SUPPLEMENTARY Submission to

Senate Economics Legislation Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Re the
Consumer Credit And Corporations Legislation Amendment (Enhancements) Bill 2011

Response to the
Treasury Discussion Paper – Maximum Annual Cost Rate
issued 2pm Friday 14th October 2011

Submitted via email to
economics.sen@aph.gov.au

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Supplementary Submission to Senate Economics Legislation Committee

Re: Treasury Discussion Paper Maximum Annual Cost Rate

(Issued 14/10/11)

1. Preliminary Matters

This response should be read in conjunction with the National Financial Services Federation's submission to the Joint Parliamentary Committee ('the Federation's Submission') on the Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011 ('the Enhancements Bill').

This Federation response includes input from 30 Members representing over 200 small amount credit provider outlets, legal advisors, an independent actuaries.

All contributors to this response believe that the unworkable and unviable option proposed is neither practical for consumers nor implementable by industry.

The Federation in its Submission proposed that Small Amount Credit Contracts ('SACC') be redefined as those where $500 or less is lent to a consumer for up to six (6) months. [1] The problems identified in this response are pertinent to both the definition of a SACC in the Enhancements Bill and in the Federation's submission. However, they are particularly acute if the definition in the Federation's submission is adopted. This doesn't mean that the reasoning articulated in the Federation's submission is undermined or that the Federation no longer supports its more restrictive definition in the context of the other proposals in that submission.

The Federation again wishes to express its concern not only about the time pressures for responses, but the implementation schedule of such major and radical reform options without first assessing the outcome of Phase 1 reforms.

[1] As opposed to the definition in the Enhancements Bill of $2,000 over 2 years.

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2. Responses to Treasury's Views

Treasury View: *The formula used to calculate the annual cost rate averages the cost of (sic) the term of the contract and therefore the impact of a new fee or charge will not usually be significant in itself.*

Response: With respect, this view flies in the face of the actuarial context in which these calculations take place. Assuming that the word "of" is meant to be "over", the view assumes, for instance, that:

- All contracts will go "full term"; and
- All contingent charges are so small as to have no "significant" impact when averaged over the life of a loan; and
- All contracts are close, in length, to the 2 years identified in the definition of SACC in the Enhancements Bill.

In fact, many consumer credit contracts are terminated earlier than their full term, whether by the consumer through early discharge or by the credit provider on the default of the borrower. When this occurs, the Annual Cost Rate ('ACR') formula, originally applied at the beginning of the loan by the credit provider as part of its compliance process, if applied after termination, may lead to much higher "rates" than first calculated.

Further, not all contingent charges are so relatively small as to have an insignificant impact over the life of a short term loan or one for which the term has been shortened by early termination. Of course, all such charges are already regulated by the National Credit Code[2], but such regulation does not prevent the recovery by the credit provider of the reasonable costs of enforcement which are likely to accompany an early termination for breach. These are likely to be even greater if there is security, for instance, over a motor vehicle.

Thirdly, the shorter the loan in its inception, the higher the relative impact of such fees on the calculation of the ACR. Even under the definition of a SACC in the Enhancements Bill, it is quite likely that the impact of contingent enforcement fees on a loan just over two years in term will be relatively high. If the definition of a SACC proposed in the Federation's submission was adopted this problem would be much greater for loans approaching the lower $500 limit.

[2] E.g. Section 32 Any third party fees or charges "passed on" must be limited to the amount actually paid by the credit provider to the third party and section and under section 107 limits the enforcement expenses which the credit provider may impose to those which are "reasonable."

Lastly, it is the interaction of all these factors together that will lead to unrealistic and unworkable results. A relatively short loan that is terminated early for breach and that is secured by personal property securities (for instance, a chattel mortgage over a motor vehicle), will be almost impossible to administer within the precepts of this proposed amendment.

Treasury View: *The formula allows a credit provider to determine the maximum amount they can charge before the contract is entered into and therefore to ascertain a relative buffer of additional costs they can charge.*

Response: Credit providers have little or no "buffer" in their business models to absorb costs which are only contingent at the beginning of any loan. Credit providers in the small personal loan market, (whether a SACC or not) will have no choice but to charge the maximum amount allowed by law, give or take a few points to provide some advantage over their competitors, and then take the risk, along with their customer, that contingencies could arise. Indeed, as is the case in the home loan market, the differences between competitors are rarely based on price but on other matters such as customer service and ease of process.

Contingencies, of course, are just that and the business model of most credit providers in this market is based on an assumption that consumers will meet their obligations and that most contracts will run full term. If contingencies arise, there must be provision in contracts and latitude in regulation for the costs of those to be recovered.

Treasury's View: *The impact of an individual fee or charge will be significant where the fees is relatively large compared to the amount of credit provided (particularly therefore where the credit provider is arranging a credit contract for a relatively small amount).*

Response: This is so but, as discussed above, it may be unavoidable and this makes the proposed amendment unworkable.

3. Consumer Detriment

a. Loss of Choice

The Federation is concerned that the application of the ACR at any time over the life of a loan, as envisaged by the proposed s32A(2), will dramatically restrict the range of products that may be made available to consumers. This will be to the detriment of consumers and reduce their choices and flexibility in the personal loan market.

For instance, if s32A(2) is passed as proposed, in order to avoid inadvertent non-compliance, credit providers will have to:

- Structure all loan repayments so as to align as closely as possible with the assumptions in the formula for the ACR in s32B, namely, equal payments at regular intervals. This will exclude those consumers who, for instance, are confident of a fixed income for a short fixed period but not so for later in the loan or vice versa. Currently, consumers have the option to “frontload” repayments or “backload” them depending on their requirements. In a competitive market, credit providers, certain of their ultimate repayment and compliant cost recovery, will accommodate consumers. This capacity for competitive accommodation and customizing of repayment schedules for the benefit of consumers will be lost under the proposed s32A(2).
- Refuse early repayments by consumers for fear that doing so will have the effect via the s32B formula of exceeding the ACR. This is because, even without an early termination fee, many of the fees incurred “upfront” in a loan, for instance, its documentation, credit record searches, fees to brokers, have already been paid and are not recoverable should the consumer pay out early.

So, while this response will discuss the various options below, **the overall position of the Federation is to oppose the re-insertion of s32A(2) as being unworkable and as reducing product flexibility and consumer choice.**

b. Administrative Costs

All of the options discussed will impose new administrative costs on credit providers. They will be forced to recalculate the ACR each and every time there is:

- The imposition of a contingency fee by the credit provider because a contingency arises usually due to the conduct of the consumer e.g. late payment.

- A fee or charge for an "extra" service provided to the consumer e.g. an extra copy of a statement.
- An adjustment to the length of the loan due to the actions of the consumer e.g. voluntary early termination or termination for breach.

c. Hardship Variations

Section 72 of the NCC[3] provides for variations in loan repayments due to "illness, unemployment or other reasonable cause." Granting applications for such variations always requires credit providers to recalculate repayments and the consequences for interest and other fees and charges. There is nothing new in s32A(1) that changes this. Section 32A(2), however, with its requirement for credit providers to stay under the capped ACR "at any time" makes these calculations more difficult and consequential. It is likely that the "safest" course for a credit provider will be to refuse such applications and wait until the relevant EDR, tribunal or court makes an order granting it or otherwise restructuring the loan. This is not a good outcome for consumers or industry.

d. Moral Hazard

While the general knowledge of consumers as to their rights and, indeed, their obligations in consumer credit is a problem acknowledged by the Federation in its Submission to the Parliamentary Committee and its other submissions, there is the possibility of a moral hazard developing if a consumer becomes aware of the capping effect of section 32A(2). If a consumer knows that, regardless of the terms of the contract that they have entered into, that no fee or charge can be imposed that takes the total amount of fees or charges for the contract over the capped ACR, there is an incentive for them to engage in conduct that triggers the imposition of such a fee or charge, for instance, late payments or failing to maintain contractually required insurance over secured property such as a motor vehicle.

This would put credit providers in the position of refusing to deal with such a consumer in the future and making reports to their credit record. This will ultimately be to that consumer's detriment when the system, if properly structured, could have provided incentives for them maintaining a better credit profile generally as well as a better standing with the particular relevant provider. It also adds considerably to the risk for credit providers dealing with particular sections of the market.

4. **The Unmanageable Risk of Inadvertent Breach**

It is possible that some fees or charges will be paid by the consumer "in relation to" the credit contract to third parties without the knowledge of the credit provider. The proposal will include

[3] As did its predecessor in the Uniform Consumer Credit Code at section 66

these fees or charges in the ACR calculation and could lead to an inadvertent, indeed, unknown breach by the credit provider of the proposed section 32A(2).

In business models where the credit provider is in constant contact with the relevant credit assister who referred the customer, this may not be a problem but this is not always the case. Likewise, if the consumer pays the credit assister on a fee-for-service rather than a commission basis, and this arrangement is not finalised at the beginning of the loan period (often described as the "settlement" time), then there is no means by which the credit provider can know of such subsequent payments. Yet these payments are required to be included in the ACR calculation.

If, for instance, the consumer offers a motor vehicle as security for a small personal loan and the credit provider, quite reasonably, requires insurance as a condition of that loan, it is arguable that ongoing insurance premiums are included in the ACR. While details of these, during the current term of an insurance policy, could be ascertained at the beginning of the consumer credit contract and, therefore, be easily included in any ACR calculation, this is not so if:

- The insurance policy term does not match the loan term;
- The insurance policy provides for premium changes mid-term; or
- Other contingent fees arise in relation to the insurance policy, e.g. a premium direct debit payment which fails and incurs a charge.

The risk of inadvertent and unintentional breach of the ACR "at any time" can only be managed by credit providers, at considerable administrative expense, if they know of all fees and charges paid by the consumer in relation to the credit contract. If they don't, and they can only rely on the consumer to tell them in many cases, then this risk becomes unmanageable.

5. **Option 1**

This option presents a substantial administrative impost to all lenders, whether they lend small amount loans or provide larger middle-to-high value loans over longer periods of time. Although the latter are at less risk of exceeding the ACR cap, it is likely that any adequate compliance program would require recalculation of the ACR on each occasion that:

- A contingent fee is imposed; or
- The term of the loan is adjusted.

Of course, as is always the case, the administrative costs of compliance fall more heavily on small credit providers and, in a relative sense, on small loans. The burden will ultimately be borne by consumers.

As discussed in the Federation's Submission, many of these costs which arise on contingencies are fixed in value regardless of the size of the relevant loan. Enforcement expenses, for instance, relate to credit provider time and resources as well as fees to third parties. The size of the loan is largely irrelevant.

The risk that some credit providers could, to use the expression in the Discussion Paper, inadvertently exceed the prescribed annual cost rate is high, especially in the case of small amount loans.

The possibility, mentioned in the Discussion Paper, that credit providers would use contingency fees to overcome the effect of the cap in s32A(1) is covered by those provisions in the National Credit Code specifically directed at fees and charges as discussed above. An inspection of the records of a credit provider by ASIC, using its powers under the licensing provisions of the National Consumer Credit Protection Act 2010, would quickly reveal whether a credit provider had:

- Charged more than what is "reasonable" for enforcement expenses; and/or
- Added any surcharges onto amounts paid to third parties.

This would lead to:

- Prosecution for offences already in the National Credit Code; and
- A reassessment of the credit provider as fit and proper to hold its licence.

Option 1 is unworkable. It would lead to potential offences in otherwise compliant situations and is unnecessary to address the remote possibility of avoidance using contingency fees and charges.

6. **Option 2**

This Option still presents the problem of inadvertent breach and the added administrative expense of calculating in all "cost of credit" which incurs "at any time." However, if it could be put into operation with precision, it is more realistic than Option 1. As a matter of principle, the Federation is opposed to the levels of complexity already imposed by the Enhancement Bill and its accompanying formulas. However, if a workable distinction between ascertainable "cost of credit" fees and charges and those that are contingent or arise out of the actions of the consumer, this may be a possible solution. It may reduce the likelihood of inadvertent breach as a result of third party payments.

In that context, some of the charges that must, at a minimum, be included in the category "contingent" and not included in the cost of credit are:

- All enforcement expenses
- Costs of answering consumer requests for:
  - Extra statements
  - Copies of the Credit Assessment
  - Any extra copies of contract documents
- Any payments to third parties in relation to the credit contract or service.

Overall, however, the Federation questions whether the additional complexity presented by Option 2, with its attendant increase in compliance costs for credit providers, is justified by the minimal regulatory gain, particularly in the light of our argument (above) that the NCCP and the National Credit Code already provide mechanisms for policing the use of contingency fees and payments to third parties.

7. **Option 3**

As recognised in the Discussion Paper, all of the problems in Options 1 and 2 with defining those fees and charges to be included in the ACR calculation apply to this Option. Its only advantage is that it would require only a "one off" recalculation of the ACR at the end of the term of the loan or its early discharge rather than multiple recalculations upon the imposition of a new charge or change to the repayments or the term.

Of course it could result in credit providers who have collected reimbursement for costs incurred during the loan having to refund consumers after discharge because the ACR recalculation takes them over the cap. Refunds are always messy and the damage to the cash flow and certainty of contracts for credit providers would have profound implications for their costs of funds and overheads.

Further, what if, as discussed above, there are third party payments by the consumer which may or may not be apparent to the credit provider at the time they do the ACR recalculation on discharge. Does the consumer come back again sometime later and demand a further recalculation which may or may not lead to a refund? What time limits would be imposed on such reassessment and claims? Without further regulation, these could be actionable, at law, up to six (6) years after the discharge of the contract?

These, combined with all other problems with Options 1 and 2, make Option 3 unsustainable.

8. **Option 4**

As acknowledged in the Discussion Paper, the ongoing nature of continuing credit contracts makes the calculation of the ACR difficult and laden with assumptions and uncertainty. Attempting to further complicate the formula by adding a distinction between fees and charges that relate to the cost of credit and all other fees and charges would render it almost unworkable.

Failing to make that distinction, as discussed above, and imposing the ACR cap obligation "at any time" as proposed in section 32A(2) would make continuing credit contracts even more unworkable than fixed term fixed credit amount contracts.

9. Conclusion

The Federation's position on the SACC provisions generally is contained in its Submission to the Committee. Its only response to the "Discussion Paper: Maximum Annual Cost Rate" must be that whether the Federation's more limited definition of a SACC and the accompanying reforms are adopted, or not, **the inclusion of section 32A(2) in the Enhancements Bill will make the administration of low value personal loans and similar products almost impossible and substantially reduce product flexibility and choice for consumers.**

This will not be a good outcome for anyone.

Appendices

Appendix 1 – Email from Treasury Friday 14th October 2011

From: Sutcliffe, Ward [mailto:Ward.Sutcliffe@TREASURY.GOV.AU]
Sent: Friday, 14 October 2011 14:12
To: Stakeholders
Subject: RE: Update - Enhancements Bill [SEC=UNCLASSIFIED]

To: Stakeholders

The Exposure Draft of the *National Consumer Credit Protection Amendment (Enhancements) Bill 2011* included a prohibition in relation providing credit where the annual cost rate exceeds 48% at any time. The purpose of the prohibition was to address potential techniques for avoiding the annual cost rate.

That provision was not included in the Bill when it was introduced into the House of Representatives. It was considered that further consultation was desirable to consider whether the prohibition introduced practical difficulties where the annual cost rate was imposed over the life of the contract.

The attached paper seeks views on the implementation of the proposed Subsection 32A(2). Can you please provide your comments on the options proposed in the paper by Friday 28 October.

Regards

Ward Sutcliffe

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Appendix 2 – Treasury Discussion Paper : Maximum Annual Cost Rate

Introduction

The Exposure Draft of the *National Consumer Credit Protection Amendment (Enhancements) Bill 2011* included a prohibition in relation to a person being a credit provider under a credit contract where the annual cost rate exceeds 48% at any time. The provision was in subsection 32A(2):

32A Credit provider must not enter into a credit contract if the annual cost rate exceeds 48%

(1) A credit provider must not enter into a credit contract (other than a small amount credit contract) if the annual cost rate of the contract exceeds 48%.

Criminal penalty: 50 penalty units.

(2) A person must not be a credit provider under a credit contract (other than a small amount credit contract) if the annual cost rate of the contract exceeds 48% at any time.

Criminal penalty: 50 penalty units.

The purpose of subsection 32A(2) was to address potential techniques for avoiding the annual cost rate, including:

- the imposition, under the credit contract, of relatively high contingent fees that were in practice usually payable (particularly a deferred establishment fee);
- varying the interest rate or increasing fees and charges to exceed the 48% cap once the credit contract has been entered into; and
- the use of continuing credit contracts where costs were imposed in a way that differed from the assumptions specified in relation to this class of contracts.

Subsection 32A(2) was not included in the Bill when it was introduced into the House of Representatives. It was considered that further consultation was desirable to consider whether the prohibition introduced practical difficulties where the annual cost rate was imposed over the life of the contract.

While the same formula was used to calculate the annual cost rate for subsections 32A(1) and (2), subsection 32A(2) would in practice operate differently from subsection 32A(1):

- Subsection 32A(1) only included non-contingent fees that were known to be payable at the time the contract was entered into.

- Subsection 32A(2) includes contingent fees that became payable under the contract (for example, fees for providing statements or deferred establishment fees where the liability arises after the contract was entered into).

The primary concern was whether subsection 32A(2) would, in practice, require credit providers to check whether or not they exceeded the annual cost rate each time they charged a contingent fee or varied the interest rate.

Having considered the matter further Treasury's view is that:

- The formula used to calculate the annual cost rate averages the cost of the term of the contract, and therefore the impact of a new fee or charge will not usually be significant in itself.
- The formula allows a credit provider to determine the maximum amount they can charge before the contract is entered into, and therefore to ascertain a relative buffer of additional costs that they can charge.
- The impact of an individual fee or charge will be significant where the fee is relatively large compared to the amount of credit being provided (particularly therefore where the credit provider is arranging a credit contract for a relatively small amount).

Option 1 – retain existing provision

The existing provision could be retained. The effect of this would be that the annual cost rate could not be exceeded, capping the amount of contingent fees that could be charged, irrespective of the type of those fees.

It would not be necessary for most credit providers to check whether they exceeded the annual cost rate every time they charged a contingent fee or increased the annual percentage rate, as for most credit providers the total amount payable would be substantially below the annual cost rate.

This approach:

- would be simple to apply, as it would not require credit providers to operate two different formulas;
- would address current avoidance techniques; and
- would create the risk that some credit providers who charge significant contingent fees could exceed the annual cost rate

Option 2 – retain existing provision but apply a modified version of the formula

The existing provision could be retained, but the formula could apply in a modified way, by distinguishing between fees that relate to the cost of credit and those that relate to costs incurred by the credit provider for services. The prohibition in respect of the annual cost rate could not be exceeded would only apply in respect of fees that relate to the cost of credit. For example, under this approach, deferred establishment or early termination fees would be included in the annual cost rate, but charges for providing statements of account would not.

This approach:

- would depend on whether the distinction between fees and charges that relate to the cost of credit and all other fees and charges can be determined or defined with precision (with the risk that it may encourage artificial changes in fees, so that fees could be charged that are not covered by the definition developed to describe fees that relate to the cost of credit);
- would address current avoidance techniques; and
- would address the risk that some credit providers who charge significant contingent fees that do not relate to the cost of credit could exceed the annual cost rate inadvertently.

Option 3 – change the obligation so that it is an obligation not to have charged more than 48% by the time the contract is discharged.

The operation of the provision would be changed, so that it would only be an offence if the annual cost rate was exceeded when the contract was discharged – so that the credit provider would either have to reduce the final payment by the debtor or refund the difference.

This approach would still need to address the issue raised in Options 1 and 2, as to whether the definition of fees and charges for the purpose of calculating the annual cost rate included all fees and charges or only those that relate to the cost of credit.

This approach:

- would only require credit providers to determine whether the total amount charged exceeds the annual cost rate at the end of the contract;
- would address current avoidance techniques; and
- would create the risk of avoidance through contracts providing that the contract is not discharged even where the debtor has made all payments due under the contract.

Option 4 – application of the provision to continuing credit contracts

The application of the annual cost rate to continuing credit contracts creates different issues. The ongoing nature of these contracts and the uncertainty as to how consumers will use the credit provided or the timing and amount of repayments makes its application more complex.

Views are sought on whether the formula could still apply to determine the annual cost rate on the basis of the fees and interest charged under the contract, including whether a distinction can be made between fees and charges that relate to the cost of credit and all other fees and charges.