

Commonwealth Bank of Australia
ABN 48 123 123 124

Group Strategic Development

Level 3
48 Martin Place
SYDNEY NSW 2000
Australia

GPO Box 2719
Sydney NSW 1155

Telephone (02) 9378 5964
Facsimile (02) 9378 3306
Mobile 0402 381 335
DX 1020 Sydney

John McLenaghan
Head of Government & Industry
Affairs

22 May 2009

Mr Geoff Miller
General Manager Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Miller,

National Consumer Credit Regulation and Australian Consumer Law (unfair contract term regulation)

The Commonwealth Bank ("the Bank") is one of Australia's leading providers of integrated financial services including retail, business and institutional banking, funds management, superannuation, insurance, investment and broking services. With over 10 million customers, the Bank is also a major service provider of home loans (at around 23 per cent of market share) and credit card issuing (at around 21 per cent of market share). The Bank has the largest branch and ATM network of any of the banks operating in Australia.

The Bank supports the foundation concepts to implement uniform and consistent consumer protection laws in Australia. The current draft proposals, however, will generate a number of unintended consequences which will have a significant negative impact on the financial services industry, consumers and the economy as a whole.

The magnitude of the potential economic impact of these regulatory changes could seriously dampen the government's current efforts to stimulate the economy.

The following points highlight our strong concerns about the proposed legislation, the likely impact if unamended, and suggested ways to address the concerns without undermining the objectives of the Government's initiatives.

Key concerns

Unrealistic timing

The unfair contract terms legislation (UCT) and the national credit protection legislation (Credit Law) are due to commence 1 January 2010 (with registration of Credit Providers commencing November 2009).

The proposed legislative timeframe is impractical and, if maintained, will lead to cost and operational impacts that will affect banks and customers negatively.

The Bank relies on standard form contracts across its various businesses. Every aspect of the Bank's business (from deposit taking to lending to the provision of services) will now be impacted as the basic relationship with the Bank and its customers is established by way of a 'standard' form of contract in all but the largest of corporate transactions. Those standard form contracts have been drafted based on current law and accepted business practices. In some cases,

clauses have been included expressly because legislation permitted them (e.g. unilateral variation clauses in the consumer credit contracts).

Under the UCT, the Bank will need to carefully review all of its standard form contracts, both for consumers and businesses. The Bank has close to 950 standard form contracts. All affected clauses will need redrafting to comply with the new law. This simply cannot be done by 1 January 2010 with final legislation not due until the end of September and even early October 2009. The transition will be impacted by system constraints and anticipated scarcity of external resources as occurred when Anti Money Laundering and FSR were introduced.

In addition, the proposed Credit Law impacts on every aspect of the “end to end” lending process from the initial inquiry, through to the approval process, loan documentation and arrears collection. The Bank will need to review each of these aspects, potentially re-engineer processes, develop associated systems and implement new documentation, systems, procedures and training before we can become fully compliant with the proposed laws. The changes will likely be as significant as those required by the Financial Services Reform.

System changes alone are likely to require 6-12 months from the time specifications are finalised, which in turn is likely to require at least 6 months from when the legislation and accompanying regulation are finalised.

Responsible lending provisions are extreme

The Bank supports the underlying principles of responsible lending as part of its prudential policies and dedication to customer service. The Bank currently has a number of initiatives to support responsible lending, including provisions for downward readjustment of credit card limits. Nor do we offer credit card limit increases to customers recorded as being in receipt of aged pensions, disability allowance and other such benefits.

Ultimately, the costs of the proposed regulation for the majority of consumers who are not suffering financial hardship need to be weighed against the benefits of protecting a small group of customers at risk of predatory lending. We believe that the proposed regulatory approach has not achieved this necessary balance and that the Credit Law imposes measures unnecessarily extreme to address the underlying issues.

Credit providers are made liable if any loan they provide to a customer is not suitable for that customer, either because they could not afford it without hardship or the loan did not meet the customer's needs and objectives. There is no duty placed on the customer to give full and accurate information. Customers need only show that the credit provider should have known they were at risk of default or that the credit provider allowed them to take a product which was unsuitable for them.

Whether the credit provider should have known a customer was going to have trouble repaying the loan and that the loan chosen was not proper for the customer are arguable and subjective. This issue of uncertainty of application of the Credit Law is then compounded by the extreme sanctions that apply. For example, the Bill (R290) sets a penalty of imprisonment for up to 5 years where a licensee enters into an unsuitable credit contract.

Application of unfair contracts legislation too broad

We consider that the scope of the legislation is too broad. The legislation was intended to apply only to consumers, but has been expanded to businesses, and possibly major corporations. None of the other countries with unfair terms contracts have adopted such a broad approach.

The effect of the UCT will be to reduce contractual certainty even where both parties are sophisticated and able to adequately protect their own interests.

Moreover, under the proposed legislation ASIC has the power to deem a particular condition “unfair” at any time in the future. This is ordinarily and rightfully a matter that should be left to the Court system.

Members of superannuation funds and managed investment schemes are beneficiaries under trust law, with their investment being subject to the terms of a trust deed made by the Trustee or Responsible Entity (trustees). Trustees have a fiduciary duty to act in the best interests of their members. The proposed law will give rise to uncertainty regarding the nature of that relationship, in particular as to whether a contractual relationship exists in addition to the one established under trust law and how that relationship is formed (e.g. through the Product Disclosure Statement). It will then be a matter for the courts to determine. We submit that the proposals should not apply to these products for this reason.

Application of credit assistance creates artificial distinction

There are significant complications arising from an artificial distinction between credit providers (such as banks) and credit intermediaries (such as brokers) involved in the provision of advice on credit products. The proposed approach would mean that the two roles result in a duplication of effort, disclosure and obligations. This will ultimately be confusing for customers and add additional costs for all concerned.

Potential impacts

Reduction in credit

The laws, as currently drafted, will significantly reduce the availability of credit. This has significant implications for the economy and the Government’s strategies for job creation.

Since the Credit Law places the onus entirely on the lender and imposes significant financial and criminal penalties on lenders, they will adopt a very conservative approach to providing credit.

This will be compounded by the increased costs caused by the legislation, which will mean that certain loan types will no longer be profitable.

Our objective of improving customer engagement and ensuring the Bank is easy to do business with has meant that our relationship with our customers varies depending on what is convenient to the customer. Phone and online banking are important channels through which our customers seek to originate or increase loans with us. In our credit card business, up to 30 per cent of customers choose to contact the bank through these channels. Under the proposed legislation, this sort of interaction will need to be curtailed or will simply no longer be provided by the Bank. We are concerned about the additional inconvenience this will have for existing customers, many of whom have had many years of experience with us.

Certain segments of the population will find their access to credit particularly limited, including first home buyers without any significant equity or savings history, younger borrowers and self-employed without an established record, contractors (e.g. miners) and loans to persons on lower incomes. All of these demographics still need credit and will either simply not borrow or be forced to borrow from less scrupulous lenders at far higher interest rates.

In relation to home lending, we estimate that up to 15 per cent of the Bank's home loan portfolio could be at risk as a consequence of the Bank needing to categorise loans to certain customers as potentially 'unsuitable'. The reduction in credit to these customers represents about \$18 billion each year, which is equivalent to around 1.5 per cent of GDP.

In relation to credit card lending, the proposed regulations will mean that issuers of credit cards will be restricted from credit limit management of their customers' cards. As noted above, the Bank supports the goals of the Government in responsible lending and has built in measures to assist customers. However, we hold a very strong view that the proposed solution will not effectively achieve the goals whilst simultaneously creating severe negative outcomes for the Australian economy.

The unintended consequences of the proposed legislation will impact:

- Australian credit card holders in the form of reduced access to credit and higher costs for those that maintain access;
- issuers of credit cards in the form of fewer customers, higher costs and higher relative credit losses amongst other material things; and
- Australian society as a whole through a wide-scale loss of jobs/reduction in job creation flowing from reduced economic activity.

By restricting the credit limit management on credit cards, our modelling analysis shows that the Australian economy may experience a reduction in expenditure of somewhere between \$19 billion to \$60 billion (over a five year period) that would otherwise have been generated by credit card spend related borrowing. The initial leakage from the economy represents approximately 0.3 per cent to 1.0 per cent of GDP. The analysis does not take into account other indirect (multiplier) effects through to the rest of the economy.

These restrictions in home and credit card lending, as well as restrictions that will occur in other credit areas of the Bank will significantly dampen the Government's policy of fiscal stimulation and have a significant negative impact on spending, investing, and job creation within the economy.

Increased costs to consumers

The costs of complying with both pieces of legislation are very significant. This may result in an increased cost to the customer; and, to the extent that the costs cannot be entirely borne by customers, will result in further reductions in the level of activity, competition and availability of loans.

This will be compounded by the restriction of credit, so that the higher costs will be shared by a smaller group of customers and will lead to customers being faced with higher interest rates and upfront and ongoing costs.

Reduced choices and convenience for consumers

The Bank is focused on providing excellent customer service. The proposed legislation will have a substantial negative impact on customer experience.

Customer choice will be constrained, as the Bank restricts borrowing options based on its limited information.

The Box below provides two examples of the proposed legislation's ability to constrain consumer choice and, thereby, an individual's well-being.

Example 1: Consumer seeks repayment option

Customer A approaches the bank for finance to help him pay for urgent car repairs amounting to \$1500. He wants an In Reduction facility over 2 years with monthly repayments. At present, the bank does not provide this type of loan facility. These types of small requests for finances are normally funded via a credit card with a small limit. Clearly, a credit card is unsuitable to the borrower's stated needs under the proposed regulations and the bank cannot suggest an alternate product that substantially meets the borrower's needs. The customer may be forced to get finance through a payday lender or similar who might charge the customer a higher interest rate than that charged by the bank's credit card product.

Example 2: Consumer seeks home loan

Customer A has a home loan with the Bank and has had for some years with an impeccable repayment history. A indicates they would like a small top up loan and wish to secure the loan via the significant amount of equity in their home so that the loan can be at the home loan rate. Currently, this process can be accommodated almost instantly. Under the proposed legislation, more information would need to be obtained about the borrower's objective and requirements to understand if they require a loan over a shorter period which may result in a different product with a higher rate. If they wanted a combination of lower rate and short term we wouldn't be able to provide them with a product as it wouldn't meet their objective. The Bank would also need to obtain a new financial position statement from the customer and verify the information including other debts, income and expenses. This process would significantly delay the outcome and result in higher costs to the customer to reflect the additional work undertaken.

Certain channels, such as online and phone applications, will be substantially curtailed or eliminated altogether.

The loan process generally will be lengthened, with even more documentation provided, questions asked and delays in the process. Our experience is that increased levels of documentation do not, in general, lift the standard of understanding by customers. As an example, the extensive standardised disclosures required by the FSRA have led to a large volume of paper being delivered to customers; however, customer research shows that the aggregate behaviour of customers with greater information has not enhanced their understanding of the risks of different financial products.

Certain product innovations may need to be withdrawn from the market. For example, banks have moved to increase transparency and choice around fees, for example, some products offer alternative fee arrangements whereby a lower upfront fee can be charged with an early

termination fee being payable if termination occurs within a set period. If early termination fees are no longer secure (due to the UCT), credit providers may remove this option altogether.

Increased compliance costs for credit provision

The level of formal scrutiny required introduces additional overhead to the Bank, particularly where approvals are currently semi-automated. This will also add to the 'red tape' in complying with the proposed legislation, running counter to the Council of Australian Government's (COAG) agenda for the reduction of the regulatory burden on businesses.

The compliance costs are both upfront and ongoing. For example, upfront training requirements will require staff at all levels and throughout all channels to be trained on the new way of processing regulated loan applications and to be advised that some of their actions could lead to criminal penalties (REM 65). The Bank currently has more than 20,000 staff that will need to train by the time the legislation comes into place. Ongoing training to ensure that staff comply with the legislation will also be required.

Way forward

Extend transition period for legislation

This is critical.

All of the negative impacts outlined above will be exacerbated if there is not sufficient time for credit providers to work through the issues and take appropriate steps to minimise the risks and customer service issues.

Given that there was a confidential consultation process, the details of the reforms were not available until relatively recently. This makes it very difficult to budget and plan for the changes and introduce the requirements in a short time frame. It is crucial that a sufficient transition period is allowed to ensure that changes are made to comply with the regime without adversely impacting on our customers.

Moreover, the culmination of these reforms, as well as the need to comply with other Federal Government legislative initiatives occurring at the same time, such as Personal Property Security Law Reform and Margin Lending Reform and other imminent reforms including Privacy will involve significant operational changes to the Bank.

We consider that credit providers require at least 12, and preferably 24, months from when the legislation is finalised. Having a longer transitional window to effectively implement the new reforms would be consistent with previous Anti Money Laundering and Financial Services Reform Act initiatives.

Given that both the UCT reform and the proposed Personal Property Security Law Reform impact upon common documentation, these reforms should be co-ordinated to limit the associated compliance costs and unnecessary duplication of documentation reviews.

In respect to reforms that pertain to credit card lending, further regulation should be assigned to Phase 2 to allow the Government the opportunity to fully assess the implications for the economy.

Eliminate criminal sanctions and strict liability tests from responsible lending

Criminal sanctions should be removed from the suitability requirements. Furthermore, the suitability requirements should be modified.

First, the standard should be modified, e.g. to not “substantially” unsuitable. Customer choices should also be respected – e.g. where a customer chooses a particular product, the Bank should not be required to second guess the customer. Requirements should be lowered for standard products like a variable rate home loan, personal loan or credit card (similar to basic deposit accounts requiring less protection under FSRA).

Allow positive credit reporting

If credit providers are required to verify a customer’s financial position, positive credit reporting is essential. Credit reporting reforms would lead to comprehensive information on credit files to identify people who are potentially over-committed and who should not be extended additional credit. Currently, Australia is one of only three jurisdictions in the world that does not permit credit reports to include positive information.¹

The Bank urges the Government to not unnecessarily delay the introduction of positive credit reform reporting in order to aid responsible lending practices in a sound manner and enable automation to help limit costs for all concerned.

The Bank’s position accords with the Australian Law Reform Commission report of August 2008 (p. 121) which recommended: “that the Australian Government only amend the *Privacy Act* to allow credit reporting to include information about an individual’s repayment history after it is satisfied that there is an adequate framework imposing responsible lending obligations in Commonwealth, state and territory legislation.”

Eliminate double handling in responsible lending assessments

Where a broker is involved, the Bank should not have to redo the assessment of whether the product meets the customer’s needs and objectives. The proposed approach would mean that the two roles result in a duplication of effort, disclosure and obligations. The Bank should also be able to rely on information sought and verified by brokers.

Where the Bank’s front line staff (or online systems) deal with customers, there should not be a separate requirement to provide documentation and make suitability assessments at the initial stage, as this will occur shortly at the lending stage. This could be fixed by making the legislation clear that the credit assistance obligations do not apply to credit providers.

Limit scope of UCT to consumers (as defined in the Trade Practices Act)

The UCT amendments to the TPA and ASIC Act should adopt the definition of “consumer” under the TPA. The UTC should only apply to contracts for goods or services intended for personal, domestic or household use or consumption and to all goods or services costing less than \$40,000 where the recipient is an individual or small business.

¹ The other countries are New Zealand and France.

Areas of support

Introduction of national consumer credit regime

The Bank welcomes the COAG's initiative to introduce a single consumer protection regulation. This is important for an organisation that operates nationally and is therefore faced with multiple consumer credit codes, increasing the costs of compliance. The national regime will also ensure that the application and enforcement are administered on a consistent basis.

Positive licensing of credit providers

The Bank is supportive of a national licensing scheme that places standards of conduct on all those providing credit assistance to ensure that undesirable elements are removed from the industry while at the same time not imposing onerous obligations on those within the industry who behave professionally, ethically and responsibly.

The Bank undertakes a number of steps for the accreditation of finance brokers to ensure that their approach and conduct in relation to the consumer and the interests of the Bank are appropriate and sound.

Initial Comments on Proposed Phase 2 Legislation

Whilst Phase 2 legislation is yet to be developed, it has been indicated that regulation will be introduced covering the provision of credit to small businesses. It is noted that a recent concern expressed by Government and other commentators is the difficulty that small businesses, including start-ups and small ventures, have in obtaining access to finance. The level of finance to this sector has been increasing, and this relies upon automation and low service ratios in order to ensure economic viability. Should the obligations described above be extended to small business, it is anticipated that this will also impact on the economy. A more inclusive and open consultation process is required for Phase 2 so that the legitimate concerns of industry and the economic effect of any changes can be given proper consideration.

There are other matters of concern to the Bank, but I have identified key points to convey the urgency of taking action to address potential consequences of the proposed legislation. We would also like to indicate the Bank's support for the submission made by the Australian Bankers' Association (ABA).

I look forward to discussing these issues with you further.

Yours faithfully



John McLenaghan
Head of Government and Industry Affairs