

Responsible lending practices in relation to consumer credit cards



Consultation Regulatory
Impact Statement

August 2008

Prepared for the Ministerial Council on Consumer Affairs.

Disclaimer

Because this publication avoids the use of legal language, information about the law may have been summarised or expressed in general statements. This information should not be relied upon as a substitute for professional legal advice or reference to the actual legislation.

Copyright

You may copy, distribute, display, download and otherwise freely deal with this information provided you attribute the Office of Fair Trading as the owner. However, you must obtain permission from the Office of Fair Trading if you wish to 1) modify, 2) charge others for access, 3) include in advertising or a product for sale, or 4) obtain profit, from the information.

Important: For full details, see the Office of Fair Trading's copyright policy at <http://www.fairtrading.nsw.gov.au/copyright.html> or email publications@oft.commerce.nsw.gov.au

© State of New South Wales through the Office of Fair Trading, 2008.

Contents

SUBMISSIONS.....	3
EXECUTIVE SUMMARY	4
1. OVERVIEW OF THE INDUSTRY	14
1.1 INDUSTRY PARTICIPANTS.....	14
1.2 SIZE AND VALUE OF THE INDUSTRY	14
2. STATEMENT OF THE PROBLEM	15
2.1 SIZE AND IMPACT OF THE PROBLEM.....	15
2.1.1 <i>Default, write-offs and minimum repayments</i>	16
2.1.2 <i>Debt Collection</i>	16
2.1.3 <i>Bankruptcies</i>	17
2.1.4 <i>Impact on consumers and potential wider impact</i>	17
2.2 WHO IS AFFECTED AND WHY?.....	18
2.3 CURRENT REGULATORY STRUCTURE	19
2.4 PROBLEMS WITH DISCLOSURE BASED REGULATION	23
2.5 GENERATING FUTURE GROWTH IN THE CREDIT CARD MARKET	23
2.6 REGULATORY FAILURE.....	26
2.6.1 <i>Application process and timing and nature of information</i>	26
2.7 SETTING THE CREDIT LIMIT.....	27
2.7.1 <i>Assessment method</i>	31
2.7.2 <i>No incentive for card issuers to change the system</i>	31
2.8 MINIMUM REPAYMENT PERCENTAGES.....	32
2.8.1 <i>Redress</i>	33
2.8.2 <i>Enforcement and penalties</i>	33
2.9 APPROACH TAKEN IN OTHER COUNTRIES TO ADDRESS CREDIT CARD ISSUES	34
3. OBJECTIVES OF GOVERNMENT INTERVENTION	35
3.1 GROUPS POTENTIALLY AFFECTED BY GOVERNMENT INTERVENTION.....	35
4. POLICY OPTIONS.....	36
4.1 OPTION 1: MAINTAIN THE STATUS QUO	36
4.2 OPTION 2: INCREASED PENALTIES AND BETTER ENFORCEMENT OF THE CURRENT LAW	37
4.3 OPTION 3: EDUCATION AND INFORMATION.....	38
4.4 OPTION 4: SELF REGULATION.....	39
4.5 OPTION 5: CO-REGULATION.....	40
4.6 OPTION 6: REGULATION	41
4.6.1 <i>Option 6.1: change the timing of essential information disclosure</i>	41
4.6.2 <i>Option 6.2: require credit providers to allow consumers to nominate the credit limit sought</i>	42
4.6.3 <i>Option 6.3: Prohibit the card issuer from providing more credit than the consumer can repay from income without substantial hardship</i>	42
4.6.4 <i>Option 6.4: Provide relief for consumers by making the debt unenforceable to the extent that it exceeds an amount granted in accordance with Option 6.3, including interest charged</i>	44
4.6.5 <i>Option 6.5: Require card issuers to warn consumers about the effect of paying only the minimum repayments</i>	45
4.6.6 <i>Option 6.6: Require card issuers to increase the minimum repayment percentage for new credit card contracts and for offers of increased credit limits on current cards</i>	46
4.7 RECOMMENDED OPTION	47
5. IMPACT ANALYSIS.....	47
5.1 OPTION 1: MAINTAIN THE STATUS QUO	47
5.1.1 <i>Evaluation</i>	49

5.2	OPTION 2: INCREASED PENALTIES AND BETTER ENFORCEMENT OF THE CURRENT LAW	50
	5.2.1 <i>Evaluation</i>	51
5.3	OPTION 3: EDUCATION AND INFORMATION	52
	5.3.1 <i>Evaluation</i>	53
5.4	OPTION 4: SELF REGULATION	54
5.5	OPTION 5: CO-REGULATION	54
5.6	OPTION 6: REGULATION	54
5.7	OPTION 6.1: CHANGE THE TIMING OF ESSENTIAL INFORMATION DISCLOSURE.....	54
	5.7.1 <i>Evaluation</i>	55
5.8	OPTION 6.2: REQUIRE CREDIT PROVIDERS TO ALLOW CONSUMERS TO NOMINATE THE CREDIT LIMIT SOUGHT.....	55
	5.8.1 <i>Evaluation</i>	57
5.9	OPTION 6.3: PROHIBIT THE CARD ISSUER FROM PROVIDING MORE CREDIT THAN THE CONSUMER CAN REPAY FROM INCOME WITHOUT SUBSTANTIAL HARDSHIP.....	58
	5.9.1 <i>Evaluation</i>	61
5.10	OPTION 6.4: PROVIDE RELIEF FOR CONSUMERS BY MAKING THE DEBT UNENFORCEABLE TO THE EXTENT THAT IT EXCEEDS AN AMOUNT GRANTED IN ACCORDANCE WITH OPTION 6.3, INCLUDING INTEREST CHARGED.....	62
	5.10.1 <i>Evaluation</i>	64
5.11	OPTION 6.5: REQUIRE CARD ISSUERS TO WARN CONSUMERS ABOUT THE EFFECT OF PAYING ONLY THE MINIMUM REPAYMENTS	64
	5.11.1 <i>Evaluation</i>	66
5.12	OPTION 6.6: REQUIRE CARD ISSUERS TO INCREASE THE MINIMUM REPAYMENT PERCENTAGE FOR NEW CREDIT CARD CONTRACTS AND FOR OFFERS OF INCREASED CREDIT LIMITS ON CURRENT CARDS.....	66
	5.12.1 <i>Evaluation</i>	68
6.	CONSULTATION.....	68
6.1	FUTURE CONSULTATION PROCESS	71
7.	EVALUATION AND REVIEW	71

Submissions

All interested individuals and organisations are invited to comment on the Ministerial Council on Consumer Affairs' *Responsible Lending Practices in Relation to Consumer Credit Cards* Consultation Regulatory Impact Statement.

The Regulatory Impact Statement is available for downloading at: www.consumer.gov.au and: www.fairtrading.nsw.gov.au

Businesses affected by this legislation should identify in their submissions any costs and benefits they might anticipate from the proposals in qualitative and quantitative terms. These should relate to individual options and not be in terms of unsupported general comments.

Comments in writing should be emailed, posted or faxed to:

Senior Project Manager (Credit)
Policy & Strategy Division
NSW Office of Fair Trading
PO Box 972
PARRAMATTA NSW 2124

Fax: (02) 9338 8918
e-mail: policy@oft.commerce.nsw.gov.au

Closing date for submissions is 3 October 2008.

Executive Summary

The problem this consultation regulatory impact statement seeks to address is that a small percentage, but substantial number of consumers are burdened with ongoing unmanageable credit card debt which appears to be occasioned by a number of factors, including inadequate protection from consumer credit laws.

While the percentage of affected consumers is relatively small compared to the much larger percentage of consumers who manage their cards successfully, the impact on the affected consumers is severe, both financially and in its social impact.

Major intervention in the consumer credit market has already occurred with the commencement of the Consumer Credit Code (the Code) in all jurisdictions in 1996.

The Code provides relevant information to consumers about the costs and conduct of the loan. In the event that consumers are treated unfairly, the Code relies on consumers taking independent action to deal with unfair practices.

The consumers that are the centre of concern in this paper are those who have low financial literacy and do not appreciate the implications of, first, spending to the limit, and second, paying only the minimum repayment. Others may have an unrealistic appreciation of their capacity to repay. This group of consumers generally consists of low income, less well educated consumers, and may include the demographic found to have the lowest financial literacy – young people and the elderly.

The problems outlined in this paper suggest that the following are factors that contribute to problematic levels of consumer credit card debt :

- Essential information is received at a time when it is unlikely to be useful;
- Credit providers' assessment practices maximise the amount of credit granted;
- Minimum repayment percentages are set at a very low level;
- The legislative requirements are remedial, not preventative, and the remedy does not have a systematic effect.

Government intervention therefore will aim to:

1. Assist consumer choice of competitively priced credit card products;
2. Adequately protect consumers, especially vulnerable or disadvantaged consumers, from lending practices which irresponsibly provide continuing credit at levels which cannot be repaid without substantial hardship;

While at the same time:

3. Minimising the effect on consumers who manage their cards satisfactorily.

Credit card debt issues are relevant to all jurisdictions. The Ministerial Council on Consumer Affairs has acknowledged the importance of this issue by including it on the national agenda.

Proposals for standard setting and regulatory initiatives which are made at a national level and which have the potential to restrict competition are required to include evidence that the competitive effects of the regulation have been considered; that the benefits outweigh the likely costs; and that any proposed response is no more restrictive than necessary in the public interest.

This document sets out the problems reported in the marketplace and identifies those structural elements which are considered to be an impediment to effective marketplace solutions.

Possible regulatory and non regulatory approaches are canvassed and options are set out, with analysis of the potential costs and benefits to the community.

Comparisons of relative benefits and costs of policy options

The objective is always to quantify benefits and costs of proposed options as much as possible. However, when dollars and cent values are not available, a qualitative assessment of potential costs and benefits is useful, as is the relative capacity of the option to meet the objectives of intervention.

Tabular presentation can assist comparison. This will help if, as is likely, a suite of policy instruments is to be considered (eg education and information combined with one or more regulatory options).

The benefits ('pros') and costs ('cons') of these options are summarised in the tables below.

Interested parties are asked to contribute to the information contained in these tables by supplying financial impact data for the purposes of obtaining the most accurate set of benefits and costs, and other knowledge, on which to base final decisions.

The options are:

- Option 1:** Maintain the status quo
- Option 2:** Increased penalties and better enforcement of the current law
- Option 3:** Education and information
- Option 4:** Self regulation
- Option 5:** Co-regulation

Regulatory options

- Option 6.1:** Change the timing of essential information disclosure
- Option 6.2:** Require credit card providers to allow consumers to nominate the credit limit sought
- Option 6.3:** Prohibit the card issuer from providing more credit than the consumer can repay from income without substantial hardship
- Option 6.4:** Provide relief for consumers by making the debt unenforceable to the extent it exceeds an amount granted in accordance with option 6.3, including interest charged
- Option 6.5:** Require card issuers to warn consumers about the effect of paying only the minimum repayments

Option 6.6: Require card issuers to increase the minimum repayment percentage for new credit card contracts and for offers of increased credit limits on current cards

Option 1 – Maintain the status quo

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
<p>Card issuers Continuation of current profits from interest etc</p> <p>Possible increases of such profits</p> <p>No costs from implementing new government initiatives</p>		
<p>Disadvantaged consumers</p>	<p>Continuing problems paying off debt and being targeted for new debt</p> <p>Increasing numbers possibly facing long-term hardship with possible impacts on family, health etc</p>	<p>No capacity to meet objectives</p>
<p>Mainstream consumers Would continue to benefit from subsidisation by consumers paying interest</p>	<p>May be affected by card issuer losses in the longer term</p>	<p>Would meet objective 3</p>
<p>Community impact Continuing benefit to mainstream credit users from subsidies</p>		
<p>Government Not seen to be imposing increased regulatory burden and costs or interfering with 'free choice'</p>	<p>Increased resources into above problems</p> <p>Not seen to be acting on</p>	

	<p>problems</p> <p>Spillover effects on health, justice, welfare systems, and economy in general, of the problems faced by vulnerable consumers</p>	
Community organisations	<p>Increased demands for services</p>	

Option 2 – Increased penalties and better enforcement of the current law

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
<p>Card issuers Profits from the majority of cardholder interest payments would continue</p>	<p>Possible increased debt write-offs</p>	
<p>Disadvantaged consumers Small percentage may obtain debt relief</p>	<p>Majority would continue to carry unmanageable debt</p>	<p>Would not address the implicit objective of prevention of irresponsible lending practices. Any benefit would not be systemic.</p>
<p>Mainstream consumers Would continue to benefit from subsidisation by consumers paying interest</p>	<p>May be affected by card issuer losses in the longer term</p>	
<p>Community impact Continuing benefit to mainstream credit users from subsidies</p>	<p>Spillover effects on health, justice, welfare systems, and economy in general, of the problems faced by vulnerable consumers</p>	
<p>Government</p>	<p>Additional resources required for outreach initiatives and for additional assistance to consumers</p>	<p>Objectives would not be met</p>
<p>Community organisations</p>	<p>Community</p>	

	organisations would require two to three times the level of staffing	
--	--	--

Option 3 – Education and information

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
Card issuers Improved image if initiatives are successful Less defaults and write-offs if initiatives are successful	Reduced profits from smaller proportion of vulnerable consumers	
Disadvantaged consumers An unidentifiable percentage would have improved ability to manage affairs and result in positive impacts on quality of life and that of family etc		Depending on level of resources and design of programs, this has the potential to address all three objectives. This would be a long term solution.
Mainstream consumers Likely to obtain greatest benefit		
Community impact May also benefit from these programs, even if they are not strictly classed as 'vulnerable' eg in sense of control	Opportunity costs of these programs	
Government Seen to be acting Not imposing regulatory burden	Significant costs of developing and implementing programs	
Community organisations Reduced demand for services in the long term		

Option 4 – Self regulation

This option is to be considered as part of the status quo.

Option 5 – Co - regulation

Not considered a viable option.

Regulatory Options

Option 6.1 – Change the timing of essential information disclosure

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
<p>Card issuers</p> <p>Transparency may benefit those with competitive products</p>	<p>Form redesign and postage etc</p> <p>Possible loss of custom</p> <p>Additional regulatory burden to manage</p>	<p>Issuers to provide estimates of costs</p>
<p>Disadvantaged consumers</p> <p>Some may choose not to proceed with unsuitable options if better information provided</p>		<p>This option would partially address objective 1 for an unquantified percentage of consumers</p> <p>Precontractual disclosure research project to test consumer responses</p>
<p>Mainstream consumers</p> <p>Search costs reduced</p> <p>Comparability enhanced</p>		<p>Depending on apportionment of costs, may meet objective 3</p>
<p>Community impact</p> <p>Possible flow on benefit in quality of product and price from greater transparency</p>		
<p>Government</p> <p>Seen to be acting to address card issuer practices</p> <p>Possible reduction in consumer complaints</p>	<p>Developing legislation</p> <p>Enforcement</p>	
<p>Community organisations</p> <p>Possible reduction in demand for services</p>		

Option 6.2 – Require credit providers to allow consumers to nominate the credit limit sought

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
<p>Card issuers</p> <p>Possibly fewer defaults</p>	<p>Reduced income from consumers</p>	<p>Card issuers to indicate costs of form design and potential losses</p>

	<p>choosing lower limit than would have been provided</p> <p>Form redesign</p> <p>Dissatisfaction if a requested high limit is refused</p>	
<p>Disadvantaged consumers No false 'assurance' that credit issuers think they can manage limit issuer offers</p> <p>Induced to evaluate and research own needs</p> <p>Increased use by those previously uncomfortable with temptation etc, but for whom credit card may be better alternative than high cost fixed-term credit</p>	Refusals of limit requests	Potential to meet objectives 1 and 2
Mainstream consumers	May be required to pay for cost of service	
Community impact Flow on benefits of improved credit management by others		
Government Reduced demand for resources if credit is better managed		
Community organisations Reduced demand for services		

Option 6.3 – Prohibit the card issuer from providing more credit than the consumer can pay from income without substantial hardship

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
<p>Card issuers Fewer defaults</p> <p>Improved image as responsible lenders</p>	Reduced income from lower credit limits	Credit providers to provide estimates of potential losses

Possible new business from consumers' improved confidence in product	Costs of adjusting assessment systems/processes	Credit providers to provide costs
<p>Disadvantaged consumers Reduced potential for consumers to be overcommitted</p> <p>Quality of life improved by reduction in financial stresses and by capacity to reallocate financial resources</p> <p>Consumers have an alternative to high cost credit</p>		Meets objective 2
Mainstream consumers	Possible increased cost if lenders seek to offset reduced income by charging higher fees/interest	
<p>Community impact Consumers' greater spending power would impact positively on local communities</p>	Banks may chose to offset any reduced income by reducing dividends to shareholders or cutting staff numbers	
<p>Government Reduced demand for government services</p>		
<p>Community organisations Reduced demand for services</p>		

Option 6.4 - Provide relief for consumers making the debt unenforceable to the extent it exceeds an amount granted in accordance with Option 6.3, including interest charged.

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
<p>Card issuers Those card issuers which comply would gain an improved public image</p>	Card issuers would have costs in setting up compliance systems	Card issuers to provide costs

Disadvantaged consumers Those granted excessive amounts of credit would obtain relief	Possible increase in fees if credit providers offset costs	Meets objective 2
Mainstream consumers	Possible increase in fees if credit providers offset costs	
Community impact Improved capacity of disadvantaged consumers for spending in local communities		
Government Complaints would be reduced Requests for assistance would be more easily resolved by objective assessment method	Cost of enforcement action for systemic abuses, if any	
Community organisations Complaints would be reduced Complaints more easily resolved because of objective assessment method		

Option 6.5 – Require card issuers to warn consumers about the effect of paying only the minimum repayments

Benefits or 'pros'	Costs or 'cons'	Relative capacity to meet Objectives, and comments
Card issuers A number of defaults may be averted	Cost of systems change to accommodate warning	Card issuers to provide costs
Disadvantaged consumers A percentage of consumers may be persuaded to use credit with caution	Credit providers' costs may be passed on to all consumers	May contribute to meeting objective 2
Mainstream consumers	As above	
Community impact Negligible	Negligible	
Government Positive perception of acting	Cost of	

to require responsible practices	developing legislative requirements and enforcing same	
Community organisations Negligible	Negligible	

Option 6.6 –Require card issuers to increase the minimum repayment percentage for new card contracts and for offers of increased credit limits on current cards

Benefits or ‘pros’	Costs or ‘cons’	Relative capacity to meet Objectives, and comments
Card issuers Possible unquantifiable changes in income stream	Systems change to accommodate requirement Possible unquantifiable changes in income stream	
Disadvantaged consumers New cardholders would pay less interest and repay debts more quickly Overcommitted consumers unlikely to be offered limit increases		Meets objective 2 and enhances effect of Option 6.3
Mainstream consumers No effect	No effect	Meets objective 3
Community impact Greater spending capacity of disadvantaged consumers supports local businesses Social problems reduced	None identified	
Government Positive community response for addressing causes of overcommitment Reduced demand for assistance and services		
Community organisations Reduced demand for assistance		

1. Overview of the Industry

1.1 *Industry participants*

The “industry” referred to in this consultation RIS is that which deals in continuing credit accessed by a card. A continuing credit contract is defined in the Consumer Credit Code as a credit contract under which –

- (a) multiple advances of credit are contemplated; and
- (b) the amount of available credit ordinarily increases as the amount of credit is reduced.

This categorisation includes store cards. The focus of the discussion will be on credit regulated by the Consumer Credit Code, which is uniform in all states and territories, and regulates credit which is predominantly for personal, domestic or household use.

Credit cards are issued by individual financial institutions which set the annual fee, interest free period, the interest rate and other conditions associated with the card. The card associations, such as Visa, Mastercard and, formerly, Bankcard, manage the brand. They establish and maintain rules and regulations covering such issues as membership, governance, technical specifications, procedures for the interchange of transactions and the setting of interchange fees (before Reserve Bank intervention), and dispute resolution.¹

The banks have, until recently, dominated the card issuing market. While they are still the major issuers, there has been an influx in recent times of non bank lenders such as Virgin Money, Aussie, Wizard (GE) and GE Money entering the market. GE issues in its own right and also funds store cards. American Express issues both credit cards and charge cards. Charge cards are not considered credit for the purposes of the Consumer Credit Code because the contract requires that the amount outstanding be paid in full every month. They are therefore not included in this study.

Store cards are issued in the name of the store, but the funds are usually supplied by large financiers such as GE.

As at 4 April 2008 Cannex listed 77 card issuers on its website, the largest of these having 23 cards on offer.

Market share statistics for all the issuers are not available.

1.2 *Size and value of the industry*

It should be noted that data sources may not always separate UCCC credit from credit which is for business use. Where this is the case, that fact will be noted in the text and some guidance given as to the proportion considered to be consumer credit.

It is also noted that available data will not give a complete picture.

Total card spending in the year ended December 2007 on personal credit cards was \$169,477 million. Balances outstanding for the year ending December 2007 for cards issued by banks for personal use were reported to be \$39,005 million. This

¹ Debit and Credit Card Schemes in Australia, October 2000, Reserve Bank of Australia & Australian Competition and Consumer Commission, p.18.

figure includes that percentage of cardholder debt which is attributed to transactional use, that is, will be paid fully on receipt of the account. However, the annual “revolve” rate stood at 72.1%.² These figures do not include card issuers other than Australian Prudential Regulatory Authority (APRA) regulated institutions, neither do they include store cards unless issued by a bank. The percentage of “revolvers” refers to card accounts, not to value, so that to accurately state the average amount of ongoing debt would be difficult.

During the last three years, when the number of accounts has grown by 22.1% and the value of purchases by 32.8%, the growth of total credit limits has increased by 44.7% with balances rising by 49.1%.³ It is evident from this data that balances outstanding on credit cards have grown at a faster rate than the other indices. The annual repayment rate, at 100%⁴, suggests that consumers are paying what they spend but that balances are not being paid down but are increasing.

The value of card products to the card issuers is less accessible. While credit cards constitute only 5%⁵ of total household debt, the profit component of this product to the issuer compared to other consumer products may not be reflected in this figure. Few public references are now made to the proportion of a financial institution’s net income generated by credit cards. The last comment noted, reported by Datamonitor on 10 August 2005, was that the Commonwealth Bank attributed its rise in net income to \$2.13 billion in the six month ended 30 June to a rise in business and credit card borrowing driving revenue. Of non-bank issuers, David Jones’ credit card business was reported by the Sydney Morning Herald on February 28 2008 to generate about 30 per cent of its annual earnings.

2. Statement of the problem

The problem, as seen by Government agencies and consumer advocates, is that a small percentage, but substantial number of consumers are burdened with ongoing unmanageable credit card debt which appears to be occasioned by a number of factors, including inadequate protection from consumer credit laws.

While the percentage of affected consumers is relatively small compared to the much larger percentage of consumers who manage their cards successfully, the impact on the affected consumers is severe, both financially and in its social impact.

It can be asked why consumers should not take total responsibility for their choices. This paper suggests that there may be a number of contributing factors. These are discussed below.

2.1 Size and Impact of the problem

This section attempts to identify, from available data, the impact of unmanageable credit card debt. There is no comprehensive data available on this issue. Neither the

² MWE Consulting, Australian Credit Cards Report, December 2007, based on APRA data. Cardholders who do not pay off their balance in full each month are said to “revolve”, that is carry over their balance and therefore pay interest on the account. The “revolve” rate for each month is averaged over the year in the percentage quoted.

³ MWE Consulting, December 2007.

⁴ MWE Consulting, Australian Credit Cards Report, November 2007.

⁵ MWE Consulting, December 2007.

card issuer nor the central bank or prudential regulator publishes these statistics on a regular basis. The figures quoted may not truly represent the number of consumers adversely affected by unmanageable credit card debt, since it is likely that some will attempt to refinance into a fixed term loan which would not then show up in these figures. Others may withdraw equity in their homes, or refinance their home to carry an increased debt. The latter practice has been the subject of concern in the US.

The inclusion of debt collection figures adds weight to the assertion in this paper that the problem of credit card indebtedness affects a significant number of people.

2.1.1 Default, write-offs and minimum repayments

The figures below are from different sources and different timeframes and can not provide a uniform or complete picture. However, the figures seek to identify the approximate number of cardholders who may be affected by card issuer lending practices, as well as providing an indication of the value of card accounts in default.

In September 2004, credit cards 90 days overdue (technically in default) were said to value 0.8% of outstanding balances.⁶ However, these outstanding balances also include those balances which are repaid every month, essentially comprising cards used for transaction purposes, which at that time amounted to 30% of the total, so that the revised default percentage on cards attracting interest would be approximately 1.1% of the value of balances at that time. In September 2004, outstanding balances were \$24,466 million, so that the amount in default would have been \$269 million.

In research conducted in 2001, card issuers interviewed by the Office of Fair Trading informed the researchers that those cardholders who habitually paid only the minimum repayment numbered between 3% and 5%. Add to this write-offs – at the time disclosed by the same card issuers as between 1 – 2%. One bank who quoted the percentage of cardholders in default recently put this figure at 3%. The percentage of consumers who pay the minimum percentage only was quoted in another document as 5% currently. It is likely, therefore, that the percentage of cardholders suffering unmanageable debt problems, adding together the categories outlined above, is approaching 10%.

Figures supplied by the Consumer Credit Legal Centre Inc (NSW) to the Senate Economics Committee in relation to Household Debt in February 2005, recorded in a one month period 146 callers out of 750 (approximately 20%) who identified credit card debt as either the major problem or a significant part of their problem. The largest proportion of these had low incomes (mainly government benefits) and owed less than \$5000, but were nevertheless struggling to pay. The number quoted above is for one month, and if taken over a year at the same rate would be 1752 cardholders who called one consumer assistance agency in one state.

2.1.2 Debt Collection

As refinancing may disguise possible problems with credit card repayment, so the effect of the percentage of credit card debts assigned for debt collection is also unknown and may skew perceptions of the size of the problem. The percentages quoted above in relation to defaults and write-offs do not include those assigned debts. In this context, it is noted that not all card issuers either assign their card debts or outsource their collection activities. One debt collector has informed the

⁶ Reserve Bank of Australia, "Box A: Credit Card indicators", Financial Stability Review, September 2004.

Office of Fair Trading that their portfolio included 3000 credit card debts over the last year. Another advised that 92% of their business consisted of credit card debt.

Those debts which are assigned/outsourced are usually 90 + days in arrears. The concern here is not what happens to those debts but the fact that they do not show up in any publicly available data.

2.1.3 Bankruptcies

Excessive use of credit was the underlying cause of insolvency in 27.2% (5555 bankruptcies) of non-business related personal insolvencies in 2006-7 across Australia, an increase of almost 1.4% compared with the previous financial year. This was second only to unemployment at 32.03%, which decreased from 33.4% in the same period⁷. The bankruptcy figures do not include those recorded for debt agreements (2682) and personal insolvency agreements (31) for the category of excessive use of credit. These constitute 40.59% and 24.22% respectively of debt and personal insolvency agreements.

A partner at chartered accountant Hall Chadwick, Mr Paul Leroy, was quoted in March 2007 as saying that the inability to meet credit card payments is the biggest reason people go bankrupt.⁸

2.1.4 Impact on consumers and potential wider impact

The issue of concern in this paper is that a relatively small sector of the community is vulnerable to exploitation by card issuers and, because of a small income base, once in a situation where all income is totally committed to maintenance and servicing debt, there is no way that the consumer can reverse the circumstances in which they have unwittingly become involved. This group of affected consumers will be referred to in this paper as “disadvantaged.”

The personal and social impact of debt can be severe: it can lead to family breakdown and violence, social exclusion and crime. Wesley Mission research conducted in 2006 from a random sample of 400 households reported that 58 percent of the people who responded said that financial stress had an impact on themselves, their family or the broader community in the past six years. Of the total sample 5.8% said worry about money contributed to relationship breakdown; 3.5% said worry about money contributed to substance abuse; 3.3% said it contributed to increased or frequent gambling, and 1.3% said it contributed to violence in the relationship.

As well, the ongoing commitment to interest payments on credit card debt has a major impact on a person’s long term capacity to provide for themselves in respect of housing, health, education and retirement. It is clear that this commitment will exclude expenditure on other goods and services, some of which may be for essential items or health care.

There may therefore be increased demands on all helping agencies whether government or community based, to assist those who are unable to provide for themselves, and has implications for pensions, health provision, housing and other government services.

⁷ Inspector-General in Bankruptcy, Annual report 2005 – 2006, Table 5.

⁸ Herald Sun, 12 March 2007, p.59.

2.2 Who is affected and why?

There is a small, but increasing body of research into consumer financial literacy, as well as research into what influences consumer decision-making. In relation to consumer financial literacy, qualitative research conducted by the A C Neilsen and the ANZ bank identifies combinations of three main factors which contributed to consumers with borrowings feeling out of control with their finances. The survey was not restricted to credit cards but covered all credit.

The two predominant factors identified were “unhealthy ways of thinking about finances” and “circumstances out of the individual’s control”, and the minority factor was “lack of skills and knowledge”. Since this study was apparently not limited to consumer credit and did not isolate credit cards, it is difficult to directly apply those categories to credit card users in percentage terms. It does, however, provide an indication of the main reasons people fall into difficulties with their cards and indicate possible strategies.

In addition, the study noted that there was an extensive range of influences acting on these factors, including individual, social, family, circumstantial, lender and product variables, and that these influences both predisposed people to these factors and accelerated their dominance. This paper does not challenge those findings or the predominant factors.

Anecdotal evidence suggests there is a group of cardholders who simply are not committed or skilled financial managers who, with some assistance in financial management, could extricate themselves from their difficulties. There are also those in all demographic categories whose profligate spending habits result in unmanageable debt. This latter group is not considered to be in need of protection but rather in need of coaching in money management. This group would, nevertheless, be subject to the same impact as those outlined in the paragraphs below in terms of future need to resort to government services. There is a much larger group of consumers who manage their cards effectively and are referred to in this paper as “mainstream”. All of these groups may at times have their capacities to deal with debt affected by changes in personal circumstances.

The consumers that are the centre of concern in this paper are those who have low financial literacy and do not appreciate the implications of, first, spending to the limit, and second – paying only the minimum repayment. Others may have an unrealistic appreciation of their capacity to repay. This group of consumers generally consists of low income, less well educated consumers, and may include the demographic found to have the lowest financial literacy – young people and the elderly. Not all consumers who fall within this demographic experience credit card problems. An extreme example of the type of consumer who might be affected was given by a visiting Barclays Bank executive: that of a single parent on benefits who had been allowed credit cards to the value of about \$200,000, but could neither fill out forms without assistance nor add up. Examples reflecting the Australian experience are set out below.

The NSW Consumer Credit Legal Centre took on 15 cases out of a total of 1475 callers to their credit helpline during one year who identified credit card debt as a problem. The cases were chosen on their level of disadvantage to the cardholder, since it was not within the service’s capacity to take on all cases which had merit. Of those 15, the following details are relevant:

- 12 were on social security (including largely Disability Support Pension but also Aged Pension, Veteran's Pension and Parenting Payment);
- 1 received Combined Social Security and casual employment;
- 1 was employed low income;
- 1 was employed medium income;
- Many clients had social and health problems including mental illness;
- The amount of credit card debt ranged from \$5,400 to \$70,000;
- 13 clients had only one lender, 12 with one card and one with two cards;
- One client had two lenders with two cards each;
- One client with 5 cards had two lenders and four of the cards were with the same lender.

Results of action taken:

- Every matter was settled except one where the client went bankrupt because of stress before the dispute could progress;
- 4 debts were waived completely, usually where there were compassionate grounds in addition to maladministration;
- 2 matters were settled on the basis that there would be no reduction in the principal amount outstanding but there would be no further interest or fees and charges accruing;
- The remainder were settled on a reduction in the principal, usually by 50% or more plus no further interest or fees.

The relatively recent discipline of "behavioural economics" has investigated the ways in which consumers make decisions, and found that for most of us, decisions are made intuitively, and further, that "visceral" factors (i.e. basic psychological impulses) are just as important in decision making as rational thinking. Rational decision-making is likely to be impaired if environmental stresses are at work when an individual is making decisions and, moreover, rational decision-making is more likely to be employed by those who are trained in this process than others.

Behavioural economics can clearly explain why consumers appear to make choices contrary to their interests; why consumers are susceptible to the "lifestyle" marketing of credit card products, and why those whose lives may be subject to severe financial and emotional stresses may be more likely than others to make poor choices.

The Wesley Mission report says that the research suggests there are three factors that contribute to households finding themselves in a position of financial stress and anxiety:

- Their exposure to credit options
- Their lack of financial literacy and ability to budget
- Their lack of knowledge about how they can address financial stress before it becomes a more significant issue.

2.3 Current regulatory structure

Consumer lending is regulated by the Consumer Credit Code (the Code), which is legislation that is uniform in all states and territories.

The Code regulates the conduct of the credit contract from the first negotiation up to the termination of the contract. It requires that information in the form of a

precontractual disclosure document is given to the consumer setting out those matters relevant to the cost of the product, and makes rules about the formation of the contract and the information that must be included in the credit contract. With respect to credit cards, the information provision and the formation of the contract differ from other credit contracts.

Transparency of process is reflected in all aspects of the legislation: any cost, requirement or term of the contract must be made known to the consumer in the contract. This extends to whether a mortgage is taken, and includes the provision of information about the contract to any prospective guarantor.

Statements of account must be given periodically, the maximum period for a credit card being 40 days. Among other requirements, the minimum repayment amount and the date on which it is due must be stated as well as the total amount due.

The most important provision in the Code in respect of the responsible lending issue is section 70, which permits a court to reopen a credit contract if it is considered to be unjust. That section sets out a number of grounds on which a court might base its determination. One of these, under section 70(2)(l) is “whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider knew, or could have ascertained by reasonable inquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship.” This provision permits the court, on application by the debtor, mortgagor or guarantor to relieve the debtor from payment of any amount in excess of what is reasonably payable if it considers the circumstances relating to the contract at the time it was entered into were unjust. This is not a stand alone provision but requires examination by the court of the circumstances in which the contract was made.

Another relevant provision in the Code is: the capacity for the consumer to negotiate a change in the contract if they are suffering temporary hardship. That change could be a reduction in repayments or a temporary moratorium on repayments. The Code also requires that the credit provider follow a specified process to enforce a contract.

There is a capacity for jurisdictions to diverge from the Uniformity Agreement covering the Code in identified areas, specifically in respect of whether a maximum annual percentage rate is applied, and whether civil penalties are paid into a trust fund for a designated purpose.

In addition to these variations, the Australian Capital Territory, under its *Fair Trading Act 1992*, requires a card issuer to take into consideration when making its initial assessment, or when considering an increased limit, all relevant income and expenditure and financial commitments of the consumer when determining capacity to repay. This legislation was introduced in response to perceived consumer detriment from irresponsible lending practices in that jurisdiction.

At Commonwealth level, the *Australian Securities and Investments Act 2001* has a regulatory role in relation to credit in that it prohibits unconscionable conduct and misleading or deceptive conduct; prohibits making false and misleading representations; and provides for implied warranties of due care and skill, and fitness for purpose, into contracts for the provision of financial services. These provisions are mirrored in state and territory Fair Trading legislation. It is unlikely that these provisions in the ASIC Act or the Fair Trading Acts could be applied to circumstances relating to overcommitment unless consumers were induced to apply for a credit card with false or misleading representations about the cost of the card. Similarly, the Banking and Financial Services Ombudsman (BFSO) considers that those

transactions involving the granting of more credit than can be repaid by the cardholder, and which fit under the BFSO's category of "maladministration" are not likely to be covered by the doctrine of unconscionability.⁹

The only relevant law which applies Australia-wide is therefore the Consumer Credit Code, and that legislation provides only individual redress.

Self Regulation

Banks may be subject to self regulation of their services under the Code of Banking Practice (Banking Code). Adherence to the Banking Code is voluntary, however banks that adopt it are contractually bound by their obligations under that document. There is nothing in the Banking Code that is in conflict with the Consumer Credit Code and in general it does not cover the same ground. The Banking Code gives way to the Consumer Credit Code where there is overlap.

In relation to the cost of credit, Section 12 of the Banking Code says: "we will make available to you, a potential customer or an appropriate external agency the interest rates and standard fees and charges applicable to a banking service that is a credit service offered by us for use in the preparation of a comparison rate." There is, however, no formula for calculating a comparison rate for credit cards in contrast to fixed term loans. The range of fees which apply to credit cards are not easily accessible, as discussed in 2.4 below.

In relation to the provision of credit, section 25.1 of the Banking Code says: "Before we offer or give you a credit facility (or increase an existing credit facility), we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it."

The Banking Code otherwise does not impact on the matters discussed in this paper.

The Banking and Financial Services Ombudsman (BFSO) was set up originally as an external dispute resolution scheme for banks that agreed to be bound by its determinations. It now covers other providers of financial services and card issuers including GE Money.

Granting credit in excess of what a consumer can repay is categorised as "maladministration" by the Banking and Financial Services Ombudsman. Maladministration in relation to credit cards was identified by the BFSO in its submission to the Senate Inquiry into the wider impacts of household debt as the fastest growing category of all consumer credit complaints. From 2000 to 2004 the number of complaints received in this category grew from 36 to 175, while for personal loans it increased from 19 to 36. For home loans and investment property loans the number of complaints in this category decreased.

The BFSO takes legislative requirements into account when making determinations as to whether "maladministration"¹⁰ has occurred in granting credit initially or in

⁹ BFSO Bulletin 45 March 2005.

¹⁰ The BFSO Terms of Reference do not define this term but that document states under 5.1(a) "The Ombudsman may consider disputes about maladministration in lending or security matters which involve an act or omission contrary to or not in accordance with a duty owed at law or pursuant to the terms (express or implied) of the contract between the financial services provider and the disputant." In BFSO Bulletin 45 it is stated "Our approach has

increasing credit limits on credit cards. Where a bank is the card issuer, the BFSO also takes into consideration a bank's obligations under Section 25.1 of the Code of Banking Practice referred to above. The BFSO bases its determinations on the credit limit that would have been appropriate to be granted, and adjusts the consumer's obligations accordingly. These determinations are binding on the credit provider but have no systemic impact.

Education and information

The Consumer Credit Code and the Code of Banking Practice regulate or influence the behaviour of credit providers. The corollary of "truth in lending-based legislation is a perceived need for consumers to be assisted to make appropriate choices. On the demand side, non-regulatory mechanisms which impact on consumer behaviour include information and education campaigns.

Governments, consumer organisations and industry alike provide or make available fact sheets, information on websites, brochures, booklets and other such printed material, as well as conducting media campaigns from time to time on various issues. The efficacy of this approach is currently being reassessed as more information comes to light on the ways in which consumers make choices and what actually influences them. There are more individual approaches such as that undertaken by the ANZ bank with low income consumers in a matched savings program, where participants are involved in financial education workshops and personal finance coaching which appear to have resulted in consumers achieving ongoing savings programs.¹¹

ANZ also funds "Money Minded", an education program developed in association with stakeholders such as the Australian Financial Counselling and Credit Reform Association as well as ASIC. 3,500 people attended Money Minded workshops in 2004 – 2005. The program was evaluated by RMIT University and found to help build money management skills.¹²

The Commonwealth Government Consumer and Financial Literacy Taskforce was set up in February 2004 to develop a national strategy for consumer and financial literacy. The Taskforce noted that "while not actually breaching any laws, it is an unfortunate fact that many business operators in Australia continue to act in unethical or unhelpful ways to consumers. A good example of this is the way in which some credit services are marketed towards vulnerable consumers."¹³

Initiatives undertaken by the Taskforce include a pilot in the ACT to integrate financial literacy into vocational training. Financial literacy is also being introduced into the school curriculum for years 3, 5, 7 and 9. A website and handbook providing information about money matters was launched, the existence of which was advertised in print, radio and TV.

These initiatives focus on a fundamental understanding of money management and are not about providing information on specific products to assist consumer choice.

always been that, in determining whether there has been maladministration in the lender's decision, the issue of the applicant's ability to repay is critical." (p.5)

¹¹ ANZ Corporate Responsibility Report 2005, p36.

¹² Ibid.

¹³ Ibid, p.xiii

2.4 Problems with disclosure based regulation

Major intervention in the consumer credit market has already occurred with the commencement of the Consumer Credit Code (the Code) in all jurisdictions in 1996. The Code is based on “truth in lending” provisions which assume that, given full, or at least, adequate knowledge of the nature of the credit product and the terms of the transaction with the supplier, consumers will make choices in their own best interests. A further assumption is that the information will be relevant, timely and freely available, and also that the consumer will have the capacity to fully appreciate the meaning and relevance of the information.

The Code, therefore, provides relevant information to consumers about the costs and conduct of the loan. In the event that consumers are treated unfairly, the Code relies on consumers taking independent action to deal with unfair practices.

The theoretical basis for disclosure-based legislation is currently under question, as recent research into consumer decision-making suggests that consumers make decisions on a number of bases which depend, in broad terms, on a person’s state of mind, social factors and training. As well, research shows that the most vulnerable consumers are least likely to go unaided through the processes necessary to access redress. As well, it should be noted that this legislation was developed and implemented prior to the widespread use and marketing of credit cards and therefore was not designed to address the problems that are seen to exist today.

Reliance on disclosure to provide consumer protection can be seen to result in the risks associated with making choices of complex products being borne by the consumer alone. Many consumers are simply not up to the task.

Disclosure-based regulation, while transferring risk to consumers, is assumed to facilitate innovation which, according to prevailing wisdom, should benefit them by giving more choice. It is worthy of note that in the credit card market, the positive features of credit cards are often the focus of marketing attention, while the costs are not easy to access. The major Australian banks’ on-line sites were recently assessed by a US research group at between -4 and -12 when testing accessibility to home loans and credit card information, demonstrating major obstacles to finding information and, in some cases, the omission of important information, including credit card fees.

This, along with the relatively large number of card applicants who are relatively unskilled in financial management, undermines the capacity of consumers to exercise their demand-side power.

2.5 Generating future growth in the credit card market

The late 1990s saw credit cards vigorously marketed, and the growth of that market is now facing saturation. This leaves the card industry with the challenge of finding ways to generate new growth. Options may include: seeking new markets; finding new ways of encouraging spending via a credit card; and increasing income from existing spending patterns.

With regard to seeking new markets, the youth market has recently been targeted with a small card that can be attached to a key ring and advertised as a fashion accessory. It has a low annual fee and a cash back offer of up to \$10 per statement period (1% of net purchases). The interest rate is high at 16.99%. Young people have the lowest financial literacy rates and no credit history. Those

that come to the notice of consumer agencies may have income only from part time or temporary employment. Other lenders are targeting high risk consumers other than the young, but with very high interest rate products.

With respect to encouraging spending, credit card data shows that, historically, the growth in the level of balances owing has kept pace with the level of credit limits. The recent aggressive marketing of increased credit limits may therefore be an attempt to encourage greater use of the card. The fact that balances are growing at a faster rate than credit limits could suggest that consumers are now paying less of the outstanding balance than before, perhaps as a consequence of limits increasing beyond a cardholder's repayment capacity.

Another strategy that may encourage spending is a system of tiered interest rates that has been introduced by some card issuers. This "rewards" consumers with higher spends by reducing the interest rate as the amount spent increases.

With regard to increased income from existing cards, reduced minimum repayment percentages could be seen to have guaranteed more interest over a longer term of repayment, as well as allowing the more risky end of the market to be assessed as eligible for a card.

All of these strategies may be a rational industry response to the reduction in growth rates in the card market. They may nevertheless have a negative impact on consumers.

A study undertaken by A C Nielson and the ANZ bank made reference to the lender's role in "out of control" debt, saying:

"For the majority of people in this qualitative study.....lenders could be seen as directly influencing an individual's path to financial difficulty. For example, the majority of people in this study had received unsolicited credit limit increase offers and around half had accepted them. Acceptance in many cases occurred where there were pre-existing unhealthy ways of thinking and the offer provided the opportunity to access credit. Acceptance was also underpinned by a perception that "it must be okay" because the lender had sent it out, coinciding with a behaviour of not reading the parameters of the offer. Once in financial difficulty, a small number of people said they felt powerless to negotiate with lenders, and said they received little understanding and flexibility from lenders overall. Experience of financial difficulty also tended to coincide with reduced or no choice about where people could borrow, forcing people to borrow from fringe lenders rather than mainstream lenders".¹⁴

The study concluded that the challenge here is for lenders to market their products responsibly, and to be responsive and appropriately flexible in dealing with consumers in financial hardship.

The Senate Inquiry into household debt considered credit card debt in their investigations and heard submissions from a large number of interested parties, including industry and consumer representatives. The final report included the following statement, after acknowledging the relatively small percentage of cardholders affected and the fact that not all consumers can be protected from unmanageable debt:

¹⁴ ACNielson, ANZ "Understanding Personal Debt and Financial Difficulty in Australia", Nov 2005, p4.

“However, the Committee is persuaded that some of the lending practices within the credit and charge card industry that have been described during the inquiry are sub-standard and are not in accordance with the standards of practice which the banking industry itself regards as acceptable.

In particular, the Committee is concerned that the practice of offering consumers unsolicited increases in credit limits without conducting a thorough appraisal of whether there is capacity to repay is unsound, and consumers are not provided with information about interest rates, and conditions of use in a form that is sufficiently user friendly.”¹⁵

The Committee went on to recommend that uniform consumer credit legislation require credit providers to undertake appropriate checks of borrowers’ capacity to pay before issuing new credit cards or raising credit limits. The recommendation noted that the ACT Fair Trading Act provides an appropriate model for this legislation.

The Committee further recommended that the Code be amended to mandate the provision, in a clear and easily understood manner, of a summary of the interest rates, key fees and core terms and conditions of card interest rates in all credit card promotional literature. This requirement was also recommended to apply to charge cards and interest free periods offered by retailers.

In a study carried out by the Saint Paul Foundation in the US, the committee comprising card issuers, financial counsellors, bank regulators, educators and elected officials commented that:

“Within the industry, there is limited incentive to help steer people away from financial trouble until it is too late. The most profitable customers for a card issuer are those long term cardholders who carry a balance, pay late, and occasionally surpass their credit limit, thus incurring additional fees”.¹⁶

This comment would apply equally to the credit card market in Australia.

The St. Paul Foundation study addresses the efficiency of the market and concludes that:

“The market’s discipline and sophistication generally result in efficient operation (*of the industry*), but this is not always the case. The consequences of irresponsible behaviour by the industry are not always immediate and can, in fact, lag for many years; such issuers may not be “caught” by the financial marketplace until much damage has been done to both investors and cardholders.”¹⁷

The study goes on to comment that while issuers determine the level of charge-offs that are acceptable given their profit goals and need for access to capital, these charge-off numbers also represent a substantial number of individuals whose financial demise creates personal trauma and also carries societal costs, including bankruptcy, health problems and employment prospects for the consumer. Economists suggest that the wide use of credit cards is inversely related to a nation’s savings rate.¹⁸

¹⁵ The Senate Economics References Committee, “Consenting adults deficits and household debt”, October 2005, p104.

¹⁶ The Saint Paul foundation, Phase 2 of the Committee exploring responsible selling and use of credit cards within vulnerable populations, Feb. 2003, p.21.

¹⁷ Ibid, p. 20

¹⁸ Ibid, p21.

This study suggests that the problem of credit card debt should not be seen in isolation but should be considered in a wider context, that is, the social impact of unmanageable debt and the effect on the economy as a whole through the payment in ongoing interest to card issuers of what would otherwise be discretionary funds which could be used more beneficially for both the individual and the economy.

2.6 Regulatory failure

The experience of a significant number of cardholders has served to identify failures in the legislative approach taken by the Code. These are set out below.

2.6.1 Application process and timing and nature of information

In reality, the provision of information at the right time and the capacity of the consumer to use that information fall well short of the ideal.

The application process for credit cards is not the same as for other products: there is usually no capacity for consumers to specify the credit limit required, and there is no comprehensive disclosure of interest rates and fees in a precontractual disclosure document, either separate to or as part of a contract document provided for an applicant to sign. Those details are supplied in the letter of offer sent by the issuer when the application has been approved and the credit limit set by the institution, and the card is ready for collection. For this product the Consumer Credit Code allows the contract to be made by using the card.

While the Code policy is essentially to ensure that consumers are armed with relevant information on which to make an informed choice, the concessions made for credit cards in that legislation effectively mean that consumers do not always have the information about the product until after they have submitted an application, the application has been accepted and the card is ready for collection. In such cases, by the time consumers receive the information they would be psychologically committed to the purchase and are unlikely to reject the card. If they did, their application may be listed on a credit reference database, which would be negatively viewed by another credit provider on receipt of a credit card application soon afterwards.

A credit reference database stores information that is of use to credit providers for the purposes of assessment. The database records which organisation the consumer has applied to for credit (this includes utilities and telephone companies as well as financial institutions). A credit file is held on individuals who are or have been credit active in the last seven years. The credit file contains identifying details of the consumer as well as records of some current accounts including: overdue accounts, bankruptcy information and judgments. The file also contains a record of credit applications or inquiries made during the past five years. This means that consumers cannot shop around, or assess whether a card is appropriate for their needs by inquiry without being listed on a database. This listing may then compromise their capacity to find the best product since the status of the inquiry or application is not listed and the credit provider with which the consumer eventually files an application will not be able to distinguish inquiries from applications which have been successful.

In terms of market failure, search costs for appropriate and useful information are high. The consumer must actively seek out price and feature information from the card issuer before applying for a credit card as opposed to other forms of credit where these are presented in a precontractual disclosure document.

Partial information may be available on request at branches, or from the internet if a consumer is making internet comparisons. A recent study of banks' online systems by US group Forrester found that illegible text, poor layouts and missing information were just some of the major design flaws. In relation to credit cards, the absence of important data such as key credit card fees was noted. These avenues are unlikely therefore to attract the more disadvantaged consumer, or the time poor consumer who will not persevere in their search given the difficulties outlined above.

The less financially literate consumer will not be aware of the costs of the product until the application is accepted. The possible consequence of these factors is that the consumer may have applied for a high cost product that does not have the most suitable features for its likely use. This group of consumers is unlikely, after their application is accepted, to read even the essential information at that stage, the decision having been made. The result may be that they pay more than they need for the credit use and are effectively prevented by the credit reference system from making a second application.

The problem of information provision is especially acute in relation to cards issued in relation to interest free purchases in stores, where there are special conditions applying to whether interest will be charged or not. If credit is provided in excess of the amount required for the interest free purchase, how this will impact on paying off the purchase to ensure that interest is not paid is not known to the consumer before they make an application, and in fact, it is not clear to them that they are applying for a credit card at that time, nor which credit provider will be providing the credit. The system for apportioning payments on a credit/store card with interest free purchases and subsequent interest bearing purchases is quite complex, and would not be understood by the average consumer even if they read the information after it was provided.

Precontractual information for credit cards is treated differently in the Code primarily because it adopted practices already operating when the Code was being formulated in the early '90's in order to minimise costs to industry. It is worth repeating, however, that the card market was in its infancy and the problems discussed in this paper were not in evidence. The aggressive marketing of cards only began in the mid to late '90's after the Code was enacted.

The provision of information as a regulatory tool is currently being reassessed. It is clear that providing more precontractual information is not the answer, but that providing summarised essential information at the appropriate time and in a way consumers can assimilate may assist the majority of consumers make optimal choices. It is a necessary but not sufficient protection. Research suggests that consumers' attention to written information varies according to the product sought, the importance attached to the product, the volume and expression of the information, when it is received, and whether credit is the primary purchase or whether it is secondary to the purchase of goods or services.¹⁹ There would be differing capacities in the public at large to use the information to best advantage, depending on the level of financial literacy of the individual.

2.7 Setting the credit limit

The legislative provisions that were intended to prevent, or at least deter, irresponsible lending have proved to be ineffective. Key to the problem is that card

¹⁹ Malbon J, "Taking Credit" , September 1999

issuers appear to be avoiding the intention of the Code in section 70 (2) (l), the objective of which is to prevent consumers being given more credit they can afford to repay without substantial hardship. This provision gives a court or tribunal the power to reopen the transaction that gave rise to the contract, mortgage or guarantee, if satisfied on the application of the debtor, that the circumstances relating to the relevant credit contract were unjust. The relevant subsection is one of the matters that may be considered by the court. It states:

“whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider know, or could have ascertained by reasonable inquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship.”

This was included in the Code to address perceived deficiencies in the Code's predecessor, the *Credit Act 1984* (in those jurisdictions which had this or similar legislation) where consumers were being granted credit they could not service from income, and would have to sell assets (usually their home) to repay their debt. This was not as a result of rational considered choice, but usually as a result of poor financial literacy skills with no understanding of the likely consequences of agreeing to the loan they were offered. At this time, credit cards were not the major issue with respect to such “asset lending” but the inclusion in the Code of section 70(2)(l) was intended to apply to all forms of credit.

Assessment practices

With respect to assessment of applicants and the amount of credit granted, card issuers have taken the widest interpretation possible of this provision. When the NSW Office of Fair Trading conducted its research in 2001, some card issuers stated that they provided an estimation of the consumer's expenses, regardless of whether the consumer had given details, and this was estimated at a very low level. Not all card issuers required details of other credit products held or their balances, nor of regular commitments.

The major problem from a consumer perspective is that card issuers are setting credit limits for low income consumers far in excess of what they want or can afford to repay. If credit providers are, as suggested by the former Reserve Bank Governor, adopting lending models that “seem to regard the bulk of income above subsistence as being available for debt servicing”²⁰, where the loss of income for a brief period, in circumstances such as illness, loss of job or family breakdown for example, will immediately result in problems with debt servicing, this would not appear to constitute responsible lending, especially where assessment practices appear to ensure that the maximum credit possible can be given and there is no opportunity for consumers to select a limit.

Assessment based on minimum repayment

The wording of section 70(2)(l) also provides further possibilities of wide interpretation in that it qualifies capacity to repay by the addition of the clause “according to its terms”. This clause was included to allow products such as reverse mortgages to be covered by the Code, which do not require repayments during the borrower's lifetime, but where the equity drawn down is recovered following the sale of the home or the consumer's death. In such cases, the consumer would have no capacity to repay during their lifetime or while they own the home. In the case of credit cards which have no fixed term, since the consumer is required only to make

²⁰ Monetary Policy and Financial Stability”, I J Macfarlane, Speech to CEDA Annual Dinner, Melbourne, 26 November 2004.

minimum repayments it may be that card issuers' practice of assessing capacity to repay on the basis that they can make the minimum repayment may be interpreted by credit card issuers as within the letter of the law if not the spirit.

Information supplied to the Office of Fair Trading in 2001 by card issuers confirmed that applicants were generally assessed on their capacity to repay minimum repayments (or thereabouts) and the credit limits set accordingly. Their living expenses were, in many cases, assessed on a figure comparable to the "Henderson Poverty Line". Such assessment processes, that factor in minimum repayment amounts and very low living expenses, would allow the credit limit set by the card issuer to be maximised. Since that time the major card issuers have reduced their minimum repayment percentages, which would allow higher credit limits to be set, and it is unknown whether assessment practices have changed, though the escalation of credit card debt would suggest otherwise.

Credit limit increases

Credit cards are probably the only product in relation to which an offer of an increased amount of credit may be made either by unsolicited mail or call centre employee, or by a teller when a consumer is making an unrelated transaction, and where an application by a consumer is assessed differently from an unsolicited offer of limit increase. Where consumers independently apply for a limit increase, they are required to provide details of their financial commitments as well as employment status and assets by all major card issuers (one issuer's application could not be accessed on-line without actually making the application), whereas in the case of unsolicited offers, they are required only to confirm that they can afford the additional minimum repayment. Consumers have reported that they have applied for a limit increase and been refused, but that an unsolicited increased limit offer arrives in the mail and is granted.

Card issuers may also offer increased limits when a consumer is spent to the limit and pays only the minimum repayment. Consumers in this predicament may accept the increased limit, perceiving it to be a way out of their problems. If these consumers accept an increased credit limit which would result in higher minimum repayments this could delay any negative consequences if the extra credit is used to make repayments but would place a further burden on the family budget and eventually also trigger default. If the credit is used for purchases, default would be likely to occur sooner rather than later. The ANZ bank has recently included in its Charter a commitment that it will not offer increased limits in these circumstances, nor if the cardholder is the recipient of a fixed benefit.

Consumer response to a limit that is set too high

The consumer will not know until they receive the letter of acceptance from the credit provider what their credit limit may be, since they have not been able to specify what is needed on the application form. Once a limit is granted which might be in excess of that a consumer might choose, behavioural economics research/analysis suggests that where action by a consumer is needed to reduce that limit, only a very small percentage of consumers would do so.²¹ This results in outcomes such as demonstrated in the following case study:

One young man had told the bank official he wanted a \$500 limit. Since there was no field relating to this on the form the official told him to write it on the top. The bank gave him a

²¹ Louise Sylvan, 2006 Consumer Affairs Victoria Lecture in Honour of Dr Maureen Brunt AO.

\$10,000 limit. He also had a car loan with the bank and was earning \$420 a week. He could not repay the debt.²²

Asset lending

The lack of specificity in 70(2)(l) may also result in card issuers relying on the fact that a consumer has an asset to ensure capacity to repay, but without necessarily taking security over that asset. While there is no specific reference in the Code to asset lending, this section was intended to prevent such occurrences. In practice it appears not to be given this interpretation.

The Credit Card Report undertaken for Visa in 2002 states: "On face value, this suggests that very low-income earners obtain a much higher limit relative to income than high-income earners. In part this will simply reflect the fact that consumption accounts for a higher share of income in low-income groups. Additionally and importantly, income is only one of the indicators of capacity to repay credit card debt used by financial institutions to decide credit card limits. Financial institutions also take into account assets and liabilities."²³

To set credit limits on the unacknowledged basis that a consumer can sell what may be their only asset in order to repay is not consistent with the truth-in-lending basis for the Code, which relies on the consumer being aware of the intentions of the credit provider and any possible obligations on their side.

Transparency of intention in relation to mortgages is fundamental to the Code regime. This is evidenced by the requirement that it must be stated in the credit contract if a mortgage has been taken, and the property which is the subject of the mortgage described. A mortgage that does not identify the property is void, as is a mortgage that exceeds the liabilities of a debtor. "All accounts" mortgages are not permitted. The consumer must receive a copy of the mortgage and a prescribed information statement describing the meaning of a mortgage and what it entails. While it is permitted for the credit provider to take security for a debt under a continuing credit contract, this has to be stated in the credit contract.

The unjust contract provisions, in addition to section 70(2)(l), contain two matters for consideration with regard to asset lending: 70(2)(a), which asks the court to have regard to "the consequences of compliance, or non-compliance with all or any of the provisions of the contract, mortgage or guarantee"; and 70(2)(i) "the extent to which the provisions of the contract, mortgage or guarantee or change and their legal and practical effect were accurately explained to the debtor, mortgagor or guarantor and whether or not the debtor, mortgagor or guarantor understood those provisions and their effect." The effect of these clauses, along with 70(2)(l), according to a legal commentary on the Code when it commenced "is to require the credit provider to be more careful in assessing transactions. Moreover, in the case of risky transactions, the credit provider will not be able to sit mute with the comfort of a guarantee or mortgage if things go wrong. The credit provider will need to make debtors, mortgagors and guarantors aware of the potential risks. This may mean that some people who need a loan to help them out of a difficult circumstance might need to be refused even though it is possible that they may be able to meet their obligations."²⁴

This confirms that even if a mortgage is taken there is a need to make the consumer aware of the risks. Where there is no mortgage but the credit provider has granted

²² Supriya Singh et al, op cit.

²³ VISA, "The Credit Card Report", November 2002, pp 19-20.

²⁴ Mark Bengtsson in "The New Consumer Credit Code", Butterworths, 1994, p78.

the credit on the basis that the consumer would have to sell an asset to repay, but this is not known to the consumer, this could certainly be considered unjust. The NSW Consumer Credit Legal Centre has negotiated a number of settlements in respect of asset-based lending on credit cards, where the credit provider has been challenged on the basis that this was unjust. Since none of these proceed to court, there is no body of law to effect systemic change.

There have been determinations by the Court in respect of mortgages over a plaintiff's home in cases brought under the Contracts Review Act 1980 (NSW). Two judgments in favour of the plaintiff held that ".....it was unconscientious for the respondent to lend a large sum of money to a person with no income with full knowledge that if the repayments under the loan were not met, it could sell that person's only asset"²⁵; "Finally the inference is open – indeed, I think, inevitable, - that the plaintiffs chose to lend solely upon the basis that they were amply secured...in circumstances where they had no basis for thinking that (the plaintiffs) could keep up repayments on the mortgage.....Their action in proceeding was, I think, in all the circumstances, unconscionable"²⁶. While the products concerned are not credit cards and a mortgage was explicitly taken, the principle is clearly the same.

The research paper from which the two cases above were sourced also quotes the NSW Law Reform Commission as saying: "Asset-based lending, where the borrower and guarantor appear unable on the face of the transaction to be able to repay the loan, is a feature of improvident transactions," while the Banking and Financial Services Ombudsman states: "No banker should rely on the realisation of assets held as security as the primary source of repayment and the banker must be satisfied that there is a clear repayment source."²⁷

The practice of assessing a consumer's capacity to repay on the basis that they can sell an asset is not, therefore, consistent with the policy basis of the Code, nor is it sanctioned by the courts in cases where this issue has been raised.

2.7.1 Assessment method

Credit providers readily agree that they use credit scoring methods rather than assessment of actual financial commitments to assess capacity to repay. Credit scoring is a computerised system that provides a cost effective indicator of the likelihood that the consumer will repay, based on variables such as length of time the applicant has held their current job, or has been living at their current address and other non financial information. This, however, cannot assess *capacity* to repay. If the applicant's income and expenditure are not known, or have changed, no matter how willing they are to maintain their repayments there may be no financial capacity to do so. There can no rational basis on which to set a credit limit without an assessment of the consumer's financial circumstances. This lack of financial scrutiny can explain why substantial credit limits, or increased credit limits, are offered inappropriately, especially to the young and the elderly, whose living situations may appear stable but who lack the capacity to service large amounts of credit.

2.7.2 No incentive for card issuers to change the system

There is no incentive for credit providers to comply with the spirit of the legislation since those consumers who may be able to keep the contract on foot by paying only

²⁵ Elkofairi v Permanent Trustee Co (2003) 11 BPR 20,841

²⁶ Small & Ors v Gray & Ors (2004) NSWSC 97 (5 March 2004)

²⁷ Nicola Howell for Consumer Credit Legal Service Inc (Vic), "Solicitor lending to consumers: a study of interest only loans and asset-based lending practices in Victoria", Sept. 2004, p88.

the minimum repayment will repay the principal debt many times over in interest and more than compensate for those consumers who may default early.

Scoring systems which focus on the likelihood that a consumer will repay would ensure that the majority of “fly by night” consumers who obtain credit and then move on without repaying, or consumers who change jobs very frequently and therefore might be considered a bad risk, are excluded from the provision of a credit card.

2.8 Minimum repayment percentages

When the consumer has received the information and picked up their card, they will be required to manage the conduct of their account without the benefit of some important information. Unlike fixed term loans, credit cards do not have a regular repayment amount, as it will not be known how much credit will be used, and when the contract will be terminated. While consumers can pay in full every month, credit card issuers require only that the minimum repayment amount be made.

Cannex, a financial services research group, recently called for card issuers to increase minimum repayments to significantly shorten the life of a card debt. Cannex has 247 personal credit cards on its database and almost 60% of the cards require a minimum repayment of two per cent or less of the outstanding balance. Cannex noted that the average minimum repayment is 2.36 per cent. It calculated that on the basis of this average, it would take 23 years and five months to repay \$2,600, which is the average account balance. The cardholder would have repaid a total of \$8,190. For those cardholders with lower than the average percentage repayment requirements, the repayment period would be significantly longer and the interest payment significantly higher.

Minimum repayment percentages are, in the case of the major card issuers, 2% or less of the outstanding balance. This barely reduces the amount outstanding and ensures, if the consumer pays only this amount, that the debt will be sustained in some cases more than a lifetime, with consequent payment of many thousands of dollars in interest. The lowest minimum repayment percentage for bank issued cards is 1.25%, which is little more than interest only. The less financially literate consumer would be unable to make the sophisticated calculations necessary to estimate the effect of making only the minimum repayment on a fully drawn credit limit.

This is equally true of the offers to increase credit limits. While the major bank card issuers will provide information on how this increases the minimum repayment amount, the flow-on effect of this on long term commitments is not known to the consumer, nor is it accessible to those unable to make the calculations themselves. While responsible use of credit is closely related to social and cultural factors, this paper is concerned with the inadequacy of Code requirements in relation to responsible lending and the effect this is having on those consumers who are not sufficiently financially literate to understand the implications of relatively high credit limits and low minimum repayment requirements.

This is not an issue for the consumer who chooses not to pay more because they opt to use their income on an occasional basis to purchase a major item, or the like. It becomes a problem where this is all the consumer can pay because their credit limit has been set too high and they have been assessed as able to pay the minimum repayment which would service that limit. It is notable that the reduced minimum repayment requirement allows card issuers to set higher limits than at a higher repayment percentage when capacity to repay is calculated on this basis.

The Code does not require any information to be given which will alert the consumer to the effect of drawing down their limit and making the minimum repayment required. Nor does it regulate the level at which a minimum repayment can be set.

2.8.1 Redress

The Code's approach to redress is to provide that a consumer (or guarantor or mortgagor) can apply for the contract to be reopened as unjust, on the basis that, at the time the contract was entered into or changed, the credit provider knew, or could have ascertained by reasonable enquiry, that the contract could not be repaid according to its terms without substantial hardship.

It should be noted that this provision is not a "stand alone" prohibition of overcommitment that might act to prevent too much credit being granted, but is one of a number of matters that a court may consider when assessing whether a contract is unjust. The consumer first has to make application to the court or tribunal. This is a major obstacle, since very few consumers in financial trouble would have the resources, either psychological or financial, to go through this process.

In a study connecting credit and low income in the United States, "The poor pay more: Consumer practices of low income families", Caplovitz found this demographic least likely to go for redress.²⁸ This is well borne out in the Australian experience. If a consumer finds their way to a consumer legal centre, and their matter is taken up by that centre to make an approach to the Court or Tribunal, redress may be obtained through this process. These matters rarely get to a hearing, not least because cases taken up by legal centres, Legal Aid, financial counsellors or the Office of Fair Trading are inevitably negotiated in the first instance, and the credit provider in the vast majority of cases taken up for consumers will negotiate a reduced debt.

While this provides relief for a small number of consumers, the percentage of consumers who might seek assistance, as opposed to those who have problems, is not high. In a benchmark study conducted by the Office of Fair Trading in 1997, only 13% of consumers who had experienced a consumer problem in the recent past had approached a government body such as the Office of Fair Trading. That study found that people in a higher socio-economic bracket were more likely to seek redress than those with low incomes, the young and the elderly. This is consistent with the Caplovitz study referred to above. The negotiated solution means that there is very little case law or body of Tribunal determinations, and no flow-on effect to provide incentives for credit providers to change their systems. There are also no penalties for providing credit inappropriately.

The safety net of appropriate redress mechanisms intended to protect the interests of those consumers who fall foul of the process can be seen as flawed in that those who are most in need of assistance are the least likely to be able to negotiate the largely self-help process.

2.8.2 Enforcement and penalties

There is nothing in the Code which puts a positive obligation on industry to assess a consumer's capacity to repay according to specified guidelines

Re-opening provisions such as section 70 do not prohibit credit providers from providing too much credit. The subjective nature of this approach does not allow it to

²⁸ Quoted in "Families at Risk Deciding on Personal Debt", Supriya Singh et al, May 2005.

be made an offence under the law if the contract is found by the court to be unjust. As well, there is no basis for enforcement action to be taken, since there is no objective measure against which the credit provider's assessment can be judged. The only function of section 70 is to allow individual consumers to seek relief.

2.9 Approach taken in other countries to address credit card issues

In the United States, the regulatory focus has been on the minimum repayment requirement. The Office of the Comptroller of Currency has asked credit card companies to increase the minimum monthly payment from the most commonly charged 2%. The recommendation to increase the minimum payment was made jointly by the Office of the Comptroller of Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and Office of Thrift Supervision. The OCC guidelines proposed that by October 2005 credit card companies must adjust the minimum payment calculation to fit an approximately 10 year repayment schedule.²⁹

This approach would mean that consumers would accrue less interest and, therefore, less debt long term. If assessment practices are similar to those in Australia (and this is not known), that is, on the consumer's capacity to repay only the minimum repayment, that suggests that lower credit limits would be offered initially. Both of these outcomes would be positive for disadvantaged consumers. However, a survey undertaken in January 2006 found that the largest card issuers were not doubling their minimum repayments and that percentage requirements ranged from 1% of the principal balance plus all current finance charges and any late or over the limit fees, to 3%.

The recently enacted US Bankruptcy Abuse Prevention Act of 2005 will require credit card companies to post a "health" warning on monthly credit card statements that notifies consumers about how long they will be in debt if they make minimum repayments. On an "open ended credit plan" (credit card) that requires a minimum monthly payment of not more than 4% of the balance on which finance charges are accruing, the following statement will be required to be clearly and conspicuously disclosed on the front of the billing statement: "Minimum Payment Warning: Making only the minimum payment will increase the interest you pay and the time it takes to repay your balance. For example, making only the typical 2% minimum monthly payment on a balance of \$1000 at an interest rate of 17% would take 88 months to repay the balance in full. For an estimate of the time it would take to repay your balance, making only minimum payments, call this number:....."³⁰

The "number" referred to in the Minimum Payment Warning above is toll free, and is to be established and maintained by the credit provider or the Federal Trade Commission, as appropriate, or a third party operating on behalf of multiple credit providers. For small credit providers, the Board of Governors of the Federal Reserve System may operate for a period not exceeding two years a number on behalf of depository institutions, including state and federal credit unions with total assets not exceeding \$250,000,000, and will establish a schedule of different rates, minimum payments and account balances and also make regulations as to how the information is to be given. These provisions have not yet commenced. The Report to Congress by the US Government Accountability Office suggests that consumers who carry

²⁹ CreditShack.org/archive/53-minimum-payment-rising.html

³⁰ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, section 1301.

revolving debt are said that they would find the personalised warning more useful, while those who paid in full every month not surprisingly were happy with the standardised warning.

The “health warning” such as outlined above, when tested on consumers informally in the context of a youth debt survey in New South Wales, elicited a major reaction in that those consumers had no concept of how long they would be carrying their credit card debt. While they indicated a commitment to clearing their card debts this was not a formal study that tracked those consumers over time.

In 2004, the Bank of Thailand announced new measures to regulate the credit card industry. These include doubling the minimum payment requirement from 5% to 10% of the whole outstanding debt. It also set a maximum credit limit by requiring it to be not more than five times the average monthly income or cashflow in a deposit account.

In the UK, in amendments to the Consumer Credit Act 1974 passed in 2006, the issue of responsible lending is dealt with by linking it to the determination of whether a consumer credit licence applicant is a fit and proper person. The House of Lords required an amendment to clarify that the test of whether the applicant engaged in business practices which the OFT may consider to be deceitful or oppressive or otherwise unfair or improper should specifically include “practices in the carrying on of a consumer credit business that appear to OFT to involve irresponsible lending.”

3. Objectives of government intervention

The problems outlined above in Section 2 suggest that the following are factors that contribute to consumer overindebtedness:

- Essential information is received at a time when it is unlikely to be useful;
- Credit providers’ assessment practices maximise the amount of credit granted;
- Minimum repayment percentages are set at a very low level;
- The legislative requirements are remedial, not preventative, and the remedy does not have a systematic effect.

Government intervention therefore will aim to:

1. Assist consumer choice of competitively priced credit card products;
2. Adequately protect consumers, especially vulnerable or disadvantaged consumers, from lending practices which irresponsibly provide continuing credit at levels which cannot be repaid without substantial hardship;

While at the same time:

3. Minimising the effect on consumers who manage their cards satisfactorily.

3.1 Groups potentially affected by Government intervention

There are four main groups that could be affected by any Government intervention: card issuers; Governments; community organisations and consumers. Community organisations may be credit legal centres or financial counsellors, some of whom are

partially funded by government. Consumers can further be divided into “mainstream”, which designates those who manage their cards satisfactorily by maintaining a low level balance, or no ongoing balance, or who may use a significant proportion of the limit but then pay that down to a low level; and “disadvantaged”, that group being essentially financially illiterate and unable to manage credit or other financial matters. In addition, there may be flow on effects from any proposals which would impact on the community generally so that comment will also reflect that possibility.

4. Policy options

The relative merits of a range of options are set out below. This section will examine the likelihood that maintaining the status quo (which includes self regulation) or relying on education would address the problems identified; whether increased penalties or better enforcement might improve the outcomes for more consumers, or whether co-regulation would be a better approach. An enhanced regulatory framework is also evaluated. The costs and benefits of those options are discussed in Section 5.

4.1 Option 1: Maintain the status quo

This is an option under which no changes would be made to the current regulatory structure. The external environment may, nevertheless, impose changes.

Additional card issuers might conceivably enter the market. While increased competition may meet objective 1 for mainstream consumers, it would not therefore do so for disadvantaged consumers. As well, increased competition may encourage further reductions in minimum repayment requirements.

With this scenario it is likely that growth in outstanding balances would continue to outstrip growth in account numbers and purchases. Card issuers would continue to benefit from the long term interest commitment of a significant number of cardholders. While one card issuer has made a commitment to not offering increased limits in circumstances where consumers only make the minimum repayment, this does not address the excessive amount of credit granted initially.

In the absence of any change to the status quo, only a small percentage of overcommitted consumers would be assisted to obtain relief from debt. Consumers have reported to consumer advocates that card issuers currently are unwilling to negotiate on their debt. It appears, therefore that, unless represented by government or community advocates the majority of affected consumers would be unable to obtain relief even if they were aware that this was a possibility.

There is nothing to suggest that the status quo would provide any impetus for systemic change from either consumer demand or environmental factors. Current trends suggest that very little could be expected to change in either the major card issuer initial assessment practices or in the choice and use of a credit card facility by the more disadvantaged consumers.

Disadvantaged consumers would continue to incur long term interest commitments and suffer the financial stresses associated with unmanageable debt.

Retail business may also be affected by significant numbers of consumers having reduced discretionary spending power. In a downturn of the economy, retailers are

among the earliest affected by negative consumer sentiment resulting in consumers paying down debt rather than spending. There would be little difference between this phenomenon and that of consumers having no discretionary spending power.

This option would, therefore, not meet Objective 2 and would meet Objective 3.

4.2 Option 2: Increased penalties and better enforcement of the current law

“Enforcement”, in this context, could not involve prosecution since there is no offence to prosecute as explained in the regulatory failure section (2.8.2). Neither is there provision in the Code for governments to represent the interests of debtors in these matters.

The most that could be done under the current regulatory scheme is for government and other agencies to increase the number of negotiations undertaken on behalf of debtors who register complaints. Such negotiations are already undertaken by governments and community organisations. It is noted above, however, that many consumers are not aware of the potential for relief if contact is not made with either government or community organisations.

The Australian Financial Review has commented that a relatively new service in Australia which markets itself as able to assist consumers to reduce debts by negotiating with creditors, could increase the number of write-offs and therefore increased bad debts for the banks. This service aims to capture 20% of the debt agreement market in Australia, handling about 200 cases per month. It is not clear what proportion of these debt agreements (or other informal arrangements) would be related to credit card debt. “Excessive use of credit” is the reason given for about 40% of current debt agreements, and this is not broken down further into products. It is also not clear what the take-up of the service would be in Australia, since negotiations to reduce or write off debts already exist through financial counsellors, credit legal centre and consumer agencies, so that it is difficult to project outcomes for either consumers or card issuers.

Such debt reduction services are commercial enterprises, and reports from consumers to date do not suggest that their indebtedness is assisted by such organisations.

Some outreach strategies in the form of advertising and information dissemination would probably need to be employed to increase consumer awareness of their rights and the services available. The success of this would depend on how many consumers could be encouraged to seek assistance, and on the resources available to helping agencies to take up their cases.

As also discussed in 2.8.2, no penalties can be applied to provisions such as reopening provisions, but credit providers would, in effect, be penalised to a degree by loss of interest on increased numbers of negotiated accounts. For criminal or civil penalties to be imposed, legislative changes to the Code would be necessary to provide an appropriate measure against which conduct could be judged.

This option does not meet Objective 1, may partially meet Objective 2 and meets Objective 3.

4.3 Option 3: Education and information

As noted above, current research confirms that consumers make decisions, financial and otherwise, in an intuitive way which is closely related to the stimuli present at the time the decision is required, the framing of the information provided and the emotional core of an attitude. Decisions made in a more considered and rational way tend to be impaired by time pressure, concurrent involvement in a different cognitive task and by the state of mind of the individual, while such considered decisions correlate positively with intelligence and exposure to statistical thinking. The observations, therefore, about the demographic which is most likely to be less aware of the dangers of credit card spending and who accept inappropriate credit cards, are supported by this Nobel Prize-winning research.³¹

Research into the effectiveness of education and information strategies suggests that consumers are most likely to be engaged by information if it is targeted or made available when the consumer is most likely to be receptive. In respect of credit cards, consumers are most likely to be receptive to product information in the period between deciding to apply for a credit card and making an application. The Ministerial Council on Consumer Affairs has funded research which will identify what information is most relevant to consumers in relation to a range of credit products, including credit cards, and the optimal timing of that information.

Information about the conduct of the contract is unlikely to be useful during this period, since consumers would not generally contemplate problems arising with repayment at this stage. It follows therefore that upfront information about the effect of minimum repayments on long debt indebtedness is unlikely to be most useful at that time. Information on credit card statements may however be effective and is addressed in Option 6.5.

Research shows that different groups within the community respond best to education programs that are specifically targeted to their needs, so that to be effective, a broad range of different programs addressing these needs is necessary.

Research pilots in the UK tested and developed the capability of Citizens Advice and its member bureaux to organize and deliver preventive financial capability education. The project was directed at hard to reach groups who were considered “at risk”. The participants were selected according to: level of need; ease of reach; and/or suitability for testing new approaches. Individual bureaux developed much of their own training material. It proved essential to draw on local knowledge, to focus on “life stage” events, and to tailor material to particular beneficiaries’ needs. The evaluation considered bureaux to be most effective when training was delivered:

- To a small group of people (10 or less) with shared needs and interests, where content was tailored to their identified interests and use made of practical examples which had day to day and local relevance;
- As part of a partner agency’s existing programme held in familiar surroundings and in “bite-sized” chunks;
- By bureau workers able to blend sound financial and local knowledge with good training skills.

³¹ Daniel Kahneman, *Maps of Bounded Rationality: a Perspective on Intuitive Judgement and Choice*, December 2002.

The evaluation identified significant outcomes for those clients who displayed greater confidence around personal finance resulting in reduced financial exclusion. Importantly, individuals surveyed some months afterwards had:

- Adhered to budgeting plans and continued to take effective measures to avoid debt; and
- Felt empowered to avoid poor deals, exploitative lending practices and excessive borrowing.³²

This program demonstrates that well designed programs can make a difference to “at risk” groups. However, it must be noted that the success of the program depends on special training of educators according to the target group, specially selected group members and small numbers. It was developed over three years. The average cost per individual beneficiary was 105 pounds (about \$250). This did not include the costs of the central team which supported the work of the pilots and helped the bureaux operate efficiently.

When further information is to hand on strategies with a proven success rate, the Ministerial Council may consider whether expansion of current education and information would be cost effective.

Education and information about consumers’ rights to redress and the services available to assist in this regard is another form of education which could have a bearing on the management of credit card indebtedness. This is addressed in Option 2, above.

It is not possible to predict whether this option would meet Objectives 1 and 2 in the future as this would depend on the success of general financial literacy programs in school and their effectiveness in guiding future generations of cardholders, as well as on the growth and effectiveness of adult programs currently being rolled out. It would meet Objective 3.

4.4 Option 4: Self Regulation

Banks are the major card issuers and they are subject to the Code of Banking Practice (Banking Code). The “responsible lending” provision of the Banking Code in clause 25.1 currently states: “Before we offer or give you a credit facility (or increase and existing credit facility) we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it.” This provision was inserted following an independent review of the Banking Code in 2001.

The reviewer of the Banking Code had proposed a stronger commitment to responsible lending in response to “considerable community concern about perceived deficiencies in bank credit assessment practices”.³³ The suggested clause was: “A bank will exercise the care and skill of a diligent and prudent banker in assessing the level of credit or loan funds it agrees to lend to a customer in order to satisfy itself that the level of credit or loan funds are suited to the customer’s stated financial needs and within the customer’s capacity to repay.” The banks did not accept this proposed commitment and have adopted wording which does not focus

³² ECOTEC, “Evaluation of the Citizens Advice National Financial Capability Project”, June 2006.

³³ Richard Viney, Review of the Code of Banking Practice Issues Paper, February 2001, p 69.

on the consumer's credit needs and does not require them to make any changes to the way their assessments are conducted.

The impetus for industry self regulation requires a recognition of the need for change in order to prevent or address industry detriment. Self regulatory actions to date have been to inform consumers at the time of an offer of increased limit what their new minimum repayment will be if accepted, and to allow consumers to request a smaller increase. The ANZ has recently included in its charter a commitment that it will not offer increased limits to consumers who are paying only the minimum repayment on a fully drawn limit.

Subsequently, the Australian Bankers' Association put forward draft principles for bank initiated credit limit increase offers on credit cards. These were intended to operate as "best practice guidelines" that banks may take into consideration when making a decision as to whether to approach existing cardholders to offer a credit limit increase. These would rely on information known to the bank and would not require any inquiries to be made by the bank. The guidelines propose that banks take into account whether cardholders have missed repayments; whether the bank is aware that the cardholder's sole income is a welfare payment; whether the cardholder pays only the minimum repayment on a fully drawn or overdrawn limit or other indicator of financial stress. These criteria would be assessed in the context of the cardholder's broader relationship with the bank. Unlike the Code of Banking Practice, there is no obligation for the bank to apply these guidelines.

None of these initiatives addresses the major concern – the amount of credit granted initially and the capacity of the consumer to repay the amount of credit granted. Since card issuers have consistently denied the need for concern about their assessment practices, it is likely that these initiatives have been implemented to assuage community criticisms.

Since there has been resistance to changing the Banking Code or implement changes to reflect community concerns, there appears little likelihood of self regulation being enhanced to deal with this issue and it should be considered as part of the status quo. It will therefore not be dealt with again as a separate consideration.

This option would not meet Objectives 1 and 2 but would meet Objective 3.

4.5 Option 5: Co-regulation

Co-regulation, as defined by the Office of Best Practice Regulation, "typically refers to the situation where industry develops and administers its own arrangements, but government provides legislative backing to allow the arrangements to be enforced....Sometimes legislation sets out mandatory government standards, but provides that compliance with an industry code can be deemed to comply with those standards. Legislation may also provide for government imposed arrangements in the event that industry does not meet its own arrangements."

The viability of this option would appear to rest on the industry agreeing to the need for arrangements to deal with a specified problem, and agreement with government as to how to address it.

To date, this has not occurred. As stated above, there has been resistance to changing the Banking Code to strengthen its "capacity to repay" provisions. Having

said this, a review of the Banking Code is currently being conducted, and it will be instructive if the provisions are changed, and to what degree.

The Banking Code is currently enforceable in that, once a bank agrees to be bound by the Code, its requirements are a contractual obligation on the bank. These would generally be “enforced” by the Banking and Financial Services Ombudsman if a complaint is made that is not resolved at bank level. There is no suggestion that enforcement of the Code requirements is not working.

The problem, therefore, with this option, is that the precondition of industry agreement as to the existence of a problem and the way in which it could reasonably be addressed, does not exist.

To all intents and purposes there is no difference in this respect from Self-regulation since it is not enforcement capacity that is lacking but a basis for agreement as to the problem and a will to address it. It will not therefore be considered further in this document.

4.6 Option 6: Regulation

Regulation of consumer credit in its current form appears to have failed to prevent card issuers from granting inappropriate amounts of credit and from offering to increase limits when a cardholder is clearly unable to pay down the balance owing. It has also failed to ensure that consumers are provided with precontractual information at a time when it can be effective in informing the consumer of the costs and features of the card. The legislation does not address the level of the minimum repayment and its effect on the long term indebtedness of consumers with low levels of financial literacy.

Set out below are a set of options which are considered to be appropriate responses to the issues identified above. They may be considered singly or collectively, excepting Options 6.3 and 6.4 which are necessarily connected. They may also be considered in tandem with non-regulatory options outlined above.

4.6.1 Option 6.1: change the timing of essential information disclosure

The essential aspect of the problem identified in 2.6.1, information about the product’s annual percentage rate and the fees that apply, as well as any interest free period, could be addressed by including this information on the application form itself. This applies also to store cards. Such disclosure would encourage competition on the basis of price. Virgin Money currently includes these disclosures in its promotional material in a simple, cost-effective way in what is called an “Honesty Box”. This is on promotional material, however, there is no reason why it should not be on the application form itself. While for internet-based systems the promotional material is viewed prior to proceeding to the application, for paper-based systems it is easy to miss the material in a branch office where it competes with other promotional publications.

The timing of information and the form in which it is presented are the subject of an independent research project currently under way as a result of the National Competition Policy review of the Consumer Credit Code, and also relates to Recommendation 8 of the Senate Economics References Committee inquiry report titled “Consenting adults deficits and household debt”. That recommendation is that “the Consumer Credit Code be amended to mandate the provision, in a clear and

easily understood manner, of a summary of the interest rates, key features and core terms and conditions of credit card interest rates in all credit card promotional literature. This requirement is also to apply to charge cards and interest free periods offered by consumers.”

This Option would meet Objectives 1 and 3, but is unlikely to meet Objective 2 for the majority of disadvantaged consumers because of the characteristics of those consumers outlined above, and in particular in section 2.2.

4.6.2 Option 6.2: require credit providers to allow consumers to nominate the credit limit sought

There is no provision on the application form for the applicant to nominate the amount of credit limit sought. Option 2 would require card issuers to provide a field on their applications which asks consumers to nominate the maximum limit sought. This would be consistent with other credit products where the consumer is asked to state the amount of credit sought and there appears to be no good reason why it should not also apply to credit cards. The legislation would prohibit the card issuer from granting credit in excess of that requested by the consumer.

This option would meet objectives 2 and 3.

4.6.3 Option 6.3: Prohibit the card issuer from providing more credit than the consumer can repay from income without substantial hardship.

While the policy intention of the current provisions in the Consumer Credit Code is to ensure consumers are not given more credit than they can afford to repay, in practice this has not been successful. This results in part from the framing of S70(2)(l) along with the fact that it is a reopening provision rather than a preventive mechanism. Reliance on consumers taking action through the court or tribunal discriminates against those least able to defend their interests and allows credit providers to continue their current assessment practices.

This option as a prohibition, puts the onus on the card issuer to ensure that consumers are not, at the time they enter into a contract, provided with more credit than they could repay from income without substantial hardship.

The majority of card issuers already require information on income, other financial commitments and personal expenditure. This would suggest that this information is already used in the assessment. However, assessment under this option would result in more manageable amounts of credit being provided to low income consumers. A formula for assessing capacity to repay would not be prescribed, but the suggested interpretation of substantial hardship, outlined below, gives an indication of what would be considered by regulators, courts or EDR schemes in assessing whether the card issuer had contravened the prohibition. Should a consumer fail to give the information requested, that would be taken into consideration in determining any subsequent complaint.

“Substantial hardship” would be defined to ensure that there is a realistic assessment of current expenses, not tied to a low indicator such as the Henderson Poverty Line. It should also include the concept that the total debt should be repayable within a definable timeframe, again by relying on an assessment of current income and expenditure. In most cases, credit card limits are for amounts that are

roughly equivalent to personal loans so that it is reasonable that they should be able to be repaid over a similar period if the consumer so desires. The longest period over which a personal loan is repaid is seven years, and this would appear appropriate as a guide for a timeframe for determining capacity to repay the amount of credit granted if fully drawn.

The Senate Economics Committee inquiry recommendation 7 suggested amendments to the Code along the lines of the approach taken in the ACT Fair Trading Act. The Australian Capital Territory has attempted to deal with this issue by requiring the card issuer to carry out a “satisfactory assessment process” under S28A(3) of its *Fair Trading Act 1992*. This is defined as “an assessment of the debtor’s financial situation sufficient to satisfy a diligent and prudent credit provider that the debtor has a reasonable capacity to repay the amount of credit provided or to be provided.” Subsection (4) provides that “without limiting subsection (3) an assessment process is a satisfactory assessment process only if the credit provider –

- (a) asks the debtor for a statement of the debtor’s financial situation, including –

- (i) income; and
- (ii) all credit accounts and applicable limits and balances; and
- (iii) repayment commitments; and

- (b) takes the statement into account in making the assessment.

While this ACT initiative requires the consumer’s income and expenditure to be taken into account, it does not overcome the problem inherent in section 70(2)(l) which allows the applicant to be assessed on their capacity to repay only the minimum repayment, and for the credit limit to be set by that capacity. With minimum repayments now at a level which barely repay interest, the ACT amendment could not be expected to be successful without other aspects of the regulatory requirements being addressed as set out in the options under discussion. It is considered that a requirement which employs the more objective measure of an assumed repayment term might be more successful, in concert with other amendments.

An alternative approach was recently by the Bank of Thailand in 2004, which requires that the limit be set at five times the average monthly income or cash flow in a deposit account. However, the average monthly income would not take into consideration the financial commitments of the individual, while tying it to the cash flow would not take into consideration the nature of the cash flow, which could be discretionary or comprise regular commitments. As well – this should be considered in the light of the much higher minimum repayment requirement. This approach is not preferred.

The current provisions in section 70(2)(l) of the Code are qualified by the inclusion of “according to its terms” which, arguably, allows the consumer to be assessed on their capacity to repay the minimum repayment only. This qualification has been removed in the above proposal. While the Code was drafted to accommodate such products as reverse mortgages by the addition of “according to its terms”, any products which, in any new provision, are unintentionally caught by this provision could be specifically accommodated.

The concept of repaying from income has been added to the proposals outlined in this Option. One of the major reasons for including a “capacity to repay” provision in the Code in contrast to its predecessor, the Credit Act 1984, was the experience of people losing their homes, having been granted credit that could only be repaid by

the sale of an asset, usually the family home. Asset lending is again being reported and, when retirees are increasingly being offered credit cards or increased limits without any assessment, could result in serious detriment in that age bracket.

The refusal of a loan because there are doubts that a consumer has the capacity to repay is not to be considered in a negative light. Mainstream lenders may justify their practices by claiming that consumers will be forced to go to fringe lenders if they do not grant credit. One answer to this is that it makes no difference, since if a consumer cannot repay either the mainstream lender or the fringe lender they are in a worse position than before. If a consumer is in financial difficulty it makes no sense to acquire more debt, and it may be more beneficial for that person to seek the assistance of a financial counsellor in the first instance to identify the range of options open to them.

Increased credit limits

The proposals contained in option 6.3 should also extend to offers of increased credit limits for current cardholders as well as for new contracts that are generated by the card issuer rather than the consumer. Many of the case histories of consumers who have accumulated unmanageable debt include the acceptance of offers of increased limits when the cardholder's limit has been reached and they are making only a minimum repayment. This may happen when a consumer's financial circumstances have changed and their income is substantially lower than previously. Offers of increased limits are not based on any assessment of the consumer's current financial situation and appear to be routinely made when it could be expected that a responsible lender's computer programmes should exclude them from further increases. Consumers already in default, as well as those who habitually pay only the minimum repayment may be offered increased limits. Consumers may also have been refused an increased credit limit when applying on their own volition but have been offered and granted an increased limit some weeks later.

It is proposed that the same assessment criteria as those outlined above for initial applications should be applied to unsolicited offers of increased credit limits as well as consumer generated requests: that is, consumers should be asked to supply updated details of their income, expenditure and other credit commitments and assessed as described above. This should not be left as a self assessment process as it is currently.

This option meets Objective 2 and, depending on card issuer strategies and options chosen may meet Objective 3.

This option should be considered in concert with Option 6.4 below.

4.6.4 Option 6.4: Provide relief for consumers by making the debt unenforceable to the extent that it exceeds an amount granted in accordance with Option 6.3, including interest charged.

Appropriate redress for consumers should be linked to the amount of credit appropriately granted. This option suggests that any credit provided and used by the consumer, if found to be in excess of what should reasonably have been granted on the grounds outlined in Option 6.3, that amount in excess should be unenforceable as well as interest that has accrued on that amount. This would require a court or independent adjudicator to assess, on the basis of information supplied by the consumer in their application, a reasonable credit limit taking into account the applicant's capacity to repay the totally drawn credit limit over 7 years from income. If

the card issuer had provided a higher credit limit, the difference between the “reasonable” credit limit assessed by the court or ADR scheme and the limit granted by the credit provider, would be considered in excess of what is reasonable and, therefore, could not be claimed as a debt by the card issuer. The interest that had accrued on that part of the debt would also be unenforceable. If a consumer had already paid a part of the interest or principal “in excess of what is reasonable” that amount should be applied to the amount of debt held to be within the “reasonable amount”.

This relief would apply to the initial application, and any limit increase whether unsolicited or not.

There is already provision in the Code that amounts in excess of those permitted by the Code are unenforceable, which gives a precedent for this proposal.

ASIC approved alternative dispute resolution schemes such as the Banking and Financial Services Ombudsman would be able to determine the amount that should reasonably have been granted and make the appropriate orders.

The Banking and Financial Services Ombudsman, in Bulletin 45, March 2005, sets out a number of questions that may be asked in an investigation which relate to the request by the credit provider for information on which an assessment would be based; the information supplied by the applicant; whether any anomalies were followed up by the credit provider or any further enquiries made; and whether the lender prompted the applicant to supply inaccurate information or altered the information supplied. These are the matters it would be expected that a court or ADR scheme would consider in assessing a “reasonable amount”.

There is one relevant issue which has not been the subject of public discussion, although there has been some public comment, notably by the Reserve Bank Governor referred to above when he noted that lending models appear to regard the bulk of income above subsistence as being available for debt servicing. This clearly does not leave much margin for unexpected expenses or interest rate rises which may occur in the normal course of events. This impacts on any assessment of what is a “reasonable amount” to be granted and while it is not intended to prescribe what percentage of a consumer’s income should be available for debt servicing, it would be useful to know what is considered “prudent” from a credit provider’s perspective in making such assessment. From the consumer’s perspective, is it maladministration if no such margin is factored in to the assessment? Comments on this issue are welcome.

This option meets Objective 2 and, depending on card issuer compliance may also meet Objective 3.

How should the court or ADR scheme view an assessment process which relies on all disposable income being available for debt servicing?

4.6.5 Option 6.5: Require card issuers to warn consumers about the effect of paying only the minimum repayments

Most consumers are shocked to learn that paying only the minimum repayment results in their carrying credit card debt for decades or, in some cases, more than a lifetime. While there is no published research to support the following assertion, conversation with participants in a youth debt survey following focus group sessions,

suggested that information about the length of time it would take to pay off their loan would encourage young cardholders to make great efforts to repay at a faster rate.

A requirement for a “health warning” on monthly statements in relation to the time that a consumer could expect to be indebted if paying only the minimum payment and not making any further purchases is likely to be beneficial both in warning consumers about the dangers of spending to the limit and in making only minimum repayments

Credit providers have noted in the past that their systems currently would not be able to deal with this on an individualised basis, and the cost of developing systems would be major.

In view of the fact that additional information is included from time to time on monthly statements it appears, nevertheless, to be possible to put a warning as well as a prescribed example or examples on the monthly statement which would inform the consumer of both the time needed to repay and the interest that would be incurred over that period if no further purchases were made, without this imposing a major cost on industry. This could apply to existing as well as new contracts.

This requirement has recently been legislated but not commenced in the US and is a recommendation made by the independent reviewer of the UK Banking Code that has been accepted by the Code sponsors.

The US system also proposes a requirement for the card issuer to supply a toll-free telephone number for consumers wanting information on repayment period and the total amount of interest that would be applicable to their current balance. This may be a cost-effective alternative to providing personalised information on the statement. It should be supplied at no cost to the consumer. This does not appear to have commenced in the US.

A study undertaken by the US Government Accountability Office found that 57% of consumers interviewed preferred potential customised health warnings over the generic warning required under the Bankruptcy Act. Those who did not carry over a balance from month to month predictably were satisfied with generic disclosures. US card issuers foresaw limited impact by any warning because not all who paid only minimum repayments could afford to pay more.

This option may partially meet Objective 2 and meets Objective 3.

Information is sought as to the costs involved in providing personalised information on monthly statements as opposed to prescribed examples of the time it would take to pay out a stated amount owing paying only the minimum repayment, as well as the total amount of interest that would be paid.

4.6.6 Option 6.6: Require card issuers to increase the minimum repayment percentage for new credit card contracts and for offers of increased credit limits on current cards.

As seen above, the United States, UK and Thailand have all required or requested that card issuers increase their minimum repayment percentage, in most cases to double it, in order to reduce instances of long term over-indebtedness. The effect of the Thai requirements is unknown, but in the US it appears that lenders have not implemented the proposals. As well, in the US the proposals were for this measure

to apply to existing as well as new contracts, which would negatively affect existing cardholders able to make only their current minimum repayments. There is no evidence from the UK as to whether these suggestions have been implemented and, if so, what the response has been.

An increased percentage repayment would reduce interest payable and also reduce the period over which a credit card debt could be repaid.

Since the major lenders' minimum repayment averages 2.36%, an appropriate minimum repayment percentage, if this option were to proceed, would be 4.5% - 5%. This percentage would not appear excessive, however, if it were to apply to current contracts, more consumers would be in danger of hardship than previously if their repayments doubled. It is suggested therefore that this apply only to new contracts, as well as existing contracts where an increased limit is offered.

This option partially meets Objective 2 and meets Objective 3.

4.7 Recommended option

At this stage there is no Government commitment to any one option. Preliminary thoughts are that some degree of regulation is necessary, perhaps coupled with educational strategies. The degree and scope of any regulation would depend to a large degree on responses to this consultation paper and a thorough assessment of arguments, costs and data presented by all parties.

5. Impact analysis

This section will make a preliminary assessment of the foreseeable costs and benefits to the participants in this market.

5.1 Option 1: Maintain the status quo

Costs of Option 1

Cost to card issuers

It is likely that defaults and write-offs, which have been delayed by the lowering of minimum repayment percentages, will increase in the longer term. There may be some increase in write-offs if organisations such as Debt Free Direct attract affected consumers. It should be noted, however, that financial counsellors and consumer legal centres already negotiate write-offs on consumers' behalf. In a rising interest rate environment the number of defaults or problems with repayment may be accelerated. Depending on the roll-out and success of financial literacy initiatives, there may be some mitigation of this trend in the longer term.

The St. Paul Foundation study suggests that there is likely to be a time lag in any negative effects suffered by financial institutions and their shareholders, but that study does not elaborate on the likely consequences. The St Paul Foundation study, which included card issuers on its committee, estimated that at that time about 25% of all cardholders were experiencing difficulties in paying their credit card debts. Should the number of cardholders with repayment problems in Australia increase substantially to the point where bankruptcy or write-offs were to occur on a large scale it is likely that card portfolios would become less profitable.

The costs to card issuers are unquantifiable, as are the potential flow-on effects to shareholders and the economy should the problem increase.

Cost to consumers

Disadvantaged

A new generation of disadvantaged consumers will be granted excessive amounts of credit, thereby reducing their capacity for spending in other areas, including consumption, health and education. These factors will impact on the capacity of young people to participate in the economy and they may become welfare dependant. This is in addition to the current generation of affected consumers. The impact of financial literacy education on this demographic over the longer term is unknown and unquantifiable.

A number of cardholders will face long term hardship from unmanageable card debt. Bankruptcies may increase. In extreme cases the financial stresses may result in increased family and health problems. These consumers may lose their homes. The number of consumers involved in this scenario is unquantifiable.

Mainstream

There should be no immediate impact on mainstream consumers from maintaining the status quo.

Mainstream consumers are most likely to be affected if card issuer losses in the longer term become significant and impose charges on those who currently do not pay for the service provided to offset those losses. Those consumers would also be likely to carry a greater tax burden to support increases in welfare dependence.

The number of such consumers and the flow on costs are unquantifiable.

Community impact

A further likely consequence if the numbers of affected consumers increase substantially is that a diminution in consumer spending power may cause some businesses to fail. This tends to have a negative impact on consumer confidence, which, in turn affects consumer spending.

Cost to governments

Governments will face increasing demand for their services, both in dealing with credit card problems by negotiating with card issuers and, if levels of indebtedness substantially reduce individuals' and families' capacity to purchase private health and housing services, from demands on the social security, health and housing portfolios.

Governments would also incur costs from the continuing production of financial literacy materials and consumer awareness campaigns about credit card use.

There would be negative public perceptions arising from perceived government inaction with respect to credit card debt, and in response to any increase in taxes to fund increased welfare support.

There would be increased pressure from community organisations for additional funding to assist consumers experiencing hardship.

Cost to community organisations

There would be increased demand for assistance in negotiating with card issuers to reduce credit card debt. This would impact heavily on currently overstretched resources.

Community organisations may also act in partnership with governments on credit card debt awareness campaigns.

Benefits of Option 1

Benefit to card issuers

Card issuers would continue to benefit from long term interest repayments by those cardholders who can not pay down their card debts. Depending on the number of defaults and write-offs, the amount of such benefit may be reduced.

Profit margins would increase as new generations of consumers entered the card market and shareholders would reap the benefits.

Card issuers would not incur costs associated with changing their assessment systems or in implementing new processes.

Benefit to consumers

Disadvantaged

In the long term, increased focus on financial literacy as a result of more targeted strategies may prevent a small proportion of vulnerable consumers from taking on unmanageable debt. Take-up of new debt negotiation services may assist a small percentage of such consumers achieve write-offs or reduced repayments.

Mainstream

This group of consumers who benefit from paying no interest on their cards would continue to benefit from being subsidised by the consumer who pays interest over a long term. This may not continue indefinitely if defaults rise to a degree where additional revenue is sought.

Community impact

No specific benefit identified.

Benefits to governments

None identified.

Benefits to community organisations

None identified.

5.1.1 Evaluation

This option would have no positive impact on the problems identified, except for a possible improvement over time in financial literacy for some groups of consumers. How improved financial literacy will impact on the disadvantaged consumers identified is not known at this stage.

A negative impact would be increasing indebtedness of disadvantaged consumers with possible consequent increasing demand on government and community services.

Reduced spending and increasing bad debt may have a negative effect on communities and the economy generally.

The market would continue to favour mainstream cardholders over disadvantaged consumers in the cost of providing a card service.

This option would not satisfy government objectives of assisting better decision-making, but may increase consumer choice. It would not satisfy the objective of adequately protecting disadvantaged consumers.

There would be no impact on competition from this option.

5.2 Option 2: Increased penalties and better enforcement of the current law

Costs of Option 2

Cost to card issuers

Card issuers would be likely to write off more debt if increasing numbers of consumers were represented. The impact on card issuers would depend on the success of strategies to advise consumers of their rights under the law.

Increased staff resources may be required to negotiate consumer relief with consumer agencies or community organisations.

Cost to consumers

Disadvantaged

There would be a sizeable majority of affected consumers who would not access agencies to assist them obtain relief. This majority would continue to carry unmanageable debt, and to suffer the reduced living standards and life opportunities that result from such debt such as described in the impact analysis of option 1.

Mainstream

These consumers would not be affected by this option in the short term, however, because this option would not bring about systemic change, any costs identified in option 1 would apply.

Community Impact

The small number of consumers involved in relation to the whole would make the costs to the community similar to those outlined in option 1.

Cost to governments

Governments would require additional resources to negotiate for consumers with card issuers to obtain relief. Increased resources would also be needed to develop and implement outreach strategies. The level of resources required would depend on the strategies undertaken and their success in encouraging consumers to make contact with government agencies. Currently, selected regional offices conduct regular information sessions and supply information to regional newspapers on consumer rights while call centres and specialist support services provide information and assistance. Ministerial media releases and education materials are routinely made public. These efforts would need to be substantially increased in order to increase public awareness sufficiently to impact on the problem.

Governments would be required to provide additional funding to consumer organisations to increase their capacity to negotiate on behalf of an increased number of consumers.

The additional expenditure on resources may bring criticism in respect of budget increases. If no additional resources were available, there may be criticism arising from a reallocation of priorities so that other services would be under-resourced.

Costs to community organisations

Consumer organisations would require increased resources if additional cases were to be taken on. For this to be meaningful in terms of impact, two or three times the current level of staffing would probably be required.

Benefits of Option 2

Benefits to card issuers

Card issuers would continue to benefit from the ongoing interest repayments from the majority of affected consumers. Their additional resource costs would have little impact on profit margins.

Card issuers would be able to continue their operations without change in respect of applications from new generations of consumers.

Benefits to consumers

Disadvantaged

Those affected consumers who were able to obtain assistance because of the additional resources in government and community organisations would obtain relief. The benefits would accrue to those individuals and would not have a systemic impact. The numbers involved are likely to be small in comparison to those who do not access assistance.

Mainstream

These consumers would continue to benefit from the use of free credit and free payment service, at least in the short term.

Community impact

No specific benefit identified.

Benefits to government

None identified.

Benefits to community organisations

If additional resources were available more consumers could be assisted.

5.2.1 Evaluation

This option would assist a small additional number of consumers to obtain relief, but would not bring about any systemic change. The relief may be obtained late in the process when it would be too late for those consumers to radically improve their financial positions.

The increased costs to government and community organisations may divert funds from other programs.

The government objectives would not be met as consumer choice would not be assisted, nor would consumers be protected from the irresponsible provision of credit.

This option would have no impact on competition.

5.3 Option 3: Education and information

Costs of option 3

Costs to card issuers

There is currently no requirement for card issuers to educate the public about the choice and use of cards. Whether they choose to do so would depend on factors including company philosophy and the state of consumer lending portfolios. Any future requirement is likely to be in the nature of change to the pre-contractual disclosure regime, if current research suggests that this would be effective. Since the research has not yet been finalised, no costs can at this stage be estimated.

Should industry decide to substantially increase financial literacy programs and significant improvements in financial literacy occur, and consumer choices improve as a result of improved disclosures, card issuers may experience a reduction in profits from credit cards.

Costs to consumers

Should additional costs be incurred by industry as a result of change to the statutory disclosure requirements, this may be passed on to consumers. Any cost to the individual consumer would be small but is unquantifiable at this stage. The cost would be the same for disadvantaged and mainstream consumers.

Community impact

No costs identified.

Costs to governments

Costs to government would be from funding additional research (as an example, one project is currently costed at \$100,000) and in government resources in developing and administering any future research project and subsequent legislative change. These costs would be met within current budgets.

If specialised, targeted financial literacy programs were to be undertaken, the cost to government may be roughly equivalent to the English experience i.e. \$250 per individual.

Costs to community organisations

None identified, unless there was involvement with targeted education programs. If this were to be the case it is most likely that government would be required to provide additional funding.

Benefits of Option 3

Benefits to card issuers

Should significant improvements in financial literacy occur, and consumer choices improve as a result of improved disclosures, card issuers may experience a reduction in defaults and write-offs.

Benefits to consumers

Disadvantaged

There is no information available about the benefits to disadvantaged children of school-based financial literacy programs.

The research on improved precontractual disclosure provisions will not specifically target the possible outcome for disadvantaged consumers of an improved regime for credit cards. Some anecdotal information could be available from this study, but at this stage any benefits are unknown.

Targeted financial literacy education has been proven to have good results for disadvantaged consumers, and could provide benefit for those groups of consumers provided with such programs. This would be a long term benefit for a relatively small number of consumers.

Mainstream

Mainstream consumers would be the likely beneficiaries of school-based financial literacy programs. Since, in the main, this group manages credit card use well, significant additional benefit would not be expected.

Improved precontractual disclosure would also benefit this group of consumers, but to an unknown extent.

Community impact

If there were to be significant widespread benefit in the long term there would be benefit to the community from increased consumer participation and spending. This cannot be predicted and is unquantifiable.

Benefits to government

Should school programs and targeted financial literacy programs prove successful in the long term, there may be reduced demand on welfare programs and consumer agency resources over time. The extent of any reduction cannot be anticipated at this stage.

Benefits to community groups

There may be reduced demand on services in the long term if current and future initiatives were to prove successful. This is unquantifiable.

5.3.1 Evaluation

The success or otherwise of across the board initiatives such as financial literacy in schools and general precontractual disclosure changes can not be predicted at this stage.

While it is likely that targeted financial literacy initiatives would be reasonably successful, it should be noted that the participants were chosen for their accessibility and their receptiveness to change. This suggests that not all consumers would be suitable for this approach. There was no estimate of the likely financial benefit likely to flow to each person, but we would assume that this would be more than the cost of \$250. How many consumers compared to the total number of financially illiterate consumers could reasonably be targeted in this way is also not estimated. It is difficult therefore to evaluate this option.

It does seem apparent that significant numbers of consumers would not be appropriate “targets” and it would seem unlikely that a majority could be reached in

this way. Benefits would seem to be incremental and very long term and may not be the most cost-effective method of dealing with the identified problem.

5.4 Option 4: Self regulation

This option considered to be part of the status quo.

5.5 Option 5: Co-regulation

Not considered a viable option.

5.6 Option 6: Regulation

There are 6 regulatory options.

5.7 Option 6.1: change the timing of essential information disclosure

Costs of Option 6.1

Cost to card issuers

For internet applications, information supplied by Virgin Money suggests there is no cost to the card issuer. For paper-based systems, it would be a relatively simple and inexpensive process, when those documents are renewed and reviewed for content, to include the information required on the application form. The printing of the form would have been a cost incurred without any such addition. The additional cost would be in the redesign of the form and resetting the print format.

Card issuers are requested to indicate in their response the likely costs of redesign of the form and printing, with an indication as to how often this is done in the normal course of events (i.e. not as a result of a regulatory requirement).

Card issuers may be affected by consumers' choice of cards in that their more profitable products may be overlooked in favour of those that are more cost effective to consumers.

Card issuers with high cost products may find that consumers do not proceed with the application and may therefore lose market share.

Cost to consumers

Disadvantaged

Minimal

Mainstream

Minimal

Community impact

There should be no negative community impact.

Cost to Governments

The cost of developing the legislative requirement as well as the cost of enforcing the provision would be incurred by government. This is core government business and it is unlikely that additional resources would be sought.

Cost to community organisations

None identified.

Benefits of Option 6.1

Benefit to card issuer

Minimal

Benefit to consumers

Disadvantaged

A proportion of disadvantaged consumers may be influenced by prominently featured cost information and may choose not to proceed with an application. The number of such consumers is unquantifiable. If high priced cards lose market share, those card issuers may be encouraged to lower their prices. This would benefit disadvantaged consumers.

Mainstream

Search costs for all consumers would be minimised. Comparability would be enhanced, which may lead to reduced credit card costs. Consumers who are price sensitive would be able to exercise their power of choice appropriately.

Community impact

The community generally would benefit from greater transparency of credit card costs and from any flow on benefit which competition might bring in terms of costs.

Benefit to Governments

There may be a reduction in the level of complaints dealt with by consumer agencies because consumers may make better choices of cost effective cards.

Benefits to community organisations

There may be a reduction in the level of complaints dealt with by community organisations.

5.7.1 Evaluation

This option would benefit both those card issuers with competitively priced products and those consumers who, if search costs were lowered, would be price sensitive. This would benefit some disadvantaged and most mainstream consumers, with some flow-on benefit to communities.

This option would meet the government objective of assisting consumer choice.

Transparency of pricing would have a positive effect on competition.

5.8 Option 6.2: require credit providers to allow consumers to nominate the credit limit sought

Costs of Option 6.2

Cost to the card issuer

Those card issuers who have granted credit in excess of that which a consumer would have sought and could afford to repay, would experience a reduction in long term interest repayments from those consumers entering the market who chose a lower limit. A small cost would be incurred from redesigning the application form to include the required field. This would be minimised by the fact that option 6.1 would,

if introduced, require changes so that all changes to the application form could be undertaken at that time.

When this issue was canvassed in 2001, none of the card issuers commented on the costs of redesigning the form. The only potential cost identified was that consumers may nominate a higher limit than the card issuer would be prepared to grant and may be dissatisfied with a rejection and, presumably, apply elsewhere

Card issuers are requested to indicate in their response the likely costs of redesigning the application form to include the suggested field.

Cost to the consumer

Disadvantaged

None identified for those consumers entering the market who would otherwise be given more credit currently than they would want or can afford. Those who were refused because they nominated too high a limit may well try elsewhere, but if objective measures for assessment are in place as suggested in option 6.3, it is unlikely that they would be successful.

Mainstream

No costs identified. Mainstream consumers have good financial management skills and manage their cards well. They are likely, therefore, to designate a suitable credit limit and continue to manage that amount appropriately.

Community impact

None identified.

Cost to Governments

Government would bear the cost of developing the legislation and enforcing its provisions. This would be funded from existing budgets.

Cost to community organisations

None identified.

Benefits of Option 6.2

Benefit to card issuers

It is likely that, with a manageable credit limit, there would be fewer defaults and write-offs, and a reduced need to use debt collection services.

Low income consumers, who previously would not apply for a credit card because they feared a debt trap, may enter the card market.

Benefit to consumers

Disadvantaged

Those consumers entering the market who lack the capacity to successfully manage their financial affairs would be less likely to be granted unmanageable amounts of credit. A proportion of consumers in this category are reported to accept the card issuer's assessment as an indication that they can use the full amount of credit granted without experiencing difficulties³⁴. Many consumers who have experienced difficulties have reported that the credit granted was far in excess of that they would

³⁴ "Understanding Personal Debt & Financial Difficulty in Australia", ANZ Bank and A C Nielson, Nov.2005, p.4.

have requested. The amount of interest saved could therefore be significant, but is not ascertainable.

Other low income earners interviewed in relation to their use of payday lenders, were reported to exhibit “ a deep suspicion of credit cards...because their repayment dates were imprecise and they were perceived to be difficult to manage”.³⁵

These consumers preferred a finite high cost product to credit cards, because of difficulties with credit cards experienced previously, or currently. While the “overconfidence” described earlier might induce consumers to accept what they are given, it seems unlikely, from reports such as these, that those consumers would have asked for more than they needed if given the choice. Some part of this group of consumers, if they are able to choose their limit, may choose a credit card instead of high cost fixed term credit.

Mainstream

No specific benefit identified.

Community impact

In the long term, should sufficient disadvantaged consumers apply for manageable amounts of credit this could have a community benefit in terms of social and financial participation. This could result in their support of local businesses and a reduction in antisocial actions.

Benefit to Governments

Government would experience fewer complaints from consumers experiencing difficulties with credit commitments. There would be reduced demand on welfare services that are government funded.

Benefits to community organisations

Community organisations would experience fewer complaints from consumers experiencing difficulties with credit commitments.

5.8.1 Evaluation

The major beneficiaries of this option would be low income and disadvantaged consumers who want only a small amount of credit, but have been discouraged as a result of their previous experience, or by the experience of others, from applying for a credit card because of the high limits set by card issuers. A significant number of low income consumers have demonstrated they are capable of responsible management of small amounts of credit. This would provide a vastly preferable alternative to payday lenders and fringe credit providers. This would have a flow on benefit to the community generally.

Governments and community organisations would benefit from a reduced demand for their resources.

Card issuers would have a reduced long term income stream but this may be offset by increased applications from those consumers who currently distrust credit card issuers. Those card issuers willing to offer small amounts of credit would benefit from this option.

³⁵ Consumer Law Centre Victoria Ltd, “Payday lending in Victoria – A research report”, July 2002, p.80.

This option would meet the government objectives of assisting consumer choice as well as helping consumers to protect themselves against irresponsible lending by choosing a credit limit that suits their need and capacity to repay.

This would be a pro-competitive option as a result of consumers being able to exercise purchasing power.

5.9 Option 6.3: Prohibit the card issuer from providing more credit than the consumer can repay from income without substantial hardship.

Costs of Option 6.3

Cost to card issuers

One cost to the card issuer would be in systems change to accommodate any legislative requirements, that is, assessment of current financial information and changes to, presumably, a computerised system which factors in the relevant data and calculates an appropriate credit limit. The costs of assessing or inputting financial data to a system will only arise if such information is not already considered. The majority of card issuers would not be “asset lending” as this has been determined by the court to be unlawful, and publicly stated by the Banking and Financial Services Industry Ombudsman to be inappropriate. It is likely to be a minority of disreputable lenders using such practices and they may incur costs in adjusting their assessment processes. Since warnings from legal firms to their clients have been issued, it is possible that this may have already been done. However, most card issuers, mainstream and fringe, are apparently calculating credit limits at an inappropriate level so that systems change would be a cost to the majority of card issuers.

A proposal for revised assessment practices was canvassed in 2001, but this specified that institutions should ask for all financial commitments of the applicant and that they should be assessed on that basis (similar to that now in force in the ACT). At that time the majority of card issuers generally affirmed their commitment to credit scoring as the best predictor of repayment capacity. There was no reference to additional costs that would have been incurred. Responses to the Victorian Credit Review did not provide any information on costs.

The cost of adjusting a computerised assessment system is not known to those outside the industry. Details of such costs are requested below.

Card issuers are requested to indicate any additional costs arising from this proposal and how those costs are apportioned in terms of human resources, training and compliance activities and computerised assessment systems.

Assessment of an appropriate credit limit for new applicants or increased limits on the basis that the applicant must be able to pay it off within 7 years, may result in reduced interest payable over time since the debt would theoretically be paid off more quickly. However, this would be offset in the short to medium term by the higher monthly minimum repayments that would ensure repayment in a shorter timeframe under this option, or that would be required under option 6.6, if this is introduced. It may be further offset by increased numbers of disadvantaged consumers applying for cards if they were seen by this group of consumers as a credit option that would not lead to problem debt.

Card issuers may choose to end the cross subsidisation of those consumers who pay no interest and therefore receive a free payment service and a period of interest free credit by requiring that group of consumers to pay for the service provided.

In a report issued by the Prices Surveillance Authority (PSA) in 1992, a number of options were considered to eliminate the various kinds of cross subsidisation on credit cards. In order to stop any cross subsidisation between those who pay early (within the interest free period) and those who pay late (and pay interest) the PSA suggested an option of eliminating the interest free period as well as charging an annual fee.³⁶ It is possible that consumers who currently use the card as a transaction instrument and pay no interest, and who are considered by the PSA to be subsidised by those who pay interest, may be required to bear a more equitable share of the cost burden if card issuers decide, for example, to implement the option outlined in the PSA report, or to address the cross subsidisation in some other way. This would be an appropriate reallocation of costs provided that people who currently pay interest were not affected by it. No data has been sourced on the costs to card issuers of transactors, and to what degree those costs are offset by annual fees.

Card issuers are requested to assess any reduction of interest that may result from the implementation of option 3, based on the difference between current assessments and minimum repayments and those which would be required as a result of this option.

Card issuers are also requested to detail the costs of training and compliance activities.

Cost to consumers

Disadvantaged

There should be no costs for these consumers. There would be no change in repayments for existing cardholders unless a higher limit was offered and accepted. However, since card issuers would be required to assess any limit increase under the new requirements, it is unlikely that consumers at the limit of their capacity would qualify for further credit.

Mainstream

Those who are able to comfortably service the amount of credit granted should not be affected since they clearly have the capacity to repay amounts in excess of the minimum repayment requirement, or they do not use credit to the limit given. This group is unlikely to be affected by any changes to practices flowing from requirements that capacity to repay should rely on income, since they would have made rational choices of product and lender to access a product they can afford and would consider an offer of a limit increase in the same manner.

Community impact

It is not clear that there would be any loss to card issuers over time that would impact on the community generally. If there were to be a net loss, this might result in the elimination of the cross subsidisation of cardholders who pay no interest as proposed by the PSA.

If card issuers suffered loss and were not prepared to recoup that loss as suggested by the PSA, they may choose to reduce staff numbers or services, or may pay

³⁶ Prices Surveillance Authority, "Inquiry into credit card interest rates", October 1992, p96

smaller dividends to shareholders. Depending on the degree of loss this could have a minor impact on the economy with loss of spending power, or minor community impact through less access to services.

Cost to Governments

Depending on card issuers' conduct following implementation of this option, Governments may be involved in enforcement activities if it was found that card issuers were continuing to avoid the requirements. Any costs are unascertainable at this time, but would require the use of internal compliance and legal resources as well as possibly a non-government Counsel. Courts would also incur costs in hearing cases brought for contraventions of the requirements.

Cost to community organisations

None identified.

Benefits of Option 6.3

Benefit to card issuers

Default numbers should be reduced in respect of new applicants and those who accept higher limits. There would also be a reduction in the resources needed to deal with "high maintenance" accounts, which require repeated contact for repayment or which are assigned to debt collectors. There is currently no reliable data to indicate the number of such consumers or the amount of credit in default that could be attributed to those that currently "slip through" the system.

Benefit to consumers

Disadvantaged

There should be a significantly reduced percentage of those consumers entering the card market, changing cards or being assessed for a credit limit increase, who might otherwise have been unable to meet their credit card commitments. Taking the sub-categories of consumers in financial difficulty identified in the A C Nielson/ANZ study: unhealthy financial ways of thinking; circumstances out of individual's control; and lack of skills and knowledge (and recognising that the three categories are not discrete)³⁷ it can be seen that all could benefit from a more conservative assessment. Those with unhealthy financial ways of thinking and those with low financial literacy would not have these vulnerabilities exploited to the degree they are now. Those who have been subjected to circumstances out of their control may have more cash reserves or savings to get them through the difficult times if they have been assessed conservatively. The exact percentage of such consumers cannot be known and the benefit is therefore unascertainable.

Those consumers who might otherwise have been granted excessive amounts of credit on the basis of assets held will not be in danger of losing their homes. Should asset-rich consumers wish to access cash or credit there are a number of products where the equity in their home can be used in an agreed and transparent way. For example, elderly consumers may wish to use a reverse mortgage where they receive cash in return for the credit provider being paid a proportion of the value of their home from their estate or a future sale. This category of consumers is most likely to be targeted for asset-based lending involving credit cards. Reverse mortgages, when sold appropriately, transparently use the consumer's equity in the home and provide an alternative to the unacknowledged (to the consumer) asset-based lending

³⁷ A C Nielson/ANZ Bank "Understanding Personal Debt and Financial Difficulty in Australia", November 2005.

that may result in consumers inadvertently having to sell their only asset to pay a debt.

Those who might otherwise be granted more than they can afford would have less available credit, but also less long term debt. It is possible that some consumers may not be granted a credit card if they do not have the capacity to repay, however, that is not considered to be a negative outcome. There are, however, alternative sources of credit available to low income consumers who are able to manage small loans. The National Australia Bank and the ANZ Bank have low interest fixed term loans available for a variety of purposes, and the No Interest Loans Scheme (NILS) provides loans without interest for specific purchases, usually whitegoods or equipment. Credit unions also provide small loans. These are all available to people on benefits, some of whom have stated they do not want credit cards, recognising that they represent a potential unmanageable debt. The products identified above all have the benefit to the consumer of paying off the debt entirely over a relatively short term.

Mainstream

No specific benefit identified.

Community impact

A number of disadvantaged consumers would have greater spending power, which would provide support for local businesses.

There may be a reduction in destructive social behaviour if financial stresses on families are reduced.

Benefit to Governments

Government might expect fewer complaints from consumers about their own or their dependents' credit card debts.

There may be reduced demand on other government services such as provided by housing and health portfolios.

Funding provided by governments to consumer organisations could be better targeted to allow organisations to help consumers in need of assistance for reasons other than unmanageable debt caused by irresponsible lending.

Benefit to community organisations

There should be a reduction in the number of consumer complaints and consequent negotiations with card issuers, as well as a reduction in the number of applications to the Tribunal or the BFSO for relief that are brought by consumers with the assistance of community organisations.

Consumer organisations' resources could be targeted to allow those organisations to help consumers in need of assistance for reasons other than unmanageable debt caused by irresponsible lending.

5.9.1 Evaluation

Low income and disadvantaged consumers who are entering the credit market as well as existing cardholders who may be offered an increased limit will be the major beneficiaries of this option. Limits granted will be appropriate for their capacity to repay, so that substantial hardship is not inevitable if they spend to the limit granted.

Lifetime credit card debt will be avoided. There would be a reduced likelihood that elderly consumers would lose their homes as a result of credit card debt. In the long term, government and community organisations would benefit from reduced demand for their services.

The current capacity of credit providers to check an applicant's credit commitments is limited by the credit reporting system which would not give a full picture. Those consumers who did not honestly disclose their commitments when these were requested, would not benefit from a more stringent assessment, and card issuers should not be called to account for wrongly assessing such consumers.

The credit reporting system is currently being reviewed by the Australian Law Reform Commission. Should the system be redrafted to give card issuers access to all relevant commitments, there should be no reason why a consumer could not be properly assessed.

Mainstream consumers may lose the subsidisation of their credit card by disadvantaged consumers.

Card issuers will forego the benefit of long term interest repayments from new applicants, but these would be offset by higher minimum repayments as described in Option 6.6.

This option would meet the objective of protecting a significant number of current and future cardholders from irresponsible lending by, firstly, making it a positive requirement that can attract a penalty and, secondly, providing a guide as to what would be considered by regulators in assessing whether card issuers had contravened the prohibition.

There would be a positive impact on competition from any reduction in cross subsidisation.

5.10 Option 6.4: Provide relief for consumers by making the debt unenforceable to the extent that it exceeds an amount granted in accordance with Option 6.3, including interest charged.

Costs of Option 6.4

Cost to card issuers

Card issuers would need to ensure compliance with the requirements and to educate their officers and representatives on any new systems. It should be recognised, however, that changes are routinely made to systems requiring internal compliance and education, so that this should not be an unusual or exorbitant cost.

Any cardholder debt which is unenforceable would be a cost to the card issuer, however, since this would be as a result of a breach of requirements this cost should not be part of the evaluation of final costs/benefits. Costs associated with disputes brought to the Banking and Financial Services Ombudsman or other dispute resolution scheme in the event of breaches should also therefore not be included in the evaluation.

Card issuers are requested to indicate costs associated with this option.

As consumer redress would rely on an examination of the credit limit allocated in relation to the consumer's financial commitments, card issuers the subject of complaints would be requested to supply the complainant's application form to the agency dealing with the consumer complaint. Card issuers would therefore need to access that consumer's file and forward it to the agency in question. The cost to the card issuer would depend on the level of compliance with the requirements of the legislation.

Card issuers are requested to assess the cost of accessing a consumer's application form and forwarding it to a relevant agency on request. Since it is unlikely that the number of requests for this information could be anticipated, costs on a per unit basis would be sufficient.

Cost to consumers

Disadvantaged

Costs may be passed on to all consumers via interest rates or fees. If a fee was imposed then all cardholders whose contract had a capacity to charge new fees would be affected. However, in view of an increasingly competitive card market, it is likely that any passed on costs would be small.

Mainstream

If fees were imposed, or the interest free period reduced or cancelled, there would be a cost to this group of consumers. This cost can not be quantified.

Community impact

Any cost related to this option would have little community impact.

Cost to Governments

Governments would bear the cost of enforcement action for systemic problems. It is likely, however, that penalty provisions in contrast to the current re-opening provisions, would deter systemic abuses.

There may initially be an increase in inquiries from consumers as to their rights.

Cost to community organisations

There may initially be an increase in inquiries from consumers about their rights.

Benefits of Option 6.4

Benefits to card issuers

Those card issuers who were not involved in enforcement actions would gain an improved public image.

Benefits to consumers

Disadvantaged

Cardholders who were granted excessive amounts of credit could obtain relief from unmanageable debt. The possibility of penalties being imposed would make it more likely that the number of consumers affected by the provision of too much credit would be reduced.

Mainstream

No specific benefit identified

Community impact

The reduced likelihood of overcommitment which would flow from the prospect of penalties, as well as a reduction in indebtedness of those consumers who had been incorrectly assessed, suggests that more consumers would have disposable income to spend in their local communities. There would be a positive impact on social cohesiveness and a reduction in family breakdown.

Benefits to Governments

Governments would benefit from reduced complaints and requests for assistance with credit card-related matters.

Complaints received would be more easily resolved since there would be a standard for assessment by which the consumer's credit limit could be measured.

Demands for government funded services such as those provided by housing, health and community services, may be reduced.

Benefits to community organisations

Community organisations would benefit from a reduced number of credit card complaints and requests for assistance. This category of complaint forms a significant proportion of community organisations' workload.

The complaints received would be more easily resolved since there would be a standard for assessment by which consumers' credit limits could be measured.

5.10.1 Evaluation

The major benefit of this option would be in it providing an incentive to card issuers to ensure compliance with requirements, and also to those consumers whose card issuer failed to observe the requirements and were granted unmanageable amounts of credit.

The cost would be shared by all card issuers in ensuring compliance with requirements. Ongoing compliance with legislation is a normal business cost, so that the initial training and systems changes would be the additional cost for this option.

This option provides additional motivation for card issuers to lend responsibly and therefore would satisfy the objective of protecting consumers from irresponsible practices.

Appropriate redress mechanisms are essential to the capacity of consumers to exercise market power. This option is therefore pro-competitive.

5.11 Option 6.5: Require card issuers to warn consumers about the effect of paying only the minimum repayments

Costs of Option 6.5

Cost to card issuers

This issue has been canvassed with credit providers on two occasions: first in 2001 and again, in the Consumer Credit Review conducted by Victoria. In 2001 industry generally responded by questioning the need for and benefits of a "health warning". No potential costs to industry were provided at that time.

In 2005, in response to the Victorian Consumer Credit Review issues paper where this option was canvassed, some card issuers referred to their current practices of warning of the increase in the minimum repayment and of warning the consumer not to accept a limit increase if their circumstances had changed and, in the case of ANZ to their Customer Charter commitments to not offer a limit increase in certain circumstances, but none of the issuers addressed the costs of this proposal.³⁸

Costs to card issuers are assumed to consist of system adjustments to print a prescribed warning with specified examples on the monthly statement, as well as a telephone-based response capacity for more personalised information. Costs of the latter could be reduced by a single source providing the service for all card issuers if agreement could be reached between the lenders.

Card issuers are requested to indicate the likely costs if including a prescribed warning on statements and an industry funded centralised telephone information system.

Cost to consumers

Disadvantaged

Depending on the level of costs indicated by card issuers, these may be passed on to consumers in interest rates or fees.

Mainstream

Depending on the method of cost recovery, if this is passed on to consumers, mainstream consumers may also be subject to increased fees.

Community impact

It is unlikely that any fee passed on to consumers would impact greatly on consumers and would therefore have little community impact.

Cost to Governments

There would be a small cost to Government in developing the requirements for such disclosure. This would be considered part of its currently funded activities and would not therefore constitute an additional cost.

Cost to community groups

No cost identified.

Benefits of Option 6.5

Benefit to card issuers

If card issuers are correct in their assertions that most credit card problems are due to sudden change in consumers' circumstances, or that consumers are not using the cards responsibly, a warning such as that proposed may assist both categories of cardholders to consider the dangers of long term indebtedness and to avoid this by reduced use of their cards and early attempts to pay down debt before the credit limit is reached. The likely benefit cannot be quantified.

Benefit to consumers

Disadvantaged

Consumers who were not aware of the dangers of paying the minimum repayment on a maximally drawn limit, or on their outstanding balance at any time, would have this information brought to their attention at a time when it is most useful. This is

³⁸ The Report of the Consumer Credit Review, Victoria, p.151.

information which seems to impact strongly on those who have not been exposed to it and may produce benefit to a large number of consumers. This is not, however, quantifiable.

An intangible benefit would be an enhanced understanding of financial matters, contributing to the increased financial literacy of this group of consumers.

Mainstream

There is no identified benefit for this group of consumers.

Community Impact

This option could increase social and financial participation for those consumers able to respond to the warning.

Benefit to Governments

Government could expect some reduction in the number of requests for assistance from consumers who were able to respond to the warning. This may have a positive impact on government resources, however, the benefit is unquantifiable.

Benefit to community organisations

Community organisations could also expect some reduction in the number of requests for assistance. Since credit card debt constitutes a significant proportion of consumer credit and financial counselling work, the benefit may be significant in the longer term if this option were to be implemented in concert with other options. The benefit is not, however, quantifiable.

5.11.1 Evaluation

The major beneficiaries of this option would be disadvantaged consumers who have not yet reached the credit limit and who may have capacity to pay down their card. New cardholders should have limits appropriate to their income, however, this would benefit them by encouraging them to pay off as much of their balance as possible and would increase financial literacy.

Card issuers would bear the cost of providing the additional information, as well as a telephone system for providing individualised calculations. There may also be a reduced income stream long term, but this would be offset by consumers making higher repayments.

This option would protect existing consumers from the consequences of irresponsible lending, while warning new consumers about possible long term debt. It therefore meets the objective of protecting consumers from irresponsible lending practices.

The effect on competition would be neutral.

5.12 Option 6.6: Require card issuers to increase the minimum repayment percentage for new credit card contracts and for offers of increased credit limits on current cards.

Costs of Option 6.6

Cost to card issuers

This is not an option which has been canvassed previously. It is estimated that there would be short term and long term costs associated with this option.

The short term costs would arise from the systems change necessary to deal with billing requirements. Since this option would apply to new cardholders and those who accept credit limit increases, the systems change would probably be substantial.

Long term costs would arise as a result of consumers paying down their accounts over a shorter period with a consequent reduction in interest. This may, however, also be accounted for under previous options, if introduced. It is likely that increased minimum repayments from new cardholders and those who elect to accept a limit increase would offset this cost. It is not possible to quantify these costs.

Card issuers are requested to provide estimated short term and long term costs of this proposal.

Cost to consumers

Disadvantaged

Consumers entering new contracts would be required to pay a higher minimum repayment. However, their assessment should be based on enhanced criteria under Option 6.3 so that their credit limits would be lower. On balance, this should not result in extra costs. Current cardholders who are disadvantaged consumers and are fully committed are unlikely, under Option 6.3, to be offered increased limits so that there is little danger of that group being required to pay a substantially higher minimum repayment.

Mainstream

Those consumers who pay the entire balance would not be affected. Those existing consumers who have a small but ongoing balance are unlikely to require or agree to a credit limit increase. New applicants in this category are highly likely to be financially literate and would understand the implication of a higher minimum repayment requirement. Any costs would be minimal.

Community impact

No specific costs identified.

Cost to governments

No identified costs apart from the development and drafting of legislation.

Cost to community organisations

None identified.

Benefits of Option 6.6

Benefit to card issuers

There would be increased income from new cards and limit increases. This is unquantifiable.

Benefit to consumers

Disadvantaged

Those consumers entering the market who paid only the minimum repayment would pay less interest and repay debts over a shorter period.

Mainstream

No benefits for mainstream consumers identified.

Community impact

Reduced indebtedness of disadvantaged consumers would allow local business to be supported and would reduce social effects of debt problems.

Benefit to governments

There may be a reduced number of consumers seeking assistance with unmanageable debt.

Benefit to community organisations

There may be a reduced number of consumers seeking assistance with unmanageable debt.

5.12.1 Evaluation

The major benefit from this option would flow to new cardholders, whose interest repayments over the long term would be reduced. The effect on card issuers is less certain and would depend on the number of new cardholders entering the market, and the take-up of increased limits by existing cardholders to offset any long term losses of interest payments.

On balance, the benefit to the individuals and the flow-on effect to the community of improved financial circumstances for a significant number of consumers would appear to outweigh the costs to card issuers.

This option would work in tandem with option 6.3 to meet the objective of protecting consumers from irresponsible lending practices by ensuring those consumers were not subject to a lifetime debt.

This option would have no impact on competition.

6. Consultation

The proposals in their current form have not been the subject of consultation. However, there have been a number of initiatives since 2000 which have involved consultation with consumers, card issuers and community organisations in relation to credit card issues and proposals for dealing with the perceived problems.

They are:

- A New South Wales Consumer Credit Phone-in in November 2000;
- A Consumer Credit Round Table Conference in February 2001;
- A New South Wales card issuer research project in 2001;
- A consultation paper in July-August 2001;
- The Consumer Credit Review conducted by Consumer Affairs Victoria between 2005 and 2007.

The Phone-in allowed consumers the opportunity to air their concerns. The Round Table Conference brought those concerns to the industry. At that Conference, industry offered access to its assessment processes. The consultation paper proposed regulatory measures to deal with the problems, based on consideration of the information provided by industry to the NSW Department of Fair Trading. The

project did not proceed further at that time. There were, however, responses from industry and consumer organisations to the proposals at that time, some of the proposals being similar in substance to those outlined above, but not necessarily the express requirements proposed.

A separate but relevant review was undertaken by Consumer Affairs Victoria covering a wide range of credit-related concerns, including responsible lending.

To the extent that there is similarity to the scope of this consultation paper the responses of interested parties to the Victorian review to the options presented here are outlined below:

Option 6.1.

This was not previously canvassed in regulatory proposals. However, in recent times there has been considerable discussion of the usefulness of disclosure material and the optimal timing of any disclosure. A research project is currently under way and will test the likely benefits of providing relevant information at an earlier stage.

Option 6.2.

A significant number of case studies identified in consumer advocates' submissions have highlighted the fact that consumers have been given more credit than they wanted, in some cases these consumers having noted on the application form the amount required even though there was no field on the form for this to be supplied. Such requests were not honoured.

This option was raised in 2001. Credit unions supported the proposal while banks claimed it was their prerogative to set the limit. Some suggested that consumers would be offended by not being granted the (higher) amount sought. This would not appear logical since consumers generally nominate the amount of credit required in relation to other products.

The Victorian Consumer Credit Review raised this issue in relation to unsolicited credit card offers and credit card limit increases, with an option that credit providers should be permitted to make provisional offers to their customers, but the customer would have to positively elect the credit limit or increased limit they require.

Credit providers argued that they have a commercial incentive to adopt prudent lending practices where, as with credit cards, there is no security and the amount outstanding does not amortise. However, the concern here is not that consumers will default and the credit provider will lose money, but that the consumer will be trapped into a never ending debt cycle.

Option 6.3.

This was previously proposed in a different form in which card issuers were required to collect all financial information on applicants' income, expenditure and credit commitments and ensure these were used to assess the applicant's capacity to repay.

These proposals were welcomed by community organisations whose clients, if properly assessed, should never have received the limits they had been granted.

Credit unions generally agreed with the proposals.

Banks were opposed, citing credit scoring as a more reliable indicator of capacity to repay and noting that information was difficult to check because of the lack of a

positive reporting system. This latter issue is acknowledged, however, the credit reporting system is currently under review, as recommended by the Wallis inquiry. The Australian Law Reform Commission has proposed that the information available to credit providers should be expanded to include information about current accounts, the dates the accounts were opened and closed, and the credit limits of each. These measures, if adopted, would provide the information necessary for credit providers to more readily assess a consumer's capacity to repay.

The claims as to the reliability of credit scoring are not accepted. Credit scoring is at best a good indicator of the likelihood that a consumer will attempt to repay, based on certain stability of lifestyle indicators. This may be a necessary consideration for card issuers but it is not sufficient, since even those who are willing to repay may not have the capacity. This would account for the large number of consumers who struggle for years to keep the account afloat to the detriment of other needs.

The Victorian Credit Review put forward an option to place a positive obligation on credit providers to adequately assess consumers' capacity to repay credit, and to assess the consumer's capacity to pay an increase in the amount of credit or in the credit limit by the same method it uses for new applicants for credit. This option noted that for the avoidance of doubt, behavioural scoring alone would not be sufficient.

Consumer advocates were generally supportive of this option but were divided as to which model should be used to define an adequate assessment.

The Australian Bankers' Association opposed the ACT model, stating there was no research to suggest it had prevented or lessened defaults, and noting that banks were already subject to a complex web of regulation. GE opposed the ACT model on the basis that it relies on information supplied by applicants which may not be accurate.

The Review notes that this option reflects principles that the Banking and Financial Services Ombudsman applies to maladministration issues.

Option 6.4.

This was not previously canvassed in the New South Wales proposals and is a relief and enforcement proposal that has parallels with requirements and relief mechanisms already in the Code.

The Victorian Credit Review option suggested that legislation should provide explicitly for a remedy that the credit contract is unenforceable to the extent that it imposes a liability on the consumer beyond that which is appropriate. This also reflects the principles and practices of the Banking and Financial Services Ombudsman in its consideration of maladministration issues.

Option 6.5.

This was previously canvassed in the NSW paper but in an expanded form. Community advocates and credit unions supported the proposal. Banks did not, citing the cost of systems that would be required for a personalised warning.

In submissions to the Victorian Credit Review, the Consumer Credit Legal Centre and the Banking and Financial Services Ombudsman both suggested that a personalised warning needed to be provided to be effective and that this should be provided for new accounts and on statements as well as when increased limits

were offered. The warning should focus on the time it would take to pay off the account if paying only the minimum repayment.

The Australian Bankers' Association noted that industry currently provides warning to consumers when offering increased limits as to how their minimum repayment would be increased by accepting the new limit, and that if their personal circumstances have changed they should not accept the new limit. The "warning" does not address the time required to pay out the new limit.

The proposal in this paper has been refined to reduce system costs and to provide personalised information in a more cost effective way.

Option 6.6.

This has not previously been canvassed but regulatory responses to similar issues in the US, UK and Thailand have resulted in either regulation or guidelines to raise the minimum repayment in an effort to deal with the consequences of low minimum repayments.

Consumer advocates overseas have raised concerns about raising the minimum repayment percentage on existing contracts which could impact negatively on consumers' capacity to repay, however, option 6.6 does not suggest that existing contracts should be affected.

In general, the banking industry has denied the need for any changes, referring to low default rates and the fact that the majority of consumers manage their cards well.

6.1 Future consultation process

This paper will be released for comment for a period of six weeks, following which the responses to the options and the costs involved in implementing those options will be considered in formulating a decision making regulatory impact statement.

7. Evaluation and Review

The options set out above have been targeted to address the problems experienced by consumers and aim to rectify the regulatory failure identified above. They, in part, reflect overseas initiatives that respond to similar problems.

The limitations of disclosure and education are discussed above, as are self regulatory mechanisms. This paper suggests that they are not viable alternatives to regulation.

The costs of these proposals are not available at this time. This paper requests that costs be supplied by industry so that a cost/benefit analysis can assist in formulating the final recommendations.

Any legislation resulting from the final recommendations would include a date by which the legislation is to be reviewed. This is commonly three or five years. In order that any review should be meaningful, data collection sources will be contacted to ensure that appropriate data can be collected and aggregated.