Chapter 5

Lending practices and household debt

Everyone enjoyed it so much when lending was growing at a rapid rate - businesses were all making lots of profits; shareholders were happy; management thought they were geniuses - and they want the party to continue. The only way it can continue is by lowering credit standards or, the other term for that, underpricing risk.[1]

Introduction

5.1 The question of whether the lending policies and practices of banks and other lenders have played a significant role in increasing household debt is contentious. Representing the banking sector, the ABA maintains that demand for credit is the primary driver of increased household debt. Nonetheless, the lenders market their products aggressively, each institution seeking to maintain market share and maximise profits. Appearing before the House of Representatives Standing Committee on Economics, Finance and Public Administration, the Governor of the RBA, Mr Macfarlane was under no illusions about the lenders' motives:

> There is a very big industry out there which is utterly determined to put out as much credit as it can.[2]

5.2 A number of regulators and commentators have expressed concern that in their pursuit of market share, some lending institutions have lowered lending standards and in some cases, engaged in questionable practices. Critics say that a number of these practices lead to excessive levels of debt in households who, because of their financial and personal circumstances, are at risk of becoming over-extended and of financial distress.

5.3 In the credit card market, the practice of offering unsolicited increases in credit limits has been criticised by a range of consumer groups. Critics point out that the practice can lead to over-commitment and financial hardship if adequate checks are not made of whether the person who is offered the limit increase is able to pay it.

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1 Governor of the RBA, Mr I Macfarlane, in House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 12 August 2005, p. 8.

2 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 4 June 2004, p. 16. Quoted from the Committee's report, *Review of the Reserve Bank of Australia Annual Report 2003*, p. 18.

5.4 Operators of department store charge cards are singled out for the practice of offering inducements such as no-deposit buying and interest free periods and when these expire, charging very high rates of interest. In the case of both credit and charge cards, disclosure of terms and conditions are claimed to be often inadequate.

5.5 Examples of poor practice in the housing market include commission-driven promotion of mortgages by brokers, with insufficient attention being paid to accepted lending standards; and attempts on the part of some lenders to distance themselves from their responsibilities under the Consumer Credit Code.

5.6 This chapter commences with a discussion of lending standards and practices, which is of relevance to household debt in general, but particularly the housing loan market. Subsequently, the chapter examines issues of more relevance to the credit and charge card sectors, which were the main focus of attention by organisations that made submissions to the inquiry.

5.7 The chapter concludes with an examination of a number of options that have been put forward for reducing the likelihood of households becoming overextended particularly in relation to credit card and charge card debt. These include:

- Mandatory checking of capacity to pay;
- Financial literacy measures; and
- Positive credit reporting.

Lending standards and practices

5.8 Both the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia have expressed concern that as a result of fierce competition for market share, some lenders have compromised lending standards.

5.9 APRA advised the Committee that it has kept the activities of Australian Deposit Taking Institutions (ADIs) under close scrutiny. While providing assurances about the financial soundness and stability of the financial sector, APRA described a number of shortcomings in lending practices which it had identified:

> In its supervisory activities, APRA has identified slippages in basic lending practices, in areas such as verification of customer data and valuation processes. APRA also sees increasing reliance on the information collected by third parties (such as mortgage brokers and mortgage managers) without independent verification by the ADI.
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> …

> APRA has also observed that ADIs are no longer relying on conservative rules of thumb when assessing a borrower's capacity to repay debt. The traditional '30 per cent rule', under which lenders would limit repayments to no more than 30 per cent of a borrower's gross income, has been giving way to a debt servicing ratio approach, which treats all income above a cost of living estimate as potentially available for servicing debt.[3]

5.10 APRA has revised a number of its policies and issued warnings to ADIs about these practices.

5.11 The RBA is also closely monitoring lending practices, and appears to be concerned that unsound practices are increasing in response to increased competition and lower growth in demand and more difficult market conditions resulting from the slowdown in the housing market:

> So there is a huge amount of competition to retain market share going on out there, and this is common in credit cycles towards the end of a credit cycle. Everyone enjoyed it so much when lending was growing at a rapid rate - businesses were all making lots of profits; shareholders were happy; management thought they were geniuses - and they want the party to continue. The only way it can continue is by lowering credit standards or, the other term for that, underpricing risk. We think a fair bit of that is happening at the moment and we have been following it.[4]

5.12 The Governor of the RBA, Mr Macfarlane, has criticised the fall in lending standards. He attributed this fall at least in part to a change in the incentives associated with distributing mortgages resulting from the increasing importance of the broking industry:

> When I said earlier that lenders may be tempted to further lower lending standards, the use of the word *further* was deliberate. The incentives in the mortgage distribution system have changed in such a way that there has been a step-by-step reduction in credit standards over recent years. A significant proportion of mortgages are now sold by brokers who are paid by commissions on volumes sold.

5.13 Mr Macfarlane also identified the entry of new lending products as contributing to the general decline in standards and an increase in the amount of debt that a lender was prepared to lend against a particular income level:

> The growth of low-doc home loans means that intermediaries are now lending to individuals whose income is not substantiated. There has also been an upward drift in the maximum permissible debt-servicing ratio. When once a maximum of 30 per cent of gross income was the norm, now

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3 APRA, *Submission 3*, p. 3.

4 Governor of the RBA, Mr I Macfarlane, in House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 12 August 2005, p. 8.

> it is possible for borrowers on above-average income to go as high as 50 per cent of gross income (and a much higher percentage of net income). The new lending models used by the banks (and provided on their websites to potential borrowers) seem to regard the bulk of income above subsistence as being available for debt-servicing.

5.14 He went on to warn that once these practices gain a foot-hold in the market, they can spread to more conservative, prudent lenders:

> It is not hard to see how a situation like this develops. Once a few lenders adopt an aggressive approach, others must match them or lose market share. They are then re-assured by standard risk-management models, which are based on Australia's history of extraordinarily low mortgage defaults. Even those lenders who have reservations find it difficult to follow a different path, especially as the lenders taking on more risk may well be rewarded by higher profits (and higher share prices) in the short run.[5]

5.15 A number of organisations that made submissions to the inquiry also raised concerns about an apparent disregard for sound lending practices on the part of some lenders.

5.16 The Centre for Consumer Law (CCL) at Griffith University was among several non-financial sector submissions that criticised the lending policies of banks and other credit providers. The CCL told the Committee of a number of practices that it said credit providers had increasingly been using to provide loans to people who may not have been successful in obtaining finance in the past, including:

- Consumers with little or no savings can seek out loans with higher loan to valuation ratios (95-100 per cent). The creditor's interests are protected with mortgage insurance and/or other restrictions, but the borrower is left with a limited buffer if their financial circumstances change and/or the property value decreases;
- Low-doc and no-doc loans enable loans to be provided on the basis of a self-certification of the borrower's capacity to pay the loan, with the creditor making little or no independent enquiries;
- Other forms of non-conforming loans have become available or promoted to consumers, including vendor finance and interest only loans;
- Some lenders appear to engage in asset-based lending for consumer purposes, where little assessment is made of the borrower's capacity to pay the loan; instead, the credit provider relies on its ability to force a sale of the security property at the end of the loan term;

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5 RBA, *Monetary Policy and Financial Stability*, speech by the Governor, Mr I. J. Macfarlane, 16 November 2004.

- Home equity and reverse equity loans have become increasingly available. These loans can be used to fund renovations or non-housing expenses, and they add to the size of the mortgage over time;
- Greater promotion of refinancing of home loans and debt consolidation. Often this involves an additional borrowing on top of the refinanced or consolidated loans; and
- Lower standards of credit assessment.[6]

5.17 Similar evidence was received from representatives of the Consumer Credit Legal Centre (NSW) Inc (CCLC), who alleged that in some cases, loan applications had been falsified or borrowers' capacity to pay deliberately misrepresented:

> The other area where we have seen a deterioration is home lending. There has been a change in attitude towards things like income ratios - what percentage of income is appropriate to service a loan. There are higher loan to value ratios, greater use of things like deposit bonds and widespread use of third party channels such as brokers. Our experience of brokers is that, whereas many of them are probably extremely responsible and professional in the way they provide their service, we see the results of a lot who are not. More and more people are coming in who have a loan secured against housing, who have very little income and whose loan applications have been seriously doctored-basically their loan application contains information that is simply incorrect.[7]

5.18 There appear to be some important incentives for mortgage brokers to pay insufficient regard to borrowers' capacity to repay loans. An APRA survey released in 2003[8] found that in a majority of cases, brokers' remuneration packages are based on the volume of business generated, providing brokers with an incentive to generate volume without appropriate regard to risk.

5.19 It appears that some fringe non-conforming lenders and a group of unscrupulous mortgage brokers or intermediaries purporting to provide loan reduction services may be responsible for such shady practices. On the basis of the evidence received, it is not possible to exclude the possibility that some banks who are lending through mortgage brokers may also be involved, either inadvertently or in complicity. The Committee notes that the four major banks received 60 per cent of all broker loan applications in the March 2002 quarter, indicating that they are heavily dependant on the broking industry.[9]

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6 Centre for Consumer Law, Griffith University, *Submission 3*, p. 4-5.

7 *Official Committee Hansard*, 16 May 2005, p.E22.

8 APRA, *Report on Broker Originated Lending*, January 2003, p. 9.

9 Discussion paper, *National Finance Broking Regulation - Regulatory impact statement*, published on line by the Office of Fair Trading, Government of NSW, p. 8.

5.20 It is difficult to determine the extent of such practices. However, Ms Cox of the CCLC implied that some mainstream lenders are involved, as part of the pressure to increase market share, and that in some cases, lenders are seeking to avoid the application of the consumer credit code, which applies in all states, and requires lenders to assess capacity to pay:

> Our concern was that the fact of that meant that lenders who were previously more careful, who would take note of things such as the consumer credit code - that says in section 70, among other things, that you are not supposed to knowingly lend to people in a situation in a situation where you know they would incur hardship to repay - are happy to be able to distance themselves in that regard. That is what we have found. They are able to increase the market share by… They put a Chinese wall between themselves and the borrower and say, 'We have done everything we possibly could.' Without naming particular institutions, there are some whose mortgage portfolios are growing enormously through using the broker channel.[10]

5.21 The CCLC attributed this problem to the increasing presence in the finance industry of mortgage brokers, and as a result, the remedies that should have been available to the consumer to seek redress in cases where lending was irresponsible were no longer available to consumers:

> Probably the biggest impact that we have seen is simply that credit providers are moving to distance themselves from transactions, so whereas once you dealt directly with the credit provider, you are now dealing with a broker and in some cases a second broker or a mortgage manager in the middle. Quite contrary to situations where those people are seen as the agent of the credit provider, in Australia the law has developed so that most of them are actually seen as the agent of the consumer. As a result, many of the traditional remedies available to consumers when things go wrong are no longer available because when they take it to the credit provider, the credit provider says, 'No, nothing to do with us.'[11]

5.22 The CCLC told the committee that this was a common problem in their casework. Representatives agreed that it was a problem most commonly seen among individuals that were financially distressed, but was not confined to that group.

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10 *Official Committee Hansard*, 16 May 2005, p.E30.

11 *Official Committee Hansard*, 16 May 2005, p.E26.

5.23 The Committee explored options for addressing this problem with representatives of the CCLC, who suggested that one option would be to make the lender responsible for ensuring the borrower had adequate capacity to repay the debt:

> **Senator BRANDIS**: Do you go so far as to suggest to this committee that, if the law were changed so as to deem a broker to be the agent of the lender, that would solve the problem?
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> **Ms Lane**: In a nutshell, we think that would be a very significant step forward in solving this problem.[12]

5.24 A failure on the part of brokers to disclose fees adequately or explain how their fees would apply to a particular transaction was also identified by some consumer groups as a feature of some operators in the mortgage and finance broking industry. This is despite a legal requirement to disclose fees. It was alleged that in some cases, failure to adequately inform consumers of the fees applying to particular services led to some households being misled into re-financing deals that did not benefit the borrower and resulted in financial hardship. Some of the fees charged appear to be disproportionately large. Ms Lane of the CCLC (NSW) told the Committee of some of the situations she had encountered in her casework:

> If the fees were disclosed at all, it was often as a percentage - which sounds fairly small until you realise how much one per cent, two per cent, three per cent or four per cent can be over a fairly large loan. The biggest problem with disclosure is for the really vulnerable client group. It would not matter what was in a disclosure document, the situation of some of our clients is such that they would be very easily duped into signing things. People who are about to lose their home are particularly vulnerable in that respect. We have seen more and more cases in the last few years. With the rise of the non-bank sector, there are people who perhaps would have defaulted on their home loan earlier but, rather than default now, they take up an option, usually offered through a broker, whereby they refinance to the nonconforming sector. They may last a few months or they may last a few years, but they inevitably default anyway.
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> …
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> We have seen clients paying $10,000 to $15,000 simply in set-up fees to get a relatively small loan. The current record was $20,000.[13]

5.25 The ABA and the ANZ Bank both submitted that the banks are conservative in their approach to lending, and that commercial imperatives mean that they aim to lend responsibly. The ABA's submission provided details of the

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12 *Official Committee Hansard*, 16 May 2005, p.E30.

13 *Official Committee Hansard*, 16 May 2005, p.E27.

safeguards that exist in the banking sector to ensure lending is conducted responsibly, highlighting:

- Income and equity tests are applied;
- Commercial incentives to ensure loans were repaid;
- Application of the Uniform Consumer Credit Code;
- Code of Banking Practice;
- Existence of external dispute resolution in the Banking and Financial Services Ombudsman; and
- APRA's supervision of prudential standards.[14]

5.26 Similarly, the ANZ provided the Committee with a description of its practices that are intended to ensure it is a responsible credit provider.[15]

Committee views

5.27 It is impossible to escape the conclusion that the lending policies and practices of lenders have had a significant impact on the demand for debt. There has been cut-throat competition for market share and enormous pressure to increase profits. The practice of raising debt-to- income repayment ratios alone allows more money to flow into an already overheated housing market, potentially increasing the risks for households who may not fully appreciate the nature of the risks that they are undertaking.

5.28 The finance droughts of the pre-deregulation years have given way to the reverse, a flood of finance into the market that lenders are anxious to place. The commercial incentives for doing this are understandable but can also have negative aspects. There is evidence that at least some lenders have sought to increase their share of the housing mortgage market and the size of their mortgage portfolios through lending practices that are unsound and in some cases, unscrupulous. This appears to be a particular problem among non-conforming lenders and mortgage brokers.

5.29 While the Committee accepts that much lending by the banks is responsible, it is concerned about the increasing reliance of banks on the mortgage and finance broking industry. The broking industry is as yet only lightly regulated and the barriers to entering it are low. There is an attendant risk that the safeguards and procedures put in place by the banks to ensure lending practices are sound will be watered down or ignored. In the never-ending quest to lower costs and at the

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14 APRA, *Submission 3* – see pp 3-6.

15 See ANZ, *Submission 17*, pp. 11-12.

same time, increase profitability and market share, the potential for standards to be compromised is ever-present.

5.30 The Committee notes APRA and RBA concerns about lending standards being reduced. The Committee also notes that the House of Representatives Committee on Economics, Finance and Public Administration has identified the lack of regulation of non-bank lenders as problematic as it tends to fall between the states' responsibilities and those of APRA and ASIC. The Committee shares these concerns.

5.31 The Committee is aware of a number of initiatives to address the problem of unsound lending practices. These include:

- The Ministerial Council on Consumer Affairs has released a comprehensive discussion paper exploring options for uniform state and territory regulation of the finance and mortgage broking industry, and acknowledging the importance of the issue, has agreed to progress as a matter of urgency proposals to address the problems raised;
- At the initiative of the Australian Government, the States and Territories have established a working party to investigate property investment advice;[16]
- The Joint Parliamentary Committee on Corporations and Financial Services released a report entitled *Regulation of Property Investment Advice* in June 2005.

5.32 APRA has also taken a number of initiatives including:

- proposed the introduction of more detailed criteria for Australian deposit-taking institutions (ADIs) to qualify for the concessional risk-weighting of residential mortgage lending;
- strengthened the capital adequacy standard for ADIs by requiring them to treat certain types of capitalised expenses such as loan origination fees and commissions paid to mortgage originators and brokers as intangible assets for prudential purposes, and to deduct them from capital;
- proposed an improved capital framework for lending mortgage insurers;
- conducted a 'stress test' of ADIs and warned them to be more cautious in housing lending.[17]

5.33 The Committee welcomes these initiatives.

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16 Described in the Government Response to the House of Representatives Standing Committee on Economics, Finance and Public Administration Committee's report: *Review of the Reserve Bank of Australia Annual Report 2003.*

17 Described in APRA, *Submission 3*.

Recommendation 6

The Committee recommends that the feasibility of deeming a broker to be the agent of the lender be further investigated as a possible method of addressing the slippage in lending practices that has entered the financial services industry.

Credit and charge cards

5.34 Credit and charge card lending is minor in comparison to lending for housing, although it is an area which attracted considerable comment by many of those who made submissions to this inquiry. Credit and charge card debt has shown a similar rate of growth over the last ten years as housing debt and totalled $31.4 billion as at June 2005, 5.4 per cent of total household debt.[18]

5.35 During the inquiry, submissions and witnesses mainly focused on problems faced by those households who are financially distressed as a result of using cards. While the number of distressed households appears to be small, severe financial hardship can result for those who do have difficulties managing credit and charge card debt.

5.36 Low household income is the major risk factor associated with financial hardship attributed to credit and charge cards, although problems also arise for higher income groups.

5.37 The rest of this chapter focuses on lending practices that contribute to credit debt difficulties, particularly unsolicited offers of credit increases and the failure to undertake realistic assessments of capacity to pay. The chapter concludes by canvassing a number of options for reform in this area.

Unsolicited credit increases

5.38 The CCLC and a number of other organisations told the Committee that the practice of sending out unsolicited offers of increased credit limits to people without checking whether they were capable of repaying that higher level of debt caused many problems for the at-risk group. Representatives also alleged that in many cases the financial institutions offering the credit increase were aware of their customers' limited repayment capacity:

> A lot of our clients have been offered increase after increase in their credit limit with no reference to their income and liabilities. Some of these people have had a change in income whereby they have a lower income than they

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[18] Derived from RBA, *Credit and Charge Card Statistics*, Table C1, http://www.rba.gov.au/Statistics/AlphaListing/alpha_listing_c.html

> had when they were first granted the credit facility, but many of them have never had a change in income and the credit provider has been well aware of their financial situation from the start.[19]

5.39 Several organisations submitted that few checks are made of whether people are capable of repaying the debt that may be incurred as a result of a credit limit being increased, or before issuing a card. Submissions were also highly critical of the practice of assessing ability to repay on whether the person could make minimum payments, rather than whether the debt could be repaid within a realistic period. The CCLC elaborated:

> Another key factor contributing to problematic credit card debt is that many lenders assess a client's capacity to pay on whether they can afford the minimum monthly payment. This means that even where some form of credit assessment is carried out by it, borrowers may face financial difficulty if they fully draw their account. The result of this is that there is a gap between financial difficulty as measured by default rates and real levels of debt related stress in the community.[20]

5.40 FCAN considered that many people do not really understand the nature of the debt they are entering into:

> Many people do not understand that most forms of credit such as credit cards from financial institutions have daily compounding interest. Many also feel that paying minimum payment required by a credit card statement will repay the debt only to find out down the track that this is not the case. Making the minimum payment will keep the debt out of the court debt recovery process, as it is the required payment, but may only cover interest and a small amount of the principal. It may take years to fully repay a credit card debt if only the minimum required payment is made.[21]

5.41 A submission from the Banking and Financial Services Ombudsman (BFSO) confirmed that the practice of increasing credit card debt without undertaking an assessment of a customer's capacity to increase the increase in credit has contributed to an increase in credit disputes. The Ombudsman, in common with a number of other submissions, noted that the increased limit in some cases results in a debt that the customer cannot afford to repay.[22]

5.42 Charge cards, particularly those operated by finance companies such as GE Finance, were also identified as a source of problems for some households. The Committee received a limited amount of evidence about these cards, and many of the issues raised were similar to those in relation to credit cards. Issues include a

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19 *Official Committee Hansard*, 16 May 2005, p. E22.

20 CCLC, *Submission 6*, p. 9.

21 FCAN, *Submission 1*, p. 1.

22 BFSO, *Submission 12*, p. 6.

lack of disclosure of the true cost of operating a card; unsolicited cards being offered to consumers without adequate checking of the customer's ability to service debt, and a lack of information about interest-free periods and the rate at which interest will be charged after the interest-free period expires.

5.43 Anglicare Tasmania was amongst those who criticised the practices of finance providers and stores in relation to these cards:

> The ease by which consumers can access credit to purchase these goods, in particular interest-free period loans and in-store credit that is offered by most large department stores and chains at very high interest rates (up to 25 per cent) further encourages/supports consumers to purchase luxury items that they often cannot realistically afford. At present, little financial information needs to be provided by the customer to access this form of credit and oftentimes clients do not fully understand the terms of the contract.[23]

5.44 Representatives of the ABA defended the practices of the credit industry, advising that in many cases the financial institutions had to rely on what the customer told them and were constrained by privacy rules from checking whether the information provided was correct:

> For example, if a customer is filling out an application for a credit card for the first time, they are asked to declare how many credit cards they have and what other credit facilities they have in place. We have no real means of checking whether or not that is the case, because of privacy rules…a customer could have a number of credit cards which they do not necessarily disclose to us, which we do not know about and which, if we did know about them, would affect our decision to lend.[24]

5.45 The ABA maintained that it was not in the industry's interest to have people take out credit that they could not repay. The ABA acknowledged that circumstances do arise where people take on more debt than they can manage, but maintained that 'We try everything possible to militate against that'. Representatives said that the industry had financial literacy programs in place to try and mitigate the problem, and also actively managed peoples' accounts. The ABA pointed out that the industry is in a situation where it is difficult to satisfy all people, and that by tightening up lending there was a risk that people who should have access to credit would be denied it:

> The response from banks is that they could tighten up their risk parameters so much to prevent that sort of thing from happening. But if you do that you end up denying money to people who should get it.[25]

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23 Anglicare Tasmania, *Submission 10*, p. 2.

24 *Official Committee Hansard*, 16 May 2005, p. E69.

25 *Official Committee Hansard*, 16 May 2005, p. E72-3.

5.46 A number of submissions and witnesses put forward a number of recommendations for addressing the issue of uncontrolled credit card debt. These include:

- Improving disclosure standards;
- Financial literacy programs;
- Mandating assessment of ability to repay debt; and
- Positive credit reporting

Disclosure standards

5.47 As is evident in the preceding paragraphs, a number of organisations consider that one reason some people have difficulty managing credit is that they do not adequately understand the nature of the commitment they are entering when they incur debt on credit or charge cards. Some identify credit card contracts where the terms and conditions are set out as excessively complex or buried in small print. The conditions are disclosed, but many people have difficulty understanding them.

5.48 Virgin Money was highly critical of the disclosure standards imposed on Australian financial institutions:

> The impact of rising credit card fees and interest charges on consumers is compounded by a lack of honesty and transparency in credit card marketing. Many Australians do not adequately understand the terms and conditions of their credit, making it all too easy for the more vulnerable to be trapped into accumulating unaffordable debt. It is this area where we believe regulation can make a difference - in increased disclosure to consumers of basic credit card product features.[26]

5.49 Virgin Money was of the view that Australian financial institutions would resist disclosure improvements, but that requiring higher standards would benefit consumers:

> But forcing disclosure of interest rates and fees would drive natural competition to bring those down and improve the situation for consumers. The industry definitely has not followed and is not planning to follow, because they adopt the practice of hiding things in the fine print.[27]

5.50 Virgin Money advocated a standard disclosure mechanism for all credit cards, modelled on the 'Schumer box' used in the United States. Virgin Money considered that this standard mechanism, termed an 'honesty box' should be provided in all credit card promotional literature and should present information

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[26] *Official Committee Hansard*, 16 May 2005, p. E1-2.

[27] *Official Committee Hansard*, 16 May 2005, p. E4.

about interest rates, key fees and core terms and conditions of the card in a clear and easily understood manner. Virgin Money recommended that standardised disclosure requirements be mandated for all credit card providers.[28]

5.51 Other submissions also advocated improved disclosure requirements. FCAN submitted that both the interest rate and how that interest is charged be disclosed:

> For example a credit card and line of credit is charged daily and compounding. FCAN would like an explanation to the consumer of what that actually means, that your interest will be added each day and then the next day you will be charged interest on your balance plus the interest each day.[29]

Financial literacy programs

5.52 There are mixed views about the importance of improving financial literacy to minimise the incidence of financial distress in the community and the misuse of credit. The Australian Bankers' Association told the Committee that the banking industry saw improving financial literacy as essential, and had taken a number of significant initiatives to improve it:

> Yes, we certainly do provide information to the community and to our customers about the best way to borrow and manage money. We do have a fairly comprehensive financial literacy program in place for both the industry and our individual banks…We are firm believers that the best borrowers are the best informed borrowers. It makes sense for us to lend money to people who understand what they are getting themselves into and can pay it back. Financial literacy is a very big issue for us.[30]

5.53 The FCAN agreed that financial literacy is lacking in Australian society and told the committee there are moves to have financial literacy included in some school curriculums. While acknowledging that moves to increase financial literacy are a positive initiative, the FCAN cautioned that literacy programs do not address the adult population's needs in this area, and that it is also necessary to address how financial products are marketed:

> It is important to curb the marketing of financial products in light of the fact that there are some in society who don't have enough financial literacy to make a sound judgement.[31]

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28 Virgin Money, *Submission 7*, pp. 2, 9.

29 FCAN, *Submission 1*, p. 2.

30 *Official Committee Hansard*, 16 May 2005, p. E71.

31 FCAN, *Submission 1*, p 2.

5.54 The CCLC was more critical, stating that financial literacy is not the answer to consumer debt:

> As a general rule consumers do not enter unmanageable debt because of ignorance. They may have an unrealistic appreciation of their capacity to repay, or an overly optimistic view of their employment prospects. These tendencies have perhaps more to do with personality types than financial sophistication.

5.55 The CCLC saw the life circumstances of people who encountered difficulties with consumer debt as more important. They advised the committee that in their experience, the people who had problems with debt tended to be those whose circumstances had changed (unemployment, illness etc) and those who have restricted choices because of their personal situation. The CCLC maintained that financial literacy would make little difference in respect of either group.[32]

Mandating assessment of ability to repay debt

5.56 Several of the consumer credit groups that made submissions or gave evidence put forward recommendations for addressing the shortcomings they considered existed in the credit industry.

5.57 The CCLC submitted that in relation to credit and charge cards, the following principles should be incorporated in the Consumer Credit Code or other appropriate legislation:

- that lenders should undertake a proper credit assessment in relation to each credit contract, or variation of credit contract, they enter to ensure that the borrower(s) has the capacity to meet their contractual obligations;
- that the above credit assessment should be based on the borrowers ability to repay the facility if it is fully drawn within a reasonable period (say under 30 years for home loans and under 5 years for all other forms of consumer lending)
- that automatic penalties apply to the lender for failure to comply with the above provisions including financial penalties for the lender in addition to relief from the relevant debt for the affected borrower; and
- the ability to market using credit limit increase offers be curtailed in situations where the borrower's repayment patterns indicate a predefined level of financial difficulty.[33]

5.58 CARE Financial Services advocated the national extension of the approach adopted in the ACT, noting that the ACT was the only jurisdiction which had moved to require credit providers to assess ability to pay:

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32 CCLC, *Submission 6*, p. 14.

33 *Submission 6*, p. 13.

> In the ACT, credit providers are now required to assess a consumer's capacity to repay the credit being offered before it is advanced on new credit cards, or through offers of increased credit on pre-existing cards.[34]

5.59 The CCCL recommended amending the Consumer Credit Code to include a requirement for credit providers to undertake a proper credit assessment in relation to each credit contract that the borrower enters. The CCCL also considered that a proper credit assessment should also be required when the borrower or credit provider seeks to increase the amount of credit available under the contract. Like CARE (ACT), the CCCL saw the approach adopted in ACT legislation as offering a model for change:

> The 'satisfactory assessment process' defined in the ACT *Fair Trading Act* would be a useful place to start in formulating an appropriate obligation. Introducing such an obligation is not a novel approach. It is already enshrined in limited scope in the ACT and, in a slightly different form, for subscribers to the *Code of Banking Practice*.[35]

5.60 While consumer legal groups consider that inadequacies in lending practices are at the root of most of the problems in the credit industry, lenders and credit bureaus maintain that a significant part of the problem is that they are forced to operate in an information–poor environment, and are forced to take much of what applicants for credit say to them at face value. Several groups took the opportunity presented by this inquiry to call for a change in credit reporting. This proposal, known as positive credit reporting, would require changes to the Privacy Act.

Positive credit reporting

5.61 The Committee received two submissions[36] advocating a change in Australia's consumer credit reporting system as a means of addressing issues of unsustainable and unaffordable household debt. These submissions focus on the role of the credit reporting system in the lending process. They put the view that a change in the type of information that consumer credit bureaus can hold will have a positive impact on manageable levels of household debt in Australia and will lead to a more efficient allocation of financial resources. Proponents also maintain that this change would lead to sounder lending practices, particularly in relation to credit cards.

5.62 On the other hand, consumer advocates are concerned that industry calls for positive credit data are based on self-interest and if successful will lead to more opportunities for the industry but will not increase prudent lending, nor decrease

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34 Care Financial Counselling Service, *Submission 2*, p. 4.

35 CCLC, *Submission 6*, p. 10.

36 Dun & Bradstreet (Australia) Pty Ltd, *Submission 14*, and MasterCard International, *Submission 15*.

default rates. Furthermore, they argue that the industry has not operated a fair and accurate limited credit reporting regime to date and existing problems can only be made worse by increasing the amount of information that the industry is permitted to gather.

Background

5.63 There are three main credit reporting agencies (credit bureaus) in Australia: Baycorp Advantage, Dun and Bradstreet and Tasmanian Collection Service. Baycorp Advantage is the largest.

5.64 Credit bureaus store credit data that is used to generate credit reports. Credit providers such as banks and telephone companies subscribe to credit bureaus and can request information from them about people's credit history.[37] This information supplements their own data gathered from credit applications as well as that acquired through past experience with an applicant.

5.65 Credit in Australia is regulated by the states and territories but Part IIIA of the Privacy Act governs consumer credit reporting. Part IIIA sets down rules about who is allowed to access credit reports, the type of information that can be held by credit bureaus and the uses to which a report can be put. Generally, it also prohibits disclosure by credit providers of credit worthiness information about an individual and provides rights of access and correction for individuals as regards their personal information.

5.66 Australia's existing system of credit reporting is described as a 'negative' credit reporting system. The information that credit bureaus may currently record about individuals is listed below:[38]

- full name, including any known aliases, sex and date of birth;
- a maximum of three addresses consisting of a current and last known address and two immediately previous addresses;
- name of current or last known employer;
- driver's licence number;

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37 Common credit providers are banks, building societies and credit unions. However credit providers also include:

- businesses that issue store credit cards, eg department stores; and
- businesses that provide a good or service and allow payment to be deferred, for example, telephone, gas and electricity companies, video hire shops, furniture stores and car hire businesses.

38 Office of the Federal Privacy Commissioner, *Privacy Act: Fact sheet 7*, viewed on 21 September 2005, at: http://www.privacy.gov.au/publications/crda.html#3.

- a record of a credit provider having sought a credit report to assess an application for consumer or commercial credit;
- default information (information may only be included here if the individual is at least sixty days overdue and the credit provider has taken steps to collect the amount outstanding); and
- certain items of publicly available information such as court judgments and bankruptcy orders.

5.67 Bureaus may only hold information about credit applications, overdue accounts (over 60 days) and court judgments on individual files for five years from the date of listing. They may keep information about bankruptcies or serious credit infringements on file for seven years from the date of listing.

5.68 Additional information that might be put in reports if the legislation were amended includes:

- a person's credit limits;
- the balance of credit accounts; and
- any delinquency patterns in payment.

5.69 In relation to credit cards, it could also allow the recording of details of all cards held by an individual, potentially addressing possible problems associated with a person being issued with further cards without the lender knowing what other cards the borrower holds.

Argument for positive credit reporting

5.70 In its submission, MasterCard International highlighted the role played by information asymmetries that exist between lenders and borrowers in hampering the efficiency of credit markets. It suggests that the resulting inefficiencies impose high costs on both the financial industry and consumers in the form of lower returns for the former and higher costs in getting credit for the latter.[39]

5.71 While the availability of negative credit information partially addresses the information asymmetry, MasterCard considers that it is only when positive information is also available that the asymmetry will be closed. It characterises positive information as the following:

> …information related to prospective borrowers' outstanding debt obligations, types of credit and their histories, even when the borrower has never defaulted or gone bankrupt.[40]

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[39] MasterCard, *Submission 15*.

[40] *Submission 15*.

5.72 Citing research about the experience in Europe, MasterCard suggests that the availability of positive credit information leads to a lowering of the credit risk inherent in credit markets. MasterCard attributes a reduction in US mortgage rates by up to two percentage points to the securitisation of mortgages which depends on the use of positive credit information. (The Committee notes that there has been a similar reduction in mortgage rates variously attributed to securitisation of mortgages in Australia which were possible without positive credit information being available)

5.73 According to Dun and Bradstreet, the Australian system does not allow for credit bureaus to record whether credit applications have been approved, and in the event that they have been, to what limit. Neither is there any information recorded on an individual's capacity to pay.[41] Dun and Bradstreet is concerned that the system limits a lender's ability to determine a consumer's capacity to service debt. It provides the following example:

> …a consumer who is struggling to make ends meet but is still managing to pay-off the minimum amount on existing loans can continue to increase his/her credit levels, because credit bureaus can only report on whether the consumer has defaulted on payments and not on the consumer's real capacity to meet further credit commitments.[42]

5.74 Furthermore, a minor default during the previous five years can prevent people from accessing affordable and serviceable credit even when they have a recent good payment history and their circumstances are significantly different to those in which they incurred the default. This is because the individual's credit report will only show a prior payment default.[43]

5.75 In relation to finding solutions to problem household debt, Dun and Bradstreet believes that there must be a focus on the decision-making process that underpins a lender's capacity to make responsible, sustainable and affordable lending decisions. This approach would be preferable to one in which there is an exclusive focus on lending practices which it considers would anyway likely improve, by reform of the consumer credit reporting system. In its submission it cites studies and a number of overseas experiences that it says point to a link between the credit reporting system, sustainable credit growth and lower default rates.[44]

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41 Dun and Bradstreet, *Submission 14*, p. 6.

42 *Submission 14*, p. 6.

43 *Submission 14*, p. 7.

44 *Submission 14*, pp 9–11.

5.76 Dun and Bradstreet recommends that credit bureaus should be permitted to store the following additional data on individuals:

- the name of each current credit provider;
- the type of each current credit account;
- the date on which each current credit account was opened; and
- the limit of each current credit account.

5.77 It is keen to point out that this additional data would not constitute a shift to the USA-style 'full-file' positive consumer credit reporting system as it does not provide the extensive information that is currently allowable in the United States of America.[45]

Argument against positive credit reporting

5.78 Except for the two submissions referred to above, the Committee did not receive any sustained comment from others as to the merits or otherwise of changing the credit reporting system.[46] This is not surprising as the issue is not specifically canvassed in the Committee's terms of reference and is peripheral to the main inquiry.

5.79 However, material from the print and related media suggests that there is significant disquiet from consumer advocates about the notion that credit providers could gain access to additional information about consumers.[47] These advocates are sceptical about the size of any benefits flowing from positive credit reporting and believe that they are unlikely to outweigh the potential risks for consumers.[48]

5.80 Additionally, one of the benefits of a positive credit reporting system put forward by the industry, is that it would enable providers to lend more money. In the light of the currently high level of household debt in Australia and the low level of savings, the Committee questions whether this would necessarily be of benefit to the community. During its inquiry the Committee found no evidence to suggest that

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45 Dun and Bradstreet, *Submission 14*, p. 8.

46 However, Anglicare Financial Counselling Service, Tasmania (*Submission 10*, p. 3) advocated that, along with restrictions on credit practices and other measures, a review of the merits of positive credit reporting should be undertaken.

47 Australian Consumers' Association, *Credit reporting: mistaken identity and other stories*, viewed on 23 February 2005, at: http://www.choice.com.au/printFriendly.aspx?ID=104159; Catherine Wolthuizen, 'Open sesame', *Consuming Interest*, Spring 2004, pp 15-17; Letter to the editor, Australian Financial Review, *Self-interest gags credit reporting*, Catherine Wolthuizen, Australian Consumers Association, 18 February 2005, p. 79.

48 Nicola Howell, Consumers' Federation of Australia, *Expanding the credit reporting system – A summary of consumer concerns*, July 2003.

a lack of availability of credit was a problem for the majority of consumers in this country, and indeed the reverse appears to be true.

Senate Legal and Constitutional References Committee Report

5.81 The Senate Legal and Constitutional References Committee recently reported on the Privacy Act. As part of its inquiry that Committee considered Part IIIA of the Act.[49] The report found significant shortcomings in the operation of Part IIIA and the Committee took the view that additional funding must be provided to the Office of the Privacy Commissioner to enable it to fulfil its regulatory oversight function. For a more detailed discussion of these issues, the Committee refers the reader to that report.

5.82 The Legal and Constitutional References Committee also considered positive credit reporting in its report. It recommended that the Privacy Act not be amended to allow the introduction of positive credit reporting in Australia.[50] Its recommendation was based on the following reasoning:

> The committee sees no justification for the introduction of positive credit reporting in Australia. Moreover, the experience with the current range of credit information has shown that industry has not run the existing credit reporting system as well as would be expected and it is apparent that injustice can prevail. As mentioned elsewhere in this report, positive reporting is also rejected on the basis that it would magnify the problems associated with the accuracy and integrity of the current credit reporting system. The privacy and security risks associated with the existence of large private sector databases containing detailed information on millions of people are of major concern.[51]

Committee views

5.83 The question of whether governments should intervene in relation to credit card debt is difficult to resolve. While there is a significant minority within the community who lack financial literacy or the skills necessary to manage their credit commitments, there is no convincing evidence that these problems are widespread. Imposing a further regulatory burden on finance providers requires careful judgements to be made about whether further regulation is justified. A balance has to be struck between protecting consumers' interests and allowing the market to operate competitively and efficiently.

5.84 Ultimately it must also be accepted that there will always be some people in the population that it is impossible to protect from either their own lack of

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49 Legal and Constitutional References Committee, *The real Big Brother: Inquiry into the Privacy Act 1988*, June 2005.

50 *The real Big Brother: Inquiry into the Privacy Act 1988*, p. 160.

51 *The real Big Brother: Inquiry into the Privacy Act 1988*, pp 159-160.

prudence or from taking desperate action driven by the circumstances in which they find themselves.

5.85 However, the Committee is persuaded that some of the lending practices within the credit and charge card industry that have been described during the inquiry are sub-standard and are not in accordance with the standards of practice which the banking industry itself regards as acceptable.

5.86 In particular, the Committee is concerned that the practice of offering consumers unsolicited increases in credit limits without conducting a thorough appraisal of whether there is capacity to pay is unsound, and consumers are not provided with information about interest rates, and conditions of use in a form that is sufficiently user friendly.

5.87 In relation to the issue of positive credit reporting, this committee is not persuaded to take a different view to that expressed by the Legal and Constitutional References Committee. The Committee does not believe that credit providers are making full use of the information currently available to them. Further, as observed previously in this chapter, defaults and other signs of financial distress in the credit card market are very low and do not justify the very significant change that would be required for positive credit reporting to be introduced. The Committee does not consider that any further parliamentary inquiry into this matter is justified at this time.

Recommendation 7

The Committee recommends that the States and Northern Territory develop and pass uniform consumer credit legislation requiring credit providers to undertake appropriate checks of borrowers' capacity to pay before issuing new credit cards or raising credit limits. The ACT Fair Trading Act provides an appropriate model for this legislation.

Recommendation 8

The Committee recommends that the Consumer Credit Code be amended to mandate the provision, in a clear and easily understood manner, of a summary of the interest rates, key fees and core terms and conditions of card interest rates in all credit card promotional literature. This requirement is also to apply to charge cards and interest free periods offered by retailers.

Senator Ursula Stephens
Chair