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

**26 October 2018**

**Submission on behalf of Consumer Credit Law Centre SA to the Interim Report**

## 1. Introduction

The Consumer Credit Law Centre SA (CCLCSA) is pleased to provide a submission in response to the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry[1]. The CCLCSA welcomes many of the findings of the Royal Commission regarding misconduct and conduct falling short of community standards and expectations in relation to brokers, responsible lending obligations and inadequate regulator intervention.

The submission is based on the CCLCSA's experience advising consumers on consumer credit matters including mortgages and loans, consumer leases and debt collection.

### Consumer Credit Law Centre SA (CCLCSA)

The Consumer Credit Law Centre of South Australia (CCLCSA) was established in 2014 to provide free legal advice, as well as legal representation for disputes filed with External Dispute Resolution (EDR) schemes and financial counselling to consumers in South Australia in the areas of credit banking and finance. The Centre also provides legal education and advocacy in the area of credit, banking and financial services. The CCLCSA is managed by Uniting Communities who also provide an extensive range of financial counselling and community legal services as well as a range of services to low income and disadvantaged people including mental health, drug and alcohol and disability services.

### Uniting Communities

Uniting Communities works with South Australian citizens across metropolitan, regional and remote South Australia through more than 90 community service

[1] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018)

programs. Our vision is: a compassionate, respectful and just community in which all people participate and flourish. We are made up of a team of more than 1500 staff and volunteers who support and engage with more than 20,000 South Australians each year. Recognising that people of all ages and backgrounds will come across challenges in their life, we offer professional and non-judgemental support for individuals and families.

Uniting Communities, through the CCLCSA, is particularly interested in the Commissioner's enquiry into Banking and the Financial Services Industry due to our extensive involvement in the provision of financial counselling over many years and ongoing advocacy on a raft of measures associated with financial matters, financial stress, and financial hardship for low and modest income households. Our particular focus is providing support to low income and disadvantaged households, and to building families and communities.

This submission first responds to some of the particular issues and questions identified in the Interim Report[2]:

- What duties does an intermediary owe to a borrower?
- What duties should an intermediary owe to a borrower?
- How can entities' systems be improved to detect and prevent breaches of responsible lending obligations by intermediaries?
- What should be disclosed to borrowers about an intermediary's obligations to the lender and to the borrower?
- What should be disclosed to borrowers about an intermediary's remuneration?
- What steps, consistent with responsible lending obligations, should a lender take to verify a borrower's expenses?
- Do the processes used by lenders, at the time of the hearings, to verify borrowers' expenses meet the requirements of the NCCP Act?
- Should the HEM continue to be used as a benchmark for borrowers' living expenses?
- Are certain types of add-on insurance, by their nature, poor value propositions for customers?
- Should negotiation and settlement be the main approach for a regulator?
- Should there be greater focus on general deterrence in regulatory strategy?
- If established principles of judge-made law and statutory provisions about unconscionability would not relieve a guarantor of responsibility under a guarantee, and if, further, a bank's voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached, are there circumstances in which the law should nevertheless hold that the guarantee may not be enforced?

[2] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1

• What would those circumstances be?

• If the guarantor is a volunteer, and if further, the guarantor is aware of the nature and extent of the obligations undertaken by executing the guarantee, is there some additional requirement that must be shown to have been met before the guarantee was given if it is to be an enforceable undertaking?

• Should lenders give potential guarantors more information about the borrower or the proposed loan?

• Should AFCA adopt FOS's approach of putting the borrower back in the position they would be in if the loan had not been made, but not awarding compensation for losses or harm caused?

• Are there circumstances in which AFCA should waive a customer's debt?

• Is it desirable to prescribe that some or all of those who are not employees of banks, but deal with bank customers, must act in the interests, or the best interests, of the client? In particular, what duty, if any, should a mortgage broker owe to the prospective borrower? – Is value based commission, paid to the broker by the lender, consonant with that duty?

• How is a value based commission consistent with acting in the interests, or best interests, of the client?

• Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice?

• If some or all intermediaries should owe the customer a duty to act in that customer's interests, or best interests, is it enough to prescribe the duty and direct 'management' of conflicts between interest and duty?

• Are changes in law necessary? – Should the financial services law be simplified? – Should carve outs and exceptions be reduced or eliminated? In particular, should • grandfathered commissions • point of sale exceptions to the NCCP Act

## 2. Introducing a best interest duty for mortgage brokers

- *What duties does an intermediary owe to a borrower?*

Generally duties owed by an intermediary to a borrower include the following statutory duties:

- a duty to act honestly and fairly in their credit activities[3];
- a duty to ensure clients are not disadvantaged by conflicts of interest[4];
- a duty not to assist a consumer enter into an unsuitable contract;
- a duty not to engage in misleading and deceptive conduct;
- a duty not to engage in unconscionable conduct.

[3] NCCP Act s 47(1)(a)
[4] NCCP Act s 47(1)(b)

Beyond express and implied contractual duties, there may arguably exist fiduciary duties in equity depending on the scope of agency between the intermediary and borrower. In the majority of cases where the broker's agency is limited to obtaining the borrower's credit report and to lodge applications and negotiate terms with lenders on their behalf, any fiduciary duty prohibiting receiving a profit from the lender is thought to be negated by the NCCP Act.

The NCCP Act allows a broker to accept disclosed commission from the lender. The broker does not have to prioritise the interest of the client to the extent of being allowed to receive disclosed commission. The NCCP Act also only requires that a broker not recommend an unsuitable loan rather than provide the best option to the client. The CCLCSA notes this may be mistaken to mean a broker is never required to prioritise the duty owed to a client. For example, the statutory duty does not limit contractual principles of representations being incorporated into broker contracts between borrower and consumer where a broker holds themselves out as finding the best deal. Nor does it limit a higher duty where the broker has a broader scope of agency to do more than lodge an application and negotiate a credit contract with a lender.

The CCLCSA however, does note that any legal argument whether a fiduciary duty can still exist where a broker acts beyond what the NCCP Act permits, or if traditional fiduciary duties assists interpretation of section 47(1)(a) of the NCCP Act requiring a broker to act fairly, honestly and efficiently does not appear to be fully tested in court[5]. For example, where a broker submits progress payment claim invoices to a lender knowing that the invoices mislead the lender and borrower to believe that funds are being deposited into an account operated by the builder. Where instead, secret commission is being channelled to an entity owned and operated by the same director and shareholders as the broker company. The CCLCSA contends that not only has the broker engaged in unfair and dishonest conduct in contravention of the NCCP Act, but owes a duty to disclose material information and not make a secret profit in equity. In this instance, that the NCCP Act may not necessarily negate the fiduciary duty that the broker is under a duty to prioritise the interests of the client, in this event where the interests of the client and the broker conflict. The CCLCSA notes that it would be difficult for a borrower to test any legal argument in court or obtain judicial ruling on the matter due to the barriers of accessing counsel. Irrespective of any legal argument as to duties owed to the borrower, a clear legal duty to act in the best interests would remove this uncertainty.

The general duty that a broker is required to do no more than not assist a borrower enter into an unsuitable credit contract can be mistaken to suggest brokers are permitted to act in conflict to their duties to the borrower beyond

[5] Many consumers are limited to EDR interpretation and application of legal principles rather than judicial precedent.

conflicted remuneration. For example, a broker who represents they will find the 'best deal' may inadvertently incorporate the representation as a term of the contract with the borrower. The borrower may argue the broker has breached the terms of the contract, induced the broker contract through misrepresentation, engaged in misleading and deceptive conduct and/or contravened the duty to act fairly and honestly.

The Mortgage and Finance Association of Australia website claims that 'Finance Brokers have a duty of care to provide the best possible advice to clients' and that 'finance brokers often can offer you the best option'. Consumers expect their broker to secure the best deal[6]. A clear legal duty of the broker to act in the best interest of the client however would simplify the law, set a clear standard and reflect consumer expectations.

As evidence led in the hearings show, statutory duties alone have been inadequate to protect consumers from harm caused by mortgage broker misconduct and irresponsible lending. The current NCCP Act statutory duties ironically exposes the borrower to greater risk of harm by allowing the broker to:

- act with a conflict to the borrower;
- receive disclosed commission from the lender; and
- act with a lower standard of not assisting an unsuitable contract

The CCLCSA supports the findings of the Royal Commission that the correlation between loan-size and volume with broker remuneration leads to poor outcomes for borrowers. The evidence before the Commission suggested that brokers did not act in the best interests of consumers, but were instead driven by sales incentives such as upfront or trail commissions. Consumers also generally have a poor understanding of the role of brokers and lack awareness of any conflicting incentives, such as commissions, which might distort the broker's advice.

- *What duties should an intermediary owe to a borrower?*
- *How is a value based commission consistent with acting in the interests, or best interests, of the client?*

[6] Productivity Commission Inquiry Report, *Competition in the Australian Financial System* (No. 89 29 June 2018) at https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf as accessed on 24 October 2018 *'As a result, many borrowers put their trust in brokers to do so, and make decisions about their home loan in reliance of the recommendation they have received from their broker. The introduction of a clear, positive obligation owed to the client would ensure that the legal obligations of brokers align with customer's beliefs'*

- *What should be disclosed to borrowers about an intermediary's obligations to the lender and to the borrower?*
- *What should be disclosed to borrowers about an intermediary's remuneration?*

The CCLCSA fully supports that duty mortgage brokers owe borrowers should be similar to that for the provision of financial advice. This duty should not differ from the duty to act in the best interests of the client that the Corporations Act imposes on financial advisers.

The CCLCSA supports the Productivity Commission[7] recommendation that the new best interest obligation be implemented through the National Consumer Credit Protection Act (the Credit Act) and cover licensees that provide credit assistance services in relation to home loans (i.e. all mortgage brokers either directly or as representatives of a licence holder, as well as lenders who provide the same services).

The CCLCSA supports the Productivity Commission recommendation that the best interest obligation governs the process through which mortgage brokers prepare recommendations for their clients and comprise several elements, including identifying and considering:

- the client's needs and objectives — including the amount to be borrowed and the term of the loan sought
- the client's priorities and preferences over different products — including preferences relating to the price of the loan, the level of customer service offered by the lender and product features such as offset accounts or bundled products
- the client's personal circumstances and financial situation, to the extent that they could affect the suitability of different products
- whether the broker has the expertise or ability to make a recommendation that meets the client's needs, objectives, priorities and preferences
- whether the broker has access to mortgage products that meet the client's needs, objectives, priorities and preferences

The CCLCSA is also supportive of the Productivity Commissioner's recommendations for disclosure to include:

- which of those mortgage products best meet the client's needs, objectives, priorities and preferences
- disclosures about the role of mortgage brokers in matching borrowers with home loan providers

[7] Productivity Commission Inquiry Report, *Competition in the Australian Financial System* (No. 89 29 June 2018) p333 at https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf as accessed on 24 October 2018

- the types of products offered by different lenders (including white label loans and which lender provides the funding for them)
- why a particular loan was recommended, including the methodology used to identify that loan (such as computer software)
- real or potential conflicts of interest, including remuneration arrangements and any ownership relationships between lenders and aggregators
- that the broker is under a duty to prioritise the interests of the client, in the event that the interests of the client and the broker conflict
- features associated with different loans
- the types of products that will not be considered by the broker (for example, if a broker cannot recommend a specific product because the lender sits outside their panel, they should inform the client of that)

The CCLCSA however agrees with the Commission that disclosure to clients needs to be consumer tested to ensure that it is effective as possible. Sometimes, consumers do not read or appreciate what is contained in disclosure statements. An example includes warning statements with respect to small amount credit contracts. Despite being provided with warning statements, borrowers often report they were unaware of alternative ways of obtaining credit. However, it is clear from evidence before the Commission that brokers did not act in the best interests of consumers and instead were driven by sales incentives such as upfront or trail commissions. It was also evident that consumers have a poor understanding of the role of brokers and lack awareness of any conflicting incentives, such as conflicted remuneration. Consumers also trust that their broker will help them get the best deal and do not understand that the 'not unsuitable' standard in the NCCP Act may not necessarily require their broker to obtain the best deal.

Further the CCLCSA shares concerns raised in the Interim Report regarding industry's proposal to tie remuneration to funds drawn down rather than the loan size approved. The CCLCSA is of the view that changing remuneration to loans drawn down will not change broker conduct. The conflicted remuneration will not prevent brokers from encouraging borrowers to apply for more credit than required or recommending loans that are not in the best interests of the consumer. Value based commissions certainly are not consistent with acting in the best interests of a borrower. The mortgage broker has an incentive to sell more credit. The structure of mortgage broker commissions causes harm in the home loan sector as incentives for banks and brokers is to engage in irresponsible lending. There is 'nothing in it' for a broker to ensure the customer is interrogated about their living expenses. Therefore a fee-for-service remuneration structure would enable brokers to act in the best interest of their client and reflect community expectations.

*Case study – broker company owned by same shareholders and same director as marketing company receiving secret kickback commissions from builders – property spruiking investment*

The CCLCSA is assisting a client in a dispute against a broker who failed to disclose that secret commissions were payable to a marketing company that shared the same director and shareholders of the broker company. The CCLCSA contends the broker engaged in unfair and dishonest conduct in contravention of section 47(1)(a) of the NCCP Act[8]. The dispute with the broker company has protracted over 4 years. A clear duty that a broker must act in the best interests of a borrower would have prevented the conduct and provide greater certainty as to the duties a broker owes a borrower. The clients are now homeless and receiving extensive welfare services.

A clear duty on brokers to act in the best interests of borrowers is required to ensure broker conduct does not harm consumers. Although the NCCP Act provides a duty not to engage in unfair or dishonest conduct this is not enough to protect consumers[9]. Clients have been unable to retain or obtain pro bono legal representation to take court action against brokers for NCCP Act contraventions. EDR is not always the appropriate forum as borrowers cannot compel discovery of documents or subpoena witnesses in cases of secret undisclosed commission. This highlights the barriers to consumers seeking access to justice when the legal argument as to the duty owed to a borrower is not a clear duty to act in the best interests of borrowers and mistaken to permit unfair and dishonest conduct.

## 3. Responsible lending – statutory credit assessments- credit risk assessments in disguise

• *What steps, consistent with responsible lending obligations, should a lender take to verify a borrower's expenses?*

• *Do the processes used by lenders, at the time of the hearings, to verify borrowers' expenses meet the requirements of the NCCP Act?*

[8] section 180A was inserted into the National Consumer Credit Protection Act 2009 (Cth) by the Consumer Credit Legislation Amendment (Enhancement) Act 2012. The Explanatory Memorandum for the Consumer Credit Legislation Amendment (Enhancement) Bill 2012 Chapter 2, Part 2 at www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r4682 describes an example of unfair and dishonest conduct as *'a broker attracts potential customers through running wealth creation seminars. Attendees are encouraged to purchase investment properties, and to have finance arranged by the broker. However, the broker has an arrangement with the developer selling the properties that it will receive as commission 50 percent of the amount of the purchase price in excess of the base price. The broker does not tell the consumer about this arrangement and it can be presumed that they were unlikely to have agreed to purchase the units, either or at all for the price for which they purchased it, had this been the case. This conduct would therefore be unfair or dishonest'*

[9] ibid

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

The majority of responsible lending complaints received by the CCLCSA concern car loans and home loans arranged through intermediaries. Often, the intermediary has completed and submitted documentation without the credit provider ever having made contact with the borrower. Even where information provided to the credit provider by the intermediary is inconsistent and contradictory, credit providers have failed to take active steps to make inquiries or verify the borrower's financial circumstances and requirements.

The lack of direct contact between credit providers and borrowers and the reliance on information provided by an intermediary to perform the credit provider's credit assessment greatly increases the risk of fraud and irresponsible lending.

The CCLCSA is of the view that credit providers, should be required to make direct contact with borrowers for the purposes of gathering and verifying information to assess the suitability of a credit contract independently of the intermediary's preliminary credit assessment. The CCLCSA is of the view contraventions of responsible lending obligations are widespread and systemic. It appears that brokers and lenders equally disregard the requirement to take *reasonable* steps to verify consumer financial circumstances. The process of not analysing bank statements and bank accounts nor requiring evidence of living expenses does not meet the requirements of the NCCP Act. A lender should request evidence, analyse accounts and follow a documentary trail rather than relying on what the borrower reports (in many cases prompted by the broker).

Despite the legislative requirements and objectives of the NCCPA, credit providers are solely relying on information and documents submitted by intermediaries to perform a credit assessment. When credit providers have direct contact with borrowers and verify information, the information provided for a suitability assessment is more likely to be accurate and reliable.

The HEM should not be used as a substitute for declared living expenses or a default if declared expenses are less than the HEM benchmark. If a lender is properly verifying expenses declared by the borrower, there is no need to use the HEM.

As covered in the Interim Report, the HEM is inappropriate as it does not include non-basic expenditure or discretionary expenditure. It does not adequately protect the borrower who has a gambling problem or is spending more than the HEM on general living expenses. A close examination of bank accounts and statements would verify or show inconsistencies with the declared living expenses. The law requires an assessment of the particular borrower's actual

expenditure and does not allow consideration of what non-basic or discretionary income they can cut back on.

A lender should require copies of all bank statements and a documentary trail tracing what occurs with a borrower's income to verify living expenses. Even when bank statements are supplied or the proposed borrower holds banking accounts with the same lender, bank accounts are not always adequately examined. Incongruent information on a loan application that should otherwise trigger red flags has seldom been further examined and investigated. A clear example is where a loan application provides expenditure below a poverty benchmark and no trigger as to the reliability of information provided is raised or process followed to verify stated expenditure. The systems and processes in place are inadequate and it seems lenders are reluctant to invest in labour and capital to properly comply with responsible lending laws out of fear of being the first mover and losing market share.

When credit providers have been in a position to doubt the reliability of information provided by an intermediary, further steps to enquire and verify financial information are not necessarily taken. The credit assessment is then based on information that is unreliable and inaccurate resulting in unsuitable contracts. When the credit provider is aware or recklessly indifferent as to reliability of the information provided (and fails to take reasonable steps to inquire and verify financial circumstances), the credit provider is engaging in unconscionable conduct[10].

Lenders should seek verification of financial circumstances by requesting copies of bank statements, payslips, payment summaries or by contacting the borrower and/or employers directly. These systemic issues are even more so evident when lenders fail to make further enquiries when lenders ought to question the reliability of information based on inconsistencies contained in the credit application.

In *ASIC v ANZ* [2018] FCA 155, ANZ (trading as Esanda) had reason to question the reliability of information provided by the intermediaries and did not seek verification of the applicant's income by seeking bank statements or contacting employers to verify information. A system that does not detect and investigate unreliable information clearly does not meet the requirements of the NCCP Act.

*Standard for responsible lending*

*Use of benchmarks to calculate living expenses and assess suitability*

[10] *Australian Securities Investment Commission v Channic Pty Ltd* (No 4) [2016] FCA 1174

Credit providers continue to use benchmarks such as the Henderson Poverty Index ('HPI') or Household Expenditure Measure ('HEM') to determine a borrower's expenditure when undertaking a credit assessment of whether a proposed credit contract is 'not unsuitable'. As covered in the Interim Report, these benchmarks (even with added margins) are unrealistic and do not reflect the consumer's actual expenditure to properly assess whether a loan is suitable. The adoption of benchmarks to assess living expenses are highly inappropriate and should not continue to be used as a benchmark for borrowers' living expenses.

The Henderson Poverty Index is a poverty line providing the minimum income level required to avoid a situation of poverty and clearly an inappropriate measure of expenses. The Household Expenditure Measure is a measure that reflects a modest level of weekly household expenditure for various types of families. Neither measure the actual expenditure of the borrower.

ASIC's Regulatory Guideline 209.49 provides that a benchmark should not be a replacement tool for making inquiries regarding the consumer's actual financial circumstances at the time.

Her Honour Justice Davies stated in *Australian Securities Investment Commission v The Cash Store* [2014] FCA 926 ('The Cash Store') that an enquiry must be made as to the borrower's actual living expenses.

Some practices include using the higher of Household Expenditure Measure and Customer Declared Expenses for living expenses in serviceability assessments. However, this does not discharge the obligation of a credit provider or credit assistance provider to make reasonable inquiries and verify information regarding a borrower's expenses. If living expenses declared are less than the Household Expenditure Measure, the lender or broker should not simply default to this benchmark but undertake further enquiries to verify and ascertain the actual expenditure of the borrower. Simply using the higher of the two figures renders the legislative responsible lending steps perfunctory. The Cash Store precedent is that an enquiry and verifications must be made as to borrowers' living expenses.

**4. <u>Introducing a presumption loan is unsuitable where lender fails to make adequate inquiries and verification of financial circumstances</u>**

*Failure to undertake credit assessment or adequately inquire and verify expenses should create a presumption the loan was unsuitable rather than using HEM as default*

The CCLCSA also contends that the failure to adequately inquire and verify expenses should attract a presumption the loan is unsuitable rather than allowing AFCA to default to the HEM benchmark to assess suitability. In the

absence of the broker or lender performing an adequate inquiry and verification of living expenses or the consumer being able to reconstruct their living expenses, the approach of EDR schemes has been to apply the HEM benchmark to determine serviceability. The CCLCSA is of the view that brokers and lenders who fail to undertake a proper credit assessment benefit from the reverse onus that is then placed on the borrower to prove the loan was in fact unsuitable.

*Proving the loan was unsuitable – considerable disadvantage on borrower when intermediary or lender have failed to meet obligation to inquire and verify financial circumstances*

The failure to take effective steps to perform a credit assessment properly and comply with responsible lending obligations[11] does not of itself provide a remedy to a consumer. The consumer further has to prove that the loan was unsuitable. When the intermediary has failed to undertake any credit assessment, the burden of proving the loan was unsuitable becomes onerous for the consumer. The consumer has to reconstruct living expenses often months or years after the lender or intermediary ought to have conducted the credit assessment. This places the borrower at considerable disadvantage where they have not left a digital footprint and unfairly advantages the lender or intermediary who has contravened the duty to undertake inquiries and verifications.

The failure to inquire and verify the actual living expenses of borrowers places an unfair and onerous evidentiary burden on the borrower many years after a proper assessment should have been conducted. The advantage this provides to a lender in cases where the borrower is unable to provide evidence of their living expenses to EDR is an incentive for lenders not to adequately verify living expenses.

The matter of *Australian Securities Investment Commission v Westpac Banking Corporation* NSD 293 of 2017 demonstrates that banks have not been thrust into investing capital and labour to improving systems to perform a proper credit assessment and verify expenses as the fundamental prohibition is not to enter into an unsuitable contract. It is more difficult for a consumer to prove the credit contract was unsuitable than proving the lender or broker did not make proper

[11] '*Fourth, different considerations may arise when the broker assembles material necessary to submit an application for a loan. In performing those tasks, does the broker owe the lender or the borrower any obligation to inquire about or verify the accuracy of the personal information that the borrower supplies? If the intermediary does owe a duty of that kind to either the borrower or the lender,* ***it is a duty that is often not performed****. The fact that so many home loan applications proceed by the lender assuming that the borrower's living expenses are equal to the HEM measure, not as the borrower declares them to be, can lead only to the conclusion that in many of those cases the broker has not taken any effective steps to inquire into, or verify, the expense information supplied by the borrower*' Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, 28 September 2018 vol 1, 58

enquiries. Justice Perram refused to approve ASIC's request to fine Westpac $35 million for allegedly breaching its responsible lending obligations despite ASIC and Westpac agreeing in a joint statement that "Westpac contravened the requirements of…the National Consumer Credit Protection".

*'[Justice] Perram …… told ASIC's lawyers that "it's not really a case in which I'm being asked to penalise irresponsible lending…because there is no agreed fact about irresponsible lending in front of me". For the avoidance of doubt, he added that the laws' "fundamental prohibition is on the making of unsuitable loans, and…there's no fact before me that any unsuitable loans were made"'* [12]

At the time of writing the submission, the Federal Court has appointed Amicus Curie to test whether the amount of settlement, and its legal basis, is justified[13]. Justice Perram asked '..the purpose of the penalty is to deter, so what do I deter? What conduct am I deterring here?'[14]. The court ordered on 11 October 2018 for the Amicus to email the Court an outline of submissions to questions asked by 18 October 2018[15]. There is no incentive for banks to invest in systems and processes to ensure steps are taken to verify expenditure when the reward for failing to comply is a lower penalty; or that the onus will be on the consumer to prove that the loan was unsuitable.

**The law should otherwise require banks to show the loan was not unsuitable; rather than the borrower showing the loan was unsuitable in responsible lending disputes. A presumption the loan is unsuitable for cases where the lender is unable to show they have met the obligation to take reasonable steps to verify expenses.**

The present standing of the matter demonstrates the barriers of consumers in having to prove the loan was in fact unsuitable. If the law provided a presumption loans were unsuitable in cases where the lender has not followed an adequate credit assessment and verified expenses, this would be an incentive for processes to change to comply with the law. It is difficult for a consumer to prove a loan was unsuitable in the absence of documented evidence of living expenses to verify financial circumstances putting them at significant disadvantage in a responsible lending dispute, particularly when living expenses have been spent withdrawing cash on incidentals or on gambling etc. The absurdity is that a lender and broker benefit from their failure

[12] Christopher Joye 'Westpac not an irresponsible lender' *Australian Financial Review* (21 September 2018) accessed at https://www.afr.com/personal-finance/westpac-not-an-irresponsible-lender-20180920-h15o6z on 25 October 2018

[13] James Eyres, 'Court questions Westpac's $35m ASIC deal' *Australian Financial Review* (21 September 2018) https://www.afr.com/business/banking-and-finance/financial-services/court-questions-westpacs-35m-asic-deal-20180921-h15one accessed on 25 October 2018

[14] ibid

[15] Federal Court of Australia Court Order made 11 October 2018 https://www.comcourts.gov.au/file/Federal/P/NSD293/2017/3781960/event/29587186/document/1265797

to comply with the NCCP Act provisions to verify expenses where EDR's approach is to default to the HEM benchmark in the absence of evidence for living expenditure. The CCLCSA is of the view that bank statements can be used as alternative evidence of living expenses in some cases[16], particularly where the consumer has significant 'non-basics' or 'discretionary expenses'. The reliance of HEM by EDR schemes where a lender has not made adequate enquiries and verification operates as grossly unfair disadvantage to a borrower.

*Too much emphasis on serviceability and failure to verify objectives and requirements*

Inquiring and verifying consumer requirements and objectives is over-simplified to only checking the type of loan facility. As the findings outlined within the Interim Report show, too much reliance is placed on serviceability and credit assessments are approached as though the assessment was one of credit risk as opposed to suitability.

*Case study Holden worker planning redundancy – clawback commission*

Tom worked in the production line at the Holden factory. He asked his broker to help him refinance. He told the broker that he wanted to pay-off his home loan when he received his redundancy package in approximately 12 months time. Tom signed a contract with the broker that provided Tom was to indemnify the broker for any clawback commission. The broker recommended Tom enter into a partially fixed interest rate mortgage.

When Tom enquired about paying out his mortgage, he was told it would incur a break cost. Tom then contacted his broker who threatened that if Tom paid out the loan early, he would also have to indemnify the broker for any clawback commission.

The broker assisted Tom to enter into a loan that was not suitable for his objectives to discharge his mortgage once he received his anticipated redundancy package. The break cost was more than what it would have cost Tom had he remained in his previous loan. Further, the broker engaged in misleading and deceptive conduct through silence and unconscionable conduct by procuring the written broker agreement when Tom made it known that he intended to pay the loan out in a time frame the broker's commission would be clawed back and where the terms of agreement provided Tom would indemnify the broker for any clawback commission.

[16] *Australian Securities Investment Commission v Channic Pty Ltd* (No 4) [2016] FCA 1174

- *How can entities' systems be improved to detect and prevent breaches of responsible lending obligations by intermediaries*?

The CCLCSA submits that credit providers should not rely on information and documents submitted by the intermediary. Lenders need to perform their own independent credit assessment and have direct contact with the borrower. Significantly, the lender needs to verify stated expenditure and identify and investigate incongruent information. It should not be acceptable for a lender to default to the HEM if the stated living expenditure is lower than the HEM benchmark. The onus is on the lender to verify information provided by borrowers. Obtaining and analysing bank statements held by the borrower would assist identifying intermediary failure to meet responsible lending obligations. A guarantee fund could require that intermediaries submit preliminary credit assessments to be scrutinised before remuneration is released to the intermediary.

*No sanction on intermediaries for responsible lending contraventions*

CCLCSA observes that failure of intermediaries to comply with the obligations to inquire or verify the accuracy of information often does not attract any sanction. This is a significant contributor to false and misleading documents being included on loan applications to lenders. Consumers seeking assistance from the CCLCSA report that the mortgage broker filled in the loan application, that they were given limited opportunity to read and understand the documentation and trusted their broker not to include misleading or false information. Often disputes are lodged against the lender rather than the broker. Typically the lender absorbs the loss for intermediary misconduct despite the broker in many cases being an agent for the borrower. The reason in many cases is because the lender has not adequately verified information provided.

*Guarantee Fund and audit similar to Solicitor Trust Fund audits to ensure intermediaries comply with responsible lending obligations*

If remuneration was not changed to a fee-for-service model and commissions continued to remunerate brokers, the introduction of a guarantee fund would secure funding for community legal services and financial counselling whilst at the same time holding brokers to account that they have acted in the best interests of the client. Intermediaries should be required to pay remuneration into a trust fund controlled by a statutory authority. The same authority could investigate and audit broker client files and preliminary credit assessments to ensure the broker is complying with their obligations to the borrower. Further, the remuneration is held in the fund for a period of time. If the loan is unsuitable, the broker is not paid remuneration.

## 5. Regulator strategy

• *Should negotiation and settlement be the main approach for a regulator?*

- *Should there be greater focus on general deterrence in regulatory strategy?*
- *Are ASIC's enforcement practices satisfactory? If not, how should they be changed?*
- *Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that it is in the public interest not to do so?*

The CCLCSA notes there is benefit for negotiation and settlement for alleged contraventions of the law. However, the main approach of using negotiation and settlement has failed to address systemic misconduct. The current proceedings in the *Australian Securities Investment Commission v Westpac Banking Corporation* NSD 293 of 2017 sends a message to industry the regulator may not always be legally correct. Prosecution and trials create clear judicial precedent but also act as effective deterrents. It seems there has been a level of indifference to complying with NCCP Act with knowledge the regulator is not properly resourced to litigate all matters, or will perform incomplete enforcement action. The Enforceable Undertaking ASIC entered with Cash Converters to exclude loans taken out in store may have been effective to prompt change of Cash Converter's payday loan business model and credit assessment but grossly unfair to vulnerable consumers who missed out on compensation[17]. The CCLCSA is of the view there should be greater focus on general deterrence in regulatory strategy. ASIC should be provided with stronger powers (including product intervention power and enhanced directions power for remediation programs and enforceable undertakings) and responsible lending compliance should be a priority of ASIC to deter responsible lending contraventions.

**The CCLCSA advocates for stronger civil, criminal and administrative penalties for irresponsible lending. This should include increased fines, director penalties and disqualifications.**

*NCCPA contraventions – inadequate regulator funding*

*Low deterrent effect and slow development of case law*

ASIC has an important task to administer and enforce compliance with the National Consumer Credit Protection Act 2009 (Cth) ('NCCPA') and Australian Securities and Investment Commission Act 2001 (Cth) ('ASICA').

The CCLCSA welcomes the ASIC Industry Funding reforms to provide ASIC with adequate resources to act in a timely manner and enforce compliance.

[17] Amy Bainbridge 'Cash Converters loans: Corporate watchdog ASIC grilled over investigation into payday lender' ABC news 2 March 2017 https://www.abc.net.au/news/2017-03-02/corporate-watchdog-defends-investigation-into-cash-converters/8318342 accessed on 25 October 2018

The lack of adequate funding to regulators and consumer credit legal services not only hinders development of responsible lending laws but also results in little or no deterrence against the contravention of consumer credit laws by credit providers.

ASIC's resources and funding need to be increased significantly in order to adequately and effectively police compliance and enforcement of the NCCPA and ASICA. Many consumers report feeling frustrated and upset when misconduct reported to ASIC does not result in any enforcement action to redress their loss or steps taken to prevent other consumers from suffering the same financial losses. It is important that ASIC be funded to exercise enforcement powers through prosecution to not only protect consumers but to deter industry from contravening the NCCPA.

The CCLCSA relies on cases ASIC prosecute against credit providers to obtain judicial precedent. The lack of adequate funding has meant under-development of case precedent concerning judicial construction of NCCPA provisions. For example, the CCLCSA has argued that the National Consumer Credit Protection Act requires that all information be taken into account when undertaking a credit assessment to determine whether a credit contract is not unsuitable. Industry, on the other hand, appears to have taken a narrower construction asserting that information provided can be disregarded in preference of benchmarks to demonstrate serviceability and thus suitability of a proposed loan. The under development of case law due to lack of adequate resourcing means External Dispute Resolution schemes do not have clear case precedents when interpreting and applying the law to disputed matters. Whilst External Dispute Resolution schemes are impartial, the danger for consumers is that if they raise construction arguments, the scheme may regard the court as the more appropriate forum to decide the dispute and the consumer is left without a remedy. The law has predominantly been interpreted and applied by arbitrators as opposed to judicial bodies.

Consumer Law Action Centre identified 37 ASIC actions ranging from enforceable undertakings, negotiated agreements and prosecutions from 2014 to March 2018, focusing on consumer credit and insurance[18]. In our view, the number of enforcement actions have been extremely low in comparison to the number of contraventions that occur on a daily basis. Inadequate resourcing of ASIC has constrained ASIC's ability to intervene and exercise its enforcement powers. It appears that the low strike rate of regulator intervention has sent a message to industry that the risk of enforcement action is extremely low and has thus created an environment where there is little to no deterrence effect to

[18] as at March 2018

contravening the NCCPA. In some cases, contraventions have worked to the advantage of the credit provider or credit assistance provider.

The low risk of prosecution by the Australian Securities Investment Commission combined with the low risk of paying any compensation if benchmarks are used to resolve responsible lending disputes provides a very low deterrent effect. Greater resourcing for surveillance and enforcement by ASIC would assist in curtailing irresponsible lending.

*Slow enforcement action delays clarity around the proper construction of responsible lending laws*

The lack of adequate resources for ASIC prosecution and enforcement has also resulted in the delay of judicial interpretation and case law regarding the NCCPA. Consumers generally are unable to fund court action moreover consumer credit legal services are not adequately funded to run test cases regarding the proper construction of the NCCPA responsible lending provisions. Swift ASIC action is important particularly when consumers and industry hold disparate views about the proper construction of the NCCPA responsible lending provisions. Consumers rely heavily on ASIC court action for judicial precedent to confirm the proper construction of NCCPA provisions.

## 6. Guarantees

*• If established principles of judge-made law and statutory provisions about unconscionability would not relieve a guarantor of responsibility under a guarantee, and if, further, a bank's voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached, are there circumstances in which the law should nevertheless hold that the guarantee may not be enforced?*

*• What would those circumstances be?*

*• Would they be defined by reference to what the lender did or did not do, by reference to what the guarantor was or was not told or by reference to some combination of factors of those kinds?*

*• Is there a reason to shift the boundaries of established principles, existing law and the industry code of conduct?*

*• If the guarantor is a volunteer, and if further, the guarantor is aware of the nature and extent of the obligations undertaken by executing the guarantee, is there some additional requirement that must be shown to have been met before the guarantee was given if it is to be an enforceable undertaking?*

*• Should lenders give potential guarantors more information about the borrower or the proposed loan? What information could be given with respect to a new business?*

The CCLCSA is of the view there should be a prohibition for parent and grandparent guarantors who are volunteers to provide a guarantee. In the

majority of cases the CCLCSA assists guarantors, the pressure to assist a child to enter the residential property market impairs the guarantor's ability to exercise independent judgement and voluntary free-will. There may be instances of actual undue influence or presumed undue influence where the law should provide that the guarantee cannot be enforced. In more serious elder abuse cases, there may be elements of duress or lack of capacity to understand the nature of documents being executed. In some cases, guarantors report being misled that they will still be able to sell their properties to downsize and have been told that the bank will not agree to transfer security for the guarantee to a new proposed property. These are instances of misleading and deceptive conduct. However, if the guarantor received the information verbally and it is not recorded in file notes, email exchange or by way of telephone recording, it is difficult at times for the guarantor to prove in evidence that they were told the guarantee would not limit their ability to sell and change housing.

The CCLCSA is of the view that a guarantor should be provided with information as to the borrower's capacity, affordability, credit report and an explanation why the lender requires a guarantee. That is the loan is considered high risk for a shortfall and the lender is seeking a guarantee in the event there happens to be a shortfall.

Guarantors do not contemplate at the time of entering a guarantee that relationship breakdown or an illness of a mortgagor may trigger defaults with the loan that the guarantor is unable to control. At times, the guarantor has become frustrated at mortgagors seeking hardship variations and protracting the accrual of interest, fees, charges and enforcement costs and increasing the liability for the guarantor. A guarantor should be advised there is little control over the mortgagor once the guarantee is entered. The guarantor cannot speed up the selling process and is at the mercy of the other parties.

The 2013 Code of Banking Practice only provided one day for the guarantor to view the documents before executing the guarantee. The CCLCSA is of the view this time period is grossly inadequate to properly assess and obtain advice as to the risks involved.

Guarantors who are volunteers should be required to undergo counselling to ensure they fully understand the risks involved with a guarantee and alternative options (ie whether they offer their child a second mortgage or gift the money required to meet the threshold where the lender does not require Lenders Mortgage Insurance or a guarantee).

Guarantors should have access to information about the borrowers to make a full assessment. The guarantor is essentially asked to take a risk that the lender is not willing to accept. Therefore, the guarantor is more deserving of all information to make a risk assessment. However, the CCLCSA is of the view that guarantees from parents and family members who are volunteers should be prohibited.

**7. <u>Improving remedies for borrowers in AFCA – incentive for lenders to invest in adequate systems and processes</u>**

- *Should AFCA adopt FOS's approach of putting the borrower back in the position they would be in if the loan had not been made, but not awarding compensation for losses or harm caused?*
- *Are there circumstances in which AFCA should waive a customer's debt?*

The CCLCSA is of the view that remedies for borrowers when a bank or intermediary breaches responsible lending laws needs improvement. This should include debt waivers for both secured and unsecured loans rather than just waiving interest and fees. This should particularly be the case when there will be a shortfall that will put the consumer in worse position than if the credit contract was never entered. In situations of a shortfall debt for a secured asset, the borrower should be offered the option of

- retaining the asset, applying interest and fees paid the principal sum and paying the remainder balance at zero percent interest; or
- selling the asset and waiving the debt

This way the principal sum is still repaid if the borrower decides to retain the asset (ie house). However, shortfalls that would not have occurred but for the unsuitable credit contract should be waived. Changing AFCA's approach to provide debt waivers would provide a greater incentive for the banks to comply with their obligations and ensure their processes and systems complied with responsible lending obligations.

Additionally, AFCA should administer bank remediation programs to compensate consumers who are victims of irresponsible lending to ensure affected customers are given redress without delay.

**8. <u>Applying the proposed design and distribution obligations to credit products</u>**

The CCLCSA submits that the proposed design and distribution obligations should also apply to credit products to ensure they are designed and marketed in a way that is safe, suitable and fair.

**9. <u>Extending the Future of Financial Advice prohibition on conflicted remuneration to credit, particularly mortgage brokers, introducers and car yards</u>**

• *Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice?*

• *If some or all intermediaries should owe the customer a duty to act in that customer's interests, or best interests, is it enough to prescribe the duty and direct 'management' of conflicts between interest and duty?*

The CCLCSA supports other consumer advocates on the position that Future of Financial Advice prohibition on conflicted remuneration should apply to credit, particularly mortgage brokers and car yards. These prohibitions should include performance targets for staff and brokers and threats of losing accreditation as a broker or distributor.

Having regard to issues identified with the provision of financial advice, the CCLCSA holds reservations that it would be enough to prescribe a duty on brokers to act in the best interests of a customer and simply direct management of those conflicts. The statutory authority to hold remuneration funds payable to brokers might be able to audit and investigate that conflicts are adequately managed.

## 10. Add-on insurances

• *Are certain types of add-on insurance, by their nature, poor value propositions for customers?*

The CCLCSA is of the view that add-on insurances such as consumer credit insurance, guaranteed asset protection (GAP) insurance, tyre and rim insurance and extended warranties can represent poor value propositions and often are mis-sold.

The CCLCSA supports calls to ban the sale of add-on insurance on credit cards and loans, except as a standalone product or under a delayed sales model where the customer has to proactively buy the insurance.

## 11. Banks to review past practices and identify customers affected by irresponsible lending

• *When an employee or intermediary is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidence of misconduct?*

The CCLCSA is of the view that banks should constantly review files to identify customers affected by misconduct. Particularly where an employee or intermediary has been identified as engaging in fraud or misconduct. The bank should be under an obligation to report the misconduct and any breaches to ASIC under a mandatory breach reporting regime for credit licensees and credit representatives.

Credit licensees seem to operate with the approach that settling disputes as and when they arise is merely a cost of doing business. A low strike rate does not provide enough incentive to ensure the processes and systems comply with responsible lending. An obligation to have to identify and remediate affected

customers would be an incentive to ensure systems and processes curbed fraud and misconduct.

**12. Removing point of sale exemption for credit providers and duty to disclose that brokers act as agents for the credit provider**

*• Are changes in law necessary? – Should the financial services law be simplified? – Should carve outs and exceptions be reduced or eliminated? In particular, should • grandfathered commissions • point of sale exceptions to the NCCP Act*

The current exemption for point of sale encourages vendor introducers to engage in irresponsible conduct while recommending credit products and leases and assisting consumers to enter those contracts. The services provided are similar to a credit licensee and there is no reason for the NCCP Act to provide a point of sale exception.

Vendor introducers have significant influence over consumer decisions to enter credit contracts. As consumers are inclined to choose a credit contract option through a car yard or retail outlet rather than shop around for the best terms of any credit offer, it is imperative that vendor introducers are regulated like any other credit provider. The CCLCSA observes that many vulnerable consumers suffer detrimental harm due to the irresponsible conduct of car dealers and that unsuitability assessments by the credit provider are flawed due to misleading information supplied by the introducer. Therefore, the law with respect to point of sale exemptions for credit providers under the NCCP Act must be removed if the NCCP Act is to carry out the objectives of consumer protection.

Similarly, grandfathered upfront and trail commissions should be prohibited in preference for a fee-for-service model. Consumers do not understand the structure of mortgage broker remuneration and how that may impact the recommendations they are receiving nor realise they may be receiving harmful advice. Commission payments incentivise brokers to prioritise suppliers over the client and linked to poor consumer outcomes. Further, the current environment of lenders competing with each other by offering higher commissions to brokers means that commissions are not competitive for the consumer. Similarly as discussed earlier, mortgage brokers must be held to higher standards to act in the best interest of their clients.

**13. Access to legal assistance and financial counselling, particularly for vulnerable consumers, is essential to achieving access to justice**

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Increased funding for financial counsellors and community legal centres is vital to help vulnerable consumers achieve access to justice. Some vulnerable consumers can only access individual remedy through financial counselling and legal support. Individual remedies obtained through Internal and External

Dispute Resolution channels not only provide the individual redress but are another mechanism for holding entities to account and enforcing the law.

In South Australia, the CCLCSA is funded by the State Department of Human Services (formerly the Department of Communities and Social Inclusion). The CCLCSA is not funded by the Commonwealth and does not receive any money from the Commonwealth or State Attorney-General Departments.

The SACOSS scoping study for funding a consumer credit legal service in South Australia was based on one solicitor, one financial counsellor, one policy worker and one administration worker. However, since establishing the service in 2014, demand for Consumer Credit Law Centre SA services in South Australia has exponentially grown and far exceeds current resourcing. The Centre is very small in comparison to other States and residents in South Australia do not have the same access to legal services provided in other states.

The CCLCSA submits that funding needs to be vastly increased to consumer credit legal services to provide just outcomes for consumers who are unable to advocate for themselves. The CCLCSA is of the view that the Commonwealth should provide or contribute to funding of specialist Consumer Credit legal services in each and every State and Territory. The findings of wide-spread systemic misconduct is grossly disproportionate to the level of funding and access to legal assistance and financial counselling services in South Australia.

There is disparity of services provided to residents living in different states due to lack of Commonwealth funding for specialist consumer credit services. South Australia has greatly benefited from the work and leadership of consumer advocates in other states. However, South Australians are at significant disadvantage compared with consumers residing in other states. As at 28 September 2018, there were 10140 public submissions to the Royal Commission. Demand for our service far exceeds available resources.

A recent study by SACOSS shows that 9% of households in South Australia live below the poverty line[19]. The CCLCSA notes these households are unlikely to secure pro bono legal representation or pay a private solicitor for their credit matters. One barrier in South Australia is the lack of commercial law firms willing to perform pro bono work for debtors.

Understandably, the reluctance of law firms to act pro bono is the future conflict from being engaged by banks, credit providers and licensees and debt collectors. Other solicitors who are not concerned with future conflicts do not

[19] SACOSS Poverty twice as high in regional South Australia (13 August 2018) https://www.sacoss.org.au/poverty-rate-twice-high-regional-sa accessed 23 October 2018

feel confident to provide specialist consumer credit advice and/or accept a complex matter that may take years to resolve. Consumers who are unable to access EDR or court are deprived justice. The Commission shows there has been widespread systemic misconduct yet there is no Commonwealth funding for specialist consumer credit services in South Australia.

One proposed model of funding, if broker remuneration was not changed to a fee-for-service model and broker remuneration continued to be based on commissions, is to require intermediary commissions to be paid into a fund managed by a statutory authority and the interest earned from those funds to be applied to consumer credit legal and financial counselling services. The fund could be similar to the Solicitors Guarantee Fund. Amounts should be kept in the fund for a period of twelve months and the interest used to fund consumer credit legal services and financial counselling. The withholding of commission entitlements to intermediaries for a period of time will incentivise brokers to conduct credit activities responsibly. If the loan is unsuitable, or the intermediary has engaged in misconduct, the remuneration should not be released. The delay to remuneration and auditing will provide an incentive to brokers to comply with the law and not cause harm to consumers.

Alternatively, the CCLCSA is supportive of proposed funding through industry and bank levies. The CCLCSA is supportive of the NACLC and FCA submission to increase funding to consumer credit legal services and financial counselling sector through banking and industry levies. The CCLCSA seeks that the Royal Commission recommend a boosting of funding across the community legal services and financial counselling sector as consumers, particularly those living in South Australia, are denied access to justice due to inadequate resourcing.

The CCLCSA observes the lack of funding and counsel representation leads to lack of judicial precedent and certainty with the law. Many legal arguments dealing with construction of the NCCP Act have not been tested in court and rather interpreted and applied by EDR schemes. Financial institutions have not followed ASIC's Regulatory Guide 209 for responsible lending obligations, nor sought declaration from a court where they may have formed a different legal view of what the NCCP Act requires. Similarly, consumers have been unable to test construction of the NCCP Act and resigned to accept EDR approaches to interpreting the NCCP Act.