SUPPLEMENTARY SUBMISSION

to the

Inquiries regarding the

NATIONAL CONSUMER CREDIT PROTECTION AMENDMENT (ENHANCEMENTS) BILL 2011

Subject:

A section 32A(2) that has not been included in the reference to either Committee and is not part of either Committee's current inquiry into the Bill before the parliament.

This Supplementary Submission is presented by the Financiers Association of Australia (FAA)/Industry/Smiles Turner Delegation (the Delegation).

About the Delegation

The FAA/Industry/Smiles Turner Delegation is the representative entity for the largest number of lending and broking companies involved in the short term, small amount finance sector, with some 147 companies, over 180 authorised credit representatives and 2 major service providers associated with these companies.

The Delegation includes the oldest peak industry body, with the FAA having been formed in the early 1930s; three of the 7 major short term, small amount lenders in Australia; an extended range of small, medium and larger lenders and brokers with business interests Australia wide; a well known compliance advisory and industry research consultancy; and Australia's major software service provider to the sector. The various lenders and brokers undertake either, or both, payday and microlending.

Of the Delegation's core team, two are Directors of the Financiers' Association of Australia and three are Directors of the second peak body, the National Financial Services Federation.

Incomplete Reference to Committees

The Delegation considers it extraordinary that the National Consumer Credit Protection Amendment (Enhancements) Bill 2011 has been referred to both the Parliamentary Joint Committee on Corporations and Financial Services and the Senate Economics Legislation Committee incomplete.

A very significant Section 32A(2), included in the Exposure Draft of the Bill, has been omitted from the Bill before the Parliament and the Committees. If this Section is introduced in any form similar to that in the Draft, it will be highly regulatory in itself. It will also have major implications in regard to the provisions included in the rest of the Bill, now being considered by both Committees, concerning the 48% tier of the 2-tier interest rate/fees and charges cap. The Treasury has now released a Discussion Paper concerning this omitted Section.

The Delegation submits that the 2 Committees' deliberations, in regard to the 48% cap, will be materially deficient without any consideration of their interface with the likely Section 32A(2).

The Content of this Submission

The Delegation details the timetable and issues associated with this incompleteness, plus provides detail and comment concerning the Treasury Discussion Paper, because the Delegation considers this to be a matter for consideration and inclusion in both Committees' reports to the House and/or Senate. We also believe that it should be an issue of considerable concern to the Parliament.

The Delegation believes that consideration of an incomplete Bill, by both Committees, seriously erodes the efficacy of the Parliamentary Committee process, could lead to a misrepresentation of the impact of the legislation to the Parliament and may lead to an Act that fails to satisfy one of the Minister's major stated objectives in presenting the legislation to the Parliament.

The Relevant Timetable

25th August 2011 - Minister issues an Exposure Draft Bill

This Exposure Draft includes the controversial Section 32A(2) (nothing to do with the Section 32A(2) in the current Bill before Parliament), together with the inclusion of one tier of a 2-tier interest rate/fees and charges cap regime, which was never canvassed with stakeholders over 18 months of consultation and 4 Treasury Discussion Papers, involving substantial submissions.

26th - Treasury Consumer and Industry Consultation Group meeting to discuss the Exposure Draft Bill

FAA/Industry/Smiles Turner Delegation member Phillip Smiles, supported by fellow Delegation member Haydn Cooper, repeatedly raised the Delegation's (then) major concern, that the inclusion of such a provision will entail continuing re-calculation by lenders - throughout the term of the credit contract - using the formula included in the Bill.

Once the significance of the measure was appreciated by the meeting, and by representatives from the National Financial Services Federation (NFSF), the other peak industry body attending, the NFSF also made significant comment. A major discussion followed and Treasury representatives attending were left in no doubt that the proposed Section had major implications for lenders and borrowers and major operational flaws.

The Delegation representatives, supported by the NFSF representatives, argued that the, then, Section 32A(2) raised issues of compliance cost and process difficulty and distortion. This with the added problem of sever deficiencies associated with the interest rate calculation formula included in the Exposure Draft, and now in the Bill.

When introducing the topic at the meeting, Delegation representative Phillip Smiles explained that his concern was based on the challenges of "averaging" a 48% interest rate during the whole term of a credit contract. This when the contract is entered into at a time when both parties cannot envisage exactly when, if at all, another fee or charge will emerge. That means "unascertainable fees and charges" will be presumed "ascertainable" under Section 32A(2).

The result being a possible need for the credit provider to be continually facing the challenge and expense of engaging in recalculation during the life of the contract, thereby changing the contract terms. Every recalculation also involves the possibility of refunding generally very small amounts of money to the consumer, for unjustifiable reason, as detailed later in this Supplementary Submission.

At the meeting, preliminary comment was raised noting that the Bill provides a criminal penalty of 50 penalty points ($5,500) that is likely to be applied for any failure on the part of the credit provider. This must be considered in the context that the short term, small amount contract involved would provide a possible gross revenue measured in hundreds of dollars, not thousands; the corrections determined could be just a few cents; and a criminal penalty means difficulty visiting countries such as the USA, remains on your public record for several years at least and threatens the lenders' annual renewal of the essential Australian Credit Licence.

In this context, it should also be noted that the significant deficiencies in the abovementioned formula have been the subject of repeated submissions to Treasury

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- first by Mr Cooper, on behalf of Min-It Software and the Financiers Association of Australia (FAA) in 2010, and this year by the FAA/Industry/ Smiles Turner Delegation, of which Mr Cooper is also a representative.

Mr Cooper, a Director of the largest software services supplier to short term, small amount lenders in Australia, has considerable expertise in the application of this formula and he personally demonstrated the problems to a senior member of the relevant Treasury team, employing the Min-It software system to do so, at the conclusion of a Delegation meeting with Treasury in April 2011.

The result of these representations at the meeting with Treasury was a later statement from Treasury that, regardless of any admitted deficiencies, the lending sector was used to the formula and it was therefore better to continue to employ it.

Unfortunately, as discussed later in this Supplementary Submission, the controversial Section omitted from the Bill presented to the Parliament and referred to the 2 Committees for inquiry, has resurfaced in a Treasury Discussion Paper and all options provided in that Paper, if submitted by the Minister as an amendment to the current Bill in November, will continue to be calculated employing this deficient formula.

21st September 2011 - Minister's 2nd reading speech to the Parliament, where the Bill is presented

22nd September 2011 - Minister refers the incomplete Bill to both Committees

"By" 14th October 2011 - Submissions to Parliamentary Joint Committee on Corporations and Financial Services due

At the time of the Committee Inquiry announcement, there was no notice from Treasury, or the Minister, of any further provisions to be included in the Bill.

3.12 pm, 14th October 2011 - Treasury email to stakeholders

Stakeholders were invited to comment on a Discussion Paper issued by Treasury, with the email concerning (the old) Section 32A(2).

This email was sent to 52 people who have participated, at various times, in the Treasury Industry and Consumer Consultation Group as well as, what appears to be, one banking organisation. This Consultation Group has met from time to time over the last 18 months. As discussed below, the Discussion Paper includes 4 highly complex options.

"By" 21st October - Submissions to Senate Economics Committee due

These submissions, as with those to the Joint Committee, are based on the incomplete Bill.

24th October - One hearing day for stakeholders, Parliamentary Joint Committee on Corporations and Financial Services

This Supplementary Submission presented to the Committee.

"By" 29th October - comments due "on the options proposed in the paper"

As notified by Treasury in its invitation sent to stakeholders.

As Committee members will have noted, Treasury will not have the opportunity to consider all submissions and present recommendations to the Minister, until after the 29th October.

Meanwhile, submissions will have been completed and the one hearing day currently scheduled for stakeholders to appear before it, by the Parliamentary Joint Committee on Corporations and Financial Services, will have been conducted. This

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with no indication of the Minister's intentions, following the receipt, presumably in November, of the Treasury recommendations in regard to this additional Section.

This is Now All Too Much

The Delegation has adopted a continuing policy of courtesy and comprehensive engagement in the consultation process. While experiencing considerable anguish on a number of occasions, and suffering growing and long term exhaustion from the process, we have made no critical comment to this point, with the possible exception of one measured expression of concern in regard to the Regulation Impact Statement associated with the Bill (see below), on any procedural or process flaw over the long gestation period associated with this Bill.

To emphasise our commitment to the consultation process, we believe that it is very important for all Committee members to know that we have made no comment of any public kind to this date:

1. as to the intolerable demands of repeated discussion papers and the Exposure Draft Bill, with ridiculously short invitation periods (often 1 week or 10 days) to comment. Such ignoring the fact that there are representative bodies on both sides of the argument associated with the issues and Bill in question, whose members deserve the opportunity, within their organisation, to be briefed and participate in discussion, before that organisation responds with a submission to government, and that time is required to facilitate the necessary communications within the organisation;
2. concerning meetings confirmed with Treasury and the Minister at 48 hours or less notice;
3. being asked to repeatedly comment on issues that have been presented in Treasury Discussion Papers previously, but with just enough difference to demand near complete reconsideration and no "cut and paste" from a previous submission;
4. being asked to repeatedly comment on yet another Treasury Discussion Paper or an Exposure Draft Bill which demonstrates that little, if anything, of the content of previous submissions or discussions has been recognised in any way;
5. concerning the fact that a Bill has been introduced into the Parliament before ASIC has published its report into its review of payday lending;
6. concerning the fact that a Bill has been introduced into the Parliament which is clearly designed to abolish payday lending, while pretending to introduce a number of regulatory reforms for payday lending. At the same time tacking on an interest rate cap which effectively abolishes most microlenders, who have not been the subject of adverse ASIC or consumer advocate interest;
7. concerning the fact that a Bill has been introduced into the Parliament that has substantially ignored all advices and very substantial research provided by the Delegation, the NFSF and others;
8. concerning the fact that a Bill has been introduced into the Parliament before a promised examination of the alternatives to commercial short term, small amount lending has even commenced. This despite the lenders' representative organisations, over a period of 18 months and, in particular, the Delegation this year, telling the Treasury, the Minister and all who would listen that the introduction of a 48% inclusive cap will drive most lenders from the industry, leaving the non-commercial lenders to cope with much of the substantial demand currently being satisfied by the commercial lenders;
9. concerning the fact that a Bill has been introduced into the Parliament providing for further significant regulation of the short term, small amount lending sector,

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when no study has been completed of the effects and consumer benefits actually achieved by the revolution associated with the Commonwealth takeover of regulating the sector, and by the major provisions of the National Consumer Credit Protection Act 2009 and associated Regulations 2010 and 2011;

10. concerning the fact that the Bill almost entirely reflects consumer advocates' dreams. These are the same consumer advocates who have not managed to undertake any research since 2009, nearly 2 years before the Commonwealth takeover. The same consumer advocates whose lobbying is based on the foundation of finding single borrower stories, without substantial verification, repeating them as often as they can and projecting them as the industry norm.

    To date, the Delegation has counted some 17 stories (all featuring just one borrower), including at least 2 in a 2011 publication of 12 stories, where the lenders named had absolutely no record of the person involved and one where the non-commercial sector failed the young woman, but the commercial sector managed to lend her some money to pay for accommodation other than her car. This in a lending environment involving 750,000 borrowers in 2010;

11. concerning the Minister's inflammatory media releases, that invite stakeholders' participation in a consultation process in 2 lines, while being highly critical of the lenders - a critical segment of the stakeholder group -and, over numerous paragraphs, presenting the Exposure Draft of the Bill as if it was set in concrete and certain to become law as drafted;
12. concerning the Minister's similar inflammatory comments made during his media interviews;
13. concerning the Minister thereafter admonishing attendees at his one meeting with an appropriately diverse and comprehensive short term, small amount lending sector representative group, for one representative body (not the Delegation) and one public company, who reacted with counter-critical media releases and media comment, following the Minister's inflammatory comments;
14. concerning the Minister publicly and in his Second Reading speech on 21st September, admonishing the lending sector for not adopting compromise and presenting him with alternatives, despite the Delegation doing just that in numerous submissions responding to Treasury Discussion Papers and at the meeting with him referred to above, with the unanimous support of all attending;
15. concerning Treasury's admission to the Senate Economics Committee, Estimates 19 October 2011, that no economic modelling had been done in regard to the interest rate/fees and charges cap included in the Bill now before the Parliament and Committees. This despite the fact that the Delegation had presented economic modelling and substantial calculations and industry research to Treasury in April (copies being provided to both Committees);
16. this information, albeit in part based on somewhat different capping options but, nevertheless, largely referrable to the caps in the Bill, clearly demonstrates, on entirely objective grounds devoid of any advocacy, that the 2-tier cap regime proposed in the Bill will not achieve the Minister's stated aim of having an economically viable short term, small amount lending sector. It will largely abolish the sector;
17. concerning Treasury claims that the interest rate/fees and charges cap included in the current Bill had emerged from "consultations with people" and "What's a fair thing" at the Senate Economics Committee, Estimates, 19th October, when the Delegation and every other lender stakeholder has been consistently telling Treasury - at every communications' opportunity - that a cap of less than $26, $28, $30 and, even possibly, $35 per $100 lent and a 48% inclusive interest rate cap would not be "fair" - it would drive most or all of the current short term, small

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amount lenders out of business because they could not even break even under such a regime.

18. concerning the fact that the above modelling and statistical information was considered by Treasury - working over an entire weekend examining it - after receiving it from the Delegation during the week before, and was the subject of discussion between Treasury and the Minister at a meeting in the Minister's offices the following week;
19. concerning the rushed nature of the final stages of the process that led to referral to 2 Parliamentary Committees, in circumstances where, presumably due to Parliamentary sittings and already committed workloads, those Committees:
    (a) had no opportunity to publish terms of reference;
    (b) provided 2 and 3 weeks respectively, for submissions to be prepared (we thank both Committees for their recognition of preparation difficulties and preparedness to grant a few extra days to stakeholders needing this assistance);
    (c) with one able to provide only 1 day for public hearings for stakeholders, with this one day having to accommodate 3 distinctly separate and unrelated issues included in the Bill; and
    (d) with this shared one day of hearings providing 2 sessions of 45 minutes each, for major lender stakeholders and their representative organisations to answer questions concerning legislative provisions that will:
        - abolish all commercial lending for loans under $3,000;
        - severely curtail the availability of loans from $3,000 to $5,000;
        - lead to around 834 lending outlets closing;
        - throw 2,500 full time equivalent people out of work;
        - leave up to 750,000 individual borrowers, annually, with nowhere to go for their loans;
        - remove most of the $1.2 billion lent to these borrowers by short term, small amount commercial lenders in 2010, from the Australian finance market;
        - require the Minister to provide - annually - 60 times the financial assistance amount he promised to the non-commercial lending section over 4 years, in a recent media release, just to fund the non-commercial lending sector's necessary loan book; and
        - require the non-commercial short term, small amount lending sector to be prepared for at least a 100 fold increase in short term small amount loan applications (plus adjustment for the 18.6% annual compound growth in demand), commencing in the second half of 2012, when the 1 July commencement "enhancements" come into force. This demand will increase as lenders pull out and/or cease to lend in the last quarter, to diminish the time they need to stay to collect outstanding loans post-1 January 2013, and will hit at full force during 2013 and every year thereafter.

The one possible exception to this reticence to make public comment, being when the Delegation offered the following notice for inclusion in the Department's website comments section after the Regulation Impact Statement (RIS) was posted on the Department of Productivity and Deregulation (the title's irony not lost on the

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Delegation) in the afternoon of the last business day before submissions were due in regard to the Exposure Draft Bill.

While the relevant RIS was dated June, it was not posted until early September and was clearly substantially written in September/October 2010, after the receipt of submissions in regard to a government Green Paper. It contained nothing of the material included in the several Delegation's submissions, or that has been presented at face to face or telephone conference meetings between the Treasury and the Delegation this year.

"COMMENT to Office of Best Practice Regulation re. RIS on Phase II released 2.9.11

Putting aside any assessment of the adequacy of the RIS, it is significant to note that the content only reflects a consideration of information available to Treasury, following the release of the Green Paper in the second half of 2010. Since that time, Treasury has been the recipient of results from major research undertaken by Smiles Turner for the National Financial Services Federation in December 2010, as a response to a Treasury Discussion Paper.

Further, on at least three occasions in 2011, as part of a response by the Financiers' Association of Australia/Industry/Smiles Turner Delegation to Discussion Papers published by Treasury, the Delegation has provided Treasury with considerable information and contemporary research results. Additional substantial information was provided during a face to face meeting and a teleconference between the Delegation and Treasury earlier this year. None of this information appears to have been considered and the RIS paper, although dated June 2010, but not posted until September 2, is a document that was plainly completed prior to the end of last year.

We regard the possibility of draft legislation, released in late August 2011, being developed on information sources no more current than November 2010, as most unsatisfactory. As someone who has been intimately involved with industry communications with Treasury and has found all relevant Treasury officers to be impressively courteous, well informed and professional, I am deeply troubled that no mention of preparation or existence of this RIS has been made at any time in the consultation process this year, given the intensity and frequency of such consultation, since January.

It would not be unreasonable to request and receive an explanation as to why this RIS was clouded in secrecy until as recently as 2nd September".

Continuing Restraint

Out of respect for the Parliamentary Committee process and at least for the period until both Committees have reported to the Parliament, the Delegation will continue to refrain from critical public comment.

The Delegation leaves it to the 2 Committees and the Parliament to consider the appropriateness of referring a Bill to 2 Committees that is incomplete, so that their deliberations are largely completed before they might even be made aware of the Minister's intentions in regard to an addition or amendment not provided to them.

Such circumstances presenting a possible opportunity for both Committees to report to the Parliament on most of the Bill, but be excluded from consideration and comment on another part that is introduced to the Parliament by the Minister - without any reference to either Committee - and which will have a major impact on short term, small amount lenders.

In another possible alternative, the Delegation leaves it to the 2 Committees and the Parliament to consider the appropriateness of the Minister presenting an amendment or addition to a Bill, not previously referred to either or both

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Committees, long after their due dates for submissions and after the one Committee conducting public hearings has completed that process.

The Issue for Lender Stakeholders - the Discussion Paper

The Treasury Discussion Paper, circulated on Friday 14th October, commences with an introduction of which the Delegation believes the Committees should be made aware. To assist in communicating the Delegation's concerns to the Committees, the following is a reproduction of that introduction, interspersed with Delegation comment as indicated:

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.

Comment:

The phrase "at any time" is the critical element. As with the 10%, 2% small contract cap in the current Bill, this concept is not known to have been introduced into any other jurisdiction.

To achieve the objective, it is understood that 2 formulae are involved. The first associated with the comparison rate, as recognised in NSW and Queensland, which anticipates that the loan will run to maturity. The second is the annual cost rate, where maturity occurs on any given day and not necessarily the maturity date of the contract. The annual cost rate formula is a new concept.

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.

Comment:

All of these concerns could have been addressed simply by prohibiting the alleged avoidance technique already well known to ASIC, given the 12 months in which they have been reviewing the payday lending sector and the many thousands of credit contracts they have collected from lenders all over the nation.

The Section also assumes that the consumer can be located to accept the repayment. This is not always the case, with a high incidence of people who are

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highly mobile, who misrepresent their position, borrow from short term, small amount lenders and "do a runner" somewhere during the term.

Lenders on accrual accounting will face difficulties when they attempt to write back the expense. The calculated excess is probably to be deemed a non-collectable. Again, the lender could have to give back money, even though they have never been paid the amount.

It must be remembered that the suggested provisions have a powerful ally. If you charge a fee, even of $5, the interest on that runs the whole term of the loan. This is also relevant with the above discussed loan term extensions, with every extension increasing the total interest paid.

The calculation issue is that you are no longer calculating on an outstanding balance, but recalculating all that has passed from day 1.

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).

Comment:

It might be more appropriate to say that 2 formulae are now needed to calculate the amounts required.

The second dot point introduces the following challenges:

(a) There has to be very precise definition provided associated with cost items;

(a) It should be expected that, for the first time, the fees of debt consolidation companies will have to be included in the cost of credit;

(b) The concept essentially requires that the lender has to calculate backwards, because the non ascertainable fees and charges that emerge during the contract term, are not capable of being anticipated and included in the contract commencement calculations.

(c) The concern is only to reduce the amounts a consumer might actually pay.

(c) There is no recognition of the fact that many of the contingent fees and charges involving legitimate cost recovery by the lender, are caused by the actions of the consumer.

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.

Comment:

This overlooks the point that the second formula demands recognition of the new fee or charge, and calculation including the amount, no matter how little or how much. There is the need for a mandatory calculation and, once calculated, even if the impact is "*not …significant in itself*", some payment, even if it is just a few cents, will have to be made to the consumer or there will be a compliance breach.

- 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.

Comment:

The opportunity to "*ascertain a relative buffer*" is pure guess work. The central issue is that the fees and charges involved are non-ascertainable. They will arise if a certain event happens in the future and will not if that event does not occur.

If the lender guesses too big a buffer, the lender loses income, because they have charged less than they might have.

If the lender guesses too small a buffer, the lender has to pay money to the consumer, even if the fee that caused the excess is one created because the consumer defaulted on one or more payments.

In other words, the regime appear to create an opportunity for people who do not acknowledge their contractual obligations, to actually receive money from the lender from payments they agreed to make at the commencement of the loan, if they defaulted. Remembering always that a default costs the lender in terms of uncollected income, administration time chasing up and the opportunity to derive income from on-lending to another consumer who would contribute to their profits.

This provision makes an absolute mockery of the 48% cap provision included in the current Bill. It effectively reduces this maximum allowable interest rate to something less and something unknown.

The 2 Parliamentary Committees have been asked to review a Bill that provides for a maximum 48% cap. If the proposed Section 32A(2) is reintroduced, the maximum will **NEVER** be 48% and the Bill will be fundamentally altered in its impact on the few short term, small amount lenders that may be left after 1 January 2013.

- 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).

Comment:

This is true, but it should not be overlooked that some fees, such as default letter fees, are constant no matter what size the loan is, because they reflect actual costs of preparing and sending a letter that are quarantined from the amount of the actual loan.

Under the proposed Section, in the case of a common $25 default letter (remembering most solicitors charge $60 for a simple rote letter), the impact will be much greater if the loan is for $200, than for one that is for $800, but the costs to the lender to generate this letter, passed on to the consumers, are the same.

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.

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Comment:

Treasury appears to assume that the issue is the large one payment, which takes the calculation over the 48%. However, the same effect can be achieved with a run of very little fees and charges, such as with a serial defaulter.

This means the frequent defaulter, who repeatedly chooses to breach their loan contract terms by not making a due repayment, will enjoy a capped cost advantage, whereby each default will cost them less per default than for the good consumer who misses just one payment during the term of the loan and has to pay the full default fee on that incident. Such occurring because the one default may not have led to the annual cost rate being exceeded.

The current Bill's 200% of principal as the maximum indebtedness allowed, presumes that the lender can recover the 100% above the principal. With this Section 32A(2), collection of all of that amount is highly unlikely. This unless the lender extended the loan out every time a fee or charge was incurred by the borrower.

Such forced extensions deserve criticism:

(a) The consumer never feels they will complete their loan obligations;

(b) The other provisions of the current Bill will mean that the extension periods will prolong the time before the consumer can get another loan.

(c) Extensions create a bad credit history, which will discourage lenders from giving the consumer another loan after the conclusion of the extended first loan.

(d) The consumer will face a prolonged period of being unable to effectively apply for an increase in their credit limit.

The delegation has noted elsewhere that the proposed section 32A(2) excludes the use of brokers as an avoidance technique. The use of brokers, as a general business policy, is also discouraged. Under what is proposed, a lender could pay a broker on behalf of the consumer, then have the consumer pay out early and find that they (the lender) are refunding part of the brokerage fee to the consumer (which they never kept in the first place).

Again, there is no recognition of actual cost recovery by the lender - as opposed to any profit.

The major problem with this option is that - at present, all credit laws allow a lender to recover costs incurred by way of a credit fee or charge and these are recognised under the comparison rate formula. In addition, under section 32 of the National Credit Code, the lender is not allowed to make any profit on a fee or charge paid entirely to a third party, yet that same lender may be obliged to repay some of that fee to the borrower.

However, if the annual cost rate formula is applied, some costs that are excluded from the comparison rate formula will be included. These costs could push the rate over the 48% limit and the lender would have to repay the borrower. This even though the lender may never have collected the fee or charge and/or this fee or charge was collected by the lender but, in both cases, a third party was paid the full amount of that fee or charge. The result is that the lender will pay out, when they have never received the contributing fee or charge in question and their profits will be reduced by that amount.

It would appear that this annual cost rate is what the states have formally called their annual percentage rate.

This burden is in addition to the employment of the traditional comparison rate formula, which was designed to cope with long term mortgages. That means there

may be significant distortions when using it for very short term loans, or for loans paid out very quickly.

The adoption of the NSW-style comparison rate contradicts Treasury promises and Ministerial promises to the Delegation and others, that a NSW-style cap would not be adopted.

The definition of "*credit cost amount*", under the Section 32A(2) regime, significantly includes the following:

(a) "*the amount of a fee or charge payable by the debtor (whether or not payable under the contract) to:*

   i. *any person (whether or not associated with the credit provider) for an introduction to the credit provider (this excludes brokerage arrangements as an avoidance technique); or*

   ii. *any person (whether or not associated with the credit provider) for any service if the person has been introduced to the debtor by the credit provider (this excludes income splitting); or*

   iii. *the credit provider for any service relating to the provision of credit, other than a service referred to in paragraph (ii)*".

The practical problem with these provisions is that, if the lender does not physically pay the person described, it is probable that such amounts will not be recorded in the lenders' loan management system. That means software designers will have to create new fields in which to record amounts only for interest rate calculation purposes.

In addition this definition of "*credit cost amount*" includes "*(c) any other amount prescribed by regulation*". That means there is no certainty and the possibility of lenders facing the expensive undoing of initial development, or the inconvenience of modification as new regulation content comes on stream.

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.

Comment:

This statement mixes in ADIs, who are exempt, and other longer term, larger lenders, with short term, small amount lenders. The latter who have to charge the permitted maximum 48% to survive, if at all.

This statement totally goes against all the modelling, statistics, research results and other information provided by the Delegation and other sector representatives, that demonstrate most lenders will not even be able to break even at 48%. It assumes that lenders in this category will suddenly be able to afford to lend at rates even lower than 48%.

The Delegation clearly and objectively explained to Treasury why a cap of less than $30, per $100 lent, will not allow most lenders to break even - so the Bill includes a cap which generates $12 per $100 lent, for 1 month or less, and $14 per $100 lent for 1 to 2 months.

The Delegation clearly and objectively explained to Treasury why a 48% inclusive interest rate cap does not generate break even income for most short term, small amount - so the current Bill includes a 48% cap and the proposed additional Section reduces that even further.

It is very hard not to be emotive in such circumstances.

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This approach:

- would be simple to apply, as it would not require credit providers to operate two different formulas;

Comment:

The simplicity referred to is that of credit providers charging so little, that they do not run the risk of having to apply the 2 formulas.

In this assertion, there is no recognition of the costs of lending involved. A lender can keep their interest rate low to come under the radar, but will that allow them to break even, let alone make a profit?

Treasury and the Minister would not know, because Treasury has admitted that it has not done any economic modelling to assist their recommendations to the Minister. Both have totally ignored the Delegation's modelling provided to assist them in their deliberations and to reach anything other than these totally fanciful conclusions that Section 32A(2) and the 48% inclusive cap can actually leave a viable commercial lending sector in existence.

- would address current avoidance techniques; and

Comment:

It probably would, but why drag down a whole financial sector when it is simpler to ban the obviously known avoidance techniques and not generate the mass of unintended consequences that are apparent with any version of the section 32A(2) included in the Discussion Paper?

In the alternative, why not introduce a simple and realistic interest rate cap regime, such as that recommended by the Delegation, which satisfies the concerns of the consumer advocates and the Minister, for the "desperate" and "vulnerable". This leaves the non-desperate and non-vulnerable borrowers to use their pent up market influence on lenders, who do not have to adopt "avoidance techniques" because there is an opportunity to make a reasonable profit, under a very simple regulatory regime, which offers the consumer a very transparent and very easily understood one-figure declaration of competitive prices.

- would create the risk that some credit providers who charge significant contingent fees could exceed the annual cost rate.

Comment:

To honestly reflect the truth, this statement should be re-written - "*would create the risk that some credit providers who charge very little interest and significant contingent fees, could exceed the annual cost rate, as would any lender who charged the maximum interest rate allowed under the Bill and even very small contingent fees*".

This statement ignores the obvious reality - the proposed Section 32A(2) is designed to:

(a) Attempt to force lenders to NOT adopt the maximum allowable interest rate under the Bill; and/or

(a) Force short term, small amount lenders (microlenders) out of the sector who might have stayed under a 48% cap regime, but cannot, with the need to adopt even lower interest rates.

Not even the most financially and business literate consumer advocate has asked for a maximum interest rate lower than 48%.

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);

Comment:

The definition of credit fees and charges appears to exclude unascertainable or contingent default fees and charges, such as dishonour letters, default notice fees and missed payment fees, but the annual credit rate will include these and enforcement charges.

In addition, recovery of both initial credit fee costs and contingent costs could depend on the actual pay out date chosen by the borrower who wants to pay out before the conclusion of their contract.

This is a further disincentive for lenders to continue in the industry, after the commencement of the Bill, inclusive of Section 32A(2).

There is a software development challenge associated with these provisions. Microsoft Excel, or similar spreadsheet software, will not do the calculations. This will require up to 18 month development programs. Development may not be complete for many on 1 January 2013, let alone 1 July 2012.

Delegation member and IT expert, Haydn Cooper, questions whether any value of ‘n’, as included in the formula, can ever be applied except on a perfectly run contract. Any number of dishonours, significant or otherwise, will distort the results. Therefore, at least for microlenders, the annual cost rate will need to be calculated daily, taking into account every single entry on the ledger of each loan. This would impose additional processing requirements on servers in regard to end of day processing. For large multi-transaction businesses, this may mean ledgers cannot be accessed in real time, due to system overload.

- 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.

Comment:

This is a more acceptable approach but:

(a) As noted, we still have the challenge of clearly defining what charges qualify for exemption - the service charges;

(b) There is still lender cost recovery, or non-recovery, involved;

(c) Again, why go to this convoluted and complex trouble, when all the proposed section needs to do is prohibit “*avoidance techniques*”, which have been clearly identified; and

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(d) Again, why not adopt a simple Delegation recommended regulatory model, where such artificial "*avoidance techniques*" are unnecessary.

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;

Comment:

The managing of cash flows by lenders, under this proposal, would be a nightmare. The lender would have to quarantine a proportion of income for every loan, to have available to refund at the end of the loan.

In addition, it still means that the frequent defaulter would enjoy an advantage over the one-off defaulter.

Lenders would still be obliged to shoulder calculation expenses at the beginning and at the end of the loan.

Again, lenders costs, incurred due to the administration associated with the extra charges involved during the term of the loan, may not be recovered because the cap does not provide any recognition of these.

There is also the practical issue, in that many borrowers ring their lender to enquire what the payout figure is during the term of the loan. Under the National Credit Code lenders have to be able to accommodate such enquiries. That means, while the option only requires the 2 calculations from the software system, the Code and consumers demand a continuing ability of the software to calculate the payout figures.

- 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.

Comment:

This concern overlooks the fact that, while the principal and interest may have been repaid, there is an overhang of default fees and charges or similar. In part, the lender wants these to pay for the cost of their administration and, in part, because they have a profit element.

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.

Comment:

Any attempt to introduce any adoption of the above regimes faces at least the following problems:

(a) Having to wait the full 12 months before attempting any recalculation;

(b) Clearly understanding the draw down fee mechanism;

(c) Again, clearly defining what fees and charges are exempt from the calculation; and

(d) Again, recognising that there is a cost recovery element in every fee and charge.

Again, the "*avoidance technique*" of obvious concern is very well known. Why attract all the complexities of 2 formula and unintended consequences, when a simple prohibition is all that needs to be included in the Bill?

Again, the major circumstance encouraging the employment of the "*avoidance technique*" exists only because state regimes have failed to adopt a simple regulatory methodology that is realistic, as opposed to what the consumer advocates want.

These are the same consumer advocates - who have never had to borrow a short term, small amount loan in their life; who have never visited a relevant lending outlet; and who have never commissioned any contemporary and professionally conducted research program - while adopting a 48% cap philosophy that has its origin with an anti-Semitic British backbencher in 1927, picking the figure of 48% (flat, not reducible) out of the air.

The Delegation would understand if there was a prohibition of the "*avoidance technique*" in question, but only if a realistic and simple regulatory regime was introduced that actually permitted the Minister's objective of having a viable short term, small amount lending sector continue to exist.

Simple Regime Exists

Such a simple regime has been outlined by the Delegation in the substantial submissions to both Committees. This model accepts Treasury and the Minister's concern to move the "desperate" and "vulnerable" away from commercial lenders, to other cheaper options "*probably better suited for this class of borrowers*", as treasury told the Senate Economics Legislation Committee, Estimates last week.

This all in accordance with the independently calculated ATO tax threshold as the criteria for the cheaper options and leaving the current Bill's small loan provisions in place. Such leaving those who earn a net income above the threshold, from any source, to participate in a lending market where lenders charge 48%, plus one only establishment/administration fee that is clearly identified, encourages price competition and requires the addition of one subsection with two lines and one new section with 11 lines to the current Bill and no other changes (satisfying the Minister's concern that the structure and content of the current Bill be largely left as is).

All consumers will continue to be protected by the already introduced "enhancements" included in the National Consumer Credit Protection Act and associated Regulations, plus other recent Acts, which include:

(a) responsible lending, including vigorous credit worthy assessment;

(b) significant new disclosure requirements for major transparency;

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(c) changes to privacy protection; including electronic transactions and anti-spam contracts;

(d) Austrac requirements;

(e) obligatory staff and management education and training;

(f) contract document inclusions;

(g) licensing procedures; and

(h) ASIC compliance inspections and prosecutions.

Adoption of any one of the proposed Section 32A(2) options would be in addition to the provisions for small loans in the current Bill - a ban on rollovers and refinancing, the ban on having more than one contract at any one time, the ban on obtaining an increase in the credit limit, the ban on debt consolidation and the draconian and completely unworkable 2-tier interest rate/fees and charges cap.

This in addition to regulation already in place, including:

(a) publication of credit guides, quotes and credit proposals;

(b) provision of privacy statements and information statements;

(c) electronic transactions agreements;

(d) spam agreements;

(e) pre-contractual statements;

(f) various (3) mandatory default notices;

(g) change of contract terms letters;

(h) highly regulated contract inclusions;

(i) mortgage or bills of sale documents;

Plus

(j) minimum education qualifications and continuing professional development requirements for staff;

(k) annual compliance certificates;

(l) demanding criteria to satisfy in order to obtain an essential Australian Credit Licence;

(m) annual renewal of Australian Credit Licenses; and

(n) penalties frequently expressed as criminal, with fines frequently up to $220,000 for the individual and $1.1 million for the company.

All this is supervised by ASIC, which can review for credit legislation compliance as well as corporations legislation compliance, and determine whether you receive, or get to keep your licence.

As the Committee members would have noted, the short term, small amount loan sector does not qualify as an outstanding example of government deregulation.

It is already drowning in regulation and does not require any more, let alone that with the complexity and anti-lender, pro-defaulting consumer content of the Section currently being considered by Treasury.

In conclusion, Committee members are reminded that none of the above options have been included in the consultation process, apart from the Treasury meeting held within 18 hours of the concept's original announcement, with the release of the Exposure Draft Bill. Consultation only rekindled on Friday 14th October.

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All the above options rank with the worst of the provisions in the current Bill before you.

All of the very complex options are set for possible introduction into a lending environment which generated only 112 lodged complaints with COSL (with 94 resolved), the major External Dispute Resolution service provider to the short term, small amount loan sector, for the whole of Australia for the 12 months to July 30th 2011.

Despite every set of contractual and associated documents issued by every lender, including multi-listing of contact details and the fact that the service was free to consumers, this complaint number to COSL constitutes just 0.005% of all loans issued during that year.

The Delegation trusts that the above is of assistance to both Committees' deliberations.

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