



# **Submission to the Australian Government's Green Paper on Financial Services and Credit Reform**

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***“...financial institutions are in a better position to avoid lending to borrowers on the verge of bankruptcy.”***

*Hong Kong Money Authority Review following the introduction of positive credit reporting*

***“Individuals who were previously constrained from accessing suitably priced credit will be able to do so and benefit accordingly.”***

*Access Economics “The benefits of Broadening Access to credit via Comprehensive Credit Reporting*

# Summary

Veda Advantage welcomes the Government's focus on long overdue reforms to financial services and credit regulation. This Green Paper, together with the work being done at COAG, builds on recommendations of the Productivity Commission's Review of Australia's Consumer Policy Framework.

As Australia's leading credit reporting agency, Veda Advantage believes credit reports should accurately reflect the repayment capacity of a borrower.

Currently, credit reporting is restricted to just negative information, making Australia one of only three OECD countries not to have comprehensive credit reporting.

**The Government has an opportunity to introduce this important micro-economic reform** and should include comprehensive credit reporting alongside the Green Paper's other proposed national consumer credit reforms.

One of the building blocks of the credit economy is the ability to accurately assess and price risk. Comprehensive reporting gives greater transparency to credit files and enables consumers to demonstrate their credit worthiness.

An Access Economics Report commissioned by Veda, *The Benefits of Broadening Access to Credit via Comprehensive Credit Reporting*, provides important Australian evidence of the economic and social benefits from comprehensive credit reporting, including **lower interest rates, increased access to credit, lower default rates and a \$1.7 billion boost to the Australian economy.**

Unlike virtually all other developed economies, credit reporting in Australia is not regulated as an aspect of financial services, but rather under the Privacy Act.

The Australian Law Reform Commission has conducted a review of the entire Privacy Act and will likely include modest widening of permitted listings on credit reports as part of its extensive series of recommendations, now with the Government.

Veda Advantage is concerned that long overdue reforms to credit reporting is at risk of being left behind while the Government considers the 2,500 page report.

**Veda therefore calls for:**

- i. Recommendations on comprehensive credit reporting should be extracted from the ALRC Privacy review and considered concurrently with recommendations impacting on credit reporting contained in other Government processes.
- ii. Credit reporting law reform to be considered a priority microeconomic reform, with joint responsibility led by the Special Minister of State and Treasurer (or other finance Minister).
- iii. An Advisory Committee of the finance industry, consumers and Veda Advantage should be brought together to assist Ministers in finalising recommendations to credit reporting laws.
- iv. Ministers should announce, by December 2008, a process for credit reporting legislative reform, to be ready by the end of December 2009.

More broadly, sensible and effective regulation of credit products must involve a national approach, and to this extent Veda Advantage supports the call of major industry associations – the Australian Bankers Association, the Australian Financial Conference and ABACUS – for the Commonwealth to assume control for all consumer credit, including credit cards, personal loans and car loans.

# Introduction

Everyday, Veda Advantage processes tens of thousands of credit checks for people applying for a range of credit activities, including personal loans, credit cards, mortgages and equipment hire.

Veda recognises the rapid growth in credit over the last twenty years has been of overwhelming benefit to household prosperity, giving Australians access to a broader, flexible range of credit products.

As an Access Economics study recently commissioned by Veda points out:

*One of the main motivations behind the deregulation of the Australian financial system in the 1980s was the lack of access to credit for many Australians. Credit was only readily available to those with either high incomes or long banking histories...many mortgages in the late 1970s and early 1980s involved a combination of finance...so called 'cocktail' loans.*

*Access Economics<sup>1</sup>*

Over the last two decades, much greater competition and widespread innovation in credit products have contributed to a widening of the number of people able to access credit from mainstream lenders<sup>2</sup>. Overwhelmingly, this has been used to build up wealth, with the Reserve Bank<sup>3</sup> estimating 90 per cent went to acquiring assets.

Twelve increases in the cash rate since 2001 have brought the health of Australian household's balance sheets into sharp focus.

While the total amount of borrowings is of less relevance than the capacity to repay borrowings, the decision to extend credit – and the basis on which that decision is made – becomes more critical in the current environment.

Currently, credit files are restricted to recording:

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<sup>1</sup> Page 6 “*The benefits of broadening access to credit via comprehensive credit reporting.*” Access Economics Pty Ltd Report commissioned by Veda Advantage, May 2008

<sup>2</sup> “*In short, deregulation, innovation and lower inflation have simultaneously increased the supply, and reduced the cost, of finance to households, and not surprisingly, households have responded by increasing their use of it.*” Address by Ric Battelino, Deputy Governor to Finsia- Melbourne Centre for Financial Studies 25 September 2007.

- identifying information such as name, address, DOB and Drivers Licence;
- credit applications and type of credit (but not whether credit was granted);
- negative payment information including payment defaults, court judgements and bankruptcies

The essential question is

***“Do lenders have the best information to assess if a person can service additional credit repayments.”***

The evidence is clear. Current laws inhibit lenders accurately assessing the ability of a potential borrower to meet commitments.

Someone who is overcommitted and struggling to make payments cannot be identified – often resulting in yet more credit being given.

Similarly, someone who is capable of making repayments, but has scant information on their credit file can be rejected for mainstream credit.

An allied concern is for people who have overcome financial difficulties. Credit reporting laws prevent a person demonstrating they are once again financially stable and able to meet commitments. They remain hamstrung by defaults listed on their file for up to five years.

Credit reporting and the provision of credit is affected by two current Government processes.

The Australian Law Reform Commission review of the Privacy Act has canvassed aspects of credit reporting, including a modest widening of allowable content on credit files.

In addition the Productivity Commission has made significant recommendations on the operation and jurisdiction of the Uniform Consumer Credit Code.

Both impact on credit provision - it is therefore highly desirable for reforms on credit reporting to be done concurrently to ensure consistency of policy outcomes.

This is particularly desirable if the Government embraces the view of consumer groups that comprehensive credit reporting, if it is to be permitted, must be accompanied by a responsible lending code<sup>4</sup>.

Veda Advantage is calling for a modernising of Australia's credit laws. Better information is better protection for both consumers and lenders.

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<sup>4</sup> *“There should be no expansion of the information held in credit reports at least while there is a lack of consumer protection in relation to irresponsible lending and credit marketing”* Consumer Action Law Centre submission to the ALRC December 2007

# Credit reporting law reform will help households

The Access Economics Report, *The Benefits of Broadening Access to Credit via Comprehensive Credit Reporting*<sup>5</sup>, provides important Australian evidence of the economic and social benefits from comprehensive credit reporting, including lower interest rates, increased access to credit, lower default rates and a \$1.7 billion boost to the economy.

The Report found that under comprehensive credit reporting system, banks and credit institutions will have access to better quality information, enabling them to better manage risk and therefore make more accurate lending decisions.

Moving to a comprehensive credit reporting system will give Australians greater access to mainstream, better priced credit, particularly younger Australians and families who currently have inadequate information on their credit file.

Access Economics finds the people most likely to benefit from increased access are those low-risk individuals who are currently viewed as high-risk.

*“...Overwhelmingly these tend to be low to middle income earners with limited track records with financial institutions...[and] new-to-bank customers, where declined applications are often as much the result of poor information as the financial status of the applicant”*

*Access Economics*<sup>6</sup>

The Report finds the current credit reporting system denies people the ability to prove they can make their financial repayments on time.

Comprehensive reporting will allow consumers to demonstrate they are a good credit risk. Lower interest rates are likely to result as financial institutions compete to attract people who can demonstrate sound management of credit.

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<sup>5</sup> *“The benefits of broadening access to credit via comprehensive credit reporting.”* Access Economics Pty Ltd Report commissioned by Veda Advantage, May 2008

<sup>6</sup> Page 21,22 Access Economics

Competition will also increase as comprehensive reporting makes it easier for people to leave their existing bank successfully apply for credit with a new lender.

Currently, established lenders have a clear advantage in assessing the risk of existing customers:

*“The acceptance rate for new customers is often nearly half the rate for existing customers and around 50% of this difference can be attributed to the relative quality and quantity of information available.”*

*Access Economics<sup>7</sup>*

The improved quality of information on a credit file will also allow people to prove their ability to manage credit well.

Access Economics finds this will foster competition amongst banks to attract these demonstrably low risk customers, putting downward pressure on interest rates.

Referring to defaults and Access Economics cited a US study conducted by Barron and Staten, demonstrating that maintaining a target acceptance rate would lead to a decrease in defaults as lenders can more easily identify high risk borrowers.

In the Australian context, Access Economics believes that in the critical area of mortgage defaults, a move to comprehensive credit reporting would lead to a small but significant decline in default rates from 0.4 per cent to 0.35 per cent and concludes:

*“While small, the total size of the mortgage lending pool – close to AU\$ 1trillion – means that any decline in mortgage default rates will still have a noticeable impact on the economy.”*

*Access Economics<sup>8</sup>*

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<sup>7</sup> Pg 3 *“The benefits of broadening access to credit via comprehensive credit reporting.”* Access Economics

<sup>8</sup> Ibid pg 24

# Credit reporting law reform will help the economy

The laws governing credit reporting in Australia are now twenty years old and Australia, New Zealand and France are the only countries in the OECD to rely on negative reporting.

In the past five years Hong Kong, Belgium, Greece and India have moved to comprehensive credit reporting.

In Hong Kong, a negative credit reporting regime failed to prevent a huge surge in consumer bankruptcies amid similar credit tightening in 2002, with bankruptcies peaking at 25,328<sup>9</sup>.

More comprehensive credit reporting was then introduced in August 2003, helping consumers and their lenders manage risk better, resulting in:

- The number of bankruptcies dropped by 45 per cent in 2004<sup>10</sup>.
- By 2005 the average indebtedness of bankrupts had declined from over 35 times a bankrupt's monthly income to 25 times<sup>11</sup>.

The recent experience of Hong Kong is illustrative.

From 2003 Hong Kong transitioned to a comprehensive credit reporting system. In a 2006 review the Hong Kong Money Authority found the move had led to a

*“conspicuous improvement in the problem of over-indebtedness”*.<sup>12</sup>

Hong Kong Money Authority

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<sup>9</sup> Official Receivers Office, Compulsory Winding Up and Bankruptcy Statistics

<sup>10</sup> Ibid

<sup>11</sup> Hong Kong Money Authority Quarterly Bulletin March 2006.

<sup>12</sup> Pg 7 “Benefits of sharing positive consumer credit data” Hong Kong Money Authority Quarterly Bulletin March 2006

Veda Advantage commissioned Access Economics to apply overseas research to the Australian context.

Access economics modeled the changes and found household buying power would be boosted by \$1.7 billion by 2020.

This follows from:

- Improved risk assessment leading to a reduction in mortgage defaults;
- A subsequent reduction in lenders losses;
- Increased profitability and a more competitive credit market putting downward pressure on interest rates and consequently increasing household buying power.

#### **ACCESS ECONOMICS - MACROECONOMIC OUTCOMES OF COMPREHENSIVE CREDIT REPORTING**

While the lack of detailed credit data limited the nature of formal modelling possible, the task was approached using outcomes from earlier US research. Using current Australian reporting framework as a base, the research was applied to aggregate Australian credit data.

The main results from the economic modelling are as follows:

- ❑ In the first year, consumers receive a boost in real incomes of around A\$265 million, in 2005-06 prices, which in turn flows through into a combination of higher real consumption expenditure, of around A\$160 million, and higher prices.
- ❑ In subsequent years, consumption increases by an average of around A\$84 million per annum, in 2005-06 prices:
  - The higher prices feed through into (slightly) higher inflation which tends to unwind part of the initial boost to real household consumption.
- ❑ Assuming a real discount rate of 5%, these results translate into a boost to real household consumption of A\$1.7 billion in net present values.

From the perspective of past microeconomic reform agendas, these estimates would indicate that reform to credit reporting would yield useful rather than large economic benefits at a national level, in the form of a meaningful boost to national living standards.