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Regulating for the First Time the Decision to Grant Consumer Credit: A Look at the First Steps Taken by the United States and Australia

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INTRODUCTION

In Fall 2007, the demise of Lehman Brothers and the near collapse and rescue of numerous other financial institutions thought too big to fail dramatically signaled a new era of financial regulation. Americans call the event the Great Recession, evidence of the American belief that it happened "to us." The rest of the world refers to it as the GFC, the Global Financial Crisis, reflecting the reality that the collapse affected the entire world. Countries around the world scrambled to establish legal controls that could stem the damage. The U.S. response was to enact in 2010 the Dodd-Frank Act, a multifaceted package of financial reforms that included sweeping changes to the regulation of consumer credit.[1] Though not nearly as badly harmed by the GFC as the United States,[2] Australia passed two new large consumer financial laws: The Australian Consumer Law,[3] and the National Consumer Credit Protection Act.[4]

Among the significant legal changes, for the first time both countries have departed from the prized common law freedom of contract by imposing constraints on a creditor's decision to grant credit to a borrower.[5] In essence, both nations sought to alter the culture of the consumer-credit industry, yet they have taken significantly different approaches to the challenge of regulating credit-granting decisions. By looking at the two approaches and the processes that led to the changes,

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Title 12 U.S.C. §§ 5301, Pub. L. No. 111-203, 124 Sat. 1376 (2010).

2. Australia experienced only a -.9% fall in GDP in the December quarter of 2008, and experienced no other drop in GDP during the recession. Chris Barrett, *Australia and the Great Recession,* WOODROW WILSON INTERNATIONAL CENTER FOR SCHOLARS (Apr. 2011), http://www.wilsoncenter.org/sites/default/files/Australia%20and%20the%20Great%20Recession.pdf.

3. *Competition and Consumer Act 2010* (Cth) sch 2 (2010) (Austl.) (replacing the *Trade Practices Act 1974* (Cth) sch. 2 (1974) (Austl.)).

4. *National Consumer Credit Protection Act 2009* (Cth) (2009) (Austl.) [hereinafter *Credit Act 2009*].

5. Karen Cox, *Consumer Credit*, HOT TOPICS (Mar. 1, 2015, 11:49 PM), http://www.legalanswers.sl.nsw.gov.au/hot_topics/pdf/consumer_credit.pdf. Strictly speaking, under Section 70(1) of the Australian Uniform Consumer Credit Code (1996), among the numerous factors a court could consider in determining in its discretion whether a contract was unjust was whether at the time the contract was entered the creditor knew or could have ascertained by reasonable inquiry that the debtor could not pay without substantial hardship. *Australian Uniform Consumer Credit Code 1996* § 70(1). This inquiry did not operate as an express limitation on contracting, but served merely as one of a number of factors to be considered in enforcement. *Id.*

there is much to be learned about the challenges faced, the choices made, and the reasons for the differences in the choices made by these two democratic nations. It may also be possible to speculate as to the likelihood of success in changing the culture of the consumer credit industries of these two nations that so highly prize individual liberty.

The Australian approach to regulating the decision to grant consumer credit differs systematically from that in the United States. First, Australia requires responsible credit granting in all forms of consumer credit, whereas the United States thus far constrains the decision only in the narrow realms of home mortgage lending, credit cards, and military payday loans. Second, the American concept of responsible consumer lending requires only an assessment of the debtor's ability to pay, whereas the Australian concept requires a determination of whether the credit is "suitable," requiring not only an assessment of the consumer's likely ability to pay, but also an inquiry into the consumer's requirements and objectives in borrowing. Third, Australia requires anyone engaging in consumer credit activity to obtain a credit license. While most American states require licenses to engage in certain types of consumer credit, such as becoming a mortgage broker, there is no such general requirement in any state, and the federal government makes no such requirement at all. Fourth, Australia alone provides a process that is unique in the world for External Dispute Resolution that is cost-free to the consumer.

In this Article, I discuss the changes in three consumer-credit realms. First, I compare the Australian regime applicable to all forms of consumer credit granting, including mortgage lending, to the American regulation of the consumer mortgage-granting decision. Second, I compare the Australian and American approaches to the decision to authorize use of, or increase the credit limit on, individual credit cards. Third, I compare the two approaches to regulating small short-term loans, usually called payday loans. Finally, I compare the enforcement regimes of both countries—perhaps the key to it all.

If a government intends to regulate transactional behavior, there are two fundamentally different approaches to doing so. One is to state in general terms what type of conduct is (or is not) permitted. The other is to extensively define in very precise terms what conduct is (or is not) permitted. Each has its strengths and weaknesses. The first approach is to state in broad terms the societal values to be adhered to or the overall results to be achieved. It has the virtue that parties engaging in transactions within the scope of the regulation will find it more difficult to avoid through cleverness of tactic. One's conduct either complies with the broad mandate or fails to comply. The problem with its imprecision lies in assuring its effectiveness. Some third party in authority must exercise judgment in determining whether the conduct of the parties at hand fits within the range of permissible practices that fall within the regulation's scope. Even if the parties have attempted in good faith to comply, their own judgment cannot be determinative.

The third party whose judgment controls may be a court or regulatory agency, and the effectiveness of the regulation will then depend on a litigation model, which counts on the parties to bring the issue of compliance to the attention of the tribunal through some dispute resolution process. Once the judgment is exercised, determining that the conduct is non-compliant, the imposition of a remedy will be the final step in ensuring effectiveness of the regulation. If this process is utilized with sufficient frequency and notoriety, persons engaging in the regulated conduct can be expected to begin to understand more clearly what kinds of conduct are permitted, what kinds are not, and to mold their conduct accordingly. If a high proportion of these parties comply, the regulation will have been successful.

Quite obviously, the decision to take this approach depends on a clear determination that the conduct needs to be regulated due to the frequency of impermissible conduct and that some aspect of society will be better off if such conduct is curtailed. But the pathway to curtailment is a fitful one. The litigation model depends on the parties to bring the issue to the tribunal. The exercise of judgment by the tribunal may require the production of complex evidence, and may require difficult choices among the genuine interests of the parties.

If the second approach to regulation is taken, defining extensively and precisely what types of conduct are required and what types are prohibited, the litigation model operates more easily because it does not depend as much on the exercise of the tribunal's judgment. Once the dispute is brought to the attention of the tribunal, it is a rather straightforward matter to determine whether the parties' conduct has conformed to the precise requirements of the regulation or not. The appropriate remedy can then be applied. Moreover, because of the precision of the regulation, the parties to the dispute can more readily predict the result, increasing the likelihood that the dispute will be settled and litigation avoided.

If the first approach to regulation is taken, defining the prohibited conduct broadly, the better enforcement approach is to rely primarily on licensing of the parties engaged in the commercial conduct. The licensing agency becomes the third party that exercises judgment as to whether there has been compliance with the broad language of the regulation. The incentive to conform one's conduct to the regulation is driven by the threat of loss of the license. The effectiveness of the regulation turns then on the extensiveness and reliability of the licensing agency, which may require a significant commitment of public funds.

As to the American and the Australian approaches to the regulation of the credit-granting decision, the two nations have taken opposite approaches. The Australian regulatory standards are stated quite broadly, and Australia depends extensively on licensing as the key to enforcing the standards. Anyone who extends consumer credit in Australia must be licensed to do so, and anyone who assists in or facilitates an extension of credit must also be licensed. In contrast, in America, the standards for compliance are extremely detailed, minimizing the exercise of third party judgment, and placing heavy reliance on the litigation model.

I. COMPARING AMERICAN REGULATION OF HOME MORTGAGE CREDIT GRANTING TO AUSTRALIAN REGULATION OF ALL CONSUMER CREDIT GRANTING

The most extensive example of American regulation of the credit granting decision appears in the home mortgage arena, whereas Australia has chosen to regulate the decision in all realms of consumer credit. Because both approaches are far-reaching, they can be meaningfully compared. The comparison must begin with the genesis of the changes.

A. *The American Approach*

Clearly, the impetus for the American changes was rooted in the causes of the GFC. While there were many causes of the GFC, the primary cause was the collapse of the American home mortgage market. The first steps to the GFC were taken in the 1990s when Wall Street discovered home mortgages.[6] More precisely, Wall Street discovered that mortgages could be bundled together in groups of thousands, and sold as a package to investors looking for safe but remunerative investments. The process came to be called "securitization," and the result was the creation of mortgage-backed securities. These securities could be sold in "tranches" (French for slice), each tranche priced according to appraised risk. The key to creating a market for these securities was development of a formula published in 2000 by Chinese mathematician David X. Li while working at J.P. Morgan Chase.[7] The formula provided a simplified method for assessing the risk of default of a tranche of mortgages. Rather than looking at the risk of default on each of the mortgages and assessing the sum of the combined risks, one needed only to apply the formula. In doing so, some tranches of these securities were judged to be virtually

6. I well recall a conversation I had in the 1990s with a Miami Real Property lawyer. He said, "When Wall Street discovered home mortgages, my practice went crazy."

7. Felix Salmon, *Recipe for Disaster: The Formula that Killed Wall Street*, WIRED (Feb. 23, 2009), http://archive.wired.com/techbiz/it/magazine/17-03/wp_quant?currentPage=all.

risk free by the rating agencies.[8] Thinking "jackpot," as in who would not want to invest in a risk-free security, financial institutions all over the world began pouring billions into these magical securities. The only problem with this astonishing development was that as applied, the banks and rating agencies made a commonly held but fatally flawed assumption: The value of residential real estate would never decline.[9] Sadly, the devastating flaw in this assumption did not appear until it was too late: the damage was done.

As billions of dollars flowed from all corners into the American home mortgage market, home prices rose steadily. With a virtually unlimited supply of mortgage money looking for borrowers, intermediaries, such as mortgage companies, mortgage brokers and banks searched high and low for potential borrowers. They sought not only borrowers seeking to buy, but also borrowers seeking to refinance their increasingly valuable existing homes, "taking out equity" to be applied to other purposes. These intermediaries are not true creditors in any sense. Although mortgage companies, banks, savings and loans, and credit unions may write a check initially, they would immediately sell the note and mortgage to the entity bundling the mortgages into securities, and take a fee. For these intermediaries, every approved mortgage application represented a fee. As the search for borrowers intensified, standards for creditworthiness fell.

The Consumer Financial Protection Bureau describes the collapse of the mortgage market as follows:

> A primary cause of the collapse was a steady deterioration of credit standards in mortgage lending. Evidence demonstrates that many mortgage loans were made solely against collateral and without consideration of ability to repay, particularly in markets for "subprime" and "Alt-A" products, which more than doubled from $400 billion in originations in 2003 to $830 billion in originations in 2006. Subprime products were sold primarily to consumers with poor or no credit history, while Alt-A loans were sold primarily to consumers who provided little or no documentation of income or other evidence of repayment ability.

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8. Everyone "from bond investors and Wall Street banks to rating agencies and regulators" adopted this method. *Id.*

9. *See id.* More precisely, the formula assumed the correlation among defaults in a pool was constant, and bankers securitizing mortgages were only too happy to draw their correlation data from the recent past in which real estate values only went up, defaults were uniformly rare, and correlation constant. *See id.* The bankers knew their models were highly sensitive to housing price appreciation, and that if it ever turned negative on a national scale, a lot of bonds rated as risk-free would blow up. *Id.* But because they were making so much money no one was willing to stop. *See id.*

> When housing prices began to decline in 2005, . . . refinancing became more difficult and delinquency rates on subprime and Alt-A products increased dramatically. By the summer of 2006, 1.5 percent of loans less than a year old were in default, and this figure peaked at 2.5 percent in late 2007. As the economy worsened, the rates of serious delinquency (90 or more days past due or in foreclosure) for the subprime or Alt-A products began a steep increase from approximately 10 percent in 2006 to 20 percent in 2007, to over 40 percent in 2010.[10]

The misdeeds of intermediaries were hardly limited to providing little or no documentation. Frequently they engaged in outright fraud. The Bureau states that lenders sometimes steered borrowers who could have qualified for prime credit to subprime mortgages, which carried higher fees.[11] There were many instances of applications leading to what have been called "liar loans" that openly misstated income figures and other information related to credit worthiness.[12]

Obviously, under the circumstances existing at the time, a very high proportion of the persons making the decisions to grant mortgage credit had no stake whatsoever in the likelihood of repayment. There is no economic theory in which a person making a business decision has no stake in the risk involved. The key to the freedom-of-contract premise is that the parties to the agreement should be free to make their own assessments of the risks and benefits entailed in the agreed exchange. Where market circumstances divorce the credit-granting decision from the risk of default, the justification for freedom to make the decision is lost. Some other constraint on the decision-making process is needed. Enter Dodd-Frank, and the charge to the Consumer Finance Protection Bureau to depart from the previously inviolate freedom-of-contract model and instead to regulate the decision to make a loan secured by a

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10. Ability–to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 35,429, 35,431 (June 12, 2013) (citations omitted) (to be codified at 12 C.F.R. pt. 1026).

11. Press Release, Fed. Reserve Bd., Federal Reserve Press Release (July 20, 2011), http://www.federalreserve.gov/newsevents/press/enforcement/20110720a.htm. The Bureau describes the consent cease and desist order entered on this ground between the Federal Reserve and Wells Fargo & Co., which resulted in a civil penalty of $85 Million. *Id.*

12. *See, e.g.*, *In re* Hill, 2008 WL 2227359 (Bankr. N.D. Cal. 2008). In that case, homeowners repeatedly refinanced their home, fraudulently filling out numerous loan applications. *Id.* The loans were treated as "stated income loans," which did not require verification of income. *Id.* at 1 In two examples of the fraud, on the April 2006, loan application, the husband's income was stated as $98,112 and the wife's income as $47,604. *Id.* at 1. On the October application, the incomes were switched, the husband's income was stated as $67,200, and the wife's as $123,600. *Id.* at 5. True incomes were: Husband's $39,000 and wife's $26,000. *Id.* at 1.

home mortgage.

B. *Departing From Freedom of Contract*

One of the most fundamental concepts in the civil law of the United States and commonwealth countries is the commitment to freedom of contract. The premise is that, absent some invalidating cause such as mistake, fraud, duress, illegality, incompetence, or infancy, all persons, individuals and entities, are empowered to arrive at agreements as they see fit. The parties to any agreement are presumed capable of weighing for themselves the benefits and detriments of an agreed exchange. To be enforceable, a promise must be supported by consideration or some substitute for it, but the requirement can be satisfied regardless of the relative values of the things exchanged.[13] Accordingly, aside from usury laws, the decision to extend credit has not traditionally been regulated. Borrowers have been permitted to enforceably agree to pay any price for the right to use borrowed money.

Regulation of consumer credit contracts is a relatively new enterprise, because consumer credit is a relatively new enterprise. Aside from mortgage lending, there was virtually no consumer credit until the 1950s. Previously, if a person or family wanted something, they had to save-up the purchase price. Following World War II, families began acquiring automobiles and household goods on credit. The business grew phenomenally;[14] new forms of consumer borrowing came into being, evolving from closed-end loans to revolving credit to credit cards and small loan companies.

By the mid-sixties, it became apparent that there were so many unregulated forms of consumer credit that the opportunities to take unfair advantage of consumer borrowers were nearly limitless. Inevitably, where an advantage–taking opportunity arises, opportunists will appear. The idea of an opportunistic credit grantor is a curious one. At first blush, it would appear that the creditor is the one taking on risk—the possibility of going unpaid. However, by making prudent credit-granting decisions, and with the help of contract remedial law, the creditor could by contracting in bulk, shift those risks to its favor.

The first, most obvious loss avoidance practice is to make careful

13. RESTATEMENT (SECOND) OF CONTRACTS § 79 (1981).

14. For example, "From the end of World War II through 1967 the amount of such credit outstanding had increased from $5.6 billion to $95.9 billion, a rate of growth more than 4½ times as great as that of the economy." Mourning v. Family Publ'ns Serv., Inc., 411 U.S. 356, 363 (1973). In a speech on the Senate floor, Senator Paul Douglas, father of the Truth in Lending Act, stated, "Since the end of World War II mortgage credit has increased almost six times from $18.6 billion in 1945 to $140 billion in 1960. Consumer Credit has increased more than eightfold—from less than $6 billion in 1945 to $55 billion by the end of 1960." 107 CONG. REC. S7859 (daily ed. May 11, 1961) (statement of Sen. Douglas).

credit granting decisions—extending credit only to those highly unlikely to default. The creditor seeking to expand has the choice of making riskier credit granting decisions if the increased default losses can be balanced by charging higher interest rates. Another balancing device is collection of additional sorts of fees, such as late-payment fees, credit insurance premiums, penalties for paying a loan off early, and the like. All of these techniques became common. So, by the mid-sixties, the awareness grew in the United States that the consumer credit industry needed to be reined in. But how? Contract law is state law, and the fifty states had done little here. Since the bulk of significant consumer-credit companies operated nationally, the piecemeal threat of state-to-state regulation was not likely to effect the needed constraints. Any attempt to control the substantive content of a consumer credit contract ran afoul of the highly prized freedom to contract. The freedom of the hypothetical consumer to contract for the optimum combination of rates and terms would be totally lost, as would be the creditor's freedom to extend credit only on terms satisfactory to it.

The discussion began at the federal level by Senator Paul Douglas, an economics professor turned Senator from Illinois. It was clear to him that different types of consumer creditors stated interest rates in so many different ways that only the most sophisticated consumers could compare one effective rate to another in order to shop for the best deal.[15] Freedom to contract by making one's own assessment of benefits and risks has no utility if the information needed to make the assessment is lacking, or worse, hidden from the ordinary consumer.

Rather than interfere with the prized freedom of both creditor and consumer to bargain for their desired terms, the focus shifted to improving the bargaining process through required disclosures. The belief was that if the consumer can be provided the needed information in an understandable format, comparison shopping would be possible. Once consumers began to shop, not only for interest rate, but also for terms, it was hoped the competition in the marketplace would drive out the unfair terms, charges, and excessive rates.

In at least one respect, the Truth-in-Lending Act has been an extraordinary success. By requiring that interest rates be uniformly stated in terms of Annual Percentage Rate (APR), the ability of consumers to compare rates was assured. Today, consumer creditors often compete

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15. For example, in his remarks vigorously defending S 1740, the Truth in Lending Act, which he had introduced, Senator Douglas quoted the testimony of Dr. Theodore O. Yntema, vice president in charge of finance, Ford Motor Co, stating: "The variety and complexity of finance and insurance arrangements and the charges for them are such as almost to defy comprehension. It is impossible for the average buyer to appreciate the rates for the finance . . . offered as compared with alternatives available to them elsewhere." 107 CONG. REC. S7856 (daily ed. May 11, 1961) (statement of Sen. Douglas).

openly on the basis of APR, and most consumers probably understand what it means. Whether consumers shop for other sorts of terms, such as default rates or prepayment penalties is far less clear. However, one more thing is clear. Even if the consumer and creditor both fully understand what is the APR to be charged, and even if it is the lowest interest rate likely to be available to the particular consumer in such a transaction, it was left solely to the consumer borrower to assess whether (s)he would be able to make the payments, or whether, under the circumstances, the decision to borrow the money and the purpose of the loan makes good sense.

How quaint.

C. *The New American Rule*

The Dodd-Frank Act created the Consumer Financial Protection Bureau (Bureau), added Section 129B to the Truth In Lending Act (TILA),[16] and authorized the Bureau to take over responsibility for Truth In Lending's Regulation Z. On June 12, 2013, the Bureau issued the final rule to adopt certain exemptions, modifications, and clarifications to the ability-to-repay rule added to the TILA by the Dodd-Frank Act. The Dodd-Frank Act now generally requires creditors to make a reasonable good faith determination of a consumer's ability to repay a mortgage loan.[17] The scope of this requirement is narrow, applying only to a consumer credit transaction that is secured by a dwelling.[18] The required basis for making this determination is regulated in great detail, requiring the creditor explicitly to consider eight factors: expected income or assets; employment status; payments on the transaction; payments on any simultaneous loan; payments on mortgage-related obligations; other debt obligations (alimony, support); monthly debt to income ratio; and credit history.[19] Payments on the transaction must be calculated using the greater of the fully indexed rate or any introductory rate,[20] and consideration of any of these factors based on third-party records must be verified.[21] The regulation also provides detailed guides as to what adequate verification must entail.[22]

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16. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1411, 1412, 1414, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301 (2010)).

17. Truth in Lending (Regulation Z) 12 C.F.R. § 1026.43(c) (2014).

18. 12 C.F.R. § 1026.43(a). This subsection lists numerous excepted transactions, including home equity loans, bridge loans, certain construction loans, and extensions of credit made or facilitated by certain governmental and tax-exempt entities. *Id.*

19. 12 C.F.R. § 1026.43(c)(2).

20. 12 C.F.R. § 1026.43(c)(5). Calculated payments must also be fully amortizing and substantially equal. *Id.*

21. 12 C.F.R. § 1026.43(c)(3).

22. 12 C.F.R. § 1026.43(c)(3)&(4).

The burden of carefuLly taking and documenting all of these steps for every mortgage loan would be substantial, if not daunting, and the increased cost would have to be passed along to the borrower. Accordingly, the Act provides a large escape hatch, called the "safe harbor," and by controlling the entrance to the safe harbor the Act regulates not only the credit granting decision, but also the substantive content (the terms) of future mortgages on dwellings.[23] One enters the safe harbor by executing a "Qualified Mortgage."[24]

There are two levels of Qualified Mortgages. The highest secures a loan that is not a "higher-priced" loan.[25] These automatically comply with the repayment ability requirements.[26] A lower level qualified mortgage is one that secures a higher-priced loan. It occupies a less-safe place in the harbor; it is *presumed* to comply with the repayment ability requirements.[27] This presumption is still a significant boon to the mortgagee, because the regulation states at length what must be proved to rebut the presumption—clearly no mean feat.[28] Yet, the absolute protection against litigation that comes with a safest-harbor loan (one that is not higher-priced) provides significant incentive to the creditor to be sure to qualify for this top-level protection.

While the requirements for a mortgage to be *Qualified* are numerous, most of the requirements are easily met.[29] Oddly, there is no explicit

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23. *See, e.g.*, *infra* text accompanying note 29 (describing the terms required to be included in a qualified mortgage securing a higher-priced loan under 12 C.F.R. 1026.43(e)(2)).

24. 12 C.F.R 1026.43(e)(1)(i). Years ago, I wrote an article recommending standardization of the terms of consumer-credit contracts. Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 VA. L. REV. 1333 (1982). In effect, the terms of future "qualified" dwelling mortgages, will now be highly standardized.

25. A higher-priced mortgage loan is one with an annual percentage rate that exceeds the average prime offer rate (APOR) by 1.5% for a first lien or by 3.5% for a subordinate lien. 12 C.F.R. § 1026.43(b)(4). APOR is derived from average loan rates for low-risk mortgage transactions derived from surveys and published on the internet. 12 C.F.R. § 1026.35(a)(1) (2014).

26. 12 C.F.R. § 1026.43(e)(1)(i) (2014).

27. 12 C.F.R. § 1026.43(e)(1)(ii)(A).

28. To rebut the presumption, the opponent of the mortgagee must show that the consumer's income and expenses, known to the creditor, would leave the consumer with insufficient residual income or assets with which to meet living expenses, including residual non-debt obligations of which the creditor was aware at the time of consummation. 12 C.F.R. § 1026.43(e)(ii)(B).

29. First, the mortgage must secure a "covered transaction," meaning simply a consumer credit transaction secured by dwelling. 12 C.F.R. § 1026.43(b)(1). The definition of 12 C.F.R. § 1026.43(e)(2) states that it must provide for periodic payments that do not increase the principal balance, allow for deferred principal repayment or result in a balloon payment (with exceptions), the loan term must not exceed 30 years, and the total points and fees may not exceed specified limits. The monthly payments must retire the principal over the term of the loan. 12 C.F.R. § 1026.43(e)(iv)(B). The creditor must verify the debtor's income, assets other than the dwelling, current debt and other obligations, and the ratio of the consumer's total monthly debt to total monthly income at the time of consumption must not exceed 43%. 12 C.F.R. § 1026.43(e)(v)–

requirement that the creditor consider ability to repay. However, the Qualified mortgagee must "take into account" the monthly payment for mortgage-related obligations,[30] must verify at or before consummation the consumer's current income or assets (other than the dwelling)[31] and current debt obligations,[32] and the ratio of "monthly debt" to monthly income must not exceed 43%.[33] In essence, taking these totals into account in calculating this ratio supplants the requirement of considering ability to repay as long as the debt-to-income ratio does not exceed 43%. The creditor need only make a mechanical calculation, and is relieved of any obligation to exercise judgment. If the ratio exceeds 43%, the creditor must decide whether to deny the loan, or to determine ability to repay.[34]

The most controversial of the requirements for Qualification is that points and fees, including payments to loan originators, cannot exceed the amounts specified in § 1026.43(e)(3).[35] Experience had shown that the intermediaries who originated the bulk of mortgage loans were focused on collecting fees to the exclusion of careful risk assessment. Because this reality had played such a significant role in destabilizing the housing market, the belief underlying the Dodd-Frank Act is that these motives must be reined in by controlling these fees. The Bureau received 1,150 comments in response to the proposed rule, many of them focusing on the calculation of loan originator compensation for inclusion in points and fees for the qualified mortgage and high-cost mortgage points and fees limits.[36] The comments received by the Bureau spawned a number of narrow exclusions.[37] Clearly, the intermediaries have no interest in

(vi).

30. 12 C.F.R. § 1026.43(e)(2)(iv). This amount must include either the maximum interest rate that might apply or an amount that will repay the loan amount over the loan term. *Id.*

31. 12 C.F.R § 1026.43(e)(2)(v)(A).

32. 12 C.F.R § 1026.43(e)(2)(v)(B).

33. 12 C.F.R. § 1026.43(e)(2)(vi). What might "monthly debt" mean? Presumably it means monthly payment obligation on debt obligations, alimony, support, and the like.

34. It will be interesting to see how the case law evolves. It would be no surprise if ratios in excess of 43% begin to operate as an informal presumption of *inability* to repay.

35. 12 C.F.R. § 1026.43(e)(3). The limits vary depending on the size of the loan, as follows:

Greater or equal to $100,000	Limit = 3% of total loan
$60,000 t0 $100,000	Limit = $3,000
$20,000 to $60,000	Limit = 5% of total loan
$12,500 to $20,000	Limit = $1,000
Less than $12,000	Limit = 8% of total loan

All specified dollar amounts will be indexed for inflation.

36. Ability-to-Repay and Qualified Mortgage Standards Under the Truth In Lending Act (Regulation Z) 78 Fed. Reg. 35,429, 35,440 (June 12, 2013) (to be codified at 12 C.F.R. pt. 1026).

37. In recognition of the deep difficulty of tracking payments to loan-originator employees, payments from consumers and creditors to brokers, the risks of double counting, and possible

limiting their own fees, and the threat of an enforcement action against such an intermediary is ephemeral at best. It is by inclusion of these fee limits in the definition of Qualified Mortgage that the lender is guaranteed to have a stake in assuring that the fees do not exceed the specified limits as a key to entering the safe harbor. Like it or not, the statute has cleverly enlisted the lenders in the policing of intermediary fees.

D. *The New Australian Rule*

Although the Australian and American laws regulating the credit-granting decision were enacted nearly simultaneously, they arrived by very different routes. The Australian act was not a reaction to the GFC. The Australian National Consumer Credit Act (Credit Act) followed in the footsteps of the Uniform Consumer Credit Code (UCCC), which was the previous statute regulating consumer credit providers. In the run-up to the implementation of the Credit Act, it was found by various legislative bodies, and task forces found that the UCCC had gaping holes that needed to be addressed.[38] Specifically, it was perceived as problematic that the UCCC only regulated disclosure and permissible terms, and that it "does not comprehensively address the appropriateness of the initial provision of the credit to the consumer. That is to say, it does not regulate whether or not it was responsible to lend to the consumer in the first place."[39] The Credit Act was passed to add front-end regulation to the regulatory scheme, to ensure that the regulations did not cover only those circumstances that occurred *after* an irresponsible loan was originally made.[40]

The national agency primarily responsible for regulating Australian consumer credit is the Australian Securities and Investments Commission (ASIC). In 2003, ASIC released a report on the finance and mortgage broker industries. In that report, ASIC detailed the existing problems with Australia's regulation of those industries—namely, that it was a state-based unreliable patchwork, and provided barely any protection in important areas.[41] ASIC found the industry suffered from a number of

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constraints on mortgage availability, the final rule recognizes three exclusions: loan originator compensation paid by a consumer to a mortgage broker when the payment has already been counted toward the points and fees thresholds as part of the finance charge, compensation paid by a mortgage broker to an employee of the mortgage broker (which is already included in the loan originator compensation paid by the consumer), and compensation paid by a creditor to its loan officers. *Id.* at 35,430.

38. Explanatory Memorandum, National Consumer Credit Protection Bill 2009 (Cth) 81 (Austl.).

39. *Id.*

40. *See id.*

41. Commission, Consumer Legal Credit Centre (NSW), Inc., *A Report to ASIC on the Finance and Mortgage Broker Industry*, AUSTRALIAN SECURITIES & INVESTMENT COMMISSION,

problems largely stemming from minimal or no barriers to entry to the profession and barely any regulatory framework for those in the profession.[42] Among the problems was the ability of brokers to operate without physical premises, overhead, or indemnity insurance, the general lack of accountability of brokers to their customers when those customers suffered damage as a result of the brokers' actions, and the widespread use of "cold calling" by brokers to manipulate customers inside their own houses. Moreover, a scheme of "reverse competition" had developed in which groups of lenders battled to gain access to brokers and their distribution and customer networks. The commissions they offered brokers rose, causing an increase of cost to consumers as a result of this competition.[43] Fraud was also found to be prevalent, as well as crimes such as creating false documents, excessive or undisclosed fees, and misrepresenting documents to clients ignorant of subtle differences between various financial instruments.[44] The report also stated that statutory prohibitions against false or misleading representations were largely toothless, because they operate only after unfair business conduct has occurred.[45] Aggrieved consumers were often forced to resort to the courts for redress, which, due to "inaccessibility, delays, daunting formality and high costs of the Court system," offered a far from satisfactory solution.[46]

The influence of mortgage brokers grew significantly in the early twenty-first century due to the minimal barriers to entry and minimal regulation of broker behavior. In 2005, the Office of Fair Trading reported the numerous ways in which broker fraud impacted the market, such as placing consumers in contracts calling for more than the consumer could pay, arranging loans for less than requested, or less than needed to purchase the property, or encouraging the consumer to lie about income or assets.[47] As mortgage foreclosures began to rise, the mainstream banks and mortgage lenders began to feel the criticism and take the blame caused by the "fringe brokers." Accordingly, they began to champion a new era of stricter nationwide regulation of the home-mortgage lending industry. These odd bedfellows, consumer representatives and mainstream banks, joined to provide the national will to comprehensively regulate the business of extending credit to

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6–7 (Mar. 2003) [hereinafter *ASIC Report*], *available at* http://download.asic.gov.au/media/1337558/Finance_mortgagebrokers_report.pdf.

42. *Id.* at 19.

43. *Id.* at 20.

44. *Id.* at 80–84.

45. *Id.* at 39.

46. *Id.* at 54.

47. *National Finance Broking Regulation: Regulatory Impact Statement Discussion Paper*, NSW OFFICE OF FAIR TRADING, 13–15, (Mar. 2, 2015, 10:22 PM), *available at* http://www.fairtrading.nsw.gov.au/pdfs/About_us/nationalfinancebrokingris.pdf.

consumers.[48] Initial efforts sought to revamp the Uniform Consumer Credit Code, in order to establish uniform state by state regulation. This project was well on its way when the GFC hit in 2007. Although Australia was not hit hard by the GFC, Australian lawmakers were well aware of the GFC and its underlying causes, particularly the subprime mortgage debacle in the United States. This only added to the enthusiasm for national consumer-credit reform.[49]

On July 2, 2009, the Council of Australian Governments (COAG) entered into an Inter-Governmental Agreement (IGA) on National Consumer Law.[50] To an American, this represents a breathtaking level of interstate cooperation, but the strong Australian desire for comprehensive national regulation helps explain it. In the Agreement, all Australian states and territories ceded to the Commonwealth the authority to regulate national consumer law, including consumer credit law. This led to the enactment of two substantial legislative acts: The Australian Consumer Law,[51] and the National Consumer Credit Protection Act[52] (Credit Act). The thrust of the Credit Act was fourfold, to: create a national licensing regime for parties engaging in credit activities, create a legal environment that permits only responsible consumer lending, create accessible dispute resolution processes, and provide a remedial regime for enforcement of these new requirements.[53]

The requirement of responsible lending applies to all "credit activity," which broadly includes participating in credit contracts, credit service (including connecting a consumer to a credit provider or acting as an intermediary), consumer leases, mortgages, guarantees and other activities later provided by regulation.[54] The Credit Act adds a new category of persons to be licensed as credit providers that had not

48. Interview with Karen Cox, Director, Consumer Credit Legal Center of New South Wales, (Feb. 28, 2014) [hereinafter Karen Cox Interview].

49. *Id.* To illustrate, Ms. Cox provided me with a joint media release published by a coalition of consumer lenders and representatives including Australian Bankers' Association, Consumers Federation of Australia, Mortgage and Finance Association of Australia, Legal Aid (NSW and Queensland), Public Interest Law Clearing House (NSW) and several law firms. The release decries predatory lending by "fringe lenders" in the home loan market. It states that the coalition is seeking to engage state and federal governments on targeted reforms to deal urgently with such practices. The release is in my possession, as well as a similar release by Wizard Home Loans. Contact me at davis@law.ufl.edu.

50. *Council of Australian Government's Meeting*, COUNCIL OF AUSTRALIAN GOVERNMENT, at 7 (July 2, 2009), *available at* http://www.coag.gov.au/node/66.

51. *Competition and Consumer Act 2010* (Cth) Sch 2 (Austl.).

52. *Credit Act 2009*, *supra* note 4.

53. This fourfold thrust is evidenced in the organization of the Credit Act. Chapter 2 is entitled Licensing of persons who engage in credit activities. Chapter 3 is entitled Responsible lending conduct. Chapter 4 is entitled Remedies, and Chapters 5 and 6 regulate Administration, Compliance, and Enforcement.

54. *Credit Act 2009*, *supra* note 4, § 204.

previously been regulated in any such fashion—assignees of debt:[55]

> If the debt is legally assigned to the debt collector, the assignee becomes the person who legally owns the debt and to whom the consumer must make repayments. The assignee debt collector is now the credit provider, and so needs to be licensed. The original credit provider would no longer be considered the credit provider because the debt is no longer legally owed to them.[56]

In this fashion, certain financial institutions and debt collectors not normally thought of as lenders, but mere purchasers of debt, would be within the ambit of the Credit Act and therefore compelled to obtain a credit license.[57]

Responsible lending requires credit grantors and credit assistance providers to make a preliminary assessment as to whether the contract will be suitable for the consumer. Section 133 of the Credit Act states that a licensee must not enter a credit contract with a consumer or increase the credit limit of a credit contract with a consumer that is unsuitable for the consumer. The definition of what is "suitable" is stated quite broadly, and refined only slightly. The contract is unsuitable if it is likely the consumer will be unable to comply with the financial obligations under the contract, or could only comply with substantial hardship, or the contract does not meet the consumer's requirements or objectives.[58] Substantial hardship is not defined. It is presumed, however, in one specified circumstance: if the consumer could only comply with the financial obligations under the contract by selling the consumer's principal residence.[59]

In determining suitability, the creditor must make "reasonable inquiries"[60] about the consumer's requirements and objectives in relation

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55. A person must not engage in a credit activity if the person does not hold a license. *Id.* § 29(1). A person engages in credit activity if the person is a credit provider. *Id.* § 6(1) item (1)(a). Credit provider includes a person to whom the rights of a credit provider have been assigned. *Id.* § 10(1)(b).

56. Australian Securities and Investments Commission, *Do I Need a Credit License?*, REGULATORY GUIDE 203, 14 (May 2013).

57. *Id.*

58. *Credit Act 2009*, *supra* note 4, § 130(1)(d). The credit would also be unsuitable if regulations prescribe unsuitability circumstances and the circumstances apply to the contract. *Id.* § 133(2)(c). One such circumstance is stated explicitly in the statute: If the consumer could only comply by selling the consumer's principal residence, it is presumed that compliance imposes a substantial hardship unless the contrary is proved. *Id.* § 133(3).

59. *Id.* §§ 131(3), 133(3). Recall that one of the criticisms of American home mortgage lenders prior to the GFC is that loans were made solely against the collateral. *See, e.g.*, *id.* These are similar ideas. In a sense, relying solely on the collateral assumes that on default, the residence will be sold to pay the debt.

60. The reasonable inquiry requirement means inquiries about the consumer's requirements and objectives, and financial situation. It also requires inquiries prescribed by the

to the contract and financial situation, and must take reasonable steps to verify the consumer's financial situation.[61] In making the determination, it is significant that the creditor is expected to take into account all information it would have had reason to believe if the creditor had made the required inquiries or verification.[62] In other words, an Australian creditor is responsible for all the information it knew or had reason to know.

The Act contemplates that the Regulations may prescribe circumstances in which a credit contract is unsuitable but the regulations have not provided any significant additional circumstances applicable to consumer credit contracts generally.[63] Most of the additional circumstances bearing on suitability apply narrowly to unique types of credit, such as small or medium-amount credit or reverse mortgages.[64]

One interesting feature of this statutory regime is that in determining suitability, the creditor must enquire into the consumer's requirements and objectives in relation to the contract, but there seems to be no obligation to take steps to verify this information. Apparently, the consumer's word is sufficient here. Moreover, there seems to be no obligation to second-guess the consumer's judgment here. For example, if a man with a family sought financing to purchase a third motorcycle, the creditor would not be expected to determine whether the family was well cared for and the consumer had a legitimate need or desire for a third motorcycle. The creditor would be expected to determine only that the credit *meets* the consumer's requirements and objectives.[65] One wonders, in light of this, whether this obligation on creditors in making the credit-

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regulations and steps prescribed by the regulations. *Credit Act 2009*, *supra* note 4, § 130(1). The regulations have added an inquiry into the maximum credit limit the consumer requires, Reg. 285A, but the regulations have not prescribed any steps to verify this information.

61. *Id.* The statute recognizes that regulations may impose inquiry into additional information or additional steps to verify any matter prescribed by the regulations. *Id.*

62. *Id.* § 133(4).

63. Regulation 28HA National Consumer Credit Protection Regulations 2010. Regulation 28HA corrects an obvious oversight, adding that certain sections apply both to entering a credit contract and increasing the credit limit. Regulation 28528528J increases the investigation period in the case of real estate mortgages from 90 days to 120 days. Regulation 285A285A28JA corrects an oversight by adding to the list of inquiries that must be made the maximum credit limit the consumer requires. Regulation 28LC limits the effect of any circumstances the regulations might add under Credit Act 2009. Credit Act 2009, *supra* note 4, §§ 131(c)(2) & 133(c)(2) (stating that credit extended under those circumstances is unsuitable "unless the contrary is proved.").

64. *See, e.g.,* Regs. National Consumer Credit Protection Regulations 2010 regs. 28XXL, 28XXF.

65. If the creditor lends the amount the consumer desires, would this not seem to *meet* the consumer's requirements and objectives? Not always. One oft-repeated example, perhaps now apocryphal, is the story of the loan in the amount of the purchase price of a house, but when the broker/intermediary took out his fees, the proceeds received by the consumer were insufficient to purchase the house.

granting decision extends meaningfully beyond determination of the consumer's ability to repay.

In at least one respect, the required inquiry into the consumer's "requirements and objectives" seems to assure one clear consumer benefit. It should deter creditors from selling things to consumers that they do not want or need, such as more credit than is necessary to achieve their specific objectives, or unneeded credit, liability, or casualty insurance.[66] Recall the discovery that in the United States, numerous mortgage brokers were found to have steered borrowers who could have qualified for prime credit to subprime mortgages, which carried higher fees.[67] Although the required determination of suitability does not explicitly prohibit extending credit that goes beyond meeting the consumer's requirements and objectives, the explicit requirement that it meet those objectives strongly implies that the credit do no more than that. Nevertheless, the responsibility for formulating reasonable objectives is left to the consumer as long as the consumer is able to make the payments without substantial hardship.

E. *Comparing the Two Approaches to Home Mortgage Lending*

In the United States, the home mortgage lender must inquire into, verify in detail, and document a lengthy and precise list of facts bearing on ability to pay and make a good faith exercise of judgment in determining the consumer's ability to repay. However, the lender can sail into the safe harbor and avoid these obligations by executing a Qualified Mortgage. While there are strict limits here on points and fees payable to intermediaries, there are no limits on what collateral products the lender may sell to the consumer as long as they do not exceed his or her ability to repay.

In comparison, an Australian mortgage licensee, whether intermediary or lender, must make reasonable inquiry into and verify the consumer's financial situation, and must ask about the consumer's requirements and objectives. The lender must, without much guidance, determine that the consumer can make the payments without substantial hardship, including no danger of having to sell the house, and the lender must not include in the sale products that the consumer does not want or need. While there is very little precision or guidance provided lenders in making these determinations, there is also no safe harbor, and the

66. Indeed, this may have been the primary goal of the required inquiry into suitability. It originated from complaints under the prior law such as loans to purchase property where, due to charges and fees, the proceeds of the loan was insufficient to purchase the property, or credit limits higher than requested. Creditors were/are not expected to judge the wisdom of the consumer's purpose. Karen Cox Interview, *supra* note 48.

67. *See supra* text accompanying note 11.

consequence of civil or criminal liability of the Australian licensee may be more severe than for the American lender, because of the risk of losing the license to participate in the consumer credit industry.

In both nations, the responsibility for making responsible borrowing decisions rests, as it always has, on the consumer, as long as the consumer is able to make the payments.

II. REGULATING THE DECISION TO AUTHORIZE USE OF OR TO INCREASE THE CREDIT LIMIT ON A CREDIT CARD

At first blush, one would think there is no need to regulate the decision to grant a credit card application because, unlike the 2007 American home mortgage market in which the persons making the credit granting decision had no stake in the consumer's ability to repay, the issuer of a credit card actually extends the credit and directly shoulders the risk of nonpayment. However, in battling for market share, credit card issuers have been able to assume a great deal of risk, in some cases too much, because they were permitted to collect not only high rates of interest,[68] but also to collect a wide array of other fees and charges. Accordingly, in 2009 lawmakers in both Australia and United States saw the need to require credit card companies to make the credit-granting or credit-increase decision more thoughtfully.

A. *The Australian Approach*

The Australian requirement of responsible lending in extending consumer credit applies to all types of consumer credit activity, including credit cards and other forms of open-end or revolving credit. The same rules described above apply. Before granting use of the card or increasing the credit limit on an existing card, the creditor must make a determination of suitability by making reasonable inquiries into the consumer's ability to meet the contractual obligations without substantial hardship. The creditor must also inquire as to whether the credit will meet the consumer's requirements and objectives. In addition to these broad guidelines, there are no special provisions bearing on the credit-granting decision.

The mandated inquiry into the consumer's requirements and objectives should add little. The consumer's objective is simply to have

68. In the United States, at least, state usury laws do not apply to credit card companies. In Marquette Nat'l Bank v. First Omaha Service Corp., 439 U.S. 299, (1978), the Supreme Court held that under the National Bank Act 12 U.S.C. § 85 federally chartered banks can charge the highest rate of its state of location. Immediately, South Dakota and a number of other states rescinded their usury laws, and card issuing national banks located in those states.

the use of a credit card and the attendant convenience it permits,[69] including the opportunity to build a credit history, avoid carrying cash, and protection against certain kinds of fraud and breach of warranty. Perhaps for a consumer that has ten credit cards, an eleventh credit card would be unsuitable. This would perhaps seem odd but unremarkable if the consumer has the ability to repay.

B. *The American Approach*

In 2009, Congress passed the CARD Act[70] amending the Truth-in-Lending Act requiring for the first time that in opening a credit card account or an open end credit plan the card issuer must consider the consumer's ability to make the required minimum payments. In considering ability to make those payments, the issuer must use a reasonable method for estimating the minimum periodic payments,[71] but this requirement may be met if the creditor estimates the payment using the prescribed method, called the "safe harbor."[72] In addition, Regulation Z requires card issuers to maintain policies and procedures to *consider* the consumer's ability to repay.[73] Reasonable policies and procedures are not defined, but examples are provided, which "include consideration of at least one of the following: The ratio of debt obligations to income; the ratio of debt obligations to assets; or the income the consumer will have after paying debt obligations."[74] So, the obligations (1) to consider ability to pay, and (2) to maintain reasonable policies and procedures can be met by calculating the minimum periodic payment according to the prescribed method, and by considering either the ratio of debt to income, the ratio of debt to assets, or disposable income after paying debt service.[75] These are

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69. Regulatory Guide 209 states: In relation to credit cards, the Explanatory Memorandum states that a

> credit card has no particular purpose and therefore there would be a limited requirement to understand the consumer's requirements and objectives in this case. . . . However, we expect that [a creditor] would still make inquiries about the maximum limit the consumer requires on the card, as this is a key feature of the product that relates to the consumer's requirements and objectives.

Australian Securities and Investments Commission, Regulatory Guide 209.37 (2014).

70. Credit Card Accountability Responsibility and Disclosure Act of 2009, 111 Pub. L. No. 24, 123 Stat. 852 (2009) [hereinafter CARD Act].

71. 12 C.F.R. § 1026.51(a)(1)(i).

72. 12 C.F.R. § 1026.51(ii).

73. 12 C.F.R. § 1026.51. The closest the regulation comes to any such prohibition is to state the obvious, that "it would be unreasonable for a card issuer . . . .to issue a credit card of a consumer who does not have any income or assets." *Id.*

74. 12 C.F.R. § 1026.51(a)(ii).

75. *Id.*

ministerial acts that do not require the exercise of judgment. There is no requirement that the issuer determine that the consumer does or does not have the ability to repay, and there is no prohibition against issuing the card to a consumer that may be unable to pay. Perhaps this is explained by the fact that, unlike the 2007 home-mortgage industry, the decision to issue the card is made by the person that extends the credit and takes the risk of nonpayment. Congress seems to assume that the self-interest of the issuer will result in responsible decisions here. However, the self-interest of the card issuer provides the consumer no protection if the issuer can collect limitless charges. Accordingly, in addition to the aspirational requirement that the creditor consider ability to repay, the 2009 amendments to the Act placed numerous additional restrictions on the profit-generating practices in which the creditor could engage.[76] By severely reducing issuer income from excessive non-interest charges, card issuers may be forced to make more careful credit granting decisions, giving up a little market share and perhaps protecting a few consumers from themselves. Rather than forcing card issuers to engage in responsible lending, by toothlessly requiring consideration, Congress may have imposed a self-correcting regime.

In one respect, the 2009 amendments explicitly regulate the credit-granting decision with great precision. Because of the perception that it was often too easy for young consumers to rack up unmanageable credit and damage their credit rating,[77] consumers under the age of twenty-one cannot now get a credit card unless they can demonstrate an *independent* ability to repay the debt or unless they have a cosigner over the age of twenty-one that has the ability to repay it.[78]

C. *Comparing the Two Approaches to Granting Use of a Credit Card*

Aside from the special American focus on issuing credit cards to persons under twenty-one years of age, the differences here may be more a matter of form than substance. The requirement of responsible lending to persons over twenty-one years of age is stated differently. The

76. By requiring consumers to opt in for over limit fees for each charge that put the consumer over the credit limit, these have effectively been eliminated, and by requiring that penalty fees such as late fees be reasonable and proportional the size of late fees has declined. Consumer Fin. Prot. Bureau, CFPB Finds Card Act Reduced Penalty Fees and Made Credit Card Costs Clearer (Oct. 2, 2013), http://www.consumerfinance.gov/newsroom/cfpb-finds-card-act-reduced-penalty-fees-and-made-credit-card-costs-clearer/; CONSUMER FIN. PROT. BUREAU, CARD ACT REPORT 20 (2013), http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf.

77. Consumer Fin. Prot. Bureau, *supra* note 76.

78. 12 C.F.R. § 1026.51 (2013). No increase in credit limit is permitted unless the cosigner agrees in writing to assume liability for the increase. *Id.* Curiously, it is only here that granting credit is explicitly prohibited by either nation.

Australian card issuer must make an assessment of suitability, and deny the card to a consumer who cannot pay.[79] The American card issuer must consider ability to repay, but is not required to deny the card to the consumer that fails the test. Once the American card issuer has been forced to consider ability to pay, the United States seems to depend on the self-interest of the issuer to act responsibly. Both nations have focused on limiting non-interest fees and charges, which, unlike interest, tend to be invisible to card applicants. Card issuers will now have to depend to a greater extent on interest income. Since they can no longer cover up a multitude of sins with limitless non-interest fees and charges, card issuers may be forced to make credit-granting decisions here more responsibly.

III. PAYDAY AND OTHER SMALL-AMOUNT SHORT-TERM CONSUMER LOANS

In both Australia and the United States, payday loans and their like have proven to be the most difficult type of consumer credit to regulate. Payday loans are typically designed as a way to bridge a cash shortage between pay or benefits checks. They share these three characteristics: (1) they are generally for small-amounts of money; (2) borrowers must repay them quickly;, and (3) the borrower must repay the full amount or give lenders access to repayment through a claim on the borrower's deposit account.[80] The length of the term is usually calculated to coincide with the next paycheck or other income source.[81] Typically, the fee for this short-term money use is stated as a cash amount ranging from $10-20 per 100.[82] As long as the borrower expects to receive a pay or benefits check in the near future, usually there is no additional inquiry into the borrower's credit-worthiness.[83] In isolation, one-time loans of this sort are inoffensive. In fact, they are seen as playing a useful role, meeting the legitimate occasional needs of consumer borrowers, despite the fact that

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79. The Credit Act states: "A licensee must not (a) enter a credit contract with a consumer who will be the debtor under the contract or (b) increase the credit limit of a credit contract with a consumer who is the debtor under the contract if the contract is unsuitable for the consumer . . ." Credit Act § 133 (2014).

80. Consumer Fin. Prot. Bureau, CFPB Finds Payday and Deposit Advance Loans can Trap Consumers in Debt (Apr. 24, 2013), http://www.consumerfinance.gov/newsroom/the-cfpb-finds-payday-and-deposit-advance-loans-can-trap-consumers-in-debt/.

81. Consumer Fin. Prot. Bureau, Payday Loans and Deposit Advance Products, A White Paper of Initial Data Findings 6 (2013) [hereinafter CFPB Payday Loans Whitepaper], http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

82. In the United States, these loans are regulated by state law. Most states with payday lending storefronts set this maximum fee per $100, averaging about $15 per 100. Some states impose a sliding scale. *Id.* at 16.

83. The creditor protects itself by insisting on immediate repayment or taking a claim on the borrower's deposit account. *See supra* note 80 and accompanying text.

the interest payable over a short period of time would seem quite high compared to typical consumer annual percentage rates.[84] A fee of $15-20 per 100 over 2 weeks equates to an annual percentage rate (APR) of 391% to 521%—but in the short term, it is only $20, a fair price for assistance in getting over the unexpected hump, particularly if the borrower's poor credit rating would preclude getting the assistance from a more traditional lender. Payday lenders also fill a gap in the lending market, because banks typically do not consider lending amounts as small as $500.

The problem with these types of loans is that frequently, at the end of the 2-week period, a consumer who has borrowed $300 at $20 per 100 cannot come up with the required $360 in cash.[85] It may be impossible to come up with the cash, or it may just be inconvenient to do so. Either way, the lender suggests that the consumer merely pay the $60 interest due, and "roll over" the loan for another 2 weeks.[86] How cooperative, and understanding such a lender is! However, the principal amount is not reduced, and if the loan is rolled over multiple times, the consumer may well pay hundreds of dollars in fees and still owe the original $300. In such a case, the effective Annual Percentage Rate can reach breathtaking heights.[87]

The societal policy question is whether there is anything wrong with this. After all, at each due date, the consumer makes the choice of whether to pay now or later. Paying now may sometimes be impossible, but usually it will be a matter of choosing not to pay or not to buy something else. Should this choice not be left to the consumer? Should it matter how many times these types of loans are rolled over, and for how long a period they remain outstanding? Is there some number of rollovers or some

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84. *See, e.g.*, Paige Martin Skiba, *Regulation of Payday Loans: Misguided*?, 69 WASH. & LEE L. REV. 1023, 1028 (2012).

85. The cost of a payday loan is a fee which is typically based on the amount advanced and does not vary with the duration of the loan. The cost is usually expressed as a dollar fee per $100 borrowed. Fees at storefront payday lenders generally range from $10 to $20 per hundred, though loans with higher fees are possible. Consumer Financial Protection Bureau Whitepaper, Payday Loans and Deposit Advance Products 8 (Apr. 23, 2014). A payday loan is typically structured as a closed-end single payment loan with a due date that coincides with the borrower's next payday or receipt of other income. Because the due date is timed in this manner, the loan term is typically two weeks. *Id.*

86. Storefront payday loan contracts generally require borrowers to return to the storefront to pay the loan and associated fee by the due date. If a borrower is unable to repay the full amount, the lender may give her the option to roll over the loan balance by paying a fee, usually equal to the original finance charge, in order to extend the loan until her next payday. If the lender is unwilling or—because of restrictions in the state law—unable to directly roll over a loan, the borrower may instead repay the full amount due and then quickly take out a new loan. *Id.* at 9.

87. To calculate the actual APR in such a case, one must know when the principal is paid off, so that the term of the loan can be known. Only then can the actual APR be calculated. For example, if the principal were paid off after 6 months (7 fortnights) the consumer will have paid $420 in interest for the use of $300 for 6 months. This equates to an APR of 521%.

effective APR that is just too high, so that society should take the choice away from the consumer? Should society attempt to distinguish between consumers who are "spiraling" deeper into debt and those that are barely keeping their noses above water? How could one measure the effect of such paternalism? Even if one could count the number of consumers saved from the spiral compared to the number not helped over the hump, which would probably be empirically impossible, how would one assess the meaning of such data? Does one consumer saved from the spiral equal two not helped over the hump?[88] Studies in both nations show that too many are not saved. Instead, they languish.[89] Accordingly, both nations recently decided that at least some nation-wide protection from these types of loans is needed and both have begun to regulate them.

A. *The Australian Regulation of Payday Loans*

On September 21, 2011, the Consumer Credit and Corporations Legislation Amendment 2011 (Enhancements Bill) was introduced into Parliament. The Bill proposed amendments to the Credit Act, including reforms to "small amount, high interest, short term loans,"[90] which are colloquially known as payday loans. The reforms were spawned by a number of studies in both countries indicating that additional protections were needed.[91]

As introduced, the Enhancements Bill contained a number of discrete prohibitions on the terms of payday loans, including a cap on fees and a prohibition on multiple lending and refinancing.[92] In response, the submissions of the payday loan industry and the consumer welfare advocates were in stark opposition to one another.[93] The industry, of

88. One might argue, for example, that a consumer not helped over the hump by expensive credit might have survived it anyway, as by working harder to earn the needed cash. The conservative argument against social welfare programs strikes a similar chord. But conservatives might not value any higher the saving of a consumer from deeper debt because the consumer might also save him/herself by working harder. Clearly, there is little to be gained in attempting this comparison.

89. There would be no telling how many are helped. Presumably, those that do not engage in repeated roll-overs are helped, but of the repeaters, there would be no telling who was helped and who was made worse off.

90. Paul Ali et al., *The Politics of Payday Lending Regulation in Australia*, 39 MONASH U. L. REV. 411, 411 (2014). "The reforms to payday loans were to be complemented by additional strategies aimed at reducing borrower reliance on payday loans, . . . such as microfinance and low and no interest community loan schemes." *Id.*

91. *See generally id.* at 416–18.

92. In describing the contest over the substantive content of the bill as originally proposed, Ali et al. state, "[t]he second contested matter . . . was principally driven by industry opposition to the proposed cap on fees and interest rates and restrictions on multiple lending and refinancing." *Id.* at 428.

93. *Id.*

course, claimed without success that no regulation was needed at all,[94] but the industry's greatest success lay in achieving significant reductions in the limitations on fees and repeat loans. The industry also succeeded in adding a significant degree of complexity, thus impenetrability, to the regulatory scheme.[95]

The original Enhancements Bill permitted charging three allowable fees: an establishment fee reflecting reasonable costs of providing credit, a monthly fee, and a default fee. The establishment fee was originally capped at 10%, with reference to the cost of origination, and the monthly fee was capped at 2% (*i.e.*, 24% per annum).[96] However, due to aggressive lobbying by the payday lenders, these amounts were doubled in the final bill, and the reference to the costs of providing credit was removed, permitting a charge of twenty percent each time a loan is initiated (rolled over).[97] The increases in these caps were required, according to the explanatory memorandum, for a "viable small amount lending industry to continue," reflecting the legislature's acceptance of the industry position.

The original Enhancements Bill contained strict prohibitions on repeat and concurrent borrowing.[98] The bill prohibited the lender from entering into a payday loan where the lender knew or was reckless as to whether the borrower was a debtor under another payday loan, or where some or all of the credit was to refinance an existing one.[99] The industry strongly opposed these limits, arguing that the general responsible lending requirements were sufficient to protect consumers here, and consumer representatives vehemently objected.[100] "However, the Parliamentary Joint Committee was persuaded . . . [that] a more appropriate response to consumer vulnerability would be to require short-term lenders to consider whether the proposed" loan is unsuitable under the circumstances.[101] Consequently, the prohibitions were removed and replaced with presumptions and obligations in relation to suitability under Chapter 3 of the Credit Act.[102] If the consumer is either in default on a small amount contract or in the previous ninety days has been a debtor in two or more

94. *Id.* at 428–30.

95. *Id.* at 445–50.

96. Ali et al., *supra* note 90, at 435–36.

97. *Consumer Credit Legislation Amendment (Enhancements) Act 2012*, (Cth) sch. 4, item 4, cl. 23A & item 12, cl. 31A(1), (2) & (3) (Austl.).

98. Explanatory Memorandum, Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011, (Cth) 52 (Austl.).

99. *Consumer Credit Legislation Amendment (Enhancements) Act 2012*, (Cth) sch. 3 (Austl.).

100. Ali et al., *supra* note 90, at 440.

101. *Id.*

102. Supplementary Explanatory Memorandum, Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011, (Cth) 14. (Austl.).

small amount contracts, then it is *presumed* that the consumer could only meet the loan obligations with substantial hardship, and thus, the loan must be denied as unsuitable.[103] Clearly, the presumption provides less protection for consumers than the outright prohibition of repeat and concurrent borrowing would have provided. On the other hand, because frequent rollovers are critical to the payday-lending business model, the outright prohibition would probably have sounded the end of most payday lending in Australia.

One wonders how these presumptions are likely to affect the Australian payday loan industry. In applying for the first payday loan, there is no presumption and the loan will most likely be assessed as suitable. When asked about requirements and objectives, the consumer will probably have a good reason for applying (*e.g.*, "My daughter is in the hospital," or "Vinnie has threatened to break my knees if I don't come up with the cash.") and the expected paycheck is all the lender needs to know about regarding ability to repay. In rolling over a payday loan, the consumer's only objective is to postpone full payment of the debt, and the agreement to permit rollover clearly meets this objective. The second rollover application raises the presumption of undue hardship and the creditor must deny the application unless it can rebut the presumption. What sorts of facts might suffice? Ordinarily, the ability to repay the third loan will be no different than the ability to repay the first, as long as the paycheck exceeds the amount of the loan plus the ten to twenty percent fee by a respectable amount. How much of a differential is respectable?[104] Arguably, because it is only a two-week loan, two weeks' living expenses (room & board) should suffice. The consumer, who wants the rollover, will insist that the differential is sufficient, and the lender, who also wants the rollover, will probably agree. If future rollovers are expected, this view might seem short-sighted, but it is far from clear how or why the number of previous rollovers bears on the ability to repay the latest loan. The confusion is only magnified when one assumes the presumption exists because the consumer may have had a couple of payday loans two months earlier, either from the instant lender or another, within the statutory ninety day period. Having ignored the posted warnings[105] and

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103. *Credit Act 2009*, *supra* note 4, §§ 118, 123, 131, 133(3A).

104. Perhaps *National Consumer Credit Protection Regulations 2010*, (Cth) reg. 28S (Austl.); *Credit Act 2009*, *supra* note 4, § 133(3A) (providing a safe harbor). Under the authority of Credit Act 2009, section 133C(1), the regulations provide that "for consumers who receive at least 50% of their income under the Social Security Act," the payment must not exceed 20% of the gross paycheck. For a consumer that is less dependent on such funds, this baseline would probably be a reliable source of rebuttal.

105. *National Consumer Credit Protection Regulations 2010* (Cth) reg. 28XXA (Austl.) requires a warning on the licensee's premises as set out in Schedule 7, stating: "Do You Really Need a Loan Today? It can be expensive to borrow small amounts of money and borrowing may not solve your money problems." The warning also suggests a number of options to be tried before

seasonably paid off those previous loans seems to suggest that the consumer should have no trouble paying off the instant loan, which would rebut the presumption of substantial hardship.[106] Given that both the consumer and the lender want the loan to be approved, it is hard to imagine many such loans being denied. Perhaps after a number of rollovers, the lender's employee might ask the consumer who has dutifully paid the fortnightly fees, "Don't you think you've rolled this loan over too many times? Why don't you forego [something] and pay it off?" Perhaps not—in fear of getting a "talking to" by the boss, such as, "What's wrong with you Charlie? Would you advise the goose to stop laying golden eggs?"

Ali, McRae, and Ramsey argue that "rebuttable presumptions as opposed to strict prohibitions is problematic,"[107] for a number of reasons. They state:

> [One] issue is the limited guidance available concerning key concepts under-pinning the rebuttable presumptions such as what constitutes substantial hardship and what constitutes unsuitability, and what is required to rebut these presumptions. In March 2013 the UK Office of Fair Trading (OFT) recommended not introducing prescriptive requirements for lenders to assess affordability of loans. An OFT investigation of payday lenders in 2012 found "significant underlying incentives" for lenders to assess loans as affordable, when in fact they are not.[108]

With regard to repeat loans, ASIC Regulatory Guide 209 provides some precision. It provides an additional responsible lending requirement for small amount credit contracts. It states:

> [T]here are risks that the repeated or continued use of credit provided through this form of credit contract will result in consumers entering into multiple contracts where the overall level of indebtedness increases over time so that:
> (a) an increasing proportion of the consumer's income will need to be used to meet the repayments; and
> (b) the capacity of the consumer to use the credit to improve their

borrowing, such as seeking free financial counseling, working out a payment plan with utilities providers, and asking for an advance against government benefits. *Id.*

106. Although, paying off the prior loan and needing another loan shortly thereafter might be a good indicator that the consumer could not really afford to pay off the previous loan, and therefore cannot afford the new one. Having been a debtor in two or more such contracts in the previous 90 days is the presumption-creating measure chosen here.

107. Ali et al., *supra* note 90, at 444.

108. *Id.* (internal citations omitted).

standard of living is diminished.

This requirement adds meaningfully to the presumption of undue burden resulting from repeat loans. Although a regulatory guide lacks the force of a statute or regulation, it is a clear statement of what ASIC will be looking for. If the creditor knows or should know that the consumer's discretionary income is decreasing due to repeated loans, it will be much more difficult to rebut the presumption of undue burden.[109] The importance of the fact that a creditor is statutorily responsible for information it should have discovered through reasonable inquiry should not be underestimated. Each time a payday loan is rolled over, the creditor is required to investigate and verify the consumer's financial situation. It will be no excuse to say, "We didn't know," or "The debtor said nothing had changed." The objectively demonstrable deterioration of the consumer's financial situation will be strong evidence of unsuitability, making the three-loan presumption difficult to rebut.

On the other hand, in seeking to rebut the presumption, there is nothing to prevent the lender from assuming the consumer will pay off the principal in partial payments over a number of rollover periods. In sum, it is far from clear that the Australian vision of responsible payday lending will cause any significant change in industry practices.

B. *The American Regulation of Payday Loans*

In 2006, the U.S. Department of Defense issued a report concluding that predatory lending practices by payday lenders and other creditors near military bases were deliberately aimed at taking advantage of military personnel and their families.[110] In 2007, Congress passed the Military Lending Act (MLA),[111] and the Defense Department issued rules to implement the law, severely limiting payday lending to military personnel and their families.[112] Because of national attitudes favoring

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109. On the other hand, where the consumer has had two such loans in the previous ninety days, the creditor might rebut the resulting presumption of undue hardship by showing, in reliance on this guide, that the consumer has not suffered any decrease in discretionary income. At some point, this argument leads to the perverse conclusion that as long as the consumer's financial situation is not worsening, the consumer needs no protection from this small loan cycle. But it is precisely by staying in the cycle that the consumer is most severely harmed.

110. U.S. DEP'T OF DEF., REPORT ON PREDATORY LENDING PRACTICES DIRECTED AT MEMBERS OF THE ARMED FORCES AND THEIR DEPENDENTS 21–22 (2006), *available at* http://www.defense.gov/pubs/pdfs/Report_to_Congress_final.pdf. These findings were the result of an empirical survey done by Steven Graves and Christopher Peterson showing that payday lenders were deliberately targeting military bases across America. Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 832 (2005).

111. The Military Lending Act, 10 U.S.C. § 987 (2006).

112. Press Release, Department of Defense Issues Final Military Lending Act Rule, DOD

protection of military personnel, there was virtually no political resistance to the MLA. In 2012, Congress amended the law by, among other things, giving the Consumer Financial Protection Bureau (CFPB) the authority to enforce it. The Bureau not only set out to enforce the MLA, but also commenced a comprehensive study of payday loans and deposit advances.[113] In April 2013, the CFPB published the initial findings on payday loans and deposit advance products. The key findings focused on consumers' sustained use of these loans. Some consumers use payday loans and deposit advances at relatively low to moderate levels. Thirteen percent of borrowers "took out only one to two loans over a twelve month period, and about one third took out six loans or less."[114] However, two-thirds of the payday borrowers had seven or more loans in a year, mostly taken within fourteen days of the previous loan. Finding that a sizeable share of borrowers conduct transactions on a long-term basis suggested that they are unable to fully repay the loan plus other expenses without taking out a new loan shortly thereafter. "Thus they continually re-borrow and incur significant expense to repeatedly carry this debt from pay period to pay period . . . . [T]he high cost of the loan or advance may itself contribute to the chronic difficulty such consumers face in retiring the debt." Also playing a material role in the harms experienced by consumers is that "lenders rely on their relative priority in the repayment hierarchy . . . without regard to whether the consumer can afford the loan," which "trumps the consumer's ability to organize and prioritize payments of debts and other expenses."[115] However, despite these findings, the Bureau concluded only that further inquiry is required into "the factors contributing to sustained use of these products by many consumers and the light to moderate use by others."[116] The Bureau is proceeding deliberately here, owing to its "objective of providing an evidence-based perspective on consumer financial markets, consumer

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Press Release No: NR-289-15 (July 21, 2015). The release states that "This rule applies the protections of the Military Lending Act to all forms of payday loans . . ." Among other protections, the Act and Rules prohibit a creditor from requiring service members to provide a payroll allotment as a condition of obtaining credit, to refinance a payday loan, to secure credit using a post-dated check, to access to a bank account (other than at an interest rate of less than 36% MAPR). Taken together, these restrictions effectively prohibit making payday loans to military personnel.

113. CFPB Payday Loans Whitepaper, *supra* note 81, at 1, 3. Deposit Advances are similar to payday loans. Payday loans are usually offered by non-depositary institutions. Depositary advances are offered by a small but growing number of depository institutions to certain deposit account holders who have recurring electronic deposits, such as direct deposit of their paychecks. The bank repays itself when the next qualifying deposit arrives. *Id.* at 6–7.

114. *Id.* at 44.

115. *Id.*

116. *Id.*

behavior, and regulations to inform the public discourse."[117]

While the CFPB continues to study the matter, the only current federal limitations on payday lending apply to the members of the military and their families.[118] The prohibitions are extensive, prohibiting charge of interest in excess of 36% APR,[119] and prohibiting roll over of any credit extended by the same creditor.[120] However, the narrow definitions of the types of loans covered by the act have permitted lenders to sidestep the prohibitions by providing other types of loans to military personnel, leading to speculation that the MLA will need to be expanded.[121] The question persists, if all military families need this protection, aside from the politics of the matter, it is not at all clear why other American families do not need at least some protections from payday lending.

Of course, the states are free to regulate payday lending, and some of them do. Some impose disclosure obligations, some impose responsible lending codes, and some limit the allowable interest on payday loans.[122] In New York State, a strictly enforced interest rate cap has resulted in the total elimination of payday lending in that state.[123] However, the rapid growth of online payday lending[124] threatens to make it much more difficult for the states that choose to regulate payday lending to do so. The State of New York has recently obtained a $1.5 million penalty settlement plus refunds from an online lending institution for violating its interest rate cap,[125] but such aggressive enforcement action requires a

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117. CONSUMER FIN. PROT. BUREAU, CFPB DATA POINT: PAYDAY LENDING 2 (MAR. 25, 2014), *available at* files.consumerfinance.gov/f/201403_ cfpb_report_payday-lending.pdf. The quoted statement is taken from the cover page of the Data Point publication. In this publication, the Bureau describes some of the findings in a recent study.

118. The scope of the MLA reaches broadly to include extensions of consumer credit to a member of the armed forces on active or reserve duty or a dependent of the member. 10 U.S.C. §§ 987(i)(1), 987(i)(2) (2014).

119. 10 U.S.C. § 987(b) (2014).

120. 10 U.S.C. § 987(e)(1) (2014).

121. Jessica Silver-Greenberg & Peter Eavis, *Service Members Left Vulnerable to Payday Loans*, N.Y. TIMES (Nov. 21, 2013, 8:48 PM), http://dealbook.nytimes.com/2013/11/21/service-members-left-vulnerable-to-payday-loans/. Loans not covered included "loans for more than $2,000, loans that last for more than 91 days, and auto-title loans with terms longer than 181 days." *Id.*; *see also* John L. Culhane, Jr., *Proposal to Expand Military Loan Act Coverage Appears Likely*, CFPB MONITOR (Nov. 26, 2013), http://www.cfpbmonitor.com/2013/11/26/proposal-to-expand-military-loan-act-coverage-appears-likely/. These problems were solved by the July 21, 2015 amendments to the Military Lending Act Rule. *See supra* note 112.

122. Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 875–77 (2007).

123. Karen E. Francis, Note, *Rollover, Rollover: A Behavioral Law and Economics Analysis of the Payday-Loan Industry*, 88 TEX. L. REV. 611, 623. (2010).

124. CFPB Payday Loans Whitepaper, *supra* note 81, at 10. "[T]he online channel is steadily growing and some industry analysts believe it may eventually overtake storefront loan value." *Id.*

125. Karen Freifeld, *Online Lender Settles New York Lawsuit Amid Crackdown on Massive 'Payday' Loans*, REUTERS U.S. ED. (Jan. 23, 2014, 10:20 PM), http://www.reuters.com/article/

substantial financial commitment that many states would not be willing politically or able financially to make. Meaningful regulation of interstate online lenders will probably require a federal effort. Perhaps the rapid growth in payday lending will provide the impetus for CFPB intervention.

C. *Comparing Australian to American Regulation of Payday Loans*

There is very little to compare here at the national level. Australia has placed great reliance on the presumption that three payday loans in a ninety-day period creates a presumption of undue hardship, but it is far from clear that this will impact business of usual. In the United States, payday lending to military personnel has been restricted.[126] Otherwise, in the United States, the CFPB is actively studying the matter.[127] As yet, however, no national regulation of payday loans has appeared.[128] The responsibility here remains with the states, and both the degree of regulation and the level of enforcement effort here varies dramatically from state to state.[129]

In reality, any attempt to regulate the decision to grant a payday loan may be futile. The nature of the business is such that as long as the borrower expects a paycheck or a benefits check, the loan will be made. The societal question is whether to permit such loans at all. If so, the challenge will be to decide how to regulate the terms such that the incentive to grant these loans is not destroyed, yet the likelihood of excessive rollovers is curtailed. This reality must be recognized: the

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2014/01/24/usa-onlinelender-lawsuit-idUSL2N0KY03N 20140124.

126. *See* Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 875–76 (2007).

127. *See, e.g.*, CONSUMER FIN. PROT. BUREAU, CFPB DATA POINT: PAYDAY LENDING 2 (2014), *available at* files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.

128. On March 26, 2015, the CFPB issued a press release stating that it is considering proposing rules that would end "payday debt traps," including payday loans, vehicle title loans, deposit advance products and certain high-cost installment loans and open-end loans. Two approaches are being considered, requiring lenders to determine at the outset that the consumer can repay the loan, or alternatively at the choice of the lender, the lender would be required to provide affordable repayment options, and the number of loans a consumer could take out in a row over the course of a year would be limited. Press Release, Mar. 26, 2015, www.consumerfinance.gov/press-releases.

129. In an interesting recent development aimed at assisting the states in enforcing their restrictions on payday lending, on August 4, 2015, the CFPB issued a press release stating that it had filed a lawsuit against numerous "offshore payday lenders" that originate and collect payday loans over the internet in 50 states, including states such as New York where those loans are void because they violate usury caps and licensing requirements. The complaint alleges that the defendants have violated the Dodd-Frank Wall Street Reform and Consumer Protection Act's prohibition against unfair, deceptive, and abusive acts and practices. Press Release, Aug. 4, 2015, www.consumerfinance.org/ Press-releases.

viability of this industry turns on the expectation of frequent excessive rollovers. If this is a necessary evil, borne of the sad fact that too many consumers have insufficient income to make ends meet, then the industry must be permitted to exist. The worthy societal goal should then be to improve the lot of necessitous consumers, either by reducing poverty or by providing alternative sources of credit. But these are lofty goals that are far from within immediate reach.

IV. COMPARING ENFORCEMENT REGIMES: THE KEY TO IT ALL

Regulation of human conduct is difficult. It is particularly difficult in cultures like those of the United States and Australia in which independence, creativity, and competitiveness are highly prized. It is self-evident that the key to the effectiveness of the regulations lies in the enforcement regulations. In comparing the instant regimes regulating the decision to grant consumer credit, there are of course similarities, but there are also substantial differences. Australia has imposed one of the most progressive consumer protection regimes in the world.[130] If the United States is to significantly alter the consumer-lending culture, it would do well to keep a close eye on the success of the Australian experience.

A. *Australian Enforcement Mechanisms*

1. Licensing

At the heart of the Australian approach is the comprehensive national licensing regime. One of the lengthiest and most detailed parts of the Credit Act is Chapter 2, Licensing of Persons Who Engage in Credit Activities. The key elements are that:

> It requires persons who engage in credit activities to, initially, be registered with ASIC, and to hold an Australian Credit License (ACL);[131]
>
> It imposes entry standards for registration and licensing, and enables ASIC to refuse an application where the person does not meet those standards;[132]

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130. *See, e.g.*, *Credit Act 2009*, *supra* note 4.

131. *Id.* § 29(1).

132. ASIC must not grant a license to a person unless "ASIC has no reason to believe that the person is likely to contravene the obligations under the statute," or "ASIC has no reason to believe that the person is not a fit and proper person to engage in credit activities." *Credit Act*

> It requires registered persons and licensees to meet certain ongoing standards of conduct while they engage in credit activities; and[133]
>
> It provides ASIC the power to suspend or cancel a license or registration, or to ban an individual from engaging in credit activities.[134]

The power of ASIC to control entry of a person into or to expel a person from the consumer credit industry provides enormous incentive to toe the line. This requires not only that the creditor operate within the responsible lending rules, but also to comply with the extensive record keeping, trust account maintenance, auditing compliance, and reporting requirements.[135] It is also significant that ASIC may exercise this power across the nation. It will not be possible for a person to get into difficulty in one state, and then move to another to set up shop anew.

2. Forums, Remedies and Enforcers

A key feature of the Credit Act is the improved access to dispute resolution in terms of location, procedural simplicity, and lower cost.[136] Credit providers and credit servicers are required to have an internal dispute resolution process, and are also required to maintain membership in an ASIC-approved External Dispute Resolution Scheme.[137] The membership fees sustain the two ASIC-approved External Dispute Resolution services, the Financial Ombudsman Service,[138] and the Credit Ombudsman Service.[139] The service is free to the consumer, and once a dispute action is lodged, all enforcement efforts are stayed until the dispute is resolved.[140] The ombudsman will normally operate initially as

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2009, *supra* note 4, § 37(1)(b), (c). ASIC must also not grant a license to a person contrary to a banning order or disqualification, or of a state or territorial order prohibiting the person from engaging in credit activity under the law of the state or territory. *Id.* § 40.

133. *Id.* §§ 47–53.

134. *Id.* ch. 2, pt. 22, div. 6, § 54.

135. *See id.* pt. 255, §§ 91–105.

136. *Id.*

137. *Id.* div. 5, § 47.

138. *About Us—What We Do*, FINANCIAL OMBUDSMAN SERVICE, http://www.fos.org.au/about-us/what-we-do/ (last visited Feb. 18, 2015).

139. *About Us –Our Role*, CREDIT OMBUDSMAN SERVICE, http://www. cio.org.au/about/our-role/ (last visited Feb. 18, 2015).

140. For example, the Financial Ombudsman Service (FOS) operates under the ASIC-approved Term of Reference (TOR), *About Us—Terms of Reference*, FINANCIAL OMBUDSMAN SERVICE, http://www.fos.org.au/about-us/terms-of-reference/ (last visited Feb.18, 2015). TOR s. 7.3 provides that FOS may require a party to do anything that it considers may assist in its consideration of the dispute. *Terms of Reference*, FINANCIAL OMBUDSMAN SERVICE 16 (Jan. 1,

a mediator, but the ombudsman is also empowered to render a final determination.[141] If neither process resolves the dispute, consumers retain access to the courts to seek redress.[142] Not only is the consumer entitled to seek redress in court, ASIC and in some instances other interested parties are entitled to participate in a dispute.[143]

The Credit Act provides a wide array of remedies against an offending credit or credit assistance provider. ASIC may seek a declaration of contravention of a civil penalty, which carries a pecuniary penalty. Recognizing that the penalty amounts need to be substantial to sufficiently deter inappropriate behavior[144] the penalties can be severe. For example, a licensee that enters a credit contract that is unsuitable for the consumer may incur a civil penalty of 2,000 penalty units, which amounts to a maximum of $220,000 for individuals and $1,100,000 for corporations, partnerships or multiple trustees.[145] In addition to civil penalties, some kinds of misconduct are defined as "offenses" for which ASIC may apply for a court order imposing a criminal penalty or imprisonment or both.[146] So, depending on the failure to comply, a licensee may be charged with both civil and criminal penalties.[147]

In addition to penalties, for which only ASIC is empowered to seek an order,[148] on application of ASIC or any other person, the court is empowered to grant an injunction.[149] Any person that has suffered damage may seek compensation for any loss or damage.[150] ASIC may apply for damages on behalf of the consumer with the consumer's consent,[151] and the consumer may seek an order varying the contract,

2014) http://www.fos.org.au/custom/files/docs/terms-of-reference-from-1-january-2010-as-amended-1-january-2014.pdf. TOR s 13.1 provides that once a disputed is lodged, the creditor must not take any action to recover the debt while FOS is dealing with the dispute. *Id.* at 27.

141. *Id.* at 19–20.

142. *Id.* at 20.

143. For example, in section 177(1), ASIC "or any other person" may apply for an injunction. *Credit Act 2009, supra* note 4, § 177(1).

144. *Id.* §§ 165–67.

145. *Id.* §§ 118, 167(3)(b), 169. "A penalty unit has the meaning given by section 4AA of the Crimes Act 1914." *Id.* § 5. Further, persons "involved in" contravention of a civil penalty, such as aiding and abetting, inducing the contravention, or being in any way knowingly concerned in it, are likewise taken to have contravened it. *Id.* § 169.

146. *See, e.g.*, *id.* § 33(2) (stating that giving information or a document to another in the course of engaging in a creditor activity that is materially false or misleading is an offense punishable by a criminal penalty of 100 penalty points or two years in prison, or both).

147. *Id.* § 173.

148. *Id.* Credit Act 2009, section 166, which is recoverable as a debt due the Commonwealth. *Id.* § 166(4).

149. *Id.* § 177.

150. *Id.* § 178.

151. *Id.* § 178(2), (3).

enforcing some or part of the contract or declaring the contract void.[152]

I asked Karen Cox,[153] Director of the Consumer Credit Legal Center of New South Wales (CCLC), "Now that the Credit Act has been in force for nearly four years, how is it going? Are Consumer Lenders complying? Is the culture of consumer lending changing? Have any creditors lost their licenses? Is Internal or External Dispute Resolution working?" She told me many things.

The mainstream lenders are being very compliant, sometimes they are even more hesitant to lend than the statute requires. They are actively putting procedures in place that will assure compliance. Cases against mainstream lenders are decreasing. There have been few disputes with mainstream lenders indicating a lack of responsible lending. So far so good, but we are still in the honeymoon.

The disputes that have so far appeared have all involved the payday lenders[154] and consumer lessors.[155] When CCLC initiates a dispute against a payday lender, Ms. Cox reports that the lender typically first offers to lower the payments, which we reject. Then the lender offers to waive the debt, which may not be acceptable either, depending on the facts and the client's instructions. Usually the lender has failed to comply with the responsible lending obligations, and we insist that the lender return all funds the consumer has paid in excess of the benefit received from the loan. The lender usually settles, denying liability for any breach of the Act, and because our services and those of the External Dispute Resolution service are free, it has cost the consumer nothing.

The reason the lenders comply with our demands is that the processes

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152. *Id.* § 179(2). The Consumer also has remedies against an unlicensed provider, including preventing the provider from profiting from the contract (disgorgement), compensation for damage suffered, and prevention of any damage likely to be suffered. *Id.* § 180.

153. Interview with Karen Cox, Director, Consumer Credit Legal Center of New South Wales, in Sydney Australia (Feb. 28, 2014).

154. In November 2011, ASIC published Report 264 Australian, *Review of micro lenders' responsible lending conduct and disclosure obligations*. The Report found that in the first six months of the new credit regime the industry has changed its practices to respond to the new obligations. AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION, REPORT 264: REVIEW OF MICRO LENDERS' RESPONSIBLE LENDING CONDUCT AND DISCLOSURE OBLIGATIONS 5–6 (2011). However, ASIC found numerous instances in which verification of consumer income and expenses was largely absent and where there was no information showing how the lender calculated that a consumer would be able to make the payments. *Id.* at 7. "There were occasions where the files reviewed contained a figure with little or no information substantiating how it was calculated." *Id.* at 19. ASIC also found numerous other shortcomings, stating generally this "increases the risk of micro lenders not being able to demonstrate that they have assessed whether the consumer would be able to repay the proposed credit contract without substantial hardship." *Id.*

155. Consumer leases fall within the definition of consumer loan where it is contemplated that on completion of the lease payments, the consumer has the right to take title to the leased goods. These are regarded as a sale by installments. *Credit Act 2009*, *supra* note 4, sch. 1, § 9.

they have followed have been sorely inadequate and they have left the consumer with insufficient funds to live on. These lenders have had no colorable defense. Admittedly, this is low-hanging fruit. Recently one ombudsman, the first to do so, issued a final determination that the lender had breached the statute by failing to assess ability to repay. The cases have not yet developed to a point that speaks to the question of what it takes to rebut the three-loan presumption. Once some payday lenders establish and follow a process to determine ability to repay, the answers to this question will begin to emerge.

Some industry participants have been barred from practicing, and some have been banned, losing their licenses. Most of these have been credit assistance providers, meaning brokers. Again, this has been low-hanging fruit. In these cases the brokers have engaged in fraud—out-and-out lying. To date, no one has lost a license for failure to assess suitability.

I asked: What is the most important part of the new statutory scheme. Her poignant response: "The requirement of responsible lending would be pointless without licensing and external dispute resolution."

In sum, much has been achieved. Mainstream lenders are so far taking responsible lending very seriously, but the payday lenders and consumer lessors are operating largely as they had before the Credit Act. Occasionally they have to settle with a consumer that lodges a dispute, but it is likely that these creditors will continue to resist change until aggressive enforcement leaves them no choice. Recently, ASIC has brought an action against one of the primary Australian payday lenders.[156] The result here could be a watershed in the Australian payday lending industry.

B. *American Enforcement Mechanisms*

1. Licensing

There is no federal licensing regime in the United States, nor is there any interstate licensing of persons engaged in interstate consumer credit activity. Intrastate licensing has long been left to the states. Moreover, the likelihood of change here is minimal. The extraordinary example of interstate cooperation among the Council of Australian Governments is hardly to be expected to occur in the United States.[157] With the advent of the GFC in 2007, Americans looked in the mirror and found the state-to-

156. *ASIC Takes Civil Action Against the Cash Store*, AUSTRALIA SECURITIES & INVESTMENT COMMISSION (Sept. 11, 2013), http://asic.gov.au/about-asic/media-centre/find-a-media-release/2013-releases/13-257mr-asic-takes-civil-action-against-the-cash-store/.

157. In the current political climate in which "red" states are staunchly opposed to empowering the federal government, one cannot imagine a unanimous agreement in which the states ceded to the federal government the authority to regulate any form of business activity.

state regulation of the participants in home mortgage markets to be spotty at best, and deplorable at worst. For example, Florida was one of the states whose housing markets were most severely hurt by the GFC. In 2008, the *Miami Herald* reported that the Financial Regulation Commissioner's office had licensed "more than 10,000 ex-felons [to] work as [*mortgage*] *brokers* since 2000, some of whom defrauded customers out of an estimated eighty-five million dollars."[158] Further, in 2007, the Chief Inspector General conducted a review ordered by the state cabinet, reporting that "231 felons whose past crimes kept them from acquiring mortgage brokering licenses, began writing mortgages as loan originators," which did not require a license.[159]

2. Forums, Remedies, Enforcers

The forum in which American disputes are to be resolved is primarily the courtroom. While alternative dispute resolution processes are possible, they are perceived, as the name implies, as the alternative. In fact, contractual mandatory arbitration clauses are prohibited.[160] The consumer and the Bureau are the parties primarily contemplated as enforcing the Truth-in-Lending Act. The Federal Trade Commission is also empowered to enforce the Act.[161] All three, consumer, Bureau, and FTC, can seek to impose civil liability for violation of the Truth-in-Lending Act as provided in 15 U.S.C. § 1640. But the remedies available here are comparatively modest.[162] In contrast, the enforcement powers of the Bureau are much more expansive. The Bureau has broad investigative

158. Catherine Dolinski, *Review: State Was Lax on Mortgage Writers*, TAMPA TRIB. (Sept. 17, 2008), http://tbo.com/news/metro/2008/sep/17/me-review-state-was-lax-on-mortgage-writers-ar-123212/.

159. *Id.*

160. 15 U.S.C. § 1639c(e)(1) (2014).

161. Any violation of a regulation issued by the Bureau pursuant to (l)(2) shall be treated as a violation of a rule promulgated under § 57(a) of the FTCA as an unfair and deceptive act or Practice. 15 U.S.C. § 1639(q) (2014).

162. 15 U.S.C. § 1640 (2014), provides that any creditor that fails to comply with any requirement imposed under the Act is liable in the amount of: (1) actual damages; (2) in a transaction secured by real property or a dwelling, not less than $400 or greater than $4,000; (3) costs plus attorney's fees; and (4) in certain cases including violation of the minimum standards for determining ability to repay, "the sum of all finance charges and fees paid by the consumer, unless the creditor demonstrates that the failure to comply [was] not material." § 1640(a). In addition to laying out the levels of civil liability attendant to violations of the Act, Section 1640 also provides the key defense: a creditor or assignee may not be held liable if it can prove that "the violation was not intentional and resulted from a bona fide error notwithstanding [] maintenance of procedures reasonably adapted to avoid any such error." Examples of bona fide errors include clerical, calculation, computer malfunction, and printing errors, but an error of legal judgment is not a bona fide error. § 1640(c). Criminal liability may be imposed for willful knowing violation or failure to comply with the Act, resulting in a fine of up to $5,000, imprisonment for up to one year, or both. 15 U.S.C. § 1611 (2014).

and administrative discovery powers.[163] It may hold hearings and adjudication proceedings,[164] and it may litigate in court.[165] The potential relief available is nearly limitless. In addition to rescission, reformation, restitution, disgorgement, and imposition of damages and costs, the Bureau can impose civil money penalties against any person that violates federal consumer financial law.[166] The penalties fall into in three tiers. In tier one, for any violation, a penalty of up to $5,000 for each day the violation continues.[167] In tier two, for any reckless violation, a penalty of $25,000 per day may be imposed.[168] In tier three, for any knowing violation, a penalty of $1,000,000 per day may be imposed.[169] Providing some comfort, the statute explicitly identifies a number of mitigating factors to be taken into account in assessing any of these penalties, which include the size of the entity, the gravity of the violation, severity of risk or loss to the consumer, history of previous violations, and any other matters justice may require.[170]

C. *Comparing Australian and American Enforcement Regimes*

The differences in the potential financial severity of violating the American and Australian Credit Acts are not striking. Because the vast majority of such lenders is likely to be made up of corporate lenders, potential liability could exceed $1,000,000 for an Australian creditor that makes an unsuitable loan, and there is no good-faith defense; liability is strict. An American corporate mortgage lender that fails properly to assess ability to repay also risks liability in the millions of dollars, but the mitigating factors will play an important role here. If the corporation maintains procedures adapted to avoid the error, it may escape severe liability by proving that the error was not intentional and bona fide.[171]

American assignees of mortgage loans are at far less risk than Australian assignees. Australian assignees are licensees falling within the scope of the Credit Act.[172] In the United States, assignees are liable only

163. 12 U.S.C. § 5562 (2014).

164. 12 U.S.C. § 5563 (2014).

165. 12 U.S.C. § 5564 (2014).

166. 12 U.S.C. § 5565 (2014).

167. 12 U.S.C. § 5565(c)(2)(A) (2014).

168. 12 U.S.C. § 5565(c)(2)(B) (2014).

169. 12 U.S.C. § 5565(c)(2)(C) (2014).

170. 12 U.S.C. § 5565(c)(3) (2014).

171. It would not be surprising if the undefined mitigating factor "any other matters justice may require" were to borrow from the Truth-In-Lending Act the mitigating conduct of maintaining procedures adapted to avoid the error. *See* 12 U.S.C. § 5562 (2014); 12 U.S.C. § 5565(c)(3).

172. *See* text accompanying 15 U.S.C. § 1641 (2014).

for violations apparent on the face of the disclosure statement.[173] Since a failure to assess ability to repay is not likely to appear in this fashion, assignee risk here is minimal.

In both countries, mainstream mortgage lenders are likely to place great emphasis on compliance with the responsible lending requirement, and mortgage brokers have been severely reined in. The days when the maker of the lending decision has no stake in the consumer's ability to pay may be gone, not because a consumer default is harmful to the mortgage company, but because of the risk of sanctions for making a loan that the consumer cannot repay.

In the credit card realm, the prospects are good that creditors will be somewhat more responsible than they had been in assessing consumer ability to repay. In part, this is because of the threat of sanctions for failing to assess ability to repay. A second motivating force is that both nations have constrained the issuer's ability to cover poor credit-granting decisions with myriad fees and charges. They will be forced to compete primarily on the basis of interest rate, which many consumers are aware of and understand. If competition on that basis forces rates lower, issuers will have to approve credit card applications more carefully.

In the world of payday lending, the irresistible force is the lender's need for consumers to borrow repeatedly. The immovable object is the consumer representatives' desire to protect consumers from spiraling more deeply into debt, which frequently accompanies payday borrowing. Absent better credit alternatives, and assuming poverty will not be eradicated, payday lenders may occupy a right balance. Perhaps in its Regulatory Guide 209, ASIC has found a pearl. If with successive loans, the consumer is left with less and less discretionary income, the spiraling is objectively apparent.[174] At that point, the lender's determination that the consumer has the ability to pay, should become highly suspect, and the unsuitability of the loan much more clear. Sanctions in such a scenario should be easy to impose.

How effective a motivator of the risk of sanctions will be will depend on the effectiveness of the enforcement regime. Australian consumer representatives have two powerful enforcement devices that Americans lack: Licensing[175] and free external dispute resolution.[176] Government funding of enforcement activities is, of course, critical. But assuming

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173. *Id.*

174. The Act holds creditors responsible for the knowledge they should have acquired if they had engaged in a reasonable inquiry, and Regulatory Guide 209 highlights the importance of the overall increase of indebtedness over time. Knowledge that the debtor's indebtedness is increasing over time provides objectively verifiable proof that the debtor is spiraling deeper into debt.

175. *Credit Act 2009*, *supra* note 4, § 29(1).

176. *Id.* div. 5, § 47.

both nations provide comparable levels of funding, enforcement in Australia should be much more effective than in the United States. The United States should take heed.

CONCLUSION

How successful these nations will be in altering the culture of their consumer-credit industries remains to be seen. Large institutional lenders will probably at least set up procedures designed to protect against extending unsuitable or unaffordable credit to consumers. Credit cards may be issued to fewer consumers who lack the ability to manage them responsibly. Payday loans, on the other hand, may prove to be much more difficult to rein in. But the game is new. Both nations are taking first steps here, and the methods for regulating credit granting decisions are certain to evolve. National commitment of resources to the effort will be crucial, and if that commitment remains steady, the bold decision to depart from freedom of contract and to regulate the decision to grant credit to a consumer may prove worthwhile.