Phase Two of the National Credit Reforms: Addressing Avoidance of the *National Consumer Credit Protection Act 2009*

Regulation Impact Statement

Table of Contents

Addressing Avoidance of the National Consumer Credit Protection Act 2009 4

Summary 5

Problem Identification 6

Adverse consequences from avoidance of the Credit Act 9

Problems association with solicitor arranged lending 10

Objectives of Government Action 13

Options 13

Option 1: Maintain the status quo 13

Option 2: Address avoidance on a limited basis 14

Option 3: Extend the jurisdiction of the Credit Act by significantly broadening its scope 17

Option 4: Encourage consumers to only use lenders or brokers who hold an Australian credit licence 19

Consultation 20

Recommended Option 22

Attachment A: Members of Consultation Groups 24

Glossary

Term	Definition
ACL	Australian credit licence
ADI	Authorised Deposit-taking Institution
ASIC	Australian Securities and Investments Commission
ASIC Act	Australian Securities and Investments Commission Act 2001
COAG	Council of Australian Governments
Code	National Credit Code. This is Schedule 1 to the *National Consumer Credit Protection Act 2009*
Credit Act	National Consumer Credit Protection Act 2009
EDR scheme	External dispute resolution scheme
RIS	Regulation Impact Statement
UCCC	Uniform Consumer Credit Code

Addressing Avoidance of the National Consumer Credit Protection Act 2009

This Regulation Impact Statement considers options in relation to extending the coverage of the *National Consumer Credit Protection Act 2009* (the Credit Act) to cover transactions that are currently excluded from the regulatory reach of that Act, irrespective of whether that avoidance is deliberate or incidental. The issue is being considered as part of the National Credit Reforms, following the decision of the Council of Australian Governments (COAG) to transfer responsibility for the regulation of credit from the States and Territories to the Commonwealth.

Background

In 2008, the Council of Australian Governments (COAG) agreed to a two phase implementation plan for the transfer of responsibility for the regulation of credit to the Commonwealth from the States and Territories.

Phase One of the National Consumer Credit Protection Reforms substantially commenced on 1 July 2010. The main features of Phase One were that it introduced:

- a comprehensive licensing regime for all providers of consumer credit and credit related brokering and intermediaries in the industry;
- responsible lending conduct requirements on all licensees to not provide credit products and services that are unsuitable, either because they do not meet the consumers' requirements or because the consumer does not have the capacity to meet the repayments, either at all or only with substantial hardship;
- improved sanctions and enhanced enforcement powers for the sole national regulator, the Australian Securities and Investments Commission (ASIC);
- expanded redress for consumer protection through universal external dispute resolution membership for licensees, streamlined court arrangements, and remedies for consumers for licensee misconduct; and
- a largely replicated version of the key state-based legislation, the Uniform Consumer Credit Code (UCCC), as the National Credit Code (Code).

The scope of the Credit Act was determined through the application of the same definitions of *credit* and *regulated credit* as were previously used in the Uniform Consumer Credit Code (UCCC) in force in the States and Territories.

COAG agreed that in Phase Two of the credit reforms the Commonwealth would consider the need to change the definition of regulated credit, and to address practices and forms of contracts that were not subject to the Credit Act.

Executive Summary

The Credit Act regulates transactions which satisfy the statutory definitions of both *credit* (section 3 of the Code) and *regulated credit* (section 5 of the Code). The same definitions have been carried over into the Code as were previously used in the UCCC, with an expansion of jurisdiction to cover credit in relation to residential investment properties.

The technical nature of the definition means that there are limitations in the application of the Code, and consequent differences in the obligations of lenders and brokers according to whether or not they are providing regulated credit or credit that is unregulated, but legally so. Historically, lenders have developed a number of methods of delivering credit that avoided the UCCC (and therefore continue to avoid regulation under the Commonwealth law).

There are two main methods of structuring transactions to fall outside the scope of the Code. The first method was a response to the introduction of a cap on costs in Queensland (prior to the transfer of responsibility for credit to the Commonwealth). This resulted in providers seeking to maintain pre-cap rates of return by restructuring a credit transaction as two contemporaneous sales of goods (with the consumer purchasing the goods at a higher price than that which they sold it for).

The second is a form of lending known as 'Solicitor Arranged lending'. This lending is unregulated as the Code only applies where the lender provides credit in the course of, or incidental to, a business. The policy intention was to exclude informal or casual loans, such as those between family members. However, the exemption also applies to loans where the lender may not be in business but has provided funds to a business to manage the loan on their behalf, despite the transaction being commercial in character.

These practices are relatively narrow in scope, and largely confined to niche markets. Consumers who enter into contracts with these persons will have significantly fewer statutory rights, as the Credit Act introduces a range of obligations covering matters such as pre-contractual disclosure and rights to borrowers in financial hardship or who have defaulted.

It is recognised that consumers should be encouraged to take responsibility for their borrowing decisions. Over-protection of consumers could be counter-productive by limiting the impacts of poor decisions, and the capacity of the market to price risk. To achieve this balance, the proposed reforms are targeted at the avoidance activities that create the most significant risks for consumers, and promote greater competition between regulated and unregulated providers than is currently the case.

It is therefore proposed to:

- amend the Credit Act to regulate some identified means of avoiding the Code; and
- introduce an anti-avoidance provision into the Credit Act (noting that this provision can utilise conduct by providers of unregulated products, for example, promotion of their products as 'credit' or 'finance' in order to provide greater certainty in the application of the provision).

The proposed reforms would result in:

- improved access to external dispute resolution for consumers;
- consistent application of responsible lending requirements across regulated products and functionally similar unregulated products;
- consistent disclosure of the costs and key terms of unregulated products; and
- improved supervision of this sector by ASIC, enhanced capacity of ASIC to take enforcement action, and ASIC able to exclude entities from the market in the event of severe misconduct.

However, these benefits must be seen in context, and balanced with other outcomes. First, the reforms are not expected to comprehensively prevent misconduct or the risk of financial harm to consumers by unregulated providers. This class of persons will need to balance new and different considerations as they decide whether to continue structuring their transactions so they are not regulated. Nevertheless, the experience in relation to avoidance suggests that there will be a number of providers prepared to take a robust attitude, and continue to operate as they currently do, unless and until ASIC takes enforcement action. Should their volume of business decrease they may also decide to increase their costs.

Unregulated providers who elect to become compliant and meet the statutory obligations on credit providers would incur transitional costs. These costs would be similar to those recently incurred by regulated providers who have become holders of an Australian credit licence since the commencement of the Credit Act in 2010. Other businesses may face uncertainty as to whether their products would be regarded as credit as a result of the anti-avoidance provision. While ASIC has existing procedures for addressing these issues these businesses would incur costs in pursuing resolution of their position with ASIC.

Finally, some consumers may find that they are no longer able to access unregulated credit, when this is currently the case. This would particularly affect those who are not eligible for regulated mainstream products.

It is difficult to quantify the cost to industry and the benefits to consumers (and difficult to observe and quantify any flow on consequences), and it is therefore not possible to state definitively whether or not this reform would have a net benefit in monetary terms. However, it is considered the reforms protect consumers in a way that as far as possible only imposes costs on those persons who are obtaining a competitive advantage by avoiding the Code, to the detriment of both consumers and lenders who are complying with its requirements.

Problem Identification

Introduction

Ever since the UCCC came into force in 1996, lenders have offered products that were not regulated by the UCCC because of differences in the design of their products. These differences can be largely controlled or determined by the provider, as they seek to exploit

opportunities for regulatory arbitrage. It also raises the prospect of the creation of different avoidance techniques in the future, and the need to look at mechanisms to reduce this risk.

Over time the States and Territories responded by amending the UCCC to bring some of these forms of lending within its ambit. However, the process was ongoing in the sense that new types of product were constantly being developed and offered in response to amendments so that an entity's lending activities continued to be unregulated by the UCCC. This process was usually driven by a deliberate intention to avoid regulation, with the design of new avoidance methods limited only by the skill of the lawyers advising providers. It continues to be the case that there are few examples of unregulated products being developed for other reasons, such as product innovation; the only major instance is home reversion schemes.[1]

This section of the Regulation Impact Statement:

- describes the conduct associated with avoidance practices;
- discusses the operation of avoidance in relation to the two areas where it is most common:
  - contracts providing small amounts of credit (up to a maximum of $2,000); and
  - Solicitor Arranged lending (noting that this was previously examined by the States and Territories prior to the transfer of responsibility for credit to the Commonwealth); and
- analyses the problems consumers experience as a result of avoidance.

Characteristics of Avoidance

The class of persons who deliberately seek to avoid the Credit Act are referred to in this Regulation Impact Statement as "serial self-exempters", as they continuously seek to restructure their business models in order to continue to retain an unregulated status. The characteristics of self-exempting models include:

- The form of lending can be legally sophisticated in its approach to avoid the Code, and driven solely by the need to avoid the Code. Credit can therefore be provided through arrangements that have no counterpart in the mainstream industry and are confusing or unnecessarily complicated (except that the outcome is similar in that the consumer receives a sum which they must repay plus charges over time).
- These providers typically find a niche market and may have little or no interest in developing a broader base of different customers. This is usually for the purpose of targeting vulnerable consumers (such as those suffering financial hardship, or those

[1] The regulation of these products is discussed in detail in detail in the Regulation Impact Statement *Delivering for Seniors: Equity Release Product Reforms* (published by the Office of Best Practice Regulation on its website on 9 September 2011)

with low financial literacy), or consumers who have difficulty accessing credit from mainstream lenders. They usually only offer a single product (with minor variations in its terms) that is geared to that market. For example, 'equity stripping' lenders would generally only offer short-term loans for one or two years, rather than developing a broader range of products.

- The nature of these products reflects the fact that they are unlikely to be attractive to consumers who can access alternative mainstream sources of finance. Their use can be driven by meeting the needs of a class of consumers who are vulnerable in that they are largely unable to negotiate on the terms on which credit is provided.

- An avoidance model may become widespread as it becomes known to, and replicated by different players. Competition on the fringes may require some players to mimic avoidance techniques used by others in order to maintain their market share. This has resulted in the proliferation of identifiable avoidance techniques over time (discussed in further detail below)

- In some models lenders rely exclusively or extensively on third parties to distribute their products. The involvement of brokers who are unregulated by the Credit Act (or, previously, by state or territory legislation) means that consumers are at risk of brokers arranging products on the basis of conflicted or fee or commission driven advice. The involvement of intermediaries in this way can be integral to some avoidance practices, and facilitates or exacerbates its distribution (and means that the broker is not an independent party who can represent the borrower's interests). For example, the role of brokers has been significant in this way in the following areas:

  – Equity stripping — ASIC's 2006 report, *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress* (ASIC's mortgage stress report) found that brokers would actively misdescribe the proposed purpose of the credit as being for business or investment purposes in order to avoid the UCCC. Brokers benefited by ensuring the loan was approved, enabling them to charge the consumers substantial fees paid from the credit advanced under the loan. The level of these fees could be disproportionate to the benefit for consumers and the level of services rendered; for example, one broker reviewed by ASIC charged borrowers a fee that was on average 21.6 per cent of the value of the equity in the borrower's home. This fee was charged when brokers are ordinarily remunerated by commission rather than fees, and when there was no risk the broker would not be paid, as the fee would be included in the amount borrowed by the consumer.

  – Third parties charging fees on short-term loans — some providers avoided the cap on costs that could be charged on some UCCC-regulated loans (where it depended on the level of fees charged by the credit provider) by having arrangements under which a broker associated with the lender could charge a fee. The broker would ordinarily only refer consumers to the one lender, rather than selecting a product from among a range of providers.

The implementation of the Credit Act has increased the obligations applying to lenders who provide products regulated by the Act. This has increased the incentives for serial self-exempters to adopt transactions or structures that are unregulated. Similar incentives

apply to persons engaging in credit activities by providing credit assistance (that is, suggesting or assisting in relation to a particular product). These persons can select an unregulated product over a regulated product without having to meet the statutory obligations applying to regulated products (including avoiding the need to conduct an assessment as to whether or not the product is suitable, and other documentary requirements).

Avoidance and Small Amount Lending

Historically, the introduction of interest rate caps in some State and Territory jurisdictions, limiting the maximum amount that lenders can charge, has prompted the development of a range of avoidance techniques. These techniques either resulted in credit being provided through a structure or form that avoided the transaction being defined as 'regulated credit' for the purposes of the Credit Act, or in more limited avoidance, by imposing fees or charges that were not included in the amounts specified as relevant to calculation of the statutory cap.

Examples of avoidance techniques developed to avoid the Credit Act are:

- the 'diamond sale' model, in which credit is typically provided through a tripartite arrangement in which the consumer purchases a diamond from a diamond vendor (with the purchase price to be repaid by instalments), and immediately sells it to another person for a lower amount, which the consumer receives immediately (with the sale price equivalent to the sum advanced under a loan, and the purchase price equivalent to the loan plus interest)[2]; and
- sham consumer leases, where the contract is structured as a lease where no cap on costs applies, but the goods being leased are already owned by the consumer.

Techniques developed to avoid the statutory cap on costs include:

- the use of deferred establishment fees, in which the contract stipulates the term of the loan as a period such as two years but the expected repayments will result in it being repaid within a shorter period, such as six months, with the consumer then liable to pay a deferred establishment fee for early repayment of the debt, with this fee not included in the costs used for the purpose of calculating the cap;
- inflating the amount borrowed by requiring the debtor to also purchase goods or services at inflated prices, with the cost of those goods or services included in the amount of credit provided under the contract, with this practice enabling a lender to obtain a higher return in two ways while still complying with the cap on charges: first, the debtor must pay an inflated price for the goods relative to the cost to the credit provider of providing them; and, second, the debtor pays interest on the cost of the goods or services; and

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[2] These transactions may be regulated where they fall within the definition of a regulated sale of goods by instalments in section 12 of the Code, that is, where the credit provider and the supplier of the goods are related bodies corporate.

- the brokerage fee model referred to above.

The level of avoidance prompted by an intention to avoid regulation of interest rates in those jurisdictions with a legislative cap has been significant. It is estimated that in Queensland, following introduction of such a cap in 2008, that 10 per cent of the payday lending market moved to a completely unregulated model, primarily through use of the 'diamond sale' model. This figure has not changed significantly following the move to Commonwealth regulation. The extent of the payday lending market has been estimated in 2008 at approximately $500 million worth of loans per annum in Australia. On this basis the extent of unregulated activity in relation to small amount credit contracts can be conservatively estimated at $50 million annually.

Nearly all other small amount lenders in Queensland used an avoidance model where they provided credit that was regulated by the Credit Act, but they were legally able to charge amounts in excess of the cap.

Consistent with the use of small amount credit contracts generally, and the review of the short-term lending market in the RIS: Regulation of Short Term, Small Amount Lending[3] (the Small Amount Credit RIS) identified that the majority of the users of this form of finance as having the following characteristics:

- They have low incomes:
  - Approximately 40 to 49% of short term customers have an annual income of less than $24,000, and between 50 to 74% of short term customers have an annual income of less than $36,000.
  - 50% of short term customers are partially employed or unemployed.
  - Between 46 and 50% of short term customers are in receipt of government benefits.
  - Possibly up to 25% of short term borrowers have incomes that are so low that they fall beneath the Henderson Poverty Line.
- Borrowers are largely excluded from being able to obtain credit from mainstream lenders (principally because of their incomes or an impaired credit history).
- Borrowers usually have an urgent or immediate need for credit. The most common uses of the funds are to meet the following costs: bills (including utilities), food, rent, and car repairs and registration. There is minimal or negligible use of short term loans for discretionary spending purposes.
- A consumer's choice of lender is primarily driven by whether or not they can have address their financial needs through quick and efficient access to credit (and that the price or features of the credit are, at best, a secondary consideration).

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[3] Published by the Office of Best Practice Regulation on its website on 2 September 2011.

  - The Small Amount Credit RIS reviewed surveys which found that less than 10% of borrowers choose short term lenders because of cost, and that only 4.9% of consumers surveyed chose their short term loan due to low fees, and only 4.5% because of good rates.[4]

- Consumers in financial stress have limited awareness of alternatives (such as assistance from financial counsellors or no interest loan schemes). A 2008 survey by the Consumer Action Law Centre found minimal knowledge of these options, in a qualitative survey involving four group discussions, and eight one to one interviews.[5] Similarly, there have been findings that navigating the range of services available to identify appropriate options can prove a formidable task for disadvantaged consumers, and a lack of information "can impact on people's capacity to make informed decisions and actively participate in the life of their community." [6]

The Small Amount Credit RIS also found that there was a high degree of loyalty by borrowers to a small amount credit provider. For example, a current supplier of software programs to a large number of payday lenders has advised that less than 5% of consumers appear on the database of more than one lender. [7] This is consistent with consumers not being price sensitivity, and also suggests that consumers who use unregulated products do not do so because they are unable to obtain small amount loans from other providers.

Providers, in order to attract customers, will still need to advertise and hold themselves out as providing credit, even if, as in the case of the diamond sale model, the transaction is structured differently from a traditional credit contract. For example, in a recent court case[8] involving provision of credit through this model by Fast Access Finance (Beaudesert) Pty Ltd (Fast Access Finance) there were findings that:

- the consumers signed a Consent Form for the lender to obtain a credit report, with the form including the statement: "We have made application to Fast Access ... to borrow a certain amount of money";

- the consumers signed a document headed "Fast Access – Finance Application"; and

- there was an advertising billboard that stated "Fast Access Finance, funds available right now".

An employee of Fast Finance, Ms Reed, gave evidence in which she conceded that consumers would not necessarily appreciate the distinction between the outcome of the transaction (in substance a loan) and that this was being achieved by them purchasing and immediately on-selling a diamond. The following exchange took place in the cross-

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[4] Z Gillam and Consumer Action Law Centre, 'Payday Loans, Helping Hand or Quicksand', 2010 (Gillam), p. 66

[5] Gillam, p. 264.

[6] Julia Farr Association, 2010, Submission to the Social Inclusion Board.

[7] Submission to the Green Paper by the Financiers Association of Australia, p. 11.

[8] Fast Access Finance (Beaudesert) Pty Ltd and Anor v Charter and Anor [2012] QCATA 51

examination of Ms Reed:

MR CLEARY: In November 2009 you advertised your services as being a lender?

MS REED: More than likely, yes.

MR CLEARY: And so ... it would be reasonable for Michael and Rachel ... to think you were a lender?

MS REED: Yes, it's reasonable for them to have thought that, yes.

Avoidance and Solicitor Arranged Lending

One of the requirements in the Credit Act for credit to be regulated is that the lender provides credit in the course of, or incidental to, a business. The original purpose of the exclusion was to exclude informal situations such as loans between acquaintances. However, the exemption also applies to loans that are largely similar to and compete with regulated credit products. It currently applies to some structured and organised forms of private lending in which intermediaries are providing a sophisticated structure to facilitate private lenders offering credit to consumers. These arrangements are essentially commercial in character, rather than being characterised by informality, or a personal relationship between the borrower and the lender.

A form of lending known as 'Solicitor Arranged Lending' is currently unregulated as a result of the operation of this exclusion. This type of lending had its genesis in solicitor lending, where historically legal practices would match a client who had funds with another client with a need for credit. Over time, some of these practices have evolved into commercial enterprises, while the fact that the transactions are unregulated has also led to them being used by serial self-exempters.

The States and Territories had previously decided to regulate this type of lending. First, in October 2005, the Ministerial Council of Consumer Affairs released an exposure draft Bill to regulate solicitor lending, and an accompanying Explanatory Paper for public consultation. Amendments to the UCCC were not made prior to the transfer of responsibility of credit to the Commonwealth. This was due to technical questions that arose during the consultation, rather than substantive questions of policy.

Similarly, in Western Australia, brokers arranging this type of credit were previously required to comply with the *Finance Brokers Control Act 1975* (WA) and the *Finance Brokers Control (Code of Conduct) Regulations 2007*, as this legislation was not limited to credit regulated by the UCCC. The effect of the transfer of responsibility to the Commonwealth has been to reduce the regulation of intermediaries in that State in this respect.

This type of lending has the following features:

- The loans are usually structured as fixed interest loans for one or two years only, and secured over real estate. The borrower will need to refinance at the end of the loan term. The structure is predicated on the intermediary being able to provide a quick and relatively safe return to the investor. This form of lending can involve significant

transaction costs due to the borrower being charged both entry and exit fees within a short period of time, and is therefore relatively expensive.

- The decision whether or not to provide credit, and, if so, the amount of credit is determining according to the level of equity in the borrower's home rather than the borrower's capacity to meet repayments. The interest charges can be capitalised into the amount to be repaid at the end of the contract, rather than being repaid by regular instalments. As a result the risk of default only arises at the end of the contract, when it will be harder to rectify, in that the consumer needs to repay the entire sum owing, rather than having to find a smaller amount to meet a missed repayment.

- Distribution channels have expanded with the intermediary seeking borrowers beyond the clients of the law firm (such as advertising through brokers who will assist consumers to apply for credit). These models are therefore no longer necessarily linked to solicitors or law practices.

- The cost of the loan is dictated largely by the rate of return paid to investors, rather than other considerations. Investments are solicited on the basis returns will be 10 per cent or more, resulting in interest rates being charged that are higher than this (to cover expenses and profits to the entity arranging the loan).

- The intermediary usually holds funds on behalf of the lenders/investors and, where this is the case, they are required to operate this arrangement as a managed investment scheme, regulated by the *Corporations Act 2001*. This Act regulates the scheme in order to protect the lender as an investor in their relationship with the intermediary, and does not affect the relationship between the borrower and the intermediary or the lender.

The scale of this type of lending has been significant. A review found that, as at February 2001, approximately $1 billion had been advanced through this type of lending.[9] This type of lending is still continuing, though not necessarily on the same scale. Those businesses that continue to lend do so in response to both supply factors (investors who still want to earn reasonably high returns from this type of lending) and demand factors (consumers who are in arrears on their home loans and unable to obtain finance elsewhere).

The internet has also led to the development of new business models, in which an intermediary matches private lenders and borrowers through a website. Because of the unregulated nature of this type of lending it is impossible to estimate numbers. However, in the UK where this type of lending began earlier and is more mature, a recent report identified that this type of lending expanded by 80.9 per cent between 2005 and 2009.[10]

The best available evidence as to the extent of current activities is that:

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[9] Hodgson Report, Run Out Mortgage Investment Schemes (March 2002)

[10] UK Personal Lending 2010: Peer to peer lending, Datamonitor Research Store, September 2010.

- 121 Australian Financial Services Licensees who are Responsible Entities of Managed Investment Schemes have authorisation from ASIC to operate a Mortgage Scheme, that is to provide mortgages through private lending.

- Up to 5 per cent of brokers may be engaged in arranging private lending of this type, noting that as at January 2011, 4408 registrants had selected' mortgage broker' as their business activity in their licence applications to ASIC.

Adverse consequences from avoidance of the Credit Act

The use of unregulated structures has the following adverse effects on both consumers and on competition between regulated and unregulated lenders.

In relation to consumers, entering into a contract that is unregulated by the Credit Act has the following greater risks relative to using a regulated product:

- They are unable to compare similar products on price, and can be misled about the relative cost of regulated and unregulated products.
  - The difference between regulated and unregulated products in the disclosed cost can be significant; for example, ASIC's mortgage stress report found that unregulated mortgage lenders disclosed interest rates as low as 9.5 per cent, when they would be 15.3 per cent if calculated in accordance with the Code (to take into account the relatively high establishment fees charged by the lender).[11]

- They may enter into contracts where they are unable to afford the repayments because of the absence of any assessment of their capacity to repay, and, in particular, face loss of their home or depletion of their equity through equity-stripping operations.

- In the event of default they have no statutory right to seek a variation of the contract on the grounds of financial hardship. In this case their only option will be to seek a refinance or face enforcement action by the lender and the potential loss of any security for the debt.

- They will be unable to obtain remedies through complaint to an External Dispute Resolution scheme (EDR scheme).

Consumers will have remedies under other legislation, including the *Australian Securities and Investments Commission Act 2001* (ASIC Act). However, this is subject to a number of limitations that mean it has not been effective in preventing this conduct or delivering remedies to consumers, for two main reasons. First, a common feature of avoidance practices is the lack of any assessment of the borrowers' capacity to meet repayments. The law does not generally recognise that conduct of this type will provide a consumer with a remedy; the absence of any such universal requirements made it necessary to include specific provisions to this effect in Part 3 of the Credit Act. Secondly, even where the consumer has a substantial legal cause of action, if they cannot obtain redress through an

[11] Table 9 in the report at page 29.

EDR scheme then in practice they will generally be unable to afford the costs of court action to obtain compensation.

Further, in the absence of any licensing requirements, ASIC lacks the power to exclude persons from operating in the industry, irrespective of the level of detriment or loss they may cause. While, under the ASIC Act, ASIC has the power to commence proceedings to seek to compensate consumers for past losses (for example, for unconscionable conduct) it is therefore unable to prevent future misconduct.

Where the credit is provided or arranged by a person who is the holder of an ACL, the consumer may assume that the obligations and standards attaching to regulated credit apply to all products arranged or provided by these persons, when this is not the case.

The use of unregulated structures places lenders and brokers who are complying with the Credit Act at a competitive disadvantaged in that they will be incurring expenses in relation to compliance costs, meeting and maintaining the requirements to hold an ACL and regulation of their interaction with consumers.

Lenders are particularly disadvantaged in relation to cost, in that they are required to disclose a comparative interest rate that includes both interest charges and fees charged to borrowers. Unregulated lenders only need to disclose the rate at which interest is charged (excluding fees). This enables unregulated lenders to legitimately understate their fees, as set out above.

This suggests that at least some lenders are taking advantage of the absence of regulation under the Credit Act to maximise their return on individual transactions, rather than seeking to undercut their competitors to increase the overall number of loans they supply.

In addition to the general outcomes outlined above, Solicitor Arranged Lending has created particular problems for consumers. ASIC's mortgage stress report found that this type of lending was frequently used in equity-stripping operations. Equity stripping, for example, is based on the desire of borrowers in default to avoid having to sell the family home. For these borrowers, social and emotional considerations can override prudent decision-making, and make them susceptible to expensive refinances that only defer rather than prevent the sale of their home (and where the reasonable course of action would be to sell the house sooner rather than later when the amount of the secured debt is as low as possible).

While equity stripping practices are almost exclusively conducted through Solicitor Arranged Lending, it would only constitute a small percentage of this type of lending. Consumer groups have advised that the level of equity-stripping activities through this form of unregulated credit has decreased significantly following the introduction of the Credit Act. This is mainly attributed to the 2010 changes in relation to the operation of the business purposes declaration in section 13 of the Code (that prevented this being used to exclude loans that were not for business purposes), and the introduction of a precontractual requirement to assess capacity to repay (through the responsible lending obligations). It is suggested the use of this form of lending may now be more common in regional areas as they are further away from potential regulatory oversight by ASIC.

The detriment to consumers from these practices (relative to regulated products) arises as:

- There is no requirement to assess the borrower's capacity to meet repayments, so that eligibility can be determined according to the level of equity in the borrower's home, creating a greater risk of the borrower defaulting and losing their home.
  - It is known that one intermediary with a substantial lending portfolio had lending guidelines that meant it would refinance borrowers already in default on their initial loan, The amount borrowed and the repayments on the second loan would both be higher so that it was reasonably foreseeable that the borrower would be unable to meet the repayments under the loan and would suffer further diminution of their equity.
- In the absence of any statutory constraints, the usual response to any default by the borrower is enforcement action to sell the mortgaged residence (rather than investigating alternatives such as hardship variations

ASIC's mortgage stress report undertook a qualitative analysis of the financial detriment to three borrowers. It found that the refinance cost them on average 27% of the equity they had accumulated in their home, and a minimum of $20,120 in fees and charges (excluding interest). Where the level of default is such that the borrower loses their home they will experience consequent economic and social costs associated with relocation, and loss of the opportunity to generate greater personal wealth through home ownership.

Nature of the Regulatory Gap

Avoidance techniques result in providers not having to meet the requirements under the Credit Act. However, these providers are still subject to the *Australian Securities and Investments Commission Act 2001* (ASIC Act) which regulates transactions that are 'credit', defined in a way that is broader than the definition in the Credit Act. The ASIC Act includes prohibitions on unconscionable conduct, misleading or deceptive conduct and the making of false and misleading representations.

Consumers can experience an increased risk of financial harm where they enter into a contract in respect of an unregulated transaction, even where the provider has not acted unconscionably or otherwise in breach of the ASIC Act. The following Table explains the principal different outcomes that would arise, and the reason why the provisions in the ASIC Act do not assist borrowers.

Conduct	Conduct by Regulated Provider	Conduct by Unregulated Provider	Effect of ASIC Act on Conduct by Unregulated Provider
Disclosure of price	Must disclose interest rate as including fees.[12]	Can disclose interest rate as figure used to determine amount owing under the	Disclosure of interest rate without fees will not infringe ASIC Act, as it will be a

[12] Section 153 of the Code.

Conduct	Conduct by Regulated Provider	Conduct by Unregulated Provider	Effect of ASIC Act on Conduct by Unregulated Provider
		contract (without fees)	correct statement of fact.
Assessment of borrower's capacity to meet repayments	Obligation to assess borrower's financial capacity and prohibition on entering into contract where the borrower cannot afford the repayments.[13]	Provider enters into contract without assessing the borrower's capacity to afford the repayments.	ASIC Act does not impose any universal duty on lenders to ensure the borrower can repay the loan.
	Presumption that contract unsuitable where it can only be repaid by sale of the borrower's primary residence.[14]	Not applicable.	Onus on borrower to demonstrate particular facts that justify a remedy.
Right to seek a variation on grounds of financial hardship	Must consider whether to provide a variation (with consumer able to complain to EDR scheme).[15]	Can ignore request for variation and enforce contract where borrower cannot meet repayments.	Enforcement of contract in accordance with their rights under the contract will not infringe ASIC Act.
Rights on default	Borrower must be given notice of intention of provider to commence court action. The notice, gives them an opportunity to negotiate, and also advises them they can complain to an EDR scheme, where they have a dispute.[16]	Provider only subject to notice requirements in accordance with the terms of the contract, or, where the contract is secured over real property, in accordance with any State requirements.	Enforcement of contract in accordance with their rights under the contract will not infringe ASIC Act. No requirement to notify borrower of right to take any dispute to an EDR scheme.

[13] Sections 130 and 133 of the Credit Act.
[14] Subsection 133(2) of the Credit Act.
[15] Section 72 of the Code.
[16] Division 2 of Part 5 of the Code.

Conduct	Conduct by Regulated Provider	Conduct by Unregulated Provider	Effect of ASIC Act on Conduct by Unregulated Provider
Resolution of complaints	Must develop internal complaints handling procedures, and be a member of an EDR scheme.[17]	Can ignore complaints unless borrower commences court action.	No penalty or remedy under ASIC Act for failure to be a member of an EDR scheme.

As the Table illustrates, the avoidance of the Code will result in consumers having significantly fewer rights, under the contract and at law.

The intention of providers of unregulated products is to avoid regulatory scrutiny. This is usually achieved through sophisticated legal advice in relation to the structure of their transactions. Consistent with this objective they do not tend to engage in practices that would infringe the ASIC Act, and structure their businesses accordingly. The absence of any need to comply with the prescriptive requirements in the Credit Act enables them to operate in a way that provides a sufficient return without needing to place their business model at risk by engaging in conduct that would breach the prohibitions in the ASIC Act.

The interaction between unregulated providers and consumers, and their capacity to rely on the ASIC Act to avoid financial loss, therefore operates in a different way to that examined in the Regulation Impact Statements in relation to lending for small businesses and lending for investment purposes. The main difference is that the extent to which unregulated providers might engage in conduct that possibly infringes the ASIC Act is very low, as the motivations for adopting transactions that are unregulated will generally also prompt them to be risk averse in relation to engaging in conduct that would be in breach of the ASIC Act prohibitions.

Objectives of government action

The objectives of government action are to:

- Reduce the occurrence of the detriment suffered by consumers that, to a large extent, is unnecessary and avoidable.
- Achieve consistency in the regulation of products that are different in form but which have similar commercial outcomes, and further competition between providers of these products.
- Provide certainty as to when products will be regulated by the Credit Act.

[17] Paragraphs 47(1)(h) and (i) of the Credit Act.

- Minimise the impact of any changes by not regulating credit in circumstances inconsistent with the current objectives of the Credit Act, including not regulating the provision of credit through casual or informal arrangements.

Options

Option 1: Maintain the status quo

Maintaining the status quo would mean that the problems arising for consumers from using unregulated credit would continue, particularly in relation to equity stripping and an inability to compare on price. Consumers would need to rely on existing remedies, such as those under the ASIC Act. There will be no incentives for lenders or brokers to change existing practices.

Impact Analysis

The risk of continuing detriment by consumers who currently enter into contracts for the use of unregulated products appears significant given that the differences in the current regulatory framework have been deliberately utilised by serial self-exempters to avoid the Code. Their conduct since the introduction of the UCCC has consistently demonstrated an election to avoid being regulated that is extremely unlikely to change in the absence of regulatory intervention. Avoidance practices are likely to be concentrated in relation to the provision of small amount credit contracts and equity stripping practices.

The risk of continued detriment for consumers is particularly pronounced in relation to equity stripping practices. As set out above, both lenders and brokers have a significant self-interest because of the potential financial gain that can be derived from consumers who lack the capacity to protect their own interests.

The proposed introduction of a national cap on costs for small amount contracts, in the *Consumer Credit and Corporations Legislation Amendment (Enhancements) Act 2012* (Enhancements Act) creates a risk that lenders will seek to restructure their arrangements to avoid the cap (either by avoiding providing regulated credit, by avoiding their contracts being characterised as small amount contracts, or by charging fees that are not included in the amounts used to calculate whether or not the cap has been exceeded). The extent of this risk can be gauged by the experience in Queensland, where, following the introduction of a cap on costs, approximately 10 per cent of the market moved to an unregulated model.

Under this proposal the main difference in outcomes for consumers, relative to Options 2 and 3, would be that they would have continued access to credit from unregulated credit providers at current levels. This will not necessarily result in benefits to consumers who currently use these products. This group can be divided into two categories:

- Those who are able to access alternative sources of credit that are regulated – this group will be provided with credit in accordance with the requirements of the Credit Act
  - In relation to consumers who use small amount credit contracts, the credit will be provided on cheaper terms once the cap in the Enhancements Act comes into force;

- In relation to consumers who would otherwise enter into unregulated equity stripping contracts, the credit provider would need to assess the borrower's capacity to meet the proposed repayments, as a result of the responsible lending requirements, minimising the risk of the borrower incurring significant costs on default.

- Those who are able to access alternative sources of credit that are regulated – this group would benefit in the short-term from being able to access funds to avoid defaulting on other liabilities. However, this may not always be in their long-term interests where they have underlying financial difficulties. In this situation, the provision of unregulated of credit can increase their overall indebtedness and make it more difficult to resolve their problems other than by going bankrupt.

Finally, under this option, fringe operators can continue to elect whether or not to adopt forms of transaction that are unregulated by the Credit Act, while providers offering regulated products will continue to be disadvantaged, because of the lack of competitive neutrality. This option would only meet the third objective, by providing continued certainty as to the scope of the Credit Act (given that it would not change).

Option 2: Address avoidance on a limited basis

This approach would involve the application of the Credit Act being extended on a limited basis, that is, by responding to current or foreseeable methods of avoidance. This extension in coverage of the Code would be complemented by specific measures designed to reduce the extent to which new avoidance structures are able to operate.

It can be contrasted with Option 3, which would involve substantial changes to the scope of the definition of regulated transactions.

It is proposed to introduce three specific measures as follows.

Regulate solicitor and peer to peer lending

This would be done by amending section 5 of the Code so that credit would be regulated where, for example, the intermediary is in the business of arranging credit, and notwithstanding that the lender may be an individual who would otherwise fall outside the definition of regulated credit.

This model would require the lender to comply with the Credit Act, and the lender would need, in practice, to make arrangements with the intermediary to be accountable for this. A private lender seeking to provide credit through an intermediary would be expected to outsource compliance to that intermediary, given that they would generally have the infrastructure and resources to fulfil this function, and already undertake this task in relation to other legal requirements (for example, anti-money laundering obligations). The exemption for special purpose funding vehicles in the *National Consumer Credit Protection Regulations 2009* (Credit Regulations) (where the lender has been excluded from the licensing requirements for other reasons) provides a proven model for implementing this arrangement.

A similar approach would be taken to the regulation of leases, to pre-empt regulatory arbitrage.

Regulate sales of goods such as the 'diamond sale' model

Section 12 of the Code would be amended, so that these transactions would be regulated where there was a 'linked credit' relationship between the supplier of the goods and the credit provider (for example, where the credit provider has agreed the supplier can arrange for consumers to apply for credit at the premises of the supplier). This relationship is already defined in section 127 of the Code, where it has been used to determine the liability of the credit provider in relation to conduct of the supplier where there are, in general terms, commercial relationships between these two parties. It is not expected that the application of this provision to determining whether or not sales of goods would be regulated by the Code would create any uncertainty. It is noted that other amendments may also be necessary to achieve this outcome (for example, specifying that the difference between the purchase price of the diamond and the resale price is interest charges for the purposes of the Credit Act).

Introduce an anti-avoidance provision

An anti-avoidance provision would be introduced that prohibits a person, either alone or together with one or more other persons, from entering into or carrying out a scheme if the scheme was for the purpose of avoiding the application of the Credit Act (either in whole or in part).

The provision can utilise criteria that is common to both regulated and unregulated credit products in order to address avoidance in a more nuanced way than is possible in other areas. As noted above in the discussion in relation to *Fast Access Finance (Beaudesert) Pty Ltd and Anor v Charter and Anor*, there were significant procedural similarities between the advertising and the application process to enter into a 'diamond sale' transaction and regulated forms of credit The use of these criteria would enable an anti-avoidance provision in relation to credit to operate with greater certainty than such provisions in other areas (for example, in relation to tax).

The application of the anti-avoidance provision would therefore include a list of criteria relevant to ascertaining whether the purpose was to avoid the Code, such as:

- whether or not the scheme was advertised or promoted as providing access to 'credit' (in the generally understood sense of the term);
- whether or not a person assessed the consumer's capacity to meet repayments; and
- whether or not a party to the scheme is operating at a loss or in a non-commercial way (such as in the diamond sale model, where the consumer is selling the diamond for less than its value, based on the contemporaneous sale price between the vendor and the consumer).

The provision would enable ASIC to take action to prevent the distribution of such products until the provider obtains an ACL, and complies with the Credit Act.

The provision would be designed to ensure that it covered known avoidance techniques, including situations where credit is provided through transactions involving multiple parties.

It may be supplemented by a provision restricting the capacity of persons who hold an ACL to recommend or arrange products that are not regulated by the Code (given that, as discussed above, some unregulated products relied extensively on brokers as a distribution channel).

Impact Analysis

Consumers

Consumers will be less likely to enter into contracts that are unregulated by the Credit Act, or that are subject to a lower level of regulation. In general terms they are likely to benefit:

- from greater transparency in pricing, which would enable them to assess the value of competing options;
- from a reduction in cost, where unregulated providers need to lower their prices because of a greater need to compete with persons offering regulated credit contracts;
- by the exclusion of players who engage in regular misconduct from the industry; and
- by having greater access to remedies in the event they suffer loss or damage, and this in turn could be expected to promote better standards of conduct by providers who are currently unregulated (to reduce the costs associated with responding to complaints, particularly complaints to an EDR scheme).

In general terms, in relation to structures motivated by avoidance of current State or Territory interest rate caps (and the proposed Commonwealth interest rate cap) consumers are more likely to have a better understanding of the costs of the transaction, and are less likely to default (given the requirement for the lender to assess the borrower's capacity to meet repayments). They are therefore less likely to resolve their default by refinancing an existing (unregulated) credit contract with the same lender, a transaction that simply increases rather than resolves their level of debt.

The benefits to consumers under this proposal vary according to the size of the transaction they are entering into.

- Consumers who are entering into credit contracts for relatively small amounts would benefit principally from enhanced disclosure before they enter into the contract, which can be expected to result in these lenders needing to lower their costs if they are to be competitive in the credit market. This could result in savings in price equivalent to the difference in the interest rate between their products while unregulated and once they become regulated.
- The financial benefits to consumers who enter into larger loans secured over their family home are likely to be more considerable. These benefits would include: avoiding being offered credit they cannot repay, and losing significant equity in their home; avoiding the excessive costs associated with 'equity stripping' loans (noting that

the ASIC report found that one broker charged borrowers a fee that was on average 21.6 per cent of the value of the equity in the borrower's home); and having remedies available (both for unjust conduct or through seeking a variation to the loan) that would enable the borrower to retain possession of their home.

One of the consequences of a more comprehensive approach to addressing avoidance of the Credit Act may be consumers are no longer able to access existing forms of unregulated credit, when their current use of these products is the result of financial exclusion from mainstream sources of credit.

There are two main areas where this may be an outcome, that is, in relation to small amount lending and to equity stripping practices.

In relation to the first area, this issue has been discussed in detail in the Regulation Impact Statement for Regulation of Short-Term, Small Amount (payday) Finance. [18] Given the extent to which this class of borrowers is indifferent to both the price and structure of small amount contracts they do not necessarily choose unregulated products because they are unable to access alternative sources of small amount credit. Treasury's view is that the majority would be eligible for finance from other lenders (in that the assessment criteria for this market segment do not vary considerably between lenders).

The position of consumers who were no longer able to access both unregulated or regulated small amount credit would not be novel, in that there are currently persons who are unable to access any form of credit, even of a short term nature, and who therefore need to utilise existing Government and community services. The recommended option in that Regulation Impact Statement including a number of reforms to specifically address the position of these persons. It recognised the need for a comprehensive response that adopted a range of strategies to complement the cap on costs that would reduce the dependency by borrowers on small amount lending, and encourage greater use of alternatives (including, for example, advising potential borrowers about the availability of no or low interest finance programs).

In relation to equity stripping practices, the nature of these activities means that almost invariably there is no benefit to the consumer from refinancing, and that it is preferable for the consumer to sell their home when they are in a position where they can no longer afford the repayments, rather than depleting their equity. Should effective regulation of avoidance techniques result in this type of credit no longer being available this would result in the class of affected consumers being in a better financial position overall, by addressing their problems earlier.

Providers of products that would become regulated and Serial self-exempters

Under Option 2 the following classes of lending would be subject to regulation under the Credit Act:

- persons engaged in solicitor arranged lending and peer to peer lending; and

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[18] Published by the Office of Best Practice Regulation on its website on 2 September 2011.

- persons using the 'diamond sale' method of avoidance.

This reform would therefore have an impact on the niche players who currently use these models. The extent of this impact (as discussed in detail previously) would be:

- In relation to Solicitor Arranged lending - 121 AFSL holders have authorisation from ASIC to operate a Mortgage Scheme, while it is estimated up to 5 per cent of licensed brokers may arrange these types of loans.

- In relation to the 'diamond sale' model - approximately 10 per cent of the small amount credit contract market annually (conservatively estimated at $50 million), although the number of lenders involved is not known.

These providers would have the choice of:

- avoiding the Credit Act by developing new forms of transactions – the impacts on this class persons would be the same as those discussed in relation to serial self-exempters below;

- electing to comply with the Credit Act – where they would incur costs as set out below; or

- exiting the market.

It is not possible to quantify the numbers or percentage who would fall into each category.

A general anti-avoidance provision (based on characteristics common to both unregulated and regulated products) could be expected to have the following impact on serial self-exempters:

- These providers would no longer have the certainty that a particular form of transaction was legally effective in avoiding the Credit Act. In substance, the business risk of being prosecuted or subject to action by ASIC is no longer within the control of the entity.

  – This may result in some providers deciding that the risk and consequent costs of action by ASIC (for example, legal costs associated with defending court action and internal costs in restructuring their business model more frequently than is currently the case[19]) is greater than the potential benefits from being unregulated (namely, profits that can be made from operating in an unregulated way relative to a regulated model). This would require a balancing of these considerations with the outcome varying from provider to provider.

- Some providers may take a robust approach and elect to continue to provide unregulated products until ASIC takes court action.

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[19] Addressing avoidance by amendment of the UCCC by the States and Territories could be a protracted and lengthy process, during which providers could continue to use the same business model.

- It is proposed that the anti-avoidance provision would take into account the way in which the product was marketed, so that if it was promoted as 'credit' or 'finance', as is commonly the case currently, there is a greater likelihood it will be found to be an avoidance mechanism. These providers would therefore face a choice between promoting their business as 'finance' in order to attract more consumers and adopting more opaque methods of promotion to reduce the risk of successful action by ASIC. It could therefore be expected that the volume of their business would be less than is currently the case.

- However, as discussed above, avoidance models, once developed, tend to proliferate within niche markets. Where a number of serial self-exempters use the same model action against one provider by ASIC (if successful) will have an effect on other providers using the same method. This will enable ASIC to target enforcement action where it will be most effective[20].

The effectiveness of the anti-avoidance provision would be limited by the extent to which serial self-exempters elect to continue operating until ASIC takes enforcement action, or they are able to adopt models that are less likely to meet the criteria to fall within the scope of the anti-avoidance provisions. This provision would therefore not be expected to result in all unregulated provider s electing to either exit the market or become compliant. It is likely that there will be a number of providers prepared to take a robust approach by continuing to operate as they currently do, unless and until they are identified by ASIC and it then takes enforcement action.

In summary the options for serial self-exempters, and the outcome for consumers who currently enter into contracts with them, would be:

- continuing to adopt forms of contract that avoid the Credit Act (but with less certainty that the avoidance method will achieve the intended outcome than is currently the case, and with potential negative impacts on the volume of business);
  - consumers would be in the same position as currently is the case, although they may face higher costs due to decreased volumes of business for the provider;
- electing to comply with the Credit Act;
  - consumers would benefit from greater statutory rights under the Credit Act, and accountability of the credit provider for non-compliance with the Act;
- exiting the market;

[20] Enforcement in this context differs from enforcement of the provisions in the *ASIC Act* in that a court decision will be considering the form of contract or transaction in all cases where it is utilised by one or more providers. The outcome would therefore have a broad precedent value in respect of all such contracts or transactions, and would not be limited to the facts of the particular case

– some consumers may find that they are no longer able to access unregulated credit, when they would currently be able to do so. This would particularly affect those who are not eligible for mainstream or unregulated products

It could be expected that at least some providers would decide to leave the industry, particularly those whose business model revolves around targeting vulnerable consumers and who have no interest in establishing a broader or mainstream presence, or therefore in meeting the range of legal obligations associated with holding an ACL. These lenders could still be regulated while they are managing existing loans, adapting the existing regulatory approach in the National Consumer Credit Protection Regulations for lenders who choose not to apply for an ACL following the commencement of the Credit Act.

Where providers elect to comply they would incur increased costs, as discussed in detail below. However, because they would now need to meet disclosure requirements, consumers will have a better capacity to understand the relative costs of different products and therefore these providers may not be able to pass on any increase in costs where, as a result of the reforms, they will need to compete with cheaper credit contracts.

Further, in relation to small amount credit contracts, the proposed introduction of a national cap on costs for small amount contracts in the Enhancements Act would restrict the amount that could be charged for this class of contracts.

Impact from costs where elect to comply

Those providers who decide to seek a licence will incur costs in relation to entry requirements, ongoing conduct standards and responsible lending conduct obligations. If the lender sought legal advice for this purpose they could expect to incur costs of $60,000 to $180,000 in order to be 'regulator-ready'. The cost would vary according to factors such as the range and type of products being provided and the extent to which existing procedures need to be changed.

Providers who apply for and meet the standards to hold a licence would also incur costs to third parties as follows:

- Costs payable to ASIC in connection with the licence, that is, an application fee, and an annual fee.[21] The amount of the fee is based on the amount of credit advanced in a year, and can range from $450 to $21,000 (although most providers are likely to be at the lower end of the scale).[22]

- EDR membership: application fee $165 - 220; membership fee (calculated according to membership type and the size and nature of business) and complaint fees.[23]

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[21] See ASIC Info Sheet 108 How much does a credit licence cost?
[22] National Consumer Credit Protection (Fees) Regulations 2010, Schedule 1, item 1.1
[23] http://www.cosl.com.au/Member-Fees; http://www.fos.org.au/centric/home_page/members/apply_for_membership.jsp

These costs would be confined to a small class of lenders, that is, those persons currently offering unregulated products who elect to continue offering either those products (once regulated) or other regulated products.

Other providers of products not regulated by the Credit Act

The introduction of an anti-avoidance provision could have an impact on those offering products that legitimately are currently unregulated by the Credit Act, by giving them greater uncertainty as to whether or not they need to hold an ACL and meet the other requirements under that Act.

To the extent possible this risk would be managed by designing the anti-avoidance provision so that it applied to transactions with particular features that are indicia of avoidance. These include whether or not the scheme was advertised or promoted as providing access to 'credit', and whether or not a person assessed the consumer's capacity to meet repayments (in a way similar to credit providers). The design would also be tested by considering its application to known legitimate transactions that are unregulated by the Credit Act.

There may be an impact on a small number of providers of products where they need certainty that the Credit Act does not apply. Where an entity is uncertain as to whether a product is regulated, but considers that there is a risk that it may be considered to be covered, it can obtain certainty through the existing exemption and modification powers in the Credit Act and exemption and exclusion powers under the Code, either by a decision from ASIC that the product is not covered and the provider does not require relief, or a decision by ASIC to grant or refuse relief on other grounds.

Similar issues and costs already arise in the context of both the credit and the financial services regime. In relation to the latter, the broad and open-ended nature of the definition of financial products can leave providers uncertain as to whether new products are regulated or not. The relief application process is well known and understood. Use of these existing powers and processes in the context of products that may be covered by the anti-avoidance procedures would not create any new requirements or issues.

Applications to ASIC for relief involve some costs, which may include application fees and potential legal costs (which would vary depending on the nature of the application. It is not necessary for legal advice to be obtained in relation to making an application for relief. The introduction of an anti-avoidance provision is therefore expected to have a minimal impact on legitimate providers. ASIC's experience to date has been that it is not uncommon for providers in the credit space to make applications directly rather than through a legal adviser.

Regulated providers

Lenders who only offer regulated products would not incur any additional compliance costs. Consistent regulation of persons providing functionally similar products is likely to enhance their capacity to compete. As a result they may increase market share due to, first, greater transparency in pricing, where their products are more competitive, and, second, the removal of distortions in distribution channels, where brokers may currently be disposed to

choose unregulated products over regulated products because of the fees or higher commissions that can be earnt.

Option 3: Extend the jurisdiction of the Credit Act by significantly broadening its scope

This approach is an alternative to Option 2 and would result in comprehensive changes to the definitions of both credit and regulated credit, to encompass the current identified techniques used to avoid the application of the law, and limit the extent to which future avoidance is possible.

Whether or not the Code applies is determined by criteria in respect of the characteristics of the transaction, the debtor and the lender, and the purpose and cost of the credit. This approach would therefore result in a possible expansion of each of the following elements of the definitions:

- Whether or not to change the definition of credit from deferred debt to a broader definition.
- Whether or not to change the purpose of the transaction
- Whether or not to change the characteristics of the debtor and the lender.
- Whether or not to change the purpose for which the credit is provided.
- Whether or not to change the circumstances in which there will be a cost to the provision of credit.

In general terms this approach may be more difficult to avoid, given that the definition will be broader and capture transactions which are not intended to be regulated and which would then need to be exempted.

This change would be supplemented by prohibiting a person, either alone or together with one or more other persons, from entering into or carrying out a scheme if the scheme was for the purpose of avoiding a particular provision of the Credit Act (for example, a cap on interest rate caps).

Impact analysis

This approach would have the following impacts

- In respect of consumers it could be expected to deliver the same types of benefits as in Option 2, but provide more comprehensive coverage of a wider range of products, and therefore result in fewer successful attempts to avoid the Credit Act. As with option 2, these benefits would vary according to the type of contract and amount of credit the consumer enters into.
  - Consumers who are entering into credit contracts for relatively small amounts would benefit from the savings in price equivalent to the difference in the interest rate between their products while unregulated and once they become regulated.

  - Consumers who enter into larger loans secured over their family home are likely to make more substantial savings, particularly through being able to retain possession of the house, rather than incurring the costs associated with the social dislocation and forced sale of the home.

- Its impact on providers of regulated products would be similar to Option 2.

- Its impact on providers of products that are unregulated because of an intention to avoid the Code may encourage these persons to comply with the Credit Act relative to Option 2 (where they may elect to take the risk their product will not be found to have the purpose of avoiding the Act).

- Its impact on providers of products that are unregulated not because of an intention to avoid the Code, but because of the use of a broader definition that may incidentally include products that are not functionally similar to credit. The change to a broad definition of regulated products may require many persons to review the products they offer to determine whether or not they fall within the expanded definition, and where they do they would need to consider applying to ASIC for an exemption. They would incur costs as a result, while the resultant uncertainty may also delay business planning.

This approach would address all four of the government's objectives. However, while it may meet the second objective to a greater extent than Option 2 this would have a correspondingly negative impact on the third and fourth objectives.

Option 4: Encourage consumers to only use lenders or brokers who hold an Australian credit licence

This option would see the use of education or information campaigns to encourage consumers to only use lenders or brokers who hold an ACL. This approach would require consumers to be actively engaged in only selecting lenders or brokers who meet the standards to hold an ACL.

This approach would not prevent lenders or brokers who hold an ACL from offering or arranging products that are unregulated by the Credit Act. Any education campaign could therefore not utilise a simple or clear high-impact message for consumers, and would need to have a nuanced message, which would dilute its effectiveness.

Impact analysis

It is likely that serial self-exempters would only change their business models if the results of the education campaign were effective in changing consumer behaviour. It is noted that some classes of consumers are particularly vulnerable and make their choices on the basis of factors other than the integrity of the lender (for example, in the case of equity stripping operations the lender promotes themselves as offering a solution to default that no other lender will, and at what would appear to be a competitive interest rate). These classes of consumers can be expected to continue to use unregulated products despite any education campaign.

There is a risk for Government in that the campaign may in fact actively mislead consumers and give them a false sense of comfort where they believe that they are protected when they obtain an unregulated product from a holder of an ACL, when this is not the case.

This approach would therefore be unlikely to meet the government's objectives, other than the third objective.

This option would result in limited benefits to consumers relative to the other options, in that only those consumers who experience and respond to the education campaign would make better choices in relation to their use of credit. However, as discussed above, consumers can be motivated to select these types of products for reasons other than cost (for example, borrowers may enter into 'equity stripping' transactions because of their desire to retain possession of the family home, even if this is not an economically sensible choice).

Lenders would not be required to incur any additional costs. They would only need to make changes, particularly by lowering their prices, in response to changes in consumer behaviour resulting from the education campaign. It is considered that the nature of any generic education message would be unlikely to have a significant impact on the operations of any individual business, resulting in minimal competitive pressure to reduce the cost of their credit.

Consultation

The Government has conducted extensive consultations in the consideration of issues under Phase Two of the credit reforms through the following consultation groups:

- The primary vehicle for consultation with stakeholders was the Industry and Consumer Representatives Consultation Group (ICRCG). Its membership comprised of representatives of the banking, financial services, mortgage and finance brokers industries, consumer credit legal services, consumer advocates, ASIC, and the Department of the Treasury. All major industry bodies are on this group, and are able to disseminate information to their members and provide their feedback.

- Consultation with this group has generally occurred on a monthly basis. Between January 2010 and October 2010, 7 meetings were held in relation to the Phase Two reforms. The usual structure for these meetings was for Commonwealth Treasury staff to circulate papers on Phase Two topics, with the topics then discussed in detail at the meetings. This format allowed members of the group to provide comments and feedback at all stages of the development of options canvassed in this RIS, and also enabled differences in views to be explored in detail. This structure enabled prompt and detailed exploration of issues with stakeholders and was important in the refinement and development of different options.

- The **Financial Services and Credit Reform Implementation Taskforce** (FSCRIT), comprises representatives from State and Territory departments and agencies, ASIC and the Department of the Treasury. Its main role in relation to Phase Two is to ensure proposals are developed in accordance with the COAG timetable. FSCRIT consultations have been conducted on a monthly or bimonthly basis, according to need.

A full membership list of each of the consultation groups is provided at **Attachment A**.

In addition, in July 2010, the Government released a Green Paper, *National Credit Reform - Enhancing confidence and fairness in Australia's credit law*, for public consultation. Approximately 60 submissions were received to the Green Paper. To facilitate consultation with small businesses, the Green Paper was also released on the Australian Government business consultation website.

Principal stakeholders who supported extending the coverage of the Code included the Australian Bankers Association (ABA) , GE Finance, the National Financial Services Federation, the Mortgage and Finance Association of Australia (MFAA), the Finance Brokers Association of Australia (FBAA), the Consumer Credit Legal Centre (NSW) and National Legal Aid. A range of different reasons were provided.

For example, the ABA submitted that the regulation of consumer credit should be competitively neutral, and stated that a case by case approach would ensure that any identified market failures are addressed specifically and avoid the risk of over-regulating.

The Consumer Credit Legal Centre (NSW) was particularly concerned that avoidance practices were often linked to the following vulnerable classes of consumers, including consumers who were in financial hardship and trying to refinance, as tese consumers often refinance to high cost loans in an attempt to save their home.

The MFAA and the FBAA both supported an extension of coverage to regulate intermediaries involved in arranging credit which would fall within the Code, except for the lender not meeting the requirements in relation to carrying on a business. They did not support further changes.

Abacus – Australian Mutuals did not support any further regulatory intervention in their Green Paper submissions, but this position was set out as a general principle and did not specifically address issues raised by the extension of coverage of the Code.

A significant number of stakeholders did not offer any comments on this topic in their response to the Green Paper, including the Australian Finance Conference , the Financial Planners Association , the Financial Ombudsman Service and the Credit Ombudsman Service Ltd.

Recommended option

Option 2 is the preferred option.

The history of credit regulation in Australia has also been the history of credit avoidance. Avoidance can be the result of:

- conduct by serial self-exempters deliberately electing to avoid the Credit Act completely;
- innovations in product design; or
- structuring the transaction so that the provider is subject to a lower form of obligations while still subject to the Credit Act.

Under Option 2 the issue of avoidance would be addressed by:

- amending the Credit Act to regulate solicitor arranged lending, where the intermediary is in the business of providing credit services;
- amending the Credit Act to regulate transaction where credit is provided through two contemporaneous sales of goods (with the consumer purchasing the goods at a higher price than that which they sold it for); and
- introducing an anti-avoidance provision into the Credit Act, so that schemes implemented with the purpose of avoiding the Act, either in whole or in part, can be prohibited or regulated.

Option 2 would:

- Deliver targeted benefits to those consumers who currently use these products through changes to practices such as clearer and uniform disclosure of costs, greater accountability of providers through access to EDR schemes, and ongoing obligations on fringe operators to meet and maintain the standards necessary to hold an ACL.
- Affect some consumers who are currently able to access unregulated credit, where they are not eligible for mainstream or unregulated products (noting, however, as discussed above, that these persons usually would have underlying financial problems that are not necessarily addressed through the provision of further credit).

These reforms would have the following impact on industry:

- Credit providers who only offer unregulated products will incur additional compliance costs, where they now elect to comply with the Code.
- Serial self-exempters face new and different challenges in continuing to structure their transactions so they are not regulated. They will need to consider whether the consequent costs and risks are sufficient to precipitate a change in approach and a decision to bring their transactions within the Code.
- Credit providers who offer regulated products will not incur additional compliance costs. They may increase their market share through some serial self-exempters electing to leave the market.
- Other businesses may incur costs where there is uncertainty as to whether their products would be regarded as credit as a result of the anti-avoidance provision. While ASIC has existing procedures for addressing this issue they would incur costs where they currently do not do so.

Option 2 is preferred to the other options as:

- It results in greater certainty than Option 3, where providers of a broad range of products may have to consider whether or not their products are regulated by the Credit Act as a result of a broad expansion of the definition of regulated credit, and, if so, seek exemptions from ASIC.

- An educational campaign, as proposed in Option 4, is subject to limitations in its effectiveness, particularly in relation to vulnerable consumers who use unregulated credit because of an inability to access regulated credit.

Implementation

It is proposed that this reform will be implemented by legislation to be introduced in the 2013 sittings of Parliament. Regulations to support the legislation may also be made. ASIC will continue to act as the national regulator of consumer credit and will be responsible for administering and monitoring compliance with the Credit Reforms.

It is expected that there would need to be a reasonable transitional period between the passage of any legislation and the commencement of the obligations, in order to allow affected businesses that currently offer unregulated credit to decide whether or not to apply for a licence.

The Government will continue to consult with stakeholders regarding implementation timeframes and transitional issues, particularly through as regular meetings of the ICRCG group. In addition, the Commonwealth Treasury also has well developed links with ASIC and industry bodies that ensure complex issues can be identified early, allowing prompt responses to be provided. The effectiveness of these relationships was demonstrated throughout Phase One, where a range of transitional and implementation issues were able to be addressed in relatively short periods of time, resulting in both the registration and licensing processes working smoothly for industry players.

Review

The terms of the National Credit Law Agreement agreed by the Commonwealth and all States and Territories in 2009, require the Commonwealth to commence a review of the operation of the National Credit Law, no later than two years from commencement.

Attachment A – Members of consultation groups

Members of the Industry and Consumer Representatives Consultation Group	
Industry representatives	Consumer group and legal representatives
Australian Finance Conference	CHOICE
Australian Bankers' Association	Consumer Credit Legal Centre (NSW)
ABACUS Australian Mutuals	Consumer Action Law Centre
National Financial Services Federation	Law Council of Australia
Mortgage and Finance Association of Australia	Dispute resolution providers
Finance Brokers Association of Australia	Credit Ombudsman Service Ltd
Financial Services Council (formerly Investment and Financial Services Association)	Financial Ombudsman Service
Financial Planning Association	Government
GE	Commonwealth Treasury
Australasian Retail Credit Association	Australian Securities and Investments Commission
	New South Wales Office of Fair Trading (as observer for the States and Territories)

Attachment A: Members of Consultation Groups

<table>
<tr><th colspan="2">Members of the Financial Services and Credit Implementation Taskforce</th></tr>
<tr><td>Commonwealth

Treasury

ASIC</td><td>Western Australia

Department Of Commerce</td></tr>
<tr><td>New South Wales

Office Of Fair Trading

Department Of Premier And Cabinet</td><td>South Australia

Attorney-General's Department</td></tr>
<tr><td rowspan="2">Victoria

Consumer Affairs Victoria

Department Of Treasury & Finance</td><td>Tasmania

Office Of Consumer Affairs And Fair Trading</td></tr>
<tr><td>Northern Territory

Department Of Justice</td></tr>
<tr><td>Queensland

Department Of Justice And Attorney-General

Department Of Employment, Economic Development And Innovation</td><td>Australian Capital Territory

Office Of Regulatory Services

Department Of Justice And Community Safety</td></tr>
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