

RESPONSIBLE LENDING LAWS: ESSENTIAL DEVELOPMENT OR OVERREACTION?

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This article considers the recent National Consumer Credit Protection Bill 2009, which will impose responsible lending obligations on all credit providers and most intermediaries who assist in the provision of credit to consumers. This article argues that the introduction of these laws is a necessary development, as irresponsible lending is a current market failure that has led to harm, both to consumers and to the economy. Current consumer protection laws are inadequate to prevent irresponsible lending or to provide redress for consumers who are victims of such lending. Alternative methods of consumer protection, such as greater disclosure requirements, consumer education or counselling initiatives and lender self-regulation, have also proven ineffectual. The proposed legislation, containing an explicit, ex-ante requirement to assess suitability prior to approving credit, is an appropriate and necessary form of regulation. However, the implementation of the legislation must find an appropriate balance between a number of factors, including protecting consumers while still allowing safe access to credit. This is a difficult task, but is essential if the legislation is to be fully effective as a consumer protection instrument.

I INTRODUCTION

*'When you gave me that money, you said I wouldn't have to repay it 'til the future. This isn't the future, it's the lousy stinking now!'*¹

A lack of responsible lending in the Australian residential mortgage market has led to increased levels of consumer financial distress and over-indebtedness, and to negative repercussions for the Australian economy. This article will argue that the problem of irresponsible lending has led to a clear market failure; one which current laws are not capable of correcting. Therefore, the proposed Commonwealth legislation, the National Consumer Credit Protection Bill 2009 (NCCP Bill), introduced as part of a radical overhaul of Australia's consumer protection laws, is both a timely and necessary response to the problem of irresponsible lending. Appropriately implemented, the proposed legislation should be effective in redressing the identified market failure, increasing consumer protection and facilitating a competitive residential mortgage market.

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¹ H Simpson, 'No Loan Again, Naturally', *The Simpsons*, Episode 12, Season 20.

Access to credit can be of great benefit to consumers. Consumer credit can be considered ‘the lubricant of economic life’,² and as ‘one method of reducing income inequality and poverty’.³ Access to mortgage credit permits the purchase of homes, which is not only a vital component in the accumulation of wealth,⁴ but also an invaluable source of comfort and security for individuals and families. However, accessing mortgage credit can be a dangerous and risky process when the mortgage market harbours unscrupulous lenders who lend irresponsibly, particularly where these lenders explicitly target and exploit vulnerable, disadvantaged or low-income consumers.

The devastating effects of irresponsible lending have become increasingly visible during recent years in many consumer credit markets. Although not all affected to the same extent, the credit markets in Australia, the United States of America (US) and the United Kingdom (UK) have all experienced negative repercussions. While historically it has not been in the best business interests of a lender to engage in poor lending practices, a number of recent changes to the consumer credit market have created a slackening of lending standards, and a correlated rise in irresponsible lending. The greater number of lenders and mortgage brokers operating in the market has led to an increase in the number and variety of credit products available to consumers.⁵ These products include ‘subprime’ or ‘non-conforming’ loans, which are made to borrowers who cannot obtain loans from traditional lenders, and ‘low-doc’ or ‘no-doc’ loans, which ‘do not require as rigorous proof of creditworthiness’.⁶ There has also been an increase in the number of lenders prepared to engage in ‘pure asset’ or ‘asset-based’ lending, where lenders grant loans based solely on the value of the borrower’s security, without regard to his or her income or ability to make repayments. These practices are not inherently harmful; however, they have the potential to lead to lax lending practices, and they have opened the door for unscrupulous lenders to engage in irresponsible and predatory lending practices.

But what does it mean to lend responsibly? The term ‘irresponsible lending’ can be defined to cover a wide range of predatory lending practices, including not only ‘affordability and the likelihood of repayment’, but also ‘advertising and marketing; selling techniques; product design; use of credit scoring techniques, appropriateness of credit to borrower; sale of associated products; and account management’.⁷ However, the NCCP Bill focuses on two key aspects of responsible lending: the appropriateness of the loan to the borrower, and the borrower’s ability to service and repay the loan. It is these two key aspects that will define ‘responsible lending’ for the purposes of this

² The EU Commission, *Proposal for a Directive of the European Parliament and of the Council on the Harmonisation of the Laws, Regulation and Administrative Provisions of the Member States Concerning Credit for Consumers* [2002] OJ C 331 E.

³ I Ramsay, ‘Regulation of Consumer Credit’ in G Howells, I Ramsay and T Whilhelmsson (eds), *Handbook of Research on International Consumer Law* (2010) 2.

⁴ O Bar-Gill and E Warren, ‘Making Credit Safer’ (2008) 157 *University of Pennsylvania Law Review* 101, 104-5.

⁵ House of Representatives Standing Committee on Economics, Finance and Public Administration, Parliament of Australia, *Home Loan Lending: Inquiry into Home Loan Lending Practices and the Processes Used to Deal with People in Financial Difficulty* (2007) 4-5.

⁶ *Ibid* 8.

⁷ Office of Fair Trading United Kingdom, *Irresponsible Lending – A Scoping Paper* (2008) 12.

article. Consideration of responsible lending issues will also be confined to the context of residential mortgages, although the NCCP Bill applies more widely than this.⁸

Despite the existence of legislation such as the Uniform Consumer Credit Code (UCCC) and the development of the general law to include doctrines such as unconscionable conduct and economic duress, there is not currently any obligation for lenders to lend responsibly. Alternative methods used to address irresponsible lending, such as stricter disclosure requirements or consumer financial counselling, have not been sufficiently effective in preventing consumer harm. However, it is now a time of rapid and dramatic change for Australia's consumer laws. On 2 October 2008, the Council of Australian Governments agreed that responsibility for the regulation of credit should be transferred to the Australian government,⁹ and agreed to a two-phase implementation plan.¹⁰ The NCCP Bill was introduced into Parliament on 25 June 2009 as part of the first phase of this plan. The UCCC is to be re-enacted as the National Credit Code (NCC), and is contained in schedule 1 to the NCCP Bill.

Part one of this article will provide an outline of the credit market in Australia, will define irresponsible lending as a form of predatory lending, and will focus closely on the impact of irresponsible lending on vulnerable and disadvantaged consumers. Part Two will look at the current law and its shortcomings in protecting consumers from irresponsible lending practices, as well as consider alternatives to regulation, such as more stringent disclosure requirements or consumer education initiatives. Part Three will outline the responsible lending obligations contained in the NCCP Bill. The form of this regulation will be analysed, as well as its effectiveness as a consumer protection instrument. A brief summary of findings and recommendations will follow.

II IRRESPONSIBLE LENDING: A PREDATORY LENDING PRACTICE

A *The Housing Finance Market in Australia – An Overview*

It is a time of contradictory trends in the Australian housing finance market. There has been unprecedented growth in household debt over the past 30 years for many developed countries.¹¹ This occurred in Australia particularly in the 1990s, where lower interest rates, low unemployment, increasing income and wealth, and the emergence of non-bank lenders meant 'households were able to afford higher levels of debt than before'.¹² This has meant that 'over the last 18 years, the total amount of debt owed by Australian households rose almost six-fold.'¹³ However, more recently, the global economic downturn has caused some households to be more cautious in taking on debt.¹⁴

⁸ See further: ss 5 and 6 of the National Credit Code; sch 1 to the National Consumer Credit Protection Bill 2009.

⁹ As recommended by the Productivity Commission: Commonwealth, Australian Government Productivity Commission, *Review of Australia's Consumer Policy Framework, Report No 45* (2008) vol 2, 107.

¹⁰ Further details of the implementation plan can be viewed and downloaded from: Australian Government, *COAG Agreement* (2009) <http://www.treasury.gov.au/consumercredit/content/coag_agreement.asp> at 2 March 2009.

¹¹ Australian Bureau of Statistics, 'Household Debt', *Australian Social Trends* (2009) 30, 30.

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ *Ibid* 37.

1 *Lending Institutions*

Broadly categorised, the lending institutions in Australia can be divided into Authorised Deposit-taking Institutions (ADIs) and non-deposit taking institutions. ADIs are entities authorised under the *Banking Act 1959* (Cth) (Banking Act), and include banks, building societies and credit unions. ADIs are also regulated by the Australian Prudential Regulation Authority (APRA). Non-deposit taking institutions are also known as ‘non-bank lenders’ or ‘non-traditional lenders’. They are less strictly regulated than ADIs, as they are not regulated by APRA, and include all other lending institutions not authorised under the Banking Act. The generic term used to refer to all of these entities will be ‘lender’ or ‘credit provider’.

2 *Changes in the Housing Finance Market*

A number of ‘significant structural changes’ have taken place in the Australian housing finance market over the past decade.¹⁵ There has been an ‘easing of credit standards’, which has meant that many borrowers who were previously ineligible were able to obtain housing loans, and that many other borrowers were able to borrow larger amounts than they otherwise might have.¹⁶ The market has also seen an emergence of non-traditional lenders over the past decade.¹⁷ These non-traditional lenders are more likely to engage in lax lending practices, such as asset-based lending, or to offer non-conforming loans, which are ‘the closest equivalent to the sub-prime market in the United States’.¹⁸ There has also been an increase in securitisation; a practice that is often associated with subprime lending, and which is discussed further below.

3 *Recent Economic Downturn*

The global economic crisis has had a significant effect on the Australian housing finance market. As a result of the downturn, some households ‘are taking a more conservative approach to their finances and...have increased savings and reduced their appetite for new borrowing’.¹⁹ This has seen households become more concerned with paying back debt and no longer so willing to withdraw equity from their homes.²⁰ While this behaviour has created a substantial slowdown in the growth of household credit, the slowdown has been ‘less marked’ for housing credit than for other types of credit²¹ and housing credit has continued to ‘grow at a reasonable pace’.²² Additionally, in recent months, there has been a slight increase in new loan approvals as a result of lower interest rates and the government’s first home buyers’ grant.²³

The Australian housing finance market has not been affected by the financial crisis to as large an extent as the markets of other countries. It has been acknowledged that part of the reason for this is that Australia ‘did not see the very marked decline in mortgage

¹⁵ Reserve Bank of Australia, *Financial Stability Review* (2009) 53.

¹⁶ Australian Bureau of Statistics, above n 11, 35.

¹⁷ Reserve Bank of Australia, above n 15, 53.

¹⁸ *Ibid* 18.

¹⁹ *Ibid* 33.

²⁰ *Ibid* 50-1.

²¹ *Ibid* 52.

²² *Ibid* 47.

²³ *Ibid* 52.

lending standards that occurred in other countries'.²⁴ Additionally, a number of lenders 'have recently unwound some of the easing in lending standards that occurred in previous years, particularly for higher-risk borrowers'.²⁵ This suggests that, as a result of the economic repercussions, a number of lenders have gone to some lengths to prevent irresponsible lending practices themselves. It will be seen in part two, however, that reliance on lender self-regulation of this kind will not be enough to prevent harm to consumers.

4 *Consumer Ability to Finance*

Rates of arrears for residential home loans are a good indicator of the ability of consumers to finance the loans they have been granted. The most recent Financial Stability Review concluded that, while arrears rates are *relatively* low overall, 'they have increased from the unusually low levels of the middle part of this decade'.²⁶ Although the rate of arrears for all housing loans in Australia is 'low by international standards',²⁷ it is estimated that approximately 20 000 borrowers were 90 or more days behind on their mortgage repayments in December 2008, compared with 13 000 borrowers in December 2007.²⁸

Unsurprisingly, arrears rates are higher for low-doc and non-conforming loans. The arrears rate for prime low-doc loans was 1.2% in June 2008, which was more than double the arrears rate for prime full-doc loans.²⁹ In comparison, the arrears rate for non-conforming loans was much higher, at 8.5%.³⁰ The arrears rate for securitised low-doc loans has also 'increased noticeably over the past year',³¹ as has the rate for non-conforming loans, which has 'increased by more than 3 percentage points over the past year'.³² Rates of arrears also highlight the differences in lending standards across different types of lenders. The arrears rate of full-doc loans originated by non-bank lenders 'is higher and has increased by more than that for equivalent loans originated by banks and other ADIs',³³ indicating that customers of non-banks may be more likely to experience difficulty in financing their loans.

B *Predatory Lending Practices*

Justin Malbon has described the practice of predatory lending as 'an enduring social scourge'³⁴ that is 'invariably the symptom of policy failures rather than the root cause of poverty and indebtedness'.³⁵ Although difficult to define, predatory lending has been described as 'a catalogue of onerous lending practices, which are often targeted at vulnerable populations and result in devastating personal losses, including bankruptcy,

²⁴ Ibid 50.

²⁵ Ibid 33.

²⁶ Ibid 52.

²⁷ Australian Bureau of Statistics, above n 11, 35.

²⁸ Reserve Bank of Australia, above n 15, 53.

²⁹ Australian Bureau of Statistics, above n 11, 35.

³⁰ Ibid.

³¹ Reserve Bank of Australia, above n 15, 52-3.

³² Ibid 53.

³³ Ibid.

³⁴ J Malbon, 'Predatory Lending' (2005) 33 *Australian Business Law Review* 224, 224.

³⁵ Ibid 225.

poverty and foreclosure'.³⁶ Irresponsible lending is an increasingly common and potentially devastating form of predatory lending.

1 *Defining Irresponsible Lending as a Predatory Lending Practice*

Where a lender does not have due regard to the appropriateness of a loan to the borrower's needs, or to the ability of the borrower to finance the loan, or where the lender maliciously and purposefully targets those consumers with little income who are willing to risk their homes to gain finance, lending is both irresponsible and predatory. Irresponsible lending can occur when a loan is sought initially, or when a lender pressures a borrower to refinance where it is unnecessary or beyond the consumer's means.

There are a number of lending practices that are generally associated with irresponsible lending; the most common being asset-based lending, 'churning' and 'equity stripping'. There has also been a rise in particular loan types that have arguably encouraged an increase in irresponsible lending; the most common being low-doc loans and subprime or 'non-conforming' loans. Any attempt to create policy responses to erase irresponsible lending must first begin with an understanding of these factors, so as to appreciate the causes of, and contributors to, the problem of irresponsible lending.

2 *Asset-based Lending*

Asset-based lending occurs when a lender relies on the value of a borrower's assets, rather than his or her income, in granting a loan.³⁷ In *Perpetual Trustee Company Limited v Khoshaba*, Basten JA defined 'pure asset lending' as 'to lend money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default'.³⁸ Asset-based lending to financially vulnerable consumers who do not understand the risks they are taking on, nor their consequences, can result in these consumers being forced to either refinance or to sell their homes, and can leave them in greater debt or with less equity in their homes.³⁹ This form of lending can lead to a greater number of house foreclosures, which can have negative social consequences, as more people turn to state welfare as a result of financial difficulty.⁴⁰

It has been argued that asset-based lending does not have negative consequences for all consumers, as it may be the consumer's desire to willingly and knowingly risk his or her assets in order to obtain a loan, with the full knowledge of the consequences of default. Dr Jeanie Marie Paterson argues that, 'in some cases, it should be accepted that the borrowers have decided to take the risk of losing the mortgaged assets in order to pursue other goals'.⁴¹ However, other commentators have described asset-based loans as 'fundamentally repugnant', because they 'violate widely shared beliefs about the

³⁶ K C Engel and P A McCoy, 'A Tale of Three Markets: The Law and Economics of Predatory Lending' (2002) 80(6) *Texas Law Review* 1255, 1260.

³⁷ J M Paterson, 'Knowledge and Neglect in Asset-Based Lending: When is it Unconscionable or Unjust to Lend to a Borrower who Cannot Repay?' (2009) 20 *Journal of Banking and Finance Law and Practice* 18, 18.

³⁸ [2006] NSWCA 41, [128].

³⁹ *Ibid* 19.

⁴⁰ *Ibid*.

⁴¹ *Ibid* 18.

acceptable outer limits of mortgage lending'.⁴² It is argued that home ownership is a 'basic necessity of life' that homeowners should not be deprived of through exploitation, and that 'homelessness imposes unacceptably large negative externalities on society as well as the homeless'.⁴³

Asset-based lending can also lead to other abusive lending practices, such as 'loan flipping' or 'churning', which occurs when homeowners default on repayments and the lender offers to refinance the mortgage in order to 'help' the borrower avoid foreclosure. The lender may persuade the homeowner to refinance their mortgage in this manner repeatedly over short periods of time, up to three or four times a year.⁴⁴ Due to prepayment penalties and 'refinancing' charges, the borrowers end up owing higher total principal and interest to the lender.⁴⁵ Loan flipping or churning therefore results in 'equity stripping', where the owner's home equity disappears and the amount owed under the loan increases.⁴⁶

3 *Low-doc and No-doc Loans*

A recent development in the mortgage market is the emergence of what are termed 'low-doc' or 'no-doc' loans. Low-doc loans 'do not require as rigorous proof of creditworthiness',⁴⁷ as they were developed primarily as a valuable tool for consumers on irregular incomes who cannot usually access traditional housing loans due to difficulties in stating their income. They may also be used by consumers who, for various reasons, do not wish to disclose their income. However, the lack of verification of income has led to concerns that low-doc loans may be abused by people who 'overstate their income to obtain a larger loan'.⁴⁸ Additionally, low-doc loan applications may not disclose the purpose of the loan, which can lead to inappropriate and unsuitable loans being granted.⁴⁹ Low-doc lending is therefore linked to riskier lending practices, and to predatory and irresponsible lending.⁵⁰

4 *Subprime and Non-conforming Loans*

Subprime loans, as they are known in the US, are termed 'non-conforming' loans in Australia. A distinction must be drawn between subprime lending and irresponsible lending, as, 'in the overwhelming percentage of cases, predatory loans are a subset of subprime loans'.⁵¹ The term 'subprime' is used simply to refer to loans that are not 'prime', as they are loans made to consumers who would generally not qualify for traditional home loans. Subprime loans have a number of common features, such as low-interest 'honeymoon' periods, followed by very high interest rates for the

⁴² Engel and McCoy, 'A Tale of Three Markets', above n 36, 1262.

⁴³ Ibid.

⁴⁴ Ibid 1263.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ House of Representatives, above n 5, 8.

⁴⁸ Reserve Bank of Australia and Australian Prudential Regulation Authority, *Joint RBA-APRA Submission to the Inquiry into Home Lending Practices and Processes*, Submission No 7 (2007) 4.

⁴⁹ See, for example: *Perpetual Trustee Company Limited v Khoshaba* [2006] NSWCA 41.

⁵⁰ See further: D Tennant, 'Low Documentation Home Loans – a Symptom of a Greater Malaise in Consumer Credit Standards' (Paper presented at the Public Forum: The Dangers of Low Documentation Loans, Australian National University, Canberra, 12 October 2007).

⁵¹ Engel and McCoy, 'A Tale of Three Markets', above n 36, 1261.

remainder of the loan, high loan-to-value ratios, and repayments that are a significant proportion of the borrower's income.⁵² These loans are also very often 'securitised'. Securitisation is a process where illiquid assets are converted into tradeable securities,⁵³ which essentially means that the lender who has provided the loan is able to sell the mortgage and therefore the risk of default on to another entity. Hence it has been argued that, especially in the US, the process of securitisation 'facilitates predatory lending',⁵⁴ as it has 'encouraged some US mortgage brokers (and originators) to engage in careless and, in some cases, improper conduct in their dealings with borrowers'.⁵⁵ While securitisation has helped many consumers to obtain loans who otherwise might not have been able to access finance, it has also 'helped to spawn predatory lending and has impeded the ability of borrowers to obtain meaningful relief from abusive loans'.⁵⁶

5 *Brokers and Intermediaries*

Many of these forms of lending occur through intermediaries such as brokers, who negotiate with and attract clients on behalf of lenders, usually in exchange for a commission. There have been many reports of brokers falsifying information on loan applications, particularly low-doc applications, in order to have the loans approved and receive their commission.⁵⁷ Problems involving brokers and other intermediaries have been compounded by the lack of redress available to consumers who have fallen victim to unscrupulous brokers, as brokers are treated in law as agents of the borrower.⁵⁸ Therefore, the lender will generally not be held responsible for any unfair conduct by the broker, and the borrower will not be able to rely on the broker's conduct as a defence to any action brought against them by the lender.⁵⁹ Under the NCCP Bill, intermediaries are known as 'credit assistants', and are subject to very similar responsible lending obligations as credit providers. This is a desirable development that should result in responsibility for unfair conduct being attributed to the appropriate entity. Brokers' obligations under the NCCP Bill are discussed further in part three.

C *Disadvantaged and Vulnerable Consumers*

Understanding the causes of financial vulnerability or disadvantage and the experiences of those consumers who are disproportionately affected by predatory lending is vital in the development of effective and efficient policy responses. Attention must be given to 'the behavioural responses of vulnerable and disadvantaged consumers to different situations and policy options'.⁶⁰

⁵² R Foreman, 'Subprime Mortgage Crisis: A legal perspective' (2007) 45(9) *Law Society Journal* 55, 57.

⁵³ Kirk Bailey, M Davies and L Dixon Smith, 'Asset Securitisation in Australia' in Reserve Bank of Australia, *Financial Stability Review* (2004) 48.

⁵⁴ K C Engel and P A McCoy, 'Turning a Blind Eye: Wall Street Finance of Predatory Lending' (2007) 75 *Fordham Law Review* 2039, 2040.

⁵⁵ Foreman, above n 52, 57.

⁵⁶ Engel and McCoy, 'Turning a Blind Eye', above n 54, 2081.

⁵⁷ See, for example: *Perpetual Trustee Company Limited v Khoshaba* [2006] NSWCA 41; see further: House of Representatives, above n 5, 25-7.

⁵⁸ *Custom Credit Corporation Ltd v Lynch* [1993] 2 VR 469; *Esanda Finance Corp Ltd v Spence Financial Group Pty Ltd* [2006] WASC 177; *Perpetual Trustees Victoria Ltd v Ford* (2008) 70 NSWLR 611.

⁵⁹ Office of Fair Trading New South Wales, *National Finance Broking Regulation Regulatory Impact Statement Discussion Paper* (2004) 31.

⁶⁰ Australian Government Productivity Commission, above n 9, 301.

1 *Defining Vulnerable and Disadvantaged*

While almost any consumer can fall victim to predatory lending practices, some consumers are more vulnerable than others. The Productivity Commission defines a disadvantaged consumer as ‘a person whose ongoing attributes or circumstances, such as poor education and low income, cause a continuing susceptibility to detriment’.⁶¹ Disadvantage is ‘typically persistent and hard to change’.⁶² In contrast, vulnerability is described as ‘a broader term relating to a particular susceptibility of consumers to detriment based on both their personal characteristics...and the specific context in which they find themselves’.⁶³ However, as Justin Malbon notes, ‘there is no clear and simple way of knowing who is financially vulnerable’.⁶⁴ Financial vulnerability is not limited to the poor, and can be created by a number of circumstances, including ‘a borrower’s lack of capacity to respond to a job loss, an injury or sickness...[or] addiction to alcohol, drugs or gambling’.⁶⁵ Financial vulnerability may be either ‘temporary or enduring’ and may affect some members of the community more than others, as a result of their ‘geographical location, race, age or marital status’.⁶⁶

2 *Financial Exclusion and Consumer Over-indebtedness*

An important aspect of understanding the effect of policy decisions on vulnerable and disadvantaged consumers is recognising the effect that financial exclusion can have on this group of consumers. Denial of credit to these consumers can, in some circumstances, be just as harmful as the granting of unsuitable credit. The failure of mainstream financial institutions to lend to people on low incomes exposes these consumers to high cost lending,⁶⁷ and ‘exacerbates over-indebtedness and financial exclusion’.⁶⁸ Consequently, any proposed regulation to address irresponsible lending must ensure that it also addresses the inherent tension between tightening lending standards and allowing fair access to credit for vulnerable or disadvantaged consumers. This is not an easy task; as Iain Ramsay observes, ‘facilitation of access may conflict with responsible lending policies’.⁶⁹ A further tension that responsible lending legislation must address is between the protection the legislation may provide for some consumers and ‘the costs that may be imposed on other consumers through restrictions on choice, price and/or the entry of new suppliers’.⁷⁰ A policy response that aids the vulnerable or disadvantaged, for example, may be of very little benefit to other consumers if it serves only to stifle their freedom of choice.

⁶¹ Ibid 293.

⁶² Ibid 295.

⁶³ Ibid.

⁶⁴ Malbon, ‘Predatory Lending’, above n 34, 228.

⁶⁵ Ibid 225.

⁶⁶ Ibid.

⁶⁷ See generally: M S Barr, ‘Banking the Poor’ (2004) 21 *Yale Journal on Regulation* 121.

⁶⁸ T Wilson, ‘Responsible Lending or Restrictive Lending Practices? Balancing Concerns Regarding Over-Indebtedness with Addressing Financial Exclusion’ in M Kelly-Louw, J P Nehf and P Rott (eds), *The Future of Consumer Credit Regulation: Creative Approaches to Emerging Problems* (2008) 91, 91.

⁶⁹ Ramsay, above n 3, 29.

⁷⁰ Australian Government Productivity Commission, above n 9, 298.

D Conclusion

Irresponsible lending is a predatory lending practice that has been the result of a combination of recent market factors, including an increase in the availability of loan products such as non-conforming, low-doc or asset-based loans. The effects of irresponsible lending may be felt most acutely by vulnerable or disadvantaged consumers who are not able to protect themselves; these consumers must be protected, but must not be subject to financial exclusion. Striking a balance between these competing policy objectives is not a simple task, and is examined further in part three. Part two, however, considers whether current Australian law is capable of protecting consumers from irresponsible lending. Part Two also considers alternative forms of consumer protection, and whether the introduction of additional regulation is justified in these circumstances.

III IS REGULATION TO ADDRESS IRRESPONSIBLE LENDING WARRANTED?

A *The Current Law*

A number of statutes govern the provision of credit in Australia, most notably the UCCC, and, at a state level, the *Contracts Review Act 1980* (NSW) (CRA). Equitable doctrines, including unconscionable conduct, undue influence and economic duress, have also developed to protect consumers and combat predatory lending. However, attempts to redress irresponsible lending practices using these laws are rarely successful, and, as the relevant case law demonstrates, modern lending practices have meant that claims are increasingly difficult to prove.

1 *Uniform Consumer Credit Code*

The provision of credit to consumers is ostensibly governed nationally by the UCCC.⁷¹ Under s 6(1), the UCCC applies only to natural persons who are seeking credit ‘wholly or predominantly for personal, domestic or household purposes’. Section 70(1) gives the court the power to reopen ‘unjust’ transactions. ‘Unjust’ is defined in s 70(7) as including ‘unconscionable, harsh or oppressive’. In deciding to reopen a transaction, the court must have regard to the public interest and the factors listed in s 70(2). Listed as part of these factors is s 70(2)(1), which allows the court to consider ‘whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider knew, or could have ascertained by reasonable inquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship’.

This section appears to offer consumers some protection from irresponsible lending. However, the second reading speech introducing the UCCC outlines the manner in which this provision was intended to be interpreted, and indeed the way it has been interpreted in the time since. That is:

The Consumer Credit Code ... [is not] intended to place obstacles in the way of lenders giving credit to borrowers who make it clear from the outset that they will have

⁷¹ The object of the UCCC was to achieve uniformity throughout Australia by each jurisdiction enacting a law stating that the Consumer Credit Code of Queensland is the law of that State or Territory. However, since the introduction of the UCCC in 1996, many States have independently altered their Codes, meaning that the Code is no longer entirely uniform.

difficulties repaying their loan but nevertheless want to take on the obligation because of the lifestyle they wish to pursue ... It is intended to deal with those lenders who consciously lend without making proper inquiries into the debtor's ability to pay rather than those lenders and borrowers who have gone down this path and made a conscious decision based on the best information available.⁷²

This explanation makes it clear that where a debtor has made a 'real and conscious choice to assume the risk of non-payment', the court will not reopen the transaction.⁷³ The difficulty with this interpretation is that it assumes two things: firstly, that consumers are appropriately informed as to the risks they take on; secondly, that consumers have a real *choice* to take on these risks. In many situations, consumers are not able to understand the terms on which they are accepting credit, and will not have a choice other than to obtain finance that is unsuitable or unaffordable, because they cannot, or believe they cannot, successfully apply for traditional finance elsewhere.⁷⁴ This interpretation also demonstrates the requirement for procedural injustice, rather than substantive injustice, to be present before relief can be granted. This means that individual circumstances must be examined, which 'reduces the potential for the development of precedent and widespread change in business practice'.⁷⁵

2 *Contracts Review Act*

Section 70 of the UCCC was modelled in part on the CRA, which, under s 7, allows the court to make a number of orders, including voiding or varying a contract, where it is found to be 'unjust'. 'Unjust' has the same meaning as under the UCCC.⁷⁶ Section 9 of the Act provides the factors to which the court must have regard in making this decision. There is no direct equivalent of s 70(2)(1) in the CRA, although s 9(2)(f) allows the court to have regard to 'the relative economic circumstances, educational background and literacy of ... (i) the parties to the contract'.

3 *Unconscionable Conduct*

Under statute, unconscionable conduct in relation to consumer mortgages was originally prohibited by the *Trade Practices Act 1974* (Cth) (TPA). However, the introduction of s 51AAB ostensibly removed financial services from the ambit of the TPA, so that ss 12CA, 12CB and 12CC of the *Australian Securities and Investments Commission Act 2001* (Cth) (ASIC Act) are now the relevant statutory prohibitions on unconscionable conduct.⁷⁷ Section 991A of the *Corporations Act 2001* (Cth) also prohibits unconscionable conduct by financial services licensees.⁷⁸

⁷² Queensland, *Parliamentary Debates*, Legislative Assembly, 4 August 1994, 8832 (Tom Burns, Deputy Premier, Minister for Emergency Services and Minister for Rural Communities and Consumer Affairs).

⁷³ A Duggan and E Lanyon, *Consumer Credit Law* (Butterworths, 1999) 359.

⁷⁴ T Wilson, N Howell and G Sheehan, 'Protecting the Most Vulnerable in Consumer Credit Transactions' (2009) 32(2) *Journal of Consumer Policy* 117, 121-2.

⁷⁵ *Ibid* 128.

⁷⁶ *Contracts Review Act 1980* (NSW) s 4: 'unjust' is defined as 'unconscionable, harsh or oppressive'.

⁷⁷ It appears, however, that s 51AC of the TPA still applies to financial services, and thus essentially duplicates s 12CC of the ASIC Act. It is suggested that s 12CC should be considered in preference to s 51AC if the wrong occurred after the commencement of s 12CC and the facts of the matter comply with the specific elements of the provision: E Webb, 'The Response of the Australian Legislature and Courts to Predatory Lending and other Unconscionable or Oppressive Practices Involving Real Property Mortgages' forthcoming in L Bennett Moses, B Edgeworth and C Sherry (eds), *Property*

The equitable doctrine of unconscionable conduct in its modern formulation was outlined in the case of *Commercial Bank of Australia v Amadio*⁷⁹ (*Amadio*). Deane J stated that the doctrine operates where one party to a transaction is under a special disability in dealing with the other party, such that there is an absence of ‘any reasonable degree of equality between them’.⁸⁰ This disability must be ‘sufficiently evident’ to the stronger party to make it ‘prima facie unfair or unconscientious’ for the stronger party to accept the weaker party’s consent to the transaction.⁸¹ Where these circumstances exist, an onus is placed on the stronger party to show that the transaction was ‘fair, just and reasonable’.⁸²

This doctrine creates a number of problems for borrowers who are victims of irresponsible lending, but who do not have a demonstrable special disadvantage of the type considered by the case law to be sufficient,⁸³ or who cannot prove actual or constructive knowledge by the lender of a disadvantage.⁸⁴ The situation is exacerbated where the borrower has arranged a loan through a broker, because, as discussed above, the broker’s knowledge cannot be imputed to the lender.⁸⁵

4 *Undue Influence*

Undue influence is an equitable doctrine concerned with the relationship of influence that a third party may have over one party to a contract, such that the consent of the weaker party was not free, voluntary and independent.⁸⁶ The standard of knowledge required by the stronger party of the third party’s influence is not yet settled,⁸⁷ although it has been suggested that actual notice will be required, as opposed to mere constructive notice.⁸⁸ If this proves correct, modern lending practices, especially where a broker is involved, will make this standard very difficult to prove.

and Security: Selected Essays (2009). See further: G Pearson, ‘The Ambit of Unconscionable Conduct in relation to Financial Services’ (2005) 23 *Companies and Securities Law Journal* 105.

⁷⁸ Western Australia is the only jurisdiction to have a positive licensing regime for credit providers and finance brokers: see *Credit (Administration) Act 1984* (WA). However, the Act exempts many entities, including banks, building societies and credit unions. Other jurisdictions have an even looser supervision scheme: see, for example, the *Consumer Credit (Victoria) Act 1995* (Vic), which gives the Director of Consumer Affairs investigation and inquiry powers if the credit provider engages in ‘unjust conduct’.

⁷⁹ (1983) 151 CLR 447.

⁸⁰ *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447, 474 (Deane J).

⁸¹ *Ibid.*

⁸² *Ibid.*

⁸³ See *Blomley v Ryan* (1956) 99 CLR 362, 405 (Fullagar J) for a starting point of circumstances that may place one party at a special disadvantage.

⁸⁴ It appears that constructive knowledge is sufficient to establish unconscionable dealing: see *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447, 467 (Mason J). His Honour states that the knowledge requirement may be satisfied where the defendant, instead of having actual knowledge of a special disadvantage, ‘is aware of the possibility that that situation may exist or is aware of facts that would arise that possibility in the mind of any reasonable person’.

⁸⁵ See: *Custom Credit Corp Ltd v Lynch* [1993] 2 VR 469; *Esanda Finance Corp Ltd v Spence Financial Group Pty Ltd* [2006] WASC 177; *Perpetual Trustees Victoria Ltd v Ford* (2008) 70 NSWLR 611.

⁸⁶ See, for example: *Bridgewater v Leahy* (1998) 194 CLR 457.

⁸⁷ Paterson, above n 37, 31.

⁸⁸ See *Perpetual Trustees Victoria Ltd v Ford* (2008) 70 NSWLR 611, [95] (Harrison J).

5 *Economic Duress*

The doctrine of economic duress is a relatively new legal development. In *Crescendo Management v Westpac*,⁸⁹ McHugh JA described the doctrine as a two-stage test; that is, ‘whether any applied pressure induced the victim to enter into the contract’ and ‘whether the pressure went beyond what the law is prepared to countenance as legitimate’.⁹⁰ However, in the case of *Karam v ANZ Banking Group Ltd*,⁹¹ the Court of Appeal limited economic duress to circumstances where there is ‘threatened or actual unlawful conduct’.⁹² As the doctrine is subsequently limited to such narrow circumstances, it seems unlikely that a borrower will be able to successfully allege economic duress.⁹³

6 *Cases Illustrative of the Problem*

The court has long been reluctant to hold that lenders have a duty to confirm a borrower’s ability to repay a loan.⁹⁴ In *Australian Securities Group Financial Services (NSW) Ltd v Bogan*,⁹⁵ Campbell J stated that neither the relevant Act nor the general law ‘support the proposition that not to seek confirmatory evidence of matters going to ability to repay a loan is sufficient to make a contract unjust.’⁹⁶ This case made it clear that in order to reopen a contract, ‘something more is needed’.⁹⁷

This ‘something more’ often comes in the form of a ‘special disadvantage’. In *Vital Finance Corporation Pty Ltd v Taylor*,⁹⁸ the disadvantage included the debtors’ lack of commercial experience, their lack of comprehension of the loan documents, and the lender’s knowledge of the high risk of default, which led it to take advantage of the debtors’ vulnerable position. However, the borrower’s disadvantage must also come to the attention of lender. In *Perpetual Trustees Victoria Ltd v Ford*,⁹⁹ the debtor, Ford, was intellectually impaired and illiterate, but Harrison J held that the lender did not have the requisite knowledge of the borrower’s disability for the purposes of unconscionable conduct or undue influence, as the loan was arranged by Ford’s son.

There have, however, been a number of New South Wales cases in which the court has held that relief be granted against an unjust contract where the loan application shows that the borrower would not have sufficient income to cover both loan repayments and living expenses.¹⁰⁰ The New South Wales court has also delivered a strong warning

⁸⁹ (1988) 19 NSWLR 40.

⁹⁰ *Crescendo Management v Westpac* (1988) 19 NSWLR 40, 46.

⁹¹ [2003] NSWSC 866.

⁹² *Karam v ANZ Banking Group Ltd* [2003] NSWSC 866, [61].

⁹³ See further: L Aitken, ‘A “Duty to Lend Reasonably” – New Terror for Lenders in a Consumer’s World?’ (2007) 18 *Journal of Banking and Finance Law and Practice* 18.

⁹⁴ See especially: *Micarone v Perpetual Trustees Australia Ltd* (1999) 75 SASR 1; *Perpetual Trustees Victoria Ltd v Ford* (2008) 70 NSWLR 611.

⁹⁵ (1989) ASC 58,557.

⁹⁶ *Ibid* 58,562 (Campbell J).

⁹⁷ *Ibid*.

⁹⁸ (1991) ASC 57,032.

⁹⁹ (2008) 70 NSWLR 611.

¹⁰⁰ See *Smith v Elders Rural Financing Ltd* (Unreported, NSW Supreme Court, Bryson J, 25 November 2004); *Permanent Trustee Australia v Gusevski* [2005] NSWSC 1281; *National Australia Bank v Satchithanantham* [2009] NSWSC 21; see also *Arbest Pty Ltd v State Bank of New South Wales Ltd* [1996] ATPR 41,963 and Kirby P’s statement at 41,982: ‘it is not appropriate for financial

against asset-based lending.¹⁰¹ In *Perpetual Trustee Company Limited v Khoshaba*¹⁰² (*Khoshaba*) the court determined that where a lender has engaged in asset-based lending, it cannot be regarded as being an innocent party.¹⁰³ In this case, the loan application had a misstatement as to income and the signature of the borrower was forged, although through no fault of the borrower, who was acting through an intermediary. Spigelman CJ held that it was the ‘indifference’ of the lender, who was ‘content to proceed on the basis of enforcing the security’,¹⁰⁴ that determined the case. While *Khoshaba* may not amount to a precedent for a general duty to lend responsibly, it has meant that a determination of asset-based lending is far more likely to result in a contract being declared ‘unjust’.

A subsequent case decided under the *Consumer Credit (New South Wales) Code* affirms this warning against asset-based lending outside the context of the CRA. In *Permanent Mortgages Pty Ltd v Cook*,¹⁰⁵ Patten JA held that, had the lenders made ‘the most perfunctory of enquiries’, they would have discovered that the borrowers were not capable of servicing the loan and could only fulfil their obligations by selling their mortgaged property.¹⁰⁶ Patten JA concluded that the ‘something more’ in this case was that the lenders should have been aware of the borrower’s ‘foolishness’, but had, in effect, encouraged it. Similarly, in *Elkofairi v Permanent Trustee Co Ltd*,¹⁰⁷ the court held that it was unconscientious ‘to lend a large sum of money to a person with no income with full knowledge that if the repayments under the loan were not met, it could sell that person’s only asset’.¹⁰⁸ The special disadvantage in this case stemmed from the borrower’s extremely limited ability to read or understand spoken English and her strained relationship with her husband, who arranged all business transactions.

It therefore appears that, subsequent to a determination of asset-based lending, the court may be more likely to grant relief under both the statutory reopening provisions and the equitable doctrines. However, in the absence of this finding, a lacuna is created in which borrowers who do not have the requisite disadvantage to qualify under the *Amadio* principle, or whose disadvantage has not sufficiently come to the attention of the lender, perhaps due to the involvement of an intermediary, are left with no avenue of redress. This is illustrated by the very recent case of *Perpetual Trustees Victoria Ltd v Longobardi*,¹⁰⁹ in which it was held that, in the absence of asset-based lending, no relief could be granted under the CRA or the ASIC Act, despite a multitude of factors that, by the judge’s own admission, ‘make the loan agreement and mortgage subjectively harsh or unfair’.¹¹⁰ The counter-intuitive outcome of this case exemplifies the need for a simpler and more widely available avenue of redress for borrowers in these situations.

institutions to lend very substantial sums of money to borrowers without making adequate and candid assessments as to the ability of such borrowers to repay such loans.’

¹⁰¹ E Hodgman and G Koning, ‘Beware of the Courts’ Ire over Asset-Based Lending’ (2007) 19(4) *InFinance* 2648.

¹⁰² [2006] NSWCA 41.

¹⁰³ M Bransgrove and M Young, *The Essential Guide to Mortgage Law in New South Wales* (LexisNexis Butterworths, 1st ed, 2008) 222.

¹⁰⁴ *Perpetual Trustee Company Limited v Khoshaba* [2006] NSWCA 41, [92] (Spigelman CJ).

¹⁰⁵ [2006] NSWSC 1104; aff’d [2007] ASC 155-085.

¹⁰⁶ *Permanent Mortgages Pty Ltd v Cook* [2006] NSWSC 1104, [88] (Patten AJ).

¹⁰⁷ (2003) 11 BPR 20,841.

¹⁰⁸ *Elkofairi v Permanent Trustee Co Ltd* (2003) 11 BPR 20,841, [59] (Beazley JA).

¹⁰⁹ [2009] NSWSC 654.

¹¹⁰ *Perpetual Trustees Victoria Ltd v Longobardi* [2009] NSWSC 654, [128]; compare with *Permanent Trustee Company Limited v O’Donnell* [2009] NSWSC 902, in which relief was granted under the

B *Alternatives to Regulation*

Interference in the market through regulation is ‘viewed by many as a blunt instrument that should be used judiciously and cautiously’.¹¹¹ Therefore, before the regulation can be justified, it must be established that alternative methods that are less extreme than market regulation are inadequate to address the market failure created by irresponsible lending. The most commonly encountered alternatives are lender self-regulation, consumer disclosure requirements, consumer education, and the extension of unfair contract terms legislation to consumer credit.

1 *Lender Self-regulation*

In considering how to address predatory lending issues, the Productivity Commission has suggested that lender self-regulation ‘may be more effective than black letter law’.¹¹² An example of this type of self-regulation has been implemented at ANZ, through their ‘public responsible lending commitments’.¹¹³ While this is a positive development, lender self-regulation can be problematic. It is likely to vary from institute to institute, and it does not have a single regulatory body governing enforcement. While many banks and prominent lending institutes have an incentive to lend responsibly to maintain their reputation,¹¹⁴ other lenders that are less likely to have repeat customers are extremely unlikely to implement responsible self-regulatory practices.

Banks may also subscribe to the Code of Banking Practice (Code).¹¹⁵ Although the choice to join is voluntary, the decision to join ‘makes the commitments in the Code binding on the subscribing bank’.¹¹⁶ Clause 25 of the Code, introduced in 2004, states that signatories to the Code will ‘exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay’ before offering or granting a customer a credit facility. A review of the Code published in December 2008¹¹⁷ found that a number of consumer advocates were concerned that ‘more detail is now needed’ for clause 25 of the Code.¹¹⁸ They suggested that banks should be required to ensure that ‘(i) the product meets the needs of the customer; and (ii) the customer has the capacity to repay the loan

CRA where the lender engaged in asset-based lending and failed to following its internal lending guidelines.

¹¹¹ E S Belsky and R S Essene, ‘Mortgage Credit at a Crossroads: Preserving Expanded Access while Informing Choices and Protecting Consumers’ (Paper presented at the Understanding Consumer Credit symposium, Harvard Business School, 28-29 November 2007) 43.

¹¹² Australian Government Productivity Commission, above n 9, 457.

¹¹³ ANZ, *Responsible Consumer Lending* <<http://www.anz.com/About-us/Corporate-Responsibility/customers/responsible-consumer-lending/>> at 22 June 2009.

¹¹⁴ See further: R P Buckley and J Nixon, ‘The Role of Reputation in Banking’ (2009) 20 *Journal of Banking and Finance Law and Practice* 37.

¹¹⁵ See also the Mutual Banking Code of Practice, the equivalent code of practice for credit unions and mutual building societies in Australia, which commenced 1 July 2009: Abacus Australian Mutuals, *Mutual Banking Code of Practice* <<http://www.abacus.org.au/consumers/mutual-banking-code-of-practice>> at 2 December 2009.

¹¹⁶ N Howell, ‘Consumer Protection in the Banking Sector: Reviewing the Code of Banking Practice’ (2009) Issue 90 *Precedent* 38, 38.

¹¹⁷ See: J McLelland and Associates Pty Limited, *Review of Code of Banking Practice: Final Report* (2008) <<http://www.reviewbankcode2.com.au>> at 26 June 2009.

¹¹⁸ Howell, above n 116, 39.

without hardship.’¹¹⁹ The Code is therefore very limited as a self-regulatory instrument. Not only is it in need of review, it is also voluntary and highly unlikely to capture those lenders most likely to engage in irresponsible lending.

2 *Disclosure Requirements*

Classical economic theory requires both parties to a transaction to have ‘perfect knowledge’ of the goods involved in the transaction.¹²⁰ This creates a more competitive market¹²¹ and enables consumers to protect themselves from bad deals. This was the theory behind the introduction of the disclosure requirements in the UCCC. One of the objectives of the UCCC was to require ‘truth in lending’, by making information such as the price of credit and the repayment and foreclosure terms easily available.¹²² Through ‘truth in lending’ practices, the UCCC ‘seeks to avoid regulation that restricts product flexibility and consumer choice’.¹²³ The UCCC therefore contains explicit disclosure requirements but no monetary caps or ceilings.

However, the large body of research into behavioural economics and the UCCC disclosure requirements repeatedly demonstrates the limitations of disclosure in addressing information asymmetries and over-indebtedness.¹²⁴ Large amounts of complex information presented to the consumer at once will not aid in the consumer’s comprehension of the transaction.¹²⁵ Even where consumers have perfect information, not all consumers will use it to their best advantage, because comparing information is complex and time-consuming, and ‘most consumers will quite rationally only dedicate a certain amount of time to the task’.¹²⁶ Behavioural economists have also found that consumers may simply ignore information disclosure.¹²⁷ For example, research into consumer over-indebtedness on credit cards has revealed that a consumer’s emotions may counteract any benefit gained from disclosure requirements.¹²⁸ Further, studies have shown that psychological manipulation of disclosure information, such as varying the number of credit options available, ‘has the same effect as a one half percentage point change in the monthly interest rate’.¹²⁹ These studies not only demonstrate the

¹¹⁹ Ibid.

¹²⁰ P M O’Shea and C Finn, ‘Consumer Credit Code Disclosure: Does it Work?’ (2005) 16(1) *Journal of Banking and Finance Law and Practice* 5, 6.

¹²¹ J Malbon for the Consumer Credit Code Post-Implementation Review Committee, *Taking Credit: A Survey of Consumer Behaviour in the Australian Consumer Credit Market* (1999) 19 <<http://www.creditcode.gov.au>> at 30 March 2009.

¹²² Ibid.

¹²³ Ibid 17.

¹²⁴ I Ramsay, ‘Consumer Credit Regulation as “the Third Way”’, (Speech delivered at Australian Credit at the Crossroads Conference, Melbourne, 8-9 November 2004). Available from: <<http://www.consumer.vic.gov.au>> at 1 April 2009.

¹²⁵ See generally: P O’Shea, ‘Consumer Credit: Too Much information?’ (2009) Issue 90 *Precedent* 22; see also: Better Regulation Executive and National Consumer Council, *Warning: Too Much Information Can Harm* (2007).

¹²⁶ Malbon, ‘Taking Credit’, above n 121, 20.

¹²⁷ R Thaler and G Lowenstein, ‘Intertemporal Choice’ in R Thaler (ed), *The Winner’s Curse: Paradoxes and Anomalies of Economic Life* (1992) 93-4.

¹²⁸ S Block-Lieb et al, ‘Disclosure as an Imperfect Means for Addressing Overindebtedness: An Empirical Assessment of Comparative Approaches’, forthcoming in J Niemi, I Ramsay and W Whitford (eds), *Consumer Credit, Debt and Bankruptcy* (2009). Available from: <<http://ssrn.com/abstract=1150864>> at 2 August 2009.

¹²⁹ M Bertrand et al, *What’s Psychology Worth? A Field Experiment in the Consumer Credit Market* (Discussion Paper No 918 (2005) 2).

ways in which consumers may ignore or fail to accurately comprehend disclosure statements, but also the potential for lenders to manipulate consumer behaviour in order to pursue increased profits.

Disclosure requirements are also highly irrelevant to those consumers who do not have any real choice in accepting credit. As Justin Malbon explains, the policy assumption behind the disclosure requirements 'is fine, providing that there are better alternative lending options available to low-income consumers'.¹³⁰ This is often not the case, and lower income consumers 'may be more inclined to take the loan they are offered without question because they believe it is the only loan they will be offered'.¹³¹ Lenders are able to exploit this belief by targeting 'unsophisticated people who believe that their ability to borrow money is limited'.¹³² For this reason, financial exclusion of vulnerable or disadvantaged consumers must be avoided; these borrowers must believe that they can get a fair deal elsewhere if disclosure statements are to have any purpose or effect.

3 Consumer Education and Counselling

Dr Elizabeth Lanyon has suggested that consumers in lower socio-economic groups may not be able to make use of disclosure information due to a 'lack of financial literacy', which 'could be improved by education initiatives'.¹³³ An example of such an initiative is the Financial Literacy Foundation, whose *Understanding Money* campaign works in schools and workplaces.¹³⁴

However, it has been demonstrated that consumer education and counselling initiatives are limited in their ability to prevent predatory lending practices. Research shows that there is only a weak correlation between the teaching of financial concepts and subsequent financial behaviour,¹³⁵ and that 'departures from the assumptions of rational decision-making are...difficult for education to correct'.¹³⁶ While extended one-on-one credit counselling has been shown to have a positive impact on borrower behaviour,¹³⁷

¹³⁰ Malbon, 'Predatory Lending', above n 34, 235.

¹³¹ Malbon, 'Taking Credit', above 121, 10.

¹³² Engel and McCoy, 'Turning a Blind Eye', above n 54, 2080.

¹³³ E Lanyon, 'Changing direction? A Perspective on Australian Consumer Credit Regulation' (Speech delivered at Australian Credit at the Crossroads Conference, Melbourne, 8-9 November 2004). Available from: <<http://www.consumer.vic.gov.au>> at 1 April 2009. For further on financial literacy education, see: G Pearson, 'Reconceiving Regulation: Financial Literacy' (2008) 8 *Macquarie Law Journal* 45; N Howell, 'Developing a Consumer Policy for the 21st Century' (2008) 33(2) *Alternative Law Journal* 80; K Gross, 'Financial Literacy Education: Panacea, Palliative, or Something Worse?' (2005) 24 *Saint Louis University Public Law Review* 307.

¹³⁴ An initiative of the Australian Government. Australian Government, *Welcome to the Understanding Money Website* <<http://www.understandingmoney.gov.au/>> at 7 February 2010.

¹³⁵ J A Smith Jr, 'Financial Literacy, Regulation and Consumer Welfare' (2004) 8 *North Carolina Banking Institute Journal* 77, 86; see also L E Willis, 'Against Financial-Literacy Education' (2008) 94 *Iowa Law Review* 197.

¹³⁶ T Williams, 'Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services' (2007) 29(2) *Law and Policy* 226, 246.

¹³⁷ See further: G Elliehausen, E C Lundquist and M E Staten, 'The Impact of Credit Counseling on Subsequent Borrower Credit Usage and Payment Behavior' (Paper presented at the Federal Reserve System Community Affairs Research Conference, 'Sustainable Community Development: What Works, What Doesn't, and Why', Washington DC, 27-28 March 2003). Available from: <http://www.chicagofed.org/cedric/seeds_of_growth_2003_conference_session1.cfm>

financial literacy programs are a ‘relatively expensive policy option’.¹³⁸ A mandatory counselling scheme, requiring consumers to go to a counsellor immediately prior to getting a loan, would also likely be highly ineffective in a situation where the consumer has the loan forms directly in front of them, waiting for them to sign.¹³⁹

Although financial counselling ‘unquestionably should be available for those who seek it’, education is ‘not a cure-all for predatory lending’.¹⁴⁰ Financial literacy campaigns must be undertaken ‘in concert with laws and regulations that address consumer protection through regulation of conduct in the marketplace’.¹⁴¹ Something more than education is required to combat irresponsible and predatory lending practices.

4 *Unfair Contract Terms Legislation*

It has been suggested that the proposed national unfair contract terms legislation¹⁴² cover banking and financial services, including credit agreements.¹⁴³ In Victoria, state unfair contract terms legislation has been extended to cover some consumer credit contracts, including non-bank housing finance that is targeted at first home buyers.¹⁴⁴ This could arguably afford consumers some protection from irresponsible lending practices, as any terms under the contract, such as repayment obligations, that were deemed too harsh or unfair would not be binding on the consumer. However, the scope of this legislation is quite narrow, applying only to standard form, non-negotiated contracts in which the consumer can be shown to have suffered detriment, and excluding the upfront price of the good or service.¹⁴⁵ It therefore seems highly unlikely to be applicable to irresponsible lending practices, particularly where the repayment terms are quite common or even objectively fair, but simply highly unsuitable for a particular consumer.

C *Is Regulation Warranted?*

Intervention in the market through regulation is very commonly viewed as a last resort. Chris Field states that:

regulation is justified where:

- (1) there is a demonstrable market failure;
- (2) the regulation proposed is directed to addressing the market failure;
- (3) the regulation is the least restrictive way of achieving its remedial purpose; and
- (4) the regulation does not create more costs than the benefits it seeks to achieve.¹⁴⁶

¹³⁸ Malbon, ‘Predatory Lending’, above n 34, 235.

¹³⁹ Engel and McCoy, ‘A Tale of Three Markets’, above n 36, 1310.

¹⁴⁰ Ibid 1309-10.

¹⁴¹ Smith, above n 135, 77.

¹⁴² See: Trade Practices Amendment (Australian Consumer Law) Bill 2009 (Cth).

¹⁴³ Commonwealth of Australia, *An Australian Consumer Law: Fair Markets – Confident Consumers* (2009) 33.

¹⁴⁴ See pt 2B *Fair Trading Act 1999* (Vic); see also Consumer Affairs Victoria, *Preventing Unfair Terms in Consumer Credit Contracts* (2009).

¹⁴⁵ See further: Trade Practices Amendment (Australian Consumer Law) Bill 2009 (Cth).

¹⁴⁶ C Field (ed), ‘Consumer Dealings’ (2005) 33 *Australian Business Law Review* 51, 52.

The previous sections have established that there is an identifiable market failure; that the current regulatory framework is not sufficient to correct the failure; and that less restrictive policy options are inadequate. However, a few arguments remain unaddressed and are summarised below to demonstrate that the introduction of new regulation is justified.

1 *Identifying a Market Failure*

The first step in formulating consumer protection policy is to clearly identify the consumer protection problem.¹⁴⁷ Some have argued that irresponsible lending in the Australian market is not extensive enough to warrant intervention, especially when compared to a market such as the US. The non-conforming housing loan market in Australia ‘accounted for only around 1 per cent of the mortgage market in mid 2007, compared to around 13 per cent in the United States’.¹⁴⁸ It is argued that ‘lending standards were not eased to the same extent’¹⁴⁹ in Australia as in other jurisdictions, and that ‘the legal environment in Australia places a stronger obligation on lenders to make responsible lending decisions than is the case in the United States’.¹⁵⁰ While it may be true, it has been seen that the consumer protection laws in Australia are still insufficient to address the problem of irresponsible lending. While the statistics may be *relatively* low, they still represent thousands of Australians who may be unnecessarily struggling to meet repayments and save their most valuable asset, the family home. A recent inquiry found that ‘Australia is highlighted (along with UK, US and Canada) for the rapid growth in lending to households with poor credit histories’.¹⁵¹ It is fair to say that there is an identifiable consumer protection problem in the Australian residential mortgage market.

2 *A Market-based Solution?*

Identifying a market failure does not mean that regulation is necessary. It must be established that there is not a market-based solution that will adequately correct the problem.¹⁵² For example, it is argued that some lenders are already engaging in more responsible lending practices. Many lenders ‘have reduced their maximum loan-to-valuation ratios (LVRs), with most of the largest lenders reportedly no longer offering 100 per cent LVR loans’. In addition, some lenders ‘are also applying tighter criteria for low-doc loans, including increased documentation requirements and risk margins’.¹⁵³ This has led some to argue that lenders will recognise that ‘predatory lending is not profitable’, and so the market will correct itself and ‘predatory lending will cease’.¹⁵⁴ However, there is no established correlation between reduced profits in the subprime market and predatory lending.¹⁵⁵ Additionally, Trebilcock notes that governments may have access ‘to information about problems that develop elsewhere but that have not yet

¹⁴⁷ M Trebilcock, ‘Rethinking Consumer Protection Policy’ in C Rickett and T Telfer (eds), *International Perspectives on Consumers’ Access to Justice* (2003) 68, 69.

¹⁴⁸ Reserve Bank of Australia, above n 15, 18.

¹⁴⁹ *Ibid.*

¹⁵⁰ *Ibid.* 19. For instance, all Australian mortgages are ‘full recourse’ loans, meaning that households cannot extinguish their debt by simply giving up the house to the lender, unlike in the US.

¹⁵¹ House of Representatives, above n 5, 12.

¹⁵² Trebilcock, above n 147, 72.

¹⁵³ Reserve Bank of Australia, above n 15, 33.

¹⁵⁴ Engel and McCoy, ‘A Tale of Three Markets’, above n 36, 1360.

¹⁵⁵ *Ibid.* 1360-1.

reached local markets',¹⁵⁶ and therefore may be in a position to identify potential problems before they occur locally. The US subprime crisis may be an example of this; the government is able to identify a gap in regulation that has caused problems overseas and address it before it gets out of hand locally. Although it may be argued that the Australian market is comparatively healthy, economies are always in flux, and it must be better to regulate now than to hope that the market continues to self-regulate into the future.

3 *Costs and Benefits*

It is necessary to weigh up the costs and benefits of the introduction of any regulation. Trebilcock argues that consumer protection regulation 'is only likely to make consumers better off if it either: (a) improves consumer estimates of the value of information; or (b) reduces the cost of information to consumers (or both)'.¹⁵⁷

The costs and benefits of the NCCP Bill have been debated in submissions on its exposure draft. Predictably, lending institutions have particularly emphasised the high compliance costs that the new legislation will create. GE Finance states that the costs to businesses of implementing the required changes will be 'very substantial', and that the ongoing compliance costs 'will be disproportionately high'.¹⁵⁸ There is concern that the regulation will 'increase the cost of lending to all credit consumers, irrespective of whether they are at high risk of defaulting', and lead to denial of credit for 'those willing and able to pay the loan'.¹⁵⁹ The Commonwealth Bank argues that compliance costs may be passed on to the consumer and that the legislation will have a 'significant negative impact on spending, investing and job creation within the economy'.¹⁶⁰

These firms have arguably overstated the true risks of this legislation. Legislation to ensure responsible lending should benefit all consumers as long as it does not result in financial exclusion. There may be additional costs borne by lenders, but they are also protecting themselves from potential consumer defaults and legal action. These issues are examined in greater detail in part three.

4 *Form of Regulation*

Identifying the appropriate form of regulation to implement is a final, key consideration. The regulation proposed is in the form of legislation that imposes an ex-ante obligation on all lenders and intermediaries to make a suitability assessment of borrowers. It has been argued that introducing such legislation is paternalistic, and may limit consumer choice and autonomy. New disclosure requirements are also proposed which may 'generate information that is costly for consumers to interpret or access' and therefore 'may be counter-productive', especially as they mandate disclosure of complex details

¹⁵⁶ Trebilcock, above n 147, 73.

¹⁵⁷ Ibid.

¹⁵⁸ GE Capital Finance Australasia Pty Ltd, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 11
<<http://www.treasury.gov.au/consumercredit/content/consultation/submissions/submissions.asp?round=1&subName=Exposure%20Draft:%20National%20Consumer%20Credit%20Regime>> at 14 August 2009.

¹⁵⁹ Australian Government Productivity Commission, above n 9, 457.

¹⁶⁰ Commonwealth Bank of Australia, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 4.

such as price, terms and conditions.¹⁶¹ The form of regulation chosen is therefore vital to its success as a consumer protection instrument, and this is examined in detail in part three.

D Conclusion

Using current consumer protection laws, it is evident that only the smallest proportion of cases will be successful in providing redress for victims of irresponsible lending. Alternative methods of consumer protection, such as lender self-regulation, greater disclosure requirements or consumer education initiatives, while less invasive of the market, are also not a complete solution. A clear market failure has been identified, for which no market-based solution will emerge. Therefore, the introduction of additional regulation is justified. The form of this regulation and its effectiveness as a consumer protection instrument are analysed in part three.

IV CONSUMER PROTECTION AND THE NCCP BILL

A *The National Consumer Credit Protection Bill*

The NCCP Bill was introduced in Parliament on 25 June 2009.¹⁶² The proposed responsible lending laws require all banks, credit unions, finance companies and other lenders, as well as all intermediaries who assist consumers to obtain credit, to become registered and licensed. In order to maintain this licence, firms must comply with a number of obligations, including responsible lending conduct. The key obligation in this respect is to ensure that lenders do not provide, suggest or assist borrowers in obtaining ‘unsuitable’ credit.¹⁶³ The responsible lending obligations are to commence on 1 January 2011.

1 *Key Responsible Lending Provisions*

Chapter 3 of the Bill contains the responsible lending provisions. Division 2 of part 3-2 imposes new disclosure requirements on credit providers, requiring them to give consumers a ‘credit guide’, ‘as soon as practicable after it becomes apparent to the licensee that it is likely to enter a credit contract with a consumer who will be the debtor under the contract’.¹⁶⁴ The division further outlines what the licensee’s credit guide must contain, including information about the internal and external dispute resolution scheme and any other requirements prescribed in the regulations.¹⁶⁵ Division 3 of part 3-2 outlines the principal responsible lending obligations on all credit providers. Section 128 states that a licensee must not enter a credit contract with a consumer, or increase the credit limit of a credit contract with a consumer, unless, within the previous 90 days, the lender has made an assessment that is in accordance with s 129 and has made the inquiries and verification in accordance with s 130.

¹⁶¹ Trebilcock, above n 147, 75.

¹⁶² C Bowen MP, *National Consumer Credit Protection Reform Package* (2009) Australian Government <<http://www.treasury.gov.au/consumercredit/content/legislation.asp>> at 25 June 2009.

¹⁶³ Commonwealth, House of Representatives, Explanatory Memorandum, National Consumer Credit Protection Bill 2009 (Cth) 79.

¹⁶⁴ National Consumer Credit Protection Bill 2009 (Cth) s 126(1).

¹⁶⁵ National Consumer Credit Protection Bill 2009 (Cth) s 126(2).

Section 129 requires the licensee to make an assessment as to whether the credit contract will be ‘unsuitable’ for the consumer if the contract is entered into or the credit limit is increased in the assessment period. To complete this suitability assessment, s 130(1)(a)-(e) requires the credit provider to ‘make reasonable inquiries’ about the consumer’s ‘requirements and objectives’ in obtaining the credit; ‘make reasonable inquiries’ about the consumer’s ‘financial situation’; ‘take reasonable steps’ to verify the financial situation; and make any inquiries or verification prescribed by the regulations. According to the Bill’s Explanatory Memorandum (Memorandum), the ‘general position is that consumers should be able to meet the contract’s obligations from income rather than equity in an asset’.¹⁶⁶ Therefore, although not expressly written in the legislation, it appears that the drafters of the Bill envisaged that asset-based lending would generally be ‘unsuitable’.

Section 131(2) outlines circumstances in which the contract will be *deemed* unsuitable. These are where ‘it is likely that’ the consumer ‘will be unable to comply’ with the consumer’s financial obligations under the contract, or is likely only to comply ‘with substantial hardship’; where the contract ‘will not meet the consumer’s requirements or objectives’; and in any circumstances prescribed in the regulations. Additionally, there is an important presumption in s 131(3), in which ‘if the consumer could only comply with the consumer’s financial obligations under the contract by selling the consumer’s principal place of residence’, substantial hardship will be presumed, making the contract unsuitable. It appears that the credit provider will be required to take only reasonably foreseeable circumstances into account when making this assessment.¹⁶⁷ It also appears that even where a borrower has satisfied a credit provider’s internal lending guidelines on suitability and capacity to repay, the credit provider will not necessarily have met the standard set by the legislation.¹⁶⁸ However, the Memorandum notes that the credit provider’s internal assessments of affordability would likely be ‘very similar’ to those required by the legislation.¹⁶⁹

Section 131(4) states that *only* information about the consumer’s financial situation, requirements or objectives that the licensee had reason to believe was true or would have had reason to believe was true if inquiries or verification under s 130 had been made, is able to be used to determine if the contract will be unsuitable. This creates an assumption that credit providers will have knowledge of information ‘that they should have become aware of if the reasonable steps to verify had been taken’.¹⁷⁰ An onus is put on credit providers to ‘ask the client about their financial situation’ and ‘make such efforts to verify the information...as would normally be undertaken by reasonable lenders in those circumstances’.¹⁷¹ What ‘reasonable’ lenders ‘normally’ undertake seems subjective, although the Memorandum suggests that conducting a credit reference check is likely to be reasonable, and that lenders are not expected to go beyond ‘prudent business practice in verifying the information they receive’.¹⁷²

¹⁶⁶ Commonwealth, House of Representatives, above n 163, 105.

¹⁶⁷ Ibid 111: the Explanatory Memorandum states that ‘for it to be *likely* that the consumer will be able to comply with the financial obligations under the contract, the credit provider must take a future view of the reasonable foreseeability of that compliance, given the financial obligations will arise into the future’.

¹⁶⁸ Ibid 108.

¹⁶⁹ Ibid 108-9.

¹⁷⁰ Ibid 109.

¹⁷¹ Ibid 107.

¹⁷² Ibid.

According to the Memorandum, refinancing of credit requires a higher level of inquiry in order to meet the 'reasonable' standard; where the level of repayments will be the same or similar to the current contract, the contract will be *prima facie* unsuitable.¹⁷³ However, the Bill itself contains no positive requirement for the refinance to put the consumer in a better position than under his or her previous contract, or even for the refinance to not put the consumer in a worse position. No such requirement has been included because it is apparently covered by the suitability requirement.¹⁷⁴ However, it has been argued that the lack of a positive requirement may mean that the suitability provisions will not cover a consumer who can still afford the refinance, but who is ultimately worse off under the new contract.¹⁷⁵

Division 4, s 133(1) prohibits a licensee lender from entering into or increasing the credit limit of an unsuitable credit contract. Section 133(6) makes it an offence to contravene the s 133(1) requirement, with the penalty being 100 penalty units or two years' imprisonment, or both.

2 *Credit Assistants*

Similar responsible lending obligations are imposed on credit assistants under part 3-1. 'Credit assistant' is defined in s 8 to be, *inter alia*, any person who suggests to or assists a borrower to apply for credit, apply for an increase in credit, or remain in their current credit contract.¹⁷⁶ Credit assistants must provide the consumer with both a credit guide and a quote, and make a 'preliminary assessment' as to the suitability of the credit for the consumer, which is very similar to the assessment that the credit provider must make. The assistant must also disclose any relevant further information, such as the commission the assistant is likely to receive as a result of the transaction. The overlap of duties and responsibilities between credit providers and credit assistants may compromise the effectiveness of the NCCP Bill, and is discussed further below.

3 *Remedies*

If a consumer is granted an unsuitable contract by a credit provider, he or she is able to seek an injunction to prevent the credit provider from collecting interest payments;¹⁷⁷ seek compensation for any loss or damage;¹⁷⁸ or seek an order to vary the contract or declare all or part of the contract void.¹⁷⁹ Where the credit provider has failed to verify income, but the borrower has made false or misleading statements in order to obtain credit that is unsuitable, the quantum of damages can be modified to reflect the culpability of the consumer.¹⁸⁰ These remedies have been described as 'appropriate'.¹⁸¹

¹⁷³ Ibid.

¹⁷⁴ Consumer Credit Legal Centre (NSW) Inc, *Submission in Response to the National Consumer Credit Reform Package* (2009) 10.

¹⁷⁵ Ibid.

¹⁷⁶ National Consumer Credit Protection Bill 2009 (Cth) s 8.

¹⁷⁷ National Consumer Credit Protection Bill 2009 (Cth) s 177.

¹⁷⁸ National Consumer Credit Protection Bill 2009 (Cth) s 178.

¹⁷⁹ National Consumer Credit Protection Bill 2009 (Cth) s 179.

¹⁸⁰ Commonwealth, House of Representatives, above n 163, 134.

¹⁸¹ Consumer Credit Legal Centre (NSW), above n 174, 14.

B *Form of Regulation: Paternalism and the Suitability Doctrine*

The NCCP Bill imposes a requirement on all lenders and intermediaries to assess ‘suitability’ before granting loans. This form of regulation is not unique and is strongly supported by some critics. However, some arguments have contended that the legislation is paternalistic and may restrict consumer choice and autonomy. There is an argument that the focus should instead be on encouraging ‘responsible borrowing’.

1 *The ‘Suitability’ Doctrine*

The ‘doctrine of suitability’ outlined in the NCCP Bill is not a new initiative and has been traced in the US back to the late 1930s.¹⁸² It has been used more recently in the US *Home Ownership and Equity Protection Act*,¹⁸³ which ‘prohibits lenders from making high-cost home loans to consumers based on their collateral without regard to their repayment ability’.¹⁸⁴ The theoretical basis for the suitability doctrine lies in the idea that lenders are in a better position than borrowers to assess the level of debt that borrowers can manage.¹⁸⁵ Engel and McCoy argue that, while disclosure requirements are ‘useless’ and financial literacy initiatives are expensive and ‘unlikely to succeed’, lenders themselves ‘can avoid the harm from predatory lending in a cost-effective manner by using traditional underwriting processes and guidelines to assess the suitability of customers’ loans’.¹⁸⁶ The suitability doctrine is therefore able to operate to protect consumers where other initiatives have failed.

Laws requiring suitability assessments for mortgage products are found in a number of other countries.¹⁸⁷ The European Commission is currently working on a consultation to analyse responsible lending issues throughout Europe.¹⁸⁸ In the US, a broader approach has been taken to address irresponsible lending and the foreclosure crisis. Legislation has been proposed to establish the ‘Consumer Financial Protection Agency’, which will be dedicated to protecting consumers from predatory lending practices.¹⁸⁹ There are also calls to allow homeowners to restructure their current mortgages under court supervision, which would allow a court to reduce the balance of a loan to bring it into line with the property’s current value, in cases where homeowners have exhausted all other options.¹⁹⁰ While these are undoubtedly positive developments, they may not prevent similar problems from re-occurring in the future. To that end, there is proposed legislation that will, *inter alia*, create a duty of care on residential mortgage originators and prevent a creditor from lending without due regard to the mortgagor’s ability to repay.¹⁹¹ It therefore seems that the NCCP Bill and its use of the suitability doctrine to

¹⁸² Engel and McCoy, ‘A Tale of Three Markets’, above n 36, 1318.

¹⁸³ 15 USC §1639, amending the *Truth in Lending Act*, 15 USC §§1601 (and the following one 1988).

¹⁸⁴ Engel and McCoy, ‘A Tale of Three Markets’, above n 36, 1319-20.

¹⁸⁵ *Ibid* 1336.

¹⁸⁶ *Ibid* 1337.

¹⁸⁷ Including Austria, Belgium, Hungary, Ireland, Malta and the Netherlands: European Commission, *Public Consultation on Responsible Lending and Borrowing in the EU* (2009) 7.

¹⁸⁸ *Ibid* 3-4: the European Commission defines responsible lending very similarly to the NCCP Bill, meaning ‘credit products are appropriate for consumers’ needs and are tailored to their ability to repay’.

¹⁸⁹ HR 3126: Consumer Financial Protection Agency Act of 2009, 111th Congress.

¹⁹⁰ Centre for Responsible Lending, *At a Glance: Top Policies for Addressing the Foreclosure Crisis* (2009) <<http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/top-policies-for-addressing-the-foreclosure-crisis.html>> at 11 September 2009.

¹⁹¹ HR 1728: Mortgage Reform and Anti-Predatory Lending Act, 111th Congress.

impose a responsible lending duty is not only an appropriate and much needed response in Australia, it is also rapidly becoming the way forward in a number of other jurisdictions.

2 *Paternalism versus 'Responsible Borrowing'*

The proposed laws have been described as having a 'patronising attitude'¹⁹² towards consumers, and as taking away or limiting consumer choice, thus making them paternalistic. Paternalistic legislation is not ideal because it both 'adds red tape and costs to consumer transactions' and 'goes to the heart of the exercise of liberty and autonomy by consumers' by restricting autonomous action.¹⁹³ While these laws do create some restriction on free choice, this is surely 'outweighed by the severe negative effects of predatory loans on borrowers and on society.'¹⁹⁴ That is, irresponsible lending has not only affected those consumers directly subject to predatory loans, it has had negative repercussions for the economy as a whole. In the US, economic problems such as falling house prices and lower incomes have meant that even 'good credit' borrowers with prime mortgages are having difficulty meeting repayments.¹⁹⁵ The effects of irresponsible lending are not felt by only a small group of vulnerable or disadvantaged consumers.

It is commonly suggested that this form of paternalistic regulation should not be necessary if consumers take greater responsibility for their own borrowing habits; that is, that there should be a duty on consumers to *borrow* responsibly. It is not disputed that it is important for consumers to educate themselves and make appropriate financial decisions. However, it must be remembered that there are groups of vulnerable and disadvantaged consumers who are incapable of protecting themselves financially. As seen in part two, lenders or intermediaries are able to actively target, manipulate and exploit these vulnerabilities in consumers, through psychological manipulations, abuse of loopholes in the legislation, or outright fraud. Consumers are not necessarily acting by free will where predatory lenders are able to rely on 'deception, naïveté, and information asymmetries – circumstances that are inimical to the formation of free will'.¹⁹⁶ In light of the immense power imbalance between lender and consumer in these circumstances, and the negative flow-on effects from bad loans that affect both the economy and other consumers, the balance must fall on the side of introducing legislation, even where doing so may create some limits on consumer choice. In this case, paternalism is necessary and justified for the broader interests of society, not just the consumers in question.¹⁹⁷

¹⁹² Australian Finance Conference, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 4.

¹⁹³ C Field, 'Having One's Cake and Eating it Too – an Analysis of Behavioural Economics From a Consumer Policy Perspective' (Paper presented at Productivity Commission Roundtable on Behavioural Economics and Public Policy, Melbourne, 8-9 August 2007) 91.

¹⁹⁴ Engel and McCoy, 'A Tale of Three Markets', above n 36, 1359.

¹⁹⁵ N Timiraos, 'Good Credit Borrowers Now Feeling Repayment Strain', *Wall Street Journal* (as published in the *Weekend Australian*, Perth), 22-23 August 2009, 30.

¹⁹⁶ Engel and McCoy, 'A Tale of Three Markets', above n 36, 1346.

¹⁹⁷ *Ibid* 1347.

C *Potential Limits on the Efficacy of the NCCP Bill*

Chris Bowen MP¹⁹⁸ has described the proposed responsible lending laws as ‘world’s best practice’.¹⁹⁹ While he admits they are ‘fairly tough’, he has also stated that they are ‘well balanced’.²⁰⁰ Balance is indeed important in the implementation of this legislation. Lending standards must be tightened so as to protect vulnerable consumers, but must not be tightened so as to unreasonably restrict consumer choice, or result in financial exclusion. The legislation must avoid being overly proscriptive, but at the same time must ensure there are no loopholes that can be exploited by unscrupulous lenders. There will naturally be some compliance costs to businesses, particularly from the new disclosure requirements, but these should not unreasonably be passed on to consumers. These are the key issues that may affect the NCCP Bill’s effectiveness as a consumer protection instrument.

1 *Financial Exclusion and Reduction in Availability of Credit*

One of the more concerning allegations made against the responsible lending provisions is that they will result in the exclusion of low-income consumers from obtaining mainstream credit. Abacus argues that there may be more stringent verification required for low-income earners, which may risk making credit less available and/or more expensive for this group of consumers.²⁰¹ The Consumer Credit Legal Service (WA) (CCLSWA) notes that ‘discriminating merely on the basis of income must be monitored and regulated’, and that there ‘are many people on a low income who have just as much capacity to service a credit contract...than those in a higher tax bracket’.²⁰² There is also a concern that lower-income consumers will be discriminated against under the ‘substantial hardship’ test, as it may be assumed that those on lower incomes may have a lower ‘hardship threshold’, despite the fact that ‘some consumers will be far more resilient than others’, regardless of income or financial commitments.²⁰³ For this reason, CCLSWA suggest that ‘substantial hardship’ should not be interpreted in its narrowest sense.²⁰⁴

The danger of excluding low-income consumers is that it may lead to greater levels of over-indebtedness. If mainstream finance is not accessible to low-income consumers, they are more likely to fall victim to predatory lenders. Consumers on low incomes must have access to ‘safe credit’ when applying for mortgages.²⁰⁵ For successful implementation of the responsible lending initiatives, it is vital that credit providers recognise that they ‘should not deny access to credit by low income, vulnerable and

¹⁹⁸ Minister for Financial Services, Superannuation and Corporate Law.

¹⁹⁹ S Bagwell, Interview with Chris Bowen MP, Minister for Financial Services, Superannuation and Corporate Law (ABC Radio National, 26 June 2009). Transcript available from: <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=transcripts/2009/008.htm&pageID=004&min=cba&Year=&DocType=>> 3 July 2009.

²⁰⁰ Ibid.

²⁰¹ Abacus – Australian Mutuals, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 7.

²⁰² Consumer Credit Legal Service of Western Australia, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 6.

²⁰³ Ibid.

²⁰⁴ Ibid 7.

²⁰⁵ Wilson, above n 68, 101.

disadvantaged consumers who are capable of managing their finances effectively'.²⁰⁶ In the US, the *Community Reinvestment Act*²⁰⁷ (Reinvestment Act) encourages banks to expand mortgage lending to low-income consumers who may have difficulty accessing mainstream finance. While the Reinvestment Act has been criticised as encouraging subprime or risky lending,²⁰⁸ there has also been much evidence disputing these criticisms.²⁰⁹ If necessary and justified, a similar principle could be applied in Australia to ensure access to home mortgage lending for low-income consumers.

However, it is not just low-income consumers who may be affected. Uncertainty as to the requirements of the legislation could lead to a reduction in the availability of credit products and services for all consumers. Some lenders have contended that the requirements and terms used in the legislation are 'arguable and subjective'.²¹⁰ For example, the requirement to 'make reasonable inquiries' is used repeatedly throughout the Bill and, although the Memorandum gives some guidance on the meaning of this term,²¹¹ it also states that 'what is reasonable will depend on the circumstances',²¹² making this requirement vague and subjective. Some lenders claim they will be forced to 'significantly reduce the availability of credit', in order to ensure they do not breach the legislation²¹³ and may stop offering certain products and services. For example, ANZ has submitted that it is uncertain whether low-doc loans would meet the standard set by the responsible lending obligations.²¹⁴ Further explanation or guidance is required on these issues; the current lack of information threatens to restrict the availability of credit for all consumers.²¹⁵

(a) *Positive Credit Reporting to Combat Financial Exclusion*

Positive credit reporting in Australia would allow credit reports to contain not only negative event information, such as defaults, but also information concerning the 'type of credit, credit provider, date the account was opened, the credit limit and the age of

²⁰⁶ Consumer Affairs Victoria, *The Report of the Consumer Credit Review* (2006) 8.

²⁰⁷ 12 USC §§ 2901 (and the following one 1977).

²⁰⁸ See: S Liebowitz, 'The Real Scandal: How Feds Invited the Mortgage Mess', *New York Post*, 5 February 2008
<http://www.nypost.com/p/news/opinion/opedcolumnists/the_real_scandal_Qjl08vDbysbe6LWDxcq03J> at 30 August 2009.

²⁰⁹ K Park, 'Subprime Lending and the Community Reinvestment Act' (Working Paper No N08-2, Joint Center for Housing Studies, Harvard University, 2008); see also M S Barr, 'Credit Where it Counts: Maintaining a Strong Community Reinvestment Act' (2006) 29(1) *Western New England Law Review* 11.

²¹⁰ Commonwealth Bank of Australia, above n 160, 2.

²¹¹ Commonwealth, House of Representatives, above n 163, 104: 'the minimum requirement for satisfying reasonable inquiries about the consumer's requirements and objectives will be to understand the purpose for which the credit is sought and determine if the type, length, rate, terms, special conditions, charges and other aspects of the proposed contract meet this purpose or put forward credit contracts that do match the consumer's purpose'.

²¹² *Ibid.*

²¹³ Commonwealth Bank of Australia, above n 160, 3.

²¹⁴ ANZ, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 7.

²¹⁵ ASIC, the regulatory body for consumer credit under the new regime, has proposed to provide guidance for credit licensees on how to meet the responsible lending obligations. It is currently seeking the views of credit providers and consumers on the proposals: Australian Securities and Investments Commission, *Consultation Paper 115* (2009). A final regulatory guide from ASIC would be a positive development and should aid in preventing a reduction in the availability of credit.

the account'.²¹⁶ Part IIIA of the *Privacy Act 1988* (Cth) currently prohibits positive credit reporting. However, in May 2008 an Australian Law Reform Commission report found that more comprehensive reporting could be introduced if accompanied by a specific legislative responsible lending requirement.²¹⁷

It therefore appears to be an appropriate time to introduce a positive credit reporting system. This system could be used to combat financial exclusion. A study has found that the positive credit reporting system in the US has led to greater accuracy in risk scoring and hence to a wider range of consumers being successful in applying for credit than in Australia.²¹⁸ It has also been argued that a positive credit reporting system 'would also result in better data verification than would be possible using the current negative reporting system'.²¹⁹ If more detailed and accurate information is available to lenders, they may be more likely to lend to those on low incomes and thereby aid in preventing financial exclusion.

2 *Potential Loopholes within the Bill*

Any restriction on free choice is justified only where the legislation concerned genuinely achieves its consumer protection goals. This legislation alters well-settled principles of law governing the contractual relationship between lender and borrower. Therefore, there may be an inclination by the court to read down the provisions of the statute and revert to more familiar legal doctrines.²²⁰ This inclination must be resisted, or the entire purpose of the legislation may be undermined. Any potential loopholes in the legislation that may be interpreted contrary to the intention of Parliament must be avoided.

(a) *Section 130(3)*

Currently, s 130(3) of the NCCP Bill allows a credit provider not to have to verify an assessment as to suitability if a credit assistant has already made a preliminary assessment under s 116. There were many concerns raised that this section has the potential to be 'exploited by predatory lenders as a defence to not undertaking further enquiry and verification'.²²¹ Reliance on inaccurate information from brokers is 'one of the key weaknesses in the current lending practice',²²² as seen in part two. The Consumer Credit Legal Centre NSW noted also that the section could be 'interpreted as limiting the credit provider's overarching responsibility to assess loan suitability, including verification'.²²³ For this reason, a number of the submissions on the Exposure Draft of the NCCP Bill argued for s 130(3) to be deleted in its entirety. In opposition, however, the Australian Bankers' Association argued that credit providers should be

²¹⁶ Consumer Affairs Victoria, above n 206, 248.

²¹⁷ As recommended: Australian Law Reform Commission, *For Your Information – Australian Privacy Law and Practice*, Report No 108 (2008) 1845-6.

²¹⁸ M Staten and J Barron, 'The Value of Comprehensive Credit Reports: Lessons from the US Experience' in M J Miller (ed), *Credit Reporting Systems and the International Economy* (2003) 273.

²¹⁹ Law Council of Australia, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 8.

²²⁰ *West v AGC (Advances) Limited* (1986) 5 NSWLR 601, 611-12 (Kirby P).

²²¹ Credit Ombudsman Service Limited, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 5.

²²² Consumer Credit Legal Centre (NSW), above n 174, 6.

²²³ *Ibid.*

able to rely on information provided by registered and licensed credit assistants, or else it would render the licensing and registration of credit assistants completely futile.²²⁴

In accordance with a recommendation from the Senate Economics Committee,²²⁵ the government will be amending the NCCP Bill to delete s 130 entirely.²²⁶ Although alternative approaches to close this loophole were available, such as requiring lenders to randomly audit information received from brokers, deleting the section entirely will allow lenders to rely on information received from brokers if they are certain that the information is correct, but will not allow predatory lenders a defence for relying solely on broker-originated information.²²⁷ This development is therefore strongly supported as a measure that will improve the NCCP Bill's efficacy as a consumer protection instrument.

(b) *Waiver*

The question of whether informed consumers should be entitled to waive their rights to suitability assessments has been raised as a suggestion to mitigate the argued paternalistic nature of the legislation.²²⁸ The difficulty with waiver, however, is that 'it opens a back door through which lenders and brokers can engage in the same abuses that militated in favour of regulation in the first place'.²²⁹ Consumers who are desperate to gain finance may unwisely waive their rights to a suitability assessment, the effects of which can 'redound to the harm of society, not just borrowers'.²³⁰ There may be room to argue that waiver be allowed only in certain circumstances, or where the consumer is informed and perhaps experienced. However, any eroding of the suitability requirement could undermine the purpose and effect of the legislation entirely.²³¹ It appears on balance therefore that such an option should not be created, as it could be exploited by unscrupulous lenders and thereby used to avoid the requirements of the legislation.

3 *New Disclosure Requirements*

The disclosure requirements contained in the Bill have been met with some criticism on the grounds that they may not add to consumer understanding, but may result in greater compliance costs for the lender. Redfern Legal Centre remarked that, in their experience, 'many of our clients don't read all the documents with which they are provided under the present regime'.²³² Many banks and other lending institutions have

²²⁴ Australian Bankers' Association Inc, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 10.

²²⁵ Senate Economics Committee, *Inquiry into the National Consumer Credit Protection Bill 2009 and Related Bills* (2009) Parliament of Australia <http://www.aph.gov.au/senate/committee/economics_ctte/consumer_credit_09/index.htm> at 17 September 2009.

²²⁶ C Bowen MP, 'Consumer Credit Reforms – Senate Amendments' (Press Release, 17 September 2009) <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/017.htm&pageID=003&min=ceba&Year=&DocType=0>> at 17 September 2009.

²²⁷ Senate Economics Committee, above n 225, 25.

²²⁸ Clayton Utz, *Submissions to Treasury on the Draft National Consumer Credit Reform Legislation* (2009) 3.

²²⁹ Engel and McCoy, 'A Tale of Three Markets', above n 36, 1348.

²³⁰ *Ibid.*

²³¹ *Ibid.*

²³² Redfern Legal Centre, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 4.

argued that the provisions are an ‘unnecessary compliance burden’.²³³ There is also concern that the current process for disclosure as outlined by the legislation could result in a doubling-up of information, meaning that the ‘consumer would be flooded with a number of disclosures which would not add clarity’.²³⁴

However, there is strong support for the new requirements from consumer advocacy groups. CCLSWA argues that the credit guide should be of great benefit to the consumer in making comparisons among credit products.²³⁵ They suggest, however, that there be a requirement for the credit guide to be ‘written in clear language, be succinct and accurate in the way it records the information, outlining all the salient points’.²³⁶ There should also be consideration given to ‘streamlining both the documents to be provided to consumers and the information contained within them’.²³⁷ The implementation of both these suggestions should result in more effective disclosure to consumers and fewer compliance costs for lenders.²³⁸

D Conclusion

The NCCP Bill proposes legislation that contains a targeted and specific duty to lend responsibly. While it may reasonably be described as paternalistic, this is justified in the light of the potential harm caused by irresponsible lending. In order to reach full efficacy as a consumer protection instrument, however, the legislation must avoid reducing the availability of credit, as this could aggravate the problems of financial exclusion and over-indebtedness. Potential loopholes that could undermine the purpose and effect of the legislation, such as the introduction of a waiver option, or provision equivalent to s 130(3), must also be avoided. The disclosure requirements contained in the NCCP Bill are supported, but ideally must contain a requirement for clarity to avoid obfuscation for consumers and must avoid any duplication of information to minimise compliance costs for lenders.

V CONCLUSION

*‘Never again should we let the schemes of a reckless few put the world’s financial system – and our people’s well-being – at risk.’*²³⁹

Irresponsible lending in the residential mortgage market can lead to devastating losses, both for individual consumers and for the Australian economy. The recent rapid expansion in the number of credit providers and intermediaries operating in the market has resulted in a rise in the availability of credit and a rise in the number and variety of credit products available to consumers. Factors such as the increased availability of non-conforming and low-doc loans, asset-based lending practices, and securitisation of loans have contributed to lowered lending standards and a correlated rise in irresponsible and

²³³ Australian Bankers’ Association, above n 224, 13.

²³⁴ Financial Planning Association, *Submission on National Consumer Credit Regime Exposure Draft* (2009) 7.

²³⁵ Consumer Credit Legal Service of Western Australia, above n 202, 5.

²³⁶ *Ibid.*

²³⁷ Clayton Utz, above n 228, 8.

²³⁸ *Ibid.*

²³⁹ President B Obama, ‘Remarks by President Obama at G20 Closing Press Conference’ (Press Release, 25 September 2009) <http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-at-G20-Closing-Press-Conference/> at 27 September 2009.

predatory lending. Consumers have been granted loans that are patently unsuitable, which has, for many consumers, placed their most valuable asset, the family home, in jeopardy. Irresponsible lending is a market failure that must be addressed to prevent further harm from occurring.

The statutory reopening provisions and equitable doctrines have been narrowly interpreted in a manner that is no longer compatible with modern lending practices. As such, they are no longer able to adequately protect or provide redress for consumers who are victims of irresponsible lending. While continued consumer financial education and counselling are vital, and consumer disclosure information allows consumers access to essential information, these methods alone cannot bridge the information gap between lender and borrower. Lender self-regulation is also inadequate as long as unscrupulous lenders are able to target vulnerable and disadvantaged consumers in the interests of increased profits. Irresponsible lending cannot be addressed through any lesser means than the introduction of additional regulation.

The proposed regulation is in the form of legislation that imposes an explicit obligation on all lenders and intermediaries to assess the consumer's capacity to repay and the appropriateness of the credit for the consumer, before approving the loan. This ex-ante suitability assessment obligation is a direct and appropriate response to the irresponsible lending problem. The legislation is arguably paternalistic in nature, but this is justified when weighed against the far-reaching negative externalities caused by irresponsible lending. However, the efficacy of the proposed legislation may be affected by a number of factors. The legislation may result in a reduction in the availability of credit, which may aggravate problems of financial exclusion, particularly for low-income, vulnerable or disadvantaged consumers. Several strategies have been suggested to combat this problem. Releasing further information to lenders will help to increase certainty and understanding of the new legislative provisions. Introducing positive credit reporting or implementing a scheme similar to that in the Reinvestment Act may also be appropriate. Loopholes in the legislation that may compromise its effectiveness, such as the former s 130(3) or the possibility of the introduction of a waiver of the suitability assessment, must be monitored and avoided. The disclosure requirements set out by the legislation are supported, but must be subject to a requirement of clarity and simplicity so as not to hinder consumer understanding.

It has been reiterated throughout this article that the introduction of any new regulation will always involve a question of balance. In the context of consumer credit law, consumer freedom, access to credit and innovation in the market must be weighed against consumer protection and market efficiency.²⁴⁰ This is not a simple process, but it is a 'vital task'.²⁴¹ The Australian government has acted promptly and commendably in introducing the NCCP Bill to combat irresponsible lending. However, markets are notoriously difficult to predict and, while the proposed legislation is a theoretically appropriate response to the identified market failure, it is by no means a panacea for irresponsible lending and all its associated practices. As Justin Malbon observes, 'the long history of lending regulation suggests that no single approach will solve the problem'.²⁴² Only time, further research and close observation will ensure that consumers are protected from irresponsible lending into the future.

²⁴⁰ Belsky and Essene, above n 111, 60.

²⁴¹ Ibid.

²⁴² Malbon, 'Predatory Lending', above n 34, 234.