

Credit
Ombudsman
Service

Comments on Consumer Credit Code
Amendment Bill 2007 & Consumer Credit
Amendment Regulation 2007

Submission By

Credit Ombudsman Service Limited

September 2007



SUBMISSION

Comments on CCA Bill 2007 & CCAR 2007

EXECUTIVE SUMMARY

Submission 1:

COSL supports the proposed amendment to introduce the new Section 7(1A)

Submission 2:

COSL supports the proposed amendment to Section 7(7)

Submission 3:

COSL does not support the proposed amendment to Section 11 as drafted

Submission 4:

COSL submits that the words "who obtained the declaration from the debtor" be deleted from Section 11(3)

Submission 5:

COSL generally supports the proposed amendment to Section 72

Submission 6:

COSL submits that the proposed Section 72(5) be amended to read "underlying costs or losses"

Submission 7:

COSL submits that the words "as applicable to the size and resources of the credit provider" be added to the proposed Section 72(7)

Submission 8:

COSL supports the proposed amendment to Section 46 but suggests that "tools of trade" as defined in section 116(2)(c)(i) of the Bankruptcy Act be included as "household property" and, therefore, "prohibited securities."

Comments on CCA Bill 2007 & CCAR 2007

1. Introduction

1.1 About the Credit Ombudsman Service Limited ("COSL")

COSL is an external dispute resolution (EDR) scheme approved by the Australian Securities and Investments Commission (ASIC).

As a condition of ASIC's approval, COSL is required to meet the stringent conditions prescribed by ASIC's Regulatory Guide 139.

COSL is a not-for-profit company. It is required to be impartial, accessible and independent, as well as absolutely free of charge to consumers. It provides consumers with an alternative to legal proceedings for resolving disputes with its members.

The key objects of COSL (as set out in its Constitution) are to:

act as the primary complaints resolution body for the credit industry; and

ensure the timely, efficient and effective resolution of complaints against members, having regard to the criteria of relevant legal requirements, recognised industry Codes of Practice, good practice in the credit industry, and fairness in all circumstances.

Importantly, COSL is able to award compensation in an amount of up to \$250,000 for direct and indirect loss. It is also able to make orders compelling a member to do or refrain from doing specified acts.

COSL has about 8,000 members, mostly mortgage brokers with some mortgage originators, non-bank lenders, aggregators, mortgage managers and some finance brokers.

An estimated 75% of loan writers who would not otherwise be covered by an ASIC-approved EDR scheme, are covered by COSL, and this benefits consumers enormously.

In the year 2006/07, COSL received 3,274 'contacts' (which included 338 new complaints) and finalised 264 complaints. About 95% of COSL inquiries and complaints are resolved by non-adjudicative means, that is by mediation and conciliation, though the Credit Ombudsman does exercise his power to make determinations, the terms of which are then published on its website¹

Like all ASIC RG 139 approved schemes, determinations made by the Credit Ombudsman bind members but not consumers. COSL's services are funded by a combination of membership fees and case management fees paid by the members. It is free for consumers and is controlled by a Board with equal representation from industry and consumer organisations and an independent chair.

¹ www.creditombudsman.com.au

1.2 This submission

COSL is uniquely placed to monitor and comment on these proposed amendments and on consumer credit issues in general.

COSL has made submissions recently to:

- The Productivity Commission Inquiry into the Consumer Policy Framework in Australia
- Queensland Department Fair Trading - Regulation of Finance Brokers (with particular reference to its proposed mandatory code of conduct)
- South Australian Parliamentary Inquiry into Credit and Investment Schemes
- Federal Parliamentary Inquiry into Home Lending Practices.
- Consumer Affairs Victoria "Application of Unfair Contract Terms Legislation to Consumer Credit Contracts"

COSL welcomes these amendments and is keenly aware of the problems posed by so-called "fringe lenders."

COSL submits that mandated membership for all credit providers of an independent, industry-based consumer dispute resolution scheme will address many of the access to justice issues facing consumers of credit from fringe lenders and, indeed, from the entire finance sector. Although, this consultation process does not specifically address issues of dispute resolution, COSL submits this is relevant to any discussion of regulation of credit.

Addressing the Draft Bills submitted in the Consultation Package, COSL will specifically comment on proposed amendments to:

- Section 7 as they are likely to affect finance brokers.
- Section 11 and Business Purpose Declarations
- Section 72 and its possible effects on smaller credit providers
- Section 46 and prohibited securities.²

2. Section 7 Amendments

2.1 What is proposed

According to the Summary provided in the Consultation Package, the purpose of the amendment to Section 7(1) is to "capture fees and charges that may or may not be set out in the credit contract, but which must be paid to a person including a person other than the credit provider, in connection with the credit contract."³

Section 7(1)(a) to (c) were inserted in the Code in 2001 to address the issue of short term lending or so-called "payday" lending specifically designed to avoid regulation by the Consumer

² Unless otherwise stated all section numbers refer to the *Consumer Credit Code (Old) 1996*

³ Ministerial Council on Consumer Affairs *Consumer Credit Code Amendment Bill 2007 and Consumer Credit Regulation Amendment Bill 2007 Consultation Package*, August 2007, p5

Credit Code (“the Code”). COSL is aware of the practice of some lenders to structure their transactions so as to load up the commissions paid to brokers, some of whom are related entities, so that these amounts, which effectively become the “profit” on the loan are:

- Not counted as fees and charges for the purposes of ascertaining whether the transaction remains within the 62 day exemption in section 7(1); and
- Not required to be disclosed under the Code.

2.2 Comment on the draft amendment

COSL generally supports the amendment as drafted. It will bring within the ambit of the Code all loans where the effective cost to the consumer is in excess of the prescribed limits, regardless of whether those costs are described as credit fees or charges or paid to a third party or not.

It is less clear, however, how the amendment will work with so-called “interest rate caps” in those States which have imposed them, namely New South Wales and Victoria or with disclosure under the Code generally.

If the fee paid to the third party, which will trigger Code capture by the new section 7(1A), is not in the “nature of an interest charge” it will still not be included in the calculation of interest for the purposes of:

- Section 15 even as proposed to be amended by the Draft Bill; or
- Interest rate capping legislation now operating in Victoria⁴, New South Wales⁵, the ACT⁶ or mooted in Queensland.⁷

Still, simply capturing those short term loans using “broker loaded” fees to split entities or related entities to avoid regulation will enhance protection for the usually vulnerable consumers using these products.

At least the unjust contracts provisions of section 72 and the enforcement protections in section 80 of the Code will apply.

2.3 Pawn Brokers

COSL supports the proposed amendment but is surprised as to its necessity given that the section 7(7) exemption should only apply to pawnbrokers “in the ordinary course of their business.”

⁴ The combined effect of the original *Consumer Credit (Vict) Act 1995* and the 2001 Code amendments is that a 48% per annum cap on interest only applies in Victoria.

⁵ *Consumer Credit (New South Wales) Amendment (Maximum Annual Percentage Rate) Act 2005* which is a “comprehensive cap” of all interest and other fees and charges but would not capture third party payments.

⁶ *Consumer Credit Act 1995 (ACT)* Part 3A is similar to the NSW legislation.

⁷ Office of Fair Trading Queensland, *Managing the Cost of Consumer Credit in Queensland Discussion Paper* November 2006, p 15

3. Section 11

3.1 What is proposed

Put simply, the amendments involve a complete rewrite of Section 11 to remove the Business Purpose Declaration as “conclusive” evidence that the credit is to be applied for business or investment purposes.

Rather, the new amendment simply requires the credit provider to make “inquiries about the purpose of the credit to be provided or intended to be provided” and if, in response those inquiries, the credit provider is given information about an “identified business purpose” or “identified investment purpose” then the presumption of regulation by the Code is rebutted.

3.2 Comments on the current law and its interpretation by the Courts

COSL is keenly aware of the various practices of some brokers and notes that the current law is directly aimed at them in that Section 11(3) identifies “finance brokers” as “relevant persons”, along with the credit provider or their employees, who can be fixed with knowledge of a false declaration.

There are numerous instances in the cases of attempts by credit providers to rely on section 11 declarations to avoid regulation. In *Brown-v-B.E.Finance* ⁸, the Consumer had signed a declaration but used the credit on a personal vehicle not suitable for the supposed business purpose. The credit provider was aware of these facts when they obtained the declaration and the Court held the contract regulated by the Code. Also, in *Daimler Chrysler Services Australia Pty Ltd v Berckelman*⁹, the Debtor signed a business purpose declaration for a loan to finance the purchase of a car but the car registration, presented to the credit provider as part of the loan application, was for private use. The Court exercised, in our respectful view, commonsense when it observed that: “There must have been some communication between the credit provider and the debtor as to the use of the motor vehicle around the time of the signing of the declaration as the registration certificate was made by the seller.” The most extreme cases of loan sharking masquerading as business lending were uncovered and exposed for what they were in *State of Queensland v Ward* ¹⁰

The current law does not, however, always work. For instance, other persons, not necessarily brokers, can misrepresent the nature of the Section 11 declaration and obtain it falsely when the true purpose of the loan is personal or domestic. If these facts come to light after the credit contract has been entered into and particularly after the credit advanced, the credit provider can still rely on the declaration to overcome the presumption of regulation.

This situation can arise by chance or, more reprehensibly, by design. Brokers, aware that they are “relevant persons” under the Code, can send consumers off to solicitors or anyone else, for that matter, to obtain Section 11 declarations. It does not matter, then, whether this other person has knowledge of the true purpose of the loan. Likewise, credit providers can immunise

⁸ Magistrates Court Qld 11/6/99

⁹ [2004] NSWSC 447

¹⁰ [2004] 1 QdR. 429

themselves from the consequences of their knowledge by simply making sure someone else obtains the declaration.¹¹

Even when brokers, as “relevant persons” under Section 11(3) obtain false declarations, all this does is remove the “conclusive” nature of the declaration leaving the ultimate test of the purpose of the loan open to construction. The Court is left asking the question “whose purpose?”

In Rafiqi & Thomas-v-Wacal Investments¹², his Honour Judge Brabazon DCJ said it was “...what a reasonable person standing in the shoes of the credit provider would have understood the predominant purpose for which the credit is provided.” Whilst this reasoning produced a pro-regulatory result in that case, the same reasoning was followed to very different effect in Neundorf v Rengay Nominees ¹³where despite the section 11 declaration being ruled invalid, the tribunal was still left to consider whether the Code applied and held that a “reasonable person in the shoes of the credit provider” in the circumstances would have believed that the loan was for business and investment purposes, therefore, the Code did not apply despite it being later revealed on the facts that it was to refinance purely personal loan.

Different reasoning was adopted in Linkenholt Pty Ltd v Quirk ¹⁴ where Gillard J said: “In considering the question it is important to look at the substance of the transaction in the context of its performance.” Judge McGill QC of the Queensland District court made a more robust rebuttal of the Rafiqi approach in Dale v Nichols Constructions Pty Ltd¹⁵. The consumers were in default on their home loan and approached a broker who approached a solicitor’s firm which organised a private mortgage loan from one of its clients. The finance broker knew of the purpose of loan but obtained Section 11 declarations from the consumers. These were declared invalid and, further, his Honour expressly disagreed with Rafiqi saying that the relevant purpose is that of the borrower. The Section 11 declaration is good evidence of that purpose but is not necessarily conclusive.

After considering this rather confused case law, Patten AJ in the recent case of Permanent Mortgages Pty Ltd v Cook ¹⁶ concluded that it didn’t really matter much as “It would, I think, be a rare case where the above propounded tests produce a different result.” In that case the loans were used to pay out pre-existing home loans. A Business Purpose Declaration was signed. It was unclear whether the credit provider knew that loans were to refinance pre-existing home loan. His Honour noted that there was no statement of assets and liabilities, no evidence of any business or investment; and the “purpose of loan” questions were left unanswered. The Credit Provider’s own “Lending Procedure” manual had not been followed. The Code was held to apply.

¹¹ This, of course, does not apply to the linked credit situation as Schedule 1 Section 1(2) makes linked suppliers persons “associated with the credit provider” for the purposes of the Code.

¹² (1998) ASC 155-024

¹³ [2003] VCAT 1732

¹⁴ [2000] VSC 166

¹⁵ [2003] QDC 453

¹⁶ [2006] NSWSC 1104

Largely, it can be concluded, that when most cases on Section 11 (and of course section 6) make it to the Courts, the result is pro-regulation and pro-consumer.

3.3 Comments on the proposed amendment

COSL cannot support the proposed amendment as drafted. It does not adequately address the issue of false declarations obtained by credit providers or brokers.

It seems to only put on the credit providers an obligation to make inquiry and if the answer to that inquiry, whether provided directly by the consumer or by another person on their behalf, say a broker, is satisfactory, then that is enough.

It is only if the person is an "officer, agent or employee of the credit provider" that their knowledge will be imputed to the credit provider by section 176.

This "asked and answered" approach provides less protection for consumers from the activities of finance brokers prepared to falsify answers and to conjure false business or investment purpose, however clearly identified, than does the current law as interpreted by the courts.

3.4 Comments on workability

The Summary in the Consultation Package specifically asks about the workability of the proposed amendment. COSL comments that it is potentially unworkable in the secured loan environment particularly for refinancing of mixed purpose loans.

Timing is a vexed issue in the proposed amendment as it is unclear as to when the "inquiry" is concluded. The broadest, most pro-regulatory interpretation of the amendment could give rise to situations where information provided to the credit provider as part of settlement preparations (for instance cheque payees) could be interpreted as putting the credit provider on notice that the funds may be being used for personal, domestic or household purposes and thus they may delay settlement at considerable cost to the consumer.

What is most likely, however, is that the alternative interpretation will prevail. Credit providers could then consider their obligation under the proposed amendment to be satisfied by initial inquiry of a debtor or their broker at point of application and ignore any other information which comes to light between then and settlement which casts doubt on the veracity of any "identified" business or investment purpose. This would fly in the face of the direction (with respect quite sensibly) being taken by the courts in interpreting the limits on the ongoing duty of credit providers to inquire about the purpose of a loan under the current law.

The certainty provided by the Business Purpose Declaration is valuable to industry in the securitisation of loans. In an environment of large scale off-shore marketing of loan portfolios, removing such certainty may have deleterious effects on capital markets.

Put simply, the proposed amendments may damage industry without helping consumers.

3.5 Ideas for reform

If the intended effect of the proposals is to reduce the instances of loans being wrongly documented and administered as business or investment loans when they should be regulated by the Code, then one simple amendment to the existing Section 11(3) could achieve this outcome without undermining, substantially, the security provided by Business Purpose Declarations.

This would be to remove the words "who obtained the declaration" from the section after the words "or any other relevant person." Thus, brokers and credit providers would be responsible for their own state of knowledge about the true purpose of the loan regardless of whether they obtained the declaration or not.

This would also remove the anti-competitive advantage currently experienced by brokers over linked suppliers as sources of credit business. The latter are caught by the Scheduled 1 Section 1(2) definition which makes them "persons associated with the credit provider" and their knowledge of the true purpose of the loan can be imputed to the credit provider.

Failing this reform, COSL must argue in favour of the status quo.

4. Section 72 amendments

4.1 What is proposed

The Summary in the Consultation Package proposes a new Section 72 which put simply, replaces the concept of "unconscionable" with "unreasonable." It also makes special provisions for default fees and deals with them slightly differently to other fees and charges in that they are based on the common law concept of a "penalty" rather than the more specific concept of "underlying costs or losses."

4.2 Brokers

COSL supports the amendment in general but has some concerns as to two aspects of the drafting.

4.2.1 Default Fees

COSL is addressing the issue of default fees as penalties for its own members who are credit providers. It is curious that the drafters have chosen to simply define the reasonable basis for "penalty" in terms of loss and for other charges in terms of "underlying costs or losses." Most credit providers are already compensated, according to their contract, for the failure to make a payment by the interest levied on the outstanding amount.

Default fees, imposed over and above such interest, can only be interpreted, in light of the common law, as being compensation for the extra costs involved in administering such defaults

e.g. reminder letters, letters of demand and, if not remedied, debt collection costs. In short, the “underlying costs.” Surely, the purpose of the Code being amended in this manner would be to clarify the common law not simply restate it.

4.2.2 Standards of commercial practice generally

This standard will be used to measure whether “underlying costs” and the fees imposed to recover them from consumers are reasonable. There is a risk that interpretation of this section will lead to a “one size fits all” determination of the costs of establishing loans, their administration and the administration of defaults.

This would be an anti-competitive result which would unfairly disadvantage those credit providers whose economies of scale are such that loan administration costs them more than for other larger institutions. They may have a competitive advantage elsewhere, such as on interest rates or personalised service, but would lose it as a result of judicial determinations of “general” commercial practice.

Adding the words, “as applicable to the size and resources of the credit provider” would turn the court’s attention to the realities of economies of scale.

5. Section 46 amendments

5.1 What is proposed

Put simply, the proposed amendment will prohibit securities over items which were not purchased in a linked arrangement with the credit provider as part of the credit contract which are those protected as “household goods” under the Bankruptcy Act. This would prohibit the so-called “blackmail” securities.

5.2 Comment

COSL supports this amendment but notes that it does not, as worded, cover all aspects of the “blackmail securities” market or all protected property under the Bankruptcy Act.

For instance, by linking the prohibition to section 116(2)(b)(i) of the Bankruptcy Act, it ignores the protections for bankrupts in relation to “tools of trade” s116(2)(c)(i) and motor vehicles 116(2)(ca). COSL is not submitting that motor vehicles, even those under the \$6,300 limit in the Bankruptcy Act be “prohibited securities” under the Code but tools of trade of less than \$2,000 should be included.

Also the section 116(2)(b)(i) list in the regulations¹⁷ does not include some items which would be regarded as common for most Australian households such as:

¹⁷ Reg 6.03

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DVD players

Computers

Computer games

It is appropriate, in COSL's view, that the section refers to the Regulation in its entirety and, therefore, to Reg 6.03 (2) which says that the property protected is that which is "reasonably necessary for the domestic use of the bankrupt's household having regard to current social standards". The list is only examples.
