

[] May 2011

The Secretary
Legislation Committee
Standing Committee on Finance and Public Administration
The Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Email: fpa.sen@aph.gov.au

Dear Ms McDonald

**Inquiry into Exposure Drafts of the Australian Privacy Amendment Legislation:
Credit Reporting**

The Credit Ombudsman Service Limited (**COSL**) welcomes this opportunity to comment on the Exposure Drafts of the Australian Privacy Amendment Legislation that relate to Credit Reporting.

About Us

COSL is an external dispute resolution (**EDR**) scheme approved by the Australian Securities and Investments Commission (**ASIC**).

COSL is a not-for-profit company currently operating in the non-bank sector. It is funded by a combination of membership and complaint fees levied on its members, which include mortgage brokers, non-bank lenders, micro lenders, building societies, credit unions, promoters of non-bank residential lending programs, aggregators and mortgage managers.

The key objects of COSL are to:

- act as the primary external complaints resolution body for the non-bank sector;
and
- provide an alternative to legal proceedings for the resolution of complaints between consumers and financial service providers who are members of COSL.

Accordingly, the primary focus and objectives of our submissions on proposals for law reform and other regulatory change are:

- to reduce the likelihood of disputes arising in the first place, and
- where circumstances that give rise to a dispute do occur, to ensure that those circumstances are brought to the attention of the parties as soon as possible, to enable prompt action to be taken with a view to expediting resolution, and
- to maximise the chances of the parties to a dispute being able to resolve the dispute themselves, and
- generally to promote attitudes, behaviours, outcomes and environments which encourage and are conducive to the resolution of disputes by the parties themselves without the need for EDR or formal legal proceedings.

COSL's observations and comments

Australia is one of only a handful of developed countries that does not yet have some form of positive credit reporting.

Our current negative credit reporting system has a number of shortcomings, including questionable data integrity and the absence of incentives for reporting entities to invest in robust and reliable reporting systems. For credit providers, the system has limited usefulness, and the attitude of consumers and privacy advocates towards it ranges from suspicion through to downright hostility.

Reform of Australia's credit reporting system presents an opportunity for the concerns of all stakeholders to be addressed, with a view to developing a credit reporting system that is effective, reliable and trusted and which operates to the genuine benefit of both credit providers and consumers.

With a view to assisting in the promotion of such an outcome, COSL makes the observations and suggestions below.

Significance of the credit reporting reforms and their implications

The proposed reforms, on one view, merely expand the categories of information available to credit reporting agencies and their clients. While this may be true, the reforms are not merely an 'evolutionary' development or refinement of the credit reporting system that has operated in Australia since 1990.

On the contrary, these reforms will mark the introduction of a fundamentally different approach to credit reporting in Australia. The reforms will begin a process that will

transform the entire credit reporting system, and every part of the credit reporting process is likely to change in some way.

As a result of the changes, it is likely that some of the concerns with the current system (eg data quality) will recede, and others (some of which have probably not yet even been anticipated) are likely to take their place. The fact that information about an individual is held by a credit reporting agency will become a fact of life for most of us, and the mere existence of an extensive credit reporting file will not have the same ability to cause alarm as it does today.

To the extent that the new credit reporting system will be a 'positive' system, i.e. it will now include information about borrowers' 'good behaviour' in relation to their repayment history, in addition to the negative information about defaults that has been reported to date, the fact that information about a customer is given to a credit reporting agency should no longer be automatically regarded as an undesirable thing that is prejudicial to the customer – as it inevitably is under a system of negative reporting. Both now, as the reforms are being developed and implemented, and in the future, as the new system becomes established, it will be possible and indeed necessary to take a more balanced view of credit reporting than has been common in the past.

At least some of the debate about the current proposals for credit reporting reform appears to be based on the (often unspoken) assumption that as a matter of principle it will continue to be undesirable for any information at all about a borrower to be reported to a credit reporting agency, and that it will invariably be in a person's best interests to ensure that credit reporting agencies hold as little information about them as possible.

Contributions to the debate made from this perspective not only miss the point that the system we are contemplating is a new and quite different one, but they also tend to overlook the benefits that could potentially be enjoyed by the majority of individuals whose credit history is unimpaired and who have demonstrated that they are able to use credit and manage it without giving rise to any concerns.

While there are clearly areas of legitimate concern about some of the risks inherent in the proposed reforms, we think that those concerns will only be accurately identified and satisfactorily addressed if they are approached with somewhat different mindset from that which has to date characterised the debate about credit reporting in Australia.

Key issues for any credit reporting system will include:

- data quality and integrity
- timeliness of reports and currency of data

- community awareness
- appropriate interpretation and use of data
- correction of errors
- data protection and privacy

Under a system of negative reporting, individuals may in practice avoid the risks which are associated with these key issues by simply ensuring that credit providers have no cause to make a report concerning them to a credit reporting agency. With more comprehensive reporting a more complex set of considerations apply, and it becomes more important for individuals to be at least generally aware how credit reporting operates and to have some understanding of the ways in which their own behaviour may affect the way in which credit providers will deal with them in future.

Summary

We have prepared this submission having regard to the fundamental difference between the current negative reporting system and the proposed more comprehensive system. In doing so, we have been able to adopt a more balanced approach to credit reporting issues than in the past.

1. Reporting of repayment history

At least some of the current debate concerns the extent to which information in relation to repayment history should allowed to be or required to be adjusted before being reported – for example, to allow for innocent delays in the payments system, to reflect agreed variations to the original loan terms (whether for hardship or otherwise), or just to allow one or two days of grace as a concession to borrowers.

This confuses repayment history with default listings, and is an example of the historical ‘negative reporting’ mindset being applied to the more comprehensive reporting regime that is now to be established in Australia.

Default listings are a familiar part of the current credit reporting system and will continue to be a feature of the reformed system. A default listing about a customer can only made if certain requirements are satisfied, and once made is clearly an adverse reflection on the customer’s credit worthiness. Repayment history, on the other hand, is simply a month by month reporting of the timeliness of payments made by the customer and in itself is neither beneficial nor prejudicial.

Variations to repayments (for hardship or other reasons): Consistent with the principles put forward in the preceding paragraphs, we would expect that a customer’s repayment history should be reported after having taken into account any variations to

the terms of the contract that the credit provider and the customer have agreed – in other words, the required timing and amount of each repayment are those which have been agreed by the borrower and the lender in the credit contract, and in any subsequent variation to the credit contract.

Variations to the contract may occur in cases where the customer is experiencing temporary financial hardship, or in any number of other circumstances, but the result should presumably be the same as far as reporting of repayment history is concerned – namely that, from the time when a lender and a borrower agree that the repayment arrangements under a credit contract are to be varied, the customer's repayment history should be reported against their repayment obligations at the time of the repayment – ie as varied.

If the parties have agreed to vary the contract so that the times at which repayments are due and/or the amounts of the repayments have changed, it would be nonsensical to report repayment history against the repayment obligations as they stood before they were varied, or against any other repayment schedule.

Sometimes borrowers who are experiencing difficulties act promptly and appropriately and seek hardship variations that are wrongly refused by their lenders, and in these cases the remedies available to the customer should include the right to have their repayment history corrected back to the date when the terms of the hardship variation would have been agreed had the lender responded appropriately to the original request for a hardship variation

'Innocent' late payments (for reasons unrelated to the borrower and beyond the borrower's control): It is true, as other commentators have pointed out, that a customer's repayment may sometimes be received late by the lender through unforeseen circumstances beyond the customer's control and which they could not have taken any practical precautions to avoid. The question is whether late payments of this kind should be an exception to the principle that repayment history should reported strictly on the basis of the actual time of payment.

We tend to the view that circumstances of this sort, which are unforeseen and beyond the control of the customer, are equally likely to affect all customers, but are unlikely to occur frequently enough on any individual's credit record to affect a lender's overall assessment of their credit history or creditworthiness.

However, we have an open mind on this point and stand willing to be corrected if there is evidence that contradicts our view either now or in the future. There are clear

benefits from waiting and taking regulatory action once problems are identified, rather than trying to guess how to deal with issues that might never actually arise. By taking action at that time, once problems have emerged in practice, rather than now when we can only speculate as to the nature and extent of what any problem might be, we will have the benefit of information and experience to help ensure that the action is targeted, proportional and likely to be effective.

The **reasons** for the views we have expressed above relate to the principles of openness and transparency.

The integrity of the system requires it to contain an objective record of borrowers' actual repayment histories, reported in a timely and consistent manner. There are many reasons why a customer's payment may be late, and a repayment history database may not necessarily be the most appropriate place for all of those reasons to be identified and recorded. If certain late repayments were to be excused, that is to say, regarded as not being late, it would appear that:

- the customer's record would show that the payment was made on time, when this was actually not true;
- apart from issues about the factual accuracy of the record, its integrity would be further challenged by the potential for concerns about the consistency with which such exemptions were managed in practice;
- excluding late payments for apparently meritorious reasons will make credit reports factually inaccurate and/or incomplete, and may also serve to conceal important information or trends and may lead to mis-interpretation of credit reports; and
- every exemption, allowance or concession made in relation to the reporting of a late repayment effectively diminishes the value to all customers of repayments that they do make on time, and devalues the overall impact of more comprehensive credit reporting by making it impossible to identify borrowers who truly do have a faultless repayment history.

Summary and recommendation

In deciding what should be included in the repayment history database, the purposes for which the data is to be collected and used should be kept clearly in mind, as should the existence of the other permitted databases (such as the default reporting database), with a view to:

- (a) ensuring that data is collected and stored in the most appropriate of the various available databases, and

(b) avoiding, or at least minimising, the inclusion in any database of additional data that would compromise the practical usefulness of that database as a means of achieving or being used for its intended purpose (it may be that, at least in some cases, assessment of the reason for a late payment and its implications should most appropriately take place, if required, outside of and separately from the credit reporting process).

Given the concern that still apparently exists about the reporting of repayment history after a loan agreement has been varied (for any reason, of which hardship is just one), we think it should be put beyond doubt by an express provision in the legislation. We believe the correct, and only logically defensible, approach is as set out above.

3. Understand the relevance of overseas credit reporting experience and keep it in perspective

Opponents of more comprehensive credit reporting in Australia have sometimes given examples of abuses or failures of positive reporting in the USA to support their position. We consider, however, that the credit reporting model being proposed in Australia is unlike the one that operates in the USA and that there are other critical institutional differences between the USA and Australia (for example in the legal and regulatory framework, market structure, types of financial products available etc). Given that there are numerous other countries that have had extensive practical experience with positive or more comprehensive credit reporting, the USA is probably one of the less helpful places for us in Australia to look for constructive practical guidance and instruction.

Summary and recommendation

We should seek to identify the countries that have had experience with credit reporting which may be relevant to the reforms currently proposed in Australia, and seek to take full advantage of any experience and knowledge that may be helpful in the context of the credit reporting reforms to be implemented in Australia.

4. Practical impact of the proposed changes to the credit reporting system:

The proposed changes to the credit reporting system are likely to lead to significant changes in the process by which customers apply for and receive credit, assessment of credit applications by credit providers, loan administration, and action taken by credit providers upon default.

One important change will be that a person's application for credit will be assessed using credit reporting information which is specifically about them, unlike the current system under which the information available to credit providers is effectively limited to credit information about a group of people who are, in certain specific respects, like the applicant. As a result credit decisions should be better informed and more accurate, with less risk that credit will be offered to applicants who are unable to afford it.

This in turn will mean that the identity of the people who get credit will change. Some of those who would have been given credit under the current system of credit reporting will be declined credit under the new system, while others, who would not currently have been given credit, are in future likely to be able to obtain it.

Whether this will lead to a change in the total amount of credit provided in Australia remains to be seen, but in this context the total amount of credit actually being provided is less important than the quality of the credit being made available. It is quite likely that factors other than credit reporting, such as economic conditions generally, interest rates, expectations, consumer confidence, etc. will be the main determinants of the quantity of credit being offered or sought at any given time.

Fears have been expressed that once more information about applicants is available from credit reporting agencies, it will be easier for credit providers to identify applicants for credit who have impaired credit histories, who are then likely to be charged higher interest rates than the rates available to borrowers generally. While this is already an issue with the current system of credit reporting, there is concern that it could become a bigger issue after the introduction of more comprehensive credit reporting.

Often, but by no means always, customers with impaired credit records are also socially or economically disadvantaged, and it may on the face of it seem inequitable that the customer who is paying the highest price for the provision of a service is the poorest and the least able to afford it.

This is not a simple issue. It has a number of dimensions, such as those briefly mentioned below, and on one view the proposed reforms to the credit reporting system will lead to more equitable outcomes than those we have at present. We make the following observations:

- In a free market credit is priced according to risk. Risk is not the only factor that determines the cost of credit but it is an important one. It is interesting to note that insurance is also priced according to risk (eg no-claim bonuses, age loadings on motor vehicle insurance, higher premiums on property insurance in areas with

more crime etc) and risk-based pricing appears to be uncontroversial. It is not clear why risk-based pricing for credit should be regarded as any less acceptable.

- If credit is required to be provided at the same price to all customers, regardless of risk, the result will be either:
 - that the less risky customers (ie the 'good' customers with unimpaired credit histories) will subsidise the riskier customers by paying more for credit than they would otherwise, which is hardly an equitable result for them, or
 - in order to be able to offer the most competitive rates to 'good' customers, lenders will simply not lend to riskier customers, creating issues relating to 'financial exclusion'
- An individual with an impaired credit history will never be able to restore their credit record if they are not given the opportunity subsequently to demonstrate that they have learned to manage credit properly. Allowing them access to higher priced credit allows them to do this without being subsidised by the majority who have unimpaired credit records, and once they have demonstrated that their problems with credit are genuinely behind them, they will be able to get access to credit again at 'mainstream' rates
- There is a common misconception that credit provided at the highest price is the most profitable for the credit provider. This is not necessarily the case. Customers who are able to get cheaper credit will not generally opt for higher priced credit, everything else being equal. For customers who end up with the most expensive credit, it is usually the best they can get owing to the lender's assessment of the risk of lending to them. For the lender, the additional revenue generated by the higher interest charges does not simply represent higher profits (although some part of it could be reflected in the lender's additional return for engaging in higher risk lending), but rather tends to be absorbed by the higher losses typically associated with lending to higher-risk customers, as well as the higher than average costs of managing these customers' accounts (which have a higher than average incidence of defaults and arrears and which are more likely to require action for recoveries and enforcement). There is no evidence that lenders who service the 'sub-prime' sector of the market with high-cost credit products are earning 'super-profits'.

Summary and recommendation

The proposed credit reporting reforms will inevitably be associated with some significant changes in the credit industry more broadly. Concerns have been expressed that credit providers may, unless prevented from doing so, be able to take advantage of the enhanced range of credit reporting information that will be available to impose unfavourable terms on vulnerable customers, including those with impaired credit histories and limited options now open to them to meet their credit needs.

Risk-based pricing of credit is capable of generating positive outcomes for all stakeholders, and is not of itself evidence of market failure requiring regulatory action. However the provision of credit to vulnerable individuals should be appropriately monitored to ensure early detection of any abuses of the opportunities provided by more comprehensive credit reporting.

5. Importance of close monitoring of implementation

Despite being one of the last countries in the developed world to adopt a more comprehensive credit reporting regime, which is taken for granted in most other developed economies, in Australia proposals for reform in this area have been strongly and consistently resisted over a long period of time.

The passage of time with opportunities for discussion and debate about potential reforms, and even the events of recent years which demonstrated the consequences of the inappropriate over-supply of credit have persuaded some former opponents of comprehensive credit reporting of its potential value. However there is still substantial continuing opposition to it and nowhere near a consensus that would enable the new credit reporting system to be introduced with bipartisan support.

The new system will therefore have to be developed and implemented under the scrutiny of stakeholders who are opposed to it as a matter of principle, who have serious reservations about its usefulness and who remain to be convinced that it will not be abused and that customers will not be put at even greater risk than they are at present of inappropriate selling of credit.

Summary and recommendation

It will be very important to ensure that the implementation of the new credit reporting system is closely and transparently monitored, and that all reasonable concerns are fully considered and investigated and appropriate action taken where issues are identified.

In order for the new credit reporting system to operate effectively it will be essential for it to be trusted by the community generally and borrowers in particular, and for them to have confidence in it and the organisations involved in running and using it, and for the outcomes it produces to be respected.

If stakeholders who are suspicious from the outset of the reforms to the credit reporting system are given any grounds for doubting the integrity of the new system or the rigour of the process by which it is introduced, they will voice their concerns loudly and noticeably. It is likely that this in turn could create doubt and uncertainty in the public mind about the new system, with the result that it comes into existence already under a cloud of public reservations and suspicion which could take some time to dispel and which could easily restrict its usefulness and limit the benefits which it capable of generating.

EDR arrangements

Credit providers and credit reporting agencies will be required to be members of EDR schemes recognised by the Information Commissioner under the Act.

As part of the recent reforms to the regulation of consumer credit generally, all credit providers and intermediaries involved in the provision, management or collection of regulated credit are subject a licensing regime and must be members of an EDR scheme approved by ASIC.

At present COSL and FOS (the Financial Ombudsman Service) are the EDR schemes which ASIC has approved.

Summary and recommendation

In the interests of simplicity, efficiency and consistency the Information Commissioner and ASIC should work together to ensure that EDR coverage of consumer credit and credit reporting is integrated and seamless so that it is clear to consumers what they

should do if they have a complaint, and the roles and responsibilities of EDR schemes are clear and consistent across the areas of credit reporting and consumer credit generally.

The requirements of the Information Commissioner when assessing an EDR scheme for recognition for the purposes of credit reporting should take into account and be consistent with ASIC's requirements for approved EDR schemes in relation to consumer credit. Duplication and/or inconsistency between ASIC and the Information Commissioner must be avoided

6. Definition of consumer credit

The definition of 'consumer credit' in the draft credit reporting provisions (s180 and s193) is different from the definition used in the National Consumer Credit Protection Act.

The reason for this is not clear to us and we regard it as highly undesirable that there be different definitions.

Summary and recommendation

Amend the draft credit reporting provisions so that the definition of consumer credit is identical in every respect to the definition in the NCCP Act

7. Drafting points – '*repayment history information*'

We make 2 comments on the drafting of s187(1)(a):

- We submitted earlier in this letter that repayment history should be assessed against the repayments which the lender and the borrower have agreed will be made, and that if there is an agreed variation to the amount and/or the timing of repayments, then it is the amended repayment schedule that should form the basis of repayment history reports. In our view there is no other sensible approach that can be taken and we are surprised that it is an issue. However we would favour an amendment to the legislation for this purpose if there remains any uncertainty. If such an amendment is made, it might well be made in this section of the Act.

- The section refers to 'monthly payments'. In some credit contracts borrowers agree to make payments at other intervals, eg fortnightly and provision should be made for the legislation to reflect this.

We would prefer not to give evidence at a public hearing, but would be happy to provide any further information or other assistance the Committee may require.

Yours sincerely

Raj Venga
Chief Executive Officer and Ombudsman