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Dear Sir or Madam

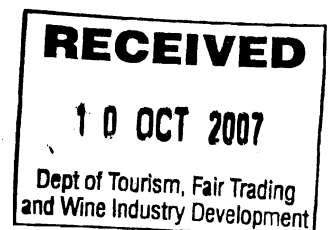
### **Fringe lending consultation package**

The Financial Services Committee of the Business Law Section of the Law Council of Australia (**the Committee**) welcomes this opportunity to comment on the draft Consumer Credit Code Amendment Bill 2007 and draft Consumer Credit Amendment Regulation 2007 released by the Ministerial Council on Consumer Affairs in August 2007.

Please note that these comments have been endorsed by the Business Law Section. Owing to time constraints, the comments have not been considered by the Council of the Law Council of Australia.

#### **1. Consultation**

The Committee is concerned as to the lack of consultation on the proposed changes. Whilst a number of the amendments have been foreshadowed in previous proposals, there are a number of aspects of the current proposals which the Committee understands to be completely new - for example the proposed changes to section 72 to allow for review of all fees which are considered to be "unreasonable". The Committee considers that all such changes should be the subject of a full Regulatory Impact Statement including a thorough cost benefit analysis and after detailed consultation. This is considered to be especially necessary given the proposal to apply all the proposed amendments to all providers of regulated consumer credit and not just fringe lenders.



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## 2. **Business Purpose Declaration**

For the reasons set out below the Committee is of the view that the current effect of a business purpose declaration under section 11 of the Consumer Credit Code (“Code”) should be retained, subject to strengthening the circumstances in which such a declaration is ineffective under section 11(3) to deal with identified abuses.

Consumer advocates have reported that business purpose declarations are subject to significant abuses, particularly by brokers and other intermediaries, and the Committee is supportive of any approach that appropriately addresses such practices. However, the Committee is concerned to ensure that the regulation put in place to deal with such abuses is both proportionate and appropriate, having regard to the nature of the abuses which are apparently taking place, and the victims of that abuse. The Committee comments below on the limitations of the proposed amendments to section 11, which include the fact that they may not adequately protect vulnerable and disadvantaged consumers. However, the Committee notes that it may be appropriate to also consider how to regulate the conduct of brokers and other intermediaries, by way of uniform licensing regimes, compulsory membership of alternative dispute resolution schemes, compulsory training and accreditation, in addition to other regulatory methods, to reduce the likelihood of brokers engaging in practices which are contrary to both the spirit and letter of section 11.

### ***Protections under the current approach***

A fundamental issue for a credit provider in making any loan is to determine whether or not the Code applies. In having regard to the key elements per section 6(1) of the Code the credit provider must determine whether “the credit is provided or intended to be provided wholly or predominantly for personal, domestic or household purposes”. The Code is presumed to apply unless the contrary is established (Code section 11(1)). This is important as it means that the onus is already on the credit provider to demonstrate that the Code does not apply. However, the credit provider can displace this assumption where the consumer provides a business purpose declaration to the effect that the Code does not apply.

The form of this declaration must warn the consumer that:

- they should not sign the declaration if the loan is not wholly or predominantly for business and investment purposes; and
- by signing the declaration they may lose their protection under the Code.

There is an important qualification to the effect of a business purpose declaration in section 11(3) which the Committee believes might be relied on to deal with any abuses of section 11(2) which might otherwise prevail. Section 11(3) provides, in summary, that a business purpose declaration will be ineffective where either the credit provider, a person associated with the credit provider or a finance broker (or a person acting through a finance broker) had the relevant knowledge. There are accordingly a broad range of circumstances in which a business purpose declaration might be ineffective. To the extent, however, that those circumstances are considered to be inadequate, (for example because of the narrowness of the definition of an “associate” in clause 1(2) of Schedule 1), the Committee considers that the appropriate response is to amend section 11(3) rather than make the changes which are proposed.

The Committee also notes that there are other mitigating factors against abuses of the use of business purpose declarations. These include legislative prohibitions on

misleading and deceptive conduct and false and misleading representations as well as provisions dealing with unjust contracts.

In the Committee's view the current situation (which was negotiated at length when the Code was being developed and takes into account amendments made in 1998) strikes the appropriate balance between consumer protection (by assuming that the Code applies unless the contrary is established) and allowing a credit provider to determine that the Code does not apply (by obtaining the regulated form of declaration from the consumer).

The Committee notes that the Consultation Package states that "It is not intended to prohibit credit providers from requiring a statement about purpose. Rather the intention is to remove any special evidentiary status". In response we note that the issues surrounding intention were debated at length when the Code was introduced, with the solution being to allow credit providers to rely on the prescribed statement given by the borrower (unless they knew it was false). The Committee is of the view that this is still an appropriate approach. However, if the intention has now changed, special evidentiary status could be removed by deletion of the work "conclusively" from section 11(2).

### ***Difficulties with proposed new approach***

The Committee does not think that the proposed section 11(2) provides an appropriate or workable solution as:

- (a) Section 11(2) provides that the presumption that the Code applies can be displaced "only" by establishing the prescribed matters. This is unduly restrictive. The current section 11(2) does not purport to provide the "only" means of displacing the presumption. There may be other perfectly acceptable means of evidencing the purpose of credit in support of a proposition that the Code does not apply, and these should not be excluded.

Further, the use of the word "only" in the section 11 context does not take into account the fact that the purpose of credit is not the only determinant as to whether the Code applies. Other factors are listed in section 6(1) (a),(c)&(d).

- (b) Both anecdotal evidence and case law dealing with inappropriately obtained and executed business purpose declarations show that, even with the clear and direct language of the currently required statutory warnings, some consumers will still sign business purpose declarations when their borrowings are wholly or predominantly for personal, domestic or household purposes. Often the reason for doing so is because the consumer becomes aware that s/he will be unlikely to obtain the credit if the business purpose declaration is not signed. The financial position of these typically vulnerable and disadvantaged consumers means that they often perceive that they have little choice than to sign incorrect business purpose declarations – because they will be unable to obtain credit elsewhere. In these cases changing the form of the section 11 declaration will not assist. It is the view of the Committee that any new approach should strengthen the protections given to the most vulnerable and disadvantaged consumers.
- (c) Proposed section 11(2)(b) could have the effect of giving consumers less protection – as there is no requirement for statutory warnings and the declaration need not be given by the actual borrower. The Committee considers that it would be an unfortunate result if the consumers the amendments were designed to protect were in fact to be disadvantaged by them.
- (d) The requirements to establish an "identified" business or investment purpose are inappropriate. Query what is meant by "identified". Would a working capital facility

qualify as an identified purpose in the business context? Loans are often provided for investment financing but the exact investment (whether it be shares, a property etc) may not be known at the relevant time or may be commercially confidential. Rather the line of credit is there so the investor can have funds available to make investments they chose to make at a time to suit them. The "identified" purpose requirement is inconsistent with the scope of the Code. The Code applies where "the credit is provided or intended to be provided wholly or predominantly for personal, domestic or household purposes" (section 6(1)(b)). Any other provision of credit is unregulated. Provision of credit wholly or predominantly for business or investment purposes is unregulated irrespective of whether an identified purpose can be established. There is accordingly an inconsistency between the proposed new section 11(2) and section 6(1)(b).

- (e) The scope of the inquiries that must be made is not clear. For example, is it the case that inquiries need only be made of the borrower? Or is it the case that inquiries must be made of third parties as well? In contrast section 70(2)(l) refers to information being ascertained "by reasonable inquiry of the debtor". In the interests of consistency if the proposed approach is to be adopted, the Committee considers that there should at a minimum be wording included making it clear that inquiries need only be made of the debtor and that they need only be reasonable inquiries.
- (f) The more that credit providers are required to make inquiries as to the purpose of credit the more likely it is that borrowers will consider the credit providers are advising them on how the credit is to be used and are accordingly responsible for any relevant investment decisions. Further, the obligations to make specific inquiries increases the risk that credit providers may be perceived to be providing financial product advice on any investments that are proposed to be acquired with the credit with consequent exposure to the licensing and disclosure requirements of Chapter 7 of the Corporations Act 2001. It is considered that it is inappropriate to expose credit providers to these risks.

### 3. Charges in the nature of interest

The Committee has the following concerns about the proposed new sections 15(2) & (3):

- (a) This proposal is inconsistent with the policy basis of the Code which, as explained in the Committee's comments on section 72, is based on flexibility and truth in lending rather than a prescriptive approach to product development.
- (b) It is understood that this proposal is based on section 10B of the Consumer Credit Act 1995 (New South Wales). However the basis for following this approach for all credit providers must be questioned given that the intent of the New South Wales provision was apparently to deal with fringe credit provider issues. This was made clear in a Statement of Regulatory Intent issued by the New South Wales Department of Fair Trading on 19 April 2006.
- (c) It is not clear what is intended by the phrase "charges in the nature of interest" and it is considered that credit providers are likely to face considerable uncertainty in determining what is intended. In contrast, the Committee notes the precision that is required by the Code in relation to the method of calculation of comparison rates. The uncertainties created by this concept were in effect acknowledged in the abovementioned Statement of Regulatory Intent which sought to explain the case law and credit determinations that deal with this concept. The Committee considers that this suggests that if this amendment is to proceed then at a minimum there needs to be legislative guidance as to what is intended by the phrase in question. It is important that there should be no such

uncertainty given that the failure to properly disclose an annual percentage rate attracts the civil penalty regime of the Code as well as the potential for criminal penalties.

- (d) Finally, if this amendment is to proceed then the Committee considers that consequential amendments will need to be made to the definition of the phrase "credit fees and charges" so that it is clear that that phrase does not include anything that is included as a consequence of the new section 15(2). Otherwise there must be a real risk of over disclosure and resulting confusion for borrowers as well as credit providers.

#### 4. **Substitute section 72**

Although presented as a response to the inappropriate conduct of fringe credit providers, proposed new section 72 represents a revolutionary change to the regulation of consumer credit by all lenders. This change would constitute a reversal of the considered position on fees reached when the Code was drafted, after very wide-ranging consultation and negotiations which themselves lasted for some years.

If implemented, proposed new section 72 would shift the foundation on which the Consumer Credit Code was based, namely that the formerly prescriptive fees approach of the old Credit Acts was to be replaced with a new approach based on flexibility and truth-in-lending. At the time the Credit Acts were replaced with the Code a very deliberate step was taken to move away from regulation under which all profit was required to be obtained from the interest rate, with only a limited number of fees and charges permitted on a cost recovery basis. The intention stated at the time was that credit providers were to be free to develop flexible products to enhance consumer choice, subject only to appropriate disclosure.

The Committee is not commenting on the relative merits of prescriptive regulation versus disclosure-based (or truth-in-lending) regulation. However, the Committee would point out that the first paragraph under 2.3.2 of the Decision Making Regulatory Impact Statement on which proposed section 72 is based does not reflect the historical fact. It states:

Unlike the previous credits act, the Code allows credit providers to impose fees and charges on loans. However, the primary intention behind permitting creditor providers to impose fees and charges on borrowers was to allow credit providers to recoup the cost of establishing and administering the loan.

This is not correct as a matter of historical record. The objectives of the Code, as stated in the second reading speech and as still noted on the website of the Uniform Consumer Credit Management Committee ([www.creditcode.gov.au](http://www.creditcode.gov.au)), are as follows:

The legislation is based on the principles of truth-in-lending, which allow borrowers to make informed choices when purchasing credit.

The Code applies rules which regulate the credit provider's conduct throughout the life of a loan, but without restricting product flexibility and consumer choice. The policy of the legislation is to rely generally on competitive forces to provide price restraint but to provide significant redress mechanisms for borrowers in the event that credit providers fail to comply with the legislation.

The Code is designed to apply to a deregulated credit market and provide standards for the provision of credit which will not be overtaken by changes in the financial marketplace.

While competitive forces may be failing to provide price restraint in respect of fringe lenders so "significant redress mechanisms" are needed, these should not be imposed on all lenders, particularly not at the cost of another core principle of the legislation, which is to rely on disclosure rather than prescription.

Given its emphasis on disclosure, the Code requires that all fees must be disclosed in the credit contract in tabular format for ease of reference. Otherwise the regulation of fees by the Code was limited to:

- Section 30 which prohibits third party fees being more than the net amount payable by the credit provider (after taking into account rebates, discounts and commissions). In fact, section 30 takes effect as a disclosure provision as it does not prohibit credit providers from charging handling fees, but merely from disguising them as part of a third party's fees.
- Establishment, prepayment and early termination fees, which were made subject to the unconscionable fees provisions under the existing section 72. Again, these fees in their application and by their title suggest that they are fees for establishing a loan or in respect of prepaying or terminating the loan. Accordingly, credit providers are required to make the fees live up to the expectation this disclosure gives rise to.

One exception to this approach was in respect of enforcement expenses. Continuing a successful regulation under the former Credit Acts, enforcement expenses were to be limited to those reasonably incurred (including by the use of staff and faculties of the credit provider) under section 99.

Section 29 was the other exception to this approach. It was included to enable regulators to act in cases of abuse of the system of disclosure coupled with the effects of competitive forces. However, section 29 had no operation, but was simply to be available as a "significant redress mechanism", to exclude specific fees, if needed. The Committee is aware of only one instance of section 29 being invoked, namely in Tasmania's Regulation 18A where a fee for assessing the value of household goods was outlawed.

Consistently with the approach of fee flexibility and disclosure, comparison rates, originally voluntary, were made compulsory some years ago, to bolster informed consumer choice by enabling easy comparison of the cost of credit.

This historical outline attests that the costs of credit have been subject to substantial analysis and have been regulated carefully, balancing consumer protection and choice, on a consistent conceptual framework since the Code began. That basis has been truth-in-lending ie disclosure.

Proposed subsection 72(5), dealing with default fees, may be seen as consistent with this broad principle of addressing disclosure and the reasonable expectations raised by disclosure, so is a development that could be viewed as a natural "evolution" of section 72. However, such fees have always been subject to judicial review based on the doctrine of penalties. In view of this and since default fees (under the label "penalty fees") are currently being reviewed by an Senate Economics Committee the Committee would submit that that review should be completed before specific regulation of such fees is decided upon.

In the Committee's view, the proposed changes to section 72 and in particular the following, need to be subject to the same level of consultation and debate as the existing laws they would replace:

- changing the standard from what is "unconscionable" to what is deemed to be "unreasonable" having regard solely to cost recovery; and
- the extension of section 72 to all fees and charges under proposed section 72(6).

Accordingly, it is the submission of this Committee that these changes, which are revolutionary rather than evolutionary, should not be introduced without full and complete research and consultation with all stakeholders in an appropriate context including a full analysis of the costs and benefits of introducing such a wide ranging change to the Code. They should not be brought into effect as part of a response to the actions of what is only a minority of fringe credit providers.

Any analysis of the effects of limiting fees to cost recovery should also include such factors as:

- the economic costs of pegging each fee to the actual costs (or actual average costs) of the credit provider in respect of the matters to which it relates, as this will inevitably involve substantial resources in tracing costs that will themselves add to the costs of credit (if recent case law is any indicator the required degree of analysis and the required audit trail would be significant); and
- the effects of removing the incentive for lenders to provide their services more efficiently and cost-effectively.

Finally, it is submitted that:

- the civil standard for modifying contracts between parties as unfair has always been (and remains in all other contexts) an act on the part of one party which is against good conscience; in other words, the "unconscionable" standard was chosen deliberately;
- replacing "unconscionable" with "unreasonable" and limiting "reasonable" to notions of cost recovery only is not a refinement on notions of good conscience. It is a shift in policy that will significantly affect mainstream lenders as well as fringe lenders; and
- any statement that a fee or charge be determined to be "unreasonable" without having regard to the full context in which it is imposed would appear to us to be a flawed approach. Section 72 is intended to be about fairness and fairness must be viewed in all the circumstances of a matter and should not be limited to matters of cost recovery only.

## 5. **Transitional Provisions**

Given the fundamental nature of the proposed changes, it is essential that robust transitional arrangements be put in place.

If fees regulation is to be changed, substantial lead times will be needed to enable industry:

- to restructure products;
- to undertake the very detailed costs tracing process which would be necessary if fees are to be individually assessed against the individual costs to the credit provider of the matters to which they relate;