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By email

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Dear Sir

Fringe Credit Project

This letter is a submission in relation to the Consultation Package issued in August 2007 on the Consumer Credit Code Amendment Bill 2007 and the Consumer Credit Amendment Regulation 2007.

1 Introduction

Mallesons Stephen Jaques is one of Australia's leading law firms. We have advised extensively on the Consumer Credit Code (CCC) (and its predecessor legislation). We act for a large number of credit providers and advised extensively on the compliance of documents, systems and procedures with the CCC.

We welcome the opportunity to comment on the proposed draft amendments. In particular, we have some concerns about the proposed changes around business purpose declarations and about the introduction of the proposed section 15(2) in combination with the proposed sections 72(1)(f) and 72(6).

2 Purpose and scope of proposed amendments

The consultation package notes that in the context of the Consumer Credit Industry, a distinction is usually drawn between the "mainstream" and "fringe" markets.

Mallesons supports measures being taken to protect against predatory practices of fringe credit providers in the Australian market. Mallesons has no independent knowledge of the extent of this issue. To the extent that proposed amendments would prevent harsh

¹ This letter has been contributed to by Edward Kerr, Andrea Beatty, Katherine Forrest and Ros Grady, Partners, and James Moore, Special Counsel, of the Mallesons Stephen Jaques Banking & Finance Group

lending practices in the fringe sector without interfering with the practice of mainstream lenders - such as the proposals to limit the use of "blackmail securities" in clause 7 of the draft Bill - Malleasons would fully support the amendments.

However, a number of the proposed amendments in the consultation package, if implemented, will impact not only on fringe credit providers but also on the mainstream credit providers. *Some of the measures could have significant impacts on the practices of mainstream credit providers which could result in significant additional costs for them.*

Imposing these additional burdens on the main body of credit providers in Australia, as a measure to discourage practices that have been identified as being carried on by fringe providers, is an inefficient and disproportionate response to the problems that have been identified. This is likely to lead to an increase in the general cost of credit available from mainstream providers.

The combined effect of the proposed changes (particularly proposed sections 15(2) and 72(1)(f) and (6)) seems to reflect an intention to impose a significant shake-up in the cost base of all credit providers in Australia, and the effective imposition of uniform standards.

We submit that these changes, if made, would stifle the flexibility in product development that the CCC was designed to provide to all credit providers in Australia.

The explanatory notes to the CCC when introduced to the Queensland Parliament in 1994 included statements as set out below about the objectives of the Bill.

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

The Bill 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 Bill 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.

We believe that the CCC as implemented has increased the flexibility available to credit providers to develop new structures and new lending products. We believe that the proposed amendments have the potential to significantly restrict that product flexibility, by seeking to determine for credit providers how their expenses and profit should be

applied across interest charges and other fees and charges. This may impact both the products that providers are able to bring to market, but also the capital structures of credit providers.

Further, we think that the proposed amendments as drafted would introduce considerable uncertainty about the enforceability of all CCC regulated credit contracts entered into in Australia. Commercial certainty for the credit products of mainstream credit providers should be preserved in any changes to the regulation of the financial sector. Efficient and well informed credit markets should be maintained.

3 Clause 5 - Business purpose declarations

3.1 The Business Purpose Declaration (**BPD**) is an important tool for credit providers in being able to establish certainty as to whether or not the CCC applies to particular loans. The clear policy position of government is that the CCC applies only to credit provided or intended to be provided wholly or predominantly for personal, domestic or household purposes. There are serious penalties that may apply where a credit contract is CCC regulated but is not documented under the CCC. Mallesons strongly believes that there should be a clear test for establishing whether or not the CCC applies to a particular contract.

3.2 If any change is made, we submit that it should respond directly to the mischief that has been identified, namely by strengthening the grounds on which a BPD may be disregarded if the credit provider is on notice that a loan is for a consumer purpose.

Mallesons submits section 11 should not be amended.

3.3 The proposed amendments impose significant additional risks for credit providers. Currently a credit provider can rebut the presumption of the CCC applying by obtaining a BPD. Under the new proposal that presumption can be rebutted only if the credit provider can establish that they have made “inquiries” about the purpose of the loan and, as a result of the inquiries, received information that the purpose of the loan was wholly or predominantly for an “identified” business or investment purpose.

This raises a number of difficult issues for a credit provider:

- (a) **What is meant by “inquiries”?** The proposed amendment does not contain any limitation around the scope of the “inquiries”. Does this mean that a credit provider will satisfy the test only by making inquiries of the debtor (ie can they rely on the word of the debtor?) or will they be obliged to further test the veracity of a response given by the debtor by making inquiries of say their employer or business partner or, in the case of an investment, the person offering the product or property in which the debtor intends to invest? (Any or

all of these persons may refuse to give information on rights to privacy grounds.)

Imposing an obligation on credit providers to make inquiries beyond the debtor is likely to result in significant additional costs for credit providers. In the case of mainstream credit providers Malleasons submits that it is difficult to perceive an advantage to be gained by debtors through this process. It would only add to the cost of providing credit.

Malleasons submits, that, although it does not agree with the appropriateness of making any change to the Act on this issue, at the very least the obligation to make inquiries should be limited to making inquiries of the debtor. This would bring it into line with section 70(2)(1) which limits the obligation to make inquiries to being inquiries of the debtor.

- (b) **Reasonableness of inquiries** The obligation to make “inquiries” in the proposed amendment is not limited by any “reasonableness” qualification. Again, it is submitted that there should be consistency of approach in the CCC on this issue (this may be contrasted with the reference to “reasonable” in section 70(2)(1)).

Further, we submit that the response given to an inquiry will often lead to further inquiries. For example, where a prospective borrower informs the prospective credit provider that they propose to purchase an asset (such as a boat, or a printer), the credit provider would need to make a further round of inquiries about the purposes for which the asset will be used, and what estimated proportion of them will relate to a business undertaking. Eventually, the credit provider for an unregulated loan is likely to need to rely on a statement by the prospective borrower that the intended use of an asset is predominantly for business purposes - that is, a BPD.

- (c) **“Identified” business purpose** The concept of being required to produce evidence of an “identified” business or investment purpose having been disclosed to the credit provider is likely to raise significant “commercial-in-confidence” issues for credit providers. For example, in the case of investment loans, many are likely to have legitimate commercial reasons for not wanting to or considering it appropriate to disclose to the credit provider the exact nature of the investment into which they are proposing to place the money being lent to them by the credit provider. Malleasons anticipates that credit providers are likely to receive many legitimate complaints from their customers about the appropriateness of seeking this information. Malleasons believes that the law should entitle a credit provider to assume the veracity of an assertion from a

borrower that they are intending to use a loan for a business or investment purpose.

- (d) **Credit provider responsibility for customer's investment decisions** Equally, Mallesons submits that there is a new risk for credit providers if there is an increase in the level of inquiries that the credit provider must make. A new requirement that the credit provider investigate the borrower's actual purpose could lead in future to claims being made against a credit provider if a proposed investment turns out to be improvident. We submit that there is a real prospect of claims being made that a credit provider is liable to the consumer for a failed investment on the basis that the credit provider "should have known" it to be improvident. The credit industry should not (and should not be required to) effectively act as an investment adviser, or to determine what investments a customer may make.

3.4 Mallesons submits that section 11(3) already provides significant protection for debtors where a credit provider or a "relevant person" knows or has reason to believe that a BPD is false. This is considered to be an appropriate balance between giving certainty to credit providers and protection for borrowers. If there are particular practices being engaged in by the fringe market which are abusing this, then remedies should be aimed solely at the fringe market in a way that does not impact mainstream credit providers.

3.5 Mallesons also queries whether the proposed amendments to section 11 will actually result in the mischief it is designed to counteract being prevented. It is relatively easy to imagine a credit provider being able to structure their inquiries to result in information being obtained that identified a business or investment purpose, for example, by structuring a series of leading questions to the borrower the answers to which could make it difficult for a court to conclude that appropriate inquiries had not been conducted.

4 Clause 6 - Amendment of Section 15

Mallesons submits section 15 should not be amended.

4.1 We submit that this proposed amendment is undesirable as it would introduce a high level of uncertainty. It is unclear what the phrase "in the nature of interest" is intended to mean. Potentially, it could be interpreted as a synonym for "this is the source of the profit of the credit provider". It might equally be interpreted to refer to an amount which is "calculated on the basis of amounts outstanding over time" or "varying with the amount outstanding from time to time". The difficulties may be illustrated by considering the example of a monthly administration charge. Is such a charge intended to be covered by section 15(2) as an amount in the nature of interest if it results in an

element of profit accruing to the credit provider, despite the fact that the fee does not vary with the amount outstanding?

- 4.2 It is surprising that this amendment is proposed without the provision of any clear parameters as to what is to be regarded as an amount “in the nature of interest”. This can be compared to the detail that was provided for credit providers to assist them in establishing a comparison rate.
- 4.3 At 5.2.1.1 of the Regulatory Impact Statement it is stated that “It is unlikely that the clarification of CCC provisions requiring credit providers to disclose an APR would impact on mainstream credit providers ... as they typically disclose an APR”. This is a significant simplification of the implications of this amendment. First, there is uncertainty as to what constitutes “an amount in the nature of interest”. If credit providers take the view that one or more of their fees could fall into this category (even on a conservative basis) then this could involve very significant changes to their systems and processes. The prospect of a finding that a particular amount should have been regarded as “in the nature of interest”, and the consequential unenforceability of that amount, could affect the external credit ratings that might be applied to Australian secured and unsecured loans. This may have an adverse impact on the funding costs of all credit providers in Australia, with flow-on consequences for the cost of credit in the Australian market.
- 4.4 We note that a provision in substantially the same terms as the proposed section 15(2) has been part of the consumer credit law of New South Wales for a number of years,² raising some issues of uncertainty³, but without significant impact on mainstream credit providers.
- 4.5 We submit that the reason why this has not raised significant concerns in the past is because the provision has not been coupled with provisions along the lines of the proposed section 72(1)(f) and (6). In the absence of a section 72(1)(f) equivalent, the clause may be understood simply as requiring a New South Wales regulated credit contract to have an annual percentage rate. (This may be contrasted with a possible fringe credit product that has no annual percentage rate but requires repayment of the principal plus a fixed amount at some future time.)
- 4.6 In the mainstream industry, the provision has been understood as requiring simply that each credit contract that has an annual percentage rate must state the annual percentage rate. The great majority of mainstream credit contracts had always been structured in

² Section 10B of the *Consumer Credit (New South Wales) Act 1995*

³ Some of this uncertainty was sought to be resolved by “Statements of Regulatory Intent and Compliance Policy” issued by the Commissioner for Fair Trading in 2006, and currently available at <http://www.fairtrading.nsw.gov.au/corporate/legislation/consumercreditmaxannualpercentagerate.html>

this way. The New South Wales provision has not been understood as requiring an analysis of whether any fees or charges include a profit element and could be restructured so as to be presented as an annual percentage rate.

- 4.7 We submit that the proposed section 15(2), **when combined with the proposed sections 72(1)(f) and (6)**, arguably would require each fee or charge to be assessed to determine whether it includes any profit element (or any element of cross subsidisation of costs), and for each such element to be applied across the credit provider's entire customer base and included in the headline annual percentage rate.

We believe that this approach represents a fundamental change in the regulation of both the fringe and the mainstream credit markets in Australia.

It would reduce the credit provider's flexibility that was intended to be introduced by the Consumer Credit Code. It would add a new layer of restrictive regulation to the Australian credit market, and introduce considerable uncertainty about how the regulations would be enforced.

We do not believe that the Regulatory Impact Statement process was designed to model the impact on mainstream credit providers of the combined changes that are proposed. As a result, we suggest that the full impact of the proposed changes has not been assessed, so that the benefits are able to be properly compared with the costs.

We submit that the flexibility that the current form of the CCC allows has generally led to positive market outcomes for Australian borrowers and credit providers. This flexibility should be maintained.

5 **Clause 11 - replacement of section 72**

Mallesons submits section 72 should not be amended in the manner that is proposed.

- 5.1 **Is the response proportionate?** We submit that the proposed replacement of section 72 is not a proportionate response to problems that have been identified as occurring in the "fringe" credit sector. The proposed amendments (particularly the proposed sections 72(1)(f) and (6) in combination with proposed section 15(2)) would be likely to lead to significant changes to the financial structure of the mainstream credit industry.

Taken as a whole, the proposed amendments represent a significant expansion to the kinds of fees and charges that may be reviewed by a Court, and a material change to the way in which a Court must assess them. We believe they are likely to have effects well beyond the fringe sector where issues have been identified.

5.2 **Could a more limited response address the mischief?** One of the key reasons that it may have been considered necessary to amend the section 72 power in relation to unconscionable fees is the outcome of the *City Finance* case⁴. In that case, the Victorian Civil and Administrative Tribunal did not find an establishment fee or charge to be unconscionable under section 72(1) even though some may have regarded the fee as being out of all proportion to the credit provider's reasonable costs of loan establishment. For the purposes of the case, the Tribunal was asked to assume that the establishment fees exceeded City Finance's reasonable costs and included a profit element. Nevertheless, the Tribunal did not find the fees to be "unconscionable" as there was no proven element of the credit provider having taken advantage of the debtor and exploiting a comparative advantage in an *Amadio*⁵ sense. This result was not unexpected given that the test in section 72(3) is that the Court must find unconscionability "hav[ing] regard to" the reasonable average costs, while under section 72(4) an early termination fee is unconscionable "if and only if" it exceeds a reasonable estimate.

Assuming that this result was not intended by the legislature, we submit that an appropriate and proportional response would be to amend the legislation to move the drafting of section 72(3) closer to the drafting of section 72(4). In our submission this change should be limited to the "fringe" credit sector. If it is impossible to so limit the effect of changes, it would still in our submission be more appropriate to amend section 72(3) and leave the balance of section 72 in its current form. For example, the test in the existing section 72(3) could be replaced with wording such as:

"... unconscionable if and only if it appears to the Court that the fee or charge is out of all proportion to the credit provider's reasonable average—

(a) costs of deciding an application for that kind of credit; and

(b) initial administrative costs of providing that kind of credit"

5.3 **"Reasonableness" test** The consultation draft suggests removing the "unconscionable" test (on the basis that there is significant existing case law on the meaning of "unconscionable"), and replacing it with a "reasonableness" test. We submit that this would be inappropriate for two reasons.

(a) **Unnecessary to make the change in response to *City Finance*** The main reason that existing case law on unconscionability arises for consideration on cases decided under section 72(3) is that the Court is required to determine

⁴ *Director of Consumer Affairs Victoria v City Finance Loans* (2006) ASC ¶155-054; [2005] VCAT 1989

⁵ *Commercial Bank of Australia Limited v Amadio* (1983) 46 ALR 402

unconscionability *having regard to* the quantum of the establishment fee. A drafting change of the kind suggested at 5.2 above would resolve this concern.

- (b) **“Reasonableness” also has a meaning** Further, “reasonableness” is also a word with a lengthy history of judicial interpretation. Introducing the concept of “reasonableness” would introduce new uncertainty into the business of credit provision in Australia. It would allow for arguments being raised that, even though a particular fee or charge reflects the *actual* costs of a particular credit provider, those actual costs could be different in hypothetical situations (ie if it had adopted a different capital structure, or newer infrastructure). This could lead to arguments being raised that, as a credit provider’s hypothetical “reasonable costs” might be lower than its actual costs, its actual costs should not be recoverable through fees and charges.

Introducing a “reasonableness” test would therefore, in our submission, reduce certainty in the credit market.

- 5.4 **Reasonableness test applying to all fees and charges** For the reasons set out in 4 above, we believe that the new proposed sections 72(1)(f) and (6) could significantly hamper credit providers’ ability to bring innovative products to market. As stated in 4.7 above, we do not believe that the Regulatory Impact Statement gave a full assessment of the costs and benefits of applying these changes to the credit sector as a whole.

Further, we suggest that the proposed clause as drafted may deliver ambiguous results when applied to real world situations.

It appears that, on an application, the credit provider would be required to establish (on the balance of probabilities, presumably) that it has actual underlying costs or losses that “give rise to” the charge.

Many mainstream credit providers are extremely large organisations. They have complex cost structures. They operate in a competitive market. There are a variety of economically sound ways that a credit provider may wish to structure the fees that apply to a particular product base so as to recover their actual costs (including cost of capital), and to generate a profit margin, from their customers as a whole.

The proposed sections 72(1)(f) and (6) puts credit providers in the position that a Court will have power to reassess, based on expert testimony, the structure that a credit provider has implemented. The Court will be able to declare that certain fees (or parts of them) are unreasonable and should be returned to the customers.

Even though the Court may find that the credit provider could have lawfully recovered the same overall return (of costs and profit) in another way, the credit provider would

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have no opportunity to re-levy alternative fees (or retrospectively increase annual percentage rates) so as to recover that return from the sources that the tribunal in a particular case determines would be “reasonable”.

Once a decision is handed down, all credit providers will be faced with a situation where they will be at risk if they do not restructure their financial arrangements according to what the Court determines is “reasonable” for the particular credit provider under challenge.

In our submission, the proposed change runs the risk of creating uncertainty about the enforceability of many consumer credit contracts in Australia. Also, it will tend to limit the ability of credit providers to innovate or provide differentiated products, for fear that a product different from those already in the market could be regarded as “unreasonable”.

We submit that the proposed changes should not be made.

Yours faithfully

[Sgd] Mallesons Stephen Jaques