Financial Services and Credit Reform

Green Paper

Submission to the Australian Treasury

July 2008

1. MORTGAGES, MORTGAGE BROKING AND NON-DEPOSIT TAKING INSTITUTIONS AND OTHER CREDIT PRODUCTS

The Green Paper suggests that the Commonwealth proposes to assume responsibility for mortgages, including associated advice, by incorporating this type of credit into the financial services provisions under Chapter 7 of the *Corporations Act*.

ANZ supports the national regulation of credit and believes it should not be limited to just mortgage lending and advice, but cover all forms of credit, including credit cards and personal loans, as was recommend by the Productivity Commission's (PC) final report on the Review of Australia's Consumer Policy Framework. Further, the method of regulating credit at a national level should be to retain the Uniform Consumer Credit Code (UCCC) as a self standing set of requirements within the broader financial services regime, and this was also supported by the PC.

Why should all credit be regulated at a national level?

The market for credit, including mortgages, credit cards and personal loans is now national with consumers shopping for these products without regard to State and Territory borders. This shift to a national market for credit has been facilitated through greater use of internet banking, phone banking as well as the availability of online applications. For example, a customer can apply for an ANZ credit card or personal loan over the Internet, or customers can shop for the same products at any of our over 820 branches located all around Australia.

The Green Paper suggests two reasons why the Commonwealth Government is considering limiting the national regulation of credit to mortgages:

- Firstly, mortgages represents the overwhelming majority of the consumer credit market at 86 per cent of all consumer loans by amount; and
- Secondly, that there may be a legitimate and ongoing role for the States and Territories to continue regulating other forms of credit because the use of credit facilities may be affected by regional differences which may need to be accounted for in the regulatory regime applying to these products.

While mortgage lending does represent the vast majority of the credit market by volume, it is also important to recognise that the average Australian consumer is more likely to hold credit products such as a credit card or personal loan, rather than a mortgage. According to data from the Roy Morgan Research Finance Monitor, in March 2008 there were 10.125 million credit card customers, 2.062 million personal/other loan customers and 5.176 million mortgage customers.[1] Based on this

[1] Sourced from data compiled by Roy Morgan Research Finance, as per ANZ Quarterly Management Definitions

data, mortgage customers represent less than 24 per cent of the Australian population[2],[3] compared to 48 per cent of the population who hold at least one credit card. So in the event that the Commonwealth simply regulated mortgage credit it would cover a significant portion of the market by dollar value, but would protect only a relatively small portion of the Australian population who purchase credit products.

While there is currently variation in the regulation of credit between jurisdictions, ANZ believes that this is largely a result of State and Territory Governments using their fair trading legislation as a means to drive consumer protection initiatives which do not have national support. It has not resulted from the need to adapt to regional differences as suggested by the Green Paper.

An example of how one jurisdiction is circumventing the intention for there to be one uniform set of credit regulation under the UCCC was the introduction of new obligations for credit card limit increase offers in the Australian Capital Territory (ACT). In 2002 the ACT introduced obligations on credit card providers to ask existing customers for new information on income and expenditure to assess manually whether a credit limit increase could be granted, rather than relying on the automated behavioural scoring tool developed and used by banks.

ANZ's analysis of our credit card customer base has shown consistently that behavioural scoring is a significantly more reliable assessment method than manual assessment of a customer's financial information. The major weakness of manual assessment is that it relies on the accuracy and currency of information provided by customers as opposed to a behavioural history.

The ACT's amendment does not reflect an attempt to address specific regional differences and puts it out of step with other jurisdictions. It added a further step to the process of granting a customer a credit card limit increase and for a relatively small segment of ANZ's customers. This has added costs and reduced efficiency but not for a discernable customer benefit.

The chart below shows credit card delinquency rates for the ACT compared with the rest of Australia. While data for the ACT is more volatile than the rest of Australia due to the small population, the chart shows that credit card delinquency rates in the ACT have generally moved almost identically to the rest of Australia. This suggests that the ACT's credit limit increase restrictions have had no observable impact on ACT residents' credit performance.

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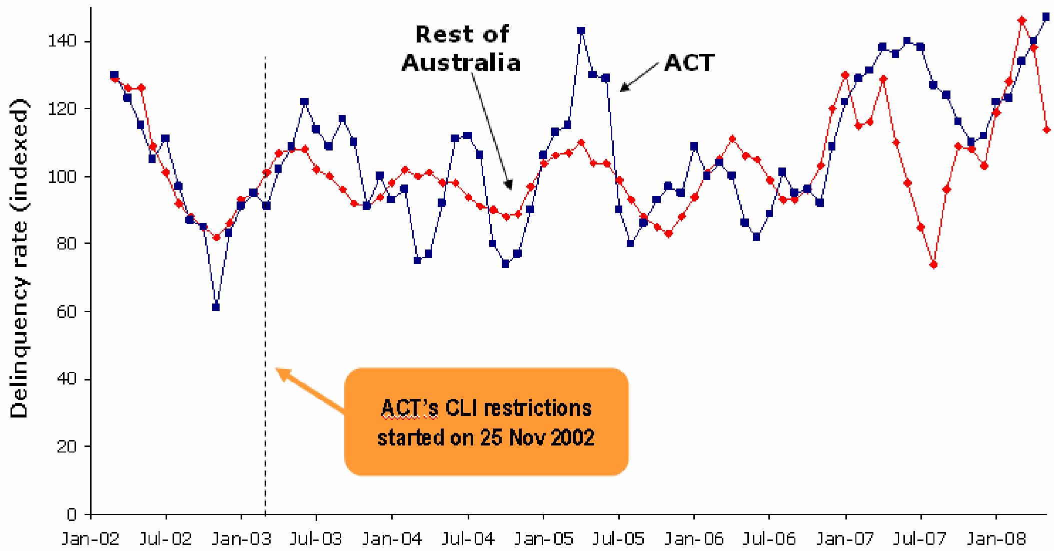
2 Estimate of the Australian population as at end December 2007 is 21.1086 million

3 Australian Bureau of Statistics, *3101.0 Australian Demographic Statistic—December 2007*, 24 June 2008

Delinquency rates of ANZ credit card customers in ACT and rest of Australia



Note: Delinquency rates show the percentage of customers 90 or more days past due in the last 12 months. Data for ACT and Rest of Australia has been indexed to give an average of 100 for 6 months prior to November 2002.

Source: ANZ Bank - Credit Cards Australia

On the basis of the information above, ANZ believes that the reasons outlined by the Green Paper alone are not sufficient to justify a carve-out of specific areas of credit to remain with the States and Territories.

If the Commonwealth Government selectively regulated some credit and left other areas with the States and Territories, ANZ and other credit providers would be subject to increased regulatory burden. Credit providers would face differing regulatory regimes for specific types of credit and credit would have nine regulators and policy makers as opposed to the current eight.

Moreover, leaving regulation of credit cards and personal loans with the States and Territories would do nothing to rectify the existing shortcomings of the UCCC. The UCCC has been widely criticised for its inability to adapt to changes in the market place in a timely manner, which has resulted in gaps in its coverage. Examples of this are responding to issues such as bills of exchange and the regulation of finance brokers.

Finally, ANZ notes that in recommending that the regulation of credit be transferred to the Australian Government, the PC final report on its Review of Australia's Consumer Policy Framework stated that the new national credit regime should "*cover all consumer credit products and all intermediaries providing advice on such products...*".[4]

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[4] Productivity Commission, *Review of Australia's Consumer Policy Framework—Final Report*, 30 April 2008, p. 107

How should credit be regulated at the Commonwealth level?

Should the Commonwealth Government choose to regulate some, or all, areas of credit at a national level, ANZ believes that this should be done in the manner proposed by the PC in its Final Report on the Review of Australia's Consumer Policy Framework.

Recommendation 5.2 of that report stated that responsibility for the regulation of credit providers and intermediaries providing advice on credit products should be transferred to the Australian Government, with enforcement undertaken by the Australian Securities and Investments Commission (ASIC).

However, rather than regulating credit under Chapter 7 of the *Corporations Act* the PC recommended that a new national credit regime should "*retain the Uniform Consumer Credit Code (UCCC) as a self standing set of requirements within the broader financial services regulatory regime…*".[5]

ANZ supports this recommendation because of the differences between credit and other financial services. As noted by ASIC in their submission to the PC's Draft Report on its review of Australia's Consumer Policy Framework:

"*The consumer and compliance risks that arise in the context of credit products are different from, and in many respects less significant than, the risks to retail investors arising from investment products. A consumer who enters a credit contract holds the lenders funds and makes long-term promises to repay in the future, with interest. In contrast, when a retail investor acquires an interest in an investment product, it is the product provider that holds the investor's money and makes the long-term promises about its management and repayment. In addition, with investment there is a very large range of different permutations of risk, cashflows, taxation, capital appreciation and potential financial loss for the investor to consider.".* [6]

Chapter 7 of the *Corporations Act* focuses on disclosure and the adequacy of training for those providing advice to ensure that a customer is aware of the risk associated with particular financial products. On the other hand, the UCCC has a core focus on 'truth in lending' and informing consumers about the terms of a credit contract (including interest rates, fees and charges) prior to its purchase. As such, ANZ believes that it is important that these differences are maintained in any transition of the regulation of credit to the Commonwealth.

ANZ is also concerned that the industry, and therefore consumers, do not incur additional compliance costs as a result of a transfer of regulation to the

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[5] Productivity Commission, *Review of Australia's Consumer Policy Framework—Final Report*, 30 April 2008, p. 107

[6] ASIC, *Productivity Commission Review of Australia's consumer policy framework: Second ASIC Submission*, February 2008, p. 7

Commonwealth Government, and this method would ensure that transitional and ongoing compliance costs for industry are kept to a minimum.

2. TRUSTEE CORPORATIONS

ANZ Trustees Limited (ANZ Trustees) is a wholly owned subsidiary of ANZ. As a statutory trustee company, ANZ Trustees is authorised to act under the trustee company's legislation of each Australian State and Territory (except Tasmania) as:

- An executor of Wills;
- A trustee of charitable and non-charitable foundations;
- A trustee of statutory common funds;
- An investment manager of common funds and foundation assets; and
- A provider of other trustee services.

ANZ Trustees provides services in estate planning, trustee management, asset management and administration to a broad range of Australian individuals, corporations and charitable institutions.

As one of the leading trustee organisations in Australia, ANZ Trustees currently administers over $2.4 billion in assets and has operated for over 100 years.

ANZ Trustees supports the introduction of uniform national trustee legislation by the Commonwealth (Option 1 in the Green Paper). Legislation that differs by State and Territory adds to the complexity and cost of providing trustee services, which is not in the interest of consumers, beneficiaries or charities.

The proposed regulatory arrangements of Option 1 will deliver benefits to consumers. The extent of the efficiency benefits gained by the industry and our customers will depend on the extent of legislation enacted, the regulator chosen and level of prudential oversight that is adopted and this is discussed below.

<u>Regulation of trustee companies</u>

Nationally consistent regulation

ANZ Trustees supports the rationalisation of licensing and reporting requirements across jurisdictions in order to enhance consistency in licensing requirements and reduce inefficiencies and cost in the conduct of trustee business.

One regulatory and licensing regime, overseen by a well resourced regulator, would streamline regulation and make it easier and more cost effective for trustee companies to conduct business interstate. This approach would ultimately facilitate a more competitive national market for trustee services, which would benefit customers through enhanced disclosure and protection arrangements and lower costs.

The current regulatory framework requiring state-by-state regulation reduces the efficiency of an organisation that operates nationally through the increased complexity of staff training, complexity of compliance effort and the associated professional advice and administration costs. It is also restrictive in allowing new players to enter the market and does not promote competition, all of which results in higher costs for the consumer.

In particular, the key issues affecting ANZ Trustees from the current compliance and licencing framework are:

- **Increased complexity of compliance function**: lack of uniformity particularly in the area of the various trustee companies' acts adds to the complexity of compliance registers and compliance monitoring arrangements. Compliance registers must not only reflect the differences in substantive law across jurisdictions, but also the circumstances in which the laws of one jurisdiction apply over the laws of another.

- **Increased complexity of compliance training**: differences in laws also add length and complexity to compliance training which must communicate the compliance requirements of a number of legislative regimes.

- **Compliance risks**: a lack of legislative harmonisation can increase the risk of compliance breaches because:

    - The compliance requirements of one jurisdiction may be confused with another;

    - Compliance requirements are never fully understood because the training material is necessarily complex; and

    - Changes to one state or territory's legislation are more likely to be overlooked when it is only one part in a patchwork of State and Territory legislation.

- **Increased professional advice costs**: the complexity of complying with multiple legislative requirements can increase reliance on professional advisers which in turn increases the operational costs of an organisation.

Uniform national trustee legislation by the Commonwealth should provide a consistent approach to:

- Conditions imposed on licence for individual trustee companies

- Fees

- Format of quarterly/half yearly activity statements

- Reserve requirements. For example, in Victoria a trustee company must keep a reserve fund. In Queensland there is a deposit made in the name of the Treasurer
- Restrictions on shareholdings and transfer of shares
- Liability of directors
- Authorisation of a trustee company to act as executor/administrator by the executor named in the will or person entitled to letters of administration. Provisions differ by State and in South Australia there is no provision.

However, we note that it is not proposed that all of the regulation of trustee companies would be assumed by the federal body. Legislation other than the trustee company Acts which is state-based as well as common law rules would still apply to trustee companies in each state and would continue to be regulated by state bodies as at present.

<u>Option 1</u>

ANZ Trustees supports a shift to licensing and supervision of trustee corporations by ASIC.

ASIC already regulates many of the activities of trustee companies in relation to their Australian Financial Services Licences (AFSL) and non-traditional trustee company activities. ASIC is therefore familiar with the activities of trustee companies and the industry is accustomed to working with it as a regulator. For example, ASIC regulated activities undertaken by the business include its Responsible Entity activities, custodial activities, dealing in financial products and providing personal advice on financial products. The recent regulation of unlisted unrated debentures provides an example of ASIC working effectively with the trustee industry.

ANZ Trustees agrees that some standards or requirements could be adopted from the custodial or depository services under the AFSL regime. This is a good example of where efficiencies could be gained from having ASIC as a regulator.

We also believe that a suitable level of prudential oversight can be achieved by using the framework applying to existing AFSL holders. ANZ Trustees holds an Australian Financial Services Licence [No. 234528] which provides the following Authorisations:

- Provide financial product advice for a range of financial products to retail and wholesale investors;
- Deal in a range of financial products for retail and wholesale investors;
- Provide custodial or depository services to retail and wholesale investors; and
- Operate registered managed investment schemes to retail and wholesale investors.

The business is also subject to ANZ policy and obligations by virtue of being a subsidiary of an ADI regulated by APRA.

Option 2

ANZ Trustees does not support regulation by APRA because the compliance costs and competitive neutrality issues associated with prudential regulation would be significantly greater than for a consumer protection/disclosure regime. For example, trustee companies holding an AFSL would be regulated by both ASIC and APRA, which would substantially add to cost and complexity and reduce competition by effectively restricting entry to the industry.

The likely standards to be administered under an APRA prudential regime (as listed in the Green Paper) are standards that are currently overseen by ASIC in relation to some trustee company activities. We would prefer ASIC's oversight be expanded to all trustee company activities rather than having two regulators.

Dispute resolution

Consistent with a move to a consumer protection regulatory approach, ANZ Trustees supports the Green Paper's suggestion for a cost effective and timely dispute resolution service in relation to trustee services. Current arrangements suffer from uncertainty relating to questions of jurisdiction of dispute resolution agencies.

ANZ Trustees' customers have access to ANZ's dispute resolution policy that includes recourse to our independent customer advocate and to the Financial Ombudsman Service – a third party external dispute resolutions service.

As some matters within the trustee business will remain under State jurisdiction, there will still be some matters which cannot be referred to an external dispute resolution mechanism. In these cases recourse is to Attorneys General in each state and the courts.

Fees and charges

The new national legislation should introduce reforms in relation to fees and charges. Currently, trustee company fees are regulated on a state-by-state basis in relation to trustee services offered, with a cap on fees that can be charged varying by state and by product.

Different fee levels between and within each state is confusing for consumers and it does not readily enable a consumer to compare fees for services. Further, in some States and service areas the caps have been set at a level that makes it uneconomic level for trustee companies to continue to provide certain services.

This has already resulted in some trustee companies restricting the types of business and services they offer, thus reducing competition and consumer choice.

An example of this is the income commission regime for charitable trusts in NSW. This sets a low cap on the fees that can be charged in NSW and makes administering charitable trusts uneconomic on all but the largest trusts.

ANZ Trustees would prefer that fees for trustee services be set by the market. ASIC regulation of trustee companies would ensure greater transparency in the disclosure of fees which would in turn enhance competitiveness in relation to fees for service by providing better information to consumers.

3. MARGIN LENDING

ANZ provides margin loans to over 13,000 customers. Those customers are predominantly retail.

The greatest risk to consumers taking out a margin loan is in single stock or concentrated exposures. Lending exposure to illiquid and small cap stocks is only responsible against modest loan-to-value ratios (LVRs) or within a diversified portfolio. As a result ANZ strongly supports and recommends diversification as an investment principle.

ANZ margin lending is mostly for diversified portfolio investing and while LVR ratios vary across the industry, ANZ takes a conservative approach with an average LVR of 40 per cent.

If margin lending is to be regulated, regulation should be light touch and not overly complicate the product or regulatory regime. The policy issues that should be addressed include:

- Simple, brief disclosure that is aimed at customer understanding and knowledge of the product features, benefits and risks of margin loans
- Recognition that margin lending is a distinct type of credit because the customer has the potential to lose equity in the underlying asset
- A distinction between sophisticated investors and retail customers
- Support for diversification as an investment principle.

ANZ believes that if the Commonwealth Government decides further regulation is appropriate it should be done as outlined in Option 2 of the Green Paper. This would amend Chapter 7 of the *Corporations Act* to define margin loans as a financial product, which would bring margin lending under the existing FSR regulatory framework.

The losses associated with margin lending relate to a fall in the value of the assets against which the funds are borrowed; risk is related to the asset and a drop in value can trigger a 'margin call'. As noted in Section 1 ensuring the appropriate regulatory framework is applied to the various types of credit and lending products available is an important policy objective. Therefore, while we support the regulation of credit under the UCCC arrangements being shifted in their current form to the Commonwealth, we agree that margin lending is more appropriately regulated under the FSR regime. This is because it:

- Recognises that the issues which have emerged recently may relate to a lack of understanding of the product and the risks associated with the product, and this is consistent with the purpose of Chapter 7
- Has an advice regime that could result in quality advice, better explained by people qualified to provide financial advice
    - ANZ would also support measures to mandate disclosure in order to improve retail borrowers' understanding of margin loans. For example, an upfront 'key issues' type disclosure which simply and briefly describes the product, outlines the risks and details the costs
- Could provide measures to enhance disclosure requirements, including to make disclosure easier to understand, that warns of the risk of losing equity in the underlying asset and that details in a simple manner other features of the product (e.g. who owns the shares, margin calls etc)
- Allows customers to choose the level of advice they require before entering into the product
- Recognises that the product is essentially a vehicle to facilitate a specific type of investment which has associated risks
- Utilises an existing national legislative framework which is appropriate for this particular type of credit product, rather than developing a new framework.

ANZ would also support an opt-out provision for sophisticated, high net worth investors. For example, ANZ Private Bank sells margin loans through our bankers and not our financial planners. Their customers are aware of the risks and do not wish to be burdened with additional hurdles to obtain investment products they understand.

ANZ concurs with the Green Paper's assessment that Option 3 would create regulatory duplication for businesses offering margin loans and other financial products which would create inefficiencies for businesses that would be required to obtain separate licenses for different products and develop disclosure documents for those products under different regimes. Option 3 would not create a superior outcome than that possible under Option 2, but it would create significant inefficiencies.

4. DEBENTURES

Esanda Finance Corporation Ltd (Esanda) is a finance company, and a wholly owned subsidiary of ANZ. It is one of Australia's largest asset-based finance companies and it is the only debenture issuer which is owned by an ADI.

Esanda is Australia's largest supplier of fixed term debentures and investments are used to fund the lending operations of Esanda. Esanda is Australia's leading provider of vehicle and equipment finance and fixed interest investments, with total assets in excess of $14 billion.

The Green Paper proposes that all debenture issuers 'carrying on an investment business who regularly offer securities to retail investors and for whom such issues constitute their main source of funding' be required to obtain an Australian Financial Services Licence (AFSL).

We recognise the Green Paper's recommendations seek to address the recent failure of property development companies. However we would also want to differentiate Esanda, as a leading provider of debentures and the only one which is a wholly owned subsidiary of one of Australia's largest ADIs, from other debenture issuing companies.

The entity collapses which are the focus of the Green Paper's options for reform (and which have been the focus of ASIC's recent consultation papers and guidelines) utilised business models where retail funds were invested in speculative property developments, often with retail investors ranking behind other funders of the debenture issuing entity (e.g. Westpoint).

In light of the recent collapses, ANZ supports legislative reform to provide protection for retail investors where investor funds are utilised for speculative purposes. However, we consider that a 'one size fits all' approach is not appropriate if it requires all debenture issuers to obtain an AFSL regardless of the nature and relative risk of the issuing entity and product and the utilisation of investor funds.

<u>Esanda's rating and business model</u>

Esanda raises funds through the issue of debentures to the retail market, ANZ Group inter company lending and by issuing commercial paper. The relative proportions of its funding vary from time to time but, on average, approximately 65% of its funds are sourced from debentures.

Standard & Poor's (Australia) Pty Ltd has rated Esanda and its short term investments (terms of one year or less) as A1+ and long-term investments (terms greater than 1 year) as AA. These ratings indicate very strong capacity to pay interest and repay principal in a timely manner and are as high as those for Australia and New Zealand Banking Group Ltd and its term deposits. To our knowledge, no other debenture stock issuer has as high a rating as Esanda.

Esanda's business model differs from the business model utilised by property development issuers in a number of material respects:

1. Esanda uses funds raised from the issue of debentures to provide asset finance to individuals and small to medium businesses operating in a range of industries in Australia. Financing is offered predominantly for vehicles, plant and equipment and farm machinery. Asset finance takes the form of leases, hire purchase agreements, bailment plans, receivables financing, chattel mortgages and secured loans where the finance is secured by the asset. Esanda has over 250,000 lending customers.

2. Often property development companies have no regular cash flows until the end of the project when sales occur and the company's return on investment is unknown until the date of the sale. In contrast, most of Esanda's loans require monthly repayment which not only improves cash flow but also allows us to more closely monitor our lending portfolio and manage our risk where a customer defaults (including exercising our right to repossess the asset the subject of the finance).

3. Unlike the Westpoint business model where investments were secured against speculative property investments on terms where investors ranked behind wholesale funders, the assets which support Esanda investments are tangible property. The conservative ratios and investor priority position required by Esanda's trust deed (discussed below) mean, in effect, that not only does the asset backing provide readily realisable security but Esanda investors also rank ahead of other creditors.

<u>Existing regulation of Esanda and its debentures</u>

Trust deed

In accordance with the Corporations Act (the Act) Esanda's debentures are governed by a trust deed dated 9 November 1955 (as amended). Permanent Nominees (Aust) Limited is the appointed trustee. The trust deed contains provisions to protect investors and the trustee supervises Esanda's compliance with those provisions. The Act requires quarterly reviews of compliance with the trust deed, including in Esanda's case, its trust deed ratios and other specific requirements of the Act.

Some important investor protections in Esanda's trust deed are:

- Shareholder and asset—investment ratios - the amount of debentures on issue at any one time must not exceed the lesser of 12 times shareholders' funds (12:1) or two thirds of Esanda's liquid assets i.e. for every $1 invested in Esanda debentures Esanda must have at least $1.50 in assets. This borrowing limitation means that there are always substantially more liquid assets than debenture stock on issue. We are unaware of any other issuer of debentures that has such a conservative limitation.

- Debentures are secured by registered charges in favour of the trustee over Esanda's assets (other than land). In any liquidation, debenture holders rank ahead of unsecured creditors and ANZ.

Further, ANZ has given a revocable undertaking for the benefit of investors to maintain a controlling interest in Esanda for the term of investments made under its prospectus. If ANZ does revoke the undertaking, it will offer investors an alternative deposit with ANZ on similar terms as to interest and duration in place of their Esanda investment.

Regulatory environment

Esanda does not currently hold an AFSL. Its debentures are sold predominantly via ANZ branches and through investment brokers, pursuant to the licence held by ANZ, or the relevant investment broker.

As an ADI, ANZ is also subject to prudential regulation by APRA. As a wholly owned subsidiary and a business unit of ANZ, Esanda is effectively subject to many of the controls put in place under APRA's supervision, and in relation to its AFSL, under ASIC's supervision. These include in the areas of risk management, conflict management, dispute resolution, maintenance of financial, technological and human resources and independent audit.

In our view, no benefit would be gained for investors were Esanda required to obtain, and maintain, an AFSL as it is already subject to the controls via existing regulation that a licence would impose. Further, its risk profile does not warrant the additional significant compliance cost involved in obtaining and maintaining the licence.

Review of trustee duties

Esanda supports ASIC's work to list trustee duties in the new Regulatory Guide 69 *Debentures – improving disclosure for retail investors*. We would support a periodic review of the list to ensure it remains relevant to trustee duties.

ANZ would be pleased to provide any further information about this submission as required, and can be contacted as follows:

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