down in comparison to the those orginally flagged by the Government in 2017.

The 2017 reforms limited repayments on consumer leases and payday loans to 10% of income for each product for all borrowers, for a maximum of 20%. The current proposal increases this so that people who are employed will be able to spend up to 40% of their income on consumer leases and payday loans. The whole point of regulation of payday loans and consumer leases is to stop people being trapped in a cycle of debt. This is what is happening now and these current proposals will do nothing to stop that.

Even worse, the changes proposed by the Government introduce a one-off establishment fee of 20% of the base price for a consumer lease.

We can provide case study after case study of detriment in both of these markets. The financial counselling sector does not support these changes.