Financial Rights LEGAL CENTRE

26 October 2018

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry – Interim Report

Introduction

The Financial Rights Legal Centre (**Financial Rights**) welcomes the opportunity to provide written submissions addressing issues that have emerged from the first four rounds of hearings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

The Financial Rights Legal Centre is a community legal centre that specialises in helping consumers understand and enforce their financial rights, especially low income and otherwise marginalised or vulnerable consumers. We provide free and independent financial counselling, legal advice and representation to individuals about a broad range of financial issues. Financial Rights operates the National Debt Helpline, which helps NSW consumers experiencing financial difficulties. We also operate the Insurance Law Service which provides advice nationally to consumers about insurance claims and debts to insurance companies, and the Mob Strong Debt Help services which assist Aboriginal and Torres Strait Islander Peoples with credit, debt and insurance matters. Financial Rights took close to 25,000 calls for advice or assistance during the 2017/2018 financial year.

Our submission puts forward our views as to what changes are required to the regulatory regime to prevent the conduct identified by the Royal Commission in first four hearings from happening again. In so doing we have noted and sought to address many of the questions posed by the Commissioner in Volume 1 of the Interim Report. Where we answer a question directly we have indicated this via reference.

What can be done to prevent the conduct identified by the Royal Commission happening again?

The Royal Commission has brought to the public's attention conduct that has not only failed to meet basic community standards of ethical and moral behaviour but also potentially illegal, even criminal behaviour. This conduct has brought justifiable condemnation from the public. –

The Commissioner rightly points out that:

> *The law already requires entities to 'do all things necessary to ensure' that the services they are licensed to provide are provided 'efficiently, honestly and fairly'. Much more often than not, the conduct now condemned was contrary to law. Passing some new law to say, again, 'Do not do that', would add an extra layer of legal complexity to an already complex regulatory regime. What would that gain?*

It is clear that the administration and enforcement of the law has left a lot to be desired and will need to be addressed. Supervision of the financial services sector and enforcement of the laws need to be reformed to empower and embolden the regulators to take stronger action to become the "tough cop on the beat" that the community expects.

It is also clear though that there are fundamental problems with the form and substance of the laws as drafted, problems that have contributed directly to the behaviour on display. These laws do require updating and reform to ensure they better align with community standards and expectations and drive improved consumer outcomes.

Many of our current laws have led to poor outcomes unintentionally, whether because of poor or ambiguous drafting; the law not being nimble enough to keep pace with developments; or well-resourced companies simply being able to take part in regulatory arbitrage to evade the spirit and intent of the law. Many of the outcomes have however been by design - legislation that has been intentionally weighted to favour shareholders and a range of conflicted financial self-interests, through decades of entrenched well-resourced lobbying efforts.

Wholesale reform to regulation of the financial services sector is required to address the poor conduct and system failings identified.

The administration of the regulatory framework needs significant overhaul to promote greater enforcement of laws and fortify the regulator's hand. A performance based regulation culture needs to be instilled to better align regulated entities with the regulator's and hence the community's goals. Ongoing monitoring to keep an eye on the sector moving into the future is vital. Self-regulation via voluntary codes of practice has failed and co-regulation must be implemented.

Laws currently in place require simplifying, consolidation, updating and strengthening to deliver improved community outcomes and ensure that that the consumer interest is placed front and centre of the framework. Loopholes must be identified and closed, penalties need to increase to more effectively deter poor corporate behaviour.

Intervention is also required to finally address fundamental cultural problems arising from misaligned incentives, conflicted remuneration structures and broadening directors' duties.

Access to justice requires vast improvement and resourcing to provide all Australian consumers and small businesses with fast, easy, and effective pathways to resolve their issues and obtain redress. Consumers need to be compensated in a faster and more effective manner.

This submission extrapolates on the above and recommends the following nine actions:

1. **Tackle cultural problems head on**

    - Introduce corporate social responsibility duties on directors
    - Enhance and extend the Banking Executive Accountability Regime (**BEAR**) regime
    - End all forms of conflicted remuneration and misaligned incentives
    - Intermediaries should be required to act in the best interests of their clients

- Professionalise the industry through strengthened licensing, appropriate conduct and qualifications standards and ethics training

2. **Update the law in line with community expectations**

   - Require loans to be suitable as opposed to "not unsuitable"
   - Prohibit worthless products including consumer credit insurance (**CCI**), add-on, funeral insurance, accidental death and accidental injury products;
   - Improve protections for vulnerable customers through strengthened guarantor rules, increased access to basic bank accounts, and improved direct debit processes
   - Prohibit pressure sales tactics and strengthened the anti-hawking regime

3. **Close the loopholes**

   - Bring 'debt management' firms into the financial services regulatory framework
   - Ensure buy-now-pay-later providers are captured by the credit law;
   - Bring small business lending into the regulatory framework by requiring licensing, External Dispute Resolution (**EDR**) and code of practice coverage for non-bank lenders
   - Prevent unsolicited credit limit increases of any kind

4. **Toughen the cop on the block**

   - Ensure that the Chair or Deputy Chair of Australian Securities and Investments Commission (**ASIC**) has a consumer protection background
   - Provide ASIC rule making powers
   - Empower ASIC to respond to emerging issues and prevent them from arising in the first place
   - Move to performance/outcome based regulation where appropriate
   - Resource ASIC with Regulatory Technology (**RegTech**) to better monitor the financial services sector
   - Resource ASIC to conduct appropriate litigation

5. **Make penalties bite**

   - Increase penalties in line with the ASIC Enforcement Review recommendations
   - Ensure codes of conduct are mandatory for all, strengthened, monitored, enforceable and attract effective sanctions via co-regulation

6. **Compensate victims**

    - Obligate financial service providers to identify and remediate consumers subject to irresponsible lending
    - Improve remedies for irresponsible lending to include debt waivers and refunds where appropriate
    - Empower the Australian Financial Complaints Authority (**AFCA**) to deliver fair outcomes that meet community expectations
    - Provide ASIC with a directions power in relation to compensation
    - Ensure timely redress with AFCA overseeing all remediation programs (industry initiated, ASIC directed or as a result of Enforceable Undertakings (**EUs**))
    - Establish a last resort compensation scheme funded by industry

7. **Improve access to justice**

    - Guarantee funding for financial counselling and community legal centres to assist consumers with disputes
    - Fund systemic advocacy by financial counsellors and community legal centres to ensure greater accountability and systemic reform

8. **Monitor and address unintended consequences**

    - Monitor and respond to issues in the credit and property markets if and as they arise
    - The Australian Prudential Regulation Authority (**APRA**) to monitor property valuation practices

9. **Never again – holding industry to account**

    - Introduce a regular sector wide-review or re-run of the Royal Commission

1. Tackle cultural problems head on

Governance, remuneration practices and the incentives they create drive the financial services sector culture that has been put on display at the Royal Commission. As the Commission has observed

> *All the conduct identified and criticised in this report was conduct that provided a financial benefit to the individuals and entities concerned. … Culture and conduct of the banks was driven by, and was reflected in, their remuneration practices and policies.*[1]

Consequently reform is required to ensure self-interested financial benefit to the individuals and the financial services entity is counter-balanced with clear incentives and directives to promote individual and corporate responsibility towards consumer's best interests and broader social responsibilities. These reforms must be targeted at every level of the financial services sector from board directors down.

Introduce corporate social responsibility duties for directors

Sections 180-184 of the *Corporations Act 2001* stipulate that directors are fiduciaries and therefore must exercise their duties for the benefit of the company, rather than either their own interest or the interests of a third party. Section 181(1) of the *Corporations Act* states that:

> *A director…must exercise their powers and discharge their duties: (a) in good faith in the best interests of the corporation; and (b) for a proper purpose.*

Section 182 of the Corporations Act provides that:

> *A director…must not improperly use their position to: (a) gain an advantage for themselves or someone else; or (b) cause detriment to the corporation.*

Directors and executives are consequently rewarded for increased profits and for delivering improved financial results for the corporation and its shareholders.

The extent to which directors are allowed under Australian law to take into account the interests of other stakeholders is limited. The Australian Government has reviewed this issue numerous times[2], consistently finding that the law is adequate and flexible enough to allow directors to take into account relevant interests - the general argument being that as companies do not operate in a vacuum and in order to be sustainable in the long term, directors must take all stakeholder interests into account, and not focus on shareholders or financial interests alone. Directors that do not are not managing their risks adequately and are arguably in breach of their duty to act with due diligence and care.

We have now seen the result of such implied duties.

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[1] Page 301, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report – Volume 1*, September 2018

[2] Most recently in Parliamentary Joint Committee on Corporations and Financial Services Corporate responsibility: Managing risk and creating value, June 2006
https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2004-07/corporate_responsibility/report/index

Short-term profits for shareholders have in practice consistently outweighed the interests of other relevant stakeholders in the deliberations of relevant boards, even where this is clearly to the detriment of the long term interests of the organisation. Directors must be explicitly directed to take all stakeholder interests into account so as to adequately manage these risks. The UK has taken this step and has included mandatory consideration by directors of certain interests other than shareholders, including, amongst others employees, customers, suppliers, and the environment.[3]

The *Corporations Act 2001* is therefore, in our view, out of step with community expectations with respect to the expected behaviour of directors and corporations, and as such, sections 180-184 of the Act should be updated to explicitly ensure directors take into account stakeholder interests other than shareholders, particularly their customers.

Enhance and extend the BEAR regime

Increasing personal accountability within financial institutions for misconduct is critical to improving standards in the banking industry and should begin from the top.

Parliament has already taken some steps towards making individual directors and senior executives accountable for the behaviour of authorised deposit taking institutions. The new BEAR passed Federal Parliament in February 2018 and in summary compels Authorised Deposit-taking Institutions (**ADIs**) to defer a minimum percentage of a senior executive's variable remuneration for at least four years and have a remuneration policy that provides for reduction of the deferred variable remuneration where a senior executive has not met their obligations under the BEAR.

However BEAR's scope is limited to poor conduct or behaviour that is of a systemic and prudential nature. BEAR has not included a central element of the UK model which ties accountability measures to poor consumer outcomes, not just prudential matters.

BEAR in its current form is unlikely to compel any executive to face consequences for the string of scandals that the Royal Commission and other inquiries have identified.

The UK regime requires senior banking executives and directors to take all reasonable steps to prevent regulatory breaches in the areas of the bank for which they are responsible. In addition to this, there are individual conduct rules that require senior managers to act with integrity and pay due regard to the interests of customers and treat them fairly. The regime has been so successful that the UK Financial Conduct Authority (**UK FCA**) is extending it to cover insurers and non-prudentially regulated firms as well as banks.

We believe BEAR should be expanded in similar ways, that is: BEAR should link accountability to poor consumer outcomes; and BEAR should apply to all Australian Financial Service (**AFS**) licensees – not simply ADIs.

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[3] Section 172 of the *Companies Act (UK)*

End all forms of conflicted remuneration and misaligned incentives[4]

All forms of conflicted remuneration for bank and credit provider employees and intermediaries including mortgage brokers, financial advisers and motor vehicle dealers must be prohibited.

Remuneration structures for bank and credit provider employees

The vast majority of banks provide incentives, commissions or bonus payments to at least some of their retail staff that are directly or indirectly related to product sales.[5] Many of these are variable payments linked directly to the achievement of sales targets or similar measures such as cross sales or referrals.

The banking sector through the Sedgwick Review recently recommended the prohibition of variable rewards payments rather than a prohibition of all forms of remuneration linked to product sales more generally, stating:

> *Sufficient evidence has not been presented to the Review of significant systemic risks of poor outcomes for customers to support an outright ban on all forms of remuneration linked to product sales. Conversely, nothing has emerged since publication of the Issues Paper that has changed my view that some practices of some banks entail an unacceptably high risk of incentivising poor selling practices potentially leading to poor customer outcomes.*[6]

The Royal Commission has provided sufficient evidence.

All forms of remuneration linked to product sales should be prohibited including any remuneration based on an overall assessment against a range of factors that includes product sales size or volume. It is inevitable that self-interest will lead to this factor outweighing all others. This prohibition needs to apply to all employees from public facing frontline sales staff to senior management and executives and everyone in between.

Intermediaries and commissions

Commissions paid to third party intermediaries are currently determined in a number of ways. The most common is as a proportion of the loan value including both upfront payments and

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[4] Addressing the following questions: We should try to answer questions at page 341: Is value based commission, paid to the broker by the lender, consonant with that duty? Should an aggregator owe any duty to the borrower? Again, are the remuneration arrangements for aggregators consonant with that duty? How is a value based commission consistent with acting in the interests, or best interests, of the client? Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice? What more should be done to implement the recommendations of the Sedgwick Review? Should any bank employee dealing with a customer be rewarded (whether by commission or as part of an incentive remuneration scheme) for selling the client a product of the employer? That is, should any 'customer facing employee' be paid variable remuneration? If the answer is either 'no' or 'some should not' what follows about incentive remuneration for managers or more senior executives? If more junior employees should not be remunerated in this way, why should their managers and senior executives? Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required? and at page 346 Should carve outs and exceptions be reduced or eliminated? In particular, … grandfathered commissions?

[5] See Stephen Sedgwick AO, Retail Banking Remuneration Review Report, 19 April 2017, https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf

[6] Page 4, Stephen Sedgwick AO, Retail Banking Remuneration Review Report, 19 April 2017, https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf

trail payments paid over the life of the loan. There are also bonus commissions (increasing motivation for an intermediary to maximise the size of the loan) and volume based commissions. Flex commissions also exist in other sectors such as the car finance sector where motor vehicle dealers receive commissions from the financier for arranging such finance, and the higher the interest rate set, the higher the commission received by the dealer.

These remuneration structures lead to a series of conflicts of interest. These include product choice conflicts (intermediaries recommending loans larger than the consumer needs or can afford, or on worse terms, to maximize their own commission) and lender choice conflicts (intermediaries recommending a specific lender due to higher commission that may not be in the best interest of the consumer). These conflicts can increase risks to the consumer, promote low quality products and increase financial hardship in both the short and long term.

All commissions, be they upfront, trailing, bonus, volume based or flex commissions, must be prohibited.

The Productivity Commission[7] has recently recommended the abolition of trail, volume-based and campaign-based commission but recommended maintaining upfront commissions based on the funds limit drawn down by customers, net of offset, instead of the limit of the loan facility. They have also recommended a limit of two years over which commissions can be clawed back.

These recommendations will not solve the problem as the conflicts of interest will remain.

While there may be issues with introducing fixed fees, including a cost to competition and smaller banks suffering more than larger lenders, we do not believe that these issues are insurmountable and can be addressed. The demand for the services of a broker in providing the leg work in choosing from a multitude of loan options will remain. Intermediaries would then compete on the value of the service they provide to consumers, just like every other business.

The Australian Banking Association (**ABA**) has recently announced[8] that the Banking Code of Practice (**Banking Code**) would be amended to ban grandfathered commissions. While a positive step, grandfathered commissions must be caught in a comprehensive prohibition.

Professionalise the industry through strengthened licencing, appropriate conduct and qualifications standards and ethics training

The financial services sector must be professionalised through appropriate professional standards, qualifications, training and licensing. This means applying mandatory professional standards to financial advice and wealth management, mortgage broking and all third party intermediaries (including motor vehicle dealers if allowed to continue at all) *and* banking employees engaged with any form of personal advice or lending.

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[7] Recommendations 11.2, 11.3 Productivity Commission, Competition in the Australian Financial System

[8] ABA, Media Release: Ending fees for no service, grandfathered payments, 10 October 2018 https://www.ausbanking.org.au/media/media-releases/media-release-2018/ending-fees-for-no-service-grandfathered-payments

We note that the recent *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* introduced new requirements for AFS licensees and their employees who provide personal advice to retail clients in relation to financial products that are not basic banking products, general insurance products and consumer credit insurance. These include increased education requirements, oversight from an independent standards body, the introduction of a code of ethics and the requirement to pass a benchmarking exam before being authorised to provide financial advice. A new Commonwealth standard setting body, the Financial Adviser Standards and Ethics Authority (**FASEA**) was also established.

These requirements must be expanded in a number of ways. Firstly they should apply to all financial products not just the “more complex financial products” and should include the 'relevant financial products' omitted under the *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017*, that is basic banking products, general insurance products, consumer credit insurance or a combination of these products.

Secondly professional standards must also be applied to all AFS licensees, credit licensees, ADIs and their employees - from board and senior executive level to front line customer facing staff and other employees not directly engaged with the core banking services such as marketing and information technology. The qualifications and certifications should be tailored to appropriate competencies to build professional judgement and decision making skills from an ethical-based position. We note that the Financial Services Institute of Australasia (**FINSIA**) and the Chartered Banking Institute (**CBI**) have introduced a Chartered Banker qualification. As with the financial advice standards, AFS licencees would have to demonstrate they meet the new minimum qualifications to be registered and that they are continuing to meet those standards for all staff through ongoing professional development. Licensees should put in place the necessary systems and processes to support their employees.

2. Update the law in line with community expectations

The Interim Report has found that not only have financial services entities breached the law as it currently stands, but they have taken advantage of laws that are out of date, poorly drafted, or out of step with community expectations. The law must be updated to reflect these expectations.

Intermediaries should be required to act in the best interests of their clients[9]

Mortgage brokers are not currently obliged by law to act in the best interest of their client. In contrast, financial advisors are obliged by law to act in the best interest of their client[10] under changes introduced by the Future of Financial Advice reforms. Financial advisors have a duty to act in the best interests of the client in relation to the advice, and take reasonable steps to do so. If the provider knows or reasonably ought to know that there is a conflict of interest, the provider must give priority to the client's interests when giving advice.

The same must be applied to all true intermediaries between a lender/credit provider and the consumer including mortgage brokers. On the other hand, introducers (if they are permitted to remain at all) and point of sale representatives such as motor dealers and retail outlets are agents for the lender. The point of sale exemption for motor dealers and retail credit should be removed.

The fundamental conflicts of interest identified in the financial advice sector apply equally to the brokering sector. The conflicts arise through the competing priorities between providing advice in the best interest of the client while at the same time selling products that either align with their own financial interest or with the interest of the financial institution providing the credit product.

Even more fundamentally, both community expectations and brokers' own advertised value proposition is that they will assist consumer to find the most suitable loan from the confusing array of options available, and assist them to negotiate the application process. The law, on the other hand, does not require the broker to do anything other than find a loan which is "not unsuitable". While brokers may not be able to access every product in the marketplace, there is a vast gap between providing a loan which is "not unsuitable" and looking for the most suitable product available to meet the consumer's needs. A broker performing their role well should not only find the most suitable loan or suite of products from their own lending panel, but point out other cheaper products in the market (if they exist) that the customer could access directly. The law should bring the broker's obligations in line with customer's expectation and the sector's own hype.

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[9] We seek to address the following questions at page 328: What duties does an intermediary owe to a borrower? What duties should an intermediary owe to a borrower? and pages 341-2: Is it desirable to prescribe that some or all of those who are not employees of banks, but deal with bank customers, must act in the interests, or the best interests, of the client? In particular, what duty, if any, should a mortgage broker owe to the prospective borrower? If some or all intermediaries should owe the customer a duty to act in that customer's interests, or best interests, is it enough to prescribe the duty and direct 'management' of conflicts between interest and duty?

[10] *Corporations Act 2001*, s961B(1)

The Productivity Commission has recently recommended the introduction of a best interest obligation for all credit licensees — whether as a lender or mortgage broker — who interact directly with consumers seeking a home loan. As with the rules for financial advisors, it would comprise of several distinct but complementary components:

- a duty to act in the best interest of the client;
- a requirement that any resulting recommendations must be appropriate to the client, having regard to the duty to act in the best interest of the client;
- a duty to prioritise the interests of the client, in the event of a conflict;
- a duty to ensure that certain information is disclosed to the client such as a conflict of interest.

The Productivity Commission recommends that where the lenders have an ownership interest in firms that provide the credit assistance services, those lenders should also have a legal responsibility to ensure that the licensee discharges its best interest obligations.[11]

These recommendations should be implemented and extended to apply to all intermediaries for all forms of lending not just home loans to avoid regulatory arbitrage. In all cases where the consumer deals with an entity other than the lender, they must be clearly an agent of the lender (as employee or credit representative) or a licensed intermediary with a best interests duty.

Loans should be suitable as opposed to "not unsuitable"[12]

Credit providers must ensure that any credit granted to a customer must be suitable to that individual's needs and that the customer can afford to repay the credit without substantial hardship. Currently credit providers must ensure that the credit contract or consumer lease is 'not unsuitable' for the consumer.

A test based on a loan being "not unsuitable" means that a credit provider can provide any old product on an unsuspecting consumer and as long as it is, at the very least not unsuitable. This is a passive requirement, the standard capturing many more products that even vaguely hit the mark. Requiring a loan to be suitable requires more action on the part of the credit provider to know the objectives and financial situation to match them to a suitable product. This is a change in mindset.

In introducing the law, many industry representatives successfully argued that ensuring that a loan is suitable is too broad a requirement and difficult to meet. However just as the ASIC has

[11] Recommendation 11.4 Best interest obligation for credit licensees that facilitate home loans, Productivity Commission, *Inquiry Report, Competition in the Australian Financial System*, https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf

[12] Addressing , in part, questions at page 329: What steps, consistent with responsible lending obligations, should a lender take to verify a borrower's expenses? Should the HEM continue to be used as a benchmark for borrowers' living expenses?

developed regulatory guidance with respect to ensuring that a loan is not unsuitable,[13] similar guidance can be provided to ensure that a loan is suitable. Currently credit providers must:

- make reasonable inquiries about the consumer's financial situation;
- make reasonable inquiries about the consumer's requirements and objectives;
- take reasonable steps to verify the consumer's financial situation; and
- take any steps prescribed by the regulations to verify any matter prescribed by the regulations.

Further, ASIC deems a loan to be unsuitable if, at the time of the preliminary assessment, it is likely that:

- the consumer will be unable to comply with their financial obligations under the proposed contract, or could only comply with substantial hardship;
- the proposed contract will not meet the consumer's requirements or objectives; or
- circumstances prescribed in the regulations apply to the proposed credit contract or consumer lease

Turning these latter requirements from a negative to a positive standard - so that, for example, a loan will be suitable if the proposed contract will meet the consumer's requirements or objectives - engenders a more active mindset on the credit provider rather than a passive one.

Credit providers must also be held to higher account then simply making reasonable inquiries. The reliance on "reasonable inquiries" is scalable for different situations. The use of reasonable however introduces an element of subjectivity that can be read down by a credit provider.

In providing a loan, credit providers should obtain answers to more precise questions with respect to a consumer's actual financial position and expenses, and verify these from transaction data and other primary documents.

Banks must take steps to: obtain and examine detailed information about the financial situation of the borrower including income and expenses; verify the financial situation of the borrower and obtain documentary evidence; and ensure the loan meets the specific needs and objectives of the borrower, which must be clearly spelt out and captured.

The onus of proof should also be reversed in responsible lending claims to further incentivise the credit provider to undertake an appropriate and thorough verification process.

Finally, the Household Expenditure Measure (**HEM**) Index was never meant to act as a default measure of household expenditure for the purposes of determining whether a loan was

[13] ASIC Regulatory Guidance 209: Credit licensing: Responsible lending conduct November 2014 https://download.asic.gov.au/media/2243019/rg209-published-5-november-2014.pdf

suitable or not. Benchmarks were mentioned in ASIC Guidance[14] as a backstop or 'sanity test' to ensure that consumers' potentially own inaccurate or overly optimistic estimates of expenses were not relied on in circumstances where they were wildly different to a recognised benchmark. .The flawed nature of using benchmarks as a default measure of household expenditure, as outlined by the Royal Commission[15] should cease. There is still a role for benchmarks like HEM, but only as a reference point against which to test the consumer's declared and appropriately verified expenses. The *National Consumer Credit Act 2009* should be amended to ensure that relying on a benchmark does not meet the reasonable steps test. Further, in relation to HEM in particular, relying on a median spend on absolute basics plus the 25th percentile spend on discretionary basics is inappropriate as it is by definition lower than the actual expenses for 75% of the population.

Prohibit worthless products

A statutory prohibition of particularly worthless products examined in modules 1 to 4 of the Royal Commission, i.e. add-on insurance and funeral insurance is required. Module 6 of the Royal Commission pointed to further products that provide little to no value to consumers including accidental death and accidental injury products. There may be others as yet unexamined. Broadening the proposed Product Intervention Powers to empower ASIC to permanently prohibit entire classes of products would be the most straightforward way to implement this.

Add-on insurance

There exists substantial evidence that the sale of add-on insurance provides very little value to consumers and has led to significant consumer detriment. Add-on insurance should be prohibited.

If a total prohibition is not implemented, a mandated deferral period for the sale of all add-on products by all distributors (including motor dealers for both new and used vehicles) should be introduced. A deferred sales mechanism can help offset pressure selling to consumers who have not sought out an insurance product. The principles for a deferred sales model should be as follows:

- the decision to purchase and/or finance a primary product must be distinct from the decision to purchase and/or finance an add-on insurance product;
- the deferral period should commence once the primary product has been purchased, financed *and* delivered to the consumer and the consumer communication has been provided. In other words the deferred sales period should begin on delivery of the primary product;

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[14] Regulatory Guide 209: Credit licensing: Responsible lending conduct https://download.asic.gov.au/media/2243019/rg209-published-5-november-2014.pdf eg RG 209.49, RG 209.104, RG 209.105: "Use of benchmarks is not a replacement for making inquiries about a particular consumer's current income and expenses, nor a replacement for an assessment based on that consumer's verified income and expenses"

[15] Pages 27-28 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report – Volume 1*, September 2018

- the consumer must instigate the contact to take up the purchase of at the end of the sales period, not the sales representative or insurer;
- the customer should have useful product information regarding an add-on insurance product and the opportunity to engage with it before the deferral period starts;
- the customer should know the total, discrete cost of add-on insurance before the deferral period starts;
- a deferral period of at least four days is required but we believe there is considerable merit in introducing a 30 day deferral period to allow a consumer to fully assess their financial situation before purchasing add-on insurance;
- insurers should not offer ‘bridging’ cover during the deferral period, as it would not address the small risk involved in the lack of coverage during the deferral period, could perpetuate high-pressure selling and could distort consumer decision-making
- Innovative, interactive consumer communication techniques should be mandated and supervised to ensure greater consumer understanding and purchase of suitable add-on insurance products. To ensure this we support a standardised model that is
    - active/interactive and not passive (that is simply providing a piece of paper); and
    - includes a series of ‘filter’ or ‘knock out’ questions, before the purchase of the product.
- Enhanced supervision obligations with specific requirements based on performance or outcomes based regulation must be introduced as a part of the deferred sales model.

Deferred sales processes should be considered for all forms of add-on insurance distributed by all third parties. Outside of the common add-on products sold by motor dealers,[16] there are a range of insurances that are added-on at the time of purchasing another product or service. These include:

- ticket insurance when purchasing a ticket to a concert or event;
- travel insurance when purchasing a flight;
- contents insurance when renting a storage unit;
- consumer credit insurance for estate mortgage.

While a deferred sales process may not neatly fit in some circumstances consideration needs to be given to interventions to empower the consumer in these transactions. Practices such as pre-ticked boxes which dupe consumers into making the purchase, and insurance sold in circumstances where there is insufficient time to read and consider the product disclosure statement before the time out expires on purchasing the tickets, should be clearly prohibited.

We are not aware of any specific regulatory monitoring of any of these add-on insurances but we would expect that the claims ratios on these products would be particularly low.

[16] Including consumer credit insurance (CCI); Guaranteed Asset Protection (GAP) insurance; Tyre and Rim; Mechanical Breakdown Insurance; Windscreen; Extended warranties including discretionary risk products and dealer-issued warranties (not a general insurance product)

Funeral insurance

There is also already substantial evidence gathered by regulators and the Royal Commission to support a case to prohibit the sale of funeral insurance. Financial Rights witnessed the ongoing slick marketing by the Aboriginal Community Benefit Funeral Plan (**ACBF**) at the NSW Dubbo Koori Knockout[17] Further, some of the issues experienced by Aboriginal communities are also experienced by other vulnerable communities, including clients from non-English speaking backgrounds and the mentally ill:

Case study –Daniel's story

60 year old Daniel is on the Disability Support Pension. He has Bipolar Disorder and an acquired brain injury. He lives alone in community housing. When he contacted Financial Rights he was paying for 11 funeral insurance policies – 5 of which were with the same insurer, and 2 with another! $140 in premiums he could not afford was coming out of his fortnightly benefit payments.

He instructed us the insurer kept ringing him and offering him more insurance, knowing he had existing policies.

The products are stepped, meaning the cost will simply increase over time. Daniels income will remain substantially the same. With the increase in premiums and the costs of living, it is almost inevitable Daniel's policies will lapse before he is able to claim.

While it is true that many people worry about the significant financial burden that their funeral may pose to their family upon their death, there are many alternative options to funeral insurance that may better suit the needs of consumers. These include pre-paid funerals, high interest savings accounts, super and life insurance, funeral bonds and the bereavement payments available through Centrelink.

If there is not a total prohibition on the sale of funeral insurance, the insured person should not be permitted to be under the age of 18, and all forms of funeral insurance should be subject to all available regulatory safeguards and as such should be financial products for the purposes of Chapter 7 of the *Corporations Act 2001* and covered by Part 2 Division 2 of the *Australian Securities and Investments Commission Act 2001*.

All distributors of life insurance products need to be covered by the Life Insurance Code of Practice (**Life Code**), so that sales practices can be monitored. The Life Code vulnerable consumers and anti-hawking provisions need strengthening.

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[17] Stephanie Chalmers, Banking royal commission: funeral insurer blasted at inquiry targets kids at Koori Knockout, ABC, 4 October 2018 http://www.abc.net.au/news/2018-10-04/funeral-insurer-blasted-at-the-royal-commission-spruiks-product/10338746; The Briefing with Alex McKinnon. The Saturday Paper, 5 October 2018 https://www.thesaturdaypaper.com.au/thebriefing

Improve protections for vulnerable customers

As the Royal Commission has clearly shown consumers who may be vulnerable due to age, disability, mental health conditions, family violence, language and literacy barriers, cultural backgrounds and financial or social distress, are the hardest hit by poor financial services sector behaviour. Specific laws needs to be put into place to ensure that they are better served and their interests protected.

Guarantors[18]

Rules around the provision of a loan guarantee need to be strengthened. The social and familial context of a guarantee was clearly demonstrated by the Legal Aid NSW client who gave evidence before the commission.

Guarantors are an inherently vulnerable group and at high risk of exploitation. They are generally older consumers, agreeing to accept personal liability and often putting their own assets and home at risk for family members, usually their own children. Guarantors gain no benefit from the transaction, and checks are rarely, if ever, performed to ensure they can afford the loan if the debtor cannot. Furthermore, guarantors are often not in a position to make a fully informed decision free of undue influence by borrower or bank representative.

Problems with guarantees often involve the guarantor having little to no understanding of their role in the process or the potential effect. This can be the result of many factors, including:

a. debtors misleading or concealing the true nature of the transaction or extent of the liability;

b. elder abuse, particularly if the guarantor is dependent on the debtor or has medical problems;

c. in many cases, the debtor organises everything before the guarantor is involved to sign the documents, meaning the guarantor may have little to no opportunity to ask any questions or understand what is involved; and

d. the guarantor may sign the guarantee in the presence of the debtor, raising the risk of undue influence or pressure.

Even in the absence of the above factors, there is often considerable pressure on the guarantor for them to proceed with providing a guarantee against their better judgment by virtue of their

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[18] Answering questions posed in Volume 2, pages 270-271 Legal Aid NSW proposed that a lender should be required to make an assessment about whether the contract of guarantee would be unsuitable for the guarantor because it is likely that, at the time the guarantee would be given, the guarantor could meet a call on the guarantee only with substantial hardship. Would that be a rule to be applied to all guarantors (and thus the principals of a corporate borrower)? If a contract of guarantee were to be assessed as unsuitable for the guarantor, what would follow: a warning to the potential guarantor or prohibition of the transaction? Would adopting provisions of this kind mean, in practice, that a guarantor could never provide his or her place of residence as security for the guarantee?

relationship to the borrower alone. While a guarantee may be provided to preserve a family relationship, the result can be quite the opposite if things go wrong and the guarantee is called upon.

The ABA has made significant steps in its recent Banking Code update to address some of these issues including prominent notice of the need to seek independent legal advice, providing more detailed information about the financial position of the borrower and a mandatory deferral period before the guarantor can enter the transaction unless they have obtained legal advice.

These have however not gone far enough to protect guarantors. The following improved protections are required under the responsible lending law::

- a guarantee could not be deemed suitable unless the guarantor can do either of the following without substantial hardship:
    - meet the repayments under the loan contract if the borrower does not; or
    - pay out the entire loan from their assets without compromising their reasonable housing needs.

If the loan is deemed unsuitable, then the guarantee should not be taken. As stated unequivocally, she would have proceeded with an extremely unwise transaction simply because she would do anything to assist her child. The lender refusing to make the loan takes the pressure off the potential guarantor, whilst potentially preserving the relationship (the guarantor has not refused to help, they have been rejected). It also avoids the inevitable disputes and reputational damage to lenders which follow when extremely vulnerable people are turned out of their homes

People with multiple assets, or very high value properties, should be free to risk a proportion of those assets with appropriate information and warnings. However people who will be left homeless, or without access to reasonable aged care when they need it, should not.

Where a lender is inclined to grant a guarantee the following protections should apply:

- banks must provide the borrower's full financial position, the banks assessment that the loan is suitable (or not unsuitable, if that standard were to remain) and their reason for requiring the guarantee;

- a guarantor must be strongly encouraged to access independent legal and financial advice which includes implications for any Centrelink pensions and access to aged care.

A deferral period in which to consider the above information and seek appropriate advice. Guarantors have historically often been excluded from accessing the free EDR scheme due to the monetary limits.

Remote communities and Aboriginal and Torres Strait Islander people

The financial services sector's engagement with remote and rural communities and the Aboriginal and Torres Strait Islander communities has been found wanting.

Regional and rural communities lack appropriate access to appropriate financial services simply due to the distances involved. Aboriginal and Torres Strait Islander people face a raft of cross-cultural, linguistic and social issues that most other communities in Australia do not experience.

While the new Banking Code includes some commitments to the needs of 'indigenous' and remote customers there is significant scope for intervention to ensure that the sector provides more appropriate services the specific needs of these communities. This includes:

- mandating greater access to basic and fee free bank accounts in these communities
- regulating the ability of banks to charge account keeping, dishonour and other penalty fees;
- ensuring banks to have specific policies (e.g. around identified Aboriginal and Torres Strait Islander positions), training (e.g. ongoing cultural awareness training) and services (e.g. interpreter services) to engage in partnership with Aboriginal and Torres Strait Islander communities and remote and rule communities;
- ensuring Banks to have specific policies and training for all staff around the AUSTRAC guidelines for identification for Aboriginal and Torres Strait Islander people;
- prohibit the sale of life insurance via outbound calls and funeral insurance by any means.

Access to basic bank accounts

Banks must be compelled to increase access to basic bank accounts and be proactive. Banks should invest in more training and identification in assisting Aboriginal and Torres Strait Islander communities as well as remote and rural communities more broadly. There are also instances where direct debits ought not be charged

The current Banking Code remains an inadequate vehicle for ensuring such access. The current Banking Code currently commits banks to asking new customers whether they hold a Commonwealth Seniors Health Card, a Health Care Card or a Pensioner Concession Card, and where they do, the bank will give that customer information about any banking services that have low or no fees. Additionally, when an individual tells a bank that they are a low income earner, the bank commits to give that individual information about accounts that may be appropriate to their needs, and information about accounts for which standard fees and charges are low or non-existent.

While there may be an onus on the bank to ask all prospective customers whether they hold certain government cards, the onus remains on consumers to otherwise disclose low income status in order to be given information about basic bank accounts. It is unrealistic to expect consumers to inform a bank of their low income status without the issue being raised by a bank staff member. With modern day banking technology, banks are now able to easily identify people who would most benefit from basic bank accounts through data collected about the amount deposited each month, or regular issues with direct debits.

It should be incumbent on banks to enquire as to a customer's financial circumstances – beyond just enquiring as to several government cards - when opening a new account and to offer a 'basic bank account' where appropriate.

Further, as customers' circumstances change throughout their lives, banks must be compelled to put in place systems and procedures to identify where a customer's account is no longer suitable, and offer that customer a more appropriate option.

Banks should also refund fees and charges incurred by customers who have been clearly identified as being in the wrong account where this should have been apparent to the bank and the customer should have been offered a low or no fee basic bank account.

Direct debit and recurring payment processes

Cancelling direct debits and recurring payments remains a significant problem, especially for vulnerable consumers.

Financial Rights routinely see vulnerable consumers be overwhelmed by direct debit fees. Often, these fees are from merchants that are selling predatory products who obtain authorisation to do so questionably and with significant ease with verbal authority, or broad contract terms.

Conversely, consumers regularly report difficulties cancelling direct debits and recurring payments: despite provision in the Banking Code to "promptly process" a request to cancel a direct debit. Banks have failed to act on the issue of recurring payments and credit cards, requiring hurdles of written notice. This causes serious consumer frustration and financial losses, and impacts most seriously on those least able to absorb those losses.

The banking sector has demonstrated an unwillingness to prioritise and resolve the issues relating to the cancellation of direct debits. Banks have expressed concern that they do not want to be seen as encouraging people not to meet their financial obligations.

Intervention is required to compel banks to cancel direct debits and recurring payments and prohibit the charging of fees to cancel. Consumers should also be able to cancel recurring direct debits on their Visa and Mastercard accounts.

Prohibition on pressure sales tactics and a strengthened anti-hawking regime

A prohibition on specific pressure sales tactics and a stronger anti-hawking legislation is required.

As the evidence presented at the Royal Commission has shown, the anti-hawking provisions of the *Corporations Act 2001* have not prevented inappropriate unsolicited sales of insurance. Nor have the prohibitions under the Codes of Practice prevented poor conduct.

We note that the companies engaged in the conduct of direct sales in insurance, like those experienced by Aboriginal consumers, are not covered by the Life Code. This is because the

Life Code only extends to Authorised Representatives defined as a "person, company or other entity authorised by the subscriber to provide financial services on its behalf under its AFS License."

Pressure selling techniques must be specifically outlawed in the financial services sector including:

- persistent pitches
- keeping consumers 'captive';
- using the cooling period as a selling point;
- unfairly highlighting the benefits of insurance over cheaper more responsible alternatives;
- masking the cost of loans
- pre-filling forms; and
- sales scripts not allowing customer to say no.

While anti-hawking laws do place strict restrictions around the sales of insurance with cold calls, insurers get around these laws via loopholes: they can obtain a customer's consent in some form such as an innocuous ticked box on an unrelated sales document or by making two calls where one is to obtain the consent and the follow up call to make sales. Anti-hawking laws need strengthening too to close the loopholes.

The ease of access of direct debits authorised over the phone and direct sales creates a vortex of harm to our most vulnerable consumers. Either, banks need to be proactive to stop excessive direct debits or businesses should be significantly curtailed in their ability to obtain consent to do so.

Implement the Small Amount Credit Contract Review to make pay day loans and consumer leases fairer

A major gap in the scope of the Royal Commission has been its inability to examine the small amount credit contract sector – a significant part of the financial services sector that has a particularly harsh impact upon those in stressed and distressed financial situations. It is this sector that the victims of poor behaviour turn to when things become worse. They are persuaded to take out high interest loans to meet an immediate need, yet the result of this decision is often to worsen their situation.

The government has developed an exposure draft of Small Amount Credit Contract legislation[19] based upon recommendation of a 2015/16 review[20]. The government has however yet to act on the legislation. This is a critical reform that needs to be introduced.

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[19] *National Consumer Credit Protection Amendment (Small Amount Credit Contract and Consumer Lease Reforms) Bill 2017* https://static.treasury.gov.au/uploads/sites/1/2017/10/c2017-t229374-Exposure-Draft.pdf

[20] Treasury, Review of small amount credit contracts – Final report, 2016, https://treasury.gov.au/consultation/review-of-small-amount-credit-contracts-final-report/

3. Close the loopholes

Too often the complexity of legislation applying to the financial services sector and consumer protection has served the needs of industry through carve-outs, loopholes and regulatory gaps are easily exploited by well-resourced, self interested and financially motivated players. Any simplification that is to take place must serve consumer protection goals rather than the cutting of red-tape, to redress the extant legislative imbalance favouring the financial services entities.

Bring debt management firms into the financial services regulatory framework

A regulatory framework that is flexible enough to capture and regulate all current and emerging financial services must be introduced. Debt management firms do not currently fall within the meaning of 'financial services' or 'financial products' as defined by the *ASIC Act 2001* or by the relevant provisions of the *Corporations Act 2001*. This means that they:

- cannot be licensed by ASIC;
- are not required to be members of EDR schemes;
- are not subject to minimum standards such as a fit and proper person test and
- are not required to provide any information on their activities nor are subject to regular audits.

While debt management firms do fall within the consumer protection provisions of the Australian Consumer Law, these protections have proven to be inadequate to protect vulnerable consumers. Some of the activities of these firms may also be regulated by the *National Consumer Credit Protection Act 2009*, the *Bankruptcy Act 1966* or the *Privacy Act 1988*, however it is unclear whether or not this is the case, or in which ways these Acts may apply.

There is no uniform regulatory framework applying to the activities of debt management firms in Australia. This leaves consumers open to exploitation, and left with little redress if subjected to hardship by such firms.

If debt management firms and other new and emerging financial businesses were required to be licensed there would be greater scope for ASIC to gather information, conduct regular risk-based audits for compliance and ensure that these unfair businesses are subject to an EDR scheme.

Ensure buy-now-pay-later providers are captured by the credit law;

Similarly we are concerned that "buy now pay later" providers have fallen through the cracks of the regulatory regime and are exempt from the *National Consumer Credit Protection Act 2009*. As with debt management firms, the regulatory framework must be reformed to be flexible enough to capture and regulate all current and emerging financial services.

Responsible lending laws require that providers are obliged to assess a consumer's ability to pay, to enter into hardship arrangements with customers in financial hardship, for an Internal Dispute Resolution (**IDR**) process to be in place and to be a member of AFCA. The fact that buy now pay later services are exempt from these obligations leaves customers of these services vulnerable.

These services must be regulated to ensure that they:

- check people's capacity to pay;
- are licensed;
- are supervised by ASIC;
- have a robust IDR process; and
- be a member of AFCA.

These changes would help people to obtain redress when things go wrong.

Bring small business lending into the regulatory framework

Financial services providers that are not engaged wholly or predominantly in personal, domestic or household credit or credit for investment in residential property are not required to hold an Australian Credit Licence (**ACL**) and therefore are not required to meet the requirement to be a member of an approved EDR scheme.

The original policy intent that lies behind this lack of licensing is that small businesses need to have access to reasonably affordable and available credit. However the result has been that small business owners are faced with court action to seek access to any form of justice, a significant hurdle for many. Further we have seen many vulnerable clients who have been mis-sold business loans and are similarly unable to easily access remedies or justice.

While the new Banking Code has now included bolstered protections for small business borrowers these protections are limited in a number of important respects. The Banking Code only applies to signatory Banks which covers 80 per cent of the small business lending market but leaves 20 per cent out. The current Banking Code also limits the definition of small businesses to those with an annual turnover of less than $10 million in the previous financial year, fewer than 100 full-time employees; and, less than $3 million total debt to all credit providers (including amounts undrawn under existing loans, any loan being applied for and the debt of all of its related entities that are businesses). As noted by the Commissioner – the independent reviewer had recommended the definition apply to any business where the loan was less than $5 million. This means a further 10,000 or 20,000 businesses are not covered by the Code.

There exists the Customer Owned Banking Code of Practice (**COBA Code**) which covers Credit Unions, Mutual Building Societies and Mutual Banks administered by the Customer Owned Banking Association. This Code covers individuals and small businesses and defines small businesses in yet another way as:

> *A business having fewer than: a) 100 full-time (or equivalent) people if it involves the manufacture of goods; or, b) in any other case, 20 full time (or equivalent) people.*

The Commissioner may wish to note that the commitments made under the COBA Code are significantly different to those under the Banking Code, significant enough to make a difference. For example, rather than exercising the care and skill of a diligent and prudent banker, the COBA Code commits to acting as a responsible lender and base decisions on a "careful and prudent assessment of your financial position and requirements and objectives as indicated by us."[21] The definition of a small business should be uniform and consistent across the sector.

Ultimately those borrowers of small business loans require an affordable and easy route to access justice in seeking resolution to poor responsible lending outcomes.

All small business lending must be required to be a member of AFCA's EDR service be it by licencing or some other way. They must also be required to commit to a Code of Practice for small business lending be it a standalone Code, a broadened Banking Code or a strengthened COBA Code.

Prevent unsolicited credit limit increases of any kind

Credit providers need to be regulated to ensure that they comply with the responsible lending obligations when offering increased credit be it via credit cards or other products. An assessment of the borrower's current financial circumstances needs to be made in all circumstances before additional credit is granted.

Unsolicited offers of credit to financially vulnerable people are incredibly problematic. If consumers want credit or to increase the credit limit on their existing account, then the consumer is in a position to make the approach and actively apply to the credit provider.

Although the law has recently been changed to restrict unsolicited limit increase offers there remain significant loopholes. It does not stop credit providers from sending further promotional material about products and services (including other credit cards and other credit products) from the credit provider or their subsidiaries and corporate partners. It does not stop credit providers packaging mortgages with a mandatory credit card inconsistent with the requirements and objectives of the responsible lending provision.

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[21] Clauses 6.1 and 6.2 of the COBA Code.

4. Toughen the cop on the block

The Royal Commission has identified failings of the regulator. There is clearly room for improvement in the timeliness and effectiveness of the regulator's responses to poor market conduct and consequent consumer harm. We note that the regulator has also conducted some very successful enforcement action and has publicly released many useful reports on most of the issues canvassed by the Royal Commission. The solution is to ensure that ASIC is empowered to enforce consumer protections; to address and prevent current and emerging issues; and is well resourced to take the action that is required to bring the financial services sector to account for illegal behaviour and behaviour that does not meet community expectations.

Ensure that the Chair or Deputy Chair of ASIC has a consumer protection background

There is currently no guarantee that ASIC will be led at the Chair or Deputy Chair level by a person with consumer protection background. The financial services Industry itself remains the key source for ASIC Commissioners. ASIC must be required to be led by commissioners with a mix of consumer and industry knowledge to ensure that they are able to do their job effectively.

A Chair or Deputy Chair with consumer protection experience is required to ensure that they can steer ASIC's enforcement action in appropriate directions to address poor consumer outcomes at the systemic level, and to guard against industry capture as it is inevitable that there will be a common pool of talent to staff the regulator and industry players.

Provide ASIC rule making powers

ASIC currently has statutory powers to make certain rules and regulations such as the power to modify certain provisions in the *Corporations Act 2001* as they apply to specified classes of people. These are known as Legislative Instruments or previously known as 'Class Orders.

Legislative instruments usually apply to a class of persons who carry out a particular activity in certain circumstances, eg operators of managed investment schemes, mortgage brokers etc.

Legislative instruments can be used to clarify certain provisions of legislation administered by ASIC but this however generally takes the form of an exemption from requirements rather than new requirements.[22] For example, in recent times, ASIC has used this power to defer application of amendments to credit hardship laws, or to exempt credit providers from small amount credit contracts from limitations on some sorts of fees. ASIC cannot use this power in the way that the product intervention power is slated to operate: it cannot impose new requirements on a class of products or providers.

The UK FCA by contrast has been provided an extremely broad rule making power. The UK FCA is authorised to make such rules applying to the organisations and people it regulates 'as

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[22] ASIC, Legislative Instruments https://asic.gov.au/regulatory-resources/find-a-document/legislative-instruments/

appear to the UK FCA to be necessary or expedient for the purpose of advancing one or more of its operational objectives'.[23] Its operational objectives relate to consumer protection, competition and market integrity. It is essentially a plenary power to legislate in relation to financial conduct matters.

In Australia there is no legal requirement that ASIC must consult stakeholders before making a legislative instrument. By contrast, the UK FCA must publish a draft for public consultation before making a rule, and it must have regard to any submissions it receives. The draft rule also needs to be accompanied by an explanatory statement and a cost/benefit analysis.

The UK FCA's power can be used to intervene in the manufacture and distribution of financial products much like the proposed Product Intervention Powers proposed in Australia.

However there are key differences between the UK power and the proposed Product Intervention Powers that must be addressed in the legislation. This is explored further below.

As stated above though, the UK FCA rule-making power is very broad and in addition to being able to ban or impose requirements in relation to specific products, types of products or practices associated with a particular product or type of product, the UK FCA can act on their own initiative to impose or vary individual requirements on a firm and to ban or impose requirements in relation to specific financial promotions.

A similarly broad power is required for ASIC to conduct similar interventions and to intervene with respect to issues relating to internal issues. For example, there is currently very little if any scope for ASIC to oversee remuneration practices. A broad rule making that enables ASIC to create legislative instruments with respect to remuneration practices would be a significant tool to address the risk of consumer detriment.

Empower ASIC to respond to emerging issues and prevent them from arising in the first place

The current Design and Distribution Obligations and Product Intervention Powers are critical regulatory tools and must be implemented. These laws will help to achieve a cultural shift within financial firms away from simply 'selling' financial products towards designing and distributing suitable products that meet customer needs. Further, equipping the ASIC with the product intervention powers would allow the regulator to intervene before consumer harm occurs and deter misconduct by financial firms.

There are however some limitations to the regime as currently designed. The legislation is significantly narrower in scope than the regime that was proposed by the Financial Services Inquiry. Significant amendments are required to ensure the legislation meets the needs of Australian consumers and addresses many of the issues raised in evidence in the Royal Commission.

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[23] Section 137 *Financial Services and Markets Act 2000*

The Interim Report has commented on a number of product design and distribution concerns that won't be addressed by this Bill without amendment. For example, in relation to marketing of credit, it was noted that:

> *The customer 'needs' are formed by reference to what the entity has to sell. And often it is the entity's representative that tells the customer what he or she 'needs'. … The customer who seeks a home loan is sold a transaction account or is sold a credit card … [T]he customer is treated as 'needing' what the entity has to sell*[24]

This underscores that credit products should be included in the Design and Distribution Obligationsso that there is a greater discipline on banks and their intermediaries to ensure customers obtain only products that are suitable for their needs.

We also note references in both the Interim Report[25] and the Productivity Commission's Inquiry Report, *Competition in the Australian Financial System*,[26] that Design and Distribution Obligations and Product Intervention Powers are slated to improve standards in the financial advice sector. However, the current Bill in fact exempts personal financial advice and dealing associated with implementing financial advice from the Design and Distribution Obligations. This exemption opens a significant regulatory loophole and will hamper ASIC's ability to enforce the Design and Distribution Obligations.

The following amendments to the legislation are critical:

- Apply the Product Intervention Powers and Design and Distribution Obligations to 'financial products' as defined in the *Australian Securities and Investments Commission Act 2001* to ensure the widest possible coverage including credit products;
- Remove exemptions from the Design and Distribution Obligations for margin loans, personal financial advice and dealing associated with implementing personal financial advice;
- Extend the civil liability regime to ensure that consumers can claim compensation for loss or damage resulting from contraventions of the Product Intervention Powers and Design and Distribution Obligations obligations; and
- strengthen to empower ASIC to permanently prohibit classes of products allowing an intervention to continue until ASIC, or the Government, decides that the risk of consumer harm posed by a given product has been addressed and the intervention order is safe to remove. The UK FCA is empowered to make temporary interventions without consultation of up to 12 months, but is able to make permanent rules with consultation with affected parties.

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[24] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report – Volume 1*, September 2018, page 64.

[25] Ibid, page 105.

[26] Productivity Commission, *Competition in the Australian Financial System – Final Report*, 3 August 2018, page 283, available at: https://www.pc.gov.au/inquiries/completed/financial-system/report.

- ASIC should be able to intervene and prohibit the sale of classes of products, for all financial products as defined under the *ASIC Act*, where there is consultation and clear evidence of poor, ongoing consumer outcomes.
- ASIC should be empowered to gather granular data on each and every insurance product on sale to identify claims outcomes and ratios via the use of RegTech.

These powers should move the regulatory regime closer to a performance or outcome based regulation rather than the more traditional prescriptive regulatory approach.

Move to performance/outcome based regulation where appropriate

The current regulatory regime largely adheres to what is known as prescriptive regulation made up of by formal, concrete rules that dictate what entities must and must not do.

The problem with this approach is, in short, that entities are able to more quickly evade prescribed regulation, meeting the letter but not the spirit of the regulations. They are able to do so in a swift manner, often outpacing regulator's ability to act. Regulators ban one product feature only to have a similar but different feature pop up in its place – witness the development of buy now pay later services and debt management firms, the hiding of mandated key fact sheets on insurer websites.

Performance or outcomes based regulation regulates the end result which a regulated entity must achieve. Its sets a measurable standard related to the regulator's goal and allows the regulated entity itself to choose how to meet that standard. It is largely used in the regulation environmental sector. An example in the environmental space is that an entity must achieve a specific level of emissions. An example in the financial services space could involve an entity achieving specified claims ratios in insurance or suitability or comprehension standards in relating to disclosure documents.[27]

This move would shift the emphasis from an entity's actions per se towards consumer outcomes sought to be achieved by the regulator. Performance based regulation aligns the regulated entity more in line with the regulator's goals. The financial services entities are enlisted to internalise suitability standards and educate consumers in the products and services that they produce and provide.

Regulatory compliance can also be measured before after or during regular intervals of the performance target. Testing and consumer surveys can be conducted at any time. With increased access to RegTech discussed further below, this will make things easier.

Resource ASIC with RegTech to better monitor the financial services sector

ASIC and APRA must be resourced and empowered to harness the financial technology (**FinTech**) revolution and use regulatory technology (**RegTech**) so as to more effectively oversee the adequacy of the compliance systems of financial services entities.

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[27] For further information on performance based regulation see Professor Lauren E Willis, 'Performance-Based Consumer Law', Loyola Law School, Legal Studies Paper No 2012-39, August 2014, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2485667.

ASIC and APRA have tentatively begun to develop template data requirements for the sector. They have, for instance, begun to work with industry to collect and publish comprehensive and reliable life insurance claims information, with a view to improving accountability and performance of life insurers.[28] ASIC and APRA plan to report on this data publicly at the aggregate industry level and at an individual insurer level.

Similar initiatives should be applied and expanded across the financial services sector including consumer lending and general insurance. Information gathered could include code of practice requirements, breaches information, pricing information, responsible lending information, underwriting, claims handling data, sales and quotes, marketing and advertising compliance and more.

The information gathered by regulators should also be used to provide information to empower consumers and promote competitive markets. For example, as above, claims data could be used to provide claims ratios for consumers at point of sale.

The information gathered via RegTech should further assist evaluating existing and proposed public policies; and evaluating affordability and availability of financial services and products and competition issues. This information can also effectively inform product intervention decisions, the use of a rule making power, and the success of any industry initiative or regularly intervention against its stated objectives.

Resource ASIC to conduct appropriate litigation[29]

The Interim Report's criticisms of ASIC's approach to litigation and enforcement in the financial services sector are valid to some extent. We note that ASIC has often failed to undertake significant litigation in response to misconduct. We note too that the ASIC Capability Review found that ASIC's litigation strategy is risk averse and that ASIC does not always pursue strategically important litigation.

We also agree that the over-emphasis on negotiating enforceable undertaking ('EUs") does produce the outcome that the financial services entity is too empowered in the process to control the outcome, and can make calculated cost benefit analysis to manage breaches as a mere cost of doing business.

These are serious concerns and must be addressed.

However we do wish to emphasise that ASIC has achieved significant outcomes for consumers through their enforcement and litigation work, despite the limitations outlined above. We also note the very real risks associated with litigation. Regulators can spend many years and significant resources litigating an issue only to be ultimately unsuccessful.

We do not wish to throw the baby out with the bathwater and establish a new regime.

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[28] This followed recommendations in ASIC *Report 498 Life insurance claims: An industry review*.

[29] Answering in part question at page 299 Is ASIC's remit too large? If it were to be reduced, who would take over those parts of the remit that are detached? Why would detachment be better? Are ASIC's enforcement practices satisfactory? If not, how should they be changed? and at page 340: Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that it is in the public interest not to do so?

We do not accept that the size of ASIC's remit is too large in administering 11 pieces of legislation and associated regulations. Splitting ASIC up will not necessarily improve outcomes for consumers – more likely it will increase confusion and increase the likelihood of demarcation issues and bureaucratic complexity.

Rather it is our position that ASIC needs greater penalties, powers and resources.

We have outlined some of the penalties and powers that ASIC requires. Resourcing is however vital.

We note the Commissioner's commentary on the issue of resourcing:

> *ASIC explained its approach to enforcement by reference to its limited resources. Of course ASIC, like any regulator, must make choices and assign priorities on the basis of resources. I need no persuasion that litigation is expensive. The expense is not just of financial outgoings but of the time and effort expended by staff. Their number is limited. As was the tenor of ASIC's evidence, resources spent on litigation represent an opportunity cost to it in respect of other forms of enforcement. But I do not accept that the appropriate response to the problem of allocating scarce resources is for a regulator to avoid compulsory enforcement action and instead attempt to settle all delinquencies by agreement.*

Resourcing is clearly not the only issue but it is in our view one of the key reasons. The lack of resourcing of ASIC to undertake enforcement has been explicitly acknowledged by Government in providing $70.1 million in additional funding in August 2018 to increase the intensity and capacity of its enforcement and supervisory activities.[30] We have already seen an uptick in enforcement activity presumably brought about by increased resourcing and, presumably, increased pressure to act arising from the Royal Commission itself.

There is however another reason that EUs are relied upon over litigation and this is the time involved in seeking remediation and redress.

ASIC are for all intents and purposes caught in a bind. They could emphasise expensive litigation with all it's uncertainty for poorly treated consumers over appallingly long periods of time. Or it can seek more direct redress direct with a financial services entity through EUs with potentially weaker results and resulting empowerment of the regulated entities.

Neither is ideal.

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Litigation cannot be seen to be the sole solution to the enforcement ills. We agree that more public interest litigation should be taking place where there is significant systemic and precedential value. However, where significantly quicker outcomes to redress consumer wrongs can occur that can also assist in producing systemic change, ASIC should be so empowered and resourced to use appropriate interventions short of litigation.

The EU system will need to be reformed to ensure that the regulated entities are less empowered to influence the outcome. But we do not wish for it be removed from the

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[30] Minister for Revenue and Financial Services, Turnbull Government expands ASIC's armoury, 7 August 2018, http://kmo.ministers.treasury.gov.au/media-release/092-2018/

regulatory toolbox.[31] ASIC must ensure that the negotiated outcomes begin from a place where it knows what it wants from the negotiation rather than what the entity is prepared to give and should act accordingly. The threat of litigation should be wielded as a stick. Contraventions of the law must have consequences rather than simple remediation. The profits arising from a contravention must be addressed and be a part of every calculation

If it is decided by the Commissioner to recommend restructuring ASIC as contemplated under section 5.2.1 then we would support Consumer's Action's alternative positions that:

- The Australian Competition and Consumer Commission (**ACCC**) should be given concurrent powers with ASIC in relation to the consumer protection provisions in the ASIC Act with ASIC retaining responsibilities for the consumer protection provisions as well as the industry-specific conduct regulation (i.e. *National Consumer Credit Act 2009*, Chapter 7 of *Corporations Act 2001*)). The ACCC would also be able to take action on misleading conduct, unconscionable conduct and other conduct; or
- the retail financial services remit (including super, credit & insurance) should be split off from corporations/markets/accounting standards regulation.

[31] The Financial Rights Legal Centre has received funds from Community Benefit payments stemming from ASIC negotiated EUs. These funds have enabled us to greatly extend the number of consumers we can provide advice and assistance to; helping to level the playing field for disaffected consumers, better expose poor conduct; and improve systemic advocacy to improve consumer outcomes. It also creates a conflict of interest for us in providing independent feedback in relation to the effectiveness or otherwise of EUs as a regulatory tool.

5. Make penalties bite

Increase penalties in line with the ASIC Enforcement Review recommendations

Penalties should be increased in line with the recommendations of the ASIC Enforcement Review in particular recommendations 32 through 45.

There are two recommendations that require amendment. Recommendation 36 states that:

> *Imprisonment should be removed as a possible sanction for strict and absolute liability offences.*

This sends the wrong message. Section 190 of the *Corporations Act 2001* currently bears imprisonment as a possible sanction for strict and absolute liability offences and even though the Attorney General's Department guide stipulates these offenses should not be punishable by imprisonment, removing this penalty altogether might undermine ASIC's prosecution of these offenses.

Recommendation 45 states:

> *Infringement notices should be set at 12 penalty units for individuals and 60 penalty units for corporations for any new infringement notice provisions*

All new infringement notice provisions in the *Corporations Act 2001* should utilise the ratio currently in use under the *National Consumer Credit Protection Act 2009*, being one-fortieth of the maximum penalty that a court could impose for civil penalty provisions.

Ensure codes of conduct are mandatory for all, strengthened, monitored, enforceable and attract effective sanctions via co-regulation

Self regulation has failed and co-regulation with ASIC must be implemented.

Industry codes of practice should be mandatory for all.

At present, there are gaps in the coverage of various codes of practice. For instance, the Life Code only applies to

> *"registered life insurance companies issuing Life Insurance Policies that are covered under membership of the FSC; and any other industry participant, including a non-FSC member, which adopts the Code by entering into a formal agreement with the FSC and the Life CCC to be bound by the Code."*

It does not apply to insurers who are not a member of the FSC, superannuation fund trustees, financial advice companies, financial advisers, or other life insurance industry participants such as distributors under their own AFS licensees.

Similarly, the General Insurance Code of Practice (**General Code**) only applies to:

> *all industry participants who have adopted it. Members of the ICA, any other general insurers, and such other entities as are approved by the ICA, may adopt this Code.*

It does not apply to those insurance distributors that operate under their own AFS licensee.

There are some industries not covered by any code of practice. The nature of the immature and emerging industries such as consumer leasing, pay day lending, FinTech, debt management firms including credit repairers, debt agreement brokers, so-called 'buy now pay later' services, and more, is that they are varied. These industries may be fragmented, made up of a number of small companies or a mix of large and small companies, with new and older companies, that have yet to or are unwilling to come together to discuss minimum standard practices.

It is vital that all financial service providers become subject to codes of practice, so that consumers using any financial service can expect some minimum standards with respect to their finances. At present, consumers are in the position of having to ascertain themselves whether or not the financial service provider they have engaged or plan to engage is a code participant. This is unrealistic, and to be at all successful would require ASIC to undertake an expensive, extensive consumer education exercise.

For industries where a code does not exist and the nature of the particular sector is such that it cannot or will not reach an agreement to develop an effective code, ASIC should be empowered to intervene to assist the sector to establish a code or recommend comprehensive legislative intervention.

Codes of practice should require the mandatory approval and oversight of ASIC.

The requirement that codes of practice have the approval of ASIC would increase public confidence in the financial services sector, ensure that codes meet minimum practice standards that they currently do not meet, and send a strong signal to consumers that they can have confidence in the codes.

Code approval would also:

- ensure that minimum benchmarks for an effective code would need to be met by all industry codes;
- allow for investigative or enforcement action to be undertaken if misrepresentations are made about a code;
- allow ASIC to monitor a code based on issues raised by consumers, EDR schemes or industry consultations;
- grant greater certainty that consumer concerns and independent review recommendations will be taken seriously and implemented;
- give consumers confidence that there is specific oversight of codes and their ongoing development;
- ensure that members cannot walk away from their code; and
- demonstrate that the financial services industry proactively responds to identified and emerging consumer issues and that the codes work to deliver substantial benefits to consumers.

Codes of practice should be strengthened.

There are several significant weaknesses in the Banking Code, for example especially with respect to credit cards, direct debits, debt collection and penalty fees.

Codes should be enforceable and violations should attract effective sanctions

A failure on the part of a financial institution to comply with a code of practice should lead to serious consequences, including enforceable sanctions, civil penalties and ASIC administrative action under the *Corporations Act 2001* s.915C, and Part IVB of the *Competition and Consumer Act 2010*. Action is required to ensure that financial institutions are held to account for Code breaches, and are incentivised to meet their commitments in a way that is stronger than the voluntary nature of the commitments extant under the current self-regulatory arrangement.[32]

All codes should also bind the subscriber to agreements with the code body and with customers. Currently this is only the case with the Banking Code and must be extended to all.

[32] This addresses question at 340: Should industry codes relating to the provision of financial services, such as the 2019 Banking Code, be recognised and applied by legislation like Part IVB of the *Competition and Consumer Act 2010* (Cth)?

6. Compensate victims

The lack of effective and easily accessible remedies to victims of irresponsible lending is a key driver of misconduct in the consumer credit industry, as lenders are generally able to recover the principal amount even when they lend irresponsibly. Often it is just fees and interest charges that are waived.

While the lender is arguably returned to its original position by being able to recover the principal amount lent, the borrower may have to sell their family home or car to repay a loan they should never have received. This can cause serious financial and personal hardship. In many cases, the hardship imposed has serious long-term consequences that mean the borrower may be unable to rebuild their financial security.

This means that banks are in a no-lose situation. Banks are able to make a calculated risk about the cost of compliance versus profitability and the likelihood of borrowers (or regulators) challenging the loan.

Significant changes are warranted.

Obligate financial service providers to identify and remediate consumers subject to irresponsible lending

There is currently no obligation on lenders to examine their books and identify consumers who may have been provided unsuitable loans and therefore breached responsible lending laws. There is also no subsequent requirement to address the issues and remediate these consumers in an appropriate and fair manner. We believe a positive obligation should be placed on financial service providers to obligate financial service providers to identify and remediate consumers subject to irresponsible lending.

Improve remedies for irresponsible lending to include debt waivers and refunds where appropriate

Reform is required to provide consumers with improved remedies in relation to responsible lending. Currently the law only compensates borrowers for the interest and fees paid under a loan contract but requires them to repay any benefit they have received. The net result of this is that borrowers can be placed in significant hardship despite having succeeded in establishing a breach on the part of the lender. While the borrower may have had the benefit of the funds received, in many cases they are simply not in a position repay the funds (because they could not afford the loan in the first place). The outcome for the lender is that they are guaranteed their principal back, even on the small proportion of loans that are challenged overall. This makes the cost benefit analysis of how to approach their responsible lending obligations fairly easily resolved in favour of ignoring the law.

Giving the debtor aright to a debt waiver, or partial debt waiver when a bank lends irresponsibly, including refunds of amounts already paid where appropriate. Where the loan is secured, the bank should also release the security in appropriate cases (for example, over a car or even the family home depending on the difference between the amount lent and the amount the borrower can afford). This would provide fairer outcomes for victims of irresponsible lending, and incentive to lenders to comply with responsible lending laws. This remedy should be included in the *National Consumer Credit Protection Act 2009*.

The practice already takes place in some limited circumstances by some banks. The new Banking Code, due to commence 1 July 2019, does put some guidelines in place regarding debt waivers, however, this is confined to situations where the person is in financial hardship and the waiver occurs on compassionate grounds, not as a result of misconduct by the bank. . The Banking Code also specifies that debts may be waived only when they are unsecured. While in practice many creditors will waive debts when consumers have little income and no assets, it is a different proposition when the borrower has something to lose.

We believe that regulatory amendment is appropriate to bolster consumer rights to remedies for irresponsible lending.

This would align with the approach under section 180 of the *National Consumer Credit Protection Act 2009*. Under section 180, if a lender engages in 'unlawful credit activity', the borrower is not liable for future payments and is entitled to recover any amounts already paid under the loan. Currently, 'unlawful credit activity' applies to limited offences under the Credit Act: engaging in unlicensed credit activity and providing short-term credit for a term of less than 16 days. Given that irresponsible lending is also a criminal offence, it is appropriate that this approach be extended to unaffordable loans.

Where a borrower would be ‘unjustly enriched’ from the use of a secured asset (for example, living in a house), there should be a straightforward and fair calculation for determining the value of the benefit they derived. This should take into account any distress or hardship the borrower experienced as a result of the irresponsible loan. If the value of the benefit is more than the amount already paid under the loan, the residual amount owed should only be repaid in affordable instalments. In cases where a home is involved, consideration should also be given to determining whether the borrower could retain and pay off the home if fees and charges are reduced, and any applicable compensation is applied to the amount outstanding.

Empower AFCA to deliver fair outcomes that meet community expectations

AFCA should have broadened powers to compensate consumers for losses and harm caused, rather than the limited approach taken by the Financial Ombudsman Service (**FOS**) on putting a borrower back in the position they would have been in if the loan had not been granted. The FOS approach can lead to unfair results.

This should be enacted via removal of the compensation cap for non-financial and indirect financial loss. The current cap is $5000 which is low when considering the loss and hardship caused by misconduct.

AFCA should also be empowered to ensure that its decisions and conciliated outcomes include fair and practical solutions regarding how that decision will be put into effect, including reasonable time frames for paying any outstanding amounts. It is often the case that an external dispute resolution outcome will be exactly what the parties could expect in a court of law, but nevertheless require a consumer to meet obligations that are harsh and onerous in their circumstances.

Provide ASIC with a directions power in relation to compensation

The recent ASIC Enforcement review identified a number of limitations with ASIC's current directions powers centred on its limitation to urgent matters, the delays that can arise due to resourcing and procedural requirements and the limitation of the EU system.

The review recommended that ASIC should be empowered to require compliance with AFS or credit licence obligations "in real time", and that ASIC should be given powers to direct licensees to take or refrain from taking actions where appropriate for this purpose, particularly where there is a need to protect financial consumers. The directions power would be triggered where ASIC has reason to suspect a licensee has, is, or will contravene financial services or credit licensing requirements (including relevant laws). ASIC would be empowered to establish a suitable programme to remediate clients, including assessing claims for restitution or compensation to customers. ASIC should be able to make an interim direction without a hearing, for a period of time, if the direction is to cease a type of activity and a delay in making a direction would be prejudicial to the public interest. The requirement to comply with a direction should be an obligation of licensees, and there should be a civil penalty provision for non-compliance.

Ensure timely redress with AFCA overseeing all remediation programs (industry initiated, ASIC directed or as a result of EUs)

In order to ensure that a remediation program – be it an industry initiated program, an ASIC direction under their directions power or an EU – is executed in a fair and reasonable manner that produces fair, timely and appropriate outcomes for consumers, we believe that AFCA should be empowered to oversee the implementation of all such programs.

ASIC currently appoints independent auditors to ensure that the entity is complying with an EU. Such auditors do not necessarily have the experience or expertise to determine what is a reasonable outcome in the circumstances, whereas these decisions are the bread and butter external dispute resolution. Other compliance audits are appropriately conducted by external auditors but remediation should be overseen by AFCA . AFCA (currently FOS and CIO) do this with similar processes in place on a large scale. Appointing AFCA to such oversight will increase confidence that remediation programs will be implemented quickly, fairly and with the consumer's interest in mind.

ASIC should retain oversight of the timeliness of remediation programs initiated by industry to ensure that time frames for resolving disputes are not extensive.

Establish a last resort compensation scheme funded by industry

Current legislation requires that licensed businesses must have arrangements for compensating customers where there is a loss or damage due to breaches of financial services or credit laws. This is generally satisfied through the holding of adequate Professional

Indemnity (**PI**) insurance. However, there are a significant number of determinations made FOS that compensation be paid to consumers, where compensation remains unpaid. FOS states that between 1 January 2010 and 31 March 2015, 126 Determinations remain unpaid.[33] The present day value of these uncompensated losses, adjusted for interest and inflation, is approximately $21.3 million.

A last resort compensation scheme is the only way to ensure that consumers who suffer loss from misconduct are compensated. Such a scheme would only be called on in a minority of cases: those where loss flows from proven misconduct by a licensee, the licensee then cannot meet the claim and the consumer cannot be compensated by recourse to Public Indemnity insurance arrangements.

It may also be appropriate for the Government to make a small contribution to the establishment of a last-resort compensation scheme, given the wider benefit to the community in reduced calls on social security, health and other welfare services as a result of uncompensated losses.

[33] For further information, see Financial Ombudsman Service Circular Issue 21, April 2015:

7. Improve access to justice

Guarantee funding for financial counselling and community legal centres to assist consumers with disputes

Misconduct uncovered by the Royal Commission is endemic and has affected hundreds of thousands of people. Irresponsible lending, unlawful debt collection, poor insurance claims-handling, inappropriate financial advice and other misconduct on the part of financial institutions results in significant demand for financial counselling and legal help. Community based financial counsellors and community lawyers provide a critical safety net for people unable to afford private lawyers when faced by a dispute with a financial institution.

Assistance provided to these people also in many cases assists financial institutions, by supporting a person to repay an owed debt. Financial institutions themselves routinely refer customers with financial hardship issues to community based financial counsellors. Despite this, banks do not currently contribute to the cost of community based financial counselling or community lawyers.

There should be a substantial additional investment in financial counselling services and specialist community lawyers. A strengthened network of community financial counselling and legal services will strengthen the integrity of financial and related institutions, while supporting consumers to resolve their financial problems and assert their consumer rights.

Expanded financial counselling services will support more consumers to address unmanageable debt, avoid financial hardship and avert legal action. Improved access to legal assistance will establish much needed accountability in the finance sector and provide some measure of redress to the power imbalance between financial institutions and vulnerable consumers. Coordinated planning and referral between financial counselling and legal services will provide more effective and efficient services to consumers.

Fund systemic advocacy by financial counsellors and community legal centres to ensure greater accountability and systemic reform

Funding for the consumer protection and systemic reform advocacy in the financial services space is limited. While some funding of community legal centres at a state level can be directed towards advocacy and systemic reform, this is incredibly limited.

Community benefit programs arising out of ASIC EUs are largely directed towards supporting under-resourced service provision and financial literacy programs, the latter being of limited use to address misconduct. Few community benefit programs are directed at supporting consumer policy development and research to assist in identifying and advocating for systemic reform. Philanthropic funds are also unlikely to support advocacy work.

Such advocacy can bring greater accountability, advance consumer rights and improve consumer outcomes through independent consumer research, policy analysis, individual casework, systemic advocacy and related consumer education. And provide a balance to well-funded industry lobbying that support industry preferred reform or even the status quo over much needed reform in the interests of consumers.

8. Address potential risks and unintended consequences

There has been a lot of hype in the media about a potential credit crunch and economic fallout as a result of the recommendations that might be made by the Royal Commission. In our view, this is somewhat alarmist. Some correction in the property market does appear to be occurring already (whether related to the Royal Commission or not), but we would argue this is both a necessary and desirable correction following years of unsustainable growth, which has the potential to improve housing affordability.

The economy has no doubt been fuelled by freely available credit in recent decades. This is not sustainable in the longer term. Households that incur debt to fund their daily consumption sooner or later come to the end of their borrowing capacity and have to tighten spending dramatically in order to repay, or enter an insolvency solution which impacts on creditors being paid. Curbing the flow of credit to more sustainable levels should have long terms benefits, by ensuring households take on sustainable amounts of debt and have surplus income available for consumption over time. There are, however, a number of potential risks that could arise as a result of changed lending conditions:

- Borrowers being "trapped" in their current loans because they are unable to refinance due to tightened responsible lending requirements;
- Borrowers who have been put in unsustainable loans being forced to sell in large enough numbers to accelerate a drop in property prices, resulting in widespread negative equity and systemic prudential risk;
- Growth in irresponsible lending in the non-ban sector and unregulated lending that is not constrained by the *National Consumer Credit Protection Act 2009*.

The risk of borrowers being "trapped" in their current loans is less problematic in the current prevailing conditions than it has been at other times in recent history. In the immediate aftermath of the global financial crisis many borrowers were trapped in very high interest home loans in the non-bank sector while bank loan interest rates dropped dramatically. Often in default on their expensive loans[34], borrowers did not qualify to refinance, despite the fact that they could have far more easily have afforded the lower repayments on the cheaper deal. As we are currently in a low interest rate environment, this is less of a risk. It could nonetheless become a problem if lenders keep increasing their interest rates for existing borrowers, whilst offering cheaper deals to new customers to attract market share.

There are several counter-measures that could be adopted by regulators to minimise the likelihood of the problems outlined above arising:

- As noted above, all cases of irresponsible lending need to be appropriately remediated. While in many cases borrowers may have to forfeit their home if they could not afford their loan in the first place (with appropriate readjustments in amounts outstanding and possible compensation), in more borderline cases it may be appropriate to allow

[34] Up to 14%

the borrower to retain their home with a reduction in the applicable interest rate and/or outstanding debt;

- Lenders should be required to offer any borrower in difficulty the best rate they offer new customers (as the very least); preferably they should provide their most competitive rates to all customers;
- ASIC should make it clear in guidance that the responsible lending requirements are scalable in so far as a lender offering new or additional credit needs to make more extensive enquiries and undertake more intense verification than a lender which is simply replacing existing credit to reduce the overall cost of credit to the customer[35]. In the case of refinancing existing debt at a lower cost the borrower already has the debt commitment and granting the credit can only improve their situation. This principle should apply whether the lender is refinancing a loan from another lender (or lenders), restructuring their own customer's debt or responding to a request for a variation on grounds of hardship. Consumer advocates and financial counsellors have encountered lenders taking more detailed financial information and setting a higher assessment bar to get a hardship variation than they did to grant the loan in the first place.
- ASIC needs to be adequately resourced to monitor lending activity in the non-bank sector to ensure there is not an increase in poor lending practice in that sector in response to a tightening by the banking sector. Also, as recommended earlier in this submission, all credit providers should be licensed and required to be members of AFCA, not just those offering consumer loans and residential investment, to ensure that ASIC has adequate oversight of relevant practices and borrowers have access to dispute resolution. The worst cases of equity stripping (where a borrower is granted a high cost loan they can clearly not afford and the excessive fees and interest are charges are extracted from the property upon sale) are usually documented as business loans despite the lender being well aware they are not, but the borrowers only avenue to raise a dispute is the court.

[35] This should be the dollar cost of credit over the life of the loan to the extent it can be estimated rather than just reducing the interest rate. Spreading a personal loan or credit card debt over a 25 or 30 year home loan may reduce the interest rate on the smaller debt but could increase the overall cost. The reduction in the cost of credit must also be inclusive of all fees and charges, whether fixed or contingent, to prevent predatory refinances aimed at stripping a borrower's equity.

9. Never again – holding industry to account

Introduce a regular sector wide-review or re-run of the Royal Commission

The Royal Commission has introduced an energy and vigour into individual financial services entity compliance, sectoral self-regulation and government regulation of the financial services sector that is unparalleled in our history.

The sunlight that has been cast on the darker corners of the sector that have failed to garner public attention has been refreshing and compelled the sector, regulators and the government to act on issues that ourselves, community legal services, legal Aid and financial counsellors have seen day in and day out for decades.

We very much fear that once the torch of the Royal Commission is switched off, that scrutiny and subsequent pressure to act will fade and do so quickly.

We cannot allow this to happen.

What is required is regular oversight and public scrutiny of a sector that has long acted contrary to the law with few consequences and regularly failed to meet community expectations; seeing the law as something to work around rather than abiding by its spirit. The sector has failed the Australian people and are in no way deserving of trust and confidence.

Given the challenges inherent in developing and passing new regulation, and the potential for responses to the Royal Commission to be watered down by the usual lobbying of the financial services sector, we have little confidence that all the problems with the sector will be resolved once and for all.

We propose that there be a regular sector wide review in a similar form to the Royal Commission to ensure that the sector, regulators and legislators continue to act in the interests of Australians with the same urgency as they have in the shown in the last 10 months into the future.