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POST-GFC REGULATION — SOME OBSERVATIONS ON CONSUMER PROTECTION POLICY CHANGES

Post-GFC, the Australian Government has moved in a more interventionist regulatory direction but, in comparison with other countries, it has gone beyond the 'regulatory plumbing' to intervening more directly in financial markets. This new approach lacks any obvious conceptual underpinning. Without this, financial regulation swings with the vagaries of politics, creating uncertainty, which ultimately affects access, cost, innovation and productivity.

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One widely reported and compelling fact that stands out in any analysis of the global financial crisis (GFC) is that too many American households had unsuitable financial products, particularly housing loans. Both advocates for stronger controls on financial institutions, and advocates for less control cite the United States' sub-prime loan crisis as evidence supporting their cause. For some, the fact that so many consumers ended up with loans they could not afford was a failure of underwriting standards and inadequate consumer protection laws. For others, it was an example of government intervention distorting markets and creating poor incentives. For example, the government's implicit support for Fannie Mae and Freddie Mac increased the supply of loans to credit risky households.

Strong move towards greater consumer protection

Despite the absence of consensus on the causes of the US sub-prime loan crisis, governments throughout the world, including Australia's Federal Government, often in cooperation with State governments, have chosen to move in a more interventionist regulatory direction. Indeed, in Australia, the government has broken with longstanding regulatory orthodoxy and is using very interventionist tools under the rationale of consumer protection.

The regulatory initiatives can be separated into three categories involving revamping of the current prudential and markets regulatory approach. First, there is a range of initiatives to increase the resilience of institutions to financial losses, by increasing the proportion of capital in funding profiles and strengthening liquidity requirements.

Second, there are initiatives to improve the transparency of financial transactions and markets by moving away from bilateral to centralised clearing and increasing disclosure. Third, there are initiatives to remove conflicts of interest and risky incentives inherent in product supply chains, such as the securitisation market, and even executive remuneration.

The Australian Government has moved on all of these fronts in cooperation with international political and policy making bodies. But, in comparison with other countries, the government here has gone beyond the 'regulatory plumbing', to intervening more directly in financial markets by undertaking initiatives at the actual product level. The Australian Government has focused on consumer protection issues more intensely than other jurisdictions. Indeed, there appears to be little international coordination of consumer protection initiatives.

Responsible lending

In 2008, the Federal Government, through the Council of Australian Governments (COAG), moved to centralise regulation[1] of consumer credit by adopting the Uniform Consumer Credit Code.[2] This initiative was aimed at improving the efficiency of regulation and removing state-based anomalies, but it also extended the scope of consumer credit oversight to cover investment housing loans. It also made it a requirement that licensed credit providers belong to an ASIC-approved external dispute resolution (EDR) scheme.[3]

The most significant change, from a consumer protection point of view, was the enshrining of a 'responsible lending' obligation in the Act, making it an offence to enter into 'unsuitable' credit products with borrowers.[4]

Despite support for the principle behind the responsible lending provision, there is an obvious concern over how the provision will be interpreted by EDR schemes, ASIC and the courts.

An 'unsuitable' product is one where meeting the contractual obligations creates substantial financial hardship for the borrower, such as where repayment obligations can only be met through the sale of the property. Another example is where there is a disconnect between the product offered or sold by the provider and the requirements and objectives of the borrower. Providing credit to buy a car through issuance of a credit card might be an example of this.

A key feature of this obligation is the necessity for the credit provider to take reasonable steps to verify the financial situation of the borrower in the information provided by the loan applicant. Without a demonstrated paper trail of checking details, the product provider is at risk of contravening the law or being unable to convince the regulator it has complied with the law. In essence, the obligation transfers the product 'suitability' responsibility from the borrower to the provider; quite a different approach from a disclosure-based model where greater onus is placed on consumers to determine what is affordable and best suits their needs.

The responsible lending provision has had a market impact; access to loans has become marginally more difficult. 'No documentation' loans are no longer supplied to the market and, for a loan applicant to obtain 'low documentation' loans, more information is required than previously. There have also been instances reported in the media in which people seeking loans with maturities in excess of the borrower's expected retirement age have had difficulty securing finance without demonstrating how they will meet the commitments after retirement. This problem led ASIC to update regulatory guidance in this area.[5]

It is not clear what evidence or market developments prompted the Australian Government to enshrine the 'responsible lending' provision in the Act.

There is no obvious evidence that banks have embarked upon irresponsible lending. For example, at the height of the GFC in early 2009, the percentage of impaired housing loans in Australia reached around 0.6 of one per cent, compared with nearly 4 per cent in the United States.[6] Also, the percentage of high-risk housing loans in Australia was very small, totalling around 1 per cent of the total housing finance market.[7]

This performance suggests the pre-existing commercial and regulatory framework yielded incentives conducive to prudent lending practices. The major banks did not enter the very high-risk lending market; it remained the domain of niche mortgage originators.

One possible reason for this is that Australia's prudential capital rules require banks to allocate a higher percentage of capital to non-standard housing loans.[8] Also, the structure of Australia's housing finance market meant that sound returns on equity could be derived from the prime lending market. Lastly, the Reserve Bank and APRA spokespersons were quite vocal in warning against high-risk housing lending.[9]

Other important factors included Australia's relatively well-performing economy, a strong preference of households towards home ownership, and the fact that lenders have recourse to assets above that of the borrower's mortgaged property.

Future of Financial Advice (FoFA)

A more dramatic intervention in the financial services market is the set of initiatives grouped under the title of the Future of Financial Advice (FoFA). Its practical aim is to impose a statutory 'best interests' duty on financial advisers and to remove the conflicts of interest in the financial advice industry by outright prohibition of certain remuneration structures. For example, financial advisers cannot be paid bonuses by lenders for achieving sales targets.

Currently, the majority of financial planners derive the bulk of their remuneration through payments from product issuers, via upfront and/or trailing commissions on recommended products or 'volume-based' incentives.

The government has announced that all volume-based (product linked) payments or payments relating to sales targets from product issuers to financial advisers will be prohibited. This will result in financial advisers relying solely on income derived directly from retail customers.

The government is also proposing to constrain directly remuneration arrangements between financial advisers and the retail customers. For example, percentage-based fees on assets under management must be based solely on the equity component of the investment (i.e. excluding assets financed by leverage).

Further, the government has announced that it will cap the duration of any financial advice contract to two years (initially the proposal was for one year), via a requirement for explicit customer contract renewal consent via an 'opt in' mechanism.

One aspect of the FoFA reforms receiving a 'warm industry welcome' is the proposed best interests duty, which clarifies the requirement for financial advisers to give priority to their client's interests before any other interests, including their own.

This is not surprising as this measure will give prospective customers greater confidence in the quality and integrity of advice and, therefore, potentially increases demand for advisory services. However, it does not deal with the issue of competence per se and, hopefully, the inclusion of this duty will not be viewed by many clients as a substitute for performance and brand reputation.

Overall, the FoFA reforms will increase the upfront cost of financial advice as advisers will not be able to cover the cost of their advice through commissions from fund managers. In this respect, it will make access harder for some consumers. It represents a very different regulatory approach to one based on disclosure.

Banning of mortgage exit fees

The government has prohibited banks and other credit providers from charging housing borrowers exit fees for terminating housing loan agreements, although fees associated with taxes, early termination of fixed rate contracts or explicit services (such as fees covering any applicable government charges) are allowable.

This initiative stemmed from a concern that competition in the housing market had declined since the GFC and that this was evidenced by banks increasing standard variable mortgage rates outside Reserve Bank changes to the official cash rate.

This initiative effectively alters the means by which banks and most other lenders recover the costs of originating housing loans. In the 1990s, most lenders charged loan establishment fees. In 2002, one mortgage originator removed this fee and introduced a deferred establishment fee instead, now commonly referred to as an 'exit fee'.

Overall, the FOFA reforms will increase the upfront cost of financial advice as advisers will not be able to cover the cost of their advice through commissions from fund managers. In this respect, it will make access harder for some consumers. It represents a very different regulatory approach to one based on disclosure.

How lenders will now recover these costs will be up to market forces, and may include a return to higher upfront loan establishment fees, a marginally higher interest rate or, explicit expansion of the initial loan amount to cover these costs.

The motivation for the banning of exit fees can be thought of as a consumer protection initiative. The government has said it is concerned about the lack of competition in banking and the impact this has on the variable interest rate. By removing a cost to switching housing loan provider, the government is aiming to place additional competitive pressure on lenders to offer competitive rates.

When the legislation came before the Senate, it was opposed by the Coalition Opposition on the grounds that it would disadvantage smaller lenders. The concern is that smaller lenders, who are not as diversified as larger lenders, face limited options as to how they can recover the lost income from the fee's removal.

At this stage, it appears that the initiative will reduce the cost of refinancing for some customers (e.g. those who 'churn' or are influenced to churn their mortgage, e.g. those leveraging perceived equity growth in security property to finance other activities), although the prohibition applies only to new loans originated after 1 July 2011.

There is no evidence to date that the major banks or other significant lenders have moved to reinstate higher loan origination fees in place of 'exit fees'. However, it should be noted that, currently, there is a housing market share war underway and the long-term structure of pricing in housing loans is probably yet to emerge.

In terms of evidence justifying this regulatory intervention, the government relied upon a logical argument that where a financial barrier existed to refinancing a loan, it must then act as a disincentive to refinancing and, therefore, diminish competition. Yet, statistics collected by the Australian Bureau of Statistics (ABS)[10] show that around 30 per cent of all new loans are refinanced loans. Switching provider appears not to be a problem.

Banning credit card over-the-limit fees

As part of its Phase Two credit[11] initiatives, the government has banned credit card over-the-limit fees.[12] Consumers will only be charged a fee if they 'opt in' to a fee arrangement with their bank, which would allow the bank to 'make good' a payment which exceeds the card limit, for a fee.

Where there is no such agreement, the bank would be forced to disallow any transaction beyond the card's limit or could honour the transaction but not charge a fee.

One stated justification for this intervention is to protect consumers against what is labelled 'excessive' fees for harmless mistakes. It is not clear how providers will respond to this measure.

Another important aspect here is the fact that the government has chosen to ban these fees even though there is evidence that competitive forces were impacting on the fee. One large bank unilaterally removed the fee and used this product change in marketing.

Banning pre-approved credit limit offers

Another recent legislative initiative by the government (part of Phase Two credit reforms) has been to ban banks from offering customers pre-approved credit limit increase offers, such as through sending a letter with relevant disclosures and requiring only a signature on a form to facilitate that increase. Customers may elect to opt in to this service.

Banks have demonstrated comfort in this practice from a credit risk perspective by basing such offers on techniques such as behavioural scoring, enabling them to identify default risk associated with that customer.

Once again, the government's justification for this intervention simply comes down to propositional logic. Many consumer advocates have successfully argued that behavioural scoring is not perfect, so some consumers will be invited to take additional credit they cannot afford if offers continue to me made.

In response, the banks argue there is no evidence that credit card debt overall is causing substantial hardship. And, when viewed at an aggregated level, defaults are low[13] and growth in credit card debt has fallen to below the rate of inflation since the GFC.[14]

Other initiatives and proposals bearing on consumer protection

In a different realm of consumer protection, the government is currently consulting industry on design features of the Financial Claims Scheme (FCS) introduced in mid-2008. One aim of the scheme is consumer protection against potential losses associated with a failed institution. However, there is little evidence available to quantify the extent of risk, particularly given the depositor priority provision in the *Banking Act* and the extensive tools available to regulators to manage a bank failure.

The Australian Greens have also made a number of proposals, including capping foreign ATM fees. This is the fee charged by the owner of an ATM to a customer (from another bank) when the customer uses its ATM. Fees average around $2.05 per transaction (domestically),[15] a similar level to that charged before the direct charging regime was introduced in 2009.

The Australian Greens have also proposed a mechanism to control housing loan variable interest rates.[16] Under the proposal, each bank would be required to price variable loans according to a formula agreed with the Australian Prudential Regulation Authority (APRA). Also, both the Federal Government and Opposition are actively attempting to influence the way banks set variable mortgage rates. Spokespersons for both organisations have stated that banks should only move variable interest rates in alignment with RBA cash rate target movements.

Dispute resolution

When Phase One of the National Credit Code was introduced in 2009, as mentioned previously, one of the key new initiatives in the *National Consumer Credit Protection Act 2009* was the requirement for all credit providers and credit brokers to belong to an ASIC-approved External Dispute Resolution (EDR) scheme. The primary dispute resolution scheme for financial services is the Financial Ombudsman Service (FOS).[17]

FOS offers consumers, who are unsuccessful in settling a dispute with their credit provider, a free dispute resolution mechanism. The scheme rules are generous to the consumer. For example, a determination by FOS does not legally bind a consumer to the determination outcome unless the consumer accepts the determination, in which case, it also binds the institution that has the FOS as its ASIC-approved EDR.

Under its terms of reference (ToR), the FOS cannot settle disputes over the cost of credit or the legitimacy of fees charged by the institution, so long as the pricing arrangements have been explicitly agreed as part of the contract.

FOS is having an effect through its capacity to delay the normal timeframes for bringing about the enforcement of a housing loan in default or recoveries from other types of consumer and small business credit facilities. Under the rules, an institution must delay recovery action while FOS is investigating the dispute.

While FOS has always had the capacity to assess whether a lender has undertaken what FOS regards as good lending practice, the new 'responsible lending' provision has intensified the process that a bank must go through before offering and issuing a loan.[18] This has widened the range of factors to be investigated and there is therefore a greater likelihood that FOS will find that the customer's loan was 'maladministered' by the lender. A finding of maladministration typically leads FOS to recommend a restructuring of the loan agreement to give the customer more flexibility in meeting the repayment obligations.

What is behind all of this regulatory activity?

The actions described in this paper point to a different regulatory emphasis from the regulatory orthodoxy relied upon since the mid-1980s. In this period, the prevailing regulatory orthodoxy was based on the idea of competitive and efficient markets. Regulation was seen as a select tool to be used only in areas where there was a clear case of market failure or potential for market failure.

Given the anti-competitive effect of information asymmetry in the market, the free market economic orthodoxy sat comfortably with extensive disclosure requirements and prohibitions against misleading business practices.

The idea of government specifically intervening in markets to control prices, ban fees, alter product features and put the onus on institutions to assess a borrower's needs and objectives, is a style of regulation we have not seen since the pre-deregulation period. There are a number of potential explanations for this:

> Loss of political confidence in the competitiveness of many financial markets in Australia, compounded by examples of poor corporate behaviour of some banks in other countries in the lead-up to the GFC. However, while increased concentration in banking has occurred (enabled by government approval of the last two bank mergers) definitive evidence of deleterious effects (excessive pricing or profitability) is hard to find.

> Behavioural economics is being used to justify more direct government intervention in product markets. While there is no doubt some consumers make poor or irrational decisions — that fact is not in dispute — whether this small risk should result in governments intervening to influence product features (which reflect preferences of the majority of customers) and investment decisions across the board is another question.

> Given bipartisan support for balanced budgets, the political tool kit for appealing to constituents is narrowed and regulation to 'crack down' on unpopular businesses like banks and financial advisers may become a 'more favourable' political option. Unfortunately, the costs and disadvantages are more difficult to observe than direct government expenditure and revenue measures which are reported in budget papers.

The Australian Government has broken with regulatory orthodoxy and is now directly intervening in financial product markets. The possible consequences of this will be to reduce access to financial services, increase cost, blunt incentives for innovation, and impair productivity.

Long-term implications

If the regulatory interventions we have seen in recent years are being driven by politicians needing to be 'seen to do something', then there will inevitably be adverse consequences. This is particularly the case for financial innovation which responds to a stable and certain environment, fostered through a regulatory system based on very clear and well-thought-through principles. Where 'politics' plays an influential role on the regulatory environment, the uncertainty it creates will impact on innovation.

History shows us that at key periods, smaller institutions and new entrants have often driven product innovation. One often-overlooked cost of government intervention in markets is that it usually has a disproportionally large impact on these smaller and less-diversified institutions (with consequent impact on borrowers and investors as discussed throughout the paper).

Conclusion

The Australian Government has broken with regulatory orthodoxy and is now directly intervening in financial product markets. The possible consequences of this will be to reduce access to financial services, increase cost, blunt incentives for innovation, and impair productivity. This, of course, needs to be assessed against potential benefits, the main one being that more consumers may end up getting more suitable financial products. However, whether there is strong empirical evidence to support such changes, which are driven by experiences of the GFC and political dynamics, is open to debate. ■

Notes

1. See COAG Communiqué of 3 July 2008, available at www.coag.gov.au/coag_meeting_outcomes/2008-07-03/docs/communique20080703.pdf
2. See version of the Queensland Government's legislation of the Uniform Consumer Credit Code (now repealed), available at www.legislation.qld.gov.au/LEGISLTN/REPEALED/C/ConsumCredCode_04B_090622.pdf. Also Treasury's dedicated consumer reforms website makes reference to the fact that 'The national regime largely replicates the State-based Uniform Consumer Credit Code [PDF] as the National Credit Code', available at www.treasury.gov.au/consumercredit/content/legislation.asp
3. See ASIC Regulatory Guide 165, p. 14, available at asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg165-published-20-4-2011.pdf/$file/rg165-published-20-4-2011.pdf
4. See Treasury dedicated website for the national consumer legislation, available at www.treasury.gov.au/consumercredit/content/legislation.asp
5. See ASIC media release of 31 March 2011, available at www.asic.gov.au/asic/asic.nsf/byheadline/11-67AD+ASIC+updates+guidance+on+responsible+lending+obligations?openDocument
6. Reserve Bank of Australia's March 2009 *Financial Stability Review* (FSR), Graph 71, available at www.rba.gov.au/publications/fsr/2009/mar/graphs/graph-71.html
7. See Reserve Bank of Australia's March 2009 *Financial Stability Review* (FSR), available at www.rba.gov.au/publications/fsr/2009/mar/html/house-bus-bal-sheet.html
8. See Attachment C, page 20 of APRA's Australian Prudential Standard (APS) 112. Note that higher risk loans are categorised as 'non-standard loans', available at www.apra.gov.au/adi/PrudentialFramework/Documents/APS-112-Dec-2010-Update_Final-4.pdf
9. See speech by Ric Battellino, Deputy Governor, Reserve Bank of Australia, 'Will Australia catch a US cold?', address to the Euromoney Forum, New York, 21 September 2011.
10. Australian Bureau of Statistics (ABS), *Housing Finance*, Australia, 5609.0.
11. Phase 1 was discussed earlier, the initiative to adopt a nationally based regulation of credit, including adoption of a responsible lending requirement.
12. The Hon. Wayne Swan MP, Treasurer, media release, 5 July 2011, available at www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/074.htm&pageID=&min=wms&Year=&DocType=0. See also the relevant legislation, *National Consumer Credit Protection (Home Loans and Credit Cards) Act 2011*, section 133 BI.
13. ABA unpublished estimate.
14. RBA Financial Aggregates.
15. *RBA Bulletin*, 'The ATM reforms – new evidence from survey and market data', Darren Flood, Jennifer Hancock and Kylie Smith, March quarter, 2011, available at www.rba.gov.au/publications/bulletin/2011/mar/index.html
16. See Australian Greens 2010 election banking policy, available at greens.org.au/files/BankingServesCommunity.pdf
17. The banking industry established the forerunner of FOS in 1989, called the Australian Banking Industry Ombudsman, as an independent EDR scheme for banks that provided a free dispute resolution service for bank customers.
18. See FOS circular of Issue 5, March 2011, available at www.fos.org.au/centric/the_circular_5_home/responsible_lending_conduct_obligations_maladministration.jsp?

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