ACTU

Submission

Green Paper on Financial Services and Credit Reform

Improving, Simplifying and Standardising Financial Services and Credit Regulation

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Recommendations

The ACTU recommends that reforms for national consistency in the regulation of the finance sector and credit lending:

1. Incorporate a full identification of emerging liquidity distribution problems and facilitate prompt, collaborative action to mitigate them. In particular in the areas subject to high risks and high magnitude of ensuing harm:

    - Micro-lending (up to $2000)
    - Home loan finance
    - Operating finance for highly leveraged industries

2. Investigate and address remuneration incentive distortions within the finance sector which facilitate poor risk management practices, loan defaults and damage market confidence.
3. Are developed from evidence-based identifiers of the source, magnitude and distribution of risks and harm from credit lending, including the quantum impact of practices promoting superannuation depletion
4. Incorporate the Principles within the Finance Sector Union's Charter of Responsible Lending[1]
5. Are developed in accordance with clear regulatory principles, including:[1]

    - Independence of Regulators
    - Usury Monitoring and Legislative Limits
    - Adequate Resourcing of Regulators
    - Fines and Criminal Sanctions
    - Corporate Governance
    - Information Disclosure
    - Procedural Fairness
    - Predatory Lending

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[1] [1] Detailed in Appendix

Executive Summary

The ACTU supports a comprehensive approach to improving and simplifying financial services and credit regulation through national consistency.

The ACTU's primary interest in financial services' regulation is to ensure that the reforms address identified problem areas, to enable a smooth passage for the economy through the slow down in the business cycle and financial market volatility.

This Submission highlights the relationship between financial services regulation and indebtedness as the context for urgent and comprehensive interventions to provide for economic stability.

The ACTU further recommends that the development of a nationally consistent framework clearly identify the areas of emerging liquidity distribution problems. Furthermore, the analysis underpinning the legislative development must also investigate and address remunerative incentive distortions which promote 'debt pushing' within the finance sector.

Finally, consumer protection is at the heart of an effective finance services sector regulation. The ACTU urges government and policy makers to ensure that consumer protection principles underpin the final form of the national regulatory regime, including incorporating the Principles within the Finance Sector Union's Charter of Responsible Lending. Further recommendations on achieving consumer protection through incorporating regulatory principles into the design of the framework are provided.

Introduction

The ACTU welcomes the opportunity to comment on the 'Green Paper on Financial Services and Credit Reform – Improving, Simplifying and Standardising Financial Services and Credit Regulation.' (Green Paper)

The proposal to improve mortgage and margin lending regulation and a thorough investigation into property spruikers is especially welcome. The Finance Sector Union (FSU) has been a key driver and participant in the forums promoting reforms to credit lending to address Australia's mounting debt stress issues.

It is recognised that the reform options proposed in the Green Paper have emerged from separate investigations which have identified problems and potential solutions. As such, it is understood that the purpose of the Green Paper is to present a way forward to implement various recommendations[2].

Unfortunately the range of investigations recommended additional information which has not been provided in the Green Paper. In addition, at the time of the policy instigations, the extent of the credit crisis and liquidity shortage was not fully realised.

To address that issue, our views are based on key problems and priorities which require further incorporation into reforms to financial services' regulation: In particular the level, distribution and escalation of Australia's private sector debt: Individual, household and business.

The primary objective of financial services' regulation is to underpin confidence and sustainability in the financial sector and the economy. This objective needs to be the core concern driving the entire suite of proposed reforms. Meanwhile, immediate collaborative measures need to be taken to ensure liquidity is available and distributed in a manner that sustains the economy.

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[2] This includes; recent reviews and recommendations by the Productivity Commission, ASIC, Council of Australian Governments, House of Representative Committee Inquiries, the Reserve Bank of Australia, and the Review of the Code of Banking Practice.

Financial Deregulation and Rise and Scope of Indebtedness

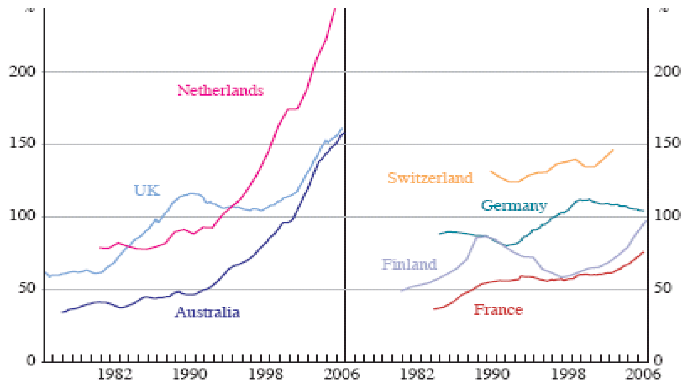
The Australian financial system has been going through an historical phase of major structural change which has increased the size and marketisation of financial instruments and institutions. One real manifestation of this shift is that a larger proportion of household assets are now held in the form of instruments more vulnerable to market risk, at a time when the share of deposits have fallen.[3]

This has shifted the risk onto to the household sector. The well being and access to liquid assets of the household sector is therefore paramount, given the size and scale of its impact on the macro economy.

The quantity of debt depends on the ability and willingness of financial institutions (and financial markets) to extend credit. This is affected by a range of factors, including the nature of regulatory controls.[4] Recent regulatory controls have enabled high levels of growth of personal, household and business debt. This is the critical position which Australia now finds itself in and 'improving regulatory reforms' needs to address this as a fundamental weakness giving rise to heightened economic vulnerability.

Indebtedness, in and of itself is not a problem, if anticipated earnings are sufficient to meet anticipated costs. Higher debt does mean that, *ex post*, an adverse shock of a given size will imply greater costs for households and potentially financial institutions. [5]

Figure 1: Debt to income rations – selected countries



RBA analysts report that the rapid growth in Australian households'

stress and Policy . The

[4] Ibid

[5] Christopher Kent, Crystal Ossolinski and Luke Willard. The Rise of Household Indebtedness, in The Structure and Resilience of the Financial System–21 August 2007

debt is directly paralleled with financial services deregulation and credit lending industry complexity.

This finding appears to be largely consistent internationally. Counties with less legislative prescription and oversight of financial services, such as the US and UK, have a much higher rate of indebtedness compared to countries with higher standards, such as Germany, Switzerland and France.[6] They also have an almost universally higher average level of debt to income. While understandable, this dynamic explains the necessity to thoroughly review regulatory mechanisms and the extent to which they encourage or protect consumers from levels of debt which are unnecessarily risky.

This evidence is supported by the International Monetary Fund. (IMF) Table 1 shows how highly the IMF rates Australia in terms of 'ease of access to credit' against advanced industrial countries . The index lies between 0 and 1, with higher values indicating easier household access to mortgage credit.

Figure 2. Institutional Differences in National Mortgage Markets and the Mortgage Market Index

	Mortgage Equity Withdrawal[1]	Refinancing (fee-free prepayment)[1]	Typical Loan-to-Value Ratio (percent)[1]	Average Typical Term (years)[1]	Covered Bond Issues (percent of residential loans outstanding)[2]	Mortgage-Backed Security Issues (percent of residential loans outstanding)[2]	Mortgage Market Index[3]
Australia	Yes	Limited	80	25	—	7.9	0.69
Austria	No	No	60	25	2.2	—	0.31
Belgium	No	No	83	20	—	1.9	0.34
Canada	Yes	No	75	25	—	3.6	0.57
Denmark	Yes	Yes	80	30	58.5	0.1	0.82
Finland	Yes	No	75	17	2.6	—	0.49
France	No	No	75	15	1.6	1.0	0.23
Germany	No	No	70	25	3.6	0.2	0.28
Greece	No	No	75	17	—	6.2	0.35
Ireland	Limited	No	70	20	4.0	6.6	0.39
Italy	No	No	50	15	—	4.7	0.26
Japan	No	No	80	25	—	4.7	0.39
Netherlands	Yes	Yes	90	30	0.7	4.6	0.71
Norway	Yes	No	70	17	—	—	0.59
Spain	Limited	No	70	20	11.1	5.7	0.40
Sweden	Yes	Yes	80	25	10.1	0.9	0.66
United Kingdom	Yes	Limited	75	25	0.9	6.4	0.58
United States	Yes	Yes	80	30	—	20.1	0.98

[1]Sources: European Central Bank (2003); Catte and others (2004); Calza, Monacelli, and Stracca (2007).
[2]Average 2003–06. Sources: European Mortgage Federation, Hypostat 2006; Bond Market Association and Federal Reserve for the United States; Dominion Bond Rating Services and Statistics Canada for Canada; Australia Securitization Forum and Reserve Bank of Australia for Australia; FinanceAsia.com and Bank of Japan for Japan.
[3]See text footnote 3 for an explanation of how this index is obtained.

The data in this table does not reflect the further relaxation in lending standards in more recent years, such as reduced loan to-value ratio standards. The reduced standards were initiated by the non bank lenders (NBLs) and then adopted by banks, seeking to compete. Banks also adopted other NBL's practices which

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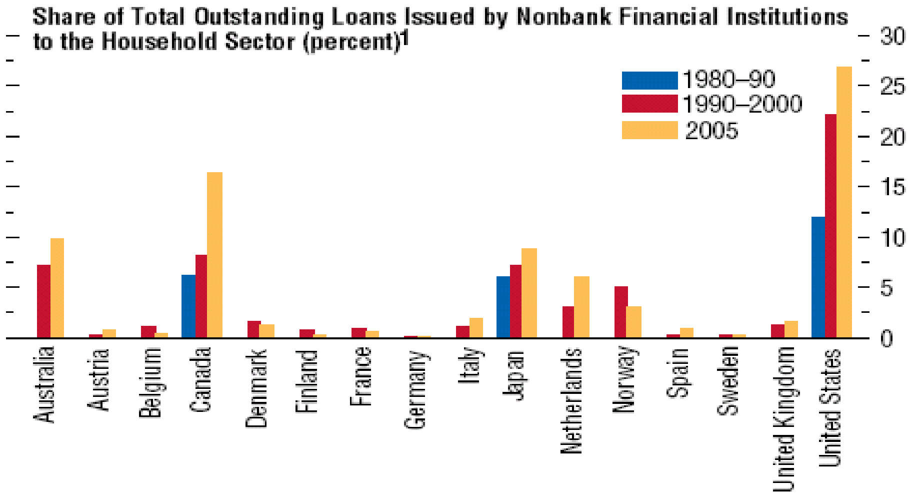
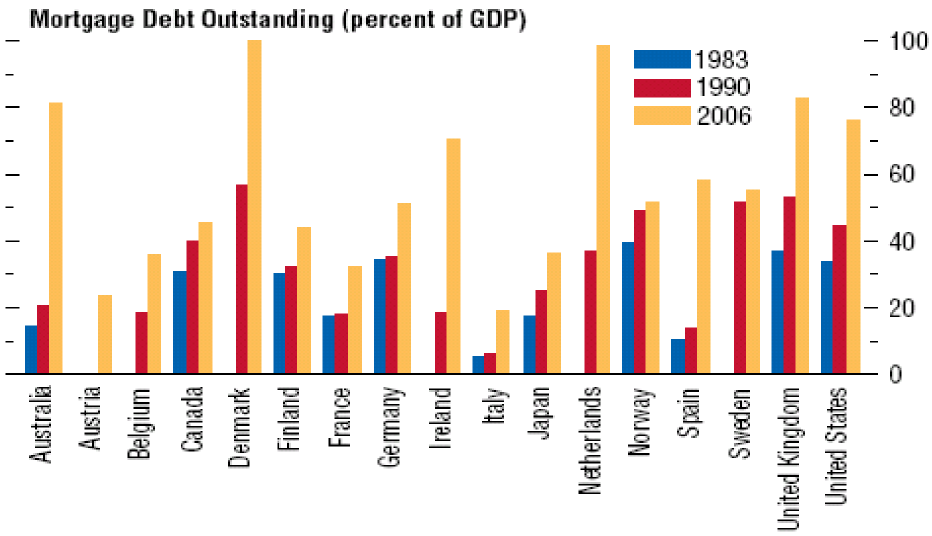
[6] Christopher Kent, Crystal Ossolinski and Luke Willard. The Rise of Household Indebtedness, in The Structure and Resilience of the Financial System , RBA August 2007

reduce scrutiny and transparency of risks. These risks emanate from the borrowing side of operations (new financial sources and instruments) as well as the selling side of operations (new brokered sales commission deals, valuation and risk uncertainties). These practices have been on a steady rise in recent years. The outcome in terms of impact on the economy has been a rapid rise in the percentage of mortgage debt outstanding as a proportion of GDP from 20% in 1990 to 80% in 2006.[7]

Tables 1 & 2





[7] World Economic Outlook, International Monetary Fund, Chapt. 3: The Changing Housing Cycle and the Implications for Monetary Policy. April 2008

Context for Urgency of Financial & Credit Lending Regulatory Reforms & Programs

When the reviews informing the Green Paper were being undertaken, there were only early indications of the correlation between financial regulation and the rapid de- leveraging of assets globally and in Australia.

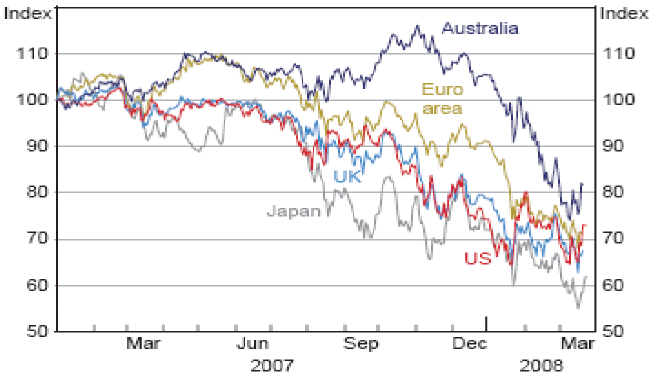
The ACTU is keen to ensure that the scope and urgency of reforms to credit lending are addressed within this context.

This sentiment was recently highlighted by the Treasurer Hon. Wayne Swan, in his statement to the International Monetary and Financial Committee, IMF on April 12 2008:

> **Rising estimates of bank losses from exposure to securities backed by U.S. sub-prime mortgages, ongoing liquidity strains in inter-bank markets, continuing worries regarding counterparty risk, and increasing concerns about contagion to other – often seemingly unrelated – markets are all contributing to significant uncertainty in financial markets. ….**
>
> **Policymakers will need to remain nimble in the short term while continuing to work towards establishing policy settings that reduce risks and susceptibility to economic shocks over the medium term.[8]**

Australian financial institutions, the intermediaries of credit in the economy, have themselves been showing signs of weakness and vulnerability. This is evidenced by their fall in value, rise in debt, increasing credit costs and risk exposures. The various difficulties being faced by financial institutions are largely reflected in bank share prices, which have fallen considerably in all of the major economies (Figure3[9]). As at March 2008 prices were down around 30–40 % from their levels in mid 2007, compared with falls in overall markets over this period of about 15–25%.

Figure 3: Banks Share Prices (1 January 2007=100)

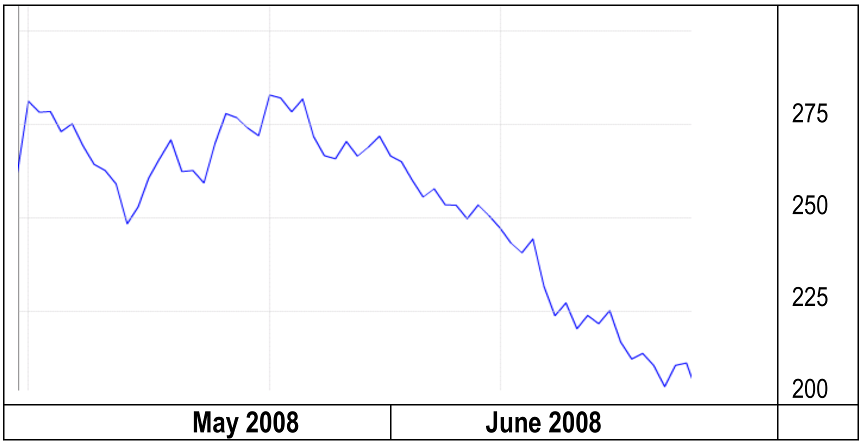


…public of), Marshall Islands (Republic of the), Micronesia (Federated States of), Mongolia, New Zealand, Palau (Republic of), Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands and Vanuatu

[9] Source: Bloomberg

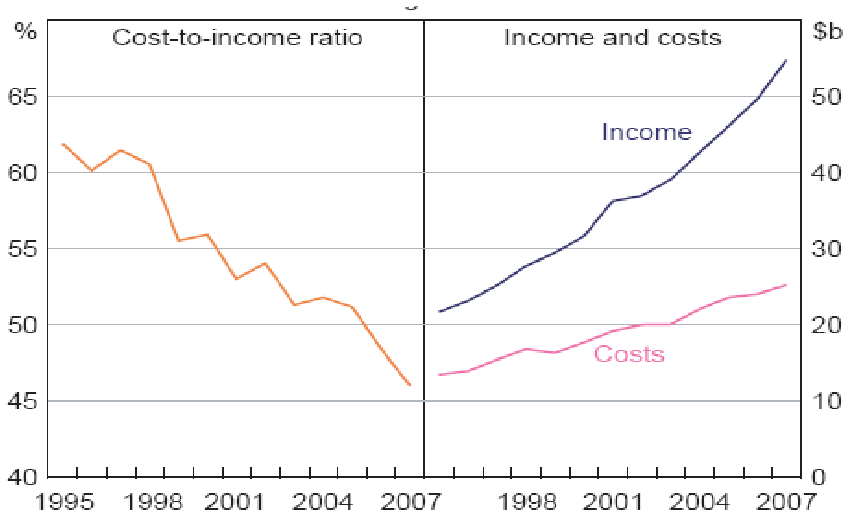
The further decline in banks' value since March is demonstrated below in Standard and Poor's 500 Bank Index performance to June 26 2008.

Figure 4: Standard and Poor's top 500 Banks Index



In itself this re-pricing is indicative of the risks banks undertook in their pursuit of high short-term returns. Figure 3, on the previous page, also demonstrates the relatively high premium for Australian bank shares, due to the high profits they have been making, (while failing to disclose underlying risks). The following diagram demonstrates the high magnitude and accelerated growth of profit, (income to cost) of Australia's largest five banks over the last decade.[10]

Figure 5: Bank profitability indicator 1998-2007 (Australia's 5 largest banks) [11] *



[10] RBA Stability Review, March 2008

[11] * Banks cost to income (Australia's largest 5 banks) Excluding significant items. 2007 data are year to December for CBA. From 2006, data are on an IFRS basis; prior years are on an AGAAP basis. Sources: Banks' annual and interim reports; RBA

The question for policy makers then is, to what extent should customers, the public and the economy be victims of banks' pursuit of high short term returns? This is particularly so if banks are continuing to undertake borrowing and lending practices, without fully informing stakeholders of the risks and future costs.

Growth in the cost of new fund raisings have increased and have tended to be for shorter maturities than previously, with investors globally demanding very high premia for term funding. Banks domestic short term interest costs, as evidenced in Figure 7 have risen significantly since August 2007.[12][13]

Figure 6: Banks Non Intermediated Debt [14]

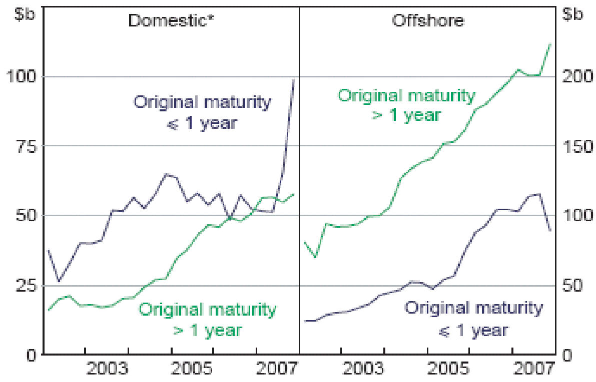
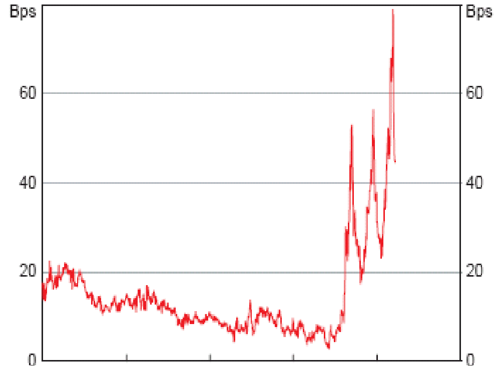
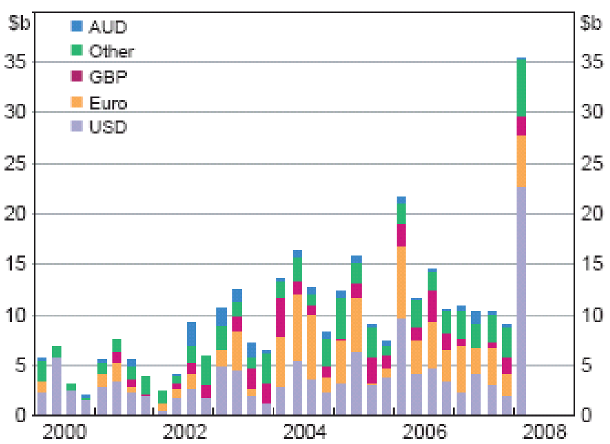


Figure 7: 3-Month Bank Bill Rate



In response to higher costs in Australia and tightening of the credit market Australian banks trebled their issuance of bonds in overseas markets. Many of these bonds give the overseas investor choice over the maturity date, after 13 months. To illuminate the pace of recent changes to banks borrowing and lending activities, the value of banks'

Figure 8: Australian Banks' Offshore Bond Issuance



offshore debt securities outstanding at December 2007 was $223 billion, whereas in the March 2008 quarter alone banks issued a further $35 billion.[15]

[12] RBA Financial Stability Review, March 2008. p31
[13] Source RBA: Tulled Prebon (Australia Pty Ltd) in Ibid.
[14] Net of interbank holdings Source: APRA
[15] Source: RBA 5 largest Banks in RBA Financial Stability Review, March 2008

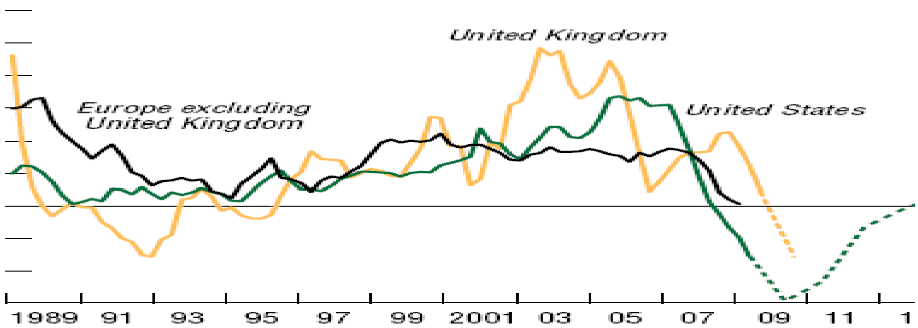
In 2006 the International Monetary Fund's 'Financial System Stability Assessment' of Australia's Financial System identified the high reliance on wholesale funding and offshore liabilities as vulnerabilities in the Australian banking system.[16] Meanwhile the RBA's latest 'Financial Stability Report' , released in March 2008 identified a distinct growth in Australian-owned Banks' Foreign Exposures in the year to December 2007.

Figure 9: December 2007, ultimate risk basis[17]

	Amount	Share of total	June 2007 Growth to 6 mnths %	Dec' 2007 Growth to six months %
New Zealand	222.1$b	45.6 %	10.9	9.5
United Kingdom	118.0$b	24.2%	18.7	2.6
United States	45.1$b	9.3%	22.8	-12.8
Other developed	66.9$b	13.7%	37.5	8.2
Other	35.3$b	7.3%	28.3	1.4
Total	487.5$b	100%	18.4	4.7
Memo: Percent of total assets 27$b				

Figure 10 depicts the risks to Australia from a failure to adequately address credit supply arrangements, and the rapidity with which they can be felt. It also demonstrates, as a proxy, the degree of risks to Australian institutions from over-reliance on overseas markets[18].

Figure 10: US and European House Prices Changes (% year on year)



Meanwhile, these costs and constraints will not only be passed on to consumers, in an economic environment where these effects are already being felt directly by consumers (inflation).

[16] John Laker. The Evolution of Risk and Risk Management –A Prudential Regulator's Perspective, RBA Conference 2007

[17] Source APRA in RBA Financial Stability Review, March 2008

[18] IMF 'Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness, April 2008.

Unfortunately the latest available comprehensive data on the impact of the flow on of these costs, is not recent enough to indicate how these impacts are effecting households.[19] However, from the data which has been published, it is clear that while the percentage of households which have experienced financial difficulties since the last minor economic slowdown, has declined, 30% of households are 'just getting along'. Moreover, even before the full effect of credit constraints more than 10% of households would not be able to raise $2,000 for an emergency within a week. This is a greater proportion of people who would classify themselves as poor.

Figure 11: Indicators of Cash-flow-related Financial Difficulties –%of households

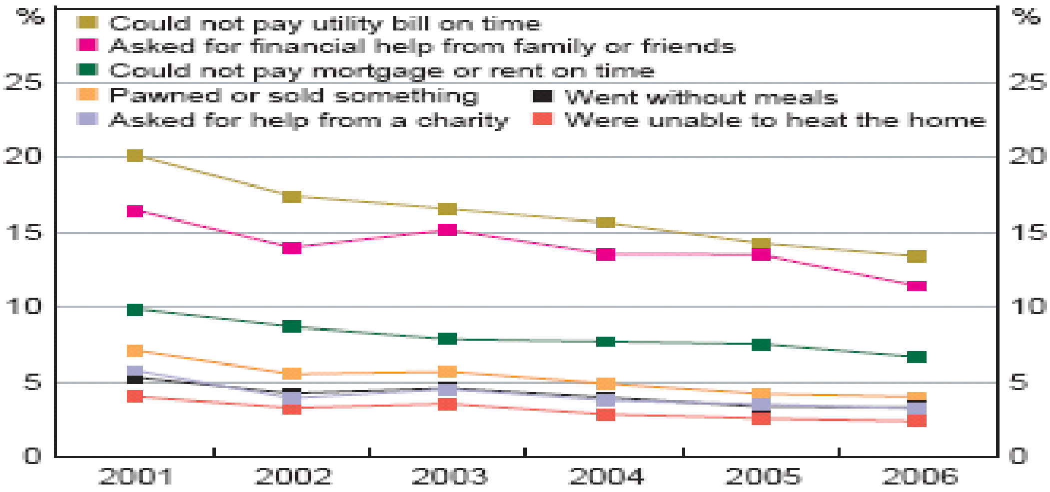
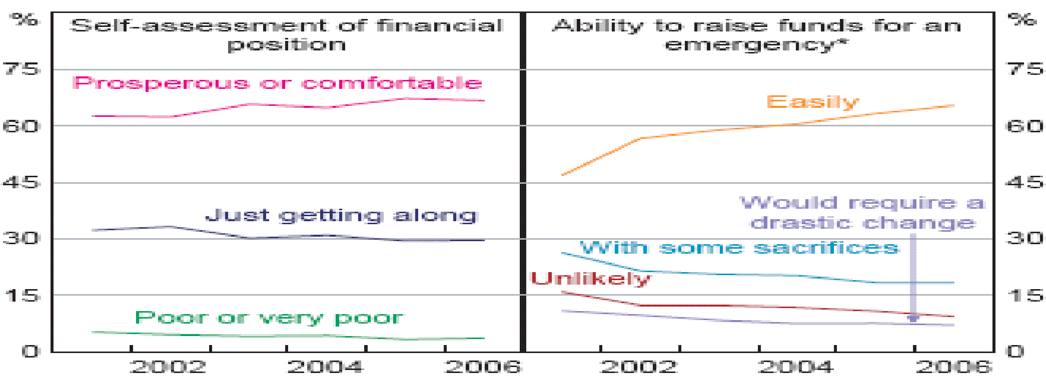


Figure 12: Other Indicators of Household Position (Percent of Households)



*$2,000 to be raised within a week

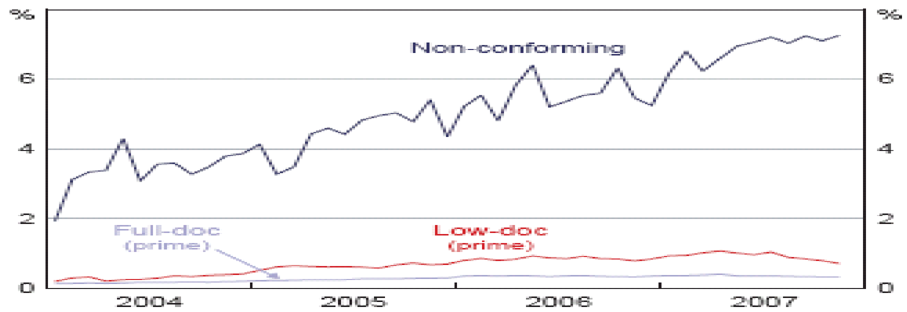
This is a very real indicator that micro-credit programs need to be developed as part of the regulatory and industry response to less accessible, more costly credit.

[19] Source the Household, Income and Labour Dynamics in Australia (HILDA) HILDA release 6.0

More recent data on housing loan arrears past 90 days due demonstrates the escalation of debt stress. In March 2008 the RBA estimated there were around 15,000 borrowers more than 90 days behind on their mortgage payments, with an additional 25,000 borrowers between 30-90 days in arrears.

While Australia does not have a consistent classification for ‘sub-prime’ loans with which to compare the US experience, the level of ‘non conforming loans’ (loans with higher credit risk rating) arrears rising to 7.5% of all loans[20].

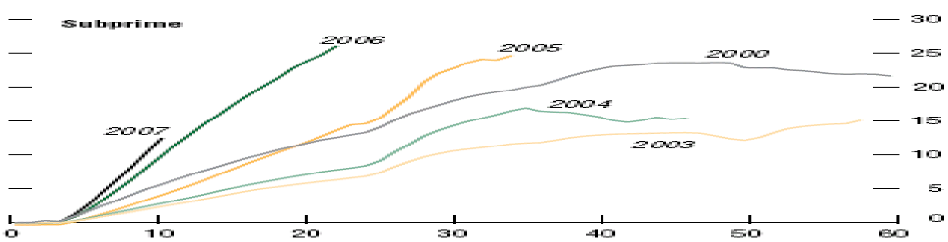
Figure 13: Housing Loan Arrears (90+ days past due, per cent of outstandings)



In addition, the proportion of low doc (non prime) mortgages in Australia extended in 2006 was 10%, compared with 3 percent in 2002. The consequence for the economy if these loans continue their rate of escalation and cease performing due to an economic slowdown, has been evidenced by recent experiences in the US. The following diagram demonstrates the ‘tail’ of default and higher costs which ensue from a slowing economy and tightened credit markets.

The escalation of arrears to defaults for this growing group of mortgages will depend on their owners’ capacity to sustain real income growth to meet escalating costs.

Figure 14 Mortgage Delinquency by Vintage Year (60+ days delinquency, % of balance)



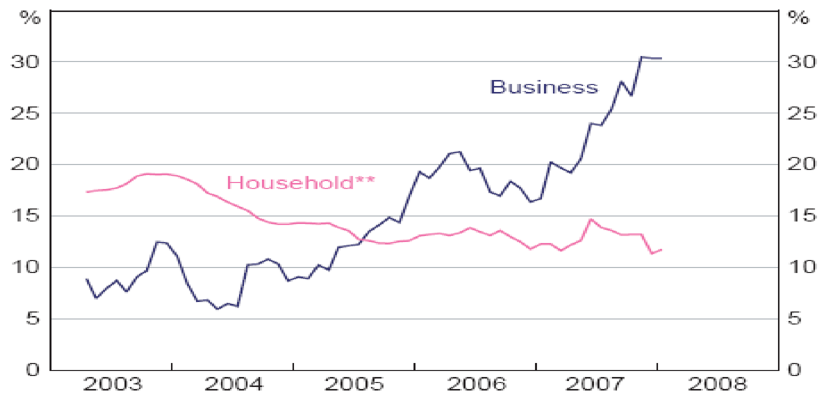
Months after origination

[20] Securitised loans. Sources: Perpetual; RBA; Standard & Poors in RBA Stability Review March 2008

This affirms the ACTU's view that regulatory and policy and program mechanisms are immediately required to reduce incidents of mortgage stress and the movement towards higher defaults by households.

A final important economic context for credit lending reforms to consider is the role of business financing. While the cost of capital becomes more expensive, households in general have responded by reducing borrowing and spending.

Figure 15 Bank Credit Six month-ended annualised percentage change



Businesses, who seek to remain solvent in circumstances where their operations are profitable, but their interest expenses have escalated, need to borrow capital in order to keep operating. However the escalating cost of finance will eventually affect their viability, if operating revenues and profits are insufficient to cover unprecedented spikes in interest payments or 'margin calls'. In the United States, the UK and the EU, billions of dollars have been spent to keep financial institutions, and the businesses they service, solvent through 'emergency interventions'.

These interventions were acknowledged as a necessary intervention to prevent the escalation of impacts from short term insolvency of major financial institutions. The government and policy makers must not allow an endemic situation where businesses become insolvent and bankrupt, when their business operations are otherwise productive and profitable. This is paramount for asset intensive essential services' industries, which tend to be highly leveraged. It is also important that other industries which employ a large number of people and therefore underpin Australia's economy and economic growth, are not forced to fail due to aberrant incidents which lead to credit cost spiralling/default.

Part 2 Credit Lending Reforms: Integral Next Steps

Policy and Program formation for the Distribution of Required Liquidity Interventions

It is recognised that the pace of deleveraging at this point in the business cycle is occurring more rapidly than the time available for comprehensive investigation and development of legislative responses. [21]

> ***Resolving institutions should go hand-in-hand with reforms to strengthen the financial system.***
>
> *An important lesson from the crisis has been the role that underlying vulnerabilities and weakness in the financial system architecture has played in amplifying problems and raising costs to both private and public parties.*

This is a key concern for the ACTU: How businesses, households and individuals are protected from the most harmful aspects of credit lending in a period of rapid devaluation of assets and credit tightening.

It is for this reason that the ACTU also recommends the development of specific practices, and collaborative programs, to guide lending and refinancing, over this period.

The projected economic slowdown is unpredictable. A confluence of factors, from the level of debt to the impact of the credit crisis on the world largest financial intermediaries, are without precedent. As such nobody can accurately predict the outcome. The most optimistic prognosis for the domestic economy is contingent on averting a rapid write-down of equity.

If credit flows are effectively managed, the IMF estimate that the tail of debt could be narrowing substantially in 12-18 months and economic growth could resume. That is *IF* credit flow is effective and credit shortages do not overly damage the economy.

How this is achieved is largely dependent on mechanisms to ensure the flow of credit efficiently through the economy.

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[21] Adrian Blundell-Wignall The Subprime Crisis: Size, Deleveraging and Some Policy Options Financial Market Trends–OECD 2008 1

While inflation has been the dominant concern of government and the RBA, the last 4 consecutive decisions to keep the cash rate on hold is evidence that the RBA accepts that demand growth has slowed to the point where the impact of a further official rate rises would further dampen the economy[22].

Interest rate hikes are well recognised as a blunt instrument to reduce borrowing and spending (the 'overheating' economy effect). The distributional impacts are not ideal for creating the conditions for resuming buoyant domestic economic growth once the 'overheating' effect has passed. The cost of funds for the banks has gone up and they're passing it onto their customers This is a cause of a lot of the credit deterioration.

While we do not expect any immediate change to monetary policy parameters, it is well recognised internationally that additional policies and interventions are required to mitigate its most negative effects.

Australia is in the fortunate position to be able to prepare for the consequence of high borrowing arrears, and prevent a high and rapid rate of defaults or run on financial institutions.

We therefore encourage an additional, more urgent measure, to protect businesses, households and consumers from credit-cashflow related defaults and bankruptcies.

Urgent measures – collaborative investigation into interventions

The ACTU is investigating a range of proposals to proactively address the impact of credit crises on householders, businesses and home owners.

We believe all parties have a responsibility and incentive to ensure that appropriate measures are in place to reduce an unnecessary lending related slowdown in the economy.

This includes the government's responsibility to oversee the creation and maintenance of trust in Australian financial markets, the economy and society.

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[22] RBA Media Release, Statement by Glenn Stevens, July 1 2008.

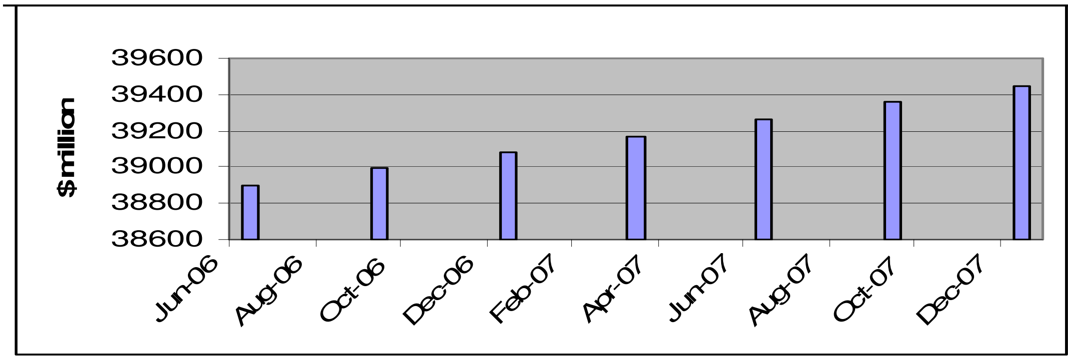
Australian households are demonstrating that they are responding responsibly to interest rate rises by increasing savings and decreasing borrowing. Figure 15.

We seek cooperative efforts to provide for a program/programs which recognise the duties of all parties to sustain the economy during a difficult period in credit markets.

Banks have accrued high profits over many years, without necessarily evaluating the risks of their practices. Banks share a responsibility to improve their early detection, reporting and responsible rescheduling of ' bad and doubtful debts' to mitigate their occurrence.

National Australia Bank chief executive John Stewart's assessment that, although he had "never seen anything like" the global markets' turmoil of the last nine months, it didn't prevent banks lifting half-year cash earnings by 2 per cent. [23] Thus banks can afford to contribute to programs to enable credit extension at discounted rates of interest, to ensure a businesses solvency, through rescheduling of their provisions for doubtful debts.[24]

Figure 16 Australian Banks Provision for Bad and Doubtful Debts



Policies supporting banks' solvency.

It is recognised that the government has introduced a number of measures to assist banks during this time of expensive credit. A range of measures have been introduced to sustain banks' borrowing power and reduce banks borrowing costs, thereby increasing their value and profit. Some of those policies include:

[23] AFR June 2008
[24] Source RBA B05 BANKS - Consolidated Group Impaired Assets

- Reform and Expansion of Commonwealth Government Securities (Treasury Bond Market $5b in 08/09)
- Future Fund Lending/Investment (details undisclosed)
- Commonwealth Government Deposit Insurance (Recommended against in the Wallis Inquiry)
- First Home Owner Savings Accounts (to increase savings in accounts from $4bil to $6.5bil after 4 years + administration revenue)

While such measures are useful, the ACTU is concerned about the degree of subsidy provided to banks, without any commensurate commitment by them to pass on the effect of the subsidies, ie. funds are being used to increase bank profit, not reduce customers borrowing costs.

There is also a major concern about ‘moral hazard’. Why would banks change their high risk/reward practices, if policies to subsidise their solvency and profit are readily provided? Indeed to rely exclusively on the public sector to provide protections and profitability for banks, is a moral question in itself.

The Moral Hazard issue is well articulated by Adrian Blundell-Wignall, Deputy Director of OECD Financial Markets[25]

> **Should taxpayers pay the price of rapid moves up the risk curve to gain short-run bonuses and returns, often involving financial innovation that is too difficult for regulators to monitor, understand and control.**
>
> **This is particularly pointed now, as signs emerge of banks beginning to take strategic advantage of the situation. “**

In the UK case, Northern Rock is being taken into public ownership for a time. In the US, the takeover of Bear Stearns by JPMorgan Chase is being assisted by a long-term facility provided by the Federal Reserve, which carries some credit risk for the Fed. In each case, there is ongoing discussion about what value the previous shareholders can reasonably expect to get from the resolution.

Australia is in a fortunate position that it has the opportunity to implement solvency measures for financial institutions, while addressing the commensurate obligations by the shareholders of those institutions.

[25] Adrian Blundell-Wignall The Subprime Crisis: Size, Deleveraging and Some Policy Options Financial Market Trends FINANCIAL MARKET TRENDS – ISSN 0378-651X © OECD 2008 1

National Consistency in Credit Lending:

The ACTU supports a comprehensive and consistent approach to credit lending nationally. The proposal to nationally regulate mortgage and margin lending regulation and a thorough investigation into property spruikers is welcome.

The ACTU also particularly welcomes further investigation into the regulation of credit products, such as credit cards, personal loans and micro-lending under the Uniform Credit and Consumer Code (UCCC)

The brevity of principles forming the national framework remains a concern. The need for federal simplicity for institutions and removal of loopholes which attract unscrupulous business practices is a worthwhile principal. Moreover, the objective of simplicity for corporations appears to have overridden the need for simplicity for consumers – the outcome of the reforms should result in a clear simple articulation of what consumers' rights are.

It is our view that government needs to determine and simply articulate what consumers' rights should be, in order to effectively determine the form and function of the legislative and regulatory oversight.

The interplay of the regulators, federal and state, will not be a simple task to disentangle and care needs to be taken in designing and implementing national consistency.

The variable operation and application of the UCCC by States results in different outcomes and spread of practices. It is the view of the ACTU that a more thorough, evidence based investigation into the most effective elements of State and Federal regulations and regulators is warranted before final form of national regulation is determined. In addition to this policymakers and government need to determine the principles underpinning the development of the national scheme. Key recommendations for the formation of those principles are provided following.

Regulatory Principles Recommendations:

Independence of Regulators:

The conflict of interest inherent in ASX's commercial and supervisory roles has been receiving increased attention and criticism[26]. As the market operator, it is not in the ASX's interest to take steps to decrease trading volumes. Significant short selling of the stock has occurred and on more than one occasion, unfounded market rumours have added to the share price volatility. Market participants have been urging the corporate and market regulators to increase their vigilance and require better disclosure to ensure a more orderly market to protect the interests of all shareholders.

Recent events have highlighted the dangers to market participants from failures to fully disclose material risks in and timely manner. Meanwhile people who do have access to market information are using it, and the markets lack of awareness of it, to their own benefit. Relatedly, reports of non disclosure by Directors of changes of interest in a timely manner is also was raised by ASX which belatedly reported that 1 in 8 directors do not disclose trading in their own shares within regulatory timelines. The findings are adding to investors' concerns that insider trading is increasingly common among directors and that the ASX and other regulators are not interested in maintaining a fair playing field for all investors.[27]

This has increased calls for the transfer of existing regulation of the market to be transferred to the Australian Securities and Investments Commission (ASIC) and disclosure introduced to protect smaller shareholders.

- **The ACTU recommends that the impacts of the conflicts of interest inherent in ASX roles are reviewed and the appropriate supervisory and regulatory roles are transferred to ASIC**
- **The ACTU also recommends as a principle that any supervisory functions developed within the national regime are separated from commercial incentives for inferior supervision.**

Usury Monitoring and Legislative Limits

Historically and internationally usury laws are used to limit the rate of interest lenders can impose and criminalises the practice of charging 'excessive interest rates'.

In the United States, usury laws are state laws that specify the maximum legal interest rate at which loans can be made. Congress has opted to put a federal criminal limit on interest rates by through definitions of "unlawful debt" which make it a federal felony to lend money at an interest rate more than two times the local state usury rate and then try to collect that "unlawful debt".

[26] QBE chairman John Cloney, April 2007
[27] The Australian Financial Review, 30 June 2008

In Australia, only one State, under the UCCC regulations utilises usury limits. Though this regime has arguably failed to achieve its full effect due to poor compliance monitoring.

- **The ACTU recommends that the implementation of national consistency in credit lending investigate the explicit introduction of usury laws.**
- **The scheme will need to incorporate, as a principle, how to most effectively set penalties and monitor compliance to ensure adherence.**
- **The regime must pay special attention to the protections from usurious practices required by persons who are vulnerable.**

Adequate resourcing of regulators

The Green Paper recognised there are differences across jurisdictions in Australia, and within the federal jurisdiction, of the different degrees of resourcing of regulators. It is critical that regulators are sufficiently resourced to perform their duties. The determination of the cost/benefit of this expenditure must explicitly include the cost of losing investor confidence in Australia's financial sector from not doing so.

- **The ACTU recommends a thorough investigation of the true budgets required to introduce an effective national credit regulation scheme.**
- **The ACTU also recommends a review of the principle of 'self funding regulatory schemes' which promote affordable rather than necessarily appropriate regulation**

Fines and Criminal Sanctions

There are major differences internationally, and nationally, in how criminal sanctions and fines are determined. The US for example has sophisticated methods for determining fines, relative to the size and financial capacity of potentially offending organisations. The level of fines therefore can act as a genuine commercial deterrent for non-compliance.

This method seeks to reduce the role of 'cost benefit analysis' or 'bean counting' as organisations' basis for determining acceptable and unacceptable risks from non compliance with regulations.

In addition, in jurisdictions of high litigiousness, like the US, precedents of very high payouts in courts, are made by judges to deter similar actions by other organisations.

Australia has no consistent principle or articulation of principles upon which sanctions, fines and penalties are calculated. Again this has led some criticism and debate about what the basis of a particular sanction or fine should be across all separate regulators.

- **The ACTU recommends that the national scheme directly investigate the principles and methodology for the setting of penalties and fines, including the consideration of the providing calculable commercial disincentives for non compliance with regulations by institutions of all sizes.**

Corporate Governance

The strongest internal supervisory mechanism investors have is the Board of Directors, whose responsibility it is to represent and protect the interest of shareholders. The conflict of interest of Directors in fulfilling their long term obligation to shareholders, while meeting shorter term targets, including for their own increasingly large bonuses, is increasingly recognised as a risk to stability in the financial sector.

- **The ACTU recommends that the national regime guiding the director's responsibilities and liabilities for failure to comply with regulations be thoroughly reviewed: And that the revised national scheme clearly articulate Directors' responsibilities and liabilities for non compliance with regulations.**

Information Disclosure

The role of disclosure of information to customers and shareholders as a risk management tool has received increased attention. Additionally the increased role for 'financial literacy', with which to interpret information is also gaining attention. The central role of absolute disclosure of credit and lending operations, in clear, concise and comparable terms must be incorporated into the national scheme.

- **The ACTU recommends that the reforms to the financial and lending sectors clearly prescribe information which must be provided to enable risk management by consumers and investors.**
- **The ACTU recommends that policymakers review overseas jurisdictions, such as the US, which have regulations prescribing more detailed and timely disclosure of information.**

Procedural Fairness

A complex interplay of factors determine the level of procedural fairness for parties within any regulatory or legislative regimes, to enable redress for harm caused. These factors include things such as practical accessibility, cost, timeliness, right of merit review, permissibility of information etc.

- **The ACTU recommends that government and policymakers explicitly determine principles to ensure that procedural fairness, for all parties, in the determination of the operation of the national scheme.**

Predatory Lending Prohibition

There is currently a deal of uncertainty about which practices constitute predatory lending, as well as the most efficacious means of addressing the impact of it systemically. One area of heightened concern is the practice of unsolicited increases in credit card limits. While it is acknowledged these offers now come with a request for the customer to inform the lender if their financial circumstances have changed, it is difficult to see how this 'measure of protection' assists vulnerable people. Practices such as increasing 'over limit' fees to encourage people to accept higher limits must also be factored as part of the assessment of predatory or unconscionable conduct.

The ACTU recommends that the government and policy makers make explicit the definition of 'predatory lending' for all classes of lenders, to inform the national framework.

The ACTU recommends that the framework provide clear definitions of protections from predatory lending which consumers should feel entitled to, and how those practices can be simply communicated and redressed in the event of non-compliance.

Compensation incentive distortions within the finance sector

Reforms to credit lending practices must address incentive distortions within the finance sector which facilitate poor risk management practices and damage market confidence.

On the 7 April 2008, the Financial Stability Forum presented their Report 'Enhancing Market and Institutional Resilience', to the G7 Ministers[28][29]. The Forum made recommendations for enhancing the resilience of markets and financial institutions.

One key area of weakness identified was the 'incentive distortions' within financial sectors. This refers to the high rate of short term remunerative incentives and rewards, unaligned to the interests of the long term stakeholders, within the financial sector.

The Forum articulates it as follows:

> *Incentive distortions*
>
> The shortcomings in risk management, risk assessment and underwriting standards reflected a variety of incentive distortions:
>
> > Compensation schemes in financial institutions encouraged disproportionate risk-taking with insufficient regard to longer-term risks. This risk-taking was not always subject to adequate checks and balances in firms' risk management systems.

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[28] The FSF was first convened in April 1999, at the initiative of G7 Finance Ministers and Central Bank Governors, in order to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country, thus destabilizing the world economy.
The Financial Stability Forum (FSF) brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments.) The Reserve Bank of Austalia is Australia's representative

[29] They draw on a large body of coordinated work, comprising that of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centres. Insights have been gained, as well, from private sector market participants.

That is, the rapid growth in compensation arrangements which reward short term outcomes and increase longer term risks, has happened without a full appreciation of the magnitude of the risks and costs.

Neither the regulators or corporate governance bodies provided sufficient oversight, or regulation of these arrangements, to ameliorate a rapid deterioration and re-pricing of the risks, once they were identified.

The hub of defaults associated with high commission based remuneration is now showing a clearer correlation of these factors. The sheer quantum of losses demonstrates how systemic, or endemic, this practice is.

The Forum made strong recommendations about the compensation models which reflect longer-term firm-wide profitability The Forum made the following recommendations for Policy Action:

Financial Stability Forum's Recommendations

- **The financial industry should align compensation models with long-term, firm-wide profitability.**
- **Regulators and supervisors should work with market participants to mitigate the risks arising from inappropriate incentive structures.**
- **Regulators and supervisors will work with market participants to identify means by which risk management policies and controls can mitigate risks associated with these incentives**

These recommendations are consistent with the ongoing concerns raised by the Finance Sector Union about the increase in remuneration principally reliant on meeting sales volumes' targets.

When 'performance based pay' schemes were introduced, their original objective was to seek to improve rewards commensurate with effort. This is a legitimate objective.

However, over time, the proportion of remuneration linked to 'performance' has grown while the share of base salary has shrunk, and employees are increasingly required to meet 'targets' to earn a liveable wage.

The finance sector is not the only sector experiencing this shift in reward practices; it is the sector which sells credit (debt).

This leaves employees in an invidious position, faced with exercising a reasonable level of due diligence or risk assessment, when they also need to earn a living.

In practice the sales targets are linked to ‘pushing’ the institutions’ favoured or most profitable debt products; loans and credit extension. While this is apparent by any attendance at a bank branch (Would you like a housing loan with that?) what has not been immediately apparent is the deficiency in governance arrangements to counterbalance what have become ‘mandatory sales targets’ for employees: Or the rate at which those targets are increasing.

The FSU has identified the same problems as the Financial Stability Forum; that the framework for ‘balancing risks with short term rewards’ is ceasing to exist in organisations.

Staff are being given short term sales targets, likewise their managers are being rewarded based on short term targets, which cascades to executives.

In addition the operational structure of organisations has resulted in targets being set at ‘operational units’ level and there is little evidence that the risk management framework informs or monitors the risks in this practice.

Given the realities of this situation the government and the regulators need to earnestly address this issue.

One proposal to address it, at the very least, is to provide transparency surrounding the level of commission based sales, to customers and investors. Investors increasingly understand the risk profile associated with commission debt sales, and are demanding better regulation of these risk exposures.

The FSU has a growing number of complaints regarding these practices and the true state of affairs of debt pushing by institutions and threats to employment of staff who do not want to undertake excessive irresponsible debt pushing practices. The use of targets to remunerate staff is the systematic means of weeding out people who have an aversion for pushing debt onto people who are vulnerable or unlikely to withstand the debt burden.

We strongly recommend that as part of their thorough review of the incidents and risks imposed by these practices, and means to regulate them, the policy makers avail themselves of this telling information.

The failure to address the insidious growth in this ‘commission based employment’ practice in the debt selling industry, will continue to increase the size and seriousness of the existing and looming debt issues Australia faces.

Superannuation Equity Depletion

Recent regulatory changes make it permissible to access superannuation savings in the event of a loan default 'threat'. According to evidence presented to the House of Representatives Committee on Economics, Finance and Public Administration Inquiry into home lending, this has amounted to dangerous and exploitative practices in the credit sector[30].

Financial institutions are issuing statements and form letters for customers, which have been scripted to conform to the regulatory criteria, to enable them to access their superannuation to pay loan arrears.

Nobody audits the veracity of the claim by the financial institution that the imminent default of their loan is the only option available. APRA does not audit the veracity of these claims. The superannuation fund can not be seen, due to conflict of interest, to be refusing to make funds available that are made in accordance with regulations.

There is currently no accessible data on the extent of this problem, but it is creating widespread concern about the extent of equity depletion for households and individuals.

The ACTU strongly urges the regulators to investigate and report on this practice before it finalises its credit lending regulatory reforms.

[30] Official Committee Hansard, Friday 10 August 2007 Reference: Home loan lending practices and processes, APH.

Appendix

FSU Charter of Responsible Lending Principles

- A consistent Commonwealth regulatory regime covering the provision of financial products should apply to all credit products and providers; incorporating on the highest standards of disclosure and procedural fairness, access, and affordability of redress for consumers,

- Provision of all loans and credit products should require a genuine assessment of the consumer's needs, the suitability of the product to meet those needs, and demonstrated capacity to meet the repayments;

- No unsolicited pre-approved credit offers should be made to consumers;

- Consumers must be informed of any and all commissions, bonuses, incentives and vendor remuneration implications arising from sale or provision of a financial product;

- Consumers must have the capacity to 'opt out' of receiving unsolicited product offers in their dealings with their financial institution;

- Sales targets linked to remuneration for finance industry staff should be additional to provision of a living wage that is maintained in real terms through guaranteed cost of living adjustments;

- Information about assistance mechanisms for people facing financial hardship must be readily available;

- All institutions are to be members of an independent disputes resolution scheme with powers to resolve disputes without redress to the courts;

- Financial literacy and education programs should be supported by the industry and government, with particular focus on vulnerable and disadvantaged groups.

ACTU Recommendations on Regulatory Principles

Independence of Regulators:

The ACTU recommends as a principle that any supervisory functions developed within the national regime are separated from commercial incentives for inferior supervision.

The ACTU recommends that the impacts of the conflicts of interest inherent in ASX roles are reviewed and the appropriate supervisory and regulatory roles are transferred to ASIC.

Usury Monitoring and Legislative Limits

The ACTU recommends that the implementation of national consistency in credit lending investigate the explicit introduction of usury laws. The scheme will need to incorporate how to most effectively set penalties and monitor compliance to ensure adherence.

The ACTU recommends that policymakers pay special attention to the protections from usurious practices towards persons in the community who are vulnerable.

Adequate resourcing of regulators

The ACTU recommends a thorough investigation of the operational budgets and funding mechanisms required to introduce an effective national scheme to regulate credit lending.

The ACTU also recommends a review of the principle of 'self funding regulatory schemes' which promote affordable rather than necessarily appropriate regulatory compliance.

Fines and Criminal Sanctions

The ACTU recommends that the national scheme directly investigate the principles and methodology for the setting of penalties and fines, including the consideration of the providing calculable commercial disincentives for non compliance with regulations by institutions of all sizes.

Corporate Governance

The ACTU recommends that director's responsibilities and liabilities for failure to comply with regulations be thoroughly reviewed and articulated. Directors' responsibilities and liabilities for non compliance with lending regulations and Corporations Law need to be clear and transparent.

Information Disclosure

The ACTU recommends that the reforms to the financial and lending sectors clearly prescribe information which must be provided to enable risk management by consumers and investors.

The ACTU recommends that policymakers review overseas jurisdictions, such as the US, which have regulations prescribing more detailed and timely disclosure of information.

Procedural Fairness

The ACTU recommends that government and policymakers explicitly determine principles to ensure that procedural fairness, for all parties, in the determination of the operation of the national scheme.

Predatory Lending Prohibition

The ACTU recommends that the government and policy makers make explicit the definition of 'predatory lending' for all classes of lenders to inform the national framework.

The ACTU recommends that the framework provide clear definitions of protections from predatory lending which consumers should feel entitled to, and how those practices can be simply communicated and redressed in the event of non-compliance.

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