31 March 2015

By email: fsi@treasury.gov.au

Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Financial System Inquiry Final Report

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the final report of the Financial System Inquiry (**FSI**).

About Consumer Action

Consumer Action is an independent, not-for profit consumer organisation based in Melbourne. We work to advance fairness in consumer markets, particularly for disadvantaged and vulnerable consumers, through financial counselling, legal advice and representation, and policy work and campaigns. Delivering assistance services to Victorian consumers, we have a national reach through our deep expertise in consumer law and policy and direct knowledge of the consumer experience of modern markets.

Summary of our response

Consumer Outcomes

Suitability and Fairness

- We strongly support the explicit shift in focus proposed by the FSI panel from consumer protection regulation based on disclosure to one focusing on fair treatment of consumers.
- We strongly support **FSI Recommendation 21** (introducing a targeted and principles-based product design and distribution obligation). In implementing this recommendation, we encourage the Government:
    - to adopt a 'performance-based' regulatory approach which provide incentives to firms to educate rather than obfuscate, and to develop simple and intuitive products that are suitable for consumers' circumstances;
    - to adapt the obligation depending on the type of product being regulated; and
    - to ensure that the obligation applies to insurance.

- We recommend that the Government
    - re-introduce the *Insurance Contracts Amendment (Unfair Terms) Bill 2013* to extend unfair contract terms provisions to insurance transactions; and
    - begin a process to improve the standard cover provisions in the *Insurance Contracts Act 1984*.

Product intervention powers

- We strongly support **FSI Recommendation 22** (providing ASIC with a product intervention power). A product intervention power should:
    - be a rule-making power;
    - not require any specific breach of the law; and
    - be automatically extended beyond 12 months unless the government has acted to deal with the problem, or the regulator has undertaken a market review justifying its expiration.
- The financial services regulator should also be given the power to initiate public market studies into particular financial markets, products, services or practices.

Disclosure

- We broadly support the position in **FSI Recommendation 23** that impediments to innovative product disclosure and communication with consumers should be removed.
- We support the position in **FSI Recommendation 23** that providers should improve communication of risks and fees, but current problems in this area will not be addressed by a voluntary industry response alone. Any industry response will need to be accompanied by investigation and enforcement work by regulators to target businesses that habitually conceal the risks and cost of their product.
- The Government should endorse the FSI panel's position in **FSI Recommendation 26** that the general insurance industry be required to provide improved guidance for consumers as to the likely replacement value for home buildings and contents being insured.
- Other elements of **FSI Recommendation 26** (improving tools, calculators and product disclosure statements for insurance) are welcome, but will not be enough to solve the consumer problems in this market. We recommend that, instead of solely focusing on disclosure, the Government should be seeking to improve the suitability and fairness of insurance products.

Advice

- We recommend that the Government accept **FSI Recommendation 24** (aligning interests of financial firms and consumers) but undertake to closely monitor the effectiveness of industry efforts to remove conflicted remuneration in life insurance.
- The Government should support **FSI Recommendation 40** to re-label general advice.
- However, the Government should go further than the proposals in **FSI Recommendation 40** regarding alignment and vertical integration of advice, including beginning the process of structurally separating product manufacturing and advice.
- Industry should do more to improve transparency and independence to the system, including through robust and enforceable industry-based codes.
- Regulation of sales and advice should apply broadly, rather than being limited to particular classes of products—this should include regulation of businesses that provide

advice and assistance to those experiencing financial difficulty, whether or not it is advice about a particular regulated product.

Other matters

- We believe it is a shortcoming of the FSI final report is that it did not consider problems caused by fringe lending and unfair business models, especially payday lending and consumer leases. We recommend that the review of payday lending laws scheduled to occur after 1 July 2015 be independent and evidence-based, and involve a consultation process. Further, enhancing regulation in this sector should be considered by the review, with the objective of improving consumer outcomes.
- We recommend that a last resort compensation scheme be a key component of financial services regulation.
- The Government should begin a process of merging the Financial Ombudsman Service and the Credit and Investments Ombudsman.
- The Government should ensure consumer organisations are resourced and permitted to take part in policy development.

Innovation

Payments

- We recommend that the Government accept the FSI panel's recommendation (at **FSI Recommendation 16**) to mandate the ePayments Code.
- We recommend that the Government accept and implement the FSI's recommendation to replace three-year weighted average interchange fee caps with hard caps (within **FSI Recommendation 17**).
- We recommend that the Government ensure that a regulator (preferably ASIC or ACCC) be given responsibility for enforcing payment surcharging rules made by the Reserve Bank of Australia (**RBA**).
- Surcharging should not be permitted for low-cost payments, such as EFTPOS and debit.
- Incentives should be placed into the regulatory framework to ensure that payments are directed to the least cost and most efficient system, but not in a way to reduce consumer choice.
- We recommend that the Australian Bankers' Association work with the RBA and scheme card providers to remove the distinction in regulation between direct debit payments from transaction accounts and credit (or scheme debit) cards.

Data

- The Government should accept **FSI Recommendation 19**, and in particular, should be consider how to ensure consumers can receive their personal and transaction data in a standardised and machine-readable format.
- Government should consider the use of customer data to target marketing of credit and engage in price discrimination, and consider whether existing regulation is adequate to manage the risks this creates.

Credit reporting

- We do not support **FSI Recommendation 20**. We recommend that the Government does not consider any further reforms in relation to consumer credit reporting until the effectiveness of recent reforms have been determined.

Regulatory System

- The Government should accept **FSI Recommendations 28 and 29** to introduce an industry funding model for ASIC with the level of funding determined on the recommendation of a three-yearly funding review.
- The Government should accept the FSI's recommendation (within **FSI Recommendation 29**) to strengthen the Australian Credit Licence and Australian Financial Services Licence regimes so that ASIC can deal more effectively with poor behaviour and misconduct.
- Penalties should also be increased substantially.
- Accountability mechanisms for the financial services regulator should be proportionate to the risks identified of expanded powers, and focused on advancing the broader objectives of the regulatory system.
- We recommend that consideration be given to enhancing the responsibilities of the ASIC CAP to more closely resemble the UK Financial Services Consumer Panel, as a measure to improve ASIC's accountability to end-users.

Consumer Outcomes

FAIRNESS AND SUITABILITY

Broad remarks

One of the defining features of the FSI panel's final report has been an explicit shift in focus from consumer protection regulation based on disclosure to one focusing on fair treatment of consumers. Implicit in that change is an acceptance that consumers are not necessarily capable of absorbing all of the information presented to them in financial services disclosure and, even if they do, various cognitive limitations and biases limit the ability of people to make rational product choices. We strongly support this shift in focus and the rationale that the FSI panel advanced to support it.

The final report also acknowledges that consumers do not end up with unsuitable products only because of their own weaknesses, but because of poor or unfair processes by businesses:

> The current framework is not sufficient to deliver fair treatment to consumers. The most significant problems relate to shortcomings in disclosure and financial advice, which means some consumers are sold financial products that are not suited to their needs and circumstances. Although the regime should not be expected to prevent all consumer losses, self-regulatory and regulatory changes are needed to strengthen financial firms' accountability.[1]

A fundamental principle of fair treatment of consumers set out by the FSI panel's final report is:

> ...the concept that financial products and services should perform in the way that consumers expect or are led to believe.[2]

[1] At page xx.
[2] At page xx.

This is consistent with a broader movement away from simplistic 'buyer beware' positions in financial services regulation and general consumer protection law, such as:

- responsible lending obligations in consumer credit, which require lenders to consider the requirements, objectives and financial situation of a borrower and be satisfied that credit advanced is 'not unsuitable' for the borrower;[3]
- unfair contract terms provisions (which apply across the economy, apart from insurance contracts) that prevent businesses from relying on terms which are 'unfair' but only if the term is not only unfair but also commercially unnecessary;[4]
- more prescriptive regulation of business models that have been proven to cause disproportionate levels of consumer detriment, such as payday lending[5] and unsolicited sales;[6] and
- developments overseas of safety net protections against unfair trading models, particularly the European Union *Unfair Commercial Practices Directive*.[7]

On top of benefits for consumers, we agree with the FSI final report that fairer financial products and services will 'enhance confidence and trust' in the financial system[8] and ultimately create a more effective financial system.[9]

FSI Recommendation 21: Introduce a targeted and principles-based product design and distribution obligation

We strongly support this recommendation. As we have indicated above, we believe that there is a clear need to move from a disclosure based consumer protection regime to one which recognises that consumers can only protect their interests if firms treat them fairly.

We suggest that this obligation is similar to, and may be modelled on, existing product safety obligations for goods. While the Australian economy has moved to a services-based one, our existing product safety laws have not kept up with this. FSI recommendation 21 (and 22) should be viewed as an opportunity to ensure that product safety is at the heart of financial services, through imposing appropriate obligation on product issuers and distributors.

The obligation during the product design phase to identify target and non-target markets should encourage product providers to design less complex products for general consumers that are easier to engage with. Identifying target markets will also help providers to design disclosure and marketing which is focused on the needs of consumers. Consumer testing during the design phase will give providers more information on how well consumers understand their products, and how to make them more user friendly.

Each of the design phase obligations will create a flow on benefit for disclosure, which will work more effectively if products are less complex and broadly do what consumers expect them to do. The obligation to consider distribution processes will mean product issuers will need to take

[3] *National Consumer Credit Protection Act 2009*, Chapter 3.
[4] Section 23 of the Australian Consumer Law and section 12BF of the *Australian Securities and Investments Commission Act 2001*.
[5] For example, the cost cap provisions at sections 23A, 31-31B and 39A-39C of the National Credit Code.
[6] Such as the anti-hawking provisions in the *Corporations Act 2001*.
[7] EU member states are required to implement laws which align with the EU Directive. This has already been enacted in the UK through the *Consumer Protection From Unfair Trading Regulations 2008.*
[8] At page xiii
[9] The FSI panel considered that fairness was one of three 'characteristics of an effective financial system' at page xv.

more responsibility for allowing their products to be sold through distribution channels known to create consumer detriment. Recent investigations have indicated significant problems with the 'add on' channel in insurance[10] and with the use of upfront commissions.[11]

Professor Lauren Willis from the Loyola Law School has written about how this sort of obligation could be implemented, particularly relevant compliance measures, describing it as ‘performance-based regulation’.[12] She refers to such regulation being applied to both suitability standards and comprehension standards:

> An intuitive move from disclosure mandates would be to set consumer comprehension standards that firms could meet by whatever means they see fit. Field-based testing of each firms customers would assess whether consumers understand the key costs and risks of the transactions in which they are engaged. If every customer were tested, firms could be prohibited from imposing on a customer those product features that she did not understand. If samples of customers were tested, performance benchmarks for the proportion of customers who must demonstrate comprehension could be set based on, for example, the nature of the market. Firms could be penalised for failing to meet the benchmarks and rewarded for exceeding them. Alternatively, evidence that a firm’s customers were engaging in transactions they did not comprehend might trigger regulator scrutiny for, or be prima face or even conclusive evidence of, unfair conduct.
>
> …
>
> Suitability standards would be closer to traditional substantive regulation, but more flexible. Regulation might define suitable (or unsuitable) uses of types or features of products, or firms might define suitable uses of their products, provided they did so publicly. Although suitability might be required of every transaction, testing every transaction for suitability would be prohibitively expensive and ad hoc ex post enforcement would create only limited incentives for firm compliance. Better to set performance benchmarks for what proportion of the firm’s customers must use the products or features suitably (or unsuitably) and use field-based testing of a sample of the firm’s customers to assess whether the benchmarks have been met. Enforcement levers could include fines, rewards, licensing consequences or regulator scrutiny.

Professor Willis states that this approach would move focus from firms’ actions to the effects of those actions on customers:

> Rather than ask whether a firm delivered a disclosure or structured a product in a particular manner, performance-based regulation asks whether consumers understood the transaction and whether the transaction is appropriate for the consumers engaged in it.

This is an outcomes based approach which appears to align with the concern of the FSI panel. It should provide incentives to firms to educate rather than obfuscate, and to develop simple and intuitive products that are suitable for consumers’ circumstances. We commend the work of Professor Willis to the Government to inform consideration as to how a product design and distribution obligation might effectively be enacted.

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[10] For example, see the comments from Peter Kell (Deputy Chairman, ASIC) on this topic in his address to the Insurance Council of Australia on 28 February 2014 (see pages 6-7).

[11] Refer to ASIC Report 413: Review of Retail Life Insurance Advice.

[12] Professor Lauren E Willis, ‘Performance-Based Consumer Law’, Loyola Law School, Legal Studies Paper No 2012-39, August 2014, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2485667.

We endorse the FSI panel's position that the obligation should not be limited to 'complex' products[13], because our experience is that consumers (particularly disadvantaged consumers) do not understand supposedly simple products either. This is supported by Paul O'Shea's work on consumer credit disclosure, which found that 'consumers do not understand important features of consumer credit contract transactions' even after reading compliant disclosure documents for those products. For example, O'Shea found that only 6% of participants understood the true cost of a home loan, 15% understood how long it would take to pay off a credit card at the minimum monthly payment, and 29% understood the total interest charges on a car loan.[14]

We encourage the Government to consider whether this new obligation might be adapted differently to different products. A key concern by the FSI panel appears to be to encourage 'class suitability'. This may be appropriate for investment products, where an individual suitability approach would remove all risk from the product entirely. Where 'class suitability' is adopted, we recommend that it not be left to firms themselves to define the relevant class. A more appropriate approach would be to leave the class broad, being those that could reasonably be expected to consider or purchase the product. It would also be important to define suitability appropriately. For investment products, it might be that the product is not suitable for the class if a person of the class could not be expected to absorb losses that are reasonably foreseeable over an investment cycle without suffering financial hardship.

For other products, such as insurance, an individual suitability test would be more appropriate. The basis for such an approach is outlined further below but might apply so that an insurer can only provide products that are 'not unsuitable'. This might be defined as where the product leaves the consumer substantially under (or over) insured.

Finally, any suitability obligation should be drafted to respond to existing limitations in insurance regulation. Section 15 of the *Insurance Contracts Act 1984* (**Insurance Contracts Act**) provides that no other law should affect an insurance contract to the extent that it provides

> relief in the form of:
> (a) the judicial review of a contract on the ground that it is harsh, oppressive, unconscionable, unjust, unfair or inequitable; or
> (b) relief for insureds from the consequences in law of making a misrepresentation;

It would be important that any legislation introducing an obligation for insurance should amend section 15 of the Insurance Contracts Act to be clear that the design and distribution obligation applies to insurers.

Recommendation

That, in implementing FSI Recommendation 21, we encourage the Government to:

- adopt a 'performance-based' regulatory approach which provide incentives to firms to educate rather than obfuscate, and to develop simple and intuitive products that are suitable for consumers' circumstances;

[13] The final report considers this at page 202.
[14] Paul O'Shea (2010), *Simplification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign - Final Report*, Uniquest Pty Ltd, University of Queensland, p 4.

- adapt the obligation depending on the type of product being regulated; and
- ensures that the obligation applies to insurance.

Unfair contract terms in insurance

Section 12BF of the *Australian Securities and Investments Commission Act 2001* provides that a term of a consumer contract for financial services is void if it is 'unfair' as defined within that Act. Section 23 of the Australian Consumer Law applies the same protection to consumer contracts outside of financial services. These are well balanced provisions that protect consumers from unfair treatment without preventing businesses from including terms in their contracts which are commercially necessary.

The weakness in the unfair terms regime is that it does not apply to insurance contracts[15]—indeed insurance is currently the one transaction a consumer is ever likely to enter that is not subject to unfair contract terms provisions.[16] It has always been our view that there is no sound reason to carve out the insurance industry from these otherwise economy-wide provisions. The Productivity Commission's 2008 review of Australia's consumer policy framework (which recommended the introduction of the unfair terms provisions) argued for a single, generic consumer law to apply across all sectors of the economy finding 'little reason for any variation' in its content.[17] As well as this in-principle support that consumer policy should be generic across Australia, four independent inquiries since 2009 have explicitly recommended that the unfair terms law should be extended to insurance contracts.[18]

The previous Government undertook extensive consultation on this topic and developed a proposal to apply unfair terms protections to insurance to which all sides agreed.[19] This proposal became the *Insurance Contracts Amendment (Unfair Terms) Bill 2013* (**Unfair Terms Bill**) which was introduced to Parliament but lapsed with the calling of the 2013 election.

The insurance industry has since argued that the solution proposed by the Unfair Terms Bill was inappropriate because it was not tailored to the particular needs of the insurance industry.[20] This is despite this Bill including significant concessions to insurers that would have made it harder

[15] The ASIC Act's unfair contract provisions do not apply to insurance contracts because of the operation of section 15 of the *Insurance Contracts Act*.
[16] Section 28 of the Australian Consumer Law also provides that the unfair contract terms provisions do not apply to some specific contracts regarding shipping, or a constitution of a company, managed investment scheme or other kind of body.
[17] Productivity Commission (2008) *Review of Australia's Consumer Policy Framework,* Inquiry Report No 45. See for example, Volume 2, p 58-61 and Volume 2, p 327.
[18] Senate Economics Legislation Committee report into the *Trade Practices Amendment (Australian Consumer Law) Bill 2009* (2009), at paragraph 10.13; Natural Disaster Insurance Review inquiry into flood insurance and related matters (2011), at recommendation 37; House of Representatives Committee on Social Policy and Legal Affairs inquiry into the operation of the insurance industry during disaster events (2012), at paragraph 7.22; and the draft report of the Productivity Commission into Barriers to Effective Climate Change Adaptation (2012) at pp 242-3. The final report of this Productivity Commission enquiry also spoke favourably about extending unfair contract terms protections to general insurance though did not specifically recommend it, presumably because the report assumes this reform is already underway: pp 318-9 and also 312, 315.
[19] The proposal was set out in David Bradbury's media release 'Protection from Unfair Terms in General Insurance Contracts', 20 December 2012.
[20] See Insurance Council of Australia, Submission: *Unfair Contract Terms (UCT) in Contracts of General Insurance*, 4 June 2013, p 1. Accessible from http://www.insurancecouncil.com.au/submissions#2013.

for consumers to use the unfair terms law in insurance than they would in all other transactions.[21]

These concessions (among other reasons) meant that the solution proposed by the Unfair Terms Bill was not the option favoured by consumer advocates.[22] However, the Bill produced a result that was in our view workable and a considerable improvement on the current situation. More importantly it was a result achieved through genuine negotiation between both sides of the debate and deserved to be enacted.

If the unfair terms protections are to be extended to protect small business (as proposed by the Federal Government[23] and recommended by the FSI final report[24]) then it should be self evident that consumers deserve this protection when they transact with insurers. The Government should reintroduce the Unfair Terms Bill to parliament in the near future.

The case for an individual suitability test in insurance

As noted above, we believe that there is a strong case to introduce an individual suitability test (that is, an assessment of suitability to be performed at point of sale for each customer) for consumer insurance products.

There is now a weight of evidence indicating that, because of structural problems in insurance, consumers frequently end up with insurance which is not suitable for their needs. For example:

- <u>sum underinsurance:</u> consumers are not capable of assessing the correct sum insured value for homes and contents[25], creating a systemic risk of underinsurance. This is a problem which tends to come to light after natural disasters[26] but in reality it affects a much larger group of consumers who are not aware they are underinsured until it is too late.
- <u>feature underinsurance:</u> consumers are also incapable of properly assessing the features and exclusions of insurance contracts due to the complexity of contracts and the lack of any simple way for consumers to compare competing products. This leads to underinsurance where consumers do not understand the coverage and exclusions. Again, this problem tends to show up after natural disasters, as in 2011 where large numbers of consumers indicated that they were not aware they were not covered for flood.

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[21] The most significant concession was that, under the draft Bill, a consumer had no right to redress unless an insurer sought to rely on a term which a court had already ruled to be unfair. Under the Australian Consumer Law and ASIC Act provisions, a consumer could challenge a term that had not yet been ruled to be unfair in court. If that term was then found to be unfair, the term was immediately void in that contract. The other concession to insurers in the Unfair Terms Bill was that an impugned term could not be considered unfair if that term reflected the 'underwriting risk' accepted by the insurer.

[22] Consumer advocates had instead argued that the existing unfair contract terms provisions in the ASIC Act simply be applied to insurance contracts without amendment.

[23] See *Protecting small businesses against unfair contract terms*, joint media release, The Hon Tony Abbott MP and The Hon Bruce Billson MP, 20 March 2015.

[24] At recommendation 34.

[25] ASIC has found that most consumers guessed their sum insured value, often based on faulty assumptions. See ASIC's media release 14-285 *ASIC sets out areas for improvement in home insurance sales practices*, Tuesday 28 October 2014.

[26] For example, see statistics on underinsurance from ASIC and Legal Aid NSW cited on page 228 of the FSI final report.

- <u>lack of effective competition:</u> the complexity discussed above, among other problems, leads to a widespread lack of competition in the consumer insurance market. This was discussed in depth by the Victorian Office of the Fire Services Levy Monitor.[27]
- <u>particular products and channels:</u> There are particular problems with certain products (such as Consumer Credit Insurance)[28] and distribution channels (such as the add on channel.[29]

The FSI final report rejected the idea of an individual suitability test finding that:

> An individual appropriateness test, where no personal advice is provided, would introduce significant costs for issuers and distributors due to necessary changes to the sales process.

Introducing an individual suitability test would create costs for industry, but costs are also created by failing to respond to an identified problem. At present, unsuitability of insurance creates costs for consumers who only find they are underinsured after suffering a loss. The relevant consideration is not whether the costs of an individual appropriateness test is too high but whether they are outweighed by the benefits.

One relevant point not noted by the FSI panel is that Australia already has a working example of an individual suitability test which is working very well—the responsible lending obligations in consumer credit. We think this demonstrates that the problems noted by the FSI panel can be overcome.

The panel also found that 'appropriateness tests are open to manipulation' but did not expand on this point. Taking the responsible lending example—it is true that the responsible lending obligations can be manipulated, though we would not say that they are 'open to' manipulation (which we take to mean that manipulation is systemic or widespread). The responsible lending obligations show that the risk of manipulation can be addressed at least in part by requirements for credit providers to keep records of their responsible lending assessments, which can then be accessed either in individual disputes or in large scale investigations by a regulator. Where the responsible lending law is being widely manipulated or avoided (as we have argued in relation to payday lending) an individual suitability test can be supplemented with additional obligations focused on that industry.[30]

An individual suitability test for insurance (as with responsible lending) can also be 'scaled' so that products that are more likely to be suitable for the consumer attract fewer assessment obligations, or even no obligations. This reduces burden on the industry and also provides incentives for insurers to produce safer products which are less burdensome to sell.

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[27] *Enhancing the Consumer Experience of Home Insurance - Shining a Light into the Black Box*, 2014. Accessible from http://www.firelevymonitor.vic.gov.au/home/news+and+information/publications/publication+shining+a+light.
[28] Refer to ASIC reports 256 (*Consumer Credit Insurance: A review of sales practices by Authorised Deposit-Taking Institutions*) and report 361 (*Consumer Credit Insurance Policies: Consumers' Claims Experiences*.
[29] For example, see the comments from Peter Kell (Deputy Chairman, ASIC) on this topic in his address to the Insurance Council of Australia on 28 February 2014 (see pages 6-7).
[30] For example, the responsible lending controls targeted at the payday lending industry introduced in 2013 (Schedules 3 and 4 of the *Consumer Credit Legislation Amendment (Enhancements) Act 2012)* responded to concerns that responsible lending obligations were not having the desired impact on payday lenders.

We propose that an individual suitability test in insurance could be built on the existing 'standard cover' regime in the Insurance Contracts Act. We consider this in more detail in the box below.

Box: Improving the standard cover regime in insurance

The standard cover regime at sections 35 and 37 of the *Insurance Contracts Act 1984* (**Insurance Contracts Act**) was enacted in response to the Law Reform Commission's (**LRC**) *Insurance Contracts* report[31]. The LRC's argument for standard cover identifies a problem that consumers still face today:

> Policies contain numerous terms which affect in unexpected ways the cover offered. In a few cases, the insured's attention is drawn to the relevant limitation at the time when cover is arranged. In the vast majority of cases, however, nothing is said. The insured's ignorance remains undisturbed until he makes a claim.[32]

The LRC characterised this problem as a distortion in what should be the normal operation of the insurance market, caused

> by the fact that purchaser's discrimination is limited to matters like price, little or no account being able to be taken of differences in the nature of the products being sold.[33]

The LRC's vision for standard cover was that model or standard policies be developed for common types of insurance representing a reasonable version of that type of insurance. Insurers would not be bound to meet the standard, but if they chose to market a product offering less cover

> ...it should have to draw the insured's attention to that fact, and to the nature of the relevant restrictions in cover. If it fails to do so, the contractual terms should be overridden to the extent to which they provide cover which is less than the standard.[34]

The limitation of the current scheme

When the standard cover regime was legislated, it nominated a group of insurance policies ('prescribed contracts') and required that those policies provide a regulated minimum amount of cover for 'prescribed events'. Section 35 then prevents an insurer from refusing to pay the minimum amount for a claim involving a prescribed event unless the insurer had 'clearly informed the insured in writing (whether by providing the insured with a document containing the provisions, or the relevant provisions, of the proposed contract or otherwise)' that that event was not covered.[35]

The limitation of the standard cover regime is in the words 'whether by providing the insured with a document containing the provisions, or the relevant provisions, of the proposed contract or otherwise'. This effectively means that, if insurers wish to offer less than standard cover, they don't need to 'draw the insured's attention' to that fact (as the LRC proposed) at all—they simply have to provide the consumer with normal contract documents that note at some point that the policy does

[31] The Law Reform Commission (1982) *Insurance Contracts*, Report No 20. Accessed from http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/lawreform/ALRC/1982 /20.html?stem=0&synonyms=0&query=law%20reform%20insurance%20contracts
[32] *Insurance Contracts*, paragraph 69.
[33] *Insurance Contracts*, paragraph 70.
[34] *Insurance Contracts*, paragraph 10.
[35] In addition, section 37 created a similar obligation for insurers who included unusual terms in contracts which are not prescribed contracts.

not meet standard cover. This is despite the LRC's findings that consumers may remain ignorant of important limitations even if they do have access to the policy documents.[36]

It is clear that the LRCs vision for standard cover has not been realised. Insurance policies are now just as likely to have terms 'which affect in unexpected ways the cover offered' as they were in 1982, and consumers are just as likely to be ignorant of those terms until they make a claim. However, we think the standard cover concept has real potential as a mechanism to help consumers compare insurance (by providing an indicator of whether insurance is at / below / above standard) and to reduce the likelihood that consumers end up with unsuitable insurance.

<u>Improving standard cover</u>

We believe there are three broad options for improving the standard cover regime:

- 'standard cover': implementing the LRC's original idea;
- 'default cover': requiring insurers to provide standard or, 'safe' policies and to place consumers in these policies unless consumers choose another option; and
- 'suitability requirements': insurers must ensure a product is 'not unsuitable' for a customer before selling it. An unsuitable product would be one which results in substantial under or over insurance.

Standard cover

The principle behind this option is to improve the existing standard cover regime so it works as the LRC intended. In our view, the only reason the standard cover regime at sections 35 and 37 of the Insurance Contracts Act does not meet the LRC's proposal is that it doesn't require insurers to 'draw the insured's attention to' the fact that cover being offered falls short of the standard. Our reading of the LRC's recommendation requires insurers being required to make a positive effort to note the unusual term ('draws attention to') and disclosure which is fairly high impact.[37] This could be achieved by:

- stronger marketing obligations, for example an obligation to note prominently in any advertisements and marketing material that the cover offers less than standard. The current requirement in consumer credit to note comparison rates as prominently as any advertised interest rate[38] is a precedent here; and/or
- an industry wide, simplified product labelling standard, such as a star rating, to help consumers see at a glance if a product is at, above or below standard and so better gauge value for money.

Default cover

A default cover option would go much further than standard cover, because in addition to the regulated standard product, it would require insurers to

- carry the standard cover product; and
- place the consumer in that product unless the consumer explicitly chose another option.

[36] *Insurance Contracts*, paragraph 70.

[37] When discussing how the consumer will be made aware of the non-standard nature of cover, the LRC refers to the insurer 'drawing the attention' of the consumer to the unusual term at the point of sale (page xxii, paragraphs 70, 73). They also refer to the possibility of additional, one page documents being provided on top of the normal contract (paragraph 72), and hint that the standard cover requirement may influence marketing material created by insurers (paragraph 75).

[38] National Credit Code, section 160.

These requirements could be coupled with the kind of disclosure obligations discussed above. The precedent for a default cover approach are the My Super system in superannuation and the requirement for energy providers in Victoria to place consumers in default 'standing offers' unless the consumer chooses another product. However, as the FSI panel argued, default products may be more suited to superannuation (which is compulsory) than it is to insurance (which is an important purchase, but still optional).[39]

The other drawback of the Default Cover proposal is that insurers who did not want to provide the cover could easily avoid doing so by pricing this policy so it was unaffordable, and promoting other policies ahead of the standard.

Suitability Requirements
This option would require insurers to assess the needs and objectives of consumers, and then be satisfied that an insurance policy was suitable for them (or 'not unsuitable') before selling it. The precedent here is the responsible lending regime in consumer credit. Suitability obligations would refer back to regulated standard cover and could be 'scaled' (as they are in credit). For example, requirements to assess suitability could be lower (or removed completely) if the insurer was selling a product which met or exceeded the 'standard'.

The advantage of this proposal is that:

- it directly addresses the issue of consumers ending up with unsuitable products;
- encourages insurers to stock a 'standard' products and price it reasonably if that standard product is subject to less suitability obligations than other products they sell; and
- the existence of a standard product offered by many insurers (perhaps alongside disclosure obligations discussed above) will help consumers understand and compare different policy.

Any uncertainty as to what suitability assessment needs to be performed can be alleviated by regulation or regulatory guidance (just as ASIC Regulatory Guide 209 provides detailed guidance on responsible lending assessments).

In our view, the suitability option is the best response to the consumer problems in insurance, though the 'standard cover' option is closest to what the LRC originally proposed.

Recommendation
We recommend that the Government:

- re-introduce the *Insurance Contracts Amendment (Unfair Terms) Bill 2013* to extend unfair contract terms provisions to insurance transactions; and
- begin a process to improve the standard cover provisions in the *Insurance Contracts Act 1984*.

FSI Recommendation 22: Product intervention powers
We strongly support FSI Recommendation 22 to amend the law to provide ASIC with a product intervention power. This power would allow the regulator to intervene to require or impose:

- amendments to marketing and disclosure materials;

[39] The FSI final report made this point at p 212.

- warnings to consumers, and labelling or terminology changes;
- distribution restrictions; and
- product banning.

Like FSI Recommendation 21, this power recognises the limited function of disclosure as a consumer protection mechanism. The power also responds to lessons from studies into consumer behaviour, recognising that consumers commonly exhibit predictable behaviours that do not accord with rational assumptions.

This power would enable ASIC to be more responsive to market conditions and to take a more proactive approach to reducing the risk of significant detriment to consumers. In our view, regulators should be given powers to intervene in the design, marketing and sale of products where it is clear those products are likely to cause consumer detriment, or where the effectiveness of competition in a market may be improved.

The FSI said this power was designed to be ‘pre-emptive’. We agree with the FSI panel that targeted early intervention 'would be more effective in reducing harm to consumers than waiting until detriment has occurred'.[40] Even where detriment has already occurred, this broad pro-active regulatory approach would significantly lessen consumer detriment by preventing the problem from affecting a larger group of consumers.

The product intervention power should be designed to apply to a class of products, rather than a particular product or a particular financial service provider. We suggest that this could be through a ‘rule-making’ power, effectively providing ASIC with the power to make subordinate regulation affecting particular product classes.[41] As subordinate regulation, it could be subject to appropriate accountability mechanisms such as Senate disallowance.

The benefit of such an approach is that ASIC could act much sooner, ahead of any breach of the financial services law.[42] The power could be twinned with ‘market study powers’ (discussed below), so the regulator undertakes a market study about a particular product class, which would include extensive industry consultation, before adopting a rule. ASIC could impose a rule in a flexible manner where it identifies that there is a risk of unfairness to consumers (for example, where it is likely that unsuitable products are purchased or where consumers are likely to suffer detriment) or where competition is ineffective or could be made more effective. This would bring alignment with FSI Recommendation 30, which is about strengthening the focus on competition in the financial system. A pro-competitive rule might respond to problems in the demand-side of the market, for example, by ensuring consumers are provided the conditions to make an effective, informed choice. This might improve aspects of disclosure, require clear warnings, or limit a sales channel which risks ineffective decision-making.

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[40] At page 209.

[41] Financial services regulators in the UK and USA are also equipped with rule-making powers; see *Financial Services Act 2012* (UK) s137A(3) and *Dodd-Frank Wall Street Reform and Consumer Protection Act* (US) s1031(b) and Subtitle E of Title X – Bureau of Consumer Financial Protection.

[42] The product intervention power in the UK does not require a breach of the financial services laws. The Financial Conduct Authority aims to ‘intervene earlier in the product value chain, proactively, to anticipate consumer detriment where possible and stop it before it occurs': Hector Sants, FSA Chief Executive, ‘Product Intervention Discussion Paper DP11/1' (2011), available at: http://www.fca.org.uk/static/pubs/discussion/dp11_01.pdf.

The FSI panel refers to the product intervention power as 'last resort'.[43] We agree that it would be used at the end of a market study or a process of consultation. Indeed, the process of investigation and consultation may focus the industry on good practices within a market, making it less likely that the intervention power will be ultimately exercised. However, we do not agree that the intervention should be 'last resort' in the context of other enforcement powers, such as infringement notices, civil penalty or criminal actions. These sorts of enforcement powers are only exercised against an individual financial service provider where there is a breach of the law. The product intervention power, in contrast, would be about improving the operation of the market where there may not be breaches of the law.

This approach is particularly useful where there may be problems with relatively simple products that create small losses for consumers, but losses that are widespread across the community. Problematic products include 'add-on' insurance, consumer leasing, and funeral insurance.

Some stakeholders believe that ASIC already has sufficient powers to intervene to improve market practices. It is true that ASIC has some powers that may apply to a class of products or providers, such as 'class orders' (now referred to as legislative instruments) or licensing conditions. Legislative instruments can be used to clarify certain provisions of legislation administered by ASIC but this generally takes the form of exemption from requirements rather than new requirements.[44] For example, in recent times, ASIC has used this power to defer application of amendments to credit hardship laws,[45] or to exempt credit providers from small amount credit contracts from limitations on some sorts of fees.[46] ASIC cannot use this power in the way that the product intervention power is slated to operate: it cannot impose new requirements on a class of products or providers.

In terms of licensing conditions, ASIC could impose a similar licence condition on a class of providers, as it has wide powers to do so. But in practice this would be difficult given ASIC must give the licensee an opportunity to attend a hearing before imposing or varying a licence condition, and limitations on ASIC imposing conditions on APRA-regulated entities.[47] Further, licence conditions are generally imposed on a specific licensee rather than a class of licensees or a class of providers.

The FSI panel recommended that the power be limited to temporary intervention for 12 months, but notes that it could be extended if more time was needed either by industry to change its relevant practices or for government to implement permanent reform. The FSI panel has not clearly identified a reason that the power be temporary but, if it is, then we suggest that after a 12 month period a 'product intervention' be automatically extended unless ASIC has undertaken a review (which includes consultation) justifying its removal or there has been government intervention to deal with the identified problem.

[43] At page 210.
[44] Australian Securities and Investments Commission, 'Class Orders - What are instruments?', accessed 30 March 2015, available at: http://asic.gov.au/regulatory-resources/find-a-document/class-orders/#what-are-leg-instruments
[45] CO 14/41
[46] CO 14/818.
[47] Under section 914A(3) of the *Corporations Act 2001* and section 45(5) of the *National Credit and Consumer Protection Act 2009*, ASIC may only impose or vary the conditions on a financial services or credit licence after giving the licensee an opportunity to appear at a hearing before ASIC.

Market study powers

As noted above, product intervention can also be pro-competitive, and linked with a regulator undertaking market studies looking at competitiveness and consumer outcomes in a particular market. Market studies are a type of public investigation into a market, particularly examining whether there is any anti-competitive issues that as a result is causing detriment to consumers. In essence, they are utilised as a tool for examining the effectiveness of competition by investigating specific products and markets, and determining if consumers are being harmed by certain practices. Market studies can act as a spearhead for competition advocacy.[48]

Like product intervention powers, it is not a requirement that the relevant conduct is unlawful for a market study to be initiated. Rather, a market study may be commenced where there is a belief the conduct is having an adverse effect on competition. It could be initiated by the regulator on its own motion, or following complaints from consumer organisations. Using the information gathered from a market study, a regulator can then assess competition in a particular area and make a recommendation of how it can be improved to the benefit of consumers.

Market studies have proven to be a flexible tool that when used efficiently and effectively, address a wide scope of requirements.[49] There are at least 40 nations that have granted their respective competition authorities the power to conduct market studies.

The Financial Conduct Authority (**FCA**) recently published its findings following a market study into competition issues arising from general insurance add-ons.[50] The FCA analysed five insurance products purchased as add-ons and compared these sales to stand alone sales. The FCA's results indicated that competition in this market was not working well and made a series of recommendations with the objective of ensuring that consumers could make better and more informed decisions. The FCA undertook this market study because enforcement was considered to be ineffective or unsuitable. The benefit of commencing this market study was that it enabled the FCA to identify a variety of remedies that would benefit consumers, which if implemented are likely have industry-wide impact.

Based on the United Kingdom and other jurisdictions' experiences with market study powers, there are clear benefits in providing regulators with market study powers. We strongly recommend the Government consider providing such powers to ASIC.

Recommendation

That the Government accept recommendation 22 and provide the financial services regulator the power to intervene in the design, marketing and distribution of products where there is a risk of significant harm to consumers, following a market study if appropriate. A product intervention power should:

- be a rule-making power;
- not require any specific breach of the law; and

[48] OECD, 'Policy Roundtables - Market Studies' (2008), available at: http://www.oecd.org/regreform/sectors/41721965.pdf.
[49] International Competition Network, *'Market Studies Project Report'* (2009), available at: http://www.internationalcompetitionnetwork.org/uploads/library/doc363.pdf >
[50] Financial Conduct Authority, *'General Insurance and Market study'* (2014), available at:http://www.fca.org.uk/news/general-insurance-add-ons-market-study.

- be automatically extended beyond 12 months unless the government has acted to deal with the problem, or the regulator has undertaken a market review justifying its expiration.

Recommendation
That the financial services regulator should be given the power to initiate public market studies into particular financial products, services or practices. The framework should require public consultation and findings.

CONSUMER OUTCOMES - DISCLOSURE

Broad remarks
We support attempts to improve disclosure in financial services, subject to the overarching principle that the purpose of disclosure is to help consumers make informed decisions (and so improve efficiency in markets) rather than being an end in itself. To be effective, disclosure must not only share information but positively influence consumer behaviour.

We expand upon this principle below.

Using the best tool for the job
Disclosure should be used where it is the best response to an identified problem, and other tools—namely product design and distribution obligations—should be used where they will be more suitable.

There is a clear role for disclosure as long as it is going to allow consumers to engage more effectively in markets. However, disclosure will never be able to overcome problems created by products which are unfair, conflicted or overly complex. In these cases, the solution is to re-design the products and sales practices themselves.

Consumer centred
Designing effective disclosure will start with a consideration of how consumers actually use disclosure and how they make decisions, rather than a focus on compliance and risk avoidance. It will be designed with an understanding of what kind of information will be useful to consumers, and when and how to present it for maximum effect.

One recent example are the 2011 credit card reforms[51] explaining how long it will take a consumer to pay off their credit card (and how much it will cost them in interest) if they only making minimum repayments. The value of this disclosure is that it provides information that:

- is relevant: the information is tailored to the individual consumer and is presented in unambiguous, dollar terms;
- is timely: the information is presented at the point where the consumer is making a decision; and
- prompts a response: having seen the warning, the consumer knows exactly how to reduce the risk they have been informed about.

[51] *National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011* (Cth).

As well as anecdotal feedback we receive from clients about the usefulness of this reform, evidence shows that the 2011 credit card reforms (which included the minimum payment warning along with other measures) have actually reduced the level of interest bearing credit card debt being held by consumers.[52]

Another example is reframing superannuation statements to disclose a member's balance in terms of the income it would give them in retirement, rather than just a total accumulation. This makes a superannuation balance more relevant to a member because they can immediately see whether their current level of super is enough to give them a comfortable retirement.

When industry super fund Cbus ran a trial sending 20,000 members statements indicating a retirement income stream amount, 97 per cent of members approved of the statement and Cbus registered a jump in engagement compared to the control group, including 12 per cent of members raising contributions and 10 per cent changing investment options.[53]

A commitment to consumer testing
Consumer testing disclosure will ensure that the disclosure does what it is intended to do, that is, help consumers understand products and make informed decisions. This is especially important given the current movement towards permitting providers to use more innovative disclosure.[54] We support this movement, but it will just produce new types of ineffective disclosure unless the innovative disclosure models are refined through consumer testing.

FSI Recommendation 23: remove regulatory impediments to innovative product disclosure and communication with consumers...
We are broadly very supportive of removing impediments to innovative product disclosure and communication with consumers. Our only limitations are that:

- any shift to electronic disclosure must be designed to avoid leaving the most vulnerable and disadvantaged consumers (who are less likely to have reliable access to the internet) behind. Improving disclosure should create benefits for everyone; and
- new methods of disclosure must be consumer tested before they are rolled out to make sure they are useful for consumers.

ASIC has recently conducted a consultation process on facilitating electronic financial services disclosure. Our submission to this process gives more detail on our position.[55]

FSI Recommendation 23: ...improve the way risk and fees are communicated to consumers.
We agree with the FSI panel that consumers generally have trouble calculating risks and uncertainty.[56] Fees and total cost of financial products and services are frequently opaque, such

[52] Since these reforms were enacted, the overall level of credit card balances that is interest bearing has stabilised and reduced (at around $35 billion) after virtually uninterrupted growth previously. Credit limits, by contrast, have continued to increase (raising $8 billion to $142 billion between January 2012 and January 2014). Reserve Bank of Australia, Credit and Charge Card Statistics – C1, available at: http://www.rba.gov.au/statistics/tables/index.html.
[53] Association of Superannuation Funds of Australia (November 2014), *The future of Australia's Super: A New Framework for a Better System,* paragraph 3.6.
[54] See for example, ASIC Consultation Paper CP 224 Facilitating electronic financial services disclosures.
[55] Available at http://consumeraction.org.au/submission-facilitating-electronic-financial-services-disclosure/
[56] Page 214-215.

as in the examples below. For these reasons we support the recommendation to improve communication of risks and fees in financial products.

However, we do not share the FSI panel's optimism that self regulation will create any substantial improvement to how providers communicate risk and cost to consumers. The biggest problems with poor communication of risk and cost are not created by businesses innocently failing to explain their product, but by businesses making a conscious decision to obscure the risks and cost of their product because it helps them to attract business.

For example, the following business models systemically obscure the true cost of their products:

- Consumer lease providers market the cost of their 'rent to own' arrangements in terms of a small weekly amount, without prominently disclosing (or disclosing at all) that this 'weekly' price is only available to customers who sign up for a minimum term of between one and four years. No consumer lease providers that we know of advertise the total cost of their rent to own agreements alongside the weekly price (let alone an effective interest rate), which usually amounts to around three times the retail cost for goods. This partial disclosure of cost usually comes alongside statements to the effect that rent to own is an affordable option for low income consumers.[57]
- 'Add-on' insurance (that is, products like Consumer Credit Insurance, Gap Cover and Tyre and Rim insurance which is sold as an add-on to a headline product like a car loan) are sold on commission to consumers who either accept the product as an afterthought or who do not even realise they have bought it. The cost of premiums are bundled with repayments on the headline product meaning the total cost is rarely evident to consumers, even though it is significant. Cases handled by our legal practice include one consumer paying over $5,500 in add-on insurance alongside a $25,000 car without knowing she had bought the insurance and another paying almost $3,000 for insurance on a $17,000 loan.

The following business models deliberately obscure risks involved in their product:

- Discretionary risk products: these are financial products usually sold as an add-on to cars or car finance and marketed as 'warranties' or 'breakdown cover'. The difference between Discretionary Risk Products (DRPs) and traditional extended warranties or insurance is that DRPs include a term giving the provider absolute discretion over whether or not to accept a valid claim. The discretionary nature of the 'cover' is disclosed in PDS', but websites and promotional brochures of providers discuss the purported benefits without any mention of the discretionary nature of the product,[58] despite this clearly being a significant risk and fundamental factor the consumer needs to understand before making an informed choice.

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[57] More detail is available in our report 'The Hidden Cost of Rent to Own', available at http://consumeraction.org.au/report-the-hidden-cost-of-rent-to-own/

[58] See for example National Warranty Company: 'Our Products' (https://www.nwc.com.au/personal/our-products/vehicle-warranties) and 'Why Buy a Warranty' (https://www.nwc.com.au/personal/why-buy-a-warranty); Australian Warranty Network: (refer to product brochures) http://www.australianwarranty.com.au/vehicle_warranties/vehicle_warranties; Integrity Extended Warranties 'Warranty Overview' http://www.iwarranty.com.au/why-buy-a-warranty/

- Debt agreement administrators[59] (that is, businesses who assist consumers to enter Debt Agreements regulated by Part 9 of the *Bankruptcy Act 1966*) in our view frequently fail to give a balanced assessment of the risks and costs of entering debt agreements in marketing materials. Our 2013 report *Fresh Start or False Hope*[60] demonstrated that many providers make extremely optimistic statements about what Debt Agreements can achieve for someone in debt (such as the amount of debt that may be forgiven by creditors), fail to mention the negative aspects of entering Debt Agreements and highlight the negatives of bankruptcy (in an effort to suggest Debt Agreements are a better option) when in many cases bankruptcy has the same impact for debtors as a Debt Agreement will.

These types of businesses will not voluntarily improve how they communicate risks and costs to consumers because their profitability depends on keeping these details obscured. Any self regulation will need to be supplemented with regulatory or enforcement responses against problem business models like the ones we have listed above.

Recommendation
That any voluntary industry response to improve disclosure of costs and risks needs to be accompanied by investigation and enforcement work by regulators to target businesses that habitually conceal the risks and cost of their product.

FSI Recommendation 26: Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.

The FSI Recommendation 26 seems to have three elements[61]:

a. that the general insurance industry should provide guidance for consumers as to the likely replacement value for home buildings and contents being insured;
b. the general insurance industry should enhance tools and calculators for consumers, including up-to-date information about building costs and building code changes; and
c. the general insurance industry should complete its work improving disclosure in PDSs, including consumer testing and providing disclosure at the appropriate point in the sales process.

We broadly support improving disclosure of the features of insurance policies, and in particular improving the way that insurers explain the risk relevant to prospective consumers. We also believe that the objectives the FSI panel seeks to achieve with these recommendations[62] are worthy objectives. However, we do not believe that improving disclosure is enough on its own to achieve those objectives.

The recommendation summarised at point (a) in the list above (guidance on the appropriate 'sum insured' amount) responds to one of the truly systemic problems in insurance. As the final report acknowledges,[63] consumers buying home building insurance are currently expected to be

[59] Debt agreement administrators are not regulated by ASIC or financial services regulation (rather by the bankruptcy regulator, Australian Financial Security Authority). They are included here as an example of a provider that consistently fails to disclose risks associated with the product.
[60] Accessible from: http://consumeraction.org.au/fresh-start-or-false-hope-are-debt-agreement-administrators-overstating-their-abilities/
[61] See the discussion on page 227 of the final report.
[62] Also on page 227
[63] At page 228

able to determine themselves how much it will cost to replace their home if it is damaged or destroyed. Producing this kind of estimate is a highly technical exercise requiring specialised skills and it cannot be done accurately by most consumers. As discussed above, expecting consumers to nominate a sum simply sets people up to fail. When they do fail, the results can be devastating.

For example, ASIC's *Report 54*: *Getting home insurance right* examined the causes of home building underinsurance after the Canberra bushfires in 2003, and noted that Canberra homeowners affected by widespread fires were underinsured by between 27% and 40% on average. This left hundreds of home owners without the means to rebuild their home, despite having home insurance. ASIC's *Report 415: Review of the sale of home insurance* from October 2014 looked further at industry practices and found that there are certain problems with insurer products and practices that contribute to under-insurance. These included:

- reluctance by sales staff to assist with identifying sum insured amounts, or to proactively inform consumers about features and exclusions;
- online sales processes that require consumers to assess product disclosure statements, rather than their attention being brought to important features; and
- either a lack of online calculators to assist with assessing sum insured, or these calculators not being on sales screens.

Giving consumers better guidance as to an appropriate sum insured is welcome but is at best a partial solution to the problem. It will presumably reduce the extent of underinsurance, but it will not prevent people being underinsured after total loss because the core of the problem—sum insured policies—remains. The only real response to this problem is total replacement cover on home building insurance (that is, contracts where the insurer agrees to replace a home in the event of total loss, regardless of cost).

Insurers (and reinsurers) tend to resist the use of total replacement policies because, where the cost of replacing a home is higher than expected, total replacement policies leave insurers out of pocket. But the alternative (sum insured policies) requires consumers to shoulder the risk, despite being the party who is least able to predict what the appropriate level of cover should be. The Natural Disaster Insurance Review panel recommended that all home building insurance policies offering sum insured cover be modified so as to offer full replacement cover in the event of total loss of the home.[64] We strongly endorse this recommendation.

The suggestions at point (b) (improved tools and calculators) and (c) (consumer testing and improving the timing of disclosure) above will also be improvements. We particularly support consumer testing of disclosure, as we have indicated above, as well as the good practices identified by ASIC in its Report 415. But we again question whether the problems the FSI panel is trying to address can be solved by improving disclosure. All of these changes need to be measured against how effective they are in helping consumers make informed decisions about which insurance policy suits them best. Will this extra information be understandable, or will it just add to the existing complexity? Will consumers be any better able to compare the policies of one provider against another? Will simplifying disclosure documents ever make it more likely that a consumer can understand a complex product?

[64] *Natural Disaster Insurance Review Inquiry into Flood Insurance and Related Matters: Executive Summary and Recommendations (September 2011)*. See page 7.

There is room to improve disclosure in insurance but when consumer problems are caused by product design (rather than information asymmetry) improving communication can only take us part of the way. We believe a more sustainable solution is to focus on improving insurance products themselves, to make them less complex, more comparable and more safe (such as through our proposal to improve standard cover, above).

Recommendation
That the Government endorse the FSI panel's recommendation that the general insurance industry provide more guidance for consumers as to the likely replacement value for home buildings and contents being insured. The Government should otherwise focus its attention on improving the suitability and fairness of insurance products rather than disclosure.

CONSUMER OUTCOMES - FINANCIAL ADVICE

FSI Recommendation 24: Better align the interests of financial firms with those of consumers

We support all elements of this recommendation, but urge the Government to go much further than the FSI panel's proposal that the Government 'require that an upfront commission for life insurance advice is not greater than ongoing commissions'. In our view, there is no reason why the life insurance advice industry should not remove upfront commissions altogether.

The FSI panel's rationale a move to level commissions (but not moving beyond commissions) is reproduced below:

> For life insurance, the Inquiry recommends a level commission structure implemented through legislation requiring that an upfront commission is not greater than the ongoing commission. This would provide a balanced and cost effective approach to better align the interests of advisers and consumers. The remuneration model needs to be sustainable; otherwise there is a risk that providers may exit the market, making it more difficult for consumers to obtain life insurance advice. The findings of the Financial Services Council and the Association of Financial Advisers working group should also be considered during the development and implementation phases.
> Alternative models of remuneration, such as delayed vesting of commissions and clawback arrangements, may simply delay the issue of churn and are complex. At this stage, the Inquiry does not recommend removing all commissions, as some consumers may not purchase life insurance if the advice involves an upfront fee. However, if level commission structures do not address the issues in life insurance, Government should revisit banning commissions.[65]

The FSI panel's assessment of this problem seems to have been stunted by a number of truisms about life insurance advice which are frequently repeated but rarely if ever supported by evidence:

a. commissions are necessary to create the incentive to sell life insurance (which is only ever 'sold', not 'bought'), and without those commissions there would be widespread underinsurance, putting pressure on the welfare system; and

[65] Page 220.

b. that consumers will not pay for life insurance advice if they were required to pay for that advice upfront and there is no real alternative remuneration model apart from commissions if we want a sustainable life insurance advice industry.

These arguments experience admirable longevity despite each being fatally, and obviously, flawed:

a. commissions have never fixed underinsurance before: life insurance advisers are the chief proponents of the argument that Australians are underinsured in life, despite receiving high commissions for many years. If commissions were the solution to underinsurance, we would surely have solved the problem by now. In addition, commissions have been proven to cause their own problems, namely that they reward the sale of unsuitable products as much as they reward responsible sales, and they actively discourage important work which doesn't attract commissions (strategic advice; advice to maintain or reduce current cover);
b. consumers buy products every day which would be unaffordable if they had to pay the full cost upfront, without commissions. Cars, whitegoods, financial services (including insurance itself) and professional services (like legal advice) are bought without commissions, and nobody ever argues that these products must be sold by commission because it is patently untrue. Instead they can be paid off over time in instalments (either with interest or without). Further, the fact that consumers are shown the true price of these products upfront means that prices are driven down over time by competition making the products more affordable. Commissions, on the other hand, obscure the true cost of advice, shielding them from competition and almost certainly keeping the price of advice inefficiently high.

The obstacle to commission-free life insurance advice has nothing to do with consumer preferences or a reluctance of consumers to buy insurance any other way. The only obstacle is an ingrained culture of advisers that refuses to believe the industry can survive without commissions. It is about time the industry either produces some evidence that commissions create more benefits than costs, or has the courage to try something else.

We note the release of the Trowbridge report, which proposes a number of reforms short of abolishing commissions, that may improve the sale of advised life insurance. Welcome reforms include a proposed ‘five year rule’—which would prevent advisers from receiving an upfront payment for advising any client who has received advice within the last five years. This will reduce or remove the incentive of advisers to recommend replacement policies or unnecessary ‘churn’. We also agree that replacing upfront commissions with a maximum upfront fee of $1200 and capped ongoing commissions is also an improvement on current practice. We further acknowledge that the Trowbridge report recommendations are designed in part to encourage more advisers to introduce fees for service—for example, an unindexed upfront cap creates less reliance on conflicted remuneration.[66]

However, the industry has not yet established evidence that wholesale removal of commission-based selling is unfeasible. A key problem caused by commission-based selling is the

[66] The Trowbridge report is available at: http://www.fsc.org.au/downloads/file/MediaReleaseFile/FinalReport-ReviewofRetailLifeInsuranceAdvice-FinalCopy%28CLEAN%29.pdf

disincentive to provide quality advice. If advisers only get paid when they sell products bearing commissions, they are less likely to provide strategic advice, such as advice that a client should keep their current level of cover or advice that a client take up group life cover through superannuation.

We agree that life insurance is an important product, and that there is a role for advisers in helping consumers find the life insurance that suits their needs. We also agree that there are significant upfront costs in providing that advice and arranging insurance for consumers, and that advisers should be properly remunerated for their work. However, we do not believe that advisers need to be remunerated by way of commission. There are plenty of other ways for consumers to pay for advice that can avoid the problems commissions cause without making insurance less affordable. Government should commit to moving life insurance advice to a commission-free remuneration model, ideally in partnership with industry.

Recommendation

That the Government:

- accept FSI Recommendation 24; and
- work with the life insurance industry to move to a commission-free remuneration model. If the industry is unwilling to make such a change over time, the Government should intervene to require that change.

FSI Recommendation 40*: *Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures

We support the recommendation that advice should be labelled in a way that allows a consumer to understand the depth and quality of the advice, for example, whether it is based on a consideration of their personal circumstances or not. However, we are not convinced that merely changing the name of 'general advice' to 'general information' or 'general financial information' will be sufficient. Existing labels like ‘general advice’ are regulatory rather than consumer terms, and consumers would not understand that advice is or is not being provided. We submit that further consumer research must be undertaken to determine whether and how labelling of advice can be improved in a way that is useful for consumers.

The remainder of FSI Recommendation 40 seeks to improve consumer understanding of how the advice from a broker or financial adviser is influenced by an association with product issuers. We support the intent behind the recommendation but do not believe it is capable of addressing the problems caused by vertical integration or alignment of advisers and brokers.

Alignment or vertical integration of advisers risks limiting effective competition by making it more difficult for advisers to consider products which may be more suitable for a client but not included on an Approved Product List. It may also mislead consumers—many consumers will not expect advisers to be limited to providing advice about products from certain providers.

Simply disclosing the existence of a conflict will not prevent it from being a problem. Even if the disclosure is noticed by consumers, it may have the effect of increasing trust in advisers rather than making consumers more wary.[67] Skilled salespeople will also be able to deflect concerns

[67] James Lacko and Janis Pappalardo, 2004, The effect of mortgage broker compensation disclosures on consumers and competition: A controlled experiment, *Federal Trade*

about vertical integration. Peter White of the Finance Brokers' Association of Australia has recently said that finance brokers can use disclosure obligations to their advantage:

> I actually believe that if a broker is upfront about ownership—let's say they are owned by Commonwealth Bank, for example—then they can sell that as a positive. It can allow them to change the discussion around bank ownership—isn't it a good thing that they have somebody so strong sitting behind them that has enabled them to grow as a brokerage and a business?
>
> ..now they have opened up the discussion with their client and they are able to explain what bank ownership really means and how the [National Consumer Credit Protection Act] governs a broker's independence.[68]

These arguments may make clients more comfortable, but they do not address the conflicts of interest that come with vertical integration. To address this problem, we suggest that:

- advisers be required to demonstrate that they consider and recommend both affiliated and non-affiliated products;
- structural separation of product issuers and advice—that is, advisers should be truly independent and not owned or aligned with any particular product manufacturers; and
- if there is no move to structurally separate manufacturers and advice, the minimum step needed is that advisers not be permitted to only offer products from only one provider unless this limitation is clearly disclosed to clients. It is not sufficient to only disclose this in Statements of Advice. It should be clear to a consumer before they begin dealing with an adviser. Increased disclosure should occur in prominent documents including on business cards, letterheads and in marketing material.

We recognise that this is a complex issue, especially given the existing significant alignment between large banks and many financial advisers. Further, consumers do not trust financial service providers even if there are only perceived conflicts created by sales targets and performance management systems. We submit that more must be done by the industry to bring independence and transparency into the system including, for example, through industry codes which have robust monitoring systems to ensure advice is provided in the best interests of the customer.

Recommendation
The Government should support the FSI Panel's recommendation to re-label general advice.

Recommendation
The Government should go further than FSI Recommendation 40 in responding to alignment and vertical integration of advice. Advisers should be required to demonstrate that they recommend non-aligned products, and the Government should begin the process of structurally separating product manufacturing and advice. Industry should do more to improve transparency and independence to the system, including through robust and enforceable industry-based codes.

Commission Bureau of Economics Staff Report referenced in Financial Services Authority, 2008, Financial Capability: A Behavioural Economics Perspective.

[68] 'Disclosure can work in Brokers' favour', *Broker News*, January 2015, p 17.

Regulation of sales and advice should apply generally: the case of for-profit financial difficulty businesses

Any consumer protection related to financial advice needs to apply to all sales and advice provided to consumers, not only particular classes of products.

There is a growing problem of firms in the business of providing advice that is not regulated, for example, to purportedly assist those experiencing financial difficulty. There is a similar problem in relation to property investment advice.

Businesses that claim to assist consumers in financial difficulty are varied, and include debt consolidation, credit repair, budgeting services, bankruptcy services and debt agreement administrators. These businesses are not currently regulated by financial services or credit regulation, as the businesses do not provide regulated 'credit assistance' services. Rather, they purport to negotiate or assist consumers in relation to existing products.

Customers attracted to these businesses will often be in considerable financial difficulty and have little understanding of their legal options, making them extremely vulnerable. In our experience, advertisements for these services may raise unrealistic expectations about what the service can achieve for clients or may be plainly misleading. Consumers receiving these services invariably pay significant fees for services they could access for free themselves (for example, through an external dispute resolution scheme) or with the support of a free financial counsellor.

The following case studies are examples of different types of business models.

> **Case study – budgeting services**
>
> Ms H was referred to Consumer Action's MoneyHelp service by a debt agreement administrator, who she had found on a Google search when wanting to deal with her debts. Ms H lives in private rental, shared with her partner, her 20 year old daughter and her daughter's boyfriend. Ms H works full time, and earns a low-to-moderate income of $50,000 per annum. Due to expenses in obtaining a visa for her partner, Ms H turned to a finance company to borrow $14,000. When she came to us she was 3 to 4 months behind in repayments, and had taken out a number of payday loans to assist her access cash. She had a $3,000 loan, a $2,500 loan, and a $500 loan with three different payday lenders. Ms H had another personal loan of about $4,000. She didn't realise this was secured against her partner's car until she was in an accident, and the lender told her that she would need to purchase another car so they could obtain a security interest over it. Before contacting the debt agreement administrators, Ms H had contacted a budgeting service. The budgeting service charged her a fee of $1,300 but it appears that the service did nothing to assist her manage her money, nor refer her to any independent advice service about her current debts or consider contesting liability for debts (for example, under responsible lending legislation).

> **Case study – credit repair**
>
> M is 23 years old. He came to Australia in 2008 from India to study. In August 2012, M wanted to get a copy of his credit report, and googled 'Veda Credit Report'. A credit repair business came up in the results of his search, and he contacted the under the misunderstanding that he was contacting Veda to get a copy of his credit report. The credit repair business offered to help M 'clear his credit history' and obtained M's authority over the phone.
>
> M entered into a contract with the business which gave M a copy of a credit report showing that

there were defaults on his record. There were mistakes on the report, including the fact that the name on the credit report was not M's name. M didn't understand the terms of the contract he signed onto, or that he'd agreed to pay to have the defaults removed. When the credit repair business sent M an invoice for $990 to remove each default that was listed, M tried to end the agreement. The business then charged him a $990 cancellation fee, relying on a provision of the contract. The credit repair business began chasing M for the cancellation fee, emailing him and texting every week.

Case study – credit repair

Simon incurred a default judgment for a debt to a finance company in the Magistrates' Court in 2008, and this judgment was listed on his credit file at that date. In 2012, Simon paid the judgment debt. In late 2012, Simon applied and was approved for a home loan, but was charged a very high rate because of the listing.

Simon's wife visited the website of a credit repair business, which she found through a web search. The business made the following representations on its website:
"Remove court judgements...
Instant approval for finance
Save thousands on interest repayments
Improving the quality of your lifestyle"

Simon's wife contacted the business to enquire about the removal of the judgment listed on Simon's credit file. The representative said that if they followed his advice, the listing would be removed by requesting the finance company to sign a notice to set aside the judgment. Simon's wife agreed to the service, and paid the business $1,095 by direct transfer.

Simon completed the notice provided by the credit repair business and submitted it to the finance company. However, the finance company refused to sign or lodge the notice, saying the listing had been correctly made.

Simon contacted the credit repair business. He was advised he could seek to have the judgment set aside by going to the Magistrates Court and seeking a rehearing on the basis that the judgment debt had been paid out and that its continued credit listing was causing him financial hardship. Simon was not advised to seek legal advice about making this application.

Simon did seek legal advice and was advised that if he was unsuccessful it is likely that he would have to pay the finance company's legal costs, which could amount to thousands of dollars.

Consumer advocates, the credit industry and regulators have all expressed concern about these businesses. However, efforts to respond on any systemic level are complicated by insufficient regulation. As noted above, these providers are not regulated by consumer credit or financial services legislation—for example, credit repair or debt negotiation services are not 'credit assistance services' as defined by the *National Consumer Credit Protection Act 2009* (**NCCP Act**). Further, debt agreement administrators are specifically exempt from ASIC's jurisdiction (there is some oversight by the Australian Financial Security Authority, but this is not comprehensive).

We submit that one regulator (most relevantly, ASIC) should be empowered to regulate any business purporting to provide solutions to consumer credit, debt, insolvency and credit reporting problems. As described further below, the regulator should also be empowered to respond to emerging problems in credit and financial services, and not be delayed by limitations in regulatory power.

A similar problem occurs in relation to property investment advice and spruiking, which appears to be growing in the wake of improved regulation for financial advice.[69] There have been many inquiries which have recommended that property investment advice be regulated in the same way as financial advice, and we support this.[70]

We submit that the Government should regulate advice whether or not it is linked to a particular regulated product. From the consumer perspective, it is the advice itself that leads to risk, not just the purchase of a particular product. This is a significant gap in our current law, and efforts to improve fairness in the financial system will fail unless this issue is dealt with. We have worked with researchers at University of Melbourne to identify potential regulatory frameworks that could apply to credit repair businesses,[71] and similar frameworks could apply to other businesses. Another option would be to broaden the definition of 'credit assistance' in the credit law so that it includes negotiation or assistance in relation to existing consumer credit contracts. Whichever approach is taken, it is essential for these businesses to be regulated by ASIC or the FSI will have failed to bring fairness to the centre of the financial system.

Recommendation
That the Government ensure regulation of sales and advice applies broadly to financial products and services, rather than being limited to particular classes of products. In particular, financial systems regulation should not allow for-profit financial difficulty businesses, budgeting services, debt agreement providers and property spruikers to fall through gaps in regulation.

CONSUMER OUTCOMES - OTHER MATTERS

Payday lending and consumer leasing

We believe it is a shortcoming of the final report that problems with fringe lending (particularly payday lending) were not considered. This is an industry causing considerable harm to vulnerable consumers, and is reflective of broader problems with the current financial system. The industry has been through some reform, but problems persist and the sector continues to grow—ASIC estimates the industry is worth $400 million per annum, and has grown 125 percent since 2008.[72]

We receive many complaints from vulnerable and low income consumers that have fallen into the debt trap of payday loans. Based on our experience, the main problems with the industry are as follows:

[69] See for example 'Crazy about Property: The Dangers of Hard-Sell Seminars', 9 August 2014, *Australian Financial Review*, http://www.afr.com/p/business/property/crazy_about_property_the_dangers_pWzddwPAaFI1dNbNWBpjnM
[70] See for example Parliament of Victoria, Law Reform Committee (2008), *Inquiry Into Property Investment Advisers and Marketeers: Final Report,* recommendation 8.
http://www.parliament.vic.gov.au/images/stories/committees/lawrefrom/property_investment/final_report.pdf
[71] A summary of this research is available at http://consumeraction.org.au/report-a-quick-fix-credit-repair-in-australia-summary-of-findings/
[72] ASIC, 'Report 426 - Payday lenders and the new small amount lending provisions' (2015), page 7, available at: http://download.asic.gov.au/media/3038267/rep-426-published-17-march-2015.pdf

a. *Repeat borrowing:* Payday loans are usually taken out to cover day-to-day living expenses (such as food, rent and utilities) rather than to build assets. Consumers already struggling to make ends meet simply cannot afford to make repayments, and are caught in a harmful cycle of repeat borrowing.

b. *Poor disclosure and high costs:* Payday loans are well known for being exorbitantly expensive. Annualised interest rates for payday loans can exceed 240 percent. However, consumers often aren't aware of the costs compared to other forms of credit because advertisements and contracts don't disclose the annualised interest rate.

c. *Compliance problems:* While we support the intent behind the presumptions of unsuitability for payday loans, which provide that a loan is presumed unsuitable if the borrower is in default with another small loan or has taken out 2 or more small loans in the last 90 days, it will often be impossible for lenders to know whether one of them is triggered. Save for relying on consumer disclosure, there is presently no simple and reliable way for lenders to obtain necessary information such as whether a borrower has had previous loans before a loan is advanced, or whether an existing loan is in default. ASIC recently found that nearly two thirds of the 288 payday lending files it had reviewed indicated that the payday lender had entered into a small amount loan with a consumer who appeared to trigger these presumptions of unsuitability, with 8 percent triggering the default presumption and 54 percent triggering the multiple loan presumption.[73]

d. *Evasion of the National Credit Code:* Payday lending businesses have a history of structuring their contracts to avoid payday lending regulations. Despite legislative attempts to close avoidance loopholes in 2014, we are still seeing payday lenders flouting the law. For example, ASIC's recent payday lending report identified problematic practices where payday lenders extend the loan term on credit contracts 12 months or more, despite the consumer requesting a loan well under 12 months. ASIC said this seems to be an attempt to ensure that even if the consumer pays out the loan earlier than the term, the lender is still entitled to 12 months of monthly fees.[74]

e. *Irresponsible lending:* In many of our cases, consumers have been given loans they simply can't afford to repay, and the business fails to assess the consumer's requirements, objectives, or financial situation as required by the NCCP Act.

The payday lending industry argues that it provides a valuable service to consumers who are otherwise excluded from mainstream credit. Financial inclusion isn't about access to any financial product, it's about access to safe, suitable products. Providing access to harmful financial products does not benefit financially excluded consumers, it just excludes them more by exacerbating their existing problems.

Similar problems exist in the consumer leasing or 'rent to buy goods' market. Big providers in this market include Thorn Group (trading as Radio Rentals) and Flexirent, but there are

[73] ASIC, 'Report 426 - Payday lenders and the new small amount lending provisions' (2015), page 12, available at: http://download.asic.gov.au/media/3038267/rep-426-published-17-march-2015.pdf
[74] ASIC, 'Report 426 - Payday lenders and the new small amount lending provisions' (2015), page 28, available at: http://download.asic.gov.au/media/3038267/rep-426-published-17-march-2015.pdf

numerous smaller (often franchised) providers as well. It has been estimated that the size of the market is $525 million.[75]

There are a number of problems with consumer leases that we have identified from our casework. These include:

a. *Evasion of the Credit Code:* As the Micah Law Centre identified in 2007, the source of most consumer detriment in the consumer lease market is created because these products are not genuine leases but 'loans in lease clothing'.[76] Consumer leases are regulated more lightly compared to credit contracts. While 2013 reforms to the credit laws did much to harmonise regulation of credit contracts and consumer leases, there is still enough difference to create incentives for businesses to structure their product as a consumer lease even when it is in substance a credit contract. In particular, consumer leases are not subject to any form of cost cap, unlike credit contracts. Businesses draft contracts which do not explicitly give a 'right or obligation to purchase' in order to fall within the definition of a 'consumer lease', but in practice allow the consumer to keep the goods. This can be done in many ways. For example, contracts currently on the market:

    - give customers a right to purchase 'similar goods' to those goods being rented (though in practice the customer and trader just agree the customer keeps the goods they rented);
    - give customers the right to require the business to give the rented goods as a 'gift' to a person nominated by the customer, for example, the customer's spouse; or
    - allow the customer to make an extra payment to enter a new 'indefinite lease' of the goods.

    Many of the clients assisted by our lawyers advise that the lease provider misrepresented, or failed to properly inform them about the nature of the agreement they were signing up to. Many expect they have a right to own the goods and are shocked to find they do not. Others think they are merely renting the product and can return it at any time, only to later find they are locked into making repayments over several years. University of Melbourne researchers have labelled this 'regulatory arbitrage' and called for the distinction between 'consumer lease' and 'credit contract' to be abolished.[77]

b. *Exploitation of Centrepay:* Centrepay is a bill payment service for people receiving Centrelink payments. It allows customers to authorise payments to be made automatically out of their Centrelink payment before it reaches them. It effectively prioritises payments made by Centrepay ahead of any other expenses. Centrepay is not available for all types of transactions, and notably it cannot usually be used to repay a credit contract. However, it can be used to rent basic household goods and lease providers are profiteering from such access. For example, Radio Rental's total revenue

75 Credit Suisse, 'Equity Research - Australia ESG/SRI: Risks in payday lending and goods rental' (2015), page 6.
76 Micah Law Centre, 'A loan in lease clothing: problems identified with instalment based rent/purchase contracts for household goods' (2007), available at: http://consumeraction.org.au/wp-content/uploads/2012/07/A-Loan-in-Lease-Clothing-report-Micah-Law-Centre.pdf
77 Ali et. al., 'Consumer leases and consumer protection: Reulgatory arbitrage and consumer harm' (2013), available at: http://www.law.unimelb.edu.au/files/dmfile/201415.pdf

last financial year was $197 million, and $90 million of that came from the Department of Human Services through the Centrepay system.[78]

We object to Centrepay being available to pay off consumer leases because transactions are effectively credit contracts, which are not permitted access to the Centrepay system for good reason. It is also inconsistent with the purpose of Centrepay (assisting low income consumers gain financial stability) to allow access to a product with a history of creating financial hardship. Allowing access to Centrepay gives a stamp of approval to this business model and helps lease providers guarantee payment—they receive repayments every fortnight from Centrelink even if the payments are unaffordable. Access should be removed until the industry cleans up its act.

c. *Irresponsible lending:* The most common problems arising in our consumer leases casework involve irresponsible lending. In these cases, clients typically advise that they were entered into a lease they couldn't afford to repay, or that the lessor failed to assess the customer's requirements, objectives, or financial situation as required by the National Credit Code. The availability of Centrepay, which secures repayment, lessens the incentive to comply with responsible lending obligations as there is almost no risk of default.

d. *Poor disclosure of price and high cost:* Our report *The Hidden Cost of Rent to Own* found consumer leases can cost at least twice retail price, usually three times and sometimes more.[79] However, this is rarely known by consumers when entering a lease because advertisements give incomplete impressions of the price of the transaction. The cost of a consumer lease is usually expressed as a low 'per week' amount, but no lease providers that we are aware of properly disclose the full cost of making many years of payments in advertisements. Credit providers, by comparison, would be required to indicate an interest rate and comparison rate if they made the same representations about 'per week' price. Failure to explain total cost leads consumers to enter overpriced contracts they would otherwise avoid, and limits price competition between lease providers.

e. *Unnecessary loopholes:* Section 171 of the National Credit Code exempts short term leases (those for four months or less) and indefinite leases from its application. This encourages lease providers to artificially structure their agreements to fall under these exemptions, leaving their customers without protection under the Code. We are aware of at least one well known firm that structures their offer as an indefinite term lease as a way of avoiding regulation under the Code.

There are a number of other options available for those attracted to fringe finance (including no interest loans, free financial counselling etc.), but we consider the Government could do more to provide access to safe alternatives to payday loans. These include expanding not for profit microfinance programs, improving access to concessions, improving lender financial hardship

[78] Credit Suisse, 'Equity Research - Australia ESG/SRI: Risks in payday lending and goods rental' (2015), page 15. See also: Josie Taylor, 'Radio Rentals made $90 million from Centrelink payments last year', 20 March 2015, available at: http://www.abc.net.au/news/2015-03-20/radio-rentals-reaps-90-million-in-centrelink-payments/6333690
[79] Consumer Action Law Centre, 'The Hidden Cost of Rent to Own' (2013), available at: http://consumeraction.org.au/report-the-hidden-cost-of-rent-to-own/.

arrangements, increasing access to responsible small amount loans from mainstream credit providers, and improving the Centrelink advance system.[80]

In its response to the final report, we recommend the Government note that one of the shortfalls of the report was its failure to address the problems associated with payday loans and consumer leases. We recommend the Government also take this opportunity to set out its expectations for the upcoming review of payday lending provisions.

This review is scheduled to occur as soon as practicable after 1 July 2015. This review must be independent and evidence-based to ensure that solutions to the many problems posed by payday lending can be properly considered and addressed. This review should involve a consultation process, which allows consumer advocates and financial counsellors to contribute. The review should also consider:

a. limiting payments to an affordable percentage of a borrower's periodic income and/or limiting the total number of loans provided to a borrower each year;[81]
b. introducing a general anti-avoidance provision;[82]
c. reforming 'unsuitability presumptions' to rules limiting repeat use of loans and create a payday lending database (provided there are strict privacy protections) to improve compliance;
d. requiring disclosure of annual percentage rates in advertisements and contracts;
e. whether consumer leases should be subject to the same regulation as payday loans; and
f. improving access to safe small amount credit and enhancing our social security nets to address the source of demand for payday loans and consumer leases.

Recommendation
That the payday lending review scheduled to occur after 1 July 2015 be independent and evidence-based, and involve a consultation process. It should consider whether consumer leases should be subject to the same regulation as payday loans. Further enhancing regulation in this sector should also be considered by the Review, with the objective of improving consumer outcomes.

Consumer loss and compensation

The FSI panel recommended that the Government consult on possible amendments to the external administration regime to 'provide additional flexibility for businesses in financial difficulty'. We submit that this consultation should extend to consideration of how best to protect consumers in the event of corporate insolvency and bankruptcy. Further, we consider it a shortfall of the final report that the establishment of a last chance compensation scheme was not discussed.

[80] See our submission to the Interim Report for further details of meeting the demand for small amount loans. pp17-18.

[81] The US Consumer Finance Protection Bureau recently release payday lending rules for consultation. One of the proposed debt trap protection requirements is to limit the amount the consumer is required to pay each month is no more than 5 percent of the consumer's gross monthly income. For more information see: http://files.consumerfinance.gov/f/201503_cfpb-proposal-under-consideration.pdf.

[82] For further information about the need for an anti-avoidance provision, see our submission on the Credit Reform Phase 2 Bill 2012: http://consumeraction.org.au/submission-to-exposure-drafts-of-the-national-consumer-credit-protection-amendment-credit-reform-phase-2-bill-2012/

We support the establishment of a last chance compensation scheme to ensure that consumers are adequately compensated for losses resulting from misconduct by financial services and credit firms. The establishment of a last chance compensation scheme has been supported by a number of key stakeholders, including the Financial Ombudsman Service (**FOS**), Credit and Investments Ombudsman (**CIO**),[83] ASIC[84] and Financial Counselling Australia.

There are high levels of uncompensated loss in the financial services and credit sectors, with recent statistics from FOS (cited in the Interim Report) that 33 per cent of determinations in the investments jurisdiction remain unpaid. CIO has stated that a last resort compensation scheme is crucial if consumers are to be compensated for their losses in circumstances where:

- the provider has ceased operating and does not have the resources to pay the compensation awarded; and
- the complaint was not covered under a professional indemnity insurance policy.[85]

Currently, not all credit providers are even required to have a professional indemnity insurance policy. Unless a licensee provides credit assistance, it is merely required to have 'adequate compensation requirements'. We understand that licensees are required to verify their compensation arrangements at the time they apply for their licence, which tends to be a multiple of their average expected loan or lease amount. However, ongoing compliance is only monitored by way of the annual compliance certificate, in which the credit provider self-certifies that they are compliant. The requirement for 'adequate compensation requirements' is therefore meaningless from a consumer compensation perspective, as the regulator may not even discover compensation arrangements are inadequate until after the business becomes insolvent.

We consider that a last chance compensation scheme is necessary, particularly in markets which are dominated by many small players. We submit that the last chance compensation scheme be industry funded, to provide an incentive for good conduct and reduce Government spending. However, it may be appropriate for the Government to make a small contribution to the establishment of a such a scheme, given the wider benefit to the community in reduced calls on social security, health and other welfare services as a result of uncompensated losses. We suggest that the scheme be limited to compensating retail clients only, and that awards of compensation be tiered and capped.

Recommendation
That a last resort compensation scheme be a key component of financial services regulation.

[83] Credit Ombudsman Service, 'Submission - Economics References Committee Inquiry: Scrutiny of Financial Advice' (2014), available at: http://www.cosl.com.au/cosl/assets/File/Submission%20-%20Economics%20References%20Committee%20Inquiry%20-%20Scrutiny%20of%20Financial%20Advice.pdf
[84] Australian Securities and Investments Commission, 'Financial System Inquiry interim report: Submission by the Australian Securities and Investments Commission', (2014), available at: http://fsi.gov.au/files/2014/08/ASIC.pdf
[85] Credit Ombudsman Service, 'Submission - Economics References Committee Inquiry: Scrutiny of Financial Advice' (2014), available at: http://www.cosl.com.au/cosl/assets/File/Submission%20-%20Economics%20References%20Committee%20Inquiry%20-%20Scrutiny%20of%20Financial%20Advice.pdf

Industry External Dispute Resolution

Consumers who have a dispute with a credit or financial services provider can make a complaint to one of two industry funded External Dispute Resolution (**EDR**) Schemes: FOS and CIO. We strongly support the use of industry EDR schemes in this industry and in others.

However, we also agree with the position of the Australian and New Zealand Ombudsman Association that it is not desirable to have multiple ombudsman schemes operating in the same industry area.[86] We do not see that competition among ombudsman services in the one industry sector operates in the interests of consumers or efficient market outcomes. Rather than creating incentives for schemes to provide better service for consumers (that is, complainants), EDR schemes will be competing for the business of industry members who will be interested in paying lower fees (which may reduce resources available per compliant received) and more industry-friendly processes.

Recommendation
That the Government begin a process of merging the Financial Ombudsman Service and the Credit and Investments Ombudsman.

Involvement of consumer organisations in reform

We welcome the position in the final report that

> Reviews and proposed changes to the financial services framework should involve consumer organisations in policy development, alongside industry, regulators and other stakeholders.[87]

There are a number of areas of financial services that lack sufficient consumer input, particularly superannuation. We have supported promises of government investment into the Superannuation Consumers Centre,[88] and we encourage that government support this organisation as a priority.

Existing consumer organisations also need to be supported to contribute to policy development. Currently, through government funding contracts, community legal centres are restricted from using Commonwealth funds to undertake policy advocacy. These restrictions limit the ability of funded organisations to provide the type of input the FSI panel is seeking, and should be abolished.

Recommendation
That the Government ensures consumer organisations are resourced and permitted to take part in policy development.

[86] ANZOA, *Competition Among Ombudsman Offices,* September 2011, http://www.anzoa.com.au/ANZOA_Policy-Statement_Competition-among-Ombudsman-offices_Sept2011.pdf.
[87] At page 193.
[88] http://consumeraction.org.au/media-release-superannuation-consumer-centre-recognises-the-importance-of-independent-advocacy/

Innovation

FSI Recommendation 16: A mandatory ePayments Code

We welcome the Inquiry's recommendation that the Government and ASIC should extend basic consumer protection regulation under the currently voluntary ePayments Code to all service providers (FSI Recommendation 16). As outlined in our submission to the Interim Report, payment system regulation needs a clearer focus on consumer outcomes. The debate over whether to favour stability or innovation in payments tends to attract the most attention, while consumer protection issues are left unsolved.

Recommendation
That the Government accept the FSI panel's recommendation to mandate the ePayments Code.

FSI Recommendation 17: Interchange fees

We welcome the FSI panel's recommendation to replace three-year weighted-average caps with hard caps, so every interchange fee falls below the interchange fee caps (FSI Recommendation 17). This would also reduce differences in fees paid by small and large merchants. In our view, this would be fairer for small businesses struggling to compete on price because of the discounts received by large merchants due to their market share. This in turn provides more choice for consumers, and improves competition. In our view, the current weighted average approach to setting interchange fees is unfair, and creates cross-subsidies.

Recommendation
That the Government accept and implement FSI Recommendation 17 to replace three-year weighted average interchange fee caps with hard caps.

FSI Recommendation 17: Payment surcharges

We support the Inquiry's comments that 'surcharging regulation should ensure merchants can surcharge to reflect their relative costs of accepting different payment methods.'[89] We agree that this could be better achieved by providing merchants with clearer surcharging limits, but consider that over-surcharging will continue unless a regulator is made responsible for enforcement. Without regulatory oversight, rules designed to limit surcharging are likely to be widely ignored. We recommend that a regulator, preferably ASIC or ACCC, be given responsibility for enforcing payment surcharging rules. The responsible regulator would need to enforce these rules robustly, in order to send a clear message to merchants that the days of excessive surcharging are over.

The FSI panel recommended a three tier approach to payment surcharging (FSI Recommendation 17), and noted that:

> *These new rules would be easier to comply with and enforce as merchants, system providers and customers would know the surcharge limits for low- and medium-cost payment methods.*

However, the three tiered approach to payment surcharging may be confusing to both customers and merchants. We do not oppose the tiered approach in principle, provided this

[89] At page 169.

approach is easy for consumers to understand, and able to be effectively enforced. Of course, there needs to be clear consequences for breaching the rules and a regulator appointed to ensure consumers have somewhere to take their complaints. Clear public messaging from the regulator and the Payments Systems Board will be required to ensure merchants understand their obligations, and consumers understand their rights.

We oppose surcharging for lower cost payment methods (such as EFTPOS, cash and debit cards). First, surcharging low-cost payment methods may mean consumers that choose this option would end up subsidising consumers who choose to use higher cost payment methods, such as high-end reward credit cards. Second, we do not believe it is fair for consumers to be surcharged for access to their own funds.

We caution against merely relying on disclosure to deal with excessive customer surcharging. Consumers rarely have a choice about whether or not they pay a surcharge (for example, when purchasing airline tickets) and in any case surcharges are often only disclosed late in the transaction. By this stage, consumers have committed to buying the product and the decision to pay the surcharge may not actually reflect their economic interests.

We reiterate our submission to the Interim Report that incentives should be placed into the regulatory framework so that payments are directed to the least cost and most efficient system. However, this should not be done in a way that reduces consumer choice. Currently consumers that use 'tap and go' functionality are not able to choose whether to use a card system or EFTPOS. While this may be good for efficiency (i.e. the merchant can direct the consumer to the cheaper system for the merchant), it is not good for consumer choice. The consumer may unwittingly be charged credit surcharge and credit card interest thinking that the amount is coming from their debit account, or they may want to use scheme debit rather than EFTPOS because EFTPOS may involve a transaction fee by the bank.

Recommendation
The Government ensure that a regulator (preferably ASIC of ACCC) be given responsibility for enforcing payment surcharging rules made by the RBA.

Recommendation
Surcharging should not be allowed for low cost payment methods, like debit cards or EFTPOS.

Recommendation
Incentives should be placed into the regulatory framework to ensure that payments are directed to the least cost and most efficient system, but not in a way to reduce consumer choice.

Recurring payments on scheme debt or credit systems
The FSI panel did not consider the difference in consumer outcomes between where recurring direct debit transactions are set up from a consumer's transaction account or their credit (or scheme debit) card. Consumers commonly establish recurring transactions and standing authorities with third party merchants to pay regular bills, such as insurance, utility bills or fitness club memberships. However, very few consumers would be aware that there is a difference in regulation and are rightly baffled when they find that recurrent payments made from a credit

card are much more difficult to cancel than payments from a transaction account, and credit card recurrent payments can continue to be made even after the card itself is cancelled.

These problems can arise when a merchant does not act on an instruction to cancel a regular payment. These problems can also arise when a consumer closes their credit card account but does not arrange with third party merchants to cancel regular payments. In this case, a consumer is generally responsible for establishing and cancelling authorities directly with the relevant merchant. They will also be responsible for any transactions debited to the credit card account, even after the account has been closed.

The approach taken with credit cards can be contrasted with direct debits on transaction accounts. Under clause 19 of the *Banking Code of Practice*, banks are required to promptly process a consumer's instruction to cancel a direct debit request. We submit that there should be no difference in treatment between credit card accounts and other accounts under the Banking Code.

In our view, a consumer should be able to instruct their bank to cancel a credit recurring payment authority, as they can with a transaction account direct debit authority. Further, upon cancellation or closure of a credit card account, a bank should take steps to cancel all regular transactions and other standing authorities.

Recommendation
That the Australian Bankers' Association work with the Reserve Bank of Australia and scheme debit card providers to remove the distinction in regulation between direct debit payments from transaction accounts and credit (or scheme debit) cards. If stakeholders fails to deal with this issue within a reasonable period, we recommend that the Government regulate to remove the distinction.

FSI Recommendation 19: Review the costs and benefits of increasing access to and improving the use of data

We support FSI Recommendation 19. In particular, consumers should be given access to their own data that is held by financial service providers in standardised and machine readable format. As we argued in our submission to the FSI terms of reference[90], this can help consumers make product choices better aligned with their needs, sending better signals to suppliers.

While increased access for consumers to their own data will create consumer benefit, the growth in data collection by business (especially credit providers) to target products and marketing brings considerable risks.

Target marketing of products to particular groups of consumers is not new. However, advances in information technology permit businesses to access consumers' personal information and use complex systems to predict an individual's behaviour. In consumer lending, this technology can be used to identify consumers who are likely to be profitable, tailor and price products that the

[90] The submission can be accessed from: http://consumeraction.org.au/submission-financial-systems-inquiry-terms-of-reference/

most profitable customers are likely to accept, and develop strategies to reduce the likelihood that the most profitable customers will close their accounts.[91]

It is often argued that this technology creates a win-win: consumers get access to products they want, and business can target their marketing and increase profits. However, the increased use of customer information has coincided with a sharp increase in levels of consumer debt. Over the last 20 years, the level of credit and charge card debt in Australia has increased from a total of around $5 billion to almost $50 billion. Over 70 per cent of this balance—$35 billion—is accruing interest.[92]

Our report *Profiling for Profit: A Report on Target Marketing and Profiling Practices in the Credit Industry* produced with Deakin University presented evidence that the two trends are linked. For example, research regarding the US economy found that "the drop in information costs alone explains 37 per cent of the rise in the bankruptcy rate between the years 1983 and 2004".[93] The report draws on the limited public information about customer management systems, but describes how banks use sophisticated systems to glean intimate personal details, using information gathered from spending patterns, call centres, product registration and point-of-sale transactions, in order to predict an individual's behaviour.

It is often argued that it is not in the interests of lenders to extend credit to people who are unable to repay. However, it is well known to our caseworkers (and, we would suggest, to the credit industry) that there are large numbers of consumers who struggle for years at a time to make repayments to their credit accounts without ever reaching the point of default. These customers will be very profitable for lenders, despite the fact that these contracts cause financial hardship.

Banks and credit providers are increasingly able to use consumer data and technology to better target particular financial services offers to 'profitable' consumers. Recent credit reporting reforms which provide lenders with greater levels of personal information are designed to help lenders better assess credit risks. These reforms are likely to lead to an increased use of 'risk-based pricing', and may result in some lenders targeting 'riskier' borrowers with higher interest rates. It appears to us that some lenders already engage in this conduct, causing consumer detriment.

> **Case study**
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> Consumer Action assisted in a matter where a consumer sought a loan for $6,250 from GE Money for the purpose of consolidating her debts. According to the loan documents, approximately $1,280 was for small debts, and an additional $4,700 was for 'debt consolidation'. The documents showed that $4,700 was in fact used to pay off a single credit card debt with a major bank, which the client then closed.
>
> Loan documents show that GE Money gave the consumer a 5 year loan at an exorbitant 34.95%

[91] Paul Harrison, Charles Ti Gray and Consumer Action Law Centre (2012) *Profiling for Profit: A Report on Target Marketing and Profiling Practices in the Credit Industry*, Deakin University and Consumer Action Law Centre, pp 5-6.
[92] Reserve Bank of Australia, Credit and Charge Card Statistics, (as updated January 2014). Accessed via http://www.rba.gov.au/statistics/by-subject.html.
[93] Sanchez, J M (2009) *The Role of Information in Consumer Debt and Bankruptcies.* Working Paper Number 09-04, The Federal Reserve Bank of Richmond.

> per annum interest—meaning she was repaying over $14,000 (including interest, fees and charges) for consolidating debts worth approximately $6,000. Given that credit card interest rates are commonly in the vicinity of 20%, it's likely the GE Money loan put the client into a worse, not better, financial position.
>
> We looked at GE's Money's website to see what interest rates were being advertised.[94] Both personal and debt consolidation loans were being advertised as being from 17.49% p.a. for loan amounts less than $20,000. On closer inspection, these rates were asterisked with the fine print stating that these rates were only available to approved customers and subject to lending and approval criteria.

We see similar problems in the credit card industry—banks would prefer to send credit card offers to those who don't pay back their full balance within the interest-free period. Known as 'revolvers', such credit card users are highly profitable compared to 'transactors' or 'convenience users', who generally do not incur interest on purchases.

The group of consumers who have trouble paying off credit card debt may be very large. ASIC recently reported that 27 per cent of personal credit card holders (being around 2 million people) do not pay off their personal credit card debt in full each month.[95] This finding is supported by a 2002 report by Visa International, *The Credit Card Report: Credit card spending in perspective*, which found that 64% of all households with credit cards in use did not pay credit card interest.

Failing to repay credit card balance every month will not always be an indicator of financial hardship. However, it should be a cause for concern because those on lower incomes are disproportionately burdened with credit card debt. Australian Bureau of Statistics figures show that households in the second lowest household net worth quintile hold considerably more credit card debt ($3,100) than the average ($2,700), being about the same level of debt as the wealthiest quintile ($3,200 of debt). The second quintile holds more debt than the third and fourth quintiles ($2,800 and $2,400 respectively).[96]

The second household net worth quintile bears the same amount of debt as the highest quintile, despite having less than one third of the disposable income ($552 per week compared to $1797). The second quintile has a little less than two thirds of the disposable income of the 'all households' average ($894 per week), while on average bearing more debt. More disturbing is that the credit card debt held by the second quintile is nearly four times the weekly *gross* income of those households ($821).[97]

In a similar vein to credit card marketing, particular mortgage borrowers can be encouraged to redraw additional funds, or to otherwise refinance or increase the amount of their mortgage. We do not mean to say that this is in any way unlawful—the competitive need of corporations to increase their profitability and return to shareholders unsurprisingly drives them to use personal information and new technologies for their ends, rather than to help consumers access the most appropriate products for their needs.

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[94] See: http://www.gemoney.com.au/loans/personal-loans.html and http://www.gemoney.com.au/loans/debt-consolidation-loans.html.

[95] *Smart people not so smart with their money,* ASIC Media Release 14-041, Wednesday 12 March 2014. Accessed 20 March 2014 from asic.gov.au.

[96] Australian Bureau of Statistics (2013) *2011-12 Household Wealth and Wealth Distribution, 6554.0,* Table 6. Accessed 21 March 2014 from http://www.ausstats.abs.gov.au

[97] Australian Bureau of Statistics (2013) *2011-12 Household Wealth and Wealth Distribution, 6554.0,* Table 1.

A recent report by US organisation Data Justice concluded that the control of personal data by 'big data' companies is not just an issue of privacy, but an issue of 'economic justice'.[98] The report was particularly concerned about the ability of big data to enable advertisers to offer goods at different prices to different people, what economists call price discrimination, to extract the maximum price from each individual consumers. The report found that such price discrimination not only raises prices overall for consumers, but particularly hurts low-income and less technologically savvy households.

The report made three recommendations:

a. for regulators to strengthen user control of their own data by both requiring explicit informed consent for all uses of the data and better informing users of how it's being used an how companies profit from that data;
b. for regulators to factor control of data into merger reviews and initiate action against monopoly control of affected sectors like search advertising;
c. for policymakers to restrict practices that harm consumers, including banning price discrimination where consumers are not informed of all discount options.

We also believe that 'big data' should be a matter for regulation if it creates risks for consumers and the financial system. In any review by the Productivity Commission into the use of data, we encourage in-depth consideration of the techniques being used to target marketing of credit, and whether existing regulation is adequate to counter the risks it creates. Regulatory responses should be informed by an understanding of how marketing is used and how it is received by consumers.

An example may be the 2011 reforms prohibiting unsolicited credit card limit increase offers, unless the customer has consented to receiving such offers.[99] These provisions were designed to address the significant consumer harm caused by the impact on many consumers who are coerced into increasing their levels of debt. Vulnerability to this sort of marketing was described in depth in our 2008 research report, *Congratulations, You're Pre-Approved.*[100] Our recent casework experience is that banks and lenders are avoiding these reforms by offering unsolicited overdrafts on transaction accounts and extensions to existing personal loans, which raise very similar risks.

Recommendation

That the Government endorses the FSI Recommendation 19. In particular, the Government should be considering how to ensure consumers have the right to receive their personal and transaction data from financial services businesses in a standardised and machine-readable format.

Recommendation

That, in any further review of data use, the Productivity Commission should consider the use of customer data to facilitate target marketing (particularly of credit) and price discrimination. Consideration should be given to whether existing regulation is adequate to manage the risks

[98] http://www.datajustice.org/blog/data-justice-report-taking-big-data-economic-justice-issue
[99] National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011.
[100] Paul Harrison and Marta Massi (2008), *Congratulations, You're Pre-approved: An analysis of credit limit upselling offers,* available at: http://consumeraction.org.au/policy-report-an-analysis-of-credit-limit-upselling-letters/.

this creates.

FSI Recommendation 20: Comprehensive credit reporting

We strongly oppose the Inquiry's recommendation to expand credit data sharing under the new voluntary comprehensive credit reporting (**CCR**) regime (FSI Recommendation 20). We also oppose recommendations that the Government should consider legislating mandatory participation, and expanding CCR to include more data fields.

The CCR has only been recently introduced after almost 10 years of policy development and implementation. There are still a number of uncertainties in regards to how the regime will work in practice (particularly in relation to repayment history information reporting) and the impact the CCR has had on consumers and credit providers. As noted by the FSI, industry suggests that significant portions of credit data will not be exchanged until late 2016 or early 2017.[101] In our view it is too early to consider wholesale changes to the regime.

We are particularly opposed to extending access to repayment history information to non-credit licensees, such as utility or telecommunication companies. Extending access would offer little extra assistance to 'good' debtors, who already have positive credit reports, and will make it harder for customers with poor credit ratings to access credit and other essential services (such as phones and utilities). This information is unnecessary for credit providers that are not licensees, which are not subject to responsible lending obligations.

This position was clearly set out in the Explanatory Memorandum to the *Privacy Amendment (Enhancing Privacy Protection) Bill 2012*, which stated**:**

> Repayment history information can only be disclosed to credit providers who are licensees. This is because licensees are subject to responsible lending obligations under the NCCP Act, and the repayment history information is intended to assist those credit providers meet those obligations.

We also oppose expanding CCR data with more data fields—particularly account balances. Access to this data would be a serious infringement of consumers' privacy. Access to account balances would merely allow credit providers further opportunity to risk price, focus client retention work and target their marketing, while providing no discernable benefit for consumers.

We welcome the FSI panel's recommendation of a review of the CCR regime in 2017. However, we disagree that this review should focus on whether a regulatory incentive or legislation for mandatory reporting is required and whether government could also consider expanding CCR to include more data fields, as we oppose both mandatory reporting and expanding CCR. Instead, we recommend that this review consider the impact on of CCR on consumers (particularly low income and disadvantaged consumers) and whether amendments to CCR legislation are required to clarify the current regime and improve consumer outcomes.

Recommendation

That the Government does not consider any further reforms in relation to consumer credit reporting until the effectiveness of recent reforms have been determined.

[101] At page 190.

Regulatory System

FSI Recommendation 27: Regulator accountability

We note the FSI's comments that given the potential significant commercial impact of the product intervention power, the regulator should be held to a high level of accountability for its use. The Final Report recommended that the proposed Financial Regulator Assessment Board should assess the use of this new power. While we strongly agree that regulator accountability is essential, we also note that the regulator is subject to existing accountability measures. For example, ASIC is subject to government and parliamentary accountability measures and regularly appears before parliamentary committees. The Australian National Audit Office also undertakes performance of audits of various ASIC functions and powers. There are certain 'industry accountability' measures that ASIC is also subject to. For example, those who have are banned from managing corporations have the right to seek merits review from the Administrative Appeals Tribunal.

Importantly, there are also consumer accountability mechanisms, including the Consumer Advisory Panel (**CAP**) of ASIC. In our submission to the 2013 Senate Inquiry into the performance of ASIC, we recommended strengthening of CAP.[102] We believe that an enhanced consumer advisory role may bring further benefits to the regulator, its work, and the confidence of the public in its performance. Ensuring consumer interests and priorities are considered closely by senior decision-makers within ASIC will mean it is more likely that decisions are made and priorities are set that accord with consumer need. Other sectoral regulators that have a consumer focus have instituted ways in which consumer interests are considered by regulatory decision makers. For example, the Australian Energy Regulator has established a Consumer Challenge Panel which provides that regulator with consumer perspectives as part of its technical and complex regulatory processes.[103]

A possible model is the Financial Services Consumer Panel (**FSCP**) which is hosted by the UK's FCA. The FSCP is an independent statutory body set up to represent the interests of consumers in the development of policy for the regulation of financial services. The FSCP panel members are selected through a competitive recruitment process, paid fees and supported by a small secretariat. The Panel Chair meets regularly with the FCA Chairman and Chief Executive, has a research budget and produces annual reports. The FSCP describes its role as bringing a 'consumer perspective to aid effective regulation', supporting or challenging the FCA where required and acting 'as an independent counter balance' to parallel boards which represent the interests of industry.[104] We would encourage a similar model for Australia.

Accountability mechanisms need to be proportionate to the risk identified, and focused on advancing the broader objectives of the regulatory system (such as competition, consumer outcomes, efficiency and fairness). Any risk introduced as a result of giving regulators more powers must also be weighed against the benefits that will be created by allowing regulators to

[102] Consumer Action Law Centre, 'Submission to the Senate Economics References Committee inquiry into the performance of ASIC' (2013), available at: http://consumeraction.org.au/submission-the-performance-of-the-australian-securities-and-investments-commission/.
[103] For more information, see: http://www.aer.gov.au/about-us/consumer-challenge-panel.
[104] See FSCP website at http://www.fs-cp.org.uk and Annual Report, 12/13, available at: http://www.fs-cp.org.uk/publications/pdf/FSCPAR%202012-13.pdf;

respond more quickly and flexibly to market problems. Given this, and existing accountability measures, we are not convinced of the need for a new Financial Regulator Assessment Board. However, should this board be established, then it will be important for its membership to be diverse (and include consumer interests) so that it is not unduly influenced by any particular party. This will be particularly important if the board's work is linked to regulator funding decisions.

Recommendation
That accountability mechanisms for the financial services regulator be proportionate to the risks identified of expanded powers, and focused on advancing the broader objectives of the regulatory system.

Recommendation
That consideration be given to enhancing the responsibilities of the ASIC CAP to more closely resemble the Financial Services Consumer Panel (which is hosted by the UK's Financial Conduct Authority), as a measure to improve ASIC's accountability to end-users.

FSI Recommendations 28 and 29: Regulator funding
We strongly support the FSI panel's recommendation to introduce an industry funding model for ASIC, with the level of funding determined on the recommendation of a three-yearly funding review (FSI Recommendations 28 and 29). Currently, reliance in yearly government funding results in peaks and troughs, making it arguably more difficult for ASIC to plan how they will allocate their resources long-term and to be responsive to market needs. The three yearly funding review would provide ASIC with much needed funding stability.

ASIC funding also needs to be at a level that enables it to be a proactive regulator that responds promptly to evidence of misconduct. Currently, ASIC does not appear to be receiving adequate funding to enable it to carry out its consumer protection mandate. Additional funding is required to enable ASIC to enhance its enforcement activities and financial literacy and outreach work, and to take on cases that test the law and challenge large players in the market. ASIC has recently faced significant funding cuts, which ASIC Chairman Greg Medcraft has acknowledged have reduced its capacity to undertake proactive surveillance. It is imperative that ASIC be provided with a level of funding that enables it to exercise its enforcement powers effectively to protect consumers and enhance confidence in the market. ASIC must also be able to offer remuneration comparable to the private sector in order to attract and retain experienced staff.

The industry funding model would also ensure that those industries that cost the most to regulate contribute appropriately to the regulator's funding. ASIC reports that the costs of regulating different participants in its mandate do not align with the revenue collected from these participants. For example, it costs ASIC about $106 million to regulate Australian financial services licensees, though fees collected by ASIC from licensees are about 3.5 percent of this amount.[105] It seems only appropriate that participants contribute an amount to ASIC's funding that corresponds with their costs of regulation. This will also hopefully encourage high risk

[105] Australian Securities and Investments Commission, 'User pays funding model for ASIC' (2014), available at: http://www.aph.gov.au/~/media/Committees/economics_ctte/estimates/bud_1415/tabled_docs/tableddoc4.pdf

participants, which are therefore more costly to regulate, to improve industry standards to drive down the cost of regulation.

We suggest, however, that any cost-recovery process be flexible and not be hampered by government processes that mean that necessary changes to regulator funding levels are delayed. At the very least, we suggest the indexation be included in cost recovery processes as a standard approach.

Recommendation
That the Government accept FSI Recommendations 28 and 29, and introduce an industry funding model for ASIC with the level of funding determined on the recommendation of a three-yearly funding review

FSI Recommendation 29: Regulator powers

We strongly support the FSI panel's recommendation that the Government should strengthen the Australian Credit Licence and Australian Financial Services Licence regimes so that ASIC can deal more effectively with poor behaviour and misconduct (FSI Recommendation 29). The licensing regimes enable ASIC to act as a 'gatekeeper' to the industry, and it is imperative that these powers are strengthened in order to keep unscrupulous traders from entering the market and being legitimised by holding a licence.

We agree that ASIC approval should be required for material changes in the ownership or control of a licensee. This will assist ASIC to exclude undesirable players from entering the licensing regime. This power may also reduce incidences of operators purchasing licenses (via the purchase of a business) that they would not have otherwise obtained if they applied to ASIC directly due to inexperience or questionable past behaviour.

We would also welcome ASIC having more capacity to impose licence conditions requiring licensees to address concerns about non-compliance. We would welcome these licence conditions being public, and transparent information provided about how the licensee is complying with these conditions. However, this response should not be considered a replacement to licence cancellations/suspensions or enforcement proceedings in cases of systemic and serious non-compliance, as these actions send an important message to the wider market. It is important that penalties for non-compliance are increased, as recommended by the FSI panel, to act as a deterrent for large firms.

Finally, we strongly support increases to the maximum penalties that can be imposed for contravening financial services consumer protection laws. Penalties must be set at a level to act as a credible deterrent against misconduct. We support the inquiry’s finding that penalties must be increased substantially, and we also think that the regulator must be able to disgorge profits associated with unlawful conduct.

Recommendation
That the Government accept FSI Recommendation 29 and strengthen the Australian Credit Licence and Australian Financial Services Licence regimes so that ASIC can deal more effectively with poor behaviour and misconduct. Penalties should also be increased substantially.

Please contact David Leermakers on 03 9670 5088 or at david@consumeraction.org.au if you have any questions about this submission.

Yours sincerely
CONSUMER ACTION LAW CENTRE

Gerard Brody
Chief Executive Officer

Katherine Temple
Senior Policy Officer

David Leermakers
Senior Policy Officer