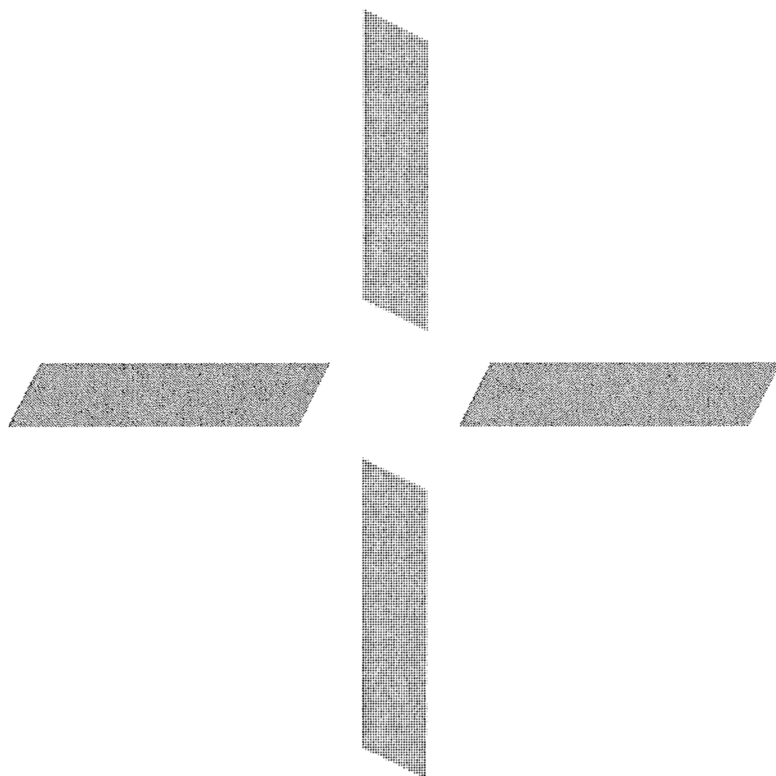
Allens Arthur Robinson

TREKS, TRAILS AND THE GREAT DIVIDE – ISSUES PERTAINING TO INTERMEDIARIES

THE REGULATORY FRAMEWORK



Catherine Parr
Partner
Allens Arthur Robinson
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1. Introduction

Finance brokers and other intermediaries play a key role in the market for personal, investment and small business credit facilities. Finance brokers and other intermediaries are a necessary part of the structure for origination of loans in a securitisation trust. They represent a substantial source of customers for many other lenders including most banks with a retail operation in Australia.

There is a patchwork of regulation of finance broking activity in Australia. Most of the regulation is at state or territory level. Some states and territories have no regulation. There is relatively little consistency in the regulation where it does exist. This creates issues for:

- intermediaries – particularly those who operate nationally who incur the costs of understanding, registering under and complying with different regimes and who, for cost and process reasons, usually need to have one set of documentation and procedures. This means that where they are operating in unregulated jurisdictions they are potentially at a competitive disadvantage to operators who carry on business only in those jurisdictions;
- lenders – who cannot rely on regulation to ensure that finance brokers throughout Australia have adequate qualifications and experience, carry professional indemnity insurance and operate consistently with appropriate standards of conduct; and
- consumers – who have little or no protection in some jurisdictions and who are being exploited by some sectors of the broking industry.

For these reasons possible national regulation of the industry is being examined.

This written paper looks at:

- the nature and scope of the current regulation where it exists;
- the proposals for new nationally consistent regulation; and
- some particular issues and risks for lenders arising out of the conduct of intermediaries.

The oral presentation will focus more on some of the "morality" issues including areas where there is lack of consistency, scope for avoidance and/or lack of a "level playing field" as between various industry participants.

2. Australian Capital Territory

In the Australian Capital Territory, finance brokers are regulated under the *Consumer Credit (Administration) Act 1996* (ACT).

2.1 Which intermediaries?

Section 3 of the Act provides that a finance broker is a person who (whether or not carrying on any other business) carries on the business of finance broking by negotiating, or acting as intermediary to obtain, consumer credit for persons other than an employer or principal of the person so negotiating or acting.

Suppliers have the benefit of an exemption from the registration requirement, but not from all of the conduct requirements. Section 30 of the Act provides that:

> Division 3.2 (Finance broking) and division 3.3 (Registration of finance brokers) do not apply to a person (the exempt person) who carries on a genuine business of selling land or supplying goods or services (whether as principal or agent) if:
>
> (a) the exempt person acts as a finance broker in relation to the provision of consumer credit exclusively for a person (the client) who deals with the exempt person in the ordinary course of that business; and
>
> (b) the client has given written authority for such credit to be applied in payment for land, goods or services sold or supplied in the course of that business.

According to the explanatory memorandum to the Act, persons who generally fall within this exemption are motor vehicle dealers and real estate agents, "but only if they genuinely act as finance brokers for clients coming to them in the ordinary course of the business."

Section 29 of the Act provides for a number of other entities to be exempt from Divisions 3.2 and 3.3. These exempt entities include banks, financial institutions, legal practitioners acting within the course of their profession, insurance and life insurance companies, securities brokers and dealers, the curator of estates, the public trustee and trustee companies.

2.2 What type of credit contracts?

The Act applies only to conduct in relation to credit contracts and leases which are regulated by the Consumer Credit Code.

2.3 Licensing

Section 32 of the Act prohibits a person who is not exempt from the registration requirement from acting, or holding themselves out, as a finance broker unless they are registered as one.

2.4 Conduct requirements

Division 3.2 of the Act applies to intermediaries who are required to be registered. It contains provisions on advertising, keeping records, the requirement for a written agreement, charging of commission and valuation fees and a prohibition on false and misleading statements.

Section 35(1) of the Act prohibits a finance broker from demanding, receiving or accepting any commission for a finance broking transaction from a borrower unless the transaction is carried under a written agreement:

- signed by the person charged or to be charged with the payment of the commission; and

- containing details of the amount of credit, the term of credit and the maximum amount of interest and other charges to be paid in respect of the credit.

Section 35 of the Act also prohibits finance brokers from receiving commission from borrowers:

- in excess of the maximum prescribed by the regulations;
- before securing the credit in respect of which the commission is charged;
- if the credit secured is less than the amount specified in the written agreement;
- if the credit secured is at a rate of interest or for a charge which is greater than the rate or charge specified in the written agreement; or
- if the credit secured is for a term less than the term specified in the written agreement.

Divisions 3.4 (disciplinary procedures such as complaints against finance brokers and disciplinary action) and 3.5 (civil penalties and false and misleading statements in relation to compliance with Part 3 (finance broking) of the Act), apply to all finance brokers, including those who do not need to be registered such as motor vehicle dealers and real estate agents.

There is no regulation of, or requirement to disclose, commissions or other benefits paid by lenders.

3. Western Australia

In Western Australia, finance brokers are regulated under the *Finance Brokers Control Act 1975* (WA). The *Finance Brokers Control Amendment Act 2004* (WA) (the ***Amending Act***) has been passed by the Legislative Council. However, the date for proclamation of the Amending Act has not yet been determined. The Western Australian Government is preparing regulations under the Act which are expected to take effect when the Amending Act commences (currently expected around September 2005).

I set out below the current regime in Western Australia and then, in 3.5, an indication of what is likely to change once the Amending Act comes into effect.

3.1 Which intermediaries?

A finance broker is, for the purposes of the Act, a person who as an agent, in the course of business, negotiates or arranges loans of money for or on behalf of other persons.

Section 5 excludes certain classes of person from the definition of finance broker, including:

> a person who, in association with a bona fide business of supplying goods or services carried on by him, acts as an agent to negotiate or arrange loans for persons who deal with him in the ordinary course of that business and who authorise in writing the application of the loans in payment for the goods or services.

So, for example, a motor vehicle dealer who is in the business of selling cars to the public, and who acts as an agent for its customers to arrange loans the proceeds of which will,

under the terms of the contracts for those loans, be applied towards payment for the cars, will be exempt. Unlike in the ACT, this is a full exemption.

This exemption is not affected by the Amending Act.

3.2 What type of credit contracts?

The Act is not limited to negotiating or obtaining loans regulated by the Consumer Credit Code. However it does not regulate negotiating or arranging lease or hire purchase arrangements.

3.3 Licensing

Section 26 of the Act prohibits a person from carrying on business, or holding themselves out, as a finance broker unless the person:

- holds a licence; and
- holds a current business certificate in respect of the licence.

Section 27 of the Act sets out some of the licensing requirements for a natural person, which include:

- being a person of good character and repute and a fit and proper person to hold a licence;
- having sufficient material and financial resources to enable them to comply with the requirements of the Act; and
- understanding fully the duties and obligations imposed on finance brokers by the Act.

3.4 Conduct requirements

Section 43 of the Act provides that a finance broker is not entitled to receive any commission, reward, or other valuable consideration in respect of finance broking services from a borrower unless :

- the finance broker is licensed and holds a current business certificate in respect of the licence; and
- the finance broker's appointment is in writing signed by the person to be charged before the receipt of the commission, reward, or other valuable consideration (whether before or after the services are rendered).

There is currently a penalty of $500 for receiving a commission in breach of section 43 (this will increase to $5,000 under the Amending Act).

Section 44 of the Act provides that the Finance Brokers Supervisory Board (the ***Board***) may fix maximum amounts of remuneration for finance brokers. These maximum amounts may be set by reference to the type of loan, the value of the loan and the type of security. A schedule of fees has been set and is available on the Board's website.[1]

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[1] www.financebrokers.wa.gov.au

The Act also deals with advertisements by finance brokers, trust accounts and audits of trust accounts and retention of records.

3.5 Effect of the Amending Act

Some of the key changes under the Amending Act are:

- the definition of finance broker will be amended to include a person managing a loan that they have arranged or negotiated;
- the Board will be abolished and responsibility for administering the Act will be handed to the Commissioner for Fair Trading (the ***Commissioner***);
- the former disciplinary functions of the Board will be carried out by the new State Administrative Tribunal;
- the requirement to hold a business certificate will be removed;
- it will be an offence for a licensee to enter into an arrangement for finance broking to be carried out by a person who is required to be licensed but is not;
- the Commissioner will have the power to suspend a broker's licence for 60 days in "serious cases of misconduct";
- the Commissioner will have greater investigative powers; and
- the maximum penalties for offences under the Act will be increased.

The WA Government is preparing the regulations for the Amending Act and it is likely that these regulations will:

- set out in the information which must be included in a licence application;
- provide an exemption for financial services licensees who negotiate or arrange loans of money in the course of negotiating or arranging life policies, contracts of insurance or other facilities for the management of financial risk.
- prescribe a Code of Conduct for finance brokers;
- require persons in bona fide control of a body corporate or firm to also hold a finance broker's licence; and
- set relevant fees and penalties.

The proposed new Code of Conduct, in draft form, has been published on the Board's website. It has attracted much comment from the broking industry. The Board has stated that unless it only makes minor or uncontentious changes to the Code of Conduct as a result of the most recent round of public comments, industry will be given another opportunity to review and comment on a final draft before it is gazetted.

As it currently stands the proposed new Code of Conduct is divided into three sections. The first section sets out general obligations for finance brokers and applies to all finance broking activities. The second section deals with *restricted finance broking activity* which is the provision of finance broking services where the lender is regulated under Chapter 5C or 7 of the *Corporations Act 2001* (Cth) or by APRA, is a licensed credit provider or is on a list maintained by the Board. The final section covers *unrestricted finance broking activity*

which is the provision of finance broking services other than restricted finance broking activity.

Some of the main features of the proposed new Code of Conduct are:

- a finance broker must always act in the best interests of its principal (the person for whom the finance broker arranges a loan) and must give its principal undivided loyalty (*general obligation*);
- a finance broker must disclose to its principal and all other parties, any interest it has in the loan transaction, in any property being purchased or offered as security and in any other transaction to which the loan is commercially relevant (*general obligation*);
- it is the finance broker's responsibility to take reasonable steps to ensure that its employees or exclusive contractors comply with the obligations set out in Article 3 of the Code (*general obligation*);
- provisions dealing with confidentiality, honesty, fairness, qualifications and misleading and deceptive behaviour (*general obligations*);
- where a finance broker deals directly with a borrower, the finance broker is the agent for the borrower unless the finance broker makes it otherwise clear (*restricted finance broking*);
- a finance broker should be able to demonstrate that it has made reasonable enquiries in relation to the personal circumstances of the borrower and that it has cautioned the borrower that the loan arrangements are based on the information provided by the borrower and the lenders canvassed and that if that information is incorrect the borrower should consider the appropriateness of the loan and seek financial advice if necessary (*restricted finance broking*);
- a detailed, two stage, disclosure regime (*restricted finance broking*) including, amongst many others, requirements that:
    - a finance broker must disclose to the borrower the lenders from whom it can obtain loans and that those lenders do not necessarily represent all lenders who offer the type of loan required by the borrower; and
    - a finance broker must give the borrower a comparative statement of the commission which might be paid by each lender and whether any other remuneration may be paid to any person by the lender if the lender were to provide a loan to the borrower; and
- when a finance broker arranges for a re-financing, it must explain to the borrower how the borrower's existing financial commitments compare to the commitments the borrower will have if they enter into the new loan (*restricted finance broking*).

4. Victoria

In Victoria, finance brokers are regulated under the *Consumer Credit (Victoria) Act 1995* (Vic).

4.1 Which intermediaries?

Part 4A of the Act regulates anyone who engages in finance broking. The Act defines engaging in finance broking as:

- negotiating consumer credit for a fee; or
- holding oneself out to the public as being prepared to negotiate consumer credit for a fee.

However, section 37B provides that the Governor in Council may declare that Part 4A does not apply to specified persons, transactions or classes of persons or transactions. By the Victorian Government Gazette dated 29 June 2000 the Governor in Council declared the following persons exempt from the operation of Part 4A:

> a person who in association with a bona fide business of supplying land or goods or services negotiates consumer credit for persons who are dealing with the first mentioned person in the ordinary course of that bona fide business and does not otherwise negotiate consumer credit.

Accordingly, as in Western Australia, retailers and other suppliers such as motor vehicle dealers are exempt.

4.2 What type of credit contracts?

The Act applies only to negotiating credit contracts and leases which are regulated by the Consumer Credit Code.

4.3 Negative licensing

Victoria does not have a positive registration or licensing regime. It relies on a negative licensing regime under which persons conducting activities of the type regulated by the Act can be prohibited from trading as finance brokers.

4.4 Conduct requirements

Section 37J of the Act provides that a finance broker must not demand, receive or accept any fee in respect of negotiating consumer credit unless:

- the finance broker has been appointed by the client in writing to negotiate consumer credit on their behalf;
- the document of appointment sets out the fee to be charged or its method of calculation;
- where the credit sought is a loan (the requirements are different for leases), the document of appointment specifies:

  - the amount of credit, or if the amount of credit is not ascertainable, the maximum amount of credit or credit limit to be negotiated under the credit contract;
  - if there is a term of the credit contract, that term;
  - the maximum annual percentage rate or rates the client is prepared to pay;
  - the duration of the appointment; and
  - an agreed maximum amount of credit application fees and valuation fees that the client may be required to pay,
- the client has signed the document of appointment before the finance broker commences negotiating consumer credit on their behalf;
- the client is given a copy of the signed document of appointment before the finance broker commences negotiating consumer credit on their behalf; and
- the client accepts the consumer credit that is specified in the document of appointment or consumer credit negotiated by the finance broker that is reasonably comparable to the consumer credit specified in the document of appointment.

The definition of "fee" does not expressly include or exclude credit provider commissions and so it is unclear whether the absence of a compliant written agreement with a client prevents a broker from collecting commission from a lender. However Consumer Affairs Victoria has said that the client agreement must include "commission payable to the broker by anyone other than the consumer" and "any soft commission available to the broker from or through the credit provider".[2]

Under section 37N of the Act, a consumer can apply to the Victorian Civil and Administrative Tribunal to recover as a debt any fee to which a broker is not entitled or apply for an order requiring the finance broker to repay the fee.

Other conduct requirements include restrictions on collection of valuation fees and application fees, a prohibition on false or misleading statements and concealment of material facts and a requirement to retain appointment documentation for 7 years.

5. New South Wales

New rules for finance brokers were introduced in amendments to the *Consumer Credit Administration Act 1995* (NSW) effective as at 1 August 2004. Given that it has been suggested that template legislation for national regulation of finance brokers should closely follow the NSW model, this paper discusses the NSW requirements, and some issues and difficulties with the NSW requirements, in some detail.

5.1 Which intermediaries?

The Act regulates the conduct of a person who engages in financing broking. A person

2 Financial Services, Mortgage and Finance Brokers, January 2005 published by Consumer Affairs Victoria and available at www.consumer.vic.gov.au

does so if they act, or purport to act, as an intermediary to negotiate and obtain consumer credit for a person in return for a commission or financial benefit, whether payable to the intermediary by the person, a credit provider or any one else. There is no vendor or supplier exception so, subject to the comments in 5.7(c) below, the Act applies to intermediaries of all types including retailers and motor vehicle dealers.

5.2 What type of credit contracts?

The legislation applies only to negotiation of credit provided under a credit contract regulated by the Consumer Credit Code. While an entity will engage in the business of finance broking if it acts as an intermediary to negotiate and obtain a consumer lease, the operative provisions apply only to credit to be provided under a credit contract within the meaning of the Consumer Credit Code, and so do not apply to consumer leases.

5.3 Negative licensing

New South Wales does not have a positive registration or licensing regime. It relies on a negative licensing regime under which persons conducting activities of the type regulated by the Act can be prohibited from trading as finance brokers. This was also the case under the New South Wales law prior to the 2004 amendments.

5.4 Conduct requirements

(a) Requirement for a finance broking contract

Under section 4C of the Act a finance broker cannot negotiate Consumer Credit Code regulated credit for a consumer until the consumer has signed a written Finance Broking Contract (***FBC***) which contains details of the credit the consumer wants the finance broker to obtain on their behalf. An FBC must be entered into prior to the finance broker commencing work irrespective of whether a commission is payable by the consumer. A copy of the FBC must also be given to the consumer before finance broking begins.

(b) Commission disclosure in an FBC

(i) Commission is very broadly defined by the Act. It includes any fee, charge, reward or other remuneration (monetary or not and whether characterised as a termination fee or not).

(ii) The FBC should state the amount of any commission payable by the consumer to the finance broker. If the exact amount is not known, the method of calculating the commission or an estimate of the amount that will be payable if the credit is provided on the terms set out in the FBC must be given (section 4C(3)(k)). When and how such commission is payable by the consumer to the finance broker must also be disclosed (section 4C(3)(l)).

The FBC should also disclose whether commission will be charged if the consumer refuses the credit secured by the finance broker. If the consumer chooses not to proceed with the loan, the finance broker can only claim commission if the finance broker and the consumer have agreed

previously in the FBC that commission may still be charged in those circumstances and if the consumer did not terminate the FBC before the finance broker secured the credit approval (section 4B(2)).

(iii) If a finance broker requires a commission from the consumer directly, the finance broker cannot demand an up-front payment. Commission can only be claimed from the consumer after the credit is obtained and if the credit matches the terms and conditions outlined in the FBC (section 4E).

(iv) The finance broker must include the following statements in an FBC:

- a statement as to the fact that the finance broker will receive a financial or other benefit from a person(s) other than the consumer;
- a statement indicating the highest and the lowest amount of the financial or other benefit the finance broker would receive from different credit providers if they were to provide consumer credit to the consumer;
- an undertaking by the finance broker that it will, after recommending to the consumer a particular consumer credit product and before the consumer enters into any credit contract with the credit provider, disclose the following matters to the consumer:
    - the amount of the financial or other benefit that the finance broker will receive from the credit provider;
    - whether or not the finance broker can determine or recommend conditions (eg interest rate, fee or term of the loan) and the effect of any such conditions on the amount the finance broker will receive from the credit provider;
    - any financial or other benefit that a person other than the finance broker (eg an employer of the finance broker or a company of which the finance broker is a director) will receive from the credit provider, if the benefit is likely to influence the finance broker's recommendations; and
    - any other interests or relationships that may influence the finance broker's recommendations.

The information required to be disclosed pursuant to the undertaking in the FBC must be given to the consumer before they sign the relevant credit contract.

The financial or other benefit referred to above may be expressed as a dollar amount or, if the total amount or value of the benefit is not ascertainable at the time that the disclosure is made to the consumer, it may be expressed by a description of the method of calculating the benefit. In either case any amount that represents the GST payable in respect of the benefit must be included.

The requirement to disclose the ability to determine or recommend conditions, in particular, is a key issue for intermediaries such as home loan originators and motor vehicle dealers who have a discretion to set their customer's interest rate and/or establishment fee. They have to tell consumers they have discretion to set the rate of interest the consumer pays and/or the amount of the establishment fee and that the higher that rate/fee, the more the originator earns.

(c) Other prescribed information an FBC

An FBC must also contain the following prescribed information:

- the total or maximum amount of credit the consumer wants;
- if the consumer credit is to be for a fixed term, that term;
- the maximum periodic repayment the client is prepared to pay (including repayment charges);
- if the consumer credit is not intended to be repaid at regular intervals, the repayment arrangements acceptable to the client (including for the repayment of any credit application fee, credit establishment fee or other fee);
- the maximum interest rate the consumer will accept;
- the date by which the credit is to be secured;
- a statement that the finance broker's recommendations will be drawn from a range of potential lenders that does not necessarily include all lenders who offer consumer credit of the nature of the consumer credit being sought;
- name, address and company details of the finance broker;
- any specific features the consumer wants in the credit product (such as a redraw facility); and
- if any financial or other benefit has been or will be paid by the finance broker to a person for referring potential clients to the finance broker, the amount of any such benefit and the name of the person.

The payment of commission to a finance broker by a consumer depends on the terms of credit being the same as those agreed to between the consumer and the finance broker in the FBC. For example, a finance broker must not accept any commission from a consumer in respect of finance broking if the amount of consumer credit secured is not the same as the amount specified in the written FBC. Further, the finance broker cannot charge a commission greater than that disclosed in the FBC.

(d) Records

A finance broker must before or immediately after entering into a transaction, record the full particulars of that transaction, including a copy of the relevant FBC.

This record must be kept for a period of at least 7 years after the date of the transaction to which the record relates. It is unclear what "full particulars" means, but it appears that just preserving the relevant written FBC is insufficient because of the use of the term "including" in the legislation.

(e) Fees

There are strict rules in the Act about brokers demanding, receiving or collecting valuation fees, credit application fees and credit establishment fees.

Valuation fees may only be accepted by a finance broker from a consumer if they are in the form of a cheque, money order or transfer made out to the valuer, and if the finance broker is authorised by the credit provider to instruct the valuer. These fees must be passed on by the finance broker to the valuer as soon as practicable after receipt.

Section 4I of the Act provides that a broker must not demand, receive or accept from a client any credit application fee or credit establishment fee unless:

- it is authorised to act on behalf of the credit provider; and
- it will itself incur the costs of determining the application and/or the initial administrative costs of providing the credit, or both.

Credit application fee and *credit establishment fee* are each defined as a fee charged by a credit provider, or a person authorised to act on behalf of a credit provider, for determining an application for consumer credit or the initial administrative costs of providing consumer credit, or both.

The second reading speech for the amending Act which introduced section 4I provides that:

> ... finance brokers may sometimes be authorised to ... assess the credit application or establish the credit contract on the credit provider's behalf. Therefore the bill allows a finance broker to accept a[n] ... application or establishment fee made payable to the broker if the broker is authorised to undertake these functions on the lender's behalf.

If an up-front fee is a "credit application fee" or "credit establishment fee", the Intermediary can only collect the fee if it incurs the costs of determining the application and/or the initial administrative costs of providing the credit. Any fee of this sort which a broker is authorised to collect and retain will be a "commission" which needs to be disclosed in the FBC.

If the intermediary itself does not incur the costs of either or both of those activities, the intermediary is prohibited from collecting such a fee. In other words, it must not charge an origination fee which represents payment for those two activities if it does not actually incur the costs of those activities.

(f) Penalties and disciplinary action

(i) Finance brokers face penalties of up to $5,500 for breaches of individual provisions of the new laws.

(ii) If a consumer believes the FBC has been breached by the finance broker or the finance broker has charged an excessive commission or otherwise acted unjustly in relation to the FBC, the consumer can apply to the Consumer, Trader and Tenancy Tribunal (the ***Tribunal***) for an order. The Tribunal may order the finance broker to pay a specified amount to the consumer. The Tribunal may also order that an amount is, or is not, owing to the finance broker and that the finance broker take or refrain from taking specified actions. If the Tribunal finds that a finance broker is guilty of an offence under these provisions, it may order the finance broker to refund any amount received or accepted in contravention of the Act with interest payable for the period from the time of the receipt or acceptance of the amount until the time it is refunded. If the finance broker fails to adhere to a Tribunal order, they could face a maximum penalty of up to $11,000 and/or 12 months imprisonment.

(iii) In addition to these new penalties, the disciplinary regime in the *Consumer Credit Administration Act 1995* (NSW) continues to apply to broking transactions. The Commissioner for Fair Trading can take disciplinary action against a finance broker such as prohibiting them from trading as a finance broker.

5.5 The aggregator/back office exemption

Regulation 2B of the *Consumer Credit Administration Regulation 2002* (NSW) is designed to exempt from the Act finance brokers who do not deal directly with the public, for example, those who are "aggregators" and those who technically fall within the definition of finance broking but carry on "back room" servicing functions. It says:

> For the purposes of section 4B(2) of the Act, finance brokers who act as intermediaries for other finance brokers and who:
>
> (a) do not deal directly with the persons for whom consumer credit is or is to be obtained, or
>
> (b) deal directly with such persons but only in relation to matters that are incidental or ancillary to the obtaining of consumer credit for such persons,
>
> are prescribed as a class of finance brokers to whom Part 1A of the Act does not apply.

If the legislation operates at the level of the entity which runs the finance broking business, rather than at the individual employee level (as I believe, for the reasons given in 5.7(a) below, that it should) then there is a significant issue with this exemption for some organisations, for example:

- those who operate both "front of house" sales functions and "back room" servicing functions (particularly if the back room function supports sales made by other organisations as well as its own); and
- those who are an "aggregator" and also have some direct clients.

For those organisations a single direct dealing with any customer through a "front of house" sales function will remove the benefit of the exemption entirely for the whole organisation. This would mean, for an organisation with a "back room" servicing function, that technically

the "back room" division will need to issue an FBC to each customer with whom they deal in a servicing/incidental/ancillary role (eg a telephone call to verify income information) unless that customer has already received an FBC from that organisation. The customer will have already received an FBC where the back office function is supporting the sales process of a different division of the same legal entity. However that will not be the case if the back office function is supporting the sales process of a different legal entity which is a finance broker.

For an "aggregator" it may mean an obligation to issue an FBC to every customer introduced through a "sub-introducer" or "sub-originator" as well as to all customers it deals with directly, even though a customer introduced through a "sub-introducer" or "sub-originator" also enters into an FBC with the "sub-introducer" or "sub-originator".

The double disclosure in either case will be confusing for the customer.

Accordingly I believe that for regulation 2B to have the desired result it should be amended so that it operates *to the extent* that the finance broker has no direct dealings other than incidental ones.

5.6 Exemption for exclusive and first choice arrangements

(a) Policy and the level playing field

When the new New South Wales legislation was passed there was substantial protest by some sectors of the market. In particular, brokers who offer securitised loans through a "single brand" shop front argued that from a policy perspective they should be treated no differently from traditional lenders (such as the banks) because a customer approaching their shop front is seeking that particular brand of loan, thinks they are dealing with a "lender" and does not understand that the loan is in fact provided by the trustee of a securitisation trust. These originators argued strongly that they should be exempt so as to create a level playing field with the "real lenders".

The regulators accepted this from a policy perspective and so prepared a further exemption in a draft regulation 2BA. The intention of this regulation was to exempt originators or brokers who have arrangements with only one lender[3].

After further submissions from the industry the New South Wales Department of Fair Trading acknowledged that the exemption should be extended to "first choice" arrangements so that an originator of this sort would not lose the benefit of the exemption entirely just because, having satisfied themselves that a prospective customer either was not eligible for, or did not want, one of the shop front "brand" loans, they offered an alternative loan product. However the intention is that, as soon as it is clear that the customer does not want or is not eligible for the first

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[3] This view is confirmed in the National Finance Broking Regulation Regulatory Impact Statement Discussion Paper where it is said "In such cases, it is considered that no useful protection would be provided to the consumer by issuing a finance broking contract and making the disclosures required by the legislation". This ignores the fact that some intermediaries eligible for this exemption may be in a position to set individual customer interest rates and/or establishment fees (and so increase their own remuneration) and so are not on the same "playing field" as lenders with published rates and fees which apply to all customers.

choice "brand loan", the exemption ceases and the finance broker must comply with the Act in relation to their conduct from that point on in discussing and offering alternative loans to that customer.

Regulation 2BA(1) now provides that Part 1A of the Act does not apply to finance brokers to the extent their actions satisfy the requirements set out in regulation 2BA(2). Regulation 2BA(2) provides that the exemption only applies to finance brokers who, among other things:

(i) have entered into an exclusive arrangement[4] with, or in relation to, a credit provider, or a first-choice arrangement[5] with, or in relation to, a credit provider to offer consumer credit advertised or promoted under a single brand, trademark or business name; and

(ii) advertise or hold themselves out in such a way, and carry on business at premises or under circumstances in such a way, that clients or prospective clients are reasonably likely to assume that the only consumer credit that may be negotiated or obtained by them is consumer credit advertised or promoted under the brand, trademark or business name referred to in (i) above.

(b) Single brand

The relevant test is whether the exclusive arrangement or the first -choice arrangement with the intermediary relates to a single brand, irrespective of whether the lender offers other brands through other channels. For example, if a vehicle financier has an exclusive or first-choice arrangement with a motor vehicle dealership relating only to car loans sold under a specific brand then that dealer would satisfy the regulation 2BA(2)(a) requirement. This is despite the fact that the vehicle financier also offers other brands through other channels.

(c) Exclusive or first-choice arrangements

Intermediaries who offer more than one "brand" of loan will not have an exclusive arrangement. They may have a first-choice arrangement. The first-choice arrangement must be such that the intermediary agrees with a lender that it will

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[4] "Exclusive arrangement" means an arrangement in respect of a class of consumer credit:

- between a finance broker and a credit provider (or other specified persons);
- under which it is agreed that the only consumer credit in relation to which the finance broker will act as an intermediary to negotiate and obtain for its clients is consumer credit provided by that credit provider; and
- under which the finance broker has no discretion to choose between credit providers.

[5] "First-choice arrangement" means an arrangement in respect of a class of consumer credit:

- between a finance broker and a credit provider (or other specified persons);
- under which it is agreed that the finance broker:
- will first act as an intermediary to negotiate and obtain for its clients consumer credit provided by that credit provider; and
- may then act as an intermediary to negotiate and obtain consumer credit from other credit providers if, after proper consideration the finance broker first determines that the client is not eligible for credit provided by the first-choice credit provider or the client is eligible but declines the credit.

first negotiate and obtain loans provided by that lender, and only after the intermediary determines that the client is not eligible for a loan provided by that lender or the client is eligible but declines that lender's loan, will it negotiate and obtain loans from other lenders.

Once the intermediary begins to negotiate other lenders' loans, the exemption ceases and the intermediary must comply with the finance broking provisions of the Act.

(d) Reasonably likely to assume

The "reasonably likely to assume" test is subjective and satisfying it will depend on the facts. It is unlikely to be an issue for a heavily branded shop front like a Wizard Home Loans franchise, but may be more of an issue for a retailer or other supplier (such as a motor vehicle dealer) seeking to rely on the exemption.

(e) Conclusion

In order to qualify for the exemption, intermediaries need to ensure that:

(i) they have an exclusive arrangement with a lender under which they will only offer loans provided by that lender and not other lenders, or a first-choice arrangement under which they will first offer loans provided by that lender before considering other lenders' loans;

(ii) the exclusive or first-choice arrangement is to offer loans (from that lender) advertised or promoted under a single brand; and

(iii) they advertise or hold themselves out in such a way, and carry on business at their premises or under circumstances in such a way, that clients or prospective clients are reasonably likely to assume that the only loans that may be offered by them are those advertised or promoted under that brand.

5.7 Particular problems with the NSW legislation

(a) Potential application to individual employees of finance brokers

There has been some confusion about how the Act applies to employees. There is some language in the Act which suggests that, where a broking business is carried on by a corporation, the Act applies at the employee level rather than the employer level. For example, regulation 2D(1)(c)(iii) requires disclosure in an FBC of "the amount of any financial or other benefit that a person other than the finance broker (such as the finance broker's employer or a company of which the finance broker is a director) will receive from the credit provider..."

When I raised the issues described in 5.5 above in relation to regulation 2B with the NSW Department of Fair Trading it was suggested to me that the issues I see with regulation 2B do not arise because the use of "person" in the Act is intended to mean "natural person" and that the Act applies to each and every individual in, or employed by, an organisation who engages in the negotiation of regulated credit. It was argued that accordingly the availability of the exemption is tested at the individual or employee level, and so a "back office" employee with no sales role

will qualify for the exemption even if another employee of the same organisation performs a sales role and does not have the benefit of the exemption.

I do not accept that is the correct construction of the legislation, but if it is then the following issues and difficulties emerge.

(i) ***Employees of lenders***

Every employee of a bank or finance company in a sales role whose remuneration is performance based, or has an element of reward for sales or contracts entered into, would arguably be "engaging in finance broking" (arguably they could even be caught if they were on a straight salary if that is still a "financial benefit" payable by the employer, the credit provider).

(ii) ***Is personal liability appropriate?***

It is an unusual step to make an employee who is not an "officer" personally responsible for compliance with legislation and personally liable for non compliance. Personal responsibility and liability are appropriate for a sole trader or the "principal" of an incorporated entity, but arguably are not appropriate for an employee in a larger organisation who has no role in management and relies on their employer to train them in compliance matters (unless the employee engages in fraud or other misconduct).

(iii) ***Problems with section 4***

Section 4 of the Act says "For the purposes of this Act, the conduct of an officer, employee or agent of a credit provider or finance broker acting within his or her actual or ostensible authority will be imputed to the credit provider or finance broker and taken to be the conduct of the credit provider or finance broker." If this legislation operates at the employee level, and makes employees individually liable as finance brokers, then it seems that reliance on section 4 provides the only avenue of redress against employers. It is exceptional not to find a remedy which applies directly to the employer above and beyond imputed liability under section 4.

Further, there is a technical issue with the language of section 4. The conduct which is imputed is that of an employee or agent of a finance broker. A finance broker is defined as a person who engages in finance broking. Section 3(3) provides that a person engages in finance broking if the person ("the intermediary") acts, or purports to act, as an intermediary to negotiate and obtain consumer credit. So a body corporate can only be a finance broker if it acts as an intermediary to negotiate and obtain credit. Of course, the only way it can act is through the natural persons who are its employees and agents, and this is the link section 4 is intended to provide. By imputing the conduct of an employee to its employer, the employer acts as an intermediary to negotiate and obtain credit and therefore is a finance broker. However, the technical problem is one of circularity. The only conduct of an employee or agent which is imputed is

conduct of an employee or agent of a finance broker, but a body corporate cannot be a finance broker until conduct of an employee or agent is imputed to it.

Great reliance seems to be placed on section 4 to ensure that finance brokers are appropriately regulated. While a court would probably interpret the section to overcome the technical issue, it is one which should not be replicated in the national regime.

(iv) ***Multiple contracts***

Section 4C(1) of the Act prohibits engaging in finance broking unless the finance broker has first entered into an FBC. This means no actions as an intermediary to negotiate or obtain consumer credit can occur before the FBC is actually entered into. The practical issue for finance brokers is, therefore, precisely at what point do they start acting in that capacity. To avoid the serious consequences which flow from a breach of section 4C, prudence should dictate that the very first thing a broker needs to do with an applicant is enter into the FBC. If the correct construction of the legislation is that each employee who negotiates credit for customers engages in the business of finance broking and must personally comply then each such employee will need to enter into an FBC with the consumer (an ***Employee Contract***).

Section 4 of the Act (leaving aside the technical argument mentioned above) imputes the employee's conduct to the employer such that the employer is also taken to negotiate consumer credit. Is the employer also required, therefore, to enter into an FBC with the consumer (the ***Employer Contract***)?

Further, on that analysis, I think it is reasonable to expect situations in which an applicant will receive several Employee Contracts. If a different employee engages in relevant conduct (for example because the first employee a customer deals with is on a lunch break, absent through illness etc) then arguably he or she must issue a new FBC before taking over the negotiations for the customer.

(v) ***Scope for avoidance – no "business"***

Section 4B has the result that the regime applies in respect of a finance broker "only insofar as consumer credit to which **the business of the finance broker relates** is or, includes, credit to be provided under a credit contract..." (emphasis added). If the "finance broker" is the individual and that individual is an employee of an organisation then the individual does not have, or carry on, a business. Accordingly the policy objectives of the legislation could be thwarted as individual employees could argue they were not caught.

(vi) ***Scope for avoidance – benefits not derived by employee***

I read section 4C(3)(m) of the Act to require, in an Employee Contract, the employee to include a statement as described only if the employee will receive a financial or other benefit from someone other than the client. Similarly, the employer is required (assuming an Employer Contract is required) to include in the Employer Contract a statement as described only if the employer will receive a financial or other benefit from someone other than the client.

Even if (still assuming the need for an Employer Contract) the Employee Contract and Employer Contract were combined into one contract (to prevent the likely confusion if an applicant received 2 very similar FBCs), in my view it would be necessary to clearly distinguish between the finance broking engaged in by the employee and the finance broking imputed to be engaged in by the employer. Section 4 of the Act does not somehow merge the 2 separate legal persons, the employer and the employee, into one, and therefore the financial benefits to be received by each of them must be disclosed in an FBC entered into by each of them under section 4C(3)(m) of the Act.

If the employee fails to disclose in the Employee Contract financial benefits payable to him or her, in breach of section 4C(3)(m) of the Act, that constitutes a breach by him or her and that failure is conduct which is imputed to the employer and is therefore also a breach by the employer. However, because the employee is not required under section 4C(3)(m) of the Act to disclose financial benefits payable to the employer, a failure to do so has no consequence, either for the employee or for the employer. The further disclosure required after a recommendation is made but before a credit contract is entered into under section 2D(1)(c) will, however, include financial benefits payable to the employer.

Finally, I note that failure by an employer to disclose financial benefits payable to it, in breach of section 4C(3)(m) of the Act, is not conduct which is imputed to the employee.

(vii) ***Scope for avoidance – certain prohibitions ineffective***

The prohibitions in sections 4C(4), 4D and 4F of the Act would not attach to employees who receive no commission from a client because lender commission arrangements are with the legal entity which runs the business (the employer). This issue does not arise if the prohibition attaches to the employer rather than the employee.

It is clear that the legislation does not work as intended if you apply it to each employee working in a finance broking business, rather than to the legal entity which runs that business (often a corporation). The legislation should be amended to clarify its operation. These difficulties should not be replicated in the proposed national template legislation (see 9 below).

There are many potential levels at which the legislation could "bite" given the roles of originators, sub-originators, aggregators and franchisors/franchisees in the finance broker market. It seems to me that the policy objective is best achieved by applying the legislation to the legal entity which runs the business, in the course of which that legal entity (where it is a sole trader) or the legal entity's employees (where it is a corporation) physically interact with customers in a sales process, on the basis that it is amounts earned by that entity which are likely to influence the conduct of that entity. This means that where a shopfront is:

- a franchise, the franchisee (not the franchisor) should comply; or
- a "sub-introducer" or "sub-originator" who effects customer introductions through, and obtains commissions from, an "aggregator", the sub-introducer and not the aggregator should comply,

and where the franchisee or sub-introducer is a corporation, it should be the corporation which needs to comply. If amounts earned by others in the chain back to the lender (for example an aggregator or mortgage servicer) could reasonably be expected to influence the recommendation of the entity with the direct contact with consumers then regulation 2D(1)(c)(iii) will, at least in theory, require the disclosure of those amounts. If regulation 2D does not adequately capture all such amounts it should be amended.

If individual employees are on specific reward or bonus schemes which are such that they personally benefit if they recommend one lender over another then, from a policy perspective, that should be disclosed. However, the way to address that is by a specific provision to cover the issue, not by seeking to apply all the requirements to every employee.

(b) Issue with the definition of "engages in finance broking"

For the purposes of the Act, a person "engages in finance broking" if the person ("the intermediary") acts, or purports to act, as an intermediary to negotiate and obtain consumer credit for a person (other than the intermediary's employer, or a principal who is not a client of the intermediary) in return for a commission or financial benefit, whether payable to the intermediary by the person, the credit provider or any other person or body (section 3(3)).

I struggle to understand the words "other than ...a principal who is not a client of the intermediary". I note the recommendations for the national template (see 9 below) specifically adopt the NSW definition including these problematic words.

(c) Is there in effect a vendor/supplier exemption?

As indicated in 5.7(a)(v) above, the limitation of the Act to credit regulated by the Consumer Credit Code has been achieved through section 4B which says:

> This Part applies to and in respect of a finance broker only in so far as consumer credit to which the business of the finance broker relates is, or includes, credit to be provided under a credit contract within the meaning of the *Consumer Credit (New South Wales) Code.*

On one view this section suggests that intermediaries who carry on a business other than a business which relates to consumer credit may not be caught. In order to be caught a finance broker needs to satisfy two tests, namely:

- the business of the finance broker needs to "relate" to "consumer credit"; and
- the "consumer credit" to which the business of the finance broker "relates", must be, or include, credit to be provided under a credit contract within the meaning of the *Consumer Credit (New South Wales) Code.*

Accordingly, the "includes" test is only relevant to the second element. The first element is that the business of the finance broker needs to "relate" to consumer credit as defined in the Act. The definition of "finance broker" prior to amendment included the words "whether or not carrying on any other business". Those words have been removed. This removal may support an argument that the "business" of the intermediary needs to be solely or primarily a business relating to consumer credit in order for Part 1A to apply.

Accordingly, I can see a basis on which it might be said that, unless the sole or primary business of the intermediary is consumer credit (as defined), the result of the operation of section 4B is that Part 1A has no application. If that were the case then motor vehicle dealers and other suppliers would be exempt, as is the case in each of the ACT, Victoria and WA. I understand from speaking to the NSW Department of Fair Trading that is not the intended interpretation of section 4B.

This is another example of the NSW legislation being less than clear, and another area where it is to be hoped that national template legislation will provide more clarity.

6. Other States and Territories

There is currently no specific regulation of finance broking in Queensland, South Australia, Tasmania or the Northern Territory.

7. Federal regulation

From 11 March 2002, the Australian Securities and Investments Commission (***ASIC***) took over responsibility from the Australian Competition and Consumer Commission for administering a number of consumer protection provisions relating to credit.

The *Australian Securities and Investments Commission Act 2001* (Cth) (the ***ASIC Act***) gives ASIC power to regulate credit facilities. A *credit facility* is broadly defined and includes:

- credit cards;
- small business overdraft facilities;
- investment loans;

- hire purchase agreements;
- personal and home loans;
- mortgages and guarantees which secure borrowings; and
- negotiable instruments including bills of exchange and promissory notes used to provide credit.

The ASIC Act does not prescribe detailed disclosure or contractual requirements but rather more generally prohibits unconscionable conduct, and provides consumer protection, in relation to financial services including credit.

Making recommendations or stating opinions that are intended to influence a person in making a decision in relation to a particular financial product is providing a financial service for the purposes of the ASIC Act. Accordingly the conduct provisions apply to broking services on the basis that those services constitute financial product advice and on the basis that the conduct of the finance broker in arranging a credit facility is "in connection with" the supply or possible supply of a financial product.

ASIC has said that its regulatory priority is to "focus on issues that are national in scope and/or have a clear systemic aspect"[6]. It expects to take a close interest in credit advertising and marketing campaigns to make sure they are not misleading or deceptive. Where a consumer has a problem with a particular loan or credit product, ASIC will usually play a referral role rather than help the consumer directly.[7]

7.1 Unconscionable conduct

A person must not in connection with the supply or possible supply to a person of financial services of a kind ordinarily acquired for personal, domestic or household use engage in conduct that is, in all the circumstances unconscionable (section 12CB of the ASIC Act). Factors which a court may have regard to in determining whether a breach of this provision has occurred include:

- whether the consumer was able to understand any documents relating to the supply or possible supply of the services; and
- whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the consumer by the supplier or a person acting on behalf of the supplier in relation to a supply or possible supply of the services.

A similar provision is contained in section 12CC of the ASIC Act and applies where financial services are being acquired for the purpose of trade or commerce and where the "price" of the services does not exceed $3,000,000. In the context of a loan the "price" includes the capital value of the loan or loan facility.

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[6] National Finance Broking Regulation Regulatory Impact Statement Discussion Paper, section 3.1.2 page 30 quoting from www.asic.gov.au/asic/asic_polprac.nsf/byheadline/Credit + homepage.

[7] Ibid

7.2 Misleading or deceptive conduct

Section 12DA of the ASIC Act contains a prohibition on engaging in conduct in relation to financial services that is misleading or deceptive or is likely to mislead to deceive.

7.3 Implied warranty

In every contract for the supply of financial services to a consumer there is an implied warranty that:

- the services will be rendered with due care and skill; and
- any materials supplied in connection with those services will be reasonably fit for the purpose for which they are supplied (section 12ED of the ASIC Act).

Further, if a consumer expressly or by implication makes known to a person any particular purpose for which financial services are required, or the result that he or she desires financial services to achieve, there is an implied warranty that the services will be reasonably fit for that purpose or are of such a nature and quality that they might reasonably be expected to achieve that result. There is an exception if the circumstances show that the consumer does not rely, or it is unreasonable for him to rely, on the person's skill or judgement (section 12ED(2) of the ASIC Act).

7.4 Remedies

If there is a breach of the provisions of the ASIC Act referred to in 7.1 or 7.2 above then the court has very broad powers (under section 12GM of the ASIC Act) to make orders including:

- for compensation;
- declaring the whole or any part of a contract to be void;
- varying a contract;
- refusing to enforce all or any provisions of a contract; and
- directing a person to refund money.

8. Self regulation

The two main industry bodies representing finance brokers are the Mortgage Industry Association of Australia (***MIAA***) and the Finance Brokers Association of Australia (***FBAA***).

Each of these bodies has a code of conduct which it requires its members to subscribe to.

The MIAA Code is under review but in the meantime MIAA members are required to adhere to the current Code. That Code contains, among other things:

- broad obligations in relation to qualification and experience;
- an obligation to undertake continuing education;
- a requirement for professional indemnity insurance;
- practice standards including:

- an obligation to suggest or recommend only mortgage finance that the member genuinely and reasonably believes is appropriate to the needs of the applicant;
- an obligation not to engage in "churning";
- an obligation to make such enquiries as are necessary to determine an applicant's capacity to repay the proposed loan;
- timeframes within which loan applications must be submitted and within which applicants must be advised of the outcome of an application;
- disclosure obligations in relation to fees and commissions;
- an obligation to act with all due skill, care and diligence and to establish and maintain honest and honourable relationships with all persons with whom they come into contact in the course of their commercial activities;
- an obligation to ensure advertising will not be misleading, dishonest or deceptive; and
- an obligation to have a written internal complaints handling policy and, if a consumer is not satisfied with the way a complaint is handled, to tell the consumer about the Credit Ombudsman Service.

The FBAA also has a code of practice which is currently under revision. A copy of the current code is not available on the FBAA's website.

9. Proposed national finance broking regulation

In late 2004 the Ministerial Council on Consumer Affairs released a Discussion Paper[8] detailing options for a national regulatory scheme for finance and mortgage brokers. Comments and submissions were invited, and closed on 15 February 2005. As indicated in the Discussion Paper, the proposals adopt aspects of the current regulation of finance brokers in Western Australia (largely the proposals in relation to licensing) and aspects of the new regime in New South Wales (in particular its disclosure requirements). The proposals in the Discussion Paper do not have the approval of any state or territory government at this stage. They are currently going through a regulatory impact assessment.

Following is a summary of the proposals canvassed in the Discussion Paper.

9.1 All credit, but with a "big business" exemption

That finance broking legislation should cover all credit except where the prospective borrower is a business entity and:

(a) it employs more than:

- 100 people if it is a manufacturing business; or

[8] National Finance Broking Regulation Regulatory Impact Statement Discussion Paper

- otherwise, 20 people; or

(b) it is seeking more than $2 million.

This includes leasing, although the Discussion Paper indicates that the possibility of exempting commercial lease broking has been raised by industry and that further comment on this issue is welcome.

9.2 Licensing

That a licensing scheme be introduced. Any licensing scheme would:

- require an applicant to be a "fit and proper" person
- impose probity checks to include:
    - convictions for offences involving dishonesty;
    - cancellation of any licence, registration or permission to trade in a regulated occupation, profession or business;
    - undischarged bankrupts;
    - a person who has breached any undertaking in relation to fair trading legislation;
- exclude a person from being a director of a finance broking business if they have been disqualified from trading;
- exclude persons under 18; and
- exclude any mentally incapacitated person.

The Discussion Paper suggests that consideration may be given to allowing states and territories to go their own way on this issue (as they currently do in relation to licensing of both finance brokers and credit providers) so this is one aspect where there may not be national uniformity.

9.3 Who needs a licence?

A designated person would be responsible for carrying out the requirements of applicable legislation and would be accountable for any deficiencies in the performance of those requirements.

Sole traders would need to hold a licence.

If a business was set up as a partnership all trading partners should be separately licensed.

Where a company has a small number of employees or contractors who are subject to the control and supervision of the employer, then only the employer need be licensed.

Where the employer is geographically distant, and there are a large number of branches with finance broking business being carried on by one or more finance brokers, then each branch should have at least one licensed finance broker on the premises who has an appropriate supervisory capacity in respect of other finance brokers on the premises. All those carrying out finance broking functions must be authorised by a licensee to do so,

whether the employer or the person on the premises, depending on the corporate structure and the devolution of responsibilities.

9.4 Training

That a training scheme be introduced which operates in a similar way to the ASIC scheme for financial product advice in targeting the required skills, but which is flexible with respect to the knowledge and skills of finance brokers making the transition from the unregulated market to a regulated market.

9.5 Written contract

That finance brokers enter into a written contract with a consumer[9] before commencing finance broking and that the contract detail the finance broker's access to credit providers as well as details of the credit required by the consumer.

It is proposed that Divisions 2, 3 and 4 of Part 1A of the *Consumer Credit Administration Act 1995* (NSW) be used as a basis for disclosure requirements, but that consumer remedies would be available as outlined below. It will be important that the current difficulties with the NSW requirements (see 5.5 and 5.7 above) be addressed and not replicated in a national regime.

9.6 Statement of reasons

That finance brokers provide the consumer with a statement of reasons setting out why the credit product recommended by the finance broker is the most appropriate product for the consumer's circumstances.

The statement of reasons could be required to address how the credit product recommended by the finance broker meets the specifications in the written contract and why the particular features of the loan make it the most appropriate product for the consumer's circumstances. If cheaper finance is available the statement of reasons could explain why this has not been recommended.

If the finance broker recommends that the consumer refinance an existing credit facility, the statement of reasons could also address:

- why the new product is more beneficial for the consumer than the existing product;
- any charges the borrower will or may incur in relation to the disposal of the existing product;
- any charges the borrower will or may incur in relation to the acquisition of the recommended product;
- any pecuniary or other benefits the borrower will or may lose (temporarily or otherwise) as a result of taking the recommended action;

[9] While the term "consumer" is used throughout this summary of the proposals, it is not proposed that any distinction be drawn between a "consumer" loan or any other loan to which the broking legislation will apply. This means, for example, that the requirement for a written contract will apply equally to small business loans.

- any other significant consequences for the borrower of taking the recommended action;
- where a change in credit product is recommended because of features other than price, whether or not those features are available under the borrower's existing credit contract (and at what cost).

Where the capacity of the borrower to make repayments greater than the borrower's existing repayments is relevant to the recommendation, the statement of reasons should contain:

- a statement of what the repayments will be; and
- a comparison of the savings which would be achieved with the borrower's existing credit facility, if the consumer were to make the increased repayments to that facility.

Where the finance broker recommends that the consumer refinance to a line of credit facility, the statement of reasons should address why the consumer requires the extra credit provided by this facility, and what the repayments would be if the borrower draws down the full amount of credit available.

Where the finance broker recommends an interest-only loan, the statement of reasons should clearly state why this is better for the consumer than a principal and interest loan, and how the finance broker and consumer have agreed that the consumer will pay off the principal when it is due.

9.7 Reasonable basis for a recommendation

That finance brokers must have a reasonable basis for recommending or obtaining a particular loan for a consumer.

This requirement would go beyond the statement of reasons by requiring a loan to actually be suitable for a consumer rather than just requiring the finance broker to present arguments why the loan is suitable.

The ASIC guide PS175 provides useful guidance for financial product advisers on what is appropriate advice in respect of financial products. The relevant sections of that document could be adapted for use by finance brokers in assisting their understanding of "reasonableness".

9.8 Offences

Offences (criminal or monetary penalties consistent with the severity of the offence) would be created where certain requirements are contravened.

Compensation would be available to consumers where the contraventions result in consumer detriment. The finance broker would be required to compensate the consumer for any loss suffered from the finance broker's actions, including loss resulting from not having the protection of the Consumer Credit Code. There could be a requirement for any dispute resolution scheme to consider:

- costs involved in entering the credit contract;

- fees/commissions paid by the consumer to the finance broker or any other party;
- price of the product compared to an appropriate product;
- cost of refinancing to an appropriate loan; and
- value of any other loss suffered by the debtor as a result of being denied the remedies under the Consumer Credit Code.

In the event of consumer detriment a finance broker would not be entitled to be paid by the consumer for any finance broking services.

Administrative sanctions would be provided for breach of any licensing/registration requirements.

Remedies should also be provided in relation to excessive commissions.

9.9 Stay of enforcement

Where a consumer has a claim against a finance broker for compensation or damages (whether in the court or under an alternative dispute resolution scheme) which is in respect of conduct by the finance broker that the consumer claims has caused the mortgagee to embark on the forced sale of their home, the Court may order a stay of enforcement proceedings.

In determining whether a stay is appropriate, the court will have regard to:

- whether the home is the primary residence of the debtor;
- whether it is likely that the home could be saved if a stay is granted;
- whether the case against the finance broker is likely to result in damages which could be applied to reduce the amount of the loan due to the credit provider to such extent that the debtor could afford to make repayments; and
- whether the consumer can make a reasonable repayment arrangement during the hearing of the dispute.

The Court will have a power to compel documents and other evidence to be produced by the finance broker and credit provider and to compel the credit provider to participate in any negotiations.

The Court will have power to direct that damages due from the finance broker be paid to the credit provider to reduce the outstanding balance, if this will make the contract viable.

9.10 Insurance

In order to ensure that compulsory professional indemnity insurance provides consumers with the maximum possible protection, it is proposed that finance brokers be required to hold professional indemnity insurance which:

- covers risks which arise from the work which the finance broker actually undertakes, regardless of what name the finance broker gives to that work. For example, a broker may call him or herself a mortgage broker, but actually undertake the functions of a mortgage manager. Unless the policy takes account

of the nature of the work the finance broker undertakes, the finance broker may not be insured for liabilities incurred in the course of that work;

- covers conduct which can result in a claim for breach of contract and/or breach of the Trade Practices Act, the ASIC Act or fair trading legislation, where such a claim could also be made in negligence;
- provides continuous coverage for consumers. This means that the finance broker must be required to maintain continuous cover, with no gaps. If the policy is a "claims made" policy, the finance broker must also be required to maintain run-off cover for a suitable period after the finance broker ceases to trade (probably at least 6 years);
- provides for a monetary limit for claims of not less than $1 million;
- is provided by an insurer that is APRA regulated, and has a Standard & Poor's rating of "A" or higher;
- covers decisions of any accredited alternative dispute resolution scheme to which finance brokers are required to belong.

In view of the volatile nature of the insurance market, the requirement to hold professional indemnity insurance could be located somewhere other than in legislation (for example, in a regulation) so that it could be removed quickly if such insurance suddenly ceased to be available.

9.11 Alternative dispute resolution

That finance brokers be required to be a member of an alternative dispute resolution scheme approved by ASIC. The Credit Ombudsman Service Limited is already approved by ASIC.

10. Broker conduct - issues and risks for lenders

Generally a finance broker is an agent of the borrower and not the lender. However this is not universally true. Some intermediaries act as the lender's agent in taking applications and, in some cases, the preparation of loan documentation. For example, motors dealers are often an agent of the lender in at least some respects and mortgage managers in securitisation structures are usually an agent of the lender.

If an intermediary is an agent of a lender then its conduct will bind the lender and its knowledge will be imputed to the lender.

If an intermediary is not an agent of the lender then generally the lender will not be held responsible for the intermediary's conduct.

However the conduct of an intermediary, even one which is not an agent of the lender, does have the capacity materially to affect the lender and the risks to it. Following are some examples of where conduct of an intermediary can expose a lender to risks and problems.

10.1 Purpose declarations

An area in which lenders are potentially exposed by the conduct of intermediaries is in determining the purpose of a loan and the use of business purpose declarations.

The Consumer Credit Code applies to a credit contract if, when the contract is entered into, the debtor is a natural person and the credit is provided or intended to be provided wholly or predominantly for personal, domestic or household purposes (section 6(1)). Investment by the debtor is not a personal, domestic or household purpose (section 6(4)). Under the Code credit is presumed conclusively not to be provided wholly or predominantly for personal, domestic or household purposes if the debtor declares, before entering into the credit contract, that the credit is to be applied wholly or predominantly for business or investment purposes (section 11(2)). A declaration must be strictly in the form required by the regulations.

However, such a declaration is ineffective if the credit provider, or any other relevant person who obtained the declaration from the debtor, knew or had reason to believe at the time the declaration was made, that the credit was in fact to be applied wholly or predominantly for personal, domestic or household purposes. For this purpose a "relevant person" is a person associated with the credit provider or a finance broker (or a person acting for a finance broker) through which the credit was obtained. Accordingly if a declaration was obtained by a finance broker or any other entity acting as agent for the lender it will be ineffective if the person who obtained it knew or had reason to believe that it was untrue.

Unscrupulous finance brokers may ask or require an applicant to sign such a declaration knowing it to be untrue.[10] Through the use of purpose declarations finance brokers can seek to avoid the application of finance broker regulation in those jurisdictions where the regulation only applies to negotiating or obtaining credit regulated by the Consumer Credit Code (NSW, Victoria and the ACT). If the finance broker tells the lender the loan is not regulated by the Consumer Credit Code the lender usually will not include commission disclosures in its credit contract. Accordingly the policy intent of both the Consumer Credit Code and the broking legislation can be defeated through the improper use of purpose declarations.

While in practice it may be difficult for consumers to set aside a business purpose declaration, lenders are clearly at risk of consumers seeking to do so. Where a finance broker has actual knowledge of the intended purpose of the loan, and a consumer can demonstrate that, the lender is seriously exposed. If it has not entered into a credit contract which complies with the Consumer Credit Code then it may incur both civil and criminal penalties, as well as reputational damage.

[10] See National Finance Broking Regulation Regulatory Impact Statement Discussion Paper page 14 and A report to ASIC on the finance and mortgage broker industry By the Consumer Credit Legal Centre (NSW) Inc. March 2003 pages 43 and 44.

10.2 Reopening an unjust transaction

Section 70 of the Consumer Credit Code gives a court power to reopen a transaction which gave rise to a regulated credit contract, if it is satisfied that, in the circumstances relating to the relevant credit contract at the time it was entered into, the contract was unjust.

In determining whether a term of a particular credit contract is unjust in the circumstances in which it was entered into the court is to have regard to the public interest and to all the circumstances of the case, and may have regard to a number of factors which are listed in section 70(2). Those factors include:

- whether or not the debtor, or a person who represented the debtor, was reasonably able to protect the interests of the debtor because of his or her age or physical or mental condition;
- the extent to which the provisions of the contract and their legal and practical effect were accurately explained to the debtor and whether or not the debtor understood those provisions and their effect;
- whether the credit provider or any other person exerted or used unfair pressure, undue influence or unfair tactics on the debtor and, if so, the nature and extent of that unfair pressure, undue influence or unfair tactics; and
- whether the credit provider took measures to ensure that the debtor understood the nature and implications of the transaction and, if so, the adequacy of those measures.

A lender who has no direct communication with a borrower is unlikely to be aware of any disability which will affect the borrower's understanding of the transaction they are entering into. A lender will be unable to form a view on whether or not the debtor understood the product they were taking and the terms of the proposed credit contract. The lender itself, when dealing through an intermediary such as a finance broker, is unlikely to take any specific steps to make sure that the debtor understands the nature and implications of the transaction[11]. The lender is exposed if an intermediary exerts or uses unfair pressure, undue influence or unfair tactics to persuade the debtor to take a particular product or enter into a particular loan contract.

To my knowledge the role and/or a conduct of intermediaries has not been tested by the courts in the context of section 70. However there is clearly a possibility that acts or omissions by an intermediary could expose a lender to a reopening on one of these grounds.

The Contracts Review Act 1980 (NSW) contains similar, but not identical, provisions. One factor under that legislation is whether any undue influence, unfair pressure and unfair tactics were exerted, not only by a party to the contract, but also:

[11] The Financial Services and Banking Industry Ombudsman has noted "an apparent increase in the delegation to brokers by banks of the responsibility of explaining the loan offer or security documents or both, including an apparent refusal by banks in some cases to have direct contact with the borrower, instead referring all questions to the broker" - ABIO Bulletin, December 2002 page 3.

- by any person acting or appearing or purporting to act for or on behalf of a party to the contract; or
- by any person to the knowledge of a party to the contract.

These risks make finance broker accreditation a significant issue for lenders. Lenders need to be confident that intermediaries they accredit are not likely to engage in conduct which gives rise to a re-opening risk for the lender.

10.3 Linked credit

A lender will be a linked credit provider of a finance broker for the purposes of Part 7 of the Consumer Credit Code if the finance broker has an arrangement with the lender under which the lender will provide credit to a debtor to finance payment of a fee charged by the finance broker for broking services to be provided by the finance broker to the debtor. A lender and a finance broker may also be "linked" on other grounds. In practice, any finance broker accredited by a lender and supplying the lender's promotional materials and/or application forms will be a linked supplier of that lender.

The consequences for a lender of being a linked credit provider of a finance broker include:

- the lender will be responsible for misrepresentation by the finance broker in relation to the loan contract (section 118); and
- if a debtor enters into a contract with the lender for the provision of credit in respect of the supply of services by the finance broker to the debtor, and the debtor suffers loss or damage because of misrepresentation, breach of contract or failure of consideration in relation to the sale contract, the finance broker and the lender will be jointly and severally liable for the amount of the loss or damage (section 119). Whose conduct caused the loss and whether there is an agency relationship between the lender and the finance broker does not appear relevant to the issue of liability to the debtor, so long as the loss or damage is the result of one of the specified causes.

"Sale contract" is defined in section 115 as a contract for the sale of goods or the supply of services. "Services" is defined in schedule 1 as including among other things, professional services or a right to services (but does not include the provision of credit or a right to credit or services provided under a consumer lease). The provision of finance broking services by an intermediary to a debtor would in my view constitute "services" and the written agreement documenting such an arrangement would be a contract for the supply of services and therefore a "sale contract" for the purpose of the Consumer Credit Code.

It is possible however to avoid the application of section 119 to the lender in relation to the broking contract by refusing to finance any fee or charge imposed by the finance broker for the finance broking services. Of course it is also possible to avoid liability under the defence in section 119(2). However as that defence relies on the lender satisfying itself that it does not have cause to suspect that a debtor might be entitled to damages for misrepresentation, breach of contract or failure of consideration in relation to the written agreement, a safer way to avoid potential liability is to avoid financing broker fees and commissions. At a commercial level that may be difficult given that in practice finance

brokers are only likely to be able to impose fees of any material amount if the debtor can pay them out of loan proceeds, and if some lenders are prepared to finance these fees then finance brokers will steer borrowers towards those lenders and avoid the ones who refuse to finance broker fees.

There are similar linked credit provisions in the *Trade Practices Act 1974* (Cth) which may apply even if the credit is not regulated by the Consumer Credit Code.

10.4 False information

If intermediaries encourage applicants to mislead lenders (for example encouraging applicants to inflate income or ignore liabilities or assisting applicants to falsify documentation) then the lender's credit and other risks increase. Intermediaries may go further and engage, or encourage applicants to engage, in identity fraud.

An additional factor that a court may consider in an application under section 70 of the Consumer Credit Code to reopen a transaction on the grounds that it is unjust is whether at the time the credit contract was entered into the credit provider knew, or could have ascertained by reasonable enquiry of the debtor at the time, that the debtor could not pay in accordance with the terms of the contract, or could not do so without substantial hardship. If the lender does not itself verify income details and other information which establishes the applicant's capacity to repay, but instead relies on a finance broker, there must be some risk that the lender is exposed under this provision.

10.5 Commission disclosure

The Consumer Credit Code has since its inception in 1996 required lenders to disclose commission which is payable by them to an intermediary for the introduction of credit business (section 15(M)). However the amount of the commission only has to be disclosed if it is ascertainable. Accordingly many commission arrangements have been structured so that the commission payable in respect of a specific loan is not ascertainable at the time the contract for that loan is entered into. In many securitisation structures there is no disclosable commission because the commission is not paid by the lender.

The New South Wales finance broker legislation requires the method of calculating the commission, or an estimate of the amount of commission, to be disclosed in an FBC where the commission is not ascertainable. It also requires a finance broker to undertake that, before a consumer enters into a credit contract, the finance broker will disclose the amount of any financial or other benefit the finance broker will receive and whether or not the finance broker can determine or recommend conditions (such as interest rates and fees) and the effect of that determination on the amount the finance broker will receive from the credit provider.

We might reasonably have expected that this obligation would have lead to some change in commission structures - in particular a reduction in the circumstances in which the finance broker can set the retail rate and so determine (wholly or in part) the level of its own commission. I am not aware whether this has in fact occurred, but I suspect that reliance (valid or otherwise) on the "single brand" exemption and/or very vaguely drafted disclosure material may have been the outcome in at least some sectors of the New South Wales market so far. If national template legislation adopts the same requirements it will

be interesting to see whether a focus by the regulators nationally on these disclosure obligations leads to changes in commission structures.

10.6 Stay of enforcement

One significant direct impact on lenders arising out of the recommendations for national regulation is the possibility of a stay of enforcement where a consumer has a claim against a finance broker for compensation or damages (see 9.9 above). It is suggested in the Discussion Paper that the court will have power to compel the relevant credit provider to participate in the negotiations. An order for a stay will obviously force the credit provider to hold its hand pending the outcome of proceedings against the finance broker. The Discussion Paper suggests that credit providers should not be unduly concerned given that the debt will remain secured over the relevant property and the court can, in appropriate cases, require the borrower to maintain repayments when ordering the stay. However if it does not do so then, even though interest is accruing, the credit provider's risk of less than full recovery obviously increases and it is likely to incur legal and other costs which it would not have incurred had such a stay not been possible.

11. Conclusion

The regulators have a significant challenge ahead of them in implementing a national regulatory scheme for finance and mortgage brokers. There has been substantial opposition to some of the suggestions in the Discussion Paper, as well as substantial opposition to the new Code of Conduct proposed for Western Australia (and there are many elements in common between these proposals).

Any national template legislation must address all the different models for lending and the different types of intermediary and consider whether the result is truly a "level playing field". It must have some level of support from key participants in the industry, although addressing some of the problems currently being experienced by consumers is likely to involve measures which the industry finds unpalatable.

It will be imperative that the drafting and interpretation issues which exist in the New South Wales legislation are not replicated in the national model.

In some respects the position of lenders is likely to be improved as finance brokers are more heavily regulated and conduct standards are imposed. However lenders will remain exposed to many of the issues and risks they face today, and they may be directly impacted by changes in a new national regime (for example in the area of enforcement).

Lenders need regularly to reassess the risks they accept when dealing through intermediaries and carefully watch future regulatory developments.

This paper is a general summary. It is not legal advice. It represents the views of the author, not necessarily those of other partners of Allens Arthur Robinson. ***It has however been prepared with the assistance of Peter Jones, Partner, and Cameron Ball, Lawyer, which assistance is gratefully acknowledged.***