Using the product intervention power: short term credit

Submission in response to ASIC's consultation paper 316

Australian Financial Complaints Authority

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afca
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Introduction

The Australian Financial Complaints Authority (AFCA) is the independent external dispute resolution (EDR) scheme for the financial sector. It replaces the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and the Superannuation Complaints Tribunal.[1]

AFCA's purpose is to provide fair, independent and effective solutions for financial disputes. It does this not only by providing fair dispute resolution services, but also by working with financial firms to improve their processes and drive up industry standards of service, thereby minimising disputes.

In addition to providing solutions for financial disputes, AFCA has responsibilities[2] to identify, resolve and report on systemic issues and to notify the Australian Securities and Investments Commission (ASIC), and other regulators, of serious contraventions of the law. More broadly, AFCA will play a key role in restoring trust in the financial services sector.

AFCA welcomes the opportunity to provide a submission[3] in response to ASIC's consultation on using its product intervention power to address the significant consumer detriment caused by the short-term lending model it has identified.

ASIC has asked for comment on the likely compliance costs and the likely effect on competition in its proposal. We consider that financial firms are best placed to assess these aspects so our submission, informed by our experience, focusses on other impacts, costs and benefits of the proposal.

Key points

In response to the consultation paper[4] (CP), the key points in our submission are:

- AFCA strongly welcomes ASIC's intervention and supports its proposal to prohibit the provision of credit using the short-term lending arrangement (Option 1)
- short term credit arrangements can have significant adverse effects on individuals, their families and communities, as well as the broader financial services system
- through its structure, firms may not require a licence and therefore are not required to be a member of AFCA, significantly limiting a consumer's ability to access justice
- further intervention is required to prohibit the provision of other poor value and harmful products including credit repair; debt negotiations and budgeting services;

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[1] Appendix A provides a brief overview of AFCA. For more information about AFCA, please visit our website at www.afca.org.au.
[2] Refer to Part C, Reporting Requirements, of ASIC Regulatory Guide 267: *Oversight of the Australian Financial Complaints Authority*.
[3] This submission has been prepared by the staff of AFCA and does not necessarily represent the views of individual directors of AFCA.
[4] ASIC Consultation Paper 316, *Using the product intervention power: Short term credit.*

junk add-on insurance cover; funeral insurance and expenses only products; buy now, pay later; dealer issued warranties and over-the-counter derivatives.

1 Overview

ASIC is consulting on its proposal to exercise its product intervention power to address significant consumer detriment caused by a short-term lending model it has identified.

What is the short-term lending model?

The short-term lending model[5] is a form of lending which involves the provision of short term credit[6] to consumers, structured in a way that means it is exempt from the regulation of the National Credit Code.[7]

Under this short-term lending model, the credit provider (Company A) provides short term credit, mostly for small amounts up to $1,000, to consumers. The application process takes approximately two weeks, however, a ‘fast-track’ application process is available through an association of the credit provider (Company B).

This ‘fast-track’ process is a ‘collateral service’ provided under a separate service agreement, and the fees for these services are extremely high. In some cases, the fees and repayments combined can be up to 990% of the actual loan amount. The money must be repaid within 62 days.

As the high fees and charges, which exceed 5% of the total amount of credit, are charged under a separate services agreement between Company B and the consumer, the short-term credit provided by Company A, meets the exemption criteria. ASIC has identified that this model has been used by Teleloans (associate) and FLD (credit provider), and Cigno (associate) and GSSF (credit provider).

2 Detriment

C1Q1 Do you consider that the short-term lending model causes detriment to consumers and that this detriment is significant?

[5] For the purposes of this submission, we have used the same meaning as ASIC in their CP. ‘Short term credit’ has the meaning in s6(1) of the *National Credit Code*, which is different to the meaning of ‘short-term credit contract’ in s5 of the *National Consumer Credit Protection Act 2009*.
[6] Short term credit is exempt from regulation under the *National Credit Code* if the contract limits the provision of credit to a total period not exceeding 62 days, does not impose fees and charges exceeding 5% of the amount of credit and does not impose interest charges that would exceed the amount payable if the interest rate was 24% per annum.
[7] S6(1) of the *National Credit Code*, Schedule 1 of the *National Consumer Credit Protection Act 2009*.

Short-term lending model has resulted in significant consumer detriment

ASIC has said that it considers the short-term lending model has resulted in significant consumer detriment[8] because:

- the model targets vulnerable consumers, generally experiencing financial stress, and incentivises them into the high-cost 'fast-track' option as the direct application process does not supply the funds quickly
- it has significantly higher up-front costs than other regulated products
- the fees are extremely high, and uncapped on default payments
- it requires payments via direct debit, which results in overdrawn fees if accounts have insufficient funds, further adversely impacting the consumers financial situation

We agree with ASIC's assessment of the identified harms these products can cause.

Market wide product intervention order restricting sale (with conditions) is appropriate

ASIC is proposing to make a product intervention order which will prohibit credit providers, and their associates, from providing short-term credit and collateral services unless the total fees charged are limited to a maximum of 5% of the credit amount.[9] AFCA agrees that this is an appropriate approach in the circumstances and agrees that the proposed order will prevent credit and collateral services providers from providing unregulated credit outside the ambit of the short term credit exemption.

We note that this type of lending is targeted at vulnerable consumers[10]. These consumers will typically, due to their circumstances, require access to money quickly. Those consumers in financial hardship, suffering financial abuse or who have low financial literacy are most vulnerable in this scenario. The short-term lending model, by design, directs these consumers to use the 'collateral service' as this is the only method available which will enable them to receive the funds quickly.

A recent report released by the Senate Economics Committee (Economics Committee) following their inquiry into credit and financial products targeted at Australians at risk of financial hardship, which included products such as consumer leases and pay day loans, found:

> "Often these products appear not only to have been targeted at Australians in financial hardship—they seem to have been designed to take advantage of them. It is difficult to escape the conclusion that many providers' business models depend on vulnerable

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[8] Part B, Significant consumer detriment identified, ASIC Consultation Paper 316, *Using the product intervention power: Short term credit.*

[9] Part C, Our proposal, ASIC Consultation Paper 316, *Using the product intervention power: Short term credit.*

[10] For the purposes of this submission, AFCA has adopted the description of a vulnerable consumer from the UK's Financial Conduct Authority, which is, someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care, https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-8-consumer-vulnerability.

consumers who have limited awareness of other product options, limited negotiating power, and limited propensity to complain about improper or illegal behaviour."[11]

AFCA considers this to be true for the short-term lending model. We strongly welcome and support ASIC's proposal to exercise its product intervention power in this circumstance. AFCA is especially concerned about any financial firm charging unreasonably high interest rates, fees or penalty charges, or specifically targeting vulnerable consumers.

3 Other harm

C1Q2 Do you consider that the short-term lending model does or might cause detriment other than that identified by ASIC, or to a greater or lesser extent? If additional or greater, how should the proposed product intervention order be expanded to address this significant detriment?

AFCA considers that the short-term lending model does cause other detriment to consumers.

Short-term lending is often structured to avoid regulation

The short-term lending model, as identified by ASIC, and other similar arrangements which are specifically designed to avoid regulation enabling the provision of unregulated credit to consumers is of serious concern to AFCA.

The purpose of the existing credit regulations is to promote specific outcomes to better protect consumers. They do so by prescribing how certain activities and services are to be structures and delivered, as well as incorporating a number of provisions designed to promote good customer outcomes. These include provisions relating to:

- disclosure and content
- conduct and unjust or unconscionable transactions or fees
- responsible lending
- price regulation
- hardship
- access to external dispute resolution (EDR)

The credit regulations provide a number of exceptions. If financial firms structure their operations, activities, products or services within the constraints of these exceptions,

[11] The Senate Economics References Committee, *Credit and hardship: report of the Senate inquiry into credit and financial products targeted at Australians at risk of financial hardship*, February 2019, pg. 4, 1.17

they are exempt from regulation. This means that the consumers of these products or services will not have the benefit of the consumer protections.

We consider that given the most vulnerable consumers are the target of this model, they are the consumers that should be most subject to consumer protection rather than be excluded from that framework. The consumer protections set out above are important to consumers generally. When consumers are dealing with specific vulnerabilities it would be an undesirable policy outcome for them to end up with less consumer protections than afforded other consumers.

Below is a case study of a financial firm specifically changing its arrangements to avoid an investigation by the then CIO brought by a consumer.

Case Study 1 – Short term credit provider

A short-term credit provider claimed the exemption under subsection 6(1) of the National Credit Code (which limits the fees and charges to 5%), while a related company acted as a 'broker' and charged consumers substantial fees in relation to the short-term credit contracts. AFCA understands this arrangement was designed to avoid the caps applicable to small amount credit contracts under the Code.

The credit provider refused to co-operate with an investigation by CIO, resigned its CIO membership, and cancelled its Australian Credit Licence. Accordingly, AFCA does not know how many consumers were affected by the credit provider's conduct. We understand this firm continues to operate as an unlicensed credit provider.

Vulnerable consumers can suffer from increased stress, spiralling debt and further hardship as a result of this kind of credit

These arrangements target those who are vulnerable, typically on low incomes, are already experiencing signs of financial stress and have very basic levels of financial literacy. These consumers will generally require access to money quickly, often at the last minute. They are mostly excluded from the mainstream banking and credit providers due to their circumstances. They will have very little option but to use these unregulated predatory services. It is this vulnerability that allows financial firms who provide unregulated credit to take advantage of consumers.

The intention in accessing this type of credit is to try and alleviate some of their financial stress. The outcome, however, is the complete opposite.

These kinds of products can exacerbate financial stress, which then has flow on effects into other areas of the consumers life. The Reserve Bank of Australia,[12] has acknowledged that financial stress has a very real human cost. This can include a

[12] Speech by Michelle Bullock, Assistant Governor (Financial System) at the Reserve Bank of Australia, *Household Indebtedness and Mortgage Stress*, 20 February 2018

deterioration or stress on personal relationships, and also a significant health impact. Good Shepherd advises that debt can be both a cause and consequence of mental illness, and being in debt can itself be a major source of mental illness:[13]

> "There are a number of health consequences associated with debt including anxiety and stress, depression, self-harm and suicidal thoughts. As well, there are social consequences such as isolation and social exclusion, shame, social embarrassment and a sense of personal failure."[14]

The Department of Health says that mental health and financial safety are strongly linked, and financial stresses can add to a mental illness. The sooner financial problems are addressed, the less impact they have on mental health.[15]

A potential outcome in the provision of unregulated credit is that it will trigger a spiral of debt. This was one of ASIC's findings in relation to the short-term lending model, which it said caused significant consumer detriment.[16] This was also a finding made by the Economics Committee regarding payday loans. The Economics Committee said:

> "Despite being sold as quick and cheap credit, in reality payday loans are pushing people into a spiral of debt…"[17]

While the structure of the payday loans considered as part of the inquiry were slightly different to the short-term lending model, they are another form of unregulated credit targeting the same consumers as the short-term lending model. Namely, those who require access to money quickly and are likely to experience financial exclusion from mainstream credit providers.

We are deeply concerned by the short-term lending model and any other arrangements that result in the unregulated provision of credit to consumers. AFCA strongly supports any efforts that aim to eliminate or reduce avoidance practices by financial firms. We believe that there should be no carve outs or exemptions in relation to the provision of credit to consumers, all financial firms should be held to appropriate standards and be regulated by the credit regulations which seek to protect consumers.

Inability to access external dispute resolution

Financial firms that hold ACL, or an Australian Financial Services Licence (AFSL), are required to maintain membership of AFCA. Consumers with complaints against these licence holders (members of AFCA) can access our EDR services for free.

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[13] Information for Financial Counsellors, *Mental Illness and Debt,* Good Shepherd, pg. 2
[14] Information for Financial Counsellors, *Mental Illness and Debt,* Good Shepherd, pg. 2
[15] https://headtohealth.gov.au/meaningful-life/feeling-safe-stable-and-secure/finances
[16] Part A, The impact of some short term lending models, ASIC Consultation Paper 316, *Using the product intervention power: Short term credit.*
[17] The Senate Economics References Committee, *Credit and hardship: report of the Senate inquiry into credit and financial products targeted at Australians at risk of financial hardship*, February 2019, pg. 3, 1.16

Some businesses, such as pay day lenders, have joined AFCA on the basis that they provide regulated services, or because they have chosen to join voluntarily. However, some businesses structure their operations so that they do not need to hold an AFSL. Unlicensed businesses are not required to be members of AFCA. Given that the short-term lending model is structured in a way to avoid regulation this means that the firms do not need to be members of AFCA.

This leaves consumers of these services with little option other than to pursue complaints they may have with these firms through the court system. AFCA considers that the court system is not the most accessible forum for resolving complaints that consumers have with their financial firm. The resources required to pursue legal action through the court system are significant, and there will generally be an uneven playing field between a consumer and the financial firm. This can include things like:

- the amount of money available to a financial firm
- the quality of legal representation a financial firm has access to, including the potential for conflicts of interest which may prevent a consumer from being able to obtain representation from certain law firms
- the effects of a protracted court process are not as significant on a financial firm

A report released by the Senate Legal and Constitutional Affairs References Committee (Legal Affairs Committee)[18] following their inquiry into the resolution of disputes with financial firms within the justice system noted that there was general consensus amongst those who made submissions and witnesses who appeared before the inquiry that the court system was rarely the best mechanism for consumers and small businesses to resolve complaints with their financial firms.

In that inquiry, Consumer Action Law Centre (CALC) submitted:

> "The court system is rarely the most suitable forum to resolve financial services disputes fairly, particularly for consumers experiencing vulnerability and disadvantage. The process is slow, legalistic, complex and expensive. Courts expose consumers to serious costs risks, and present significant barriers to accessing justice..."[19]

In our view, consumers of these services would not readily understand or appreciate that they are not dealing with a licensed business given that the services provided relate to credit. Nor should consumers have to rely on the business voluntarily deciding to join AFCA, especially when the decision to cease being a member rests with the business rather than the consumer. Further, it is not a real option for a consumer to take litigation against a financial firm if they have a complaint.

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[18] The Senate, Legal and Constitutional Affairs References Committee, *Resolution of disputes with financial service providers within the justice system*, April 2019
[19] Consumer Action Law Centre submission to the Senate Inquiry: *Resolution of disputes with financial service providers within the justice system*, 1 March 2019

4 An intervention order should be made

C1Q3 Do you agree with our proposal to make an intervention order by way of legislative intervention prohibiting credit providers and their associates from providing short-term credit and collateral services except in accordance with a condition which limits the total fees that can be charged? Please provide details of why, or why not.

AFCA considers that ASIC should pursue Option 1 and make an intervention order by legislative intervention. We do not consider that Option 2 or 3 will meet ASIC's objectives.

We also think that ASIC should consider making a similar order for other types of products which cause significant consumer detriment.

Other products also cause significant harm to consumers and require ASIC's intervention

CALC has submitted that ASIC should also consider how consumers who have suffered as a result of this short-term lending model receive compensation, and called has for ASIC to continue using its powers for other harmful products including:

- credit repair, debt negotiations and budgeting services
- 'junk' add-on insurance cover, funeral insurance and expenses only products
- buy now, pay later
- dealer-issued warranties.[20]

AFCA supports ASIC using its product intervention powers to prohibit the provision of other harmful products such as those identified by CALC.

We also consider that ASIC should use its product intervention power to prohibit the sale of over the counter (OTC) derivatives to retail clients, such as contracts for difference (CFD) and Forex, as we do not believe these products are appropriate for many consumers.

They are banned in many countries, including the United States of America and the European Union. These products are marketed to people with little to no experience who are told that they can 'learn to trade' with the provider. The trades can be highly leveraged, and consumers can lose significant amounts of money very quickly.

The structure of the products is also unacceptable. Usually they are marketed as being related to an underlying real price – for example, the price of a currency pair, or the price of a share, or share index, or a commodity like gold or oil. The reality is that

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[20] Media Release, Consumer Action Law Centre, 9 July 2019

many providers set their own price and do not commit to reflecting the price of the corresponding asset on a real market.

Complimenting this are a range of other problems including sales tactics, bonus credits and difficulty withdrawing funds. A report by ASIC[21] in June 2018 revealed that practices within the retail OTC derivatives sector have also fallen short of its expectations. These practices included, amongst others:

- misleading materials
- confusing pricing
- insufficient risk management arrangements.

ASIC noted that it identified a number of risks in connection with products offered by OTC derivatives issuers to consumers, with the most concerning being the lack of clarity around pricing and misleading claims about profitability in marketing material.

AFCA strongly believes that OTC derivatives are inappropriate for retail clients and consumers and would welcome ASIC's intervention to prevent further poor consumer outcomes.

5 An intervention order is the best option

C1Q4 What alternative approaches (including Options 2 and 3) could ASIC take that would achieve our objectives of preventing the consumer detriment identified in this paper?

We do not think that the disclosure approach will meet the objectives of ASIC. We consider that the only approach available is Option 1 – to make the industry wide order to discourage these kinds of arrangements. If ASIC takes no action, the consumer harm that has already been caused will continue, so we consider it is appropriate action is taken by the regulator now.

[21] ASIC Report 579: *Improving practices in the retail OTC derivatives sector*, June 2018