Comments: Philip Trinca, Partner, Blake Dawson, Melbourne

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PREDATORY LENDING - RESPONDING TO "LENDERS BEHAVING BADLY"

By Philip Trinca, Partner, Blake Dawson, Melbourne

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In his paper "Lenders Behaving Badly", Professor O'Donovan has given us an excellent overview of the general circumstances in which predatory lending may arise. In addition, he has noted and examined "the fragmented response of the Australian legal system" to many of these predatory practices. It is this fragmentation of response on which I intend to focus my own comments.

That we have inherited a fragmented response to this age old problem is not something that should really surprise us. Predatory lending has been a scourge to commercial societies for millennia, and the responses to those charged with controlling it have never been entirely successful. To be fair, the regulation of commerce, even undesirable commerce, is a balancing act. It needs to balance the protection of the vulnerable against the encouragement of enterprise and competition. This is not an easy task, in any field of commerce.

The real difficulty in framing an appropriate response, however, is that the causes and opportunities for predatory lending are varied and complex. In addition, the opportunities to engage in predatory practices continue to expand. The ever increasing range and complexity of financial products is seeing to that. A further difficulty is that the regulation of undesirable practices is mostly responsive, while human ingenuity for maximising personal profit is often "ahead of the game".

Accordingly, there are likely to be some good reasons for why our responses to date can be accused of being fragmented. The trick, as we try to do better, will be to imagine the best framework upon which to continue to build and develop our response to the problem. In my view, we need to pursue a layered and flexible approach – even if this does continue to run the risk of being seen to be fragmented.

If we try to imagine and implement a single or "one size fits all" approach, we will fail. The complexities of the modern world will quickly see to that. Just as there is not a single problem to address, there is not a single or universal solution to be applied. That is not to say, however, that some regulatory restraints ought not to be universally applied. These universal restraints could be viewed as the base layer of the response.

The application of caps on interest rates and the regulation of unfair contract terms, would be a couple of good examples of where a base form of universal regulation might be continued to be applied. The harder task is the formulation and application of the more targeted responses to the particular predatory practices, as they arise. These responses will fall into two parts: the application of industry knowledge to understand the issues of today and tomorrow and the effective enforcement of the envisaged solutions. A cap on interest rates, for example, is of no value if it is not strictly enforced. That requires money and the will to apply the law. The regulation and control of other (often less obvious) predatory practices requires:

- the industry knowledge to identify the current and developing predatory strategies;

- the application of judgement as to how they might best be regulated, or otherwise controlled;
- the legislative flexibility to respond to new predatory practices as they arise; and
- the commitment and financial resources to back up and enforce the legislative response.

Despite the apparent difficulties of the task, there does seem to be a general acceptance that something more needs to be done to control unfair or predatory practices.

Not coincidentally, in Australia we are currently poised on an opportunity to re-evaluate the manner in which consumer lending is regulated. We have been examining and preparing for a range of regulatory changes that were to be implemented at the State level. Now, consequent upon the decisions of COAG[19] in March and early July 2008 to transfer regulatory power for consumer lending to the Commonwealth, we have an opportunity to re-assess and re-evaluate the existing levers of regulation as well as those which might be imagined and brought to bear.

Our current fragmented history of regulation is both a legacy of past endeavours to regulate unacceptable practices as they arise, together with the fragmentation of regulation which has arisen from our historical circumstance of having eight separate jurisdictions regulating the same sphere of commercial activity. By moving to a single Commonwealth regulator we have the opportunity to considerably improve the focus of our response to any predatory behaviour by lenders. Whether this opportunity will be used for maximum advantage, however, is still very much open to question. A chief concern is that those who will have responsibility for formulating and giving substance to our new grand scheme, are being given very little time to envisage and implement the right balance of regulation and control.

Their task is not an easy one and, as usual, the lessons of history will be difficult to adapt and apply. Time constraints, or other factors, may well mean that the initial outcome is simply a Commonwealth version of our currently State based Uniform Consumer Credit Code (**UCCC**). We can, however, probably expect to have one or two "add ons" that have been extracted and copied from the most recent individual legislative attempts of some States to address particular needs that have arisen.

In the context of these general comments, I would now like to make some more specific comments on some of the regulatory options that are available for consideration or are current features of our existing approach to regulating consumer credit. I should emphasise that these are largely personal views.

1. Is the value of truth in lending overstated?

One of the key principles that underlies much of the recent regulation of consumer lending is the concept of truth in lending. The idea is that if borrowers are provided with ready access to relevant information, they will be better able to compare and decide upon credit terms that may be offered to them by one or more credit providers. While this is a worthy aim, and has a logical appeal at an intellectual level, truth in lending as a means of redressing the balance is subject to a number of limitations.

The first concern I have is that consumers are rarely in a position to conduct an objective comparison of competing financial products. There are many reasons for this. Often, there is not a choice of products offered at the point of sale, or there may be a range of commercially self-interested reasons why a consumer is directed to, or offered only, one product.

Even where there is a choice, unless the product is one of particular simplicity, the making of useful and informative comparisons between the full range of features and risks offered by the available products is likely to be beyond most consumers.

[19] The Council of Australian Governments.

Separately, there does not appear to be much evidence that the disclosure of all fees and charges will necessarily influence the behaviour or risk appetite of borrowers. The legislative requirement to disclose key features of a loan in a schedule, such as the interest charges and fees, remains a potentially valuable strategy. Nevertheless, it is liable to be considerably diluted by the volume of the disclosures, where numerous fees are listed, or numerous interest rate options are listed and explained. It might be concluded that truth is only valuable where it is brief. Too much truth runs the danger of losing the message. Additionally, the increasing complexity of financial products on offer also works against the ideal of allowing key features of a product to be compared with other products. We are seeing the same problems in the regulation of financial products under Chapter 7 of the Australian Corporations Law. There, there are detailed and apparently sensible disclosure requirements that must be made within a Product Disclosure Statement (**PDS**). As a recent example, I drafted a PDS which I thought was bursting with clarity, plain English and full disclosure. It took me two hours to conduct my final read through, and I knew what it said!

In the context of the format for the disclosure of key features of a loan, an interesting survey was conducted a few years ago in Queensland by Paul O'Shea. It is described in his paper entitled "Consumer Credit Code Disclosure: Does it Work?".[20] The paper describes an experiment that was conducted to determine whether disclosure of key financial details in the financial table in accordance with the UCCC increased the comprehension of relevant terms over disclosure of the same information, where it is embedded within the body of the contract. The results achieved suggest that our perceptions about the value of financial tables may well be overrated. Paul O'Shea reported that:

> "… there was a barely statistically significant improvement in the mean [for comprehension of the selected information] for the Code-compliant …contracts over the embedded contracts, [and that] only 2.9% of this variance is explained by the difference in the documents. The rest is attributable to other factors."

If we are to persist with "scheduled" disclosures, it suggests to me that the disclosures should be limited to a few compulsory headline items that require no more than a page to disclose.

Even if we are fully informed, that does not mean that we will make our choices accordingly.

The free will of the prospective borrower is considerably diminished by the fact that the finance is, in most cases, simply a means to an end. The finance may be required to fund a purchase that the borrower has already decided to make. For example, in-store finance allows a customer to purchase the plasma TV of their dreams, or the washing machine of their needs. In many respects, the finance contract and its particular terms are secondary to the main objective (the purchase) and the main objective cannot be achieved without the finance. The purchase decision will already have been made. It is likely that the borrower will not have the opportunity, the desire, or even the skills to consider competing finance products (even if we assume that they have knowledge of the availability of alternative finance options).

At a consumer level, we also need to bear in mind that consumers rarely, if ever, have the opportunity to negotiate the terms of an offered credit contract. This is particularly so in the case of mortgages, credit cards and finance in stores and car yards. In a housing context, few of us would read the detailed terms and conditions, even if we are lawyers. We know that if we want the money, we sign the mortgage.

Even as "educated" borrowers with some degree of choice, our response may be to choose to rely on our perception of the reputation of the lender as our primary form of

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[20] (2005) 16(1) JBFLP5.

protection. We concern ourselves, therefore, with headline items, such as the applicable interest rate and the establishment costs. This has resulted in an opportunity for lenders who have devised and applied an increasingly varied range of fees and charges that are used to generate a very significant portion of the lender's return. A particular community concern at present is that some of these fees and charges fall on those most vulnerable, for example, in the form of default or exception fees applied when the borrower runs into financial difficulty and misses payments.

What this suggests to me is that relying on the borrowers to protect themselves, even where the relevant financial information has been required to be presented in the most comprehensible terms, is not the best way to address or control predatory practices.

2. Regulation of fees and charges

At present in Australia, we are in the midst of re-evaluating the means and degree to which credit fees and charges should be regulated. The present position under the UCCC is that only a very few fee types are regulated, and principally, only subject to attack where they are unconscionable within the meaning of the common law. Effectively, this means the fees have to be pretty outrageous before they are vulnerable. Further, any remediation requires court action to establish the unconscionability. In 2007, following a review of the UCCC at various levels of government, the Ministerial Counsel on Consumer Affairs issued a Consultation Package which, through a draft Consumer Credit Code Amendment Bill 2007, proposed that all fees be subject to challenge in circumstances where they are "unreasonable". This proposal raised considerable concern amongst lenders, particularly where they were required to demonstrate reasonableness by reference to underlying cost. Of course, not all fees have an underlying cost. Separately, establishing average costs of providing a particular service is not only difficult, but often too simplistic as an approach.

Following industry consultation, it is understood that the re-drafting of the proposed reform package has been moving towards a proposal under which fees would be subject to challenge where they are "unfair". It is understood that the determination of what is unfair would be left to the Court, rather than prescribed by Regulation. Now, following the COAG decision in July, we have the proposal to move the regulation of all consumer credit to the Commonwealth sphere and we are, to a large extent, left to imagine the degree to which the Commonwealth will elect to regulate fees. A significant starting clue, however, was contained within the green paper which preceded COAG's decision. In the green paper, it was stated that:

> "It is important to note that the government does not intend to regulate bank fees and charges... Regulation of bank fees and charges discourages new investment and innovation, increases compliance costs for industry and may eventually lead to an increase in prices for consumers. The government considers a competitive market to be a more effective mechanism for driving down fees and charges."[21]

Whether this market driven philosophy will prevail in the drafting of the new Commonwealth laws is yet to be seen. My personal view is that relying on the market to regulate fees and charges is not likely to have any significant impact on predatory lending practices.

That leaves the difficult question of the extent to which, and the manner in which fees might otherwise be regulated. There are some existing regulations that are achieving their purpose, such as section 30 of the UCCC – which limits a credit provider's recovery of the third party expenses it incurs to the net final cost of that expense. A move beyond this point requires a decision as to whether we should:

[21] Green Paper June 2008 – Financial Services and Credit Reform, Improving, Simplifying and Standardising Financial Services and Credit Regulation, page 15.

- return to the days of the Credit Acts' approach to regulation; or
- stick with the market control approach that is permitted under the UCCC.

The better option, it seems to me, is to stick with the UCCC's approach, but to monitor the effectiveness of that form of control on different fee types. Where the market control is not working, as some would say is currently the case with exception fees, and where regulation will not stifle competition and innovation, there would be a case for imposing limits on the amounts that may be charged for specific fee types. This might be more effectively done by imposing direct price control caps on certain types of fees, but that is not a solution that many would favour.

3. Unfairness and the public interest

As a separate comment, it is worth drawing attention to the New South Wales decision of *Permanent Mortgages Pty Ltd v Cook*[22], to which Professor O'Donovan has referred. It involved a Ponzi Loan. In that case, the Court was required by the terms of section 70 of the UCCC to consider whether a mortgage was unjust. Evidence had been given by Associate Professor Keen that the loan approved by the lender exceeded the capacity of the Cooks to service the loan by around $100,000 (based on the credit assessment models utilised by a number of major banks). Under section 70, the court was required to consider the public interest, before deciding whether the mortgage was unjust. The evidence of Professor Keen was that:

> "… were the practice of Ponzi Lending to become widespread, it would substantially increase the tendency of the Australian financial system to asset bubbles and subsequent financial crisis …".[23]

The view of Professor Keen was that Ponzi Loans thus have an adverse economic consequence that extends well beyond the immediate parties to the loan agreement.

The court, however, concluded that against any public interest in discouraging loans of this type, there is a public interest in the enforcement of contractual obligations freely entered into. Patten AJ concluded:

> "In the result, I do not regard the public interest as of much significance in resolving this case. Rather, I think the greater focus should be upon factors personal to the Defendants, or more directly concerned with the particular transaction."[24]

One might be forgiven for concluding that the Court effectively dismissed the relevance of the public interest consideration in the context of an individual loan.

4. Interest rate caps

Caps on interest rates are one of the oldest, if not the oldest, forms of regulating predatory lending. Interest rate caps have been applied for millennia.

They remain a key means by which some control over the worst excesses of predatory lending can be applied. The real issue with interest rate caps, however, is not the imposition of the cap itself, but the diligence with which it is enforced.

Currently in Australia, New South Wales and the ACT seek to go one step further by combining fees and interest within the maximum interest rate cap.

5. Information, positive credit reporting, low doc loans and liars

The rules that make the most sense to me are those that are imposed on the person best able to control the outcome. Problems arise, however, where inaccurate or

[22] [2006] NSWCA 41.
[23] [2006] NSWCA 41 at paragraph 81.
[24] [2006] NSWCA 41 at paragraph 85.

misleading information is being given to the person making the relevant decisions and exercising the relevant control – typically the lender.

As a general proposition, accurate and more detailed information should reduce the circumstances in which inappropriate loans are made. Accordingly, most credit providers are strongly in favour of allowing positive credit reporting in the sense that such reporting will allow them to have access to wider verifiable information, such as information about existing loans (both disclosed and undisclosed), the repayment performance of borrowers under those loans and the amounts then borrowed. In particular, lenders wish to know whether a borrower has the capacity to repay a requested loan. Ultimately, they should be the person responsible for making the assessment as to whether and how much to lend.

The concerns against allowing lenders access to so called "positive credit information" centre on privacy concerns and the protection of the rights of the individual.

There seems little doubt, however, that manipulation of the truth does occur in the lending environment. Borrowers under low doc loans can overstate their income and financial capacity. Brokers, for their own selfish reasons, may be tempted to bend the truth when putting forward a loan applicant for a loan. At the other end of the scale, financiers who are planning to have no long term interest in the loan may be less inclined to check various claims. The quality of many of the loans written in the US at the bottom end of the market is ample illustration of this point.

A good example of what we should not do, however, was illustrated by the recent draft National Finance Broking legislation. Under the original draft legislation, it was proposed to make all "brokers" responsible for checking and assuring the financial capacity of the borrower. This might be appropriate in some real property mortgage situations, but as soon as a broker is widely defined, it becomes an entirely different proposition. Is a car salesperson or a shop assistant really capable of making such an assessment? As a consumer, would you want to give them the required financial information to establish your capacity to repay?

6. Fear

There is no doubt that active Regulators are more likely to drive proper behaviour than inactive ones. Nevertheless, the extent to which they can be effective is dependant upon the powers they have, the financial resources at their disposal and the consequences applicable to lenders who transgress.

While no-one would wish for a return of the days of the Credit Act, when interest rights were automatically forfeited for the most trivial disclosure breaches, the almost voluntary breach disclosure regime that applies under the UCCC has arguably led lenders to a false sense of security about the risks of prosecution or examination.

There have been very few prosecutions by Regulators, and where Regulators have become visibly active, there has often been little political choice about their doing so. This has meant that a number of practices have remained untested and a degree of complacency has, one might suggest, settled in.

If one thing is clear, it seems that clear guidelines and guidance of what is and is not acceptable on the one hand, combined with rigorous oversight and enforcement on the other, is the most likely means by which effective regulation can be administered.

7. Concluding comments

There is no one or single solution to the issues we have discussed today. As financial products become more complex, the regulation of these products through a single means has an increasingly diminished value. Against that, a plethora of regulatory approaches or a "global" approach accompanied by a diverse and complex

scheme of exceptions, such as that we are experiencing under Chapter 7 of the Corporations Law, is also undesirable.

There are a number of possible ways forward. They range from limiting regulation to basic products with defined but limited features, to placing more complex conditions upon access to positive credit information, or upon the provision of the more complicated financial products. Such conditions may include the requirement on the lender to do something in justification of its lending decisions. For example, if positive credit reporting information is to be provided, a lender might be required to document and record the basis on which it decided that the borrower had the capacity to repay it.

The regulation of brokers, as currently proposed in Australia, so as to require them to effectively assess and be responsible for the credit capacity of a borrower, seems to me to be a less obviously desirable approach. At the end of the day, it is the lender that lends the money and takes the risk. It is the lender that should have the experience to measure credit capacity and to test the information provided to it by the applicant and/or the borrower.
Nevertheless, I do think that our ongoing response needs to continue to test new regulatory models and to be flexible and adaptable to changing circumstances. While this will impose an ongoing cost at both industry and government level, it is something that seems to me to have the best prospect of improving the focus and implementation of the regulatory response.