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ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

Submission on the Interim Report – Rounds 1 to 4

INTRODUCTION

1. This written submission is provided by Consumer Action Law Centre (**Consumer Action**).

2. Consumer Action works to advance fairness in consumer markets, particularly for disadvantaged and vulnerable people, through financial counselling, legal advice and representation, policy work and campaigns and training and outreach.

3. In the last financial year, Consumer Action provided financial counselling assistance to 11,177 people and 4,617 instances of legal assistance. Consumer Action's legal practice represented 132 clients in disputes with traders, including through courts, tribunals and external dispute resolution (**EDR**) schemes. Of those represented, 86% were experiencing financial disadvantage. Consumer Action also supported community workers to assist their clients on 1,030 occasions and made over 87 submissions to various inquiries and consultations. Five of Consumer Action's clients have given oral evidence before the Commission on consumer lending and insurance matters.

4. Our response to the Interim Report is based on Consumer Action's extensive experience supporting Victorians with banking, consumer credit, insurance, debt collection and debt management disputes. Misconduct in these industries affects everyone but has a disproportionate impact on the lives of low income, vulnerable and disadvantaged Australians, whose voices are often not heard.

5. The case studies examined by the Commission are representative of the systemic issues in our banking and finance sector, and not just that of a 'few bad apples'.[1] Consumer Action's lawyers and financial counsellors hear from people in distress every day who are the victims of irresponsible lending and mis-selling of financial products. We agree with the Commissioner's conclusion that much of this misconduct has been driven by a culture of greed and the pursuit of profit over people, a culture which has been allowed to thrive because of inadequate laws and policies, delays in reform, conflicts of interest, insufficient resourcing and powers for regulators, and a lack of access to justice for consumers.

6. Law and policy reform intended to address the long-standing issues exposed by the Commission has been lacklustre. Due largely in part to concerted lobbying efforts by industry, successive governments have failed to better protect consumers and to give regulators the resources and remit needed to

[1] Interim Report, Vol 1, 87.

ensure compliance. Furthermore, limited government funding for tailored legal and financial counselling assistance for those hit hardest by misconduct and conduct falling below community standards has meant demand consistently outstrips capacity, and many victims are denied access to justice.

7. The Interim Report has confirmed that industry self-regulation has failed. To the extent that simplification of our legal framework is to be considered, it should only be considered through the lens of enhanced consumer protection. Too often in the past simplification has been pursued to 'cut red tape' for business, and has resulted in financial risk being shifted away from business onto everyday Australians who are least able to bear that risk. As noted by the Commissioner, 'Although regulatory complexity imposes burdens on business, the largest entities are very sophisticated and well-resourced. They are well able to find out what the law requires of them.'[2] The focus should therefore be on improving consumer outcomes, and regulatory settings that will help to achieve this.

8. As noted by the Commission, 'treating consumers fairly and honestly has important economic consequences.'[3] During the course of the hearings which exposed systemic misconduct and conduct falling below community standards, financial service providers made hasty operational decisions and promised to do better. It is hoped that industry upholds these promises and is doing so in recognition of the fact that competition, consumer choice and access to financial and credit services are enhanced by stamping out misconduct and conduct that harms consumers.

9. Further, when considering reform, we must not forget the ultimate social purpose of banking and finance. If industry is serious about restoring trust and confidence in the sector, industry needs to accept that short-term profit-seeking should not be at the expense of the financial wellbeing of Australians. To meaningfully support law and policy reform, industry must fully remediate customers who have suffered loss as a result of misconduct and engage in sustained operational change to avoid perpetuating the issues exposed by the Commission.

10. This submission responds to policy issues raised in rounds 1, 3 and 4 relating to consumer lending, small and medium enterprise lending and issues impacting remote and regional communities.

ISSUES

Access

11. This section responds to questions from Round 4 on issues affecting regional and remote communities, including basic bank accounts, informal overdrafts and dishonor fees, and comments on funding for legal and financial counselling assistance.

Do all Australians have adequate and appropriate access to banking services?

12. We consider that not all Australians have adequate and appropriate access to banking services. While the Commission has accepted evidence that a lack of access in itself is closely linked with financial exclusion, mere 'access' does not necessarily mean 'adequate' or 'appropriate' access.

[2] Interim Report, Vol 1, 295.
[3] Interim Report, Vol 1, 21.

13. Consumer Action's casework experience indicates that the mis-selling of high-cost and low-value products, such as funeral insurance, add-on insurance and credit cards, exacerbates financial exclusion. 'Access' is therefore meaningless where the product does not protect the consumer when needed or work as they expect. Consumer 'needs' have too often been influenced by sales targets. As noted in the Interim Report:

> *The customer's 'needs' are formed by reference to what the entity has to sell. And often it is the entity's representative that tells the customer what he or she 'needs'. That is why the banks have rewarded and continue to reward staff and intermediaries for 'cross-selling' products.*[4]

14. For example, Consumer Action has made extensive submissions to the Commission in relation to the unsuitability of add-on insurance.[5] This product, sold with cars, loans and credit cards, is often high cost and low-value and therefore unsuitable for many consumers as evidenced by:

- Low claims ratios, for example, 5% for consumer credit insurance (**CCI**) sold in motor dealerships.
- Products sold with little or no value, for example, guaranteed asset protection (**GAP**) insurance sold where there is little or no gap to cover and CCI where the customer is unemployed; and
- CCI which duplicates cover which a customer already has under life insurance, including in superannuation.

15. Furthermore, these products are typically sold using pressure-selling tactics, when the customer is focused on another primary purchase. In motor dealerships in particular, the products are primarily sold to generate income for the seller—they are not designed to meet consumer need or demand. Given the widespread mis-selling of unsuitable financial products and services, and research indicating significant levels of financial exclusion in Australia, we do not consider that all Australians have adequate and appropriate access to banking services.[6]

Do financial services entities have in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander peoples?

16. As outlined in Consumer Action's Round 4 policy submission,[7] we do not consider that banks have in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander peoples to overcome obstacles associated with remoteness, cultural barriers, linguistic barriers and financial literacy. While we acknowledge that the Aboriginal and Torres Strait Islander communities are as diverse as the broader Australian population, Aboriginal and Torres Strait Islander peoples are among the most

[4] Interim Report, Vol 1, 64.
[5] Consumer Action Law Centre, *Submission on Round 6 Hearings - Insurance*, 25 October 2018.
[6] The Centre for Social Impact (CIS) defines financial exclusion as where individuals lack access to appropriate and affordable financial services and products, and in 2014 found that 16.9% of adult Australians were either fully or severely excluded from financial services (*Measuring Financial Exclusion in Australia* (April 2014), <https://www.nab.com.au/content/dam/nabrwd/documents/reports/financial/2014-measuring-financial-exclusion-in-australia.pdf>).
[7] Consumer Action Law Centre, *Submission on Round 4 Hearings*, 16 July 2018, <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/07/180716-ConsumerAction-Submissions-Policy-Round4.pdf>.

financially excluded in the country.[8] Research has consistently provided that these communities have difficulties accessing bank accounts, particularly due to identification issues.[9]

17. Aboriginal and Torres Strait Islander communities are also more likely to be excluded as banks continue their rapid shift towards digital banking. The National Aboriginal and Torres Strait Islander Social Survey shows that while 85.7% of Aboriginal people living in urban and regional areas have accessed the internet in the last 12 months, only 53.1% of those living in remote and very remote areas have done so.[10]

18. In developing approaches to overcome these barriers, it is critical for policymakers to engage with Aboriginal communities and community organisations to identify issues relating to banking services, with recognition that community organisations need to be adequately resourced to engage in these consultations. These engagements should be led by communities and in partnership with community organisations. It is imperative that culturally appropriate methodologies are used to gather information locally within each of these communities. Time should be taken to ensure that any consultation is meaningful and respectful. Consultations should follow best practice guidelines to ensure that participation is ethical and appropriate.[11] The need to develop tailored and local responses was also reflected in the Code Compliance Monitoring Committee's (**CCMC**) report *Access to Banking Services by Indigenous Customers*, which said that 'one size does not fit all' and noted the different approaches by banks 'reflects the diversity of both Indigenous communities as well as the challenges different communities and service providers face.'[12]

19. Some steps that banks can take to provide more culturally appropriate and sensitive banking services were identified by Lynda Edwards of Financial Counselling Australia who gave evidence in the Commission's Round 4 hearings.[13] The CCMC's report also provided several examples of best practice in relation to financial inclusion, financial literacy and cultural awareness.[14] Reconciliation Australia has also suggested a number of options for improving financial literacy and access to financial products and services for Aboriginal people in its 2007 report *Banking for the Future*.[15] The Australian Securities and Investment's (**ASIC**) Indigenous Outreach Program has also done significant work in this area.[16] We refer to and repeat our submissions in relation to identification requirements.[17]

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[8] Exhibit 4.138, Witness Statement of Nathan Boyle, 25 June 2018, [25]–[26]; In 2012, CIS found that among survey respondents who identified as Aboriginal, 43.1% were either severely or fully excluded compared to the 2012 national average of 17.2%.
[9] CIS, *Measuring Financial Exclusion in Australia* (May 2012), 27 <https://www.nab.com.au/content/dam/nabrwd/documents/reports/financial/2012-measuring-financial-exclusion-in-australia.pdf>; Department of Prime Minister & Cabinet, *FSRC Background Paper No. 21: Aboriginal and Torres Strait Islander Consumers' Interactions with Financial Services*, 3; Reconciliation Australia, *Banking in the Future: National Indigenous Money Management Agenda* (November 2007), 32 <http://www.fnf.org.au/uploads/6/3/1/1/6311851/banking_for_the_future.pdf>.
[10] Prof. Julian Thomas, et. al., *Measuring Australia's Digital Divide: The Australian Digital Inclusion Index 2017* (2017), 16 <https://digitalinclusionindex.org.au/wp-content/uploads/2016/08/Australian-Digital-Inclusion-Index-2017.pdf>.
[11] For example, see: <https://aiatsis.gov.au/sites/default/files/docs/research-and-guides/ethics/gerais.pdf>.
[12] Banking Code Compliance Monitoring Committee, *Special Report: Access to Banking Services by Indigenous Customers* (July 2017), 5 <http://www.ccmc.org.au/2017/07/26/ccmc-special-report-access-to-banking-services-by-indigenous-customers/>.
[13] Exhibit 4.140, Witness Statement of Lynda Edwards, 22 June 2018, [73].
[14] Banking Code Compliance Monitoring Committee, *Special Report: Access to Banking Services by Indigenous Customers* (July 2017) <http://www.ccmc.org.au/2017/07/26/ccmc-special-report-access-to-banking-services-by-indigenous-customers/>.
[15] Reconciliation Australia, 32.
[16] Exhibit 4.138, Witness Statement of Nathan Boyle, 25 June 2018
[17] Consumer Action Law Centre, *Submission on Round 4 Hearings – Policy*, [60]–[64].

Recommendation 1
Policymakers should engage with Aboriginal communities and community organisations to identify issues relating to banking and financial services. These engagements should be led by community and in partnership with community organisations. We reiterate our recommendations for reform in our Round 4 policy submission.[18]

Basic bank accounts

20. Banking is an essential service and should be so treated. Further, the potentially disastrous financial impact of banking fees and charges, particularly for low income people, mean that access to and awareness of basic bank accounts is enormously important. The Australian Banking Association's (**ABA**) Affordable Banking website lists 11 banks, including the big four, which offer a transaction account that is fee-free to eligible customers. These accounts are known as 'basic bank accounts'.

21. Evidence adduced before the Commission indicates that at least some banks are not taking sufficient steps to promote the availability of fee-free accounts to eligible customers, including Aboriginal and Torres Strait Islander customers. Further, family support worker Thy Do's evidence in Round 4 suggested that ANZ may have actively put barriers in place to her client opening a basic bank account and instead opened a different account that was inappropriate.[19]

22. The lack of awareness about basic bank accounts was raised by consumer advocates during the Code of Banking Practice Review (**the Code Review**) in 2016, noting that 'despite the efforts of the ABA and individual banks, many eligible consumers have no idea about the existence of basic bank accounts.'[20] The CCMC also found in July 2017 that 'banks could do more to promote their basic bank accounts'. In a review of the major banks' websites, the CCMC conduct keyword searches for 'basic bank account' and 'Indigenous', neither of which produced results showing the banks' basic account offerings.[21]

23. It appears that banks could easily identify customers eligible for basic bank accounts through account indicators or when setting up a bank account. The Code Review agreed in part, stating that 'ideally signatory banks would have systems and processes whereby they could scan for customers who are likely to be eligible for basic bank account, and proactively offer that option.'[22] ANZ, in its Round 4 Submission, acknowledged that it can identify whether a customer receives unemployment benefits for the purposes of assessing whether it will provide an informal overdraft.[23] There is no clear reason why

[18] Consumer Action Law Centre, *Submission on Round 4 Hearings – Policy*.
[19] Transcript, Senior Counsel Assisting, 6 July 2018, 4146.
[20] Joint Consumer Representative Submission to the Australian Bankers' Association Inc., *Independent Review of the Code of Banking Practice 2016* (September 2016), 29 <http://consumersfederation.org.au/wp-content/uploads/2016/09/160916_ABACodeReview_Submission_FINAL.pdf>; see also, Reconciliation Australia, *Banking in the Future: National Indigenous Money Management Agenda* (November 2007), 34: 'relatively few NIMMA [National Indigenous Money Management Agenda] community consultation participants are aware of the basic bank accounts… In addition, some participants who were aware financial institutions offered a basic bank account or a low fee transaction account have limited branch access thus rely on alternative access points, such as a third party ATM, limiting the benefit of these accounts.' <http://www.fnf.org.au/uploads/6/3/1/1/6311851/banking_for_the_future.pdf>.
[21] Reconciliation Australia, 10.
[22] Phil Khoury, *Independent Review Code of Banking Practice* (31 January 2017), 172 <http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/02/Report-of-the-Independent-Review-of-the-Code-of-Banking-Practice-2017.pdf>.
[23] ANZ, *Submission on Round 4 Hearings*, 16 July 2018, [97], < https://financialservices.royalcommission.gov.au/public-hearings/Documents/Round-4-written-submissions/ANZ-written-submission.pdf?>.

banks could not similarly identify income sources for the purposes of identifying eligibility for a basic bank account.

24. The revised Code of Banking Practice recently approved by ASIC committed to raising the awareness of basic accounts and training staff but did not commit to proactively identifying eligible customers and offering them a basic bank account. We consider this a missed opportunity to require a more proactive obligation. Further, the industry failed to adopt the Code Review's recommendation that banks only be permitted to avoid opening a basic bank account where opening the account would be unlawful or where the consumer's conduct amounts to an offence under legislation.[24] However, while the ABA said that it supported this recommendation 'in part' in response to the Code Review,[25] the obligation to open a basic account was not included in the revised Code.[26]

Recommendation 2
We recommend that banks be required to proactively offer basic bank accounts to all eligible customers, both new and existing, and create accounts requested in a timely manner.

Informal overdrafts

25. We consider that informal overdrafts can cause significant harm to consumers regardless of whether their income is derived from Centrelink benefits. At the point of granting the informal overdraft, there is no assessment of suitability. While it appears that informal overdrafts are technically legal, we submit that they are not appropriate and do not meet community standards and expectations. We reiterate our Round 1 submissions regarding lack of appropriate suitability assessments for overdraft facilities, and the dangers of 'pre-approved' credit offers.[27]

Recommendation 3
Regardless of income source, we recommend that overdrafts:

- only be provided once a suitability assessment is completed in accordance with the requirements of the *National Consumer Credit Protection Act 2009* (**NCCP Act**) and ASIC's Regulatory Guide 209 (**ASIC RG209**); and
- only be offered in response to a proactive request by the consumer and subsequent assessment as 'suitable'.

Code of Operation

26. In our view, the 90% arrangements provided by the Code of Operation should be applied automatically. This reflects the current legal requirements on signatories to the Code of Banking Practice and Customer

[24] Khoury, 170.
[25] Australian Banking Association, *Response by Australian Bankers' Association to Review Final Recommendations* (28 March 2017), 27 <https://www.ausbanking.org.au/images/uploads/ArticleDocuments/113/Banking%20Industry%20response%20to%20Khoury%20Review.pdf>.
[26] Australian Banking Association, *Code of Banking Practice*, commences 1 July 2019 <https://www.ausbanking.org.au/images/uploads/Banking_Code_of_Practice_2019_web.pdf>.
[27] Consumer Action Law Centre, *Submission on Round 1 Hearings — Consumer Lending*, 3 April 2018, [7], <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/04/180403-Submission-on-Consumer-Lending-FINAL-1.pdf >.

Owned Banking Code of Practice. Signatories to the 2013 ABA Code of Banking Practice commit to complying with the applicable requirements of the Code of Operation.[28] The 2019 Code also requires signatories to comply with the Code of Operation, and to only choose debt collectors that agree to comply with the guidelines.[29] Both Codes are incorporated into the contract with the customer, making it a contractual commitment.[30] The Customer Owned Banking Code of Practice, published by Customer Owned Banking Association (**COBA**), includes a similar commitment.[31]

Recommendation 4
The 90% arrangements provided by the Code of Operation be applied automatically.

Dishonour fees

27. In our view, the proactive obligation to offer basic bank accounts to eligible customers would significantly reduce the harm caused by excessive dishonor fees as these are not incurred on basic accounts.

28. The Code Review also recommended that signatory banks be required to set default fees that are reasonable having regard to the bank's costs. The Code Review recommended a broad definition of default fees be included in the Code of Banking Practice. However, the banking industry did not accept this recommendation, which we consider was yet another missed opportunity. This recommendation would limit the detrimental financial impact of dishonor fees, while allowing banks to continue to recover their costs.

29. We also refer to the comment of French CJ in *Paciocco v ANZ Banking Group Ltd* on the inability of the law of contractual penalties to address credit card late payment fees (a fee that is very similar to dishonor fees): 'It may be that in this country statutory law reform offers more promise than debates about the true reading of English legal history'.[32]

30. As discussed below, there might also be circumstances where a debt waiver is appropriate.

Recommendation 5
Lenders be required to set default fees at reasonable levels having regard to the bank's costs.

Access to legal and financial counselling assistance

31. Misconduct in the banking and finance sector has resulted in significant demand for legal and financial counselling assistance. There is considerable unmet legal need, caused by misconduct, including irresponsible lending, unlawful debt collection, inappropriate financial advice and others. Banks and other financial service providers routinely refer customers in financial hardship to community-

[28] Australian Banking Association, *Code of Banking Practice* (2013) cl 19.1.
[29] Australian Banking Association, *Code of Banking Practice* (2019), ss. 181–2.
[30] Australian Banking Association, *Code of Banking Practice* (2013), cl12.3. See also *National Australia Bank v Rice* [2015] VSC 10; *Commonwealth Bank of Australia v Doggett* (2015) 47 VR 302; [2015] VSCA 351*; Commonwealth Bank of Australia v Wood* [2016] VSC 264.
[31] Customer Owned Banking Association, *Customer Owned Banking Code of Practice* (2018), cl 26.5.
[32] [2016] HCA 28, [10].

based services. Too often, without this assistance, the consumer will not have the means or the will to 'take on the battle.'[33]

32. We have reviewed and strongly support the submission made by Financial Counselling Australia and the National Association of Community Legal Centres that substantial additional investment in community services is required. We consider that improving access to justice is critical to addressing the 'striking asymmetry of power and information between bank and customer that favours the bank.'[34]

Recommendation 6
Increased investment in legal and financial counselling assistance and community services, as recommended in submissions to the Interim Report by Financial Counselling Australia and the National Association of Community Legal Centres.

Intermediaries

33. Consumer Action's responses to questions relating to intermediaries are limited to the three types we most commonly encounter in our casework: finance brokers (including mortgage brokers), introducers and point-of-sale sellers.

For whom do the different kinds of intermediary act?

34. In relation to brokers, in the consumer lending round the Commissioner asked 'who does the broker act for', 'who does the customer think the broker is acting for?' and 'who does the lender think the broker is acting for?'.[35] As set out in Consumer Action's initial submission,[36] the broking industry advertises itself as acting for the consumer to help them get the best deal. However, as highlighted by the Commissioner and the evidence adduced before the Commission, the roles and responsibilities of the range of intermediaries are complex.

35. The courts have traditionally approached this question as one of agency, which is a question of fact.[37] The Financial Ombudsman Service (**FOS**) has adopted a similar approach.[38] The cases relating to whether the knowledge of the broker should be ascribed to the credit provider are mixed, however more recently the courts have taken into account the level of control and direction exerted by the principal and agent.[39] Other relevant facts include whether the broker has had the sole interaction with

[33] Interim Report, Vol 1, 293.
[34] Interim Report, Vol 1, 269.
[35] Transcript, Commissioner Hayne, 23 March 2018, 982.
[36] Consumer Action Law Centre, *Submission on Behalf of Consumer Action Law Centre - Part 2*, 5 February 2018, 14, <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/02/180205-Consumer-Action-Sub-to-Royal-Commission-Part-2-FINAL.pdf>.
[37] *Perpetual Trustees Australia Limited v Schmidt & Anor* [2010] VSC 67; *Custom Credit Corporation Ltd v Lynch* [1993] 2 VR 469, 481.
[38] See Financial Ombudsman Service*, Determination 293257* (4 February 2015) <https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/293257.pdf>; and Financial Ombudsman Service, *Determination 287764* (22 August 2014) <https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/287764.pdf>, in which FOS held that the brokers were the agents of the Financial Services Provider.
[39] *Perpetual Trustees Australia Limited v Schmidt & Anor*; *Michalopoulos v Perpetual Trustees Victoria Ltd & Anor* [2010] NSWSC 1450.

the borrower, the arrangements between the bank and the broker and agreements between the borrower and the broker.[40]

36. We consider that the current approach for resolving this question in consumer lending disputes is inadequate and agree with the Commissioner that 'notions of 'agency' are apt to mislead.'[41] The 'intermediary is paid only by the lender' and 'in the eyes of at least some lenders, the broker's task is to sell that lender's products'.[42] Yet banks routinely claim that the broker is acting as the agent for the borrower and that the borrower should lodge a complaint against the broker for any incorrect assessment of expenses.[43] This is unreasonable given that, irrespective of whether the broker was the agent for the consumer or the bank, the bank must take reasonable steps to verify the consumer's financial situation.[44]

37. Consumers have a poor understanding of the role of brokers and generally lack awareness of any conflicting incentives, such as commissions, which may distort the broker's advice. The technical legal answer to the question 'for whom does the intermediary act?' does not address the most important question, which is 'who does the consumer believe the intermediary acts for?'. These difficulties are further compounded when the consumer making a complaint bears the burden of proving who the intermediary acted for.

38. Other intermediaries such as introducers and point-of-sale sellers of loans 'are entitled to, and do, act as agents for lenders without holding an Australian Credit Licence.'[45] However, similar confusions about the roles and responsibilities of these types of intermediaries can arise as with finance brokers.[46] However, these intermediaries owe even lesser duties to the consumer, as discussed below.

For whom should each kind of intermediary act?

39. Brokers should be presumed to act for the consumer and they should (as we argue below) have a duty to act in the best interests of their customer. However, this should not absolve lenders from responsibility for breaching their responsible lending obligations. Lenders have an obligation to assess the suitability of a loan and verify a consumer's financial situation—a duty that is not discharged by relying on the brokers' assessments.[47]

40. Other intermediaries, such as introducers and point-of-sale sellers, should be treated as the agent of the lender. These types of intermediaries do not represent that they find the best product, and often only sell one or perhaps two types of credit products.

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[40] Australian Banking Industry Ombudsman, *Ombudsman Bulletin 36* (2002), recently upheld as the current FOS approach in Financial Ombudsman Service *Determination 287764* (22 August 2014) <https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/287764.pdf>.
[41] Interim Report, Vol 1, 57.
[42] Interim Report, Vol 1, 56–8.
[43] Exhibit 1.86, Letter from ANZ to Consumer Action Law Centre dated 15 March 2018 re: Robert Regan.
[44] *National Consumer Credit Protection Act 2009* s 130.
[45] Interim Report, Vol 1, 63.
[46] Interim Report, Vol 1, 64.
[47] *National Consumer Credit Protection Act 2009* s 130.

41. Lenders should also share responsibility for misconduct where the lender is on notice about problematic intermediary conduct, for example, where the lender suspects a broker is submitting fraudulent documents.

Recommendation 7

- Brokers should be presumed to act for a consumer if they are to have a duty to act in their best interests.
- Other intermediaries who do not represent themselves as assisting consumers in the way brokers do should be treated as agents of the lenders.
- Lenders must be held responsible for breaches of their responsible lending obligations, even when provided information by an intermediary, and should share responsibility for intermediary misconduct where the lender is on notice about the conduct.

Duties owed to consumers

42. While brokers are required to comply with general conduct rules under Australian Consumer Law (for example, not to mislead or deceive), contract and equity laws, the primary obligations are under the NCCP Act. A broker 'owes the borrower no duty larger than not to negotiate an unsuitable loan'.[48] The duties owed by other intermediaries are even lesser, with point-of-sale sellers of loans and introducers not subject to the majority of the NCCP Act, with the exception of section 180A.

43. The current 'not unsuitable' standard in the NCCP Act for brokers does not appear to be in line with community expectations. The evidence adduced before the Commission has shown that consumers often expect that brokers, particularly mortgage brokers, are acting as trusted advisers and helping them to get the best deal. This perception is promoted by the industry itself. For example, the Mortgage and Finance Association of Australia website claims that 'A Finance Broker will consider loans from a range of lenders and find you a product that best suits your circumstances'[49] and that 'finance brokers often can offer you the best option—not only saving you money but time, energy, effort and stress.'[50] However, the reality is that mortgage brokers are not required by law to act in a borrower's best interests. This mismatch in expectations is arguably misleading and poses a risk of consumer harm.[51]

44. The mortgage broking industry has pushed back against introducing a 'best interests duty' and removing conflicted remuneration, arguing that any significant reform in this regard would hamper their role in bringing competition in the market.[52] However, the Productivity Commission Inquiry into Competition in the Australian Financial System refuted the industry's claims regarding its role in generating competition, finding that:

> *In home loan markets, the mortgage brokers who once revitalised price competition and revolutionised product delivery have become part of the banking establishment. Fees and trail commissions have no*

[48] Interim Report, Vol 1, 58.
[49] Mortgage and Finance Help, What is a broker? (2018) <https://www.mortgageandfinancehelp.com.au/what-is-a-broker/>.
[50] Mortgage and Finance Help, Can a finance broker get you the better deal? (2018) <https://www.mortgageandfinancehelp.com.au/first-home-buyer-news/can-finance-broker-get-you-better-deal/>.
[51] For further information, see Consumer Action Law Centre, *Submission on Behalf of Consumer Action Law Centre - Part 2* and *Submission on Round 1 Hearings — Consumer Lending*.
[52] See Productivity Commission, *Competition in the Australian Financial System,* Inquiry Report No 89 (2018), 335 (Report Box 11.7).

evident link to customer best interests. Conflicts of interest created by ownership are obvious but unaddressed. [53]

45. The industry has also pointed to its own satisfaction surveys to avoid reform. Industry surveys about customer satisfaction levels are generally high, but as noted by the Productivity Commission 'it is not at all surprising that consumers would consider they are getting good value from what appears to them to be a totally free service'.[54] It is also difficult for consumers to judge whether they have received the best deal when they are only presented with limited options.

46. The reforms proposed by industry through the Combined Industry Forum (**CIF**) have achieved limited tangible outcomes for consumers and have not responded effectively to the ABA's Retail Banking Remuneration Review (**Sedgwick Review**)—for example, recommendation 18 which proposed delinking commissions from the size of a loan.[55] The CIF has proposed to expand its definition of a 'good customer outcome' to incorporate a 'customer first duty'.[56] However, the Productivity Commission noted that it is 'unclear how CIF's statement of aspirations will translate into practice'.[57] The industry has argued that 'self-regulation must continue',[58] despite the severe and obvious limitations of this approach.

47. We support the Productivity Commission's recommendation that the NCCP Act be amended to impose best interest obligations on licensees that provide credit or credit services in relation to home loans.[59] However, consideration should be given to extending this obligation to all intermediaries that hold themselves out as providing 'advice' to consumers about credit or financial products.

48. We submit that a best interests obligation for brokers could be implemented under the current regulatory and licensing regime for consumer credit. Alternatively, the current best interests duty that applies to personal financial advice in Division 2 of Part 7.7A of the *Corporations Act 2001* (**the Corporations Act**) could be extended. There must also be significant penalties and appropriate access to redress for consumers when breaches of the best interests duty occur. The current penalties and civil liability provisions for financial advice are set out in sections 961K-961P of the Corporations Act.

49. The content of the best interests duty should be linked to the reasons consumers choose to use brokers. Consumers say that they use brokers for a range of reasons, including to get a better interest rate, get help with application process, gain access to a wider range of loans and increase their chances of approval.[60] However, research has shown that while consumers often choose to use a broker to get the

[53] Productivity Commission, *Competition in the Australian Financial System*, 2.
[54] Productivity Commission, *Competition in the Australian Financial System*, 308.
[55] Stephen Sedgwick AO, *Retail Banking Remuneration Review* <https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf>,
[56] Interim Report, Vol 1, 62.
[57] Productivity Commission, *Competition in the Australian Financial System*, 336.
[58] Mortgage and Finance Association of Australia, *Statement from the MFAA on the Royal Commission Interim Report* (7 October 2018) <https://www.mfaa.com.au/news/statement-from-the-mfaa-on-the-royal-commission-interim-report>.
[59] Productivity Commission, *Competition in the Australian Financial System*, 43.
[60] Productivity Commission, *Competition in the Australian Financial System*, 307.

best deal, brokers are not consistently finding lower interest rates for consumers.[61] In fact, ASIC found that broker customers get the same rate as direct customers and pay down their loans slower.[62]

50. The primary content of the duty should be focused on the broker finding the best loan for the customer (particularly considering the interest rates and fees) based on their individual circumstances. Further content of the duty could be explained in ASIC regulatory guidance, as is the case for financial advisers.[63] This duty could be tailored to the type of advice provided by brokers, acknowledging that it can differ from personal financial advice. Further guidance could include factors such as:

    - The position the client would have been in if they did not follow the advice—this means at times a broker should recommend a person does not take out a loan if it is unsuitable;
    - The subject matter of the advice sought by the client;
    - The client's objectives, financial situation and needs; and
    - Product features that the client particularly values.[64]

51. We do not consider that 'safe harbour' steps would be needed, as this appears to have contributed to a culture of 'tick-the-box' compliance in financial services. We also do not consider that the duty should be solely about prioritising conflicts of interest that arise. The focus should be on consumer outcomes, not simply process.

Recommendation 8
Mortgage brokers, and intermediaries providing advice on financial or credit products, be required to act in their clients' best interests.

Disclosure

52. The Commission has asked what should be disclosed to borrowers about an intermediary's obligations and remuneration. In our view, disclosure should not be relied upon in isolation as a consumer protection tool as it has been proven to be ineffective.

53. While increased transparency is welcome, structural change is needed to remove conflicts of interest and improve standards of advice being provided by brokers. Additional information alone will not achieve this.

54. There are particular risks when disclosing vertical and horizontal integration, as outlined in our joint consumer submission to the Productivity Commission:[65]

[61] Productivity Commission, *Competition in the Australian Financial System*, 310.
[62] Australian Securities and Investments Commission, *Review of mortgage broker remuneration*, Report No 516 (March 2017), 15, 163 <https://download.asic.gov.au/media/4213629/rep516-published-16-3-2017-1.pdf>.
[63] Australian Securities and Investments Commission, *Regulatory Guide 175*, 14 November 2017.
[64] Ibid. Similar considerations apply to the best interests duty.
[65] Consumer Action Law Centre et al, *Submission – Inquiry into Competition in the Australian Financial System* (September 2017) 9–10 <https://www.pc.gov.au/__data/assets/pdf_file/0008/221867/sub023-financial-system.pdf>.

Even if the disclosure is noticed by consumers, it may have the effect of increasing trust in advisers rather than making consumers more wary.[66] Skilled salespeople will also be able to deflect concerns about vertical integration. Peter White of the Finance Brokers' Association of Australia said that finance brokers can use disclosure obligations to their advantage:

> "I actually believe that if a broker is upfront about ownership—let's say they are owned by Commonwealth Bank, for example—then they can sell that as a positive. It can allow them to change the discussion around bank ownership—isn't it a good thing that they have somebody so strong sitting behind them that has enabled them to grow as a brokerage and a business? …now they have opened up the discussion with their client and they are able to explain what bank ownership really means and how the [NCCP Act] governs a broker's independence."[67]

55. Research has also found that disclosure of a specialist's bias or conflicts can increase the likelihood that the consumer relies on the advice, despite mandated disclosure being intended to make consumers more alert to potential conflicts.[68] Disclosure can 'lead to an increase rather than a decrease in trust if the disclosure is interpreted as a sign of honesty or if the fact that the advisor is receiving payments is interpreted as an indication of professional standing.'[69]

56. Any additional disclosure needs to be consumer tested to ensure that it is as effective as possible. However, the reality is that even consumer-tested disclosure is only likely to reach consumers who are willing and able to engage.

Recommendation 9
Consumer test any additional mandated disclosure needs to ensure effectiveness.

Broker fraud and misconduct

57. The Commission has also questioned what information, if any, clients should be given about broker fraud and misconduct. Consumer Action considers it critical that consumers are informed about broker fraud and misconduct, including broker banning orders. Evidence adduced before the Commission suggests that at least some brokers have been more concerned to 'ensure maintenance of the stream of income from trail commissions on loans that those brokers had written', than being upfront with consumers.[70]

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[66] James Lacko and Janis Pappalardo, *The effect of mortgage broker compensation disclosures on consumers and competition: a controlled experiment*, Federal Trade Commission Bureau of Economics Staff Report (February 2004), referenced in Financial Services Authority, *Financial Capability: A Behavioural Economics Perspective*, Consumer Research Report 69 (2008).
[67] 'Disclosure can work in Brokers' favour', *Broker News*, January 2015, 17.
[68] Sunita Sah, 'The Paradox of Disclosure' *The New York Times* (New York), 8 July 2016 <https://www.nytimes.com/2016/07/10/opinion/sunday/the-paradox-of-disclosure.html>.
[69] George Loewenstein et al, 'The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest (2011) 101(3) *American Economic Review: Papers and Proceedings 2011* 423 <https://www.cmu.edu/dietrich/sds/docs/loewenstein/PitfallsdisclosingCOI.pdf>. Also see James Lacko and Janis Pappalardo, *The effect of mortgage broker compensation disclosures on consumers and competition: a controlled experiment*, Federal Trade Commission Bureau of Economics Staff Report (February 2004) <https://www.ftc.gov/reports/effect-mortgage-broker-compensation-disclosures-consumers-competition-controlled-experiment>, referenced in Financial Services Authority, *Financial Capability: A Behavioural Economics Perspective*, Consumer Research Report 69 (July 2008).
[70] Interim Report, Vol 2, 40.

58. Consumers must be informed about fraud and misconduct in order to assess their rights against the broker and lender for that misconduct. Broker firms and lenders should treat problematic brokers (and other intermediaries) as 'patient zero' and complete a comprehensive review of past and present customers who access loans via that broker. Further, broker firms and lenders should take steps to determine whether borrowers had suffered detriment because of the misconduct of brokers. This could mean a review of client files, or other data on their systems. Systems and processes should be in place to detect problems early, identify affected consumers and remediate consumers appropriately and in a timely manner. We also suggest ASIC provide additional details relating to banning orders to the public, and make these orders easier to access. The current banned and disqualified persons register is difficult to find and search, making it inaccessible for many.

Recommendation 10

- Brokers and lenders be required to:
  - inform former and current consumers of fraudulent or banned brokers about misconduct;
  - conduct file reviews to determine if remediation is required; and
  - if so, remediate in a timely manner.
- ASIC provide additional details relating to banning orders to the public, and make these orders easier to access.

How should intermediaries be remunerated?

59. We consider that the ban on conflicted remuneration should be extended to all credit and financial products, but in particular to circumstances where consumers are being provided 'advice'. This includes mortgage broking.

60. As identified in the Interim Report, selling has become the focus of banks and financial services providers' attention. 'From the executive suite to the front line, staff were measured and rewarded by reference to profit and sales'.[71] Remuneration arrangements have encouraged third parties to pursue their own profit interests at the expense of the consumers' interests. Conflicted remuneration has driven toxic sales cultures:[72]

> *Staff and others engaged by an entity will treat as important what they believe that the entity values. Rewarding volume and amount of sales is the clearest signal that selling is what the entity values. What staff and others believe that the entity values informs what they do. It is a critical element in forming the culture of the entity.*

61. Consumer Action agrees with the Commission that the unstated premise for conflicted remuneration that staff and intermediaries will not do their job properly without it must be challenged.[73]

62. The consequences of the misconduct that this kind of sales cultures encourages cannot be understated. As canvassed in Karen Cox's evidence before the Commission, the resulting harm can be both financial and non-financial. This harm can be devastating to the individual, their family and their communities.[74]

[71] Interim Report, Vol 1, xix.
[72] Interim Report, Vol 1, 55.
[73] Interim Report, Vol 1, 317.
[74] Interim Report, Vol 1, 53.

63. While industry have proposed some changes through the CIF, these changes have not gone far enough. The problem of trail commission remains and upfront commissions continue to encourage mortgage brokers to sign up consumers to larger loans than they can potentially afford.

64. The structure of mortgage broker commissions is a reversal of competition in many ways, rather than any rationale based on improving outcomes for consumers. Claims that commissions are in consumers' interests appear to be thinly veiled attempts to protect incumbent income streams. Evidence adduced before the Commission shows a systemic failure of lenders and brokers to manage the resulting conflicts of interest effectively, suggesting these conflicts must be removed rather than 'managed'.

65. Currently there is 'nothing in it'[75] for a broker to ensure the customer is facing the truth of his or her expenditure, or to 'interrogate the customer when the customer reports living expenses as X dollars a month'.[76] This is because the broker is rewarded for writing the loan, not compliance. The CBA's former CEO Ian Narev admitted to the Commission that upfront and trailing commissions for mortgage brokers can lead to poor customer outcomes, and further that the CBA failed to disclose these commissions to consumers or change to a fee-for-service model.[77] Documents produced by NAB relating to its scandal-plagued home loan introducer program summed up the problem as follows[78]: 'The risk and reward equation for bankers was unbalanced in favour of sales over keeping customers and the bank safe.' The Commission has rightly identified a 'first mover' problem in the market, indicating that legislative intervention would be required to rectify conflicted remuneration practices.

66. The cost of commissions and other benefits being paid to mortgage brokers is ultimately being borne by consumers, and is reducing price transparency. Mortgage brokers do not appear to promote effective competition in the home loan market but rather add to distribution costs and pricing opacity. This was confirmed by the Australian Competition & Consumer Commission's (**ACCC**) recent interim report that revealed 'less-than-vigorous' mortgage price competition, especially between the big four banks.[79] That report identified a troubling irony: banks do not publish the rates at which mortgages can be obtained (but instead publishing 'standard rates' with substantial discretionary and no-transparent discounts), meaning that many consumers consider that they need to engage a broker to find a good deal, only to be charged additional amounts through opaque means. In Consumer Action's view, if mortgage brokers are providing a valuable service then consumers would be willing to pay for that service under a fee-for-service model. The regulator in the Netherlands has implemented flat fee remuneration arrangements where the flat fee is paid by the consumer to the broker, and as ASIC understands it, this has not undermined the existence of a healthy mortgage broker sector.[80]

67. Consumer Action recommends that the Commission further investigate the role of unregulated entities, and the conflicted remuneration being paid by financial service providers for sales and referrals. These entities include introducers, vendor introducers, and point-of-sale sellers of loans.

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[75] Transcript, Commissioner Hayne, 19 March 2018, 476.
[76] Ibid, 467.
[77] Transcript, Daniel Huggins, 15 March 2018, 259.
[78] Transcript, Counsel Assisting, 23 March 2018, 974.
[79] Australian Competition and Consumer Commission, *Media release – Mortgage pricing not strongly competitive* (March 2018) <https://www.accc.gov.au/media-release/mortgage-pricing-not-strongly-competitive>.
[80] Australian Securities and Investments Commission, *Submission on Round 1 Hearings – Consumer Finance*, 3 April 2018, [17], <https://financialservices.royalcommission.gov.au/public-hearings/Documents/Round-1-written-submissions/ASIC.pdf>.

Recommendation 11
Extend the ban on conflicted remuneration to all credit and financial products, with priority given to removing conflicted remuneration from home lending.

External Dispute Resolution

Are external dispute resolution mechanisms satisfactory?

68. Our views on the EDR framework in the financial system are detailed in a series of joint submissions to the Review of the Financial System External Dispute Resolution Framework (**EDR Review**)[81] in 2016-17 and subsequent consultation on the establishment of Australian Financial Complaints Authority (**AFCA**).[82] This section will focus on the EDR model and transition to AFCA.

69. One of the more significant advances in consumer protection in the past 20 years has been the establishment of mandatory EDR in many industry sectors. EDR in the financial system has provided access to justice for hundreds of thousands of consumers who would have been unable to resolve disputes if they had to rely on existing courts and tribunals, which are slow, intimidating, complex and largely inaccessible without expensive legal representation.

70. While there is clearly room for improvement, EDR is an extremely important *alternative* to the court system. By comparison to courts and tribunals, the existing EDR schemes and AFCA have useful structural features that can contribute to strong justice outcomes.[83]

71. We have some concerns about some consumers being excluded from FOS during the transition to AFCA. While timeliness of EDR decisions is important, this should not be at the expense of high-quality and fair resolution of disputes. We acknowledge that the timelines for transition imposed on AFCA and the existing schemes are problematically short and are putting the existing schemes and their staff under pressure. To the extent that there is a trade-off between preventing complaint backlogs and accepting jurisdiction to hear a complaint (even one with low merits), we strongly encourage the schemes to err on the side of accepting complaints.

72. It is critical that AFCA decision-makers bring an inquiring mind to the dispute resolution process. Early case management, including jurisdictional decisions, preliminary assessments, and case assessments, are areas of ongoing concern. Only a very small number of disputes reach an ombudsman or expert panel, so it is important that early case management is staffed by skilled case managers that can identify all relevant issues, whether or not raised directly in the consumer's application. This is particularly important for the vast majority of consumers who are unrepresented. Unlike firms with access to specialised staff and legal advice, consumers are often unaware of the intricacies of relevant laws and EDR terms of reference.

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[81] See joint submissions in response to: EDR Review Issues Paper, 10 October 2016, available at https://consumeraction.org.au/edr-review/); EDR Review Interim Report, 3 February 2017, available at https://consumeraction.org.au/edr-review-interim-report/.

[82] See joint submissions in response to: AFCA Proposed Rules, 2 July 2018, available at https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/07/180702-Joint-submission-Proposed-AFCA-Rules.pdf; Treasury's consultation on exposure draft legislation, date, available at; and the Senate Inquiry into the bill establishing AFCA, 29 September 2017, available at https://policy.consumeraction.org.au/2017/10/05/treasury-laws-amendment-putting-consumers-first-establishment-of-the-australian-financial-complaints-authority-bill-2017/.

[83] See joint submission to EDR Review Issues Paper, above n 81, 2-3.

73. We are concerned that AFCA Rule A.8.3 continues the process described at FOS as a 'case assessment', enabling AFCA to decide that it is not appropriate to continue handling a complaint where the 'financial firm has committed no error' or the complaint is 'without merit'. It is difficult to see how an AFCA decision-maker could know, at an early stage, that a firm has made no error without actually investigating the complaint. Once a complaint is within jurisdiction and, absent an agreed outcome, these decisions should only be made after a proper assessment of the merits of the dispute.

Recommendation 12
That AFCA:

- investigate all apparent claims, rather than taking a narrow approach to the definition of a dispute; and
- require a random selection of disputes to be periodically externally quality-assessed, including whether the outcome was fair and legally correct, as well as the appropriateness of the conduct of the dispute resolution process;
- provide its preliminary assessment in writing with reasons or, alternatively, permit a party to request written reasons within a reasonable time; and
- retain the existing and more prescriptive rules on the content of, and process for, jurisdictional decisions, preliminary assessments and determinations in FOS ToR 8.5(a) and 8.7.

74. Other outstanding concerns about the AFCA Rules include but are not limited to:[84]

a) *Good faith requirements* – when AFCA requests all relevant documents to assist it in making a determination, we must be able to trust that banks and other firms will, in good faith, provide the requested information, and act in good faith in negotiations.
b) *Hold on enforcement action* – we recommended that AFCA adopt the Credit & Investments Ombudsman's (**CIO**) more expansive restrictions on enforcement action that a firm must not initiate or continue during an open complaint;
c) *Firm's failure to provide documents* – an ongoing problem for consumers is getting any, or timely, access to documents that the firm is required to provide under laws and industry codes. This failure impedes the consumer's ability to evaluate and substantiate their claims, and resolve their dispute. AFCA Rule B.2.1 should be amended to clarify that a complaint can arise merely from the firm's failure to provide documents;
d) *Gaps in membership*, including for new industries and products (such as 'buy now, pay later'), lenders providing loans to small businesses and the 'gig economy', the conflicted debt advice industry, which profits from financial hardship, and warranties and loans issued by car dealers.
e) *Consumer monetary jurisdiction* – we recommend a single claim limit and compensation cap of $2 million for consumer claims to simplify the confusing claim limit/compensation cap distinction, and account for rising house prices.
f) *Test case provisions* – firms appear unwilling to consent to test cases, likely due to the cost. There must be improved mechanisms to run test cases to clarify gaps in the law, without consumers bearing the legal costs or putting their home at risk.

75. While higher limits are needed, high-quality dispute resolution must occur for claims of all values. There is a risk that lower value consumer disputes could become the 'poor cousin' of AFCA's expanded small

[84] See joint submissions in response to AFCA Proposed Rules.

business jurisdiction. We note that 'low value' disputes under $15,000 at AFCA will be allocated to the Fast Track stream to be decided by an adjudicator, not an ombudsman.[85] Low value does not mean low impact on the individual affected, especially for people living on lower and fixed incomes. Similarly, low value does not necessarily mean low factual or legal complexity. CCI disputes are but one example.

76. Please refer to our comments on FOS and AFCA throughout this submission.

Enhanced remediation administered by AFCA

77. Given the sheer volume of people affected by misconduct, we recommend an enhanced collective redress mechanism, avoiding the need for individual AFCA complaints or legal action.

78. One option is for ASIC to be given a mandate to identify misconduct suitable for remediation programs, and design or approve these programs to be administered by AFCA. Financial firms should also be encouraged to voluntarily establish effective remediation schemes providing complete redress.[86]

79. As a first step, the recommended 'directions power' for ASIC should be legislated. The ASIC Enforcement Review Taskforce Report recommended that ASIC be empowered to direct firms to establish a suitable program to remediate clients.[87] This would significantly strengthen ASIC's powers as ASIC would no longer by hamstrung by the need to negotiate with firms or forgo future enforcement action. The Government agreed in principle in this recommendation in April 2018 but enabling legislation has not been introduced.

80. We recommend the following design features for remediation programs administered by AFCA:

a) ASIC be required to design or approve proposed remediation programs having regard to the general principles in ASIC Regulatory Guide 256[88] in consultation with an expert panel, including consumer representatives. For example, the process of review and remediation should be comprehensive, timely, fair and transparent;

b) ASIC be empowered to enforce the terms of approved remediation programs as licence conditions or civil/criminal penalties for breaches;

- Require that firms provide full redress (financial and non-financial), include a wide scope of misconduct and proactively locate and remediate all affected customers;
- Costs for remediation be borne by the relevant financial firm, or if in liquidation, a last resort compensation fund;
- A separate, self-funding unit of AFCA administer the programs with monitoring by ASIC to ensure effective and efficient administration and accountability; and

[85] AFCA, Complaint Process Map, as at 20 October 2018, available at: https://www.afca.org.au/custom/files/docs/afca-process-map-2018.pdf.
[86] Our views on current challenges with remediation programs are detailed in our submission to the Australian Law Reform Commission's Class Actions and Third-Party Litigation Funders Inquiry, 17 August 2018, available at: https://policy.consumeraction.org.au/2018/08/20/class-actions-and-third-party-litigation-funders-alrc-inquiry/.
[87] See Chapter 8, available at: https://treasury.gov.au/review/asic-enforcement-review/.
[88] Australian Securities and Investments Commission, *Regulatory Guide 256: Client review and remediation conducted by advice licensees* (15 September 2016).

- Appropriate resources be provided to ASIC and AFCA to ensure they can perform their new roles in remediation efficiently and fairly. Set up funding may be required to establish new teams to complete this work.

Should there be a mechanism for compensation of last resort?

81. No victim of financial services misconduct should be left behind. A compensation fund must be established to compensate victims of past and future misconduct by firms that are insolvent or otherwise fail to provide redress. When the loss goes uncompensated, the impact on individuals and families can be severe, with flow-on costs for the community, Government and trust in our financial system. An ongoing last resort compensation fund will be a critical piece of our financial services architecture in future, incentivising good conduct and ensuring no victim goes without compensation.[89]

82. For the establishment and design of a last resort compensation scheme to rebuild lost trust and confidence in our financial system, it must be broad in its scope, going beyond financial advice claims. Credit providers and mortgage brokers must be included in the scheme as these types of disputes can often affect particularly vulnerable consumers.[90]

83. We recommend that a last resort compensation fund:

a) Be available to consumers and (appropriately defined) small businesses;
b) Apply to unpaid compensation awards from external dispute resolution schemes, as well as court and tribunal orders;
c) Apply to all financial service providers, including credit licensees, mortgage brokers and operators of managed investment schemes;
d) Apply to future claims and claims dating back 10 years, including legacy unpaid determinations of the Financial Ombudsman Service and Credit & Investments Ombudsman ($14,146,094 at 30 June 2017);
e) For future claims, be funded by all industry participants – the new ASIC Industry Funding Model is an example;
f) For past claims, be funded by industry with a contribution by Government. If full redress is not possible, a rationing mechanism based on financial hardship should apply;
g) Trigger ASIC action against the firm's directors and managers to eliminate phoenixing and incentivise prudent behaviour;
h) Be administered by a separate, self-funding unit of AFCA with oversight by ASIC; and
i) Be governed by a board with an independent chair and an equal number of directors from industry and consumer backgrounds.

Recommendation 13
Establish an enhanced collective redress measures and a last resort compensation scheme for all victims of misconduct.

[89] See our detailed submission to the EDR Review Supplementary Issues Paper for further information, 4 July 2017, available at https://policy.consumeraction.org.au/2017/07/05/edr-review-supplementary-issues-paper/.
[90] See Carol's story in Consumer Action et al, Joint response to EDR Review Issues Paper, 10 October 2016, 74, <https://consumeraction.org.au/wp-content/uploads/2016/10/EDR-Review-Joint-consumer-submission-1.pdf>.

Responsible lending

Should the test be applied by the lender remain 'not unsuitable'?

84. We consider that the test to be applied by licensees providing credit or credit services should be 'suitable', rather than 'not unsuitable'. Not only would this provide clarity but would also ensure lending products are suited to the needs of borrowers. The current standard of 'not unsuitable' is arguably a lower standard than 'suitable', which would be an affirmative obligation to provide only a suitable product.[91] The higher standard would also complement the best interests duty discussed above.

85. As noted by Professor Gail Pearson, suppliers in the market for goods and services have long been required to provide goods that are fit for the purpose of the buyer. Professor Pearson says that 'there is a long history to legislation expressing the policy that providers should provide products that are suitable for the requirements of acquirers.'[92] That credit providers and credit service providers should supply or arrange loans that are suitable for the borrower should not be considered a startlingly new concept.

86. Consumer Action strongly supports the proposed Design and Distribution Obligations (**DADO**) applying to consumer credit. The Proposals Paper justified the exemption for regulated credit products from the DADO regime on the basis that there is a 'potential overlap with the responsible lending obligations that already apply to credit products'.[93] Responsible lending obligations apply only at the point of sale and are limited to assessing whether a product is 'not unsuitable' for a consumer. In contrast, the DADOs would apply during product design, distribution and post-sale. The obligations would require firms to design safe and suitable credit products and distribute them accordingly—this would be an important additional protection for borrowers.

87. The proposed DADO regime also currently does not extend to funeral expenses-only products, as they are not financial products under the Corporations Act. However, the current Product Intervention Power (**PIP**) proposed for ASIC does extend to these products. In our view, funeral expenses policies should fall within both the DADO and the PIP. Major concerns with various funeral insurance products which would warrant the DADO applying include:[94]

- cancellation rates of 80%;
- steadily increasing premiums, which can make the product unaffordable;
- negative value policies, under which people pay more in premiums than the policy will pay in benefits;
- sales to young people who are unlikely to benefit from the product; and
- highly emotive sales and marketing which invokes a sense of fear about the need to provide for the costs of funerals.

[91] Gail Pearson, 'Reading Suitability against Fitness for Purpose — the Evolution of a Rule' (2010) 32 *Sydney Law Review* 311, 328. <http://www.austlii.edu.au/au/journals/SydLawRw/2010/15.pdf>.
[92] Ibid, 334.
[93] Commonwealth of Australia, *Design and Distribution Obligations and Product Intervention Power,* Proposals Paper (2016), 12.
[94] Joint consumer submission, *Revised Design and Distribution Obligations and Product Intervention Powers Bill,* 15 August 2018, 16 <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/08/180815-Joint-Submission-Revised-exposure-draft-PIP-DADO.pdf>.

88. While it is promising that ASIC will be able to act on the basis of these factors (we note that Aboriginal Community Benefit Fund (**ACBF**), is continuing to sell its funeral products in Aboriginal communities, including to families[95]), it is preferable that product issuers be bound by the DADO, to prevent these products causing consumer harm in the first place. If the legislation is not amended to bring funeral expenses products under the DADO, the Minister could and should bring these products under the DADO by regulation.[96]

89. We note that there are several other significant exemptions from the DADO regime, including personal financial advice and dealing associated with implementing personal financial advice. The Financial Services Inquiry Final Report made it clear that the DADO regime was intended to complement the Future of Financial Advice (**FOFA**) regime for personal financial advice. We have serious concerns that products could be systematically distributed to consumers outside the determined market through this loophole.[97] The various exemptions throughout the current Bill would hamper ASIC's ability to enforce the obligations, and results in overly complex legislation that risks undermining the important original objectives of the regime.[98]

Recommendation 14
Extend the proposed DADO regime to all financial and credit products, and consider changing the 'not unsuitable' standard for credit to 'suitable'.

How should the lender assess suitability?

90. Consumer Action supports the requirement for a lender to consider both sides of the ledger—income and expenditure—when making reasonable inquiries about and verifying a consumer's financial situation.[99] Recent responsible lending jurisprudence supports this position.[100]

91. The current processes used by lenders and brokers to inquire into and verify borrowers' income generally meet the requirements of the NCCP Act. In Consumer Action's experience, most lenders obtain at least 3 months of continuous recent pay slips or a recent Centrelink statement and review bank statements to confirm that income is being deposited into the borrowers' accounts. The processes could be improved by also verifying the borrowers' income summaries and tax returns for the previous two or three years (where available),[101] and making further inquiries where there are any irregularities with declared income which can occur where borrowers' work overtime sporadically in the three months' prior to applying for a loan.

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[95] Stephanie Chalmers, 'Banking royal commission: funeral insurer blasted at inquiry targets kids at Koori Knockout', *ABC* (online), 5 October 2018, <https://www.abc.net.au/news/2018-10-04/funeral-insurer-blasted-at-the-royal-commission-spruiks-product/10338746>.
[96] Under *Corporations Act 2001 (Cth)* sch 1 s 994B(1)(e).
[97] For more information, see: Joint consumer submission, *Revised Design and Distribution Obligations and Product Intervention Powers Bill*.
[98] Ibid.
[99] Interim Report, Vol 1, 24.
[100] *Australian Securities and Investments Commission v Cash Store Pty Ltd (in liquidation)* [2014] FCA 926; *Australian Securities and Investment Commission v Chanic Pty Ltd* (No 4) [2016] FCA 1174.
[101] Exhibit 1.87, KPMG, *Australian and New Zealand Banking Group Limited: ADI Targeted Review for 2016/17 Accuracy of data used in home loan underwriting* (28 April 2017), 6.

92. The current processes used by brokers and lenders to inquiry into and verify borrowers' expenses do not meet the requirements of the NCCP Act, nor do they meet the standards of ASIC RG 209. At its simplest, in order to discharge their responsible lending obligations a broker or lender should actually ask the borrower about their income and expenses,[102] and obtain information about the consumer's actual expenses,[103] not their best guess or a benchmarked estimate. This is ordinarily done by way of a statement of financial position when a prospective borrower applies for a loan.[104]

93. It is critical that the statement of financial position has multiple expense categories which capture essential expenditure (such as food, housing, transport, childcare) and discretionary expenditure (such as alcohol, entertainment and cigarettes). In our experience, consumers are poor historians when recalling expenses without being prompted to recall certain expenditure which is why a more detailed statement of financial position is required.

94. At a minimum, we would expect lenders and brokers to require consumers to disclose (and then verify) the categories of expenses which appear on the FOS Statement of Financial Position form, which consumers are required to complete where they seek financial hardship from a lender, or seek to challenge an irresponsible loan.[105] If the lender intends to rely on the Household Expenditure Measure (**HEM**) to test the veracity of the borrower's expenses, the statement of financial position should also include categories for discretionary expenditure as those expenses are defined by HEM. This is because those expenses are excluded from the HEM benchmark so there is no way to test the veracity of these expenses against HEM. Borrowers should also disclose existing financial obligations in addition to their expenses because those type of debt obligations are excluded from HEM. Credit providers and brokers should verify a borrower's disclosed financial obligations by reviewing their credit file and recent 90-day bank statements and credit card statements.[106]

95. We agree with the KPMG ADI Target Review report[107] that lenders and brokers should ask customers to provide documentary evidence of their major expenses which could include rent/board, insurance, child maintenance, school fees, essential travel, non-essential travel, childcare and TV subscriptions. In addition, lenders and brokers should verify utility, telecommunication bills and recurring transport expenses.

96. Credit providers should also obtain account statements that cover at least the immediately preceding period of 90 days. The requirement to obtain supporting bank statements is scalable, but it should not

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[102] Revised Explanatory Memorandum, National Consumer Credit Protection Bill 2009 (Cth), 108–9 [3.146].
[103] Australian Securities and Investments Commission, *Regulatory Guide 209* (5 November 2014), 15 [209.30].
[104] Exhibit 1.86, Witness Statement of William Andrew Ranken, Australian and New Zealand Banking Group (4 March 2018) 7 [44]-[58]; Exhibit 1.87, KPMG, *Australian and New Zealand Banking Group Limited: ADI Targeted Review for 2016/17 Accuracy of data used in home loan underwriting* (28 April 2017), 6; Interim Report, Vol 1, 25–6.
[105] FOS, *Statement of Financial Position* (2018) <https://sofp.fos.org.au/>. The FOS statement of financial position includes expenses for housing (rent, rates, insurance, utilities, communications (phone, internet, pay TV), repairs and maintenance, other housing expenses), Personal and family: food and groceries; clothing; health, entertainment, personal care, personal insurance (eg. Life), pets, other. Transport: vehicle, public transport/taxis, other. Education and children: children education/childcare, self-education, other.
[106] Exhibit 1.87, KPMG, *Australian and New Zealand Banking Group Limited: ADI Targeted Review for 2016/17 Accuracy of data used in home loan underwriting* (28 April 2017), 6; ASIC RG209, 22 [RG 209.50], table 4.
[107] Exhibit 1.87, KPMG, 6–7.

be scaled below three months.[108] This would align home lending, credit cards and car lending with the minimum verification requirements performed by small amount credit contract providers under the NCCP Act.[109] Where borrowers hold a credit card, credit providers and/or credit assistant providers should also obtain credit card statements that cover the preceding period of 90 days at a minimum.[110]

97. Critically, licensees need to review the bank statements and credit card statements supplied by borrowers for evidence of income and expenses. This approach aligns with the requirements contained in ASIC RG209 and responsible lending case law which states that licensees must bring their "own inquiring mind" to the loan assessment.[111]

98. Beyond verifying expenses, a review of a prospective borrower's bank statements will assist licensees discharge their other responsible obligations because it will help:

    a) Identify any obvious inconsistencies between a consumer's statement expenses and transaction history;[112]
    b) Detect a pattern of income and expenditure which will elucidate whether the borrower can meet the additional financial obligations of further loan repayments;
    c) Determine whether all money from the account is withdrawn on pay day (suggesting an inability to be able to repay further loans without substantial hardship);
    d) Assess whether and how often the account is overdrawn;
    e) Assess whether direct debits have been declined;
    f) Assess whether the borrower has the ability to save funds or is living pay cheque to pay cheque; and
    g) Detect whether the borrower has financial obligations owing to debt collectors or financial dangerous products like consumer leases and payday loans which suggest hardship or financial difficulty.

99. Credit providers will no doubt claim that verifying obligations as outlined above is "too hard".[113] We disagree. In Consumer Action's experience, where a borrower seeks to challenge a loan as irresponsible, the credit provider and FOS ordinarily require a borrower to complete a detailed current and retrospective income and expenditure statement with verifying documents to demonstrate their current income and expenses (to demonstrate future serviceability of the loan) and their actual expenses at the time of the loan (to demonstrate a breach of the law). This places a burden on consumer advocates because they are required to locate these verification documents from the time of the loan, which can be several years ago. It is therefore illogical that it is "too hard" for a large, well-resourced licensee to verify contemporaneous expenses when a borrower applies for a loan, but standard practice

[108] The Robert Regan case study showed that ANZ accepted 1 month of bank statements: Transcript, William Ranken, 19 March 2018, 479–80. The Nalini Thiruvangadam case study showed that Bank of Melbourne accepted Ms Thiruvangadam's application without any supporting bank statements: Exhibit 1.142, Witness Statement of Philip Godkin, 5 March 2018, [17].
[109] *National Consumer Credit Protection Act 2009* (Cth) ss 117(1A), 130(1A).
[110] Exhibit 1.87, KPMG, *Australian and New Zealand Banking Group Limited: ADI Targeted Review for 2016/17 Accuracy of data used in home loan underwriting* (28 April 2017).
[111] *Australian Securities and Investment Commission v Chanic Pty Ltd* (No 4) [2016] FCA 1174, [1804].
[112] Exhibit 1.87, KPMG; Transcript, Robert Regan, 16 March 2018, 434–48; ASIC RG209; Financial Ombudsman Service, *The FOS Approach Responsible Lending series* (July 2014), 6.
[113] Interim Report, Vol 1, 25; Transcript, William Ranken, 19 March 2018, 469.

requires under-resourced consumer advocates to retrospectively produce this evidence to substantiate their clients' irresponsible claims often where these records are no longer available.[114]

100. Due to the onerous nature placed on borrowers to establish their responsible lending claims, the Royal Commission should recommend that there be a reverse onus of proof with respect to responsible lending claims. This will have the dual effect of incentivising lenders to verify borrowers' actual expenses and reduce the burden on consumer advocates in supporting vulnerable clients who have received irresponsible loans from financial service providers. A reversal of onus of proof will align with the spirit of the law which is responsible lending, not responsible borrowing.

Recommendation 15

- Require lenders to obtain and analyse at least 90 days' of bank statements and credit card statements to inquire into and verify income and expenses.
- Require lenders to use a detailed statement of financial position for loan applications
- Require lenders to obtain and review documentary evidence of borrowers' major expenses including rent/board, insurance, child maintenance, school fees, essential travel, non-essential travel, childcare, TV subscriptions, utility, telecommunication bills and recurring transport expenses.
- Reverse the onus of proof in responsible lending cases.

Should HEM continue to be used as a benchmark for borrowers' living expenses?

101. We do not oppose the HEM being used as a benchmark for borrowers' living expenses, however we agree with the Commission that it cannot be used as a tool to verify consumers' expenses.[115]

102. The HEM was never designed to replace making actual inquiries from a borrower as to their expenses.[116] The HEM was developed as a way for credit providers and credit assistant providers to determine whether the expenses reported by prospective borrowers were reasonable.

103. The HEM takes into account the area that people live in[117] and the broad characteristics of the household. It was developed as an alternative and more tailored benchmark than the Henderson Poverty Index (**HPI**), which does not vary with borrowers' income or location.

104. However, the HEM is an intentionally modest figure.[118] It is therefore intended that the vast majority of Australians will have expenses that far exceed the HEM figures. Should lenders default their expenses to the HEM, even if they allowed an additional buffer, the vast majority of Australians would have expenses which exceed the amount relied upon by the lender to approve the loan.

[114] See for example FOS Determination 478761 (11 September 2017), FOS Determination 492831 (25 July 2018) and FOS Determination 503089 (14 August 2018) where FOS found in favour of the Financial Service Provider and the Applicants did not or were unable to provide supporting documents of their expenses.
[115] Interim Report, Vol 1, 28.
[116] See comments of Guyonne Kalb of the Melbourne Institute, Applied Economic and Social Research, University of Melbourne, who devised the HEMS benchmark, at <https://www.abc.net.au/7.30/banks-moving-to-tighten-lending-rules---but-its/10010386>.
[117] The HEMS' geographic region is very broad and is not defined by postcode.
[118] This is apparent from the calculation methodology of HEMs based on the median spend on absolute basics but only the 25th percentile on discretionary basics.

105. After inquiries are made by a broker and/or credit provider from a borrower as to their expenses, the HEM benchmark could be used to cross-check whether the declared expenses are too low, or if the borrower has declared expenses which fall within the HEM categories of a discretionary basic (private school fees, alcohol, tobacco and until recently childcare costs[119]) or non-basic expenditure (overseas holidays) which would mean that their expenses would exceed HEM. Different factors should be taken into account when cross-checking expenses for vulnerable consumers against the HEM. For example, low income consumers may live outside metropolitan cities due to housing affordability and their transport costs would therefore exceed the aggregated transport costs included in HEM.

106. Restricting the use of the HEM benchmark in this way accords with ASIC RG209 which says that benchmarks can be used for testing the reliability of the information obtained by credit providers as part of the process for taking reasonable steps to verify the consumer's financial situation.[120]

107. This position also accords with the findings of *Australian Securities and Investment Commission v Channic Pty Ltd*:

> *A question might arise about whether the adoption of a benchmark directed to particular categories of expenses of a consumer operates as the making of reasonable inquiries about that aspect of a consumer's financial situation and whether adoption of such a benchmark operates as the taking of reasonable steps to verify that aspect of a consumer's financial situation…the adoption of the notional figure is not conduct of "making" reasonable inquiries about the consumer's financial situation or conduct of "verifying" the consumer's financial situation. In truth, it is a substitute for doing either of those things.*[121]

108. The Commission observed that credit providers have relied on the HEM benchmark to verify a consumer's expenses where they apply for a car loan or home loan.[122] It is plain that the guidelines contained in ASIC RG209 are insufficient to safeguard consumers from lenders taking shortcuts when discharging their responsible lending obligation to verify expenses.

109. We recommend an amendment to the NCCP Act by inserting a new section 130(1C) which says that for the purposes of paragraph 130(1)(c), it is presumed that a licensee has not taken reasonable steps to verify the consumer's financial situation where it has relied on a benchmark to verify a consumer's expenses.

Recommendation 16
Amend the NCCP to insert a presumption that a licensee has not taken reasonable steps to verify the consumer's financial situation where it has relied on a benchmark to verify a consumer's expenses. The HEM should not be solely relied upon to verify expenses.

[119] Childcare costs were included in the June 2018 updated HEMs published by the Melbourne Institute. See Nicolas Hérault, et al, Melbourne Institute, Applied Economic and Social Research, *Re-development of the Household Expenditure Measure (HEM) based on the Household Expenditure Survey 2015/16: a note for HEM subscribers describing a new approach and data* (June 2018).
[120] ASIC RG209, 21 [209.49].
[121] *Australian Securities and Investment Commission v Chanic Pty Ltd* (No 4) [2016] FCA 1174, 456 [1736].
[122] Interim Report, Vol 1, 28.

HEM and the Financial Ombudsman Service

110. The FOS has increasingly relied on the HEM benchmark as the sole measure of verification in its recent determinations on responsible lending or maladministration matters. This is a disturbing trend.

111. In 2016 to 2017, FOS accepted 10,973 credit disputes.[123] Of those, 9,673 related to consumer credit and 23% (2,100) related to a financial service provider's decision.[124] Often that decision is the decision to grant credit. Accordingly, the FOS approach to responsible lending disputes is a key factor in the approach taken by industry.

112. The FOS publishes its approach to responsible lending and also publishes its decisions. The FOS Approach document[125] says that benchmarks relied upon by financial service providers (**FSP**) are often incomplete as they omit expenses for a consumer's particular needs, such as medical expenses and voluntary commitments such as school fees.

113. Despite the position taken in the FOS approach, virtually all FOS Determinations rely upon a benchmark to assess a consumer's living expenses. FOS has primarily used the HEMS in recent years, although on occasion it has used the HPI plus a 10% buffer. Consumer Action is only aware of one decision where actual living expenses were used to determine that a loan was irresponsible.[126]

114. We have reviewed multiple FOS Determinations which were published between 2016 and 2018. A review of those FOS Determinations show that:

- FOS uses a benchmark to assess general living expenses;
- That financial service providers are only required to assess affordability based on basic and essential living expenses;
- Financial service providers are not required to consider discretionary expenses when assessing affordability;
- An unwillingness to consider actual living expenses at the time of entry into that contract;
- Financial service providers are not required to verify disclosed living expenses beyond application of a benchmark;
- Financial service providers are not required to consider transaction account statements to verify expenses;
- Financial service providers are not required to consider actual expenses that were readily apparent to the financial service providers;
- FOS gives undue weight in favour of FSPs where a borrower has signed a standard form declaration that he or she has read and understood the contract and that their stated income and expenses are true and correct.

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[123] Financial Ombudsman Service, *Annual Review 2016–17* (October 2017), 62 <http://www.fos.org.au/custom/files/docs/fos-annual-review-20162017.pdf>.
[124] Ibid.
[125] Financial Ombudsman Service, *The FOS Approach Responsible Lending Series* (July 2014).
[126] Financial Ombudsman Service, *Determination 438112* (23 January 2016) <https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/438112.pdf>. Determination 438112 rejected the use of HEMs in that dispute. It adopted the approach in ASIC RG209 Credit Licensing: Responsible Lending that use of a benchmark is not a replacement for making enquiries about a consumer's expenses and verifying those expenses. It noted that the consumer spent a significant amount for cigarettes and that expense had not been considered by the FSP. However, that decision also took the approach that retrospectively determining actual expenses might not always be possible.

115. Many FOS Determinations appear to proceed on the basis that the statutory obligation is on the borrower to take all necessary steps to borrow responsibly, rather than the primary obligation resting with the financial service provider to lend responsibly. It has also reverted to using current industry practice as its guiding principles, rather than best industry practice.

116. We consider that the approach taken by FOS in these Determinations falls below community standards and expectations. We have summarised a number of determinations that we consider problematic below:

- Determination 481247[127] – no obligation to inquire into actual expense

  The consumer obtained a car loan and noted that under the loan he was required to insure the car. The financial service provider did not consider the consumer's actual expenses for registration and insurance but relied upon the HEMs benchmark. FOS determined that reliance on the HEMs benchmark was sufficient as it included an allowance for such costs:

  > *It was not necessary for the FSP [financial service provider] to include the costs identified by the applicant in its servicing assessment as separate and additional items.*

  Notably FOS concluded:

  > *The FSP is not required to account for discretionary expenditure in its assessment of serviceability. Under good industry practice and legislative lending obligations, the FSP is only required to consider capacity having regard to basic and essential living expenses* [our emphasis].

- Determination 448069[128] – no requirement to verify expenses using transaction account statements

  The FSP provided the applicant a $20,000 line of credit. FOS rejected the consumer's submission that the financial service provider should have reviewed his transaction account for his living expenses and not simply relied upon his credit application. The decision noted that:

  > *There was no obligation on the FSP at the time to cross check living expenses with account statements.*

- Determination 496153[129] – no requirement to collect information of expenses

  A credit card limit was increased from $9,500 to $36,100 based on repayment history and without the consumer's actual living expenses being required. FOS calculated the livings expenses of the Applicant by applying a benchmark of HPI plus 10%. The FOS Determination stated in support of its general approach in such cases:

  > *This is standard industry practice where the credit application is being made without an individual's actual expenses being disclosed, or where an applicant is claiming living expenses that are unrealistically low.*

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[127] Financial Ombudsman Service, *Determination 481247,* (15 February 2018) <https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/481247.pdf>.
[128] Financial Ombudsman Service, *Determination 448069* (21 December 2016) <https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/448069.pdf>.
[129] Financial Ombudsman Service, *Determination 496153* (10 April 2018) <https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/496153.pdf>.

117. Given the problems outlined above, we are concerned that consumers engaged in responsible lending disputes may not have been appropriately remediated for harm caused by the lenders' misconduct and conduct falling below community standards and expectations.

Recommendation 17

- Lenders should be required to independently review all responsible lending complaints received to assess whether their responses meet community standards and expectations, responsible lending laws and ASIC RG209.
- AFCA review and republish its approach to responsible lending disputes.

Credit limit increase offers

118. We submit that the evidence presented at the hearings supports a finding that credit providers do not have adequate policies to ensure that they comply with their responsible lending obligations under the NCCP Act when offering personal overdrafts, credit cards and credit card limit increases to consumers, insofar as those policies require them to:
    - make reasonable inquiries about the consumer's requirements and objectives in relation to the credit contract;
    - make reasonable inquiries about the consumer's financial situation; and
    - take reasonable steps to verify the consumer's financial situation.

119. As set out in Part 1 of our initial submissions to the Commission, the use of automated systems to process and approve applications for unsecured credit is particularly problematic. CBA gave evidence that it automatically assessed customers as eligible for credit limit increases simply by reference to whether a person's monthly average repayments over the last six months were equal to or greater than 2% of the proposed new limit.[130] Further, CBA gave evidence that no inquiries or verification of expenses were conducted as part of the credit limit increase offer processes. Some lenders suggested that small amounts required little or no verification, yet as noted by the Commission even a small loan can cause financial difficulties for a consumer on a low income.[131]

120. We consider that manual assessment is required before credit limit offers should be approved. We also note the recent law reform that made unsolicited credit card limit offers unlawful.[132] Given unsolicited offers of other forms of credit have a similar impact on customers, we consider that they fall below community standards and expectations and should similarly be made unlawful.

Recommendation 18

All unsolicited offers of consumer credit should be unlawful, attracting criminal and civil penalties.

[130] Interim Report, Vol 1, 29.
[131] Ibid.
[132] *Treasury Laws Amendment (Banking Measures No 1) Act 2018 (Cth)*, enacting amendments to section 133BE of the NCCP Act.

AFCA approach to debt waivers and compensation

121. When assessing loss in cases of irresponsible lending,[133] FOS's approach is that the financial service provider should not profit from the transaction[134] and the consumer should be returned to the position they were in before the loan was approved.[135] The perception is that if the borrower does not account for the "benefit" they received from an irresponsible loan, this will cause an injustice to the financial service provider.[136] This approach suffers three flaws:
    - it does not appreciate the significant harm caused to borrowers who experience financial hardship as a result of an irresponsible loan;
    - it undermines the objectives of the responsible lending, which are to ensure strong consumer protection through truth in lending principles;[137] and
    - it assumes that the amount lent was always to the borrower's 'benefit'.

122. Similar concerns were raised in the Round 1 hearings on consumer lending. For example, in the case of Nalini Thiruvangadam, the FOS approach did not take into account the substantial hardship she experienced, including missing rent and utility bill payments to pay her car loan repayments, as a result of the irresponsible loan.[138] Further, in the case of Robert Regan where the lender approved a 30 year loan in the amount of $50,000 to a single 72 year old pensioner for home renovations, the settlement offer from the lender failed to account for the hardship experienced by Mr Regan.[139] The Commission found that the position taken by ANZ in that matter, of requiring full repayment of the capital amount, does not accord with what the community would expect.[140] We agree.

123. The effect of the "penalty" is that the lender is unable to charge fees and interest for the life of the loan, but there is little financial incentive to enter into a reasonable payment arrangement following a determination. While the lender is arguably returned to its original position by being able to recover the principal amount lent in a shortened period, the borrower may have to sell their family home or car to repay a loan they should never have received. This can cause serious financial and personal hardship. In many cases, the hardship imposed has serious long-term consequences that mean the borrower may never recover financially.

124. The lender also has little incentive to lend responsibly. If the loan is determined to be irresponsible, and so no interest is payable, the loan will be accelerated and repaid over a comparatively short term—effectively limiting the loss occasioned by the FOS determination.

125. FOS can forgive a debt in resolution of a responsible lending dispute, however, debt waivers are quite rare.[141] Though there is legal precedent for irresponsibly lent contracts to be set aside ab initio as unjust

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[133] Financial Ombudsman Service Australia, *The FOS Approach to Responsible lending series: How we work out a consumer's loss* cl 1.2.
[134] Assuming what FOS calls the "credit risk", Financial Ombudsman Service Australia, *The FOS Approach to Responsible lending series: How we work out a consumer's loss* cl 1.2.
[135] Assuming what FOS calls the "investment risk", Financial Ombudsman Service Australia, *The FOS Approach to Responsible lending series: How we work out a consumer's loss* cl 1.2.
[136] *Esanda Finance Corporation Ltd v Tong* (1997) 41 NSWLR 482; *First Mortgage Managed Investments Pty Limited v Pittman* [2014] NSWCA 110.
[137] Revised Explanatory Memorandum, National Consumer Credit Protection Bill 2009 (Cth), 6.
[138] Consumer Action Law Centre, *Submission on Round 1 Hearings — Consumer Lending*, [9.26]–[9.40].
[139] Consumer Action Law Centre, *Submission on Round 1 Hearings — Consumer Lending*, [4.1]–[4.14].
[140] Interim Report, Vol 2, 51.
[141] Financial Ombudsman Service, *Determination 266568* (25 February 2013), 15.

transactions, borrowers are generally still required to repay the principal amount owed, and thus account for any "benefit" obtained under the loan.[142] It is difficult to understand how this represents what the community would expect to be fair and reasonable in all the circumstances.

126. Borrowers should be provided with a clear right to debt waivers when a bank lends irresponsibly, including refunds of amounts already paid where appropriate. Where the loan is secured, the bank should also release the security (for example, over a family home or car) where appropriate. This would provide fairer outcomes for victims of irresponsible lending, and incentive to lenders to comply with responsible lending laws.

127. This would also align with the approach under section 180 of the NCCP Act: if a lender engages in 'unlawful credit activity', the borrower is not liable for future payments and is entitled to recover any amounts already paid under the loan. Currently, 'unlawful credit activity' applies to limited offences under the NCCP Act: engaging in unlicensed credit activity and providing short-term credit for a term of less than 16 days. Given that irresponsible lending to consumers is also a criminal offence,[143] it seems appropriate that this approach be extended to unaffordable loans. The Banking Code of Practice also provides for debt waivers in exceptional circumstances.[144]

128. Where a borrower would be 'unjustly enriched' from the use of a secured asset (for example, living in a house), there should be a straightforward and fair calculation for determining the value of the benefit they derived. This should take into account any distress or hardship the borrower experienced as a result of the irresponsible loan. If the value of the benefit is more than the amount already paid under the loan, the residual amount owed should only be repaid in affordable instalments. A reasonable repayment plan ought to begin with repayments being made within the original term of the loan.

129. We also consider that the compensation cap for non-financial and indirect financial loss at AFCA should be removed.[145] Due to these differing limits there is a marked disparity in potential financial outcomes for otherwise similar disputes, which may encourage forum shopping. This specific limit should be removed, with AFCA empowered to award fair and reasonable compensation for consequential loss. Alternatively, this specific limit should be increased substantially.

Recommendation 19

- Provider borrowers with a clear right to debt waivers when a bank lends irresponsibly, including refunds of amounts already paid where appropriate.
- Remove the AFCA cap on compensation for non-financial or indirect financial loss.

[142] *Australian Securities and Investments Commission v Channic* [2016] FCA 1174.
[143] *National Consumer Credit Protection Act 2009* (Cth) s 133.
[144] Australian Banking Association, *Code of Banking Practice* (2019) cl 171, <https://www.ausbanking.org.au/images/uploads/Banking_Code_of_Practice_2019_web.pdf>.
[145] The proposed cap is currently $5,000 and would provide insufficient compensation for loss and hardship caused by misconduct in many cases. The Office of the Australian Information Commissioner has no limit on non-financial loss. The Queensland Civil and Administrative Tribunal can award compensation of up to $100,000 for loss or damage (including injury to feelings or humiliation) in privacy complaints, and there is no limit on compensation for discrimination complaints in Queensland (Office of the Information Commissioner Queensland, *How to put a price on damage suffered as a result of a privacy breach* (May 2018) <https://www.oic.qld.gov.au/information-for/information-privacy-officers/case-notes/how-to-put-a-price-on-damage-suffered-as-a-result-of-a-privacy-breach>; Anti-Discrimination Commission Queensland, *Complaint Outcomes* <https://www.adcq.qld.gov.au/complaints/resolving-complaints/complaint-outcomes>).

Should the NCCP Act apply to any business lending?

130. Consumer Action considers that neither the general law, or the Code of Banking Practice, is sufficient to offer adequate protection to small business borrowers, or third-party guarantors.

131. Consumer Action regularly receives contacts from consumers in relation to difficulty arising from small business loans. There are generally two types of difficulties—first, where loans are written as a business loan but are used for personal or domestic purposes (i.e. when a lender seeks to avoid consumer lending rules) and second, where loans are advanced without sufficient assessment of the sustainability of the business venture or affordability of repayments.

132. We submit that consideration should be given to applying the NCCP Act to business lending, particularly sole traders. The growth of the 'gig economy', for example ridesharing and delivery services, has meant that the line between business and consumer credit has blurred. Unscrupulous brokers and lenders have taken advantage of this lack of clarity by pressuring or suggesting that consumers take out 'business' loans to avoid licensing requirements and complying with the protections offered by the consumer credit laws. While this misconduct currently appears to be limited to non-bank fringe lenders (which appear to fall outside the Commission's terms of reference), these practices can be promoted by brokers.

133. In relation to assessments, Consumer Action considers that there are strong incentives on banks to seek security for a small business loan, and for this security to be a residential home. This in turn dulls the incentive for lenders to undertake inquiries expected of a 'diligent and prudent banker' when deciding to lend to a small business. We consider that this dynamic justifies greater obligations on lenders when lending to small business, as well as when obtaining a third party-guarantee.

134. The Productivity Commission recently examined issues associated with small business lending in its Inquiry Report into Competition in the Australian Financial System. It found that a significant amount of lending to small and medium enterprises is secured by real estate, often a residence. Around a third of all small business lending by value by the major banks is secured by residential property.[146] For the smaller Australian-owned banks, the share of small business lending secured by residential property is higher.[147]

135. The Productivity Commission's analysis found that the APRA capital requirements create an incentive for lenders to seek a residence as collateral for small business finance. This is because the risk weighting that is applied to residence-secured loans is far lower than that applied to unsecured small and medium enterprise lending. The Productivity Commission notes that for a $100,000 unsecured loan, an authorised deposit taking institution would be required to offset the loan with $7,000 in capital, compared to $2,450 to $5,250, if secured by a residence.[148] This creates a significant incentive for the lender to seek security over a residential property.

136. Academic analysis confirms that the taking of collateral for business lending can create inappropriate incentives for lenders. For example, it has been suggested that collateral may induce bad performance

[146] Productivity Commission, *Competition in the Australian Financial System*, 442.
[147] Ibid.
[148] Productivity Commission, *Competition in the Australian Financial System*, 450.

linked to reduced monitoring and investments by the bank.[149] This has been termed the "lazy bank effect". Banks also play an important economic function by screening projects thereby reducing project failures and thus mitigating their private and social costs. One article suggests that strong creditor protection may lead to market equilibria in which cheap credit is inappropriately emphasised over project screening.[150]

137. We note that business-owners may have limited equity or assets other than the owner's house. However, we are concerned that the ability of lenders to obtain collateral means that they are less likely to make detailed inquiries and assessments of business plans and the applicant's financial position before advancing a business loan. In short, banks can rely on their security rather than overly concern themselves with the sustainability of the loan.[151]

138. We also consider that banks and other lenders are likely to have significant intelligence and information about the sustainability of particular business ventures. First, many small businesses fail each year. The Productivity Commission has found that up to 15% of small businesses close each year, and that only around 65% of small businesses last three years.[152] Second, many of the case studies considered by the Commission concerned franchise businesses, and the large banks in particular are likely to have good information about the sustainability of particular franchise businesses. This is because they are likely to have experience lending to these types of businesses. We do not consider it onerous for banks to use this information to inform themselves about a lending decision.

139. This is particularly a concern given the implication of non-payment and default on a small business loan can be the loss of a family home or financial difficulty more generally. Calls to the National Debt Helpline are increasingly from owners of small business in distress. This financial difficulty has significant consequences not only for the individuals involved (including stress, anxiety, upheaval and potentially detriment to health and wellbeing associated with homelessness) but there are also costs incurred by the broader community and society. These costs can be invisible to the bank or lender who maintains its profit because of recourse on any security and may in fact be in excess of any benefits that are attributable to access to credit for small business ventures generally. We are particularly concerned about the position of distressed small business borrowers who sometimes seek additional finance to keep their business afloat, with some practices of lenders amounting to equity or asset stripping.

140. We also note that existing case law on clause 25.1 of the Code of Banking Practice does not appear to require a that a bank must form an opinion that a borrower will be able to repay the loan.[153] Instead, this clause is concerned with the process and forming of the opinion, and not the substantive decision to lend itself. In this context, we do not think it is unreasonable for the law to set out in more detail what is required of a diligent and prudent banker when deciding whether to lend to a small business.

141. We consider that provisions of NCCP Act, and particularly amendments proposed to extend responsible lending provisions to prescribed small business loans contained in the Exposure Draft of the National

[149] Julien Cadot, 'Collateral, bank monitoring and firm performance: the case of newly established wine farmers', 57(3) *Australian Journal of Agricultural and Resource Economics* 344.
[150] Michael Maove et al, 'Collateral versus project screening: a model of lazy banks' (2001) 32 *RAND Journal of Economics* 726.
[151] In New South Wales, this form of asset lending for business may be held to be unjust under the *Contract Review Act 1980 (NSW)*. See *Perpetual Trustee Company Limited v Albert and Rose Khoshaba* [2006] NSWCA 41.
[152] Productivity Commission, *Business Set-Up, Transfer and Closure*, Report No 75 (2015) 56–7.
[153] *Doggett v Commonwealth Bank of Australia* (2015) 47 VR 302; [2015] VSCA 351.

Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012,[154] provide a workable model.

142. In the alternative, small business borrower protections could be enhanced by extending section 76 of the NCCP Act relating to unjust transactions to all business transactions.[155] Further, the current 'business purpose' test that requires 50% or more of the loan to be for a business purpose to avoid regulation could be increased to 100%.[156] This would limit the regulatory loopholes for lenders looking to skirt the law by providing unaffordable loans to people who are not borrowing wholly for a business purpose, and also simplify the law.

Recommendation 20

- Introduce amendments proposed to extend responsible lending provisions to prescribed small business loans contained in the Exposure Draft of the National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012.
- In the alternative, extend section 76 of the NCCP Act relating to unjust transactions to all business transactions. Further, the current 'business purpose' test that requires 50% or more of the loan to be for a business purpose to avoid regulation could be increased to 100%.

Is the definition of 'small business' satisfactory?

143. We do not consider that the definition of small business in the Code of Banking Practice is satisfactory. We support the definition of 'small business' as will be used by used by AFCA as having "less than 100 employees at the time of the act or omission by the Financial Firm…"[157] with credit facilities of up to $5 million.[158] Adopting a definition that is consistent with the AFCA approach would reduce complexity and provide more appropriate protections to small business borrowers. In practice, it is likely that AFCA would consider the Code of Banking Practice obligations as examples of good industry practice in making determinations, even where the credit facility limit exceeded the cap in the Code of Banking Practice, making the differences even less justified.

Recommendation 21

The definition of small business in the Code of Banking Practice be consistent with the definition adopted by AFCA.

Guarantees

144. The dynamic described above in relation to small business lending operates similarly in relation to the practice of banks to seek guarantees in the form of security over a residential home where the small business borrower doesn't hold any security personally. A guarantee can be commonly provided by a family member, such as the case of Carolyn Flanagan and Westpac. Sometimes guarantees are made by directors or shareholders of a small business borrowing company, with the family member (often an

[154] Exposure Draft, National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012.
[155] This would align Australia with the law of New South Wales which permits court to re-open any contract, or a provision of a contract, which is unjust. *Contract Review Act 1980 (NSW)*.
[156] See definition of 'credit activity' in section 6 of the *National Consumer Credit Protection Act 2009 (Cth)*.
[157] Australian Financial Complaints Authority, *Complaint Resolution Scheme Rules* (2018) E.1.1, 42.
[158] Ibid, D.4, 35.

elderly parent) installed in one of these roles in an effort to suggest that they are obtaining a direct financial benefit from the transaction. However, more often than not, they are in substance a volunteer, and do not obtain benefit from the arrangement.

145. The Interim Report notes that the general law has always been careful of the position of the volunteer: the person who enters a transaction from which he or she stands to gain no benefit.[159] While equitable and statutory prohibitions on unconscionable conduct, as well as provisions of the Code of Banking Practice, have operated in some cases to prevent a bank from enforcing a guarantee, we consider that these do not respond effectively to the risk of substantial detriment to a particularly vulnerable group.

146. First, the level of duty required by the prohibition on unconscionable conduct is far from clear. While the *Amadio*[160] and *Garcia*[161] decisions provide some insight in the context of guarantees, more recent decisions relating to unconscionable conduct provide varying jurisprudence about the meaning of the prohibition.[162]

147. Moreover, the *Amadio* and *Garcia* cases related to situations where the bank took no steps to explain the transaction and the guarantor did not receive independent legal advice. In many cases, the bank does take steps to explain the transaction and to refer the guarantor for independent legal advice. Indeed, clause 31 of the Code of Banking Practice[163] requires subscribing banks to give prominent notice of financial risks and other rights, including the right to seek independent legal advice. Our experience is that, while not always effective, banks do have policies and procedures that contribute to compliance with these procedural requirements.

148. Our concern, however, is that vulnerable people may agree to provide a guarantee to their detriment although the transaction has been explained. This is because, despite their stated 'understanding' of the transaction and the risk of losing their home, the decision to enter the guarantee is taken without a full understanding of the implications or because of a sense of familial duty. This lack of full understanding occurs because of the emotional context of the familial relationship, diminishing the prospect for rational decision-making. Even where legal advice is obtained, this might not overcome this sense of familial duty. As Ms Flanagan stated, she would have signed anything for her daughter: "If you can't help your children, who can you help?".[164]

149. There is also much evidence of the impact of elder abuse in this context. For example, the Australian Law Reform Commission (**ALRC**) has recognised that guarantees and joint loans are a particular site of elder abuse.[165] Elder abuse can occur even without intention, that is, the borrower might not actively intend to cause harm, but the effect on the older person can be catastrophic if a guarantee they have provided is called upon. The key finding from the ALRC inquiry is, in relation to financial elder abuse, that banks and other financial institutions will often be in a prime position to detect and prevent the financial abuse of their older and at-risk customers. We agree, however for the reasons outlined above,

[159] Interim Report, Vol 1, 178.
[160] *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.
[161] *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395.
[162] Robert Baxt, 'Continuing furore over moral obloquy and unconscionability' (2017) 91 *Australian Law Journal* 809.
[163] Australian Bankers' Association, *Code of Banking Practice* (2013) cl 31.
[164] Transcript, Carolyn Flanagan, 21 May 2018, 2046.
[165] Australian Law Reform Commission, *Elder Abuse—A National Legal Response,* ALRC Report No 131 (2017), 309.

we are not convinced that information provision and independent legal advice is sufficient to protect vulnerable older guarantors.

150. The requirement to be a diligent and prudent banker also does not appear to operate to assist a guarantor or put an effective obligation on the bank to ensure potential detriment to the guarantor is minimised. For example, in *Doggett,* the court held that

> *"a bank may take due care in forming an opinion as to whether a borrower can repay a loan and decide that, although it is possible that the borrower may not be able to repay the loan, it will offer the loan in any event. That may be, for example, because additional resources can be obtained by the borrower before the loan proceeds or during its term. Or it may be because other financial resources, not immediately available to the borrower, would in the event of default be available to the bank (**in particular by way of security or guarantee arrangements**)" [emphasis added].*[166]

151. Given the above, we consider that there is strong evidence to shift the boundaries of established legal principles, existing law and the industry code of conduct in relation to guarantees. Currently, the focus seems to be on what the bank did, knew or understood about the guarantor's understanding of the transaction. As stated in the Interim Report in relation to Ms Flanagan: "[t]o decide whether Westpac acted unconscionably in taking the guarantee, it would be necessary to pay close attention to what the banker concerned knew or understood about Ms Flanagan's appreciation of what she was doing".[167] This pays insufficient attention to the potential for detriment to the guarantor that loses their home, and the consequent social or community costs. It also fails to respond to the concerns outlined above about the limited effect of information or advice, or the dynamic of financial elder abuse.

152. Consumer Action therefore recommends a new obligation on banks and lenders when accepting a guarantor from a third-party volunteer. In particular, we consider that if the guarantee provided involves security over a residential property, there should be a specific suitability obligation. This would require a lender to be satisfied that the arrangement is suitable for the guarantor and, in particular, that the lender would be required to assess that the arrangement as unsuitable if it would cause the guarantor substantial hardship if the guarantee is called upon. Substantial hardship should be presumed where consumers are required to sell their home, or release equity, to meet the guarantee. In the event that a lender enforces a guarantee and the guarantor is required to sell their residential property to comply with the lender's demand, the guarantor should be given the option to remain in their home and the guaranteed debt be converted as a security against the home that only becomes payable upon sale of the home or death of the guarantor.[168] We consider this to be a balanced approach that will allow guarantees to be provided by those with sufficient resources to do so, but will ensure that more vulnerable people are not left in financial difficulty due to inappropriate guarantees.

Recommendation 22

- If a guarantee provided involves security over a residential property, there should be a specific suitability obligation. This would require a lender to be satisfied that the arrangement is suitable for the guarantor and, in particular, that the lender would be required to assess that the arrangement as unsuitable if it would cause the guarantor substantial hardship if the guarantee is called upon.

[166] *Doggett v Commonwealth Bank of Australia*, 342 [163]; 48 [163].
[167] Interim Report, Vol 2, 268.
[168] This aligns with the relief granted in the Carol Flanagan case study and Westpac admitted "that the outcome ultimately reached with Ms Flanagan could and should have been reached earlier" Interim Report, Vol 2, 269 [1.6].

- If a guarantee is enforced and the guarantor is required to sell their home to comply with the guarantee, the guarantor should have the option to remain in the property and the debt be converted as an interest free security against the home.

How should lenders manage exit from a loan if the borrower is in default?

153. The answer to this question begins with the original suitability assessment completed by the lender, and the credit assistance provider where appropriate. As demonstrated by Robert Regan's case study, some lenders have simply engaged in asset lending by approving loans based on the person being able to sell their home to meet loan repayments. In Mr Regan's case, an ANZ assessment officer considered that Mr Regan's 'exit strategy' was for him to 'downsize if required and pay out the loan', despite no such exit strategy being discussed with him.[169] In this case, the loan is presumed to be unsuitable as the borrower could not afford to make repayments without selling their principal place of residence.[170] In these circumstances, we consider that an appropriate remedy is for interest and fees to be waived, and compensation or debt waivers to be provided, as discussed above. We do not consider that selling the home would be an appropriate strategy for managing exit from the loan in these circumstances.

154. However, often people enter financial hardship after the approval of a loan. Lenders have hardship obligations under the NCCP Act.[171] These provisions require lenders to respond to a hardship notice provided by a borrower in writing within 21 days. The lender must confirm whether the credit provider agrees to a hardship variation or, if the credit provider does not agree, provide details about external dispute resolution. If a credit provider does not agree to a hardship variation, all enforcement must stop until 14 days after the notice of refusal is given.

155. The Code of Banking Practice arguably goes further, requiring signatories to work with borrowers to help you a sustainable solution to financial difficulties, and sets out examples of steps that might be taken to help a borrower.[172] Signatories are also not permitted to a sell a debt if the lender is considering a hardship variation or if the borrower is complying with a hardship arrangement.[173]

156. We consider that complying with these obligations is essential to ensuring that borrowers experiencing financial difficulties are able to get back on their feet. Lenders' approach to handling consumers in default should be tailored to the borrower's circumstances. The response should also include an analysis of whether the loan was initially irresponsibly lent, as this should change the remedy offered to the borrower. Arrangements for exiting a loan when in default should ideally not leave the consumer suffering long term financial hardship as a result.

157. Often loans in default are referred to external debt collectors by lenders. Aggressive debt collection practices can be highly distressing for borrowers, and might also contravene the ACCC/ASIC Debt

[169] Interim Report, Vol 2, 47. See also FOS Determination 428083 (21 March 2017), https://forms.fos.org.au/DapWeb/CaseFiles/FOSSIC/428083.pdf where broker developed an "exit strategy".
[170] *National Consumer Credit Protection Act 2009* (Cth) s 131.
[171] *National Consumer Credit Protection Act 2009* (Cth) sch 1, ss 72–5.
[172] Australian Banking Association, *Code of Banking Practice* (2019) cl 167–173 <https://www.ausbanking.org.au/images/uploads/Banking_Code_of_Practice_2019_web.pdf>.
[173] Ibid,) cl 184.

collection guideline.[174] Consumer Action regularly deals with cases where banks have sold the unsecured debt of people living on low incomes, and then the debt collector seeks recovery including through bankruptcy resulting in escalating trustee fees and the loss of a home. We strongly supported Code of Banking Practice signatories being required to monitor the behaviour of their external debt collectors,[175] which was recommended by the Code Review.[176] However, the industry did not support this recommendation.[177] We consider that banks should go further and commit to not selling debt of people living on low-incomes (for example, Centrelink income) given the deleterious consequences that commonly follow.

Recommendation 23

- Lenders improve financial hardship practices to reduce the number of consumers suffering long term financial hardship.
- Require lenders to monitor the behavior of external debt collectors.
- Lenders should commit to not selling the debt of people who live on low-incomes.

Regulation and the regulators

Has ASIC's response to misconduct been appropriate?

158. Currently, ASIC is unable to intervene until consumer harm has already occurred. Often misconduct has been occurring for years before enforcement action is able to be taken. While the proposed product intervention power should assist ASIC to respond more quickly to risks of consumer harm, the current Bill has limitations. For example, interventions are to be limited for 18 months. Without permanent rule making power, which is available to the Financial Conduct Authority in the United Kingdom, poor practices may continue. We have recommended throughout the consultations on the product intervention power that the proposed power be strengthened significantly.[178] ASIC also needs the resources and leadership required to use these powers effectively.

159. The ASIC Enforcement Review Taskforce has also identified some important gaps in the effectiveness of the regulatory framework and recommended reforms should be adopted as soon as possible.[179] We support the reforms proposed by the Taskforce as we consider that these enhancements would assist ASIC to more effectively regulate the sector, and increased penalties would better deter misconduct. However, despite the increase, we remain concerned that the courts may not seek to impose high penalties.

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[174] ASIC/ACCC, *Debt collection guideline: for collectors and creditors*, July 2017, <https://www.accc.gov.au/system/files/776_Debt%20collection%20guideline_July%202017_FA.PDF>.
[175] Joint consumer submission, *Submission to the Independent Review of the Code of Banking Practice 2016* (September 2016) <http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/01/24-Joint-Consumer-Submission-Review-of-Code-of-Banking-Practice-CCMC.pdf>.
[176] Khoury.
[177] Australian Bankers' Association, *Code of Banking Practice: Response by Australian Bankers' Association to Review Final Recommendations* (28 March 2017) <https://www.ausbanking.org.au/images/uploads/ArticleDocuments/113/Banking%20Industry%20response%20to%20Khoury%20Review.pdf>.
[178] Most recently here: Joint consumer submission, *Design and Distribution Obligations and Product Intervention Powers*.
[179] https://treasury.gov.au/review/asic-enforcement-review/>.

160. Consumer Action considers that the proposed increase in maximum civil penalties may not have the desired impact. The OECD reports that when maximum penalties for breach of competition laws have been increased, courts did not award correspondingly higher penalties.[180] The report suggests that jurisdictions that use a more structured approach to the setting of civil penalties result in higher penalties being imposed. See our submission to the exposure draft legislation on penalties for more information. [181]

161. ASIC's funding needs to be at a level that enables it to respond promptly to instances of misconduct. Additional funding is required for enhanced enforcement activities, financial literacy and outreach work, and to run test cases to challenge systemic misconduct. ASIC needs the ability to exercise its enforcement powers effectively to protect consumers and enhance confidence in the market. ASIC must also be able to offer remuneration comparable to the private sector in order to attract and retain experienced staff who are responsible for investigations and prosecutions of misconduct.

162. Lack of resources can contribute to delays between the identification of misconduct redress. Delays to ASIC's investigative processes can also be caused by inadequate systems within the entities being investigated. For example, the Commission was critical of Westpac and NAB's inability to draw together information about instances of misconduct, saying that it indicated a 'disjointed, piecemeal approach to monitoring compliance with applicable laws.'[182]

163. Consumer Action reviewed ASIC actions from 2014 to the present, focusing on consumer credit and insurance. This included enforcement actions through the courts, enforceable undertakings and negotiated agreements. Of the 37 actions identified, the average time period from when the misconduct occurred to the conclusion of the action (or the undertaking or agreement date) was approximately five years. Evidently, the court process is generally not conducive to speedy outcomes for consumers.

164. ASIC is also required to enforce laws that in some cases do not adequately address the consumer harm caused, and leave significant room for entities to avoid responsibility for any conduct falling below community standards and expectations. In addition, technical innovation means that legislation and regulators are failing to keep pace with the rate of changes among the finance sector.

165. Notwithstanding the above, we consider that ASIC's response to misconduct overall has been appropriate. ASIC has been forced to prioritise its work across its many areas of responsibility and has recently been able to focus on consumer remediation. However, we agree that community expectations of the regulator's role have not been met. It is our view that both the regulator and the Government are responsible for responding to this with increased powers, penalties and resources and enforcement action where appropriate.

Recommendation 24

- Improve ASIC resources and powers, and increase penalties, to improve enforcement capabilities.

[180] OECD, *Pecuniary Penalties for Competition Law Infringements in Australia 2018*, 26 March 2018, http://www.oecd.org/daf/competition/pecuniary-penalties-competition-law-infringements-australia-2018.htm.
[181] Consumer Action Law Centre, Submission to Treasury on the Exposure Draft of the Treasury Laws Amendment (ASIC Enforcement) Bill 2018, 18 October 2018, <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/10/181018-Submission-to-Treausry-ASIC-2.pdf>.
[182] Interim Report, Vol 1, 41-42.

- Ensure any external review of ASIC has equal representation from industry and consumer advocacy sectors.

CAUSES

166. We refer to and repeat Part 2 of our initial submissions to the Commission in relation to drivers of misconduct and conduct falling below community standards and expectations.[183]

167. We agree with the Commission that key causes of the conduct identified and criticised in the Interim Report were conflict of interest and duty, remuneration structures, culture and governance and the regulatory response. We have made further comments about below, and have also summarised additional causes we consider can be attributed to misconduct.

Conflict of interest and remuneration

168. Conflict of interest and remuneration structures are addressed together, as we consider that they are inextricably linked.

169. Sales targets, product sales commissions and product-based payments inevitably distort adviser and sales-staff behaviour, elevating the sales imperative above considerations of consumer well-being. A number of international studies have confirmed a strong correlation between target-based sales incentives and consumer harm.[184] The frequency and extent of this harm is such that the role of commissions and product-based payments, indeed the whole sales-based culture of banking and insurance, should be fundamentally reconsidered.

170. The existing requirement to disclose commissions to consumers[185] cannot resolve the systemic conflict created by commissions structures. Disclosure does not necessarily alert a customer that they need to proactively assess the advice they receive, as discussed above.

171. The Sedgwick Review also found that some remuneration practices 'carry an unacceptable risk of promoting behaviour that is inconsistent with the interests of customers'.[186] Following the publication of the Sedgwick Review, many banks have taken welcome steps to remove 'financial outcomes' from bank tellers' and other bank staff's performance assessment criteria. However, this review did not advocate for the removal of conflicted remuneration from the finance sector and as the Interim Report recognises, 'banks continue to remunerate employees in ways that emphasise sales'.[187] As noted previously in this submission, the recommendations of Sedgwick have not been fully adopted, confirming the inadequacy of a self-regulatory approach. It is clear from the evidence at the Commission that far more needs to be done.

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[183] Consumer Action Law Centre, *Submission on Behalf of Consumer Action Law Centre — Part 2*.
[184] A summary of this research is available in: Consumer Action Law Centre, *Submission to the Retail Banking Remuneration Review Issues Paper* (12 February 2017), 3–5 <https://consumeraction.org.au/wp-content/uploads/2017/02/170212-Consumer-Action-Submission-Sedgwick-Review-Issues-Paper-FINAL.pdf>.
[185] See, for example, *Corporations Act 2001 (Cth)* s 942B(2)(e).
[186] Stephen Sedgwick, *Retail Banking Remuneration Review* (19 April 2017), 4.
[187] Interim Report, Vol 1, 316.

172. Consumer Action notes that remuneration must be considered alongside incentives. This might mean career advancement, threats of performance management or simply management priorities. Remuneration is a powerful influencer of behaviour, but other structural incentives to prioritise selling also create significant conflicts of interest. We agree with the Commission's observation that 'experience… shows that conflicts cannot be 'managed' by saying, 'Be good. Do the right thing'. People rapidly persuade themselves that what suits them is what is right'.[188] Remuneration and incentives are key to encourage compliance and a customer-centric culture.

173. Consumer Action considers that conflicted remuneration and incentives should be prohibited in relation to all financial and credit products, particularly in circumstances where the consumer is led to believe they are receiving 'advice'—either general or personal. While the FOFA regime had good intent, the ultimate outcome was complex legislation with significant loopholes that failed to address consumer harm caused by conflicts of interest. We support the prohibition on conflicted remuneration being extended to managers and senior executives. As noted by the Commission, 'providing senior management with incentives based on sales or revenue and profit will inevitably affect how senior management acts with respect to more junior members of staff.'[189] We need to challenge the assumption that without variable incentives people will simply stop doing their job or will perform badly.

Recommendation 25

- Conflicted remuneration and incentives should be prohibited in relation to all financial and credit products.
- Ensure the ban on conflicted remuneration is extended to senior management and executives.

Culture and governance

174. As discussed above, Consumer Action considers remuneration and incentives to be key drivers of poor culture. Our response below focuses on the potential role of the Banking Executive Accountability Regime (**BEAR**) in improving executive and organisation culture, and why the regime needs to be strengthened.

175. We are supportive of the intentions of the BEAR reforms but consider that alterations should be made to ensure these intentions are better realised. This could be achieved by better linking executive remuneration and any penalties to widespread consumer harm as well as providing ASIC with equivalent powers to ensure it can effectively regulate non-ADI entities such as insurance and financial advice providers.

176. The BEAR should require ADIs and non-ADI entities to clearly assign responsibility to specific managers holding them accountable through a statutory duty of responsibility. The accountability regime should also require accountable persons to take reasonable steps to prevent regulatory breaches, including breaches of regulations related to consumer protection, in the areas of the bank for which they are responsible. Additionally, the BEAR should ensure accountable persons are required to act with integrity and pay due regard to the interests of customers and treat them fairly.

[188] Interim Report, Vol 1, 91.
[189] Interim Report, Vol 1, 308.

177. The accountability measures in the BEAR should mirror the United Kingdom's Senior Manager's Regime where powers to the Prudential Regulation Authority and the consumer and conduct regulator (the Financial Conduct Authority) have been extended. These regulators have worked together to clarify requirements that industry must meet, ensuring that the United Kingdom regime covers both prudential and consumer matters.

178. There must be significant penalties for accountable persons and ADIs for contravening the BEAR provisions to properly deter misconduct, negligence and poor conduct generally. These penalties must be supported by a proactive and effective enforcement regime. This includes public reporting of APRA enforcement actions, such as naming disqualified accountable persons.

179. In November 2017 we submitted to the Senate Standing Committee on Economics that the BEAR is currently restricted in its application as it only applies to "conduct that is systemic and prudential in nature."[3] This fails to provide accountability measures for poor consumer outcomes. The scope of entities covered also contrasts with other jurisdictions such as the United Kingdom where the equivalent regime has been extended to cover insurers and non-prudentially regulated firms as well as banks.[4] Extending the application of the BEAR to account for consumer outcomes would likely require powers to be shared between APRA and ASIC. These powers should be developed in tandem rather than isolation to ensure that there are no gaps in the system.

Recommendation 26
Extend the Banking Executive Accountability Regime to mirror the equivalent regime in the United Kingdom.

Regulator response

180. As noted by the Commission, it should not be forgotten that 'each financial services entity is responsible for its own conduct.'[190] While some members of community have been critical of ASIC's response to misconduct, it is the entities involved that have broken the law and harmed consumer. Their culpability should be in no way diminished.

181. In relation to the ASIC Enforcement Review, we broadly support the recommendations made. In particular, we strongly support increased penalties and extending civil penalties to the general obligations of licensees. However, we recommend that the general prohibition on misleading and deceptive conduct as well as the prohibition on unfair contract terms to be offence provisions and subject to a civil penalty. Further, as discussed above, we consider that there is a need to provide additional guidance to the courts to impose higher penalties that meet community expectations. We also support funds obtained through a relinquishment order being returned to customers or groups acting in customers' interests in appropriate circumstances.[191]

182. In terms of ASIC's enforcement priorities, we have welcomed ASIC's recent focus on customer remediation. In terms of setting enforcement priorities, we consider that customer remediation should continue to be a significant priority in addition to enforcement. We support increased enforcement action but note that ASIC has taken enforcement action in the past without seeing improved practices across the relevant sector, particularly in relation to irresponsible lending. Further, as noted above,

[190] Interim Report, Vol 1, 268.
[191] For more information, see Consumer Action Law Centre, *Submission to Treasury on the Exposure Draft of the Treasury Laws Amendment (ASIC Enforcement) Bill 2018*.

Courts have often been reluctant to impose significant penalties when action has been taken. This has allowed firms to take a 'risk-based approach' rather than a 'zero tolerance approach' when it comes to compliance. For example:

- *ASIC v ANZ* [2018] FCA 155 – Irresponsible lending. Total available penalties were $30.6 million, actual penalty imposed was $5 million.
- *ASIC v Make It Mine (No 2)* [2015] FCA 1255 – Irresponsible lending. Make It Mine making $2.51 million per month for the year 2014/15. Penalty of $1.25 million imposed.
- *ASIC v GE Capital Finance Australia* [2014] FCA 701 – False and misleading conduct in relation to credit cards. GE income for 2011 over $494 million. Penalty of $1.5 million imposed.

183. There are limitations on the outcomes that court action can achieve, particularly given the length and cost of instituting proceedings. Often a decision will not be reached until years after the offending conduct. In the interim, countless consumers can continue to be harmed by misconduct across the industry while waiting for a court outcome. While we strongly support and expect robust enforcement action from the regulator, we consider that the enforcement response must be tailored having regard to which approach would achieve the best outcomes for consumers. Regulators require flexibility in making enforcement decisions in order to do this.

Other causes

184. We consider that other causes of misconduct include:

- Inadequate laws and policies, including insufficient remedies for irresponsible lending, insufficient penalties, regulatory gaps and avoidance tactics. We have seen a tendency for proposals to be watered down during policy-making and legislative process, caused in part by industry lobbying;
- Delays in regulatory reform, often due to the nature of legislation making;
- Inadequate investment in internal systems to comply with regulation and detect and respond to misconduct. This includes over-reliance on benchmarking and third parties by credit providers to discharge responsible lending obligations;
- Inadequate supervision of third parties and representatives, including brokers, car dealers and referrers;
- Over-reliance on self-regulation, including a lack of effective enforcement of industry codes of conduct and a 'first mover problem' in the industry; and
- Inadequate access to justice for consumers, including access to financial counsellors and legal assistance, which reinforces the drivers of misconduct in the belief that poor practices will go unpunished.

RESPONSES

What responses should be made to the conduct identified and criticised in this report?

185. We consider that ten broad responses are required to address the conduct identified and criticised in this report, and the conduct identified in our casework:

- Stopping over-reliance on self-regulation;
- Regulating having regard to the social purpose of banking and finance;
- Improving conduct standards, product design and distribution;
- Reducing or eliminating conflicts of interest;

- Improving access and support for groups experiencing disadvantage;
- Increasing industry professionalism;
- Providing redress for consumers;
- Improving funding for consumer assistance and advocacy;
- Deterring misconduct with significant consequences for contraventions; and
- Future-proofing and fast-tracking regulatory reform.

186. Specific recommendations relating to these ten themes have largely been set out above. Additional recommendations are outlined below in response to the Commission's questions relating to simplification of the law, eliminating carve outs, funeral insurance and the regulatory response, including outcomes-based regulation and the role of the regulator. Most of these recommendations require law reform to implement.

Should the financial services law be simplified?

187. We support the financial services law being simplified so that carve-outs and exemptions from important consumer protections are reduced. In our view, any simplification should only be considered in the context of removing regulatory loopholes or duplication that creates unnecessary complexity in the law. Simplification should not be used as a guise for reducing consumer rights. 'Cutting red tape' has too often been used as an excuse for increasing the power imbalance between business and consumers. The evidence adduced at the Commission has shown that we need a reduction in carve outs, not a reduction in consumer protections.

188. The judiciary has had concerns about the unnecessary complexity of consumer laws previously, including the different definitions for 'financial product' in the Corporations Act and ASIC Act. We have previously advocated for important consumer protections to be applied using the simpler definition of 'financial products' in the ASIC Act to remove unnecessary loopholes, for example, in relation to the proposed design and distribution and product intervention powers.[192] Justice Rares expressed his frustration in *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* [2012] FCA 1028, saying:

> *The repealed, simple and comprehensive s 52 of the Trade Practices Act 1974 (Cth) that prohibited corporations engaging in misleading or deceptive conduct in trade or commerce has been done away with by a morass of dense, difficult to understand legislation. Those Acts, that now deal with misleading and deceptive conduct, apply differently depending on distinctions such as whether the alleged misleading conduct is in relation to "a financial product or a financial service" (s 1041H(1) of the Corporations Act 2001 (Cth)) or "financial services" (s 12DA(1) of the Australian Securities and Investments Commission Act 2001 (Cth)). Those apparently simple terms are nothing of the sort. A "financial product" is defined in mind-boggling detail in 7 pages of small type in Div 3 of Pt 7.1 of the Corporations Act while a "financial service" takes another 6 pages to be defined in Div 4 of Pt 7.1. The ASIC Act only takes about 4 pages to define "financial service" in s 12BAB.*
>
> *Obviously, there are differences in what each of these Acts and definitions cover – but why? The cost to the community, business, the parties and their lawyers, and the time for courts to work out which law applies have no rational or legal justification. The Parliament should consider returning to a simple clear two line long universal norm of conduct, as was contained in s 52, if it considers that misleading and deceptive conduct in trade or commerce ought be prohibited.*

[192] Joint consumer submission, *Design and Distribution Obligations and Product Intervention Powers*.

189. We note that industry has often opposed simplification in the context of removing carve outs and exemptions. The sector has at times baulked at important consumer protections applying broadly across the sector rather than in piecemeal fashion and has benefited from complexity and loopholes. Principles-based regulation has been opposed on the grounds of 'regulatory uncertainty', with the sector often demanding detailed regulatory guidance or legislation to fill the gaps or simply interpreted these principles as setting a low bar. The courts have at times not helped in this regard, particularly in relation to judicial interpretation of unconscionable conduct.[193]

Recommendation 27
Simplification should only be considered in the context of reducing regulatory loopholes or duplication that creates unnecessary complexity in the law. Simplification should not be used as a guise for reducing consumer rights.

190. We have made additional comments below about particular carve outs we consider should be removed: the point of sale exemption and funeral expenses exemptions.

Point-of-sale exemption

191. The Interim Report clearly demonstrates the consumer harm that flows from car dealers and other retailers being exempt from the NCCP Act provisions. Consumer Action has for many years supported the removal of this exemption.[194] The point-of-sale exemptions under the NCCP Act have resulted in retail dealers placing their own interests ahead of their customers. Consumer Action's caseworkers witness first-hand the harm and stress that results from individuals being signed up to exploitative loans through car dealerships.[195] We strongly urge the elimination of point-of-sale exceptions under the NCCP Act so that car dealers and exempt retailers are regulated on par with other credit providers and are required to meet responsible lending requirements. We note that the Finance Brokers Association of Australia have supported the removal of these exemptions for car dealers for some time.[196]

Funeral insurance

192. We refer to our submission on the Commission's Round 4 hearings.[197] As a general principle, funeral expenses insurance should be regulated in the same way as other forms of funeral insurance.

193. There is a lack of clarity as to which legislation regulates funeral expenses-only products. We agree that the ASIC Act should be amended to make it clear that funeral expenses policies are 'financial products' under the ASIC Act.[198]

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[193] For example, see *Kobelt v Australian Securities and Investments Commission* [2018] FCAFC 18.
[194] For example, see Consumer Action, *Submission to Discussion Paper: The exemption of retailers from the National Consumer Credit Protection Act 2009*, March 2013 < https://consumeraction.org.au/wp-content/uploads/2013/04/Consumer-Action-Law-Centre-submission-Exemption-of-Retailers-from-NCCP-March-2013.pdf>.
[195] For example, Exhibit 1.138, Witness Statement of Nalini Thiruvangadam, 15 March 2018.
[196] Finance Brokers Association of Australia Ltd., *FBAA meets ASIC over flex commissions for car dealers* (16 August 2016) <https://www.fbaa.com.au/fbaa-meets-asic-flex-commissions-car-dealers/>.
[197] Consumer Action Law Centre, *Submission on Round 4 Hearings - Policy*.
[198] *Australian Securities and Investments Commission Act 2001 (Cth)* s 12BAA(8)(o).

4.14. Expenses-only products are exempt from the Corporations Act on the basis that:

> *[A] funeral expenses policy, where provided for the sole purpose of paying in the future for a funeral, does not warrant regulation by the licensing and disclosure provisions of the Corporations Act.*

4.15. In our view, evidence adduced before the Commission, particularly in relation to the conduct of ACBF, shows that funeral expenses-only products should not be distinguished from other funeral insurance products at law. The design, sale, claims-handling and other elements of these products should be regulated as insurance.

4.16. Consumer Action also recommends that all insurance, including all forms of funeral insurance, should have a suitability requirement.[6] A suitability test would focus more broadly than just the age of the insured person. In determining whether a product is suitable, factors to consider would include claims ratios, cancellation rates, terms that limit claims and value to customer (including consideration of age). Product affordability, sales channels, commissions and incentives, and whether the products do what the customer understands it to do are also relevant factors.

4.17. Considering the evidence put forward in relation to ACBF, Consumer Action considers that a funeral expenses policy such as that of ACBF would fail to meet a suitability requirement, particularly if it were sold to a person under the age of 18 years.

194. There is a need in Aboriginal and Torres Strait Islander communities for funeral payment arrangements, and value is placed on having a funeral cover product. However, in our view this need should be fulfilled by alternatives which are affordable and better suited to communities. The development of any alternative product should be community-led and involve real consultation on the benefits and role of funeral cover in communities. There should also be community-led education on funeral products, to minimise the risk of vulnerability to ongoing inappropriate sales.

Recommendation 28

- Point-of-sale exemptions under the NCCP Act should be removed.
- All regulatory carve outs for funeral insurance should be removed.
- All insurance should be subject to a suitability requirement.
- Genuine consultation that is Aboriginal community-led should be conducted in relation to a more suitable alternative products and funeral payment arrangements.

A shift to outcomes-based regulation

195. Consumer Action considers that regulation must shift from prescription-based to outcomes or performance-based, and that this may work to better align the interests of financial service providers and insurance.

196. This approach eschews complex and prescriptive disclosure requirements, recognising that people generally do not read or understand disclosure documents. Regulation that prescribes details about disclosure is also costly for industry. Instead of this level of prescription, outcomes-based regulation

sets simpler standards, for example, comprehension or suitable standards. Professor Lauren Willis has written about how this sort of obligation can be implemented:[199]

> *An intuitive move from disclosure mandates would be to set consumer comprehension standards that firms could meet by whatever means they see fit. Field-based testing of each firm's customers would assess whether consumers understand the key costs and risks of the transactions in which they are engaged. If every customer were tested, firms could be prohibited from imposing on a customer those product features that she did not understand. If samples of customers were tested, performance benchmarks for the proportion of customers who must demonstrate comprehension could be set based on, for example, the nature of the market. Firms could be penalised for failing to meet the benchmarks and rewarded for exceeding them. Alternatively, evidence that a firm's customers were engaging in transactions they did not comprehend might trigger regulator scrutiny for, or be prima face or even conclusive evidence of, unfair conduct.*
>
> *…*
>
> *Suitability standards would be closer to traditional substantive regulation, but more flexible. Regulation might define suitable (or unsuitable) uses of types or features of products, or firms might define suitable uses of their products, provided they did so publicly. Although suitability might be required of every transaction, testing every transaction for suitability would be prohibitively expensive and ad hoc ex post enforcement would create only limited incentives for firm compliance. Better to set performance benchmarks for what proportion of the firm's customers must use the products or features suitably (or unsuitably) and use field-based testing of a sample of the firm's customers to assess whether the benchmarks have been met. Enforcement levers could include fines, rewards, licensing consequences or regulator scrutiny.*

197. The proposed DADO regime is similar in concept, but puts the DADO obligation on the firm to identify target markets, implement controls to ensure the product is delivered in accordance with its expectations, and periodically review the product. As outlined above in this submission, there are gaps in the proposed DADO regime that will limit its effectiveness. Furthermore, the role of regulator scrutiny is far more limited compared to the proposal set out above.

198. We consider an outcomes-based regime should provide incentives to firms to educate rather than obfuscate, and to develop simple and intuitive products that are suitable for consumers' circumstances. It should, however, be used in conjunction with clear rules that can be easily enforced where consumer risk is considered high. Such an approach is more aligned with the social purpose of finance.

Recommendation 29
In simplifying the law, preference should be given to outcomes-based regulation in conjunction with clear rules that can be easily enforced where consumer risk is high.

How should ASIC respond to conduct and compliance risk?

199. The Interim Report says ASIC's starting point in responding to misconduct appears to have been "how can this be resolved by agreement?", rather than the regulator 'always asking whether it can make a

[199] Lauren E Willis, 'Performance-Based Consumer Law, Loyola Law School, Legal Studies Paper No 2012-39, August 2014, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2485667>.

case that there has been a breach and, if it can, then ask why it would not be in the public interest to bring proceedings to penalise the breach'.[200]

200. Consumer Action considers there is no definitive statement of good practice in enforcement in consumer protection in Australian or overseas English language literature. In 2008, CHOICE published *Good Practice in Consumer Protection Enforcement* which noted extensive literature and debate about good practice regulation, very little considers enforcement.[201] CHOICE's report does provide a useful good practice model model from the perspective of capacity, effectiveness and accountability and sets out a number of elements necessary for each. In the case of enforcement capacity, the elements are: powers, an enforcement policy (addressing specified particulars), and resources. In the case of enforcement effectiveness, the elements are: monitoring, targeting, and achievement of actual enforcement outcomes.

201. Another well-known approach to regulatory practice generally is the 'regulatory pyramid' that depicts a hierarchy of sanctions and interventions available to a regulator, including enforcement. Less formal and coercive measures, such as education and self-regulation, appear at the base of the pyramid, with more interventionist strategies and punitive sanctions, such as criminal prosecutions, civil penalties and removal of licence to operate, at the peak of the pyramid. Ayres and Braithwaite who developed this approach assert that regulators are best able to secure compliance when they act as 'benign big guns' and rarely invoke the most severe sanctions.[202]

202. Consumer Action considers that it is wrong for regulators to adopt the regulatory pyramid model in a linear way, i.e. use education and persuasion, and only if that doesn't work move to the next layer. This is not an effective way to ensure compliance and enhance consumer protection. In particular, regulators who adopt this approach can suffer from a form of paralysis in their concern to be fair to all businesses (for example, where a problem is market-wide or there is a first mover problem).

203. Consumer Action consider that an effective regulator is one that 'picks important problems and fixes them'.[203] In previous research, Consumer Action called this a 'campaign approach' to enforcement.[204] This approach recognises that regulators are generally confronted with the reality that they do not have enough resources to respond to each and every breach of consumer protection law. Rather than merely respond to matters that are brought to its intention, this approach ramps up enforcement in areas identified as high risk. The regulator might adopt a range of compliance and enforcement strategies more or less simultaneously or over a short period: making strongly worded public statements or warnings; raising possible non-compliance directly with firms; undertaking investigations into market practices; and taking enforcement action. This approach is likely to have a more significant positive impact on a market, and may be particularly helpful in emerging or rapidly changing markets or where rules have changed. In such markets, businesses will be experimenting with new business models and market strategies in an uncertain regulatory environment. The regulator could sit on its hand and see what happens or could play a role in shaping the market by sending early messages that particular types of conduct will not be tolerated.

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[200] Interim Report, Vol 1, 277.
[201] K Halliday, T Lozano and G Renouf, *Good Practice in Consumer Protection Enforcement: A Review of 12 Consumer Protection Regulators*, 2008.
[202] Ayres I and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate,* Oxford University Press, 1992.
[203] Malcolm K Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems & Managing Compliance*, Brookings Press, 2000.
[204] Consumer Action, *Regulator Watch: The enforcement performance of Australian Consumer Protection Regulators,* March 2013 < https://consumeraction.org.au/wp-content/uploads/2013/04/CALC-Regulator-Report-FINAL-eVersion.pdf>.

204. The Interim Report notes the role of the Commonwealth's obligation to act as a model litigant that is set out in Appendix B to the *Legal Services Directions 2017*. Former Attorney-General Hon. Daryl Williams QC has pointed out that the model litigant policy should not inhibit regulators from taking enforcement activity. In relation to the policy's obligation to avoid litigation wherever possible and the related requirement that litigation that is issued has reasonable prospects for success, Williams has said:

> *Indeed, there are some agencies such as regulatory agencies that need, in many cases, to institute litigation in order to discharge their statutory functions. The prosecution of these proceedings will form a substantial part of the role of the agency. In these circumstances, the model litigant obligation to avoid litigation wherever possible means that a proper assessment must be made in each case of whether there are reasonable grounds for bringing the proceedings. There will generally be reasonable grounds for starting proceedings where there are reasonable prospects for success. There may also be reasonable grounds for instituting or defending proceedings or for bringing an appeal where the prospects of success are not strong. An agency will have reasonable grounds for pursuing litigation where the institution or continuation of the litigation* ***is justified in the public interest, including where pursuit of the litigation is a legitimate means of clarifying the law on a particular topic*** *(emphasis added).*[205]

Recommendation 30

- Regulators should adopt a campaign-based approach to enforcement by 'picking the important problems and fixing them'.
- The model litigant policy should not stand in the way of robust enforcement action in the public interest.

Should the regulatory architecture change?

205. Consumer Action considers that significant changes to the regulatory architecture are *not* required, but we reiterate that existing regulators must be provided more appropriate tools, rulemaking powers and resources to enforce the law. We support existing plans to allocate registry responsibilities to the Australian Tax Office (**ATO**), which we consider will reduce the administrative burden on ASIC. However, we support consumer protection, corporations and market supervision remaining within ASIC's purview.

206. We support ASIC and other regulators being subject to regular external review, provided that there is equal representation between industry and consumer representatives on review panels. We note that ASIC has already been subject to external reviews, including the ASIC Capability Review.[206] ASIC is also subject to the Regulator Performance Framework.[207] ASIC also holds regular meeting with its External Advisory and Consumer Advisory Panels, which we consider very important feedback loops to ASIC.

207. Should the Commission be minded to recommend detaching tasks from ASIC, we consider that ASIC and ACCC should share concurrent powers in relation to the consumer protection provisions in the ASIC

[205] Hon Daryl R Williams AM QC MP, 'Justice and Accountability: The Establishment of the Administrative Review Tribunal and the Model Litigant Obligation', Speech to the Government Law Group, September 2000.
[206] Australian Securities and Investments Commission, *ASIC Capability Review* (April 2016) <https://asic.gov.au/about-asic/what-we-do/how-we-operate/performance-and-review/asic-capability-review/>.
[207] Australian Securities and Investments Commission, *Regulator Performance Framework* <https://asic.gov.au/about-asic/what-we-do/how-we-operate/performance-and-review/regulator-performance-framework/>.

Act. This would essentially remove the carve out of financial services in the *Competition & Consumer Act 2010* (Cth) (**CAC Act**).[208] This would ensure that ASIC retains responsibilities for important consumer protection provisions and industry-specific conduct regulation (for example, in the NCCP Act, the Insurance Contracts Act and the Corporations Act), but ACCC would also be able to take action on general Australian Consumer Law matters such as misleading conduct, unconscionable conduct and unfair contract terms. We consider that this arrangement would be beneficial for consumers, particularly in the context of ACCC establishing a financial services unit. Ideally, the arrangement would mean greater regulator action in total, including research and market studies resulting in targeted regulatory action. We have seen multi-regulator models for the Australian Consumer Law work well in other jurisdictions.[209] Financial regulators in the United Kingdom also share concurrent powers for competition.[210]

208. While it is not our preferred model, should the Commission consider that ASIC's remit is too large and certain functions should be removed entirely, we consider that it would be better for responsibilities relating to consumer protection (including licensing and conduct obligations in credit, financial services, insurance and superannuation) to be placed in a new, separate agency focusing on financial services consumer protection. ASIC could therefore remain as the market responsible for corporations including insolvency, markets, accounting standards etc. This would be preferable to giving financial services consumer protection responsibility to the ACCC, as some have suggested. ACCC is an effective economy-wide consumer protection and competition regulator and, we consider, is not well-placed to administer licensing schemes. A new agency focusing on financial services consumer protection would be able to develop the regulatory culture called for in the Interim Report. However, Consumer Action considers that major changes to the regulatory architecture should only occur if there is significant independent evidence of likely improved consumer outcomes from sharing regulatory responsibilities.

Recommendation 29

- Significant changes only be made to the regulatory architecture if there is independent evidence of likely improved consumer outcomes from sharing or reallocating regulatory responsibilities.
- If the Commission is minded to recommend changes, then a concurrent regulatory model between ASIC and ACCC should be preferred. As a second alternative, consideration could be given to a new agency focusing on financial services consumer protection, separate from ASIC's markets and corporations functions.

Accountability of regulators

209. Consumer Action considers regulators should be accountable to the public for who they stand to serve. We are concerned that existing accountability measures focus too much on the interests of industry rather than the interests of consumers.

[208] Revoking section 131A.
[209] Productivity Commission, *Consumer Law Enforcement and Administration,* Research Report (March 2017) <https://www.pc.gov.au/inquiries/completed/consumer-law/report>.
[210] The UK Government Competition & Markets Authority has a statutory obligation to report annually on the concurrency, the most recent report (April 2018) is available at: <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/703566/annual_concurrency_report_2018_cma79.pdf>.

210. For example, the Regulator Performance Framework established by the Commonwealth (which ASIC is subject to) is concerned with how agencies administer regulation, with the aim of regulators undertaking their functions with minimum impact on business.[211] This Framework does not seek to measure performance in relation to the outcomes achieved for consumers, the economy or society more broadly.

211. Similarly, the ASIC Capability Review considered a need for enhanced assessment of the effectiveness and performance of ASIC. In its response to this recommendation, the Government indicated that it would seek feedback from the Financial Sector Advisory Council.[212] While the Government has suspended the operation of this council during the period of the Commission,[213] we note that the membership of the council is made up entirely of senior representatives of industry and includes managing directors and chief executives of large financial services entities.[214]

212. Consumer Action considers that there needs to be radical change in accountability mechanisms so that this is more focused on the interests of consumers, rather than industry. Key elements of accountability to consumers include transparency and effective consultation.

213. ASIC has effective consumer consultation mechanisms, including through its Consumer Advisory Panel (**CAP**), and through close relationships with consumer groups. This could be improved by giving greater standing and resources to the CAP. A possible model is the Financial Services Consumer Panel (**FSCP**) which is hosted by the UK's FCA. The FSCP is an independent statutory body set up to represent the interests of consumers in the development of policy for the regulation of financial services. The FSCP panel members are selected through a competitive recruitment process, paid fees and supported by a small secretariat. The Panel Chair meets regularly with the FCA Chairman and Chief Executive, has a research budget and produces annual reports. The FSCP describes its role as bringing a 'consumer perspective to aid effective regulation', supporting or challenging the FCA where required.[215]

214. ASIC could also improve transparency by publishing all consumer complaints and how they are responded to. The Consumer Financial Protection Bureau's Consumer Complaint Database provides a good model.[216] Publishing complaints would not only provide a level of public accountability about the regulator's response to consumer concerns, but would also assist consumers make decisions about particular financial service providers and provide incentives for such providers to respond more effectively to the needs of consumers.

Recommendation 30
Enhanced accountability for ASIC should focus on accountability to consumers through consultation and transparency.

Industry codes

[211] Australian Government, *Regulator Performance Framework* < https://www.jobs.gov.au/australian-government-regulator-performance-framework>.
[212] Australian Government, *Response to ASIC Capability Review Report Recommendations* < https://static.treasury.gov.au/uploads/sites/1/2017/06/ASIC-Capability-Review-Govt-Response.pdf>.
[213] Richard Gluyas, 'Government to suspend Financial Sector Advisory Council', *The Australian,* 23 May 2018.
[214] Kelly O'Dwyer MP, Minister for Small Business and Assistant Treasurer, *Media Release: Financial Sector Advisory Council* < http://kmo.ministers.treasury.gov.au/media-release/067-2016/>.
[215] See FSCP website at <https://www.fs-cp.org.uk/>.
[216] See <https://www.consumerfinance.gov/data-research/consumer-complaints/>.

215. The Interim Report noted that breaches of industry codes did not amount to a breach of the law, and that "the enforcement of these norms (in codes) should not be left to borrowers (or customers)". The Interim Report asked whether industry codes relating to the provision of financial services be recognised and applied by legislation like Part IVB of the CAC Act. For as long as industry codes are largely authored by industry participants themselves, we do not support them being given the force of law in this way. This would, in effect, result in the industry writing the law, which is inappropriate. Industry codes should go beyond the law, rather than simply mirror it. Industry bodies should also not be considered regulatory bodies, given their proven ineffectiveness.[217]

216. However, systemic breaches of industry codes could be taken into consideration by the regulator in determining whether the general obligation to provide services efficiently, honestly and fairly has been breached. We recommend that either amendments are enacted to this effect or for this to be included in any regulatory guide relating to applying civil penalties to general conduct obligations.

217. Consumer Action reiterates concerns that self-regulation has not been sufficient or effective. If codes have a future, it should be co-regulation, that is, all industry codes should be approved by the regulator and approval should be on the basis of certain clear factors including:

- that the code responds to the consumer concerns and/or undesirable practices in the sector;
- that the code is enforceable, not just through EDR but also as a contractual right;
- that the code contains meaningful sanctions that incentivise performance; and
- that the relevant code monitoring body has sufficient resources to effectively oversee compliance.

218. Codes should be regularly reviewed to ensure that they are responding to market developments. Reviews should be conducted in accordance with the principles published by the Consumers' Federation of Australia on consumer advocate involvement and expectations of development and review of industry codes. These principles require:

- independence of the process;
- evaluation of impact;
- meaningful, genuine and efficient consumer engagement and consultation;
- resourcing for consumer engagement;
- clear and realistic timeframes;
- effective implementation of recommendations from reviews.

Recommendation 31

- Industry codes be taken into consideration by the regulator in determining whether the general obligation to provide services efficiently, honestly and fairly has been breached.
- There should be a move to co-regulation and code obligations should form part of the signatory's contract with the consumer.
- Code development and review should be in accordance with the principles published by the Consumers' Federation of Australia.

[217] Interim Report, Vol 1, 150.