Regulation Impact Statement: Credit for investment purposes

Introduction

This Regulatory Impact Statement (RIS) considers whether credit provided for investment purposes should be regulated as part of the National Credit Reforms.

Executive summary

In recent investment collapses, high levels of losses to individual consumers were exacerbated in some situations by the use of credit to invest. The Government is concerned with preventing excessive detriment to consumers, and better addressing misconduct engaged in by parties involved with credit for investment purposes. This Regulatory Impact Statement (RIS) considers whether credit provided for investment purposes should be regulated more broadly than is currently the case.

Over 87 million dollars in personal finance was provided to Australians in the past twelve months,[1] some of which was used for investment purposes. Borrowing to invest can increase both the returns and the losses to consumers, and is a decision made by the individual that should reflect their risk profile.

Some activity by market participants can distort this risk-return relationship. Misconduct can include the provision of investment products or services in contravention of licensing, disclosure and/or general conduct obligations in the *Corporations Act 2001* (Corporations Act) and the *Australian Securities and Investments Commission Act 1901* (ASIC Act). This regulation applies to general conduct, and does not specifically target investment lending and its inherent risks. Even with better resourcing and more enforcement action by ASIC, incentives for misconduct would remain.

The current legislative framework does not adequately address this misconduct. Enforcement activity by the Australian Securities and Investments Commission (ASIC) is ineffective due to a combination of regulatory and enforcement gaps, the prohibitive cost and inefficiency of enforcement action and the unlikeliness of targeted enforcement action by ASIC resulting in behavioural change in the industry as a whole. There are also substantial barriers to recovering compensable losses, both in actions taken by ASIC and by consumers in their own right.

Consumer losses due to misconduct are amplified where the consumer has borrowed to invest. There is a higher risk that a lender or intermediary's conduct will contribute to the consumer's detriment where they are influenced by conflicts of interest and/or lack financial incentives to ensure that loans are reasonable for consumers (for example, where the loan is secured).

1 ABS, 5671.0 - Lending Finance, Australia

Further, disclosure and financial literacy education are increasingly thought to be inadequate to protect and inform consumers in this area. The Government is particularly concerned with situations where consumers fail to appreciate the risks associated with borrowing to invest, and entering into credit contracts where they are over-leveraged (that is, the level of lending is inconsistent with the risk they would have been prepared to take had they understood the transaction), either as the result of limitations in financial literacy, misconduct by parties to the transaction, or a combination of these factors.

It is recognised that consumers cannot be absolved of all responsibility for their financial decisions, and a balance reached between protecting vulnerable consumers and allowing the market to price risk. To achieve this balance, it is proposed to implement responsible lending obligations on lenders in situations where there is the highest risk of detriment to consumers.

Introducing new requirements on lenders and brokers will reduce misconduct by other parties such as intermediaries and product providers, due to disincentives for dealing with unlicensed parties and incentives to improve due diligence. It would also result in improved disclosure and discussion of risk with consumers.

In addition, credit licensing will improve ASIC's supervision and enforcement ability and will give ASIC effective powers to exclude entities from the market in the event of severe misconduct.

The proposed reforms would also result in:

- improved access to external dispute resolution for consumers;
- less investment loans secured against people's primary residences where those people do not have other assets from which they could meet repayments;
- more conservative lending practices where the product is unlicensed and there is a potential conflict of interest;
- improved due diligence by lenders; and
- a reduction in the flow of credit into illegally unlicensed investments.

The reforms are not expected to comprehensively address misconduct in the investment market, but are targeted at circumstances in which investment lending has the potential to amplify consumer losses and further restricted to situations where there is a higher risk of consumer detriment.

It is difficult to quantify the cost to industry and the benefits to consumers (and the difficulty in observing and quantifying any flow on consequences), and it is not possible to state definitively whether or not this reform would have a net benefit in monetary terms. Costs to business will include implementation costs (including system changes) and the modification of procedures to address regulatory risk. There will be ongoing compliance costs related to improved due diligence and other changes to procedures. Treasury considers that the reforms will lead to improved consumer confidence, and greater integrity in the investment lending market through reducing the risk of harm to consumers from specific high-risk practices, improving the accountability of lenders and intermediaries and enhancing the capacity of consumers to seek and obtain redress.

However, it is considered the reforms balance the need to protect consumers while minimising as far as possible the costs to industry, and have the potential to reduce significant losses to individuals.

Context

Investment Lending in Australia

Investment lending in this paper is defined to include credit which is used predominantly for the purpose of investment in:

- Financial products within the meaning of the Corporations Act.
- Physical items of value (for example, artwork).
- Other products which are not financial products within the meaning of the Corporations Act (such as commercial property investments).

In February 2012, $7243 million in personal finance (excluding housing loans for personal occupation) was provided to Australians.[2] Statistics regarding the proportion of this amount that would constitute investment lending are not available.[3]

1. Consumers mainly deal with three classes of persons when they are borrowing to invest:
   - Operators or providers of the investment product or scheme (called ***investment operators*** in this RIS);
   - Intermediaries (including brokers and financial planners); and
   - Lenders.

The role of each of these classes, and their contributions to the investment landing landscape are examined in more detail below.

Regulatory Framework

Legislation

Current regulation includes measures for the protection of consumers in the investment and financial services sectors, including licensing regimes under the Corporations Act, the imposition of statutory conduct and disclosure obligations and rights of redress for consumers.

In general terms, this legislation applies as follows:

- The Corporations Act imposes licensing and conduct obligations in relation to the supply of products and services which satisfy the definition of a financial product the

[2] ABS, 5671.0 - Lending Finance, Australia, Feb 2012, available at http://www.abs.gov.au/ausstats/abs@.nsf/mf/5671.0

[3] The Australian Bankers Association has advised that banks do not collate this data, and are unable to provide any general estimate of the volume of credit for investment purposes. The Australian Securities and Investments Commission (ASIC) is likewise unable to provide estimates.

Corporations Act.4 In general terms, this definition covers products by which a person makes a financial investment, that is, where they give a sum of money to another person with the intention of generating a return, and where the investor has no control over the use of the funds.5

- The Corporations Act imposes the same obligations on lending for investment purposes through a margin lending facility; this is defined as a facility where the consumer borrows money to invest and where they may receive a margin call requiring them to pay a lump sum at short notice.6 Providers of margin loans are also required to comply with targeted disclosure obligations and responsible lending obligations.
- A "managed investment scheme" is a financial product, and is also required to be separately registered with ASIC in certain circumstances.7
- The National Consumer Credit Protection Act 2009 (Credit Act) regulates lending in relation to residential investment properties, and imposes licensing and conduct obligations (including responsible lending requirements) on lenders and credit service providers who deal with credit for investment in residential property.
- Lenders who also provide credit for personal, domestic or household purposes8 are required to hold an Australian Credit Licence (ACL) under the Credit Act. Licensing conditions require the licensee to meet various requirements including mandatory External Dispute Resolution (EDR) membership, minimum competence and training standards, financial standards and insurance arrangements.
- Persons who are required to hold an Australian Financial Services Licence (AFSL) under the Corporations Act must likewise meet minimum licence conditions, including in relation to competence, training and financial standards.
- The Corporations Act and the ASIC Act have a number of general conduct obligations which apply to all providers, including licensees, where the conduct is in relation to a "financial product" or a "financial service", or to the general provision of credit (including credit for investment purposes, irrespective of the product in which the investment is made).
- ASIC is able to take action on behalf of investors who have suffered a loss if it is deemed to be in the public interest to do so. ASIC has succeeded in obtaining compensation for retail clients in a number of cases brought under section 50 of the ASIC Act, and may also secure compensation as an outcome of an investigation into a licensee's conduct.

The consequences of these arrangements are that they result in areas of conduct where no prescriptive regulation applies, as follows:

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[4] Section 763B of the Corporations Act.
[5] Sections 763A and 763B of the Corporations Act.
[6] Section 761EA of the Corporations Act.
[7] Section 601ED of the Corporations Act.
[8] Section 5(1) of the Credit Act.

- Investment operators need to comply with the Corporations Act where they are providing or dealing in a financial product by which a person makes a financial investment, but not in relation to other investments.
- Lenders need to comply with the Credit Act where the credit is provided in relation to a residential investment property but not otherwise. They do not need to comply with the Corporations Act, even where the investment is in a financial product by which a person makes a financial investment.
- Intermediaries may need to comply with the Corporations Act depending on whether they are providing advice in relation to a regulated financial product, or only acting in relation to arranging or recommending credit.

Codes of Conduct

Lenders or brokers may be a signatory to a voluntary code of practice developed by their industry body. These Codes may provide borrowers with contractual rights and may also provide them with an ability to resolve disputes through complaint to an EDR scheme.

The following Codes are in operation:

- the Code of Banking Practice;
- the Mortgage and Finance Association of Australia (MFAA) Code of Practice;
- the Mutual Banking Code of Practice; and
- the Finance Brokers Association of Australia (FBAA) Code of Practice.

In general terms these Codes provide borrowers with protections in relation to matters such as:

- pre-contractual disclosure requirements;
- obligations in relation to assessing the suitability of credit for the consumer;
- a positive commitment to assisting borrowers in financial hardship; and
- mandatory membership by members of an ASIC-approved EDR scheme.

External Dispute Resolution

As a result of the operation of these Codes of Conduct, borrowers will be able to have complaints against member lenders or brokers considered by an External Dispute Resolution (EDR) scheme, and therefore potentially resolved without court action.

Other lenders or brokers will be members of an EDR scheme where they are required to hold an Australian Credit Licence (ACL) because they engage in credit activities in relation to credit for personal use. Once the entity has EDR membership for this purpose, the scheme will also be able to hear complaints in relation to investment transactions.

An EDR scheme may be unable to determine a complaint by a borrower where the complaint is not covered by their terms of reference, such as:

- Where the amount in dispute exceeds the monetary threshold (given that small business lending may involve amounts higher than consumer lending).

  - The two main EDR schemes, the Financial Ombudsman Service (FOS) and the Consumer Ombudsman Service Ltd (COSL), can both consider claims up to $500,000. However, the maximum amount of any award of compensation is $280,000 for FOS, and $250,000 for COSL; the complainant must agree to accept compensation not exceeding $250,000 even if they would otherwise be entitled to more in another forum.[9]

- Where the dispute is about matters of commercial judgement (such as a refusal to provide credit, or the assessment of an investment product).

Limitations of Current Regulation

The issues with the current regulatory regime for investment lending centre on:

- the efficiency and cost effectiveness of current enforcement procedures, and the unlikeliness of enforcement action by ASIC resulting in behavioural change;
- the practical difficulties consumers face in getting remedies or compensation for losses caused by illegal conduct; and
- specific regulatory and enforcement gaps, primarily ASIC's inability to comprehensively exclude persons from the market where they have been involved in illegal conduct.

The current regulatory design presents difficulties in relation to ASIC's ability to appropriately deal with investment losses caused by misconduct. It is also inefficient in that it does not adequately facilitate early detection and enforcement action by ASIC.

The reasons for this are as follows:

- It is difficult for ASIC to detect illegal activity, and as a result it is generally only identified ex post, once a large number of consumers have already have provided funds to the investment operator and may have suffered substantial losses. This is partly because persons who are offering investment products without holding an AFSL (whether legally or illegally) can maximise the sale of those products in a short period of time by paying high commissions to brokers to distribute them.
- ASIC will usually not be aware of these schemes when they commence seeking investments from consumers (as the operators will not have notified ASIC of their existence, and where their product is distributed through intermediaries, they will have no visible marketing presence). The period of time over which they can continue to operate depends on the following factors:
  - The extent to which they increase their profile (for example, by seeking investments on a broader scale or more publicly through advertising).
  - The period of time between initially raising funds and any failure to make payments to investors (which is likely to result in consumer complaints to ASIC).

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[9] Clauses 9.1 and 9.2, definitions 44.1 in COSL Rules (March 2010 version). The monetary compensation limit will increase to $280,000 on and from 1 January 2012 and will be adjusted thereafter every three years using the higher of the increase in the MTAWE or CPI (COSL Member Alert, 8 September 2009).

  - Whether or not the investment operator is prepared to litigate the issue with ASIC, and argue in court that their product is not a financial product and therefore does not need to be managed in accordance with the Corporations Act.[10]

- Once misconduct induced losses have been incurred, it can be difficult and expensive for ASIC to prosecute and recover losses for consumers. ASIC can only take action on behalf of consumers where it is in the public interest to do so (with regard to the cost of taking action), which often means that action will only be taken where there is large scale detriment. This means that individual investors may not obtain recourse through action by ASIC, and, further, that where they do, it may not be in a timely manner.

- During this delay, the harm to consumers increases. This is especially so where credit has been used for the investment and the consumer has to continue making loan repayments to avoid enforcement action regardless of whether there is a prospect that they will receive some compensation in the future.

- Where consumers incur compensable losses as a result of illegal conduct, it is also difficult to recover compensation in practice.

  - The investment provider who has acted illegally often has no funds left from which to compensate consumers.

  - Intermediaries usually have no financial capacity to compensate consumers, as they are unlikely to have a large enough asset base to meet claims (because of the nature of their business) and professional indemnity insurance is likewise insufficient.[11]

  - Lenders will generally have a greater financial capacity to compensate consumers (by having amounts owing under loan contracts reduced). However, they are currently only likely to be legally accountable to consumers in limited circumstances.

- A lender or broker who engages in credit activities in relation to investment activities cannot be excluded from the industry irrespective of the level of fraud or misconduct they engage in. They do not have to meet any entry standards and also cannot be banned by ASIC from engaging in credit.[12]

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[10] This dynamic is illustrated by the operations of the Westpoint group of companies (Westpoint). Westpoint began distributing its products in 2001. In May 2004 ASIC commenced proceedings in the WA Supreme Court to determine whether the investments were financial products. It obtained rulings to this effect in November 2004 (from a single judge) and in June 2006 (on appeal). Westpoint products continued to be distributed after November 2004. By the time of this decision the Westpoint group of companies had already collapsed, with debts of approximately $388 million and assets of only $78 million.

[11] This is explored further in the public report, *Compensation arrangements for consumers of financial services*, by Richard St. John.

[12] The limitations in the current arrangements are illustrated by the Westpoint collapse. ASIC has banned 23 licensed advisers and 4 unlicensed advisers from holding an AFSL as a result of their conduct in relation to Westpoint. These persons can still act as finance brokers in relation to investment lending.

Current regulation provides limited protections and rights of redress for borrowers of credit for investment purposes, both where action is taken by ASIC on behalf of consumers and where action is taken by consumers in their own right. The limitations are as follows:

- The Corporations Act obligations do not apply to investment scheme operators or product providers who are not required to be licensed, which includes operators of commercial property investment products which do not constitute managed investment schemes and other products which are not financial products.
- In regards to margin lending, the responsible lending obligations only apply to the margin loan itself, and do not extend to situations where credit is arranged using a borrower's equity in their home which is then used as security for the margin loan.
- Intermediaries have no specific obligations in relation to investment lending, so are not accountable for their conduct unless they contravene general conduct provisions in the ASIC Act (or the Corporations Act if they fall within the definition of financial service providers).
  - There are various difficulties in proving the contravention of general conduct provisions in credit circumstances, and limitations in the scope of protection provided by these provisions.
  - Unconscionable conduct requires one party be at a special disability in dealing with the other, the other party to be aware of that disability, and the other party to act in a way that makes it unfair to accept the offer of the weaker party in the circumstances.[13] There are barriers to establishing each of these elements. In particular, special disadvantage is generally only established in situations where there is an extreme inequality of bargaining power, which limits the scope of parties who can rely on this cause of action (for example, it has been found to apply in a situation where an elderly, illiterate person relied on others to understand documents and material information was withheld from them[14]).
  - Misleading and deceptive conduct is difficult to establish are there are often evidentiary difficulties associated with what was and wasn't said by the parties and how these things should reasonably been interpreted in the circumstances.

Establishing one of these causes of actions is a legally complex process, which requires a considerable degree of resources. If a cause of action is established, intermediaries are unlikely to have sufficient assets to compensate consumers (this is discussed further below).These complexities result in a high cost to ASIC if it chooses to pursue parties through the courts. This makes it prohibitively expensive to increase the level of enforcement action, and the gain from doing so would be minimal in comparison to its cost.

Standalone enforcement action has proven to be ineffective in creating behavioural change in the industry. This is due to the amount of time that parties can operate before legal action is taken against them (and the amount of profit that can be made in this time), the apparent unlikelihood of prosecution in the short to midterm (or ever), the lack of regulator presence

[13] *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.
[14] Commercial Bank of Australia Ltd v Amadio (1983) 151 CLR 447; Commonwealth v Verwayen (1990) 170 CLR 394.

in relation to parties dealing in or with unlicensed products (as these products are difficult for ASIC to detect), and the legal uncertainty of whether prosecution will be effective.

- Lenders have no specific obligations in relation to investment lending, except where credit is used to invest in residential property.[15]

- The Future of Financial Advice (FOFA) reforms (discussed in more detail below) do not regulate the lending aspect of borrowing, so that intermediaries can still continue to encourage consumers to maximise the amount they invest, without being under any specific duties or legal obligations.

- In many cases, it is difficult for consumers to pursue parties in their own right if they do not have the time or resources to do so. This is exacerbated when the product provider or intermediary is not a member of an EDR scheme.

Future of Financial Advice Reforms

In 2009 the practices of Storm Financial in relation to arranging investments were the subject of a review by the Parliamentary Joint Committee on Corporations and Financial Services (PJC Committee). Its findings were set out in a November 2009 report, *Inquiry into financial products and services in Australia* (the PJC Report).

The PJC Report has resulted in significant legislative changes to the regulation of financial products, through the Future of Financial Advice reforms (FOFA reforms)[16]. These reforms will introduce significant changes including banning some types of commissions currently paid to financial advisers, and introducing a requirement for advisers to act in the best interests of their clients. While these reforms are intended to improve the conduct of the industry generally they do not have a direct impact on consumer protection in the area of investment lending, and therefore limited effect on the problems identified in this RIS.

It is considered the FOFA reforms will have the following outcomes:

- They will decrease the extent to which advice in relation to regulated financial products is commission-driven.

- They will increase the gap between the financial benefits that can be earned by intermediaries for arranging regulated investments (where no commission may be payable) and unregulated investments.

It may be that the FOFA reforms will increase the attractiveness of unregulated products to fringe advisers, as the gap widens between the financial incentives available for promoting unlicensed products relative to licensed products (creating an increased risk of illegal activity, through financial products being offered in contravention of the licensing, governance or conduct requirements in the Corporations Act).

The experience of recent investment schemes demonstrates that the payment of financial benefits is a key element in securing distribution channels for high risk products. The FOFA reforms may encourage some intermediaries to recommend unlicensed products, as they may earn commissions which will not be payable in respect of regulated products.

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[15] Section 5(1) of the Credit Act.
[16] Future of Financial Advice, http://futureofadvice.treasury.gov.au/

Problems experienced by users of credit for investment purposes

Introduction

Consumer protection as an objective for regulatory change in investment lending is centred on protecting vulnerable consumers from sustaining "unacceptable" investment losses (which may in some cases involve losing their primary residence). A degree of judgment is required to determine what constitutes an unacceptable loss, and which consumers are particularly vulnerable or in need of additional protection.

Consumer protection has other complementary objectives:

- improving investor understanding of risks, or financial literacy more generally; and
- reducing the detriment associated with losses stemming from misconduct by product providers, lenders and intermediaries.

In quantifying the scope and scale of investment losses, care is needed to avoid equating the often large scale of consumer losses where an investment product fails with the number of investment failures generally, and the number of consumers who have used credit to invest in these investments.

The public report on *Compensation arrangements for consumers of financial services*, by Richard St. John, provides a detailed explanation of attempts to quantify the scale of detriment of investment losses (let alone those contributed to by investment lending, and the magnitude of its contribution), and why it is not possible to arrive at a reliable estimate. It should be noted however that the detriment incurred in recent investment collapses was sufficient to prompt the Government to introduce the raft of FOFA reforms.[17]

This lack of quantitative data related to investment lending should be taken into account when establishing the balance as to what constitutes an unacceptable loss, and which consumers are particularly vulnerable or in need of additional protection. It justifies a more conservative assessment of the quantum of regulation which is necessary than would otherwise be the case.

The highest level of detriment is suffered by consumers where an investment fails completely. As a general proposition, where credit has been used for the investment, the risk of detriment to the investor increases. The collapse of an investment financed through borrowings may result in a 'problem' for the consumer; however, this of itself does not warrant regulatory intervention. The cost of investment losses to the economy (or a qualitative assessment of the problem) and the impetus for Government action depends on a combination of:

- Whether there has been, or is likely to be misconduct which contributes to the investment collapse, or contributes to consumer losses. In all of the recent investment collapses (see **Attachment A**), there has been misconduct by one or more party which has directly impacted on the losses sustained by the consumer. Misconduct increases the likelihood of an adverse outcome, including the mispricing of risk (where

[17] The problems promoting the reforms were discussed in the Regulation Impact Statement, Future of Financial Advice - Ban on conflicted remuneration structures that distort financial advice

consumers are misled) or higher levels of unrecoverable consumer detriment (where losses are directly or indirectly attributable to misconduct);

- Whether consumers understood, or are likely to understand the risks of borrowing to invest, and whether this is due to the adequacy of disclosure, misconduct by involved parties or a lack of financial literacy;
- The scope and magnitude of detriment to consumers; and
- Where the costs are most efficiently absorbed by the market, and the basis on which a shift in responsibility is justified (arising out of a moral imperative, due to specific instances of misconduct or otherwise).

The following analysis examines the different roles of investment operators, intermediaries, lenders and consumers in relation to each of these problems, and is informed by an examination of a number of recent investment collapses (as set out in **Attachment A**).

Conduct by Investment Operators

Investment operators or product providers have financial incentives to engage in high-risk practices where they need to raise funds to finance investment venture, or in the case of a scam, where their intention is to seek investment funds for personal profit.

They can often continue to operate under ASIC's radar (for the reasons discussed above in the section on Inadequacies of Current Regulation) until the investment collapses. At this stage, their assets are likely to have disappeared or are not readily recoverable as a result of the failure of the investment and other illegal behaviour such as hiding assets.

Misconduct engaged in by investment product providers has included:

- Unlicensed provision of investment products and/or unregistered managed investment schemes (where licensing and registration was required);
- Provision of illegal investment structures such as Ponzi schemes; and
- Breaches of duties by officers of the company, including making false or misleading statements.[18]

Conduct by Intermediaries

Consumers or retail investors commonly use the services of intermediaries, particularly financial planners and finance brokers, to navigate complexity associated with lending to invest. Intermediaries may assist consumers by:

- advising in relation to the investment product, including providing either personalised or general investment advice;
- advising in relation to credit, including nominating the amount to be borrowed, the terms of the contract, and recommending or arranging a lender and

[18] For example, two of Westpoint's officers have been found guilty of multiple counts of making false or misleading statements. Other examples are contained in Attachment A.

- preparing loan applications, including providing evidence of the consumer's income and financial situation.

Intermediaries can arrange for consumers to invest in a particular product and also to borrow to invest. They are typically remunerated by:

- fees charged to the consumer (usually as a percentage of the amount invested);
- commissions paid by the investment operator; and
- commissions paid by the lender.

Intermediaries have financial incentives to engage in practices which create risks for consumers, including:

- earning commissions from both the operator of the investment scheme and lenders, creating an incentive for them to maximise the amount invested (to increase commissions from product providers) and to maximise loan amounts (to increase commissions from lenders and to maximise the amount invested); and
- encouraging consumers to invest in illegal investments where they will earn a higher rate of commission than under a regulated product (with the risk of this occurring increasing as a result of the Government's FOFA Reforms, as discussed above).

Due to these incentives, there have been cases where intermediaries encourage consumers to invest in illegal investments and/or arrange for the consumer to borrow the maximum amount available (to increase the commission earned). Investment operators of illegal products have historically been prepared to pay above market commissions (this is possible in part because they incur lower compliance costs).[19]

It is recognised that some onus should be placed on the investor/borrower to investigate the intermediary they are dealing with (including researching whether the intermediary is properly licensed, their qualifications, experience, integrity and how they are renumerated) and to exercise judgment regarding an investment proposal or plan and whether it is robust and suited to their personal circumstances. It follows that consumers should not be protected from the risk of loss from borrowing to invest in all circumstances.

However, a consumer's capacity to exercise sound judgment can be adversely affected by misconduct engaged in by financial services providers (including brokers and financial advisors). Types of misconduct that have been engaged in by financial service providers include:

- Unlicensed provision of financial services or advice (where licensing was required);
- Misconduct in relation to applications for loans, including falsifying information and failure to verify information;
- Provision of inappropriate advice, including:
  - Failure to investigate and understand the nature and risks of financial products recommended.

[19] For example in the Westpoint and Storm Collapses. See Attachment A.

- Failure to undertake a full analysis of the client's financial circumstances, and making recommendations to invest in the products that were not suited to the client's risk profile.
- Failure to discuss with the consumer the risk they will lose their home (noting that there is no legal requirement for intermediaries to assess this issue in relation to the loan), which would enable tailoring the amount of the loan or the structure of the transaction consistent with the consumer's risk appetite.
- Failure to properly warn the client of the risks of investing in the products, and the risks of investing against equity in the family home.
- Making misleading or deceptive statements concerning the features and risk of the products.
- Providing inaccurate or incomplete information to clients.
- Misrepresenting to the consumer the degree of certainty that the loan repayments will be met by investment revenue, and downplaying to the consumer the risk of losing their home if the investment revenue decreases or ceases.
- Providing false and misleading information in Statements of Advice.

The scope of these activities is not known. However, an intermediary who engages in misconduct is likely to be prepared to do so on an ongoing basis, resulting in losses being sustained by a larger number of his or her clients. The Westpoint/Power Financial Planning case study in **Attachment A** is an example of this occurring.

Conduct by Lenders

Lenders earn profits through interest on borrowings. The potential for moral hazard occurs where lenders are insulated from losses through the loan being secured against the borrower's other equity (usually real property). This means that lenders have limited or no financial incentive to check whether the borrower is using credit to invest in an illegal product, or whether the borrower can afford to make repayments. By contrast, where the borrower is seeking an unsecured loan (usually for a smaller amount) a more stringent assessment procedure may be necessary, to manage the risk of the loan not being repaid.

Lenders currently have no legal obligation to inquire into what a consumer is using their funds to invest in, other than to ascertain whether the investment is in residential property (in which case responsible lending obligations apply). This may mean that lenders are also less likely to adopt lending practices that mitigate the effect of high-risk practices by investment providers and intermediaries.

In the case studies in **Attachment A**, although lenders did not necessarily engage in conduct that would give consumers a right to compensation, there is evidence that they engaged in poor lending practices, including:

- Failure to follow internal procedures, including failures to verify information and failure to ascertain the purpose of the loan. The PCJ Committee was concerned "by the

bulk of evidence received that suggests there may be a gap between bank policy and practice regarding the approval of loan applications"[20];

- Outsourcing of loan approval processes to third parties, including third parties with a conflict of interest (without adequate compliance procedures to address the risks created by that conflict of interest);
- Alleged valuation shopping to inflate the value of properties proposed as security (to maximise the amount that can be lent); and
- Providing credit in respect of financial products that are being offered illegally (that is, illegally unlicensed products or products being offered by persons who do not hold appropriate licenses) where this should have been apparent to the lender if they had done basic due diligence.

Lenders also commonly enter into commercial arrangements with third parties in relation to investment lending. Under these arrangements, lenders may outsource the assessment of borrower's eligibility for credit to these parties without being liable at law for misconduct by these parties. Lenders therefore do not have any consequent incentive to supervise their behaviour (and it may even provide an incentive for wilful blindness).

These arrangements create additional risks for consumers particularly where those third parties have a conflict of interest that can affect the advice they give consumers or result in them misrepresenting the consumer's financial position, and the lender does not adopt or adhere to adequate compliance procedures that address and manage the conflict of interest.

The extent of these practices is unknown. However, the fact that that they can occur on a systematic scale amongst prudentially regulated lenders is illustrated by findings in the PJC Report about the relationship between Storm financial and lenders. The report found that:

- the ANZ Bank had ignored internal lending guidelines (paragraph 3.115);
- the Bank of Queensland had relied on information about borrowers' financial circumstances as provided by Storm, contrary to internal lending guidelines (paragraphs 3.50 and 3.51); and
- the Commonwealth Bank of Australia acknowledged shortcomings in its approvals process(paragraph 3.108).

A more detailed analysis of the impact of commercial arrangements on lending practices is included in the case studies in **Attachment A**.

The limitations in current practices are also illustrated by the conduct of a number of lenders in continuing to provide credit for consumers to invest in Westpoint products between 2004 and 2006, even after the WA Supreme Court had found that these investments were financial products requiring the operator to hold an AFSL (when even basic due diligence would have established the confirmed illegal nature of the product).

The nature of the conduct engaged in by credit providers therefore reflects their different role and motivations in the transaction, in that:

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[20] At 3.63

- They are not the provider of an illegal investment but can benefit to a greater extent, or reduce the risk of claims by investors, through providing loans where they are not aware the investment is being provided illegally.
- They do not earn fees or commissions from arranging investments, but can benefit to a greater extent or reduce the risk of claims by investors, through providing loans where they are not aware the amount or terms of the loan are inconsistent with the borrower's willingness to incur losses to gain benefits.

Conduct of Borrowers

Investors have different risk profiles, with some willing to take on higher risk to secure the possibility of higher returns. Credit for investment purposes necessarily involves increasing risk to obtain higher returns, since debt involves a commitment to make specified payments in all circumstances, regardless of the performance of the investment. This is not of itself problematic; identifying, allocating and pricing risk is a key role of the financial system.

Where there is market failure, the pricing of risk is distorted. Market failure in the form of information asymmetry occurs in investment lending as follows:

- Factors which inhibit rational decision making operate as follows:
  - In relation to illegal lending, there are particular factors that affect the way in which consumers make investment decisions in relation to illegal products. There is a pronounced information asymmetry, in that they make the decision without receiving the disclosure documents mandated by the Corporations Act, and the risks inherent in these products relative to other financial products are neither obvious nor easily ascertainable.
  - Borrowing to invest is more complex than simply investing existing funds, as the borrower needs to make two separate purchasing decisions, the first in relation to the investment product and the second in relation to the use of credit. In practice, borrowers are more likely to focus on the investment decision and treat the credit decision as subsidiary.
  - Consumers generally have limited experience or familiarity with investment products. This increases their dependency on information provided by persons such as investment operators and intermediaries.
  - Borrowing to invest will also only generate an overall return to the consumer where the investment returns are achieved at a higher level than the rate at which interest is charged under the contract. This means that investments tend to be in more volatile (and often complex) products in order to generate the higher returns.
- Some consumers, despite having adequate information available to them, are unable to sufficiently comprehend or process this information due to a lack of financial literacy, or information overload. Disclosure and financial literacy education are increasingly proving to be inadequate consumer protection measures for complex investment arrangements:
  - The 2011 ANZ Survey of Adult Financial Literacy in Australia found that 47% of respondents would invest in an investment having a return well above market rates and no risk. This statistic is not significantly different from 2008, despite

continued financial literacy campaigns. This suggests that 47% of consumers do not understand the risk-return relationship in investment and are susceptible to being targeted to invest in illegal products (which typically promote high return and no or low risk). Consumers who lack basic understanding of investment principles are also more likely to borrow to invest, including against the equity in their home, without understanding or fully understanding the consequences of doing so.

  - Local and international behavioural economics research suggests that there are innate shortfalls in the way all people process investment decisions, regardless of their level of experience. These cognitive and emotional biases are exacerbated by complex information and choices.[21]

- On the fringes, consumers are being targeted for the equity in their homes by both product providers and intermediaries, and misled about the potential consequences of securing an investment loan against their primary residence. For example, there have been cases where consumers have been told that loan repayments will be met by investment revenue, and are not made aware of the risk of losing their home if the investment revenue decreases (these cases are discussed in detail in **Attachment A**).

- Where the consumer is borrowing to invest in a product that is being offered illegally there are additional factors that create a greater information asymmetry. These are, first, the consumer is making the decision without receiving the disclosure documents mandated by the Corporations Act, and, second, the risks inherent in these products relative to other financial products are neither obvious nor easily ascertainable.

The best available evidence in relation to consumer understanding of the elements to be taken into account in deciding whether to borrow to invest is form the financial literacy statistics cited above. It is otherwise difficult to assess the scope and magnitude of this problem. This is because the presence and effect of information asymmetry often only becomes most visible when an investment collapses, and consumers lose all or most of their investment capital.

Consumer Protection and Detriment

Consumers should generally be responsible for managing their perceived achievable living standards into the future, but Government intervention may be required to prevent "excessive" harm.

Where the investment has a high risk of failing, and the detriment that will be sustained by the consumer is also likely to be very high, this is more likely to constitute an "unacceptable risk" and in the interests of consumer protection, regulatory intervention is more likely to be required.[22]

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[21] Reeson & Dunstall (CSIRO), Behavioural Economics and Complex Decision-Making; CMIS Report Number 09/110, 7 August 2009; Bertrand et al, What's Advertising Content Worth? Evidence from a Consumer Credit Marketing Field Experiment, The Quarterly Journal of Economics (2010) 125 (1): 263-306; Garcia & Van Boom, Information Disclosure in the EU Consumer Credit Directive: Opportunities and Limitations, December 2009.

22 The Financial System Inquiry (Wallis Report), upon which the current financial regulatory framework is based, provides a useful discussion of the "intensity" of financial promises and its impact on the need for Government intervention for the purposes of consumer protection.

The following situations present a higher risk of a higher level of detriment in the event of an investment failure:

- The consumer has secured the loan against their primary residence. When the investment fails, their debt obligations remain unchanged. If they cannot meet these repayments from another source of income, they are susceptible to losing their house when they default.
  - The risk is even greater when the consumer both secures the loan against their primary residence, and is double geared (that is, where credit is arranged using a borrower's equity in their home to purchase an investment and this investment is then used as security for the margin loan).
- The investment scheme is being operated illegally, without the investment operator holding an AFSL. Where the investment is a scam, the consumer is more likely to lose their principal investment (due to the depletion of investment capital).

The risk and quantum of consumer detriment in these situations is likely to depend on the following factors:

- Whether or not the lender relies on the investment operator or the intermediary to verify the consumer's financial position or to conduct activities relevant to the approval of the loan. These parties' interests can be misaligned with those of the lender in the sense that they are remunerated on a commission basis or through the receipt of additional funds for investment, but they bear no real risk consequent on the loan defaulting. The risk increases where:
  - the financial benefits to the intermediary or the scheme operator from having a loan approved create a conflict of interests – this can result in the consumer's financial situation being misrepresented or overstated in information provided to the lender; and
  - the lender is protected through having adequate security in the event of default, by being able to be repaid through sale of the borrower's home (so that the lender has limited or no incentives to adopt robust assessment procedures).
- Whether or not an intermediary is arranging for the consumer to borrow money from a third party lender and the intermediary has a conflict of interest, or seeks to maximise their financial return at the expense of the borrower in a way that adversely affects the quality of advice, selection of investment or amount to be borrowed to invest.
- Whether or not the persons offering or recommending the investment hold an AFSL and meet the associated licensing conditions. Although consumer detriment due to misconduct does still occur in circumstances where the persons are licensed, it is less likely for the following reasons:
  - Licensees must be members of an EDR scheme. Without access to an EDR scheme consumers will find it difficult to obtain redress without instituting costly legal proceedings. EDR schemes now also have discretion to handle

complaints against a member that has ceased to carry on business or ceased to have a licence.[23]

– The consequent lack of accountability can encourage a greater level of misconduct, particularly by investment providers or intermediaries. Once a licence is granted it is not subject to annual or other periodic renewal. However, a licensee is expected to notify ASIC if it is unable to meet its licence obligations. ASIC also has greater capacity to supervise licensee conduct.

– Consumers that deal with unlicensed financial service providers (or unregistered managed investment scheme operators) are less likely to have any recourse through the product issuer to compensation arrangements. This is because an unlicensed provider is very unlikely to have set up the compensation arrangements that are required of a licensed provider.[24]

As discussed above, one of the consequences of the FOFA reforms will be to increase the attractiveness of unregulated products, as the gap widens between the financial incentives available for promoting unlicensed products relative to licensed products (creating an increased risk of illegal activity).

- Whether or not the borrower is relying on a return from the investment in order to meet the repayments under the credit contract, and whether or not the lender assesses the borrowers' capacity to meet repayments under the contract from their existing income or the lender conducts no capacity assessment and relies on the level of security being offered.

  – Consumers can be encouraged to borrow significant amounts of money on the basis the investment will meet the repayments under the credit contract, making the investment seem 'cost free', and therefore attractive. These consumers may be unaware of the potential volatility of the investment, or the consequent impact on their capacity to meet repayments under their credit contract.

  – The PJC Report acknowledges that an investment failure (in that case, the Storm collapse) had a catastrophic impact on investors, particularly those double-geared clients who now face great challenges in meeting living expenses, repaying debts and, in some cases, keeping their homes.[25]

- Whether or not fringe or rogue operators are obtaining investment funds by targeting vulnerable consumers.

  – The Case Studies in **Attachment A** indicate that the target market for illegal operators typically includes consumers who have significant equity in their homes, but limited other assets as they approach retirement. They are particularly susceptible to being encouraged to invest on the basis that the returns from the investment will fund their retirement.

  – The following vulnerable classes of consumers have been targeted:

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23 ASIC RG139, paras 139.196 to 200, para 3.10 of the FOS Constitution and para 10.1 of the COSL Constitution.

24 This is explored further in the public report Compensation arrangements for consumers of financial services, by Richard St. John.

25 At 3.1

: Consumers who are either recently retired or approaching the end of their working lives, and have insufficient superannuation to maintain a reasonable standard of living in retirement.[26] These persons face a perceived wealth gap. This can leave them anxious about their financial future and therefore susceptible to promotions by either intermediaries or investment scheme providers that the investment will address these concerns.[27]

: Persons with equity in their home who are able to refinance their existing home loan, and convert their equity into cash that can be used for investing (including investing on the basis of representations that they will be able to repay their home loan more quickly).

Government's Objectives

The objectives of government action are to:

- prevent excessive detriment to consumers;
- better address the financial harm associated with the practices of parties engaging in misconduct in situations where credit has been used to invest in the products associated with the misconduct;
- improve borrowers' understanding of the risks of using credit for investment purposes; and
- do these things a way that as far as possible:
  - allows consumers to continue to make their own informed investment choices according to their personal risk profile; and
  - minimises the impact on industry by utilising existing legal obligations or requirements.

Options

This RIS considers 3 options for addressing the issues raised by investment lending:

- Maintaining the status quo.
- Extending to investment lending the licensing requirements for holders of an ACL.

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[26] It has been estimated that the shortfall between the amount of the age pension and the amount needed for a "comfortable lifestyle" in retirement is $20,683 per annum for a single person (so that current median super savings for persons aged 65 to 69 of $80,000 would cover this shortfall for approximately 4 years) and $23,397 per annum for a couple (so that combined median super savings for a couple of $160,000 would cover this shortfall for approximately 7 years). Source: http://www.superannuation.asn.au/RS/default.aspx

[27] The case studies in Attachment A provide various example of this occurring. For example, submissions made to the PCJ Inquiry on Corporations and Financial Services stated that many of the investors had lower than average super savings, which made them susceptible to borrowing to invest on the basis of advice that their current asset base was not large enough to support a comfortable retirement: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/report/report.pdf, p28.

- Introducing targeted reforms to address the risks identified in relation to investment lending.

One option that is not considered is expanding the AFSL licensing regime to include a greater range of investment products. This would be a major regulatory change, potentially affecting a broad range of investments with different characteristics and risks. The options considered relate to the role of persons in providing or arranging credit irrespective of the nature of the underlying investment.

Option 1: Maintaining the status quo

Maintaining the status quo would mean the retention of the continued hybrid regulation through:

- broad general conduct prohibitions in the ASIC Act (for example, in relation to unconscionable conduct); and
- voluntary self-regulation where a lender or broker is a signatory to an industry code of conduct.

Impact Analysis

There will be no additional impacts on business under this option.

Individuals with investment loans would continue to rely on generic statutory remedies, such as for misleading or deceptive conduct in the ASIC Act. As discussed above, these remedies have a limited deterrent effect in relation to misconduct, as they do not provide comprehensive or readily enforceable remedies.

Consumers would continue to have a restricted capacity to obtain compensation from other parties to the transaction as:

- intermediaries and investment providers usually have no financial capacity to compensate borrowers, irrespective of the extent of their misconduct; and
- lenders usually have no liability to the consumer, as they are not responsible for the conduct of the broker or investment provider, and they are under no statutory duty to apply responsible lending obligations when providing credit.

The existing reliance on financial literacy as a means of improving investment decisions would remain. It is noted that ASIC currently produces information encouraging consumers to only invest in products where the provider holds an AFSL (including on its MoneySmart website). Materials such as these would continue to be important in seeking to discourage investment in unlicensed products; however, the experience of the investment schemes reviewed in this RIS suggests that this educational material has limited impact.

Option 2: Introduce Registration/Licensing Requirements For persons who engage in credit Activities in relation to Investment Lending

Under this proposal persons would be required to hold an ACL where they engage in credit activities in relation to credit for investment purposes. This would mean that:

- These persons would need to meet both entry and ongoing conduct standards (for example, that they would act honestly, fairly or efficiently, meet competency standards and satisfy minimum financial requirements).

- It would be a condition of licensing that the person is a member of an EDR scheme.
- ASIC would be able to ban persons from holding an ACL on grounds such as systemic or serious misconduct or incompetence.
- Licensed lenders and brokers would be prohibited (under section 31 of the Credit Act) from dealing with unlicensed lenders and brokers.

The obligation would apply to the following classes of persons:

- credit providers; and
- persons who engage in credit services as defined in section 7 of the Credit Act (either by providing credit assistance, such as by acting as a broker or suggesting or arranging particular products, or by acting as an intermediary between an investment operator and a lender).

The effect of this proposal in practice would be to impose licensing requirements only on those persons who would currently not hold an ACL. The main classes of affected persons would be:

- investment operators where they engage in credit services in relation to their own investments (either by arranging or recommending credit directly for consumers or where they refer consumers to brokers for the purpose of arranging credit);
- brokers and lenders who currently exclusively provide or arrange credit for investment purposes; and
- financial planners who also engage in credit activities in relation to investment lending (noting that a number of financial planners already hold both an ACL and an AFSL).

Persons who already hold an AFSL, but not an ACL (particularly financial planners) would be able to be streamlined to a licence in recognition that some of the entry requirements for each licence overlap and have already been satisfied.

As is currently the case, lenders would need to hold an ACL and be a member of an EDR scheme as long as they engaged in credit activities -as long as they were parties to a credit contract that had not been discharged or finalised. Brokers would be able to cease membership once they stop arranging contracts.

Impact on Consumers

Consumers will benefit from dealing with lenders and intermediaries:

- who have met the entry standards to hold an ACL or AFSL;
- who are less likely to engage in systemic misconduct because:
  - there is a greater capacity to exclude those with a propensity for such misconduct as persons banned from holding an AFLS or an ACL would be unable to act as brokers and lenders in relation to investment lending; and
  - the more comprehensive capacity to exclude persons operates as a greater deterrent against misconduct than is currently the case; and

- they will be able to obtain redress through complaints to an EDR scheme against investment operators offering illegal products where they engage in broking activities or referrals to brokers in order to distribute their products (when they currently would not be members).

It is acknowledged that investment operators who are prepared to provide financial products in contravention of the Corporations Act would also therefore be prepared to act without meeting the proposed requirements under the Credit Act. The number of such operators would not reduce solely as a result of the introduction of licensing requirements on this class of persons.

However, this consequence is acknowledged and addressed by introducing new requirements on lenders and brokers, who have different motivations, principally that their financial incentives do not operate in the same way. This means they are less likely to be prepared to engage in illegal activity themselves or support such conduct by investment operators where they would now have a greater liability.

The extent of illegal activity could therefore be expected to diminish as a result of the reforms. Investment operators offering illegal products who rely on sales of the investment through credit from third parties would need to be licensed and known to ASIC in relation to their credit referral activities. Downstream brokers or lenders would be prevented from accepting referrals or loan applications from an investment operator unless they were licensed, as a result of the operation of section 31 of the Credit Act. While the investment operator may be prepared to take the risk of acting illegally, the stricter requirements under section 31 would make lenders and brokers more reluctant to accept this risk than is currently the case. This would have the additional regulatory benefit that where these investment operators became licensed in relation to their credit activities their identity, location and role would become known to ASIC and allowing for earlier intervention than is currently the case.

This requirement would also mean that a person who was banned from holding an AFSL could also be prevented from engaging in credit activities in relation to investment lending.

Overall, consumers will be able to have greater confidence in lenders and persons providing credit services, and be less at risk of financial harm from commission-driven advice that may not be in their best interests, or other forms of misconduct.

Impact on Industry

The main impact of this requirement would be on investment operators who currently act illegally in offering financial products and on fringe or rogue operators who engage in misconduct or have behaved in a way that they do not meet the entry requirements to hold an ACL (for example, persons who were banned from holding an AFSL would not be able to satisfy the criteria to obtain an ACL).

These persons would be excluded from the industry unless and until they demonstrated they were able to engage in credit activities by meeting the entry standards for a licence (which would require them to demonstrate significant changes to their practices).

It will have a limited impact on most lenders and intermediaries, including financial planners, as they already hold an ACL or AFSL. If lenders, intermediaries and investment operators were required to hold an ACL and sought legal advice for this purpose they could expect to incur costs of $20,000 to $60,000 in order to satisfy ASIC's licensing requirements

(noting that the content of those requirements is well understood as the obligations have been in force for over 18 months).

There are no statistics available relating to how many businesses would need to obtain an ACL.[28] The reform could be expected to have a greater impact on small businesses, which are less likely to have staff with legal understanding and more likely to need to divert resources away from their day-to-day operations to implement changes to business practices. These impacts would be minimised by the release of clear and simple guidelines by ASIC, a simple and straightforward licencing system (which currently exists) and continued discourse between Treasury and ASIC and organisations representing affected small businesses.

New licensees 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.[29] The amount of the fee is based on the volume of credit arranged, and can range from $450 to $21,000 (although most lenders and brokers are likely to be at the lower end of the cost scale. It therefore does not disproportionately impact smaller businesses).[30]
- EDR membership: this includes an application fee of $165 - $220; a membership fee (calculated according to membership type and the size and nature of business) and complaint fees.[31]

In summary, this option will have the following effects:

Parties affected	Conduct or issue targeted	Effect of Reform
Intermediaries who engage in credit services (in particular, those who are operating legally but do not hold an AFSL), lenders who do not already hold an ACL	General behaviour and all types of misconduct (including disclosure obligations)	Intermediaries and lenders would need to meet both entry and ongoing conduct standards under the Credit Act. This would have a substantial impact on intermediaries who are not required to hold an AFSL and a minimal impact on current ACL and AFSL holders.
Intermediaries and product providers who are illegally unlicensed (under the AFSL regime and/or the ACL	Parties operating illegally without a licence, where a licence is required	It is currently difficult for market participants to determine whether a party is required to hold an AFSL in

28 ASIC is unable to provide any estimate, largely because they have little control over or awareness of unlicensed providers except where complaints are made in relation to them.
29 See ASIC Info Sheet 108 How much does a credit licence cost?
30 National Consumer Credit Protection (Fees) Regulations 2010, Schedule 1, item 1.1
31 See http://www.cosl.com.au/Member-Fees;
http://www2.fos.org.au/centric/home_page/members/apply_for_membership.jsp

regime)		some circumstances. This will not be the case with the ACL regime, in that all parties dealing with investment credit will need to be licensed. Licensed lenders and brokers would be prohibited (under section 31 of the Credit Act) from dealing with unlicensed intermediaries and product providers who engage in credit services. This would limit the flow of funds into products provided or facilitated by unlicensed intermediaries.
Intermediaries who engage in credit services and lenders who do not hold EDR membership	Lack of access to EDR for consumers	It would be a condition of licensing that the person is a member of an EDR scheme.
Intermediaries who engage in credit services, investment lenders who do not currently hold an ACL	ASIC's lack of ability to exclude parties from the credit market.	ASIC would be able to ban persons from holding an ACL, thereby excluding them from the market.
Intermediaries and product providers who engage in credit services, investment lenders who do not currently hold an ACL	ASIC's difficulty in supervising market participants	All intermediaries and product providers who engage in credit services in relation to investment lending, and lenders who provide credit for investment purposes would be required to be licensed, and therefore known to ASIC. ASIC would need to identify and take action against parties who are illegally unlicensed. This would be straightforward to establish (except insofar as an enquiry would need to be made about whether something is an investment product generally).

This proposal does not target:

- Intermediaries or product providers who do not engage in credit services; and
- Intermediaries or product providers who engage in credit services and partake in illegal behaviour in contravention of the Credit Act despite the disincentives for doing so (except to the extent that ASIC can identify and act in relation to this behaviour). A greater proportion of parties will hold an ACL, making the supervision of and enforcement against these parties easier for ASIC; and
- Intermediaries or product providers who partake in illegal behaviour in contravention of the Corporations Act (for example, those operating illegally without an AFSL, or those who are licensed but are not complying with conduct requirements). It should be noted that the FOFA reforms are expected to have a substantial impact on the conduct of licensed parties, and that a further assessment of regulation of these parties will be undertaken as part of that regulatory process.

Option 3: Introduce Targeted reforms for persons who engage in credit Activities in relation to Investment Lending

Under this option the following reforms (in combination or with exclusions) are proposed:

- Introduce a responsible lending requirement where a person's primary residence is security for the debt so that lenders and brokers need to assess the capacity of the borrower to make repayments.
  - The existing presumption in section 131 of the Credit Act, that a contract is unsuitable where the borrower can only repay the debt by selling their residence, would be applied to investment lending. Lenders and brokers could displace the presumption by showing informed consent by the borrower to this risk.
  - The requirement is intended to address the risk of the lender or intermediary engaging in conduct that downplays or misrepresents to the borrower the risk they will lose their home. It is intended to ensure the borrower makes a fully informed decision about the risk of losing their primary residence.
- Introduce a responsible lending requirement that applies where:
  - the lender, intermediary or investment operator is providing or arranging credit for investment in a product other than a regulated financial product; and
  - the lender or intermediary has a commercial relationship with the investment operator (based on the definition of a linked relationship in section 127 of the Credit Code) (so that the requirement would not apply, for example, where the borrower independently approaches their existing lender for a loan, but is restricted to the situation where lender plays a role in distributing the product further than would otherwise be the case, to the their benefit).

If both of these criteria are met, the lender and the intermediary or investment operator (where they are providing credit assistance (by arranging or recommending a credit contract)) would be required to conduct a suitability assessment as to the proposed contract, which would involve determining whether or not the borrower can meet the repayments.

The depth of this assessment would depend on whether or not the lender and broker include income from the proposed investment in assessing the borrower's capacity to make repayments. Where the lender and broker choose to include the predicted income, they will be required to have made reasonable inquiries into the likelihood it will be generated, which would necessitate a degree of due diligence. They would not be able for example, to accept at face value extravagant claims by the investment operator as to the proposed returns.

- Introduce a specific remedy where a lender breaches the current prohibition in the Corporations Act, on being knowingly involved in the offering of an illegal financial product by another person. This would apply to lenders in limited circumstances – only where they provide credit in situations where they are aware that the product is being offered illegally, within the meaning of the Corporations Act. The remedy would see the introduction of a presumption that the court should, if at all possible, provide a remedy for loss or damage that allowed the consumer to remain in their home.
  - The remedy would require a court to make an order that allows the consumer to remain in their home where appropriate, rather than allowing the lender to sell their home and the borrower having to seek compensation from the lender.
  - This element does not involve the creation of a new offence but seeks to make an existing offence more effective, by deterring lenders who may otherwise accept this risk on the basis that the most adverse outcome from court action is an order to repay a lump sum (where such compensation may either be paid slowly or not at all should the lender go into liquidation or otherwise insulate its assets against claims).
- Extend the existing remedy for unjust conduct in relation to credit contracts in section 72 of the National Credit Code, and the remedy for unfair conduct by brokers and intermediaries in section 180A in the Credit Act, to all credit contracts for investment purposes.
  - This remedy would provide a remedy against lenders for some asset-based lending practices in relation to credit for investment purposes. In practice, the provision would not provide a general remedy for all such practices but would only apply in situations where there is unjust conduct, such as wilful negligence or where there has been a failure by staff to follow internal lending policies.
  - Enhancing remedies for consumers will encourage lenders and brokers to develop tailored compliance responses to address the risk of unjust or unfair conduct, while still allowing them flexibility in relation to their lending and broking practices.

Impact on borrowers of credit for investment purposes

This model could be expected to deliver the following benefits in relation to investment lending:

- All borrowers taking out credit secured over their home would be better informed about the risk of losing their home.
  - However, consumers prepared to accept the risk of losing their home for higher returns would still be able to borrow at a level consistent with their risk appetite.

  - It would particularly benefit unsophisticated investors who are likely to be more conservative in their borrowing than is currently the case (as the level of borrowing aligns with their risk profile).

- In relation to unlicensed and illegal financial products, where lenders currently engage in asset-based lending, consumers would be less likely to enter into credit contracts for amounts they could only afford to repay on the basis they would receive the income forecast or proposed to be earned for the investment. This would reduce the risk of default.
  - Consumers would enter into credit contracts for lower amounts they could afford to repay either from their existing income only or with the addition of a discounted proportion of the investment income (according to the approach taken by the lender).
  - This would only apply where there are underlying commercial arrangements between the lender and the other parties to the transaction that create a potential conflict of interest (which increases the risk of detriment to the consumer where commissions influence behaviour that is not in the consumer's interest).
- Improved access to remedies for borrowers who suffer investment losses due to misconduct.

Impact on industry

This model would have the following impact on persons engaging in credit activities in relation to credit for investment:

- Lenders, intermediaries and investment operators would need to make changes to their practices through the introduction of responsible lending requirements in the two above scenarios.
  - The approach taken to the formulation of the requirements is designed to allow for flexibility in approach and outcomes. For example, lenders could elect to only lend amounts that the consumer can repay from their existing income in order to satisfy the requirements. This approach would be consistent with the existing responsible lending obligations in relation to credit for personal use. Alternatively they could elect to introduce more sophisticated practices, such as developing procedures to assess the borrower's risk appetite or assessing the proposed investment income.
- Implementation of the responsible lending obligations would result in additional costs, with the level of cost depending on the extent to which they already provide credit for personal use, and therefore would be familiar with and able to apply similar obligations to a broader class of contracts.
- Similarly the extension of the unjust contract and unfair conduct provisions would result in minimal additional costs for those lenders and intermediaries who currently provide credit for personal use, and would only need to extend current compliance practices to a larger class of contracts.
- The introduction of a specific remedy in relation to illegal products would not have any impact on the majority of lenders. It is targeted at fringe lenders who are knowingly involved in the offering of an illegal financial product who are currently

prepared to take this risk on the basis there will be practical difficulties in borrowers obtaining, first, an order for payments, and, second, the enforcement of such an order.

Entities would incur costs in relation to meeting the responsible lending conduct obligations, and the other obligations referred to above. If they sought legal advice for this purpose they could expect to incur transitional costs estimated at around $40,000. The implementation costs of those obligations cannot be specified as it varies according to a range of factors including the size of the business, the number of staff who would need training, and the approach taken to implementation (noting that the reforms allow for flexibility in this).

In summary, this option will have the following effects:

Parties affected	**Reform**	**Effect of Reform**
Lenders	Responsible lending where a person's primary residence is security for the debt	Greater responsibility and role for lenders, improved communication and disclosure, and better appreciation by the borrower of the risk of losing their home. Less investment loans secured against people's primary residences, where those people do not have other assets from which they could meet repayments.
Lenders	Responsible lending where the product is unlicensed and the lender or intermediary has a commercial relationship with the product provider	More conservative lending practices where the product is unlicensed and there is a potential conflict of interest. Less investment credit used in this scenario, where there is a higher risk of consumer detriment. Reduction in the flow of credit into unlicensed investments (whether legally or illegally so)
Lenders	Improved remedy where lender is knowingly involved in the offering of an illegal financial product by another person	Makes an existing offence more effective, by deterring lenders who may otherwise accept the risk of financial detriment associated with the current remedy. Improved due diligence by lenders, a reduction in the

Parties affected	Reform	Effect of Reform
		flow of credit into illegally unlicensed investments.
Lenders and intermediaries	• Extending the remedy for unjust conduct	Incentive for lenders and intermediaries to conduct greater due diligence, or implement improved procedures to address the risk of wilful negligence or failure by staff to follow internal lending policies.

Except insofar as it would affect the amount of credit secured against a person's primary residence, this proposal does not target:

- Intermediaries and providers who are licensed, but are not complying with other Corporations Act requirements. It should be noted that the FOFA reforms are expected to have a substantial impact on the conduct of licensed parties, and that a further assessment of regulation of these parties will be undertaken as part of that regulatory process.

Consultation

Extensive consultations have been conducted in relation to these reforms.

Consultation began with submissions to the Phase Two Credit Green Paper which provided stakeholder feedback on the need for investment lending regulatory reform generally.

Treasury then convened two consultation groups as follows:

- Industry and Consumer Representatives Consultation Group (ICRCG). Its membership comprises 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 in this group, and are able to disseminate information to their members and provide member feedback. Consultation with this group has generally occurred on a monthly basis. The membership of the group was expanded to cover a number of organisations whose membership specialises in investment lending, including the Commercial and Asset Finance Brokers Association, Short Term and Bridging Finance Association and industry bodies for accountants; and
- The Financial Services and Credit Reform Implementation Taskforce (FSCRIT), which 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 regular basis, according to need.

Stakeholder views

The views of key stakeholders in response to the Green Paper were:

- The Financial Planning Association of Australia Ltd supports regulation of investment lending. It supports regulation under the Credit Act rather than the Corporations Act as "the considerations regarding borrowing are fewer, simpler and different from that of investing"[32].
- The Australian Bankers Association, Australian Finance Conference, National Australia Bank, and Australia and New Zealand Banking Group do not support the regulation of investment lending, as they consider there is no evidence of market failure.
- The Australian Financial Markets Association supports the status quo. If regulation is to be introduced, they suggest that this should be through the Corporations Act where credit is provided predominantly to acquire a financial product. Obligations should not apply to the lender where the consumer has sought financial advice in relation to a product.
- The Financial Ombudsman Scheme supports regulation of investment lending under the Credit Act.
- The National Information Centre on Retirement Incomes supports the regulation of investment lending. It supports regulation through the Corporations Act for credit for investment in financial services products, for consistency with the margin lending regime.
- CPA Australia, representing certified practicing accountants, supports the regulation of investment lending. It supports this under the Credit Act, because consumers may not seek the advice of a licensed financial advisor.

The discussions in the consultation group chaired by Treasury subsequently identified the following issues:

- The primary concern was not to introduce requirements that required the credit provider or broker to be liable for any failure of the investment to provide the expected reforms.
  - This has been addressed by providing a balanced approach, so that although there is an increase in regulatory risk to lenders and brokers, there is greater flexibility in its management.
- The second major concern was not to require credit providers or brokers to undertake a detailed legal analysis as to whether or not a third party was offering a financial product illegally.
  - This has been addressed by only applying the responsible lending requirements where the lender or broker has commercial arrangements with the investment operator (and could be expected to be conducting due diligence inquires in any event) and by providing a 'safe harbour' where no investment income is taken into account in assessing capacity to repay.
- A third concern was regarding lender liability for the conduct of an intermediary.

[32] Submission to Green Paper, August 2010, p.9.

– This has been addressed by placing additional obligations on lenders where they enter into specified types of commercial arrangements with intermediaries, but without making them responsible for the conduct of those intermediaries.

Recommended Option

The recommended option is a combination of:

- Option 2 – extension of the Australian Credit Licence requirements to credit for investment purposes; and
- Option 3 – introduction of targeted reforms.

Combining these options would result in a series of reforms that would operate in a complementary way to provide the most comprehensive response to the issues identified in this RIS.

There would be significant limitations in introducing Option 2 by itself, as there would in practice be only limited standards of conduct the licenses would have to meet (such as acting honestly, fairly or efficiently). ASIC would still be able to ban entities but would need to rely on conduct such as serious fraud, rather than being able to rely on a failure to comply with the requirements in Option 3. It would also not introduce conduct obligations to address the problems identified in this RIS.

Similarly, if only Option 3 was introduced, while the majority of entities could be expected to comply, it would not in itself deter or prevent conduct by those prepared to act illegally (who would be unable to be excluded from the investment credit market).

Conclusion

The effect of this option would be:

- less risk of harm to consumers from specific high-risk practices currently engaged in by investment operators, intermediaries and lenders;
- an enhanced capacity of consumers to seek and obtain redress because of the greater accountability of persons engaged in credit activities in relation to credit for investment purposes; and
- increased integrity of the investment lending market through:
  - introduction of entry and ongoing conduct standards for participants; and
  - greater accountability of these persons to ASIC (including through the capacity of ASIC to exclude serious or repeat offenders from the market).

Given the difficulty in quantifying the cost to industry and the benefits to consumers (and the difficulty in observing and quantifying any flow on consequences), it is not possible to state definitively whether or not this reform would have a net benefit.

Implementation

This reform will be implemented through legislation to be passed during 2013, as part of the changes in Part Two of Phase Two of the Credit Reforms. This reform will be effected

through amendments to the Credit Act which will mean that ASIC will be responsible for administering and monitoring compliance.

Review

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

Attachment A to the Regulation Impact Statement – in respect of the regulation of lending for investment purposes

This attachment to the Regulation Impact Statement (RIS) analyses a number of recent failed investment schemes that involved systemic misconduct (including fraud) that caused significant losses to consumers, and provides evidence of market failure. It reviews the way in which the scheme operated, how it was promoted to consumers (including the incentives provided to third parties to distribute the products), and the practices of lenders when providing credit. This review informs the problem identification section of the RIS.

The schemes are:

- The collapse of Karl Suleman Enterprizes Pty Ltd in 2001 with over 600 investors suffering losses of $60 million.
- The double-gearing business model of Storm Financial that affected approximately 3,000 investors, and resulted in many investors losing their homes.
- The investments offered by the Streetwise group of companies between 2002 and 2005, in which at least 30 consumers lost approximately $10 million.
- The conduct of Power Financial Planning that resulted in 120 consumers investing over $10 million in mezzanine financing products offered by the Westpoint group of companies, shortly before the failure of those investments.

The Froggy.com group of companies

Karl Suleman was the sole director and principal of Karl Suleman Enterprizes Pty Ltd (KSE), a company involved in a trolley collection business for supermarkets located between Cairns and Adelaide. From December 1999 until November 2001, investment capital was sought from the public to fund the supermarket trolley collection business. Investors entered into a contract with KSE (called a 'Financial Investment Agreement'), in which KSE agreed to pay high returns to the investor on a monthly basis.

The scheme promised, and initially paid, massive returns to investors from the trolley collecting business operated by KSE. Many investors were attracted by word of mouth within the Assyrian community, including through the local church. More than 600 investors invested over $60 million in the scheme. In fact, the investment was a Ponzi scheme. Investors initially received high monthly payments. However, these returns were paid not, from the success of the underlying investment, but from new investment funds. The scheme therefore depended on new investors continually being brought into the scheme so that their funds could be used to meet the promised monthly returns to existing investors.

KSE operated the investment without being licensed in accordance with the requirements of the Corporations Act (under the scheme that was the statutory predecessor to the AFSL regime). In 2001 ASIC commenced proceedings before the NSW Supreme Court to close down the scheme as an unregistered managed investment scheme.

KSE was placed into voluntary administration on 12 November 2001. KSE and the other companies within the Froggy Group have since been placed into liquidation. On 15 April 2004, Suleman was sentenced to jail in the NSW District Court, on fraud charges brought by

ASIC. In February 2009 the voluntary administrators for KSE forecast a return to investors/creditors of between 2.5 and 12.5 cents in the dollar.

Many of the consumers raised substantial sums of money to invest by refinancing their home loans, often to the maximum leverage that lenders would allow. Following the collapse of KSE those investors who had borrowed money to invest stopped receiving regular payments and were left to meet their loan repayments from other resources. These loans were arranged by brokers, principally through non-bank lenders. Brokers received significant commissions from KSE, including being paid large sums of cash for arranging loans as the scheme was beginning to implode and the need for new sources of funds escalated.

Some brokers engaged in systemic misconduct in relation to applications for loans, in order to ensure loans were approved. For example, Boushra Gadallah, a broker and accountant acting on behalf of Perfect Loans Pty Ltd and Xclent Accountants Pty Ltd, arranged loans for consumers without verifying information in both their home loan applications and supporting taxation returns; he also arranged loans even when he knew the investments were likely to fail. As a result, in May 2004 ASIC banned Boushra Gadallah from acting as an investment adviser for a period of 10 years.

There is also evidence that one lender did not follow their internal procedures. *Perpetual Trustee Company Ltd v Khoshaba* [2006] NSWCA 41 was a case in which the lender had advanced $120,000 to two pensioners, for their daughter to invest in KSE. The court found that there had been breaches of internal lending guidelines by the lender, including a failure to verify the employment and income of the borrowers, and a failure to ascertain the purpose of the loan (with that purpose being outside the lending guidelines as it provided a benefit to a third party rather than the borrowers), with the borrowers granted relief by the court as a result.

Analysis

This investment scheme illustrates the following matters:

- A scheme that operates illegally can raise significant funds in a relatively short period of time, before ASIC is able to take court action to prevent it operating.
- Brokers arranged loans on the basis of the commissions they would earn, irrespective of the merits of the underlying investment or the needs or interests of their borrower clients.
- One lender ignored prudent lending practices, where it was protected from loss by taking security for the loan over the borrower's residence.

Storm Financial

Storm Financial held an AFSL and operated a financial planning business in which it arranged for consumers to invest in the share market via index funds. Its investment strategy relied on highly gearing consumers; as a result many incurred significant losses in the market downturn in 2008, as the value of their investments fell markedly, resulting in both margin calls that they were unable to meet, and also in a loss of revenue streams from their investment that let to defaults on loans secured over their homes.

The circumstances and consequences of this collapse were examined by the Parliamentary Joint Committee on Corporations and Financial Services, with its findings set out in a November 2009 report, *Inquiry into financial products and services in Australia* (the PJC Report). The scope of the inquiry was limited to making recommendations in relation to the investment aspects of the collapse (and did not address lending practices). However, the review made findings that are relevant to consideration of the issue of lending for investment purposes.

Storm operated a business model in which it was remunerated through both asset based fees and commissions:

- For geared clients, Storm charged a fee for service model of approximately 7.5% on all money invested by clients, including the initial sum invested and any additional money invested by the client (including dividends or returns from the investment).
- Product manufacturers would pay Storm annual trail commissions of between 0.2% and 0.385% on the value of that client's investment at the time (including the margin loan).

The effect of the upfront fee was to significantly reduce the return payable to the consumer. For example, assuming the consumer borrowed $100,000 they would only have available $92,500 to invest after the upfront deduction of their fee. Storm promoted returns of 11% per annum. A return at this rate over five years (compounded annually) equates, on the sum of $92,500 actually invested by the consumer, to an average annual return of nearly 13%.

Storm Financial encouraged clients to be both highly geared and double geared. It entered into arrangements with lenders, primarily banks, for Storm Financial staff to complete application forms and forward them to the lender for consideration. Storm Financial arranged for approximately 3,000 investors to be double-geared: consumers borrowed a lump sum, secured against their home, to purchase an initial investment, and then used this investment as security to obtain a margin loan, to increase the total amount invested[33]. Increases in the value in the borrower's property (both shares and real property) were used to support additional borrowings, by borrowers increasing their existing margin loans, so that borrowers continued to be highly geared, rather than having a buffer in the event of a fall in value of the investment.

The investors included a significant percentage of retirees or persons nearing the end of their working life, who were encouraged to invest in order to fund their retirement. Some of Storm's clients did not understand, or fully understand, that by borrowing against the equity they had in their family home they were effectively putting their ownership of that home at risk. Borrowers consistently told the Committee that Storm advisers strongly downplayed the risk of losing the family home[34].

Following the market downturn in 2008, many borrowers received margin calls. Because these borrowers were so highly geared and, in some cases, were dependent on the pension for income, they were unable to meet the margin calls by either reducing the amount of their loan or offering additional security. As a result many borrowers defaulted on margin loans and on the loans secured over the family home.

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[33] PJC Report, paragraph 3.12.
[34] PJC Report, paragraph 3.39.

The PJC Report found at paragraph 3.5 that: *For many investors, the consequences of their involvement with Storm have been financially and emotionally devastating. Their losses have typically been magnified by the degree of leverage in which they were encouraged to engage.*

The PJC report also found that:

- the ANZ Bank had ignored internal lending guidelines (paragraph 3.115);
- the Bank of Queensland had relied on information about borrowers' financial circumstances as provided by Storm, contrary to internal lending guidelines (paragraphs 3.50 and 3.51); and
- the Commonwealth Bank of Australia acknowledged shortcomings in its approvals process, and changed its internal procedures as a result (paragraph 3.108).

The Committee also received allegations about improprieties by Storm Financial when arranging loans, including:

- consumers signing blank application forms (that were subsequently completed by Storm Financial staff with incorrect information); and
- 'valuation-shopping', where different valuations would be sought until the value of the security was sufficient to support the loan (paragraph 3.57).

The Committee did not make any specific findings in response to these allegations. However, it made the following observation about the consequences of the close relationship between intermediary and lenders. At paragraph 3.63 it stated:

> *The committee is concerned by the bulk of evidence received that suggests there may be a gap between bank policy and procedure regarding the approval of loan applications. The evidence that the committee received from Storm and bank staff about approval processes did not match up with the evidence the committee received from investors about inaccurate and misleading data on their loan forms. The committee has some doubts about the degree to which banks were acting ethically, appropriately, morally and prudently in their decisions to grant loans to some Storm customers.*

Analysis

- The Storm financial investment model was inherently high risk, as borrowers would be at risk of defaulting in the event of a market downturn, and consequent margin call.
- Banks engaged in poor lending practices, possibly because of the volume of business being generated by Storm Financial at the branch level, and because they were protected against loss by security over the borrower's home.
- Lenders failed to adequately check information about a consumer's financial circumstances and relied on information provided by a third party, Storm Financial, that had a conflict of interest and a financial incentive to maximise the amount of credit being provided.
- Some investors did not understand the risks of the transaction, particularly in relation to the volatility of the investment and the potential consequences in relation to their capacity to meet repayments on the loan secured over their home.

Kovelan Bangaru was the principal and controlling director of 13 companies in the Streetwise group. He raised funds from consumers for investing in property development projects. The way in which the product was structured, as a joint venture, meant that the investment was not a financial product as defined in the Corporations Act, and therefore no licensing or conduct obligations applied.

Streetwise attracted potential investors through approaches made by representatives through stalls in shopping centres. It targeted consumers who either had substantial equity in their homes or owned them outright. Most of the investors had limited or low incomes, and also low levels of financial literacy that were able to be exploited by Streetwise.

Streetwise agents would then arrange a subsequent home visit, in which the potential investor was asked to consider a joint venture. Investors were told they would become directors of a joint venture company that would own the property to be developed. Streetwise organised for investors to obtain an interest only loan secured over their home, with Streetwise agreeing to pay the interest until the property was developed and sold, when the loan would be repaid from the proceeds of sale. Streetwise would take a management fee or commission and the profits would be divided between Streetwise and the investor. In fact, the scheme was fraudulent, with the money largely spent by Bangaru on supporting a lavish lifestyle.

Joint venture companies were invariably never incorporated, investors never became shareholders, and their rights and interests were therefore unprotected. Repayments were made by direct debit from the investors' bank accounts. Initially investors were reimbursed by Streetwise depositing funds into the investors' bank accounts, but these payments soon ceased, with many investors then defaulting.

Streetwise arranged for at least 30 consumers to borrow money to invest before the seven companies controlled by Bangaru went into administration on 18 July 2005. The companies were subsequently placed into liquidation by their creditors. A further six companies were placed into liquidation by ASIC in October 2005. When the companies went into liquidation there was a shortfall of approximately $16 million owed to creditors, which meant investors lost the entire amount they had paid to the Streetwise group.

Bangaru was found guilty on 24 August 2010 on 13 charges of fraud under the Crimes Act (NSW), including charges that:

- between January 2004 and May 2005, Bangaru fraudulently obtained approximately $9.1 million from a number of financial institutions, including the National Australia Bank, by providing false financial statements in support of various loan applications from companies of which he was a director; and
- between November 2001 and July 2005, Bangaru induced a number of persons to invest in Streetwise property developments by making false representations to them about how their funds would be applied.

Streetwise arranged loans for investors through a number of lenders, but principally through a wholesale lender known as Nationale Limited, trading as Tonto Home Loans (Tonto). Streetwise and Tonto entered into a "Tonto Introduction Deed" on 10 April 2002, under which it was agreed that Streetwise would act as an introducer for investors seeking loans to Tonto. Tonto would agree to provide finance to any applicant who satisfied its lending criteria, provided that any potential shortfall on the sale of the property was covered by lenders mortgage insurance.

As the introducer, Streetwise controlled the information relied upon by Tonto in deciding whether or not to approve a loan application. All loan applications were submitted electronically. Tonto did not receive or hold any original documents. In some cases Streetwise included inaccurate or falsified information as to the investors' incomes, assets and liabilities in applications, in order to ensure the loan was approved. Tonto paid Streetwise introduction fees of up to $5,000 on a $500,000 loan.

The commercial arrangements Tonto had agreed to meant it did not adopt any compliance practices to address the risk of Streetwise lodging false applications. Tonto elected to protect itself from the risk of borrowers defaulting (whether this was as a result of false applications from Streetwise or for other reasons) by ensuring the debtor's liability was secured through a mortgage over their home.

It is understood that some of the investors have had to sell their homes as a result of defaulting on the loans arranged by Streetwise (including, in one case, a couple who previously owned their home outright).

Analysis

- The principal lender, Tonto, outsourced the loan approval process to a third party who had a conflict of interest in getting the loan approved in order to finance an investment they would profit from.
- Tonto engaged in asset lending by, first, securing the debt over the borrower's home, and, second, protecting itself from the risk of a shortfall in the event of default by taking out a lenders mortgage insurance policy.
- Streetwise targeted consumers because of the equity in their home, which ensured that it would be able to obtain investment funds through a loan.
- Borrowers were at risk of being unable to meet the repayments on the loan, either through misrepresentations by Streetwise as to their financial capacity, or because they relied on the income from the investment to meet repayments.

Westpoint group of companies and Power Financial Planning Pty Ltd

The Westpoint group of companies offered consumers investments in mezzanine financing for a number of different property developments, through promissory notes with a one or two year term, and a return of around 14 per cent. Mezzanine financing is a high-risk form of investment in that the funds raised cover the difference between the amount mainstream lenders are prepared to finance and the actual cost of the projects. The investments were therefore unsecured over any assets of the property developers.

Westpoint began distributing its products in 2001. The investment was structured as a promissory note. Westpoint argued that the promissory notes were not financial products regulated by the Corporations Act. In May 2004 ASIC commenced proceedings in the WA Supreme Court to determine the status of the investments. In November 2004, Justice Simmonds ruled that the promissory notes gave rise to interests in a managed investment scheme and were therefore regulated by the Corporations Act. This decision was confirmed by the WA Court of Appeal in June 2006. By the time of this decision the Westpoint group had already collapsed, with debts of approximately $388 million and assets of only $78 million.

Financial products to invest in Westpoint were distributed by a range of intermediaries, including both licensed and unlicensed intermediaries. ASIC has banned 23 licensed intermediaries and 4 unlicensed intermediaries for promoting investments in Westpoint products. The conduct of intermediaries who held an AFSL demonstrates the effect of financial incentives on product selection, as this class of intermediaries were able to arrange for consumers to invest in financial products that were either regulated by the Corporations Act (and met appropriate consumer protection requirements) or in unregulated products where they would receive higher commissions.

This section of the RIS considers in detail at the way in which one finance broker, Power Financial Planning Pty Ltd (Power), arranged for the distribution of investments in Westpoint products.

Between 2005 and 2006 Power arranged for approximately 120 clients to invest over $10 million in Westpoint products (including the Prime Retirement and Aged Care Property Trust, Kebbel Development Capital Fund No. 2 – Mount Gilead Trust and Kebbel Development Capital Fund No. 3 – The Riverside Pier Trust). The investments were therefore arranged at a time when ASIC had already obtained a court ruling that the products were regulated by the Corporations Act.

Power promoted the 'Power Equity Loan' by representing to consumers that they would be able to accelerate repayment of their home loan by borrowing to invest. Power attracted investors through direct marketing in shopping centres and through wealth creation seminars. It targeted consumers with existing home loans. Potential clients were advised that if they took out a Power Equity Loan they could invest the proceeds of the loan in an investment product that earned more interest than they would be paying under the loan, generating income that could be used to pay off their home loan quicker and saving interest. Consumers were encouraged to refinance their existing home on this basis.

Power earned commissions from Westpoint for arranging investments calculated at 3% of the amount invested, Given that Power clients invested over $10 million Power would have received a three per cent commission amounting to over $300,000. Power also received base and trailing commissions on the Power Equity loan.

The investment strategy was high-risk and low return: borrowers could face the loss of the lump sum invested, and the investment was only for a period of one to two years, so that the maximum value of the savings they could generate would be a relatively small amount in dollar terms. In addition, the value of the expected return was offset by interest costs and the transaction costs borrowers incurred in refinancing their home loans.

Lenders provided credit on terms that meant the loan could only be repaid if the investment generated returns. In a typical example, investments were made by a permanent part-time nurse and his wife who worked at a hardware store. They had a mortgage of $85,000 with a bank. As a result of advice from Power they borrowed $288,000: $88,000 to repay the bank loan and meet expenses, and $200,000 to invest in Mount Street Mezzanine Pty Ltd. They received interest payments for a 6 month period only. As a result of this loss they have had to sell their house. In another case an invalid pensioner who had an unencumbered title to their house was advised to take out a loan and then had to sell their home.

Analysis

- The investment strategy was both high-risk and low return, as consumers faced the potential loss of the entire sum invested for a relatively small amount in dollar terms.

- Lenders were protected against loss through the equity in the borrower's home, and provided credit to persons on low incomes who would have no choice but to sell their home if the investment failed.
- Power attracted consumers on the basis they would be able to repay their home loan more quickly, enabling their product to have a broad appeal to all borrowers with home loans. The target audience included financially unsophisticated consumers.

Conclusion

The following Table summarises the role and conduct of investment operators, intermediaries and lenders, in relation to incentives or factors that encourage high-risk lending or broking practices, by analysing three factors: the way in which they can earn financial benefits from the transaction, the extent of their accountability at law to consumers for losses from those practices, and their financial capacity to compensate consumers for those losses.

Table 1 Roles and motivations of key participants in lending for investment purposes

Investment Operators	Intermediaries	Lenders
Need to raise funds to finance investment venture or, in the case of a scam, finance lifestyle or personal profits.	Can earn commissions from the operator of the investment scheme, and also from lenders. Commissions can increase according to the amount invested. Commissions may be higher for unregulated financial products.	Earn profits through interest on borrowings. Relatively low-risk lending in the event of default if the loan is secured by a mortgage over other assets (especially real property).
No accountability in relation to conduct of brokers or lenders (even though commission payments may create incentives for brokers to engage in systemic misconduct).	Can engage in commission-driven conduct by misleading borrowers and/or lenders This can include maximising commissions by: (a) encouraging consumers to invest in illegal investments (that pay a higher rate of commission); or (b) arranging for the consumer to borrow the maximum amount available (to increase the commissions earnt).	Limited accountability to borrowers as lender usually not liable at law to borrower for: (a) conduct of brokers or investment scheme operators; (b) success or failure of investment; or (c) failing to assess the borrower's capacity to meet repayments (either at all or on the basis of income other than that potentially generated by

		the investment).
The investment scheme operator is unlikely to have sufficient funds to meet claims, as these typically are consequent on the failure of the investment.	The intermediary is unlikely to have sufficient funds to meet claims, as the losses suffered by consumers will be significantly greater than the commissions or fees earned from investors/borrowers.	Consumers can be compensated by having amounts owing under loan contracts reduced.

The following conclusions can be drawn:

- Investment operators and intermediaries have the strongest financial incentives to engage in high-risk practices, and, in the event of systemic misconduct, the least financial capacity to compensate consumers.
- Lenders will generally have the greatest financial capacity to compensate consumers (by having amounts owing under loan contracts reduced), but are less likely to be accountable to consumers (unless they are responsible for the conduct of investment operators or intermediaries), and therefore may also be less likely to adopt lending practices that mitigate the effect of high-risk practices by investment providers and intermediaries.