CHERPA
Consumer Household Equipment Rental Providers Association

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Committee Secretary
Senate Standing Committee on Economics
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600
AUSTRALIA

Re: Senate Inquiry into National Consumer Credit Protection Amendment (Small Amount Credit Contract and Consumer Lease Reforms) Bill 2019 (No. 2).

Dear Sir or Madam,

Thank you for the opportunity to participate in this Senate inquiry.

Please find attached our submission following. We welcome any feedback you may have, or further dialogue on this matter. Additionally, we would appreciate a confirmation of the receipt of this submission.

We look forward to your response.

Sincerely,

Steven King
President
CHERPA
[redacted]

Nicholas King
Media Contact and Submission Author
CHERPA
[redacted]

CHERPA Submission

to Senate Standing Committee on Economics

20th February 2020

Regarding the National Consumer Credit Protection Amendment (Small Amount Credit Contract and Consumer Lease Reforms) Bill 2019 (No. 2).

Overview

CHERPA (Consumer Household Equipment Rental Providers Association) is the peak body for the domestic household rentals industry (hereafter referred to as "the industry"), or more specifically, operators that provide consumer leases within Australia. As an industry organisation, CHERPA is broadly in favour of federal regulatory change for the industry.

Though it is true CHERPA exists to represent the needs of industry members, nevertheless as a non-profit peak body we are equally concerned for our consumer stakeholders, and strive to assist our industry members with effective self-regulation through **voluntary adherence** to our Code of Conduct, a prerequisite for CHERPA membership.

Our code of conduct exists to preserve not only the safety of our consumers, but to provide an ethical and responsible framework for our industry members to operate within, with the intent of fulfilling the needs and preserving the wellbeing of all industry stakeholders.

Submission Purpose

This submission exists to respond to **two key elements** of the *National Consumer Credit Protection Amendment (Small Amount Credit Contract And Consumer Lease Reforms) Bill 2019* (hereafter referred to as "the Bill").

These two key elements include:

1. **Cap on costs under consumer leases** *[Schedule 1, items 58, 64 and 65, section 175AA and subsection 204(1) of the Code]*; and
2. **Affordability of consumer leases: protected earnings amount** *[Schedule 1, items 30 and 34, guide to Part 3-4, sections 156A, 156B]*

CHERPA is not opposed to the introduction of a cap on costs under consumer leases, nor to affirming the affordability of consumer leases through limiting consumer spending. However, as a matter of economics and business viability, **we are opposed to the specific numbers** invoked by the Bill for each of these items.

We note as stated in the Bill's *Explanatory Memorandum* that the above two elements are derived from recommendations provided by the *Independent Review of the Small Amount Credit Contract Laws - Final Report (March 2016)* (hereafter referred to as "the Review"). The specific recommendations in question are **Recommendation 11** ("Cap on cost to consumers") and **Recommendation 15** ("Affordability"). This submission will rebut certain aspects of these two recommendations, and provide sound reasoning as to why these two recommendations **should not be implemented** in their current form.

We feel strongly that the implementation of these two recommendations as currently drafted could have far-reaching unintended consequences that negatively impact both industry viability and the financial inclusion of consumers.

This submission will additionally provide comment on **Recommendation 17** ("Early termination fees"), which touches on a flaw in the Review's argument upon which the other two recommendations largely depend.

We are not providing objections to the remainder of the Bill, and look forward to achieving regulatory change.

Premise

The arguments in this submission are intended to preserve both:

- the **ongoing viability** of the consumer household equipment rental industry and their suppliers; and
- the **financial inclusion** of consumer stakeholders generally.

Conversely, we **state unequivocally** that the Bill, in its current form, contains elements that are a **profound threat** to both ongoing viability and financial inclusion as defined above. We feel we cannot overemphasise the destructive impact the currently proposed Bill could potentially have on the industry, nor the stakes involved in correctly anticipating and dealing with these issues before they are cemented in passed legislation, unless certain essential changes are made.

We do not believe these statements to be composed of hyperbole nor excessive dramatisation; rather, they speak to the heart of the matter.

Additionally, any argument that seeks to establish an effective economic baseline for supporting the industry and its consumers must appeal to an appropriate **chain of logic**, as well as sound **business arithmetic**, in order to proceed effectively. We establish both in this submission.

Furthermore, we cite a key principle from Ashton de Silva's article, *An Australian Household's Choice: Housing Deprivation or Financial Debt "Betwixt the Devil and the Deep Blue Sea"?*, namely that although we seek to deliver *Pareto Optimal* economic reform, there is danger in limiting a consumer's financial choices to the degree that they are faced with **deprivation of essential household items**, that is, financial exclusion. Of all the outcomes sought by legislative change, we consider this the most far-reaching, impactful, and concerning threat to be avoided. However, we note that such deprivation may yet occur as a result of two reigning factors:

1. The **ultimate unavailability** of household items to some consumers due to industry shrinkage, that is, forced business closures due to lack of viability (due to the "cap on costs" i.e. key element 1).

2. The **unreasonable limitation** of consumer spending on essential household items (as provided by consumer leases) through legislation (due to the "protected earnings amount" i.e. key element 2).

As de Silva notes in his article, a great proportion of households that utilise consumer leases in Australia are **unable to obtain** essential household items by other means, whether through conventional credit, cash purchases, or otherwise. We feel this further highlights the need to preserve the industry's ongoing viability, if only to preserve financial inclusion.

Additionally, the size of industry as a whole, with up to **700,000 active consumer lease contracts** at any given time, clearly denotes the scope of the impact that regulatory change and any subsequent financial exclusion could create. Again, we welcome regulatory change, but it must not threaten the viability of the industry.

The ultimate solution to the problem proposed by regulating the industry requires finding a healthy balance that allows the industry to remain viable, promotes ample financial inclusion for consumers, and simultaneously clamps down on unethical or financially exploitative behaviour by industry members. **We illustrate in this submission how this is possible to achieve.**

Discussion and Arguments

The Review's Final Report is a thorough investigation that excellently tables the issues faced by the industry, and makes many superb recommendations that CHERPA fully supports. Nevertheless, we believe that despite their best intentions and independent, nonpartisan approach, the Review errs in some matters, to significant effect. We outline these errors with the following arguments.

Argument 1 - Accurately Assessing and Comparing Industry Risk

The industry suffers from a high degree of risk exposure from consumers, a fact not adequately tabled in the Review. In fact, it would appear that the true nature of industry risk may be the equivalent of the "elephant in the room" when it comes to crafting industry regulations.

The issue is largely one of *enforcement* in the case of default on consumer leases. In essence, enforcement in almost all cases is **impractical**, either being cost ineffective, or functionally impossible, meaning that goods recovery in the case of default is rare, and not supported by the current legislative or regulatory framework.

Furthermore, in recognition of this, the industry has largely adopted the approach of allowing goods rented on consumer leases to be returned to the lessor **at any time** throughout the lease (outside of the first 90 days of a contract), without penalty or termination fee, in the hope that the goods will actually be returned, and returned in good condition (which is often not the case) in the case of client default or inability to pay. (This is a core component of CHERPA's code of conduct, which has been adopted by approximately 40% of industry members nationwide as members of CHERPA, and many other industry members independently.)

Regarding this, the Review states:

> *"The Panel, therefore, considers that lessors should be entitled to recover their loss if a contract is terminated early.* ***They may choose not to exercise that right in practice*** *(emphasis added)."* (p. 71.)

Far from being a mere option for industry members to utilise, as inferred by the Review, CHERPA considers the decision not to charge a termination fee to be **industry best practice**.

On the one hand, the Review's provision for industry members to charge enforcement or termination fees (*the Review*, pp. 69–70) appears initially logical and appropriate. It notes that in such circumstances, industry members are at liberty to receive or retrieve the leased goods once again, granting them power to charge a fee if desired, and re-let the items to mitigate any losses.

However, what the Review does not recognise is the extraordinary cost of the realities the industry faces due to risk exposure, specifically:

1. **Returned Items:** Actual voluntary early returns form the smallest part of early terminations or defaults. When this does occur, it is usually due to unexpected hardship experienced on the part of the consumer (or other important change in the consumer's circumstances, such as moving interstate, or a change in personal relationships). In such cases, we note that all CHERPA members are required to receive the items again without further penalty to the client, and to do their best to flexibly work through any leasing issues with the client. Although it is indeed possible to re-let such returned items (if returned in good condition), likely at a reduced rate from the original lease, the proportion of these returned items is so small as to be dismissed as to having any significant effect on the industry.

2. **Consumer-retained Items:** The **vast majority** of lease defaults are experienced by industry members as consumer-retained items, which is to say, effectively **stolen** items after the consumer's decision to cease payment (for whatever reason) and retain the items. Due to lack of effective recovery powers (as explained in the next section), industry members frequently experience lease defaults that include loss of their initial investment in the rental goods, unable to be mitigated by item returns NOR termination fees.

3. **Damaged or Broken Items:** Whether the item is returned or retained, consumers will frequently cease paying if their leased item is broken or damaged. Though it is true that industry members voluntarily shoulder the risk in these cases, and that replacement warranties may be called upon where available and where the warranty has not been voided, this is still another meaningful category of industry risk. Repair costs where an item cannot be replaced by warranty also have to be taken into account for this category. These may be offset by repair fees passed on to the consumer, but these alone often don't cover the additional loss incurred by non-payment of the lease while the repair is pending.

Statistics supplied by CHERPA member **1st Choice Rentals** (taken from their May 2016 submission on the Review) that support the above categories of risk are as follows:

A. Stock that has either been disposed of by the client or stolen – **4.5% of stock purchases.**
B. Stock written off as uneconomical to repair (outside of warranty, requiring purchase of additional goods to fulfill the lease contract) – **24% of stock purchases.**
C. Direct Cost of 3rd party, in-house repairs, pick up and return – **4% of revenue** (plus other indirect costs).

Statistics supplied by CHERPA member **OzeRentals Pty Ltd** from their Hobart franchise's consumer lease contracts written in 2015 include:

- Total contracts written: 378
- Total lease defaults with **goods not returned**: 94 (24.8% of all contracts)
- Average contract value fulfillment before default: 25.6% (that is, on average defaults occurred after only 25.6 % of payments were received)

- Total loss value incurred on defaulted contracts: 19.9% of the contracts' value

The franchisee in question, Colin Quon, noted that since this year (2015) his default rate has improved, but that this is not an unreasonable set of statistics as experienced by the industry. He also does not include in these statistics the number of clients that simply returned their goods early, ceasing their lease contract, as by his estimation this was not a default (as the CHERPA code of conduct allows for this).

The franchisee also noted that he was able to recover a small amount of the lost contract value over time as some clients in default made further intermittent payments, but these did little to compensate for the overall loss from defaults.

Lack of Recovery Powers

As a frank summation of the recourses available in the case of lease defaults, industry members are effectively neutered in their attempts to recover items if the client is not willing to voluntarily return them.

Leased items under default are rarely if ever considered "stolen" by police, meaning the matter is relegated to the civil domain, the result of which is that leased items cannot be recovered without a court order, which is rarely financially practical to pursue (for example, it is not practical to sue at law for the value of a $600 RRP washing machine).

Without a court order, industry members or their representatives have no right of entry to consumer dwellings to recover items. Additionally, consumers have all power to cease any payments they make, whether via Centrepay (for Centrelink recipients) or direct debit. Industry members are additionally unable to recommence payments without the express authorisation of the consumer in question.

Furthermore, attempting to charge a fee for either the termination of the lease or in many cases the value of the goods (if not returned) is unlikely to bring satisfaction either, given that:

1. The general consumer in the industry often has little if any cash in reserve, and is simply unable or unwilling to pay the defaulted amount;
2. The only recourse on a financial default is often to report the debt to a collection service, which can have variable success in achieving collection of monies owed, with a significant delay before successful collection, and debts often recovered in part (if any is recovered at all).

Due to this lack of recovery powers, combined with the default rate, it is well understood throughout the industry that we need to **charge sufficiently for all consumer lease repayments to as to offset the risks as described above**. This is the key and unwavering point of this submission.

This, of course, is no justification for exorbitance, financial exploitation, irresponsible lending, or excessive charges by unethical industry rogues. However, it does go a long way to explaining the industry's support and genuine need for the multiples recommended by CHERPA (found later in this submission under *Recommendations*), which represent, in our estimation, a good balance of affordability for clients and mitigation of risk to industry members, which we feel are and must remain the ultimate aims of regulatory controls on the industry.

Without effective enforcement options, the Review's statements on allowances in their consumer lease model for "enforcement costs" appear to us to be woefully inadequate. This is despite other potential mitigating factors referenced in the Review, such as industry members often enjoying the option to purchase goods below RRP, while lease costs are calculated from the RRP as the base price – to us, this is just another factor that somewhat mitigates the industry risks as described above, rather than an opportunity to "cash in" at the consumer's expense, so to speak.

Unfortunately, specific industry-wide data as to the proportion of lease defaults that occur ending in consumers retaining the items (and resulting in bad debt without further mitigation) is regretfully unavailable at this time. However, should the Senate Committee consider it of value to their deliberations, we would be happy to attempt to pursue and provide it.

Contrast with SACC Lending

We note here that although the SACC lending industry contemplates similar types of risks when it comes to dealing with bad debt or non-repayment, the actual degree of risk and recourses available for dealing with default are significantly different when contrasting SACC loans and goods recovery for consumer leases.

We submit that, all other things being equal, the consumer lease industry likely has a **higher rate of default**, and definitely suffers from **fewer options for recovery**, as there is no cost-effective regulatory structure for dealing with lease arrears or consumer-retained goods because **the lease arrears are not a debt**. Therefore, the two cannot be compounded as one when it comes to implementing regulatory controls.

Functional Difference Between "Sale by Instalment" and Consumer Leases with Purchase Mechanisms

The Review notes:

> *"The Panel also notes that under the law a lessor under a consumer lease retains ownership of a good and cannot guarantee ownership to the consumer at the end of the agreed lease period. However, in practice, many consumer lease providers have* ***mechanisms to allow ownership at the conclusion of the term*** *(emphasis added) to pass to the lessee or their nominee. This practice highlights the artificiality of the distinction under the National Credit Code between sales by instalment (including hire purchase) which currently are subject to the 48 per cent APR cap and consumer leases which currently escape any cap. The distinction, which is based on* ***form rather than substance*** *(emphasis added), provides no reason not [to] seek to achieve similar consumer protection, whether through appropriate caps or otherwise, for both categories of products."* (p. 54.)

We feel it necessary to rebut the argument that the difference between most sale by instalment contracts and consumer leases with purchasing mechanisms is one of form only. The simple fact here is that there is a **difference in responsibility for the goods** including maintenance costs and more under a consumer lease when compared to sale by instalment, whether the consumer ultimately purchases the goods or not. That does not mean it is inappropriate to seek caps for consumer leases, but simply that they need to be considered separately as the level of risk shouldered by the lessor differs widely between the two models.

Argument 2 - Cost of Business Operations at Variance with SACC Lending

Beyond simple industry risk issues, CHERPA notes that any rental operator faces significant costs of business operations that simply are not applicable for SACC lenders, or other purely financial lending (non-leasing) business models.

This is significant, as the Review recommends that certain provisions applicable to SACC lending also be applied to consumer leases, without fully accounting for these costs. The Review does however note and recommend allowances for some costs, such as delivery fees, service fees, and enforcement fees. However, it does not contemplate the following non-exhaustive list of example costs which are either inapplicable or less applicable to SACC lending, which contribute to additional operating overheads for consumer leases:

- Goods supply (stock purchasing from suppliers; vehicle running costs for delivery to warehouse;)
- Stock warehousing (whether items are purchased in advance, or at point of consumer request, some warehousing is always required;)
- Administration costs (collection and disbursement of GST, not applicable to SACC loans;)
- Staffing costs (time required for replacement of damaged or faulty goods, and executing warranties; delivery process frequently requiring two staff members for delivery, installation and demonstration;)
- Insurances (public liability against product and delivery; business contents insurance;)
- Marketing (vehicle and office signage; client-facing uniforms;)
- Depreciation of goods, including obsolescence of household technology items (computers, laptops, tablets, gaming systems, televisions etc.;)
- Regulatory compliance (including responsible lending practices, plus time and documentation needed for client assessments during the application process.)

It is essential to note that a significant portion of staff time in the industry is spent responding to repair and maintenance issues, the costs of which are often **not directly passed** on to consumers, but are rather built into the overall risk mitigation model provided by CHERPA's multiples (that is, instead of clients paying for servicing of goods directly, the costs are distributed and recouped from general lease payments). We feel this is appropriate insofar as leasing companies still own the goods under the lease, and should be responsible for paying for their maintenance in the absence of any malicious or deliberate harm or neglect by the consumer causing damage to the goods.

Argument 3 - Inadequacy of Justification for 10% Protected Earnings Amount

The Review uses a peculiar and, in our opinion, somewhat arbitrary justification for introducing 10% as the recommended figure for a consumer protected earnings amount. In particular, it references the consistency of the 10% net income amount with the amount recommended by Centrelink Code of Operation in the recovery of Centrelink defaults.

CHERPA agrees with the application of a 10% net income limit to SACC loan repayments, insofar as these are functionally similar in many respects to Centrelink debt recovery. However, applying the same income limit to consumer leases is, in our opinion, to make a **grievous error of comparison**.

The error here is that of the clear **ongoing utility** provided by consumer leases, in comparison to SACC loans, or in particular, Centrelink debts (which provide no ongoing utility, or limited ongoing utility depending on what was purchased by the Centrelink advance or overpayment). When considering the ultimate purpose of the 10% limit, a key purpose is to avoid financial exclusion, as expressed by the Review:

> *"The Panel considers that SACC repayments which consume more than 10 per cent of net income have the potential to be unaffordable or cause harm particularly for low income earners and can exacerbate financial exclusion."* (p. 16.)

However, in the case of consumer leases, a 10% cap has the potential to **independently cause financial exclusion** insofar as it may prevent consumers from accessing the utility of consumer leases in a national environment where there is often no other recourse for obtaining essential household items. We truly believe that consumers do not wish to be regulated or limited in their *spending*, insofar as the repayments on a consumer lease **are not debt recovery**, but are a payment in exchange for ongoing utility, which cannot be said of SACC loans or Centrelink debt recovery.

CHERPA would prefer the industry to rely upon responsible lending practices instead of a mandated protected earnings cap, as these are more flexible to the needs of the consumer, and can be adjusted to suit. Nevertheless, if a protected earnings amount is deemed necessary, then we must emphasise our view that the best viable amount that both protects consumers from excessive spending while minimising financial exclusion is **20% of net income** (see *Recommendations* later in this submission).

CHERPA's recommended protected earnings amount is also in recognition that, if CHERPA's recommended higher repayment multiples are adopted in lieu of the Review's multiples, then a higher protected earnings amount would be necessary as a matter of course to account for the disparity. However, even if CHERPA's multiples are not adopted, we deem the 10% protected earnings amount to be inadequate to cover the needs of many consumers, and that the Review's basket of essential goods (*the Review,* p. 65) does not meet the definition of "suitable goods" in all cases, meaning the costs for actual suitable goods may be higher.

In fact, in CHERPA's 2017 submission on the Review, we noted that the equivalent cost for the more appropriate basket of goods recommended by CHERPA was **$3,220**, not the $2,070 indicated by the Review.

Furthermore, CHERPA's member base are more than aware that the provisions of responsible lending, and specifically the need to accurately assess a client's capacity to pay without placing them into hardship, are **mutually beneficial** to both industry members and consumers. This is because the first thing that happens when a client's capacity to pay is exceeded is that, in the vast majority of cases, **they stop paying**, which is naturally an undesirable outcome. We are confident that **none of our membership base have any desire to exceed a client's capacity to pay.**

As a general trend, through feedback from its membership CHERPA has noted that the approximate limit above which the average consumer will begin to encounter financial difficulty in making repayments is **17.5%** of net income. We nevertheless recommend the 20% amount to allow industry members some flexibility in the case of some consumers genuinely needing to spend up to this amount in order to obtain suitable goods, while allowing the provisions of responsible lending practices to make the final determination as to what is an appropriate limit to accept per consumer under this 20% amount. (Despite leases not being loans, responsible lending practices are still applicable to and requisite of all CHERPA members.)

Furthermore, the Review notes:

> *"During consultation, a number of lessors indicated that while formal hardship application rates are relatively low, approximately 25-35 per cent of lease consumers are behind on their consumer lease payments. This suggests that a large portion of consumer lease consumers routinely encounter difficulties meeting their consumer lease payments."*

We note that in the associated footnote, the figure of 25–35 percent is vaguely derived from "oral consultation with the panel" meaning we cannot consider this authoritative in the first instance. We also question the interpretation of these numbers, as although we would agree that this appears to be a high arrears rate, whatever the true figure may be it is also composed of consumer leases in **allowed arrears** (that is, the lessor has made an arrangement to temporarily reduce or suspend the lessee's payments due to hardship or other crisis circumstances), which, while being payment exceptions that have nothing to do with everyday affordability, are still counted as "arrears" in a statistical sense.

Recommendations

We strongly recommend that the Bill adopt the following:

<u>Recommendation 1 - CHERPA's Cap on Costs</u>

Implement CHERPA's **financial multiples caps** for consumer leases, by year, as follows:

Contract Term	Multiple
12 months	2
24 months	3
36 months	3.5
48 months	4

Note that the above multiples are **inclusive** of the base price of the consumer lease.

Also, when determining the value of the base price, CHERPA recommends using the listed **Recommended Retail Price** in all cases when the RRP is known (as per the Bill). However, CHERPA also recommends clarifying the wording in the Bill under *Schedule 1*, section *175AA* items *(5)(a)(ii)* and *(5)(b)(ii)* from:

"the agreed purchase price"

to

"the agreed purchase price between a retailer and the consumer" or words to that effect, as that is the intent of the recommendation in the Review, as follows:

> *"However, lessors should use a lower price when determining the Base Price if that is the price agreed in store with the consumer, for example, when lessors provide leases through a third party retailer."* (p. 55.)

This will avoid any ambiguity in the selection of the base price.

The multiples above are not derived from a specific interest rate applied monthly, as per the Review, but rather have been agreed upon amongst our industry members as being realistic in that they are achievable for operators, and affordable for consumers. They also include provision for weighting returns slightly towards the shorter term leases, as shorter leases have a higher probability of default and loss of goods.

We believe that the multiples system outlined in the above table will ensure that consumer leases provided by our members and the industry at large are able to remain competitive and profitable while also ensuring that the government can meet its objectives of undertaking these reforms.

Should the Review's recommended cap on costs be implemented, there will be a significant decline in the number of operators in the industry with commensurate loss of:

- Competition – the industry will consolidate and look for scaled returns;
- Access to goods for consumers leading to increased cost of goods, especially for more remote and regional consumers;
- Service and support on goods supplied for those vulnerable consumers who are most in need; and
- Jobs in local communities.

Lessors will necessarily have to stop providing their current level of support as a cost saving measure to avoid losses from the reduced cap. Additionally, under these circumstances we would expect to see a much higher insistence on fee collection from industry members for fees that **can** be collected (such as penalty fees stipulated in the contract, e.g. missed or late payment fees).

Recommendation 2 - CHERPA's Protected Earnings Amount

Implement a **protected earnings amount of 20% of net income**, rather than the 10% amount suggested by the Review.

This limit on spending for consumer leases will:

1. adequately protect consumers from exorbitant charges by rogue industry operators;
2. prevent the vast majority of consumers from suffering financial exclusion, and should allow the prevention of all severe financial exclusion; and
3. assist the industry in remaining viable.

This reflects CHERPA's existing 20% protected earnings amount defined in CHERPA's code of conduct.

As part of our commitment to responsible lending, we wish to highlight that CHERPA members take into account all of a client's living expenses when determining their capacity to pay.

Closing Remarks

In line with the Review, we offer the following:

> *"The Panel has decided to recommend a* ***higher cap than that allowed in general*** *(emphasis added) for credit products to ensure a viable continuing consumer lease of household goods market. The Panel acknowledges this cap may result in changes to the leasing market as businesses adapt to the new environment."* (p. 47.)

We share the same intent as the Panel of the Review, in that higher caps must be allowed for consumer leases than general credit products. However, these caps need to be based upon sound reasoning and reflect the realities dealt with by the consumer leasing industry as a whole.