Exposure draft of the Credit Contracts and Consumer Finance Amendment Regulations 2020

Commentary and submission from Westforce Credit Union.

Established 1981 Westforce Credit Union is not a registered bank but a locally owned and operated Financial Service Provider. We offer financial services to our Members with offices situated in West Auckland, South Auckland & Whangarei.

New Regulations Likely to Drive Lending Underground

The credit system is an integral part of a healthy economy. Businesses and private citizens with access to affordable credit can meet their goals and cover needs that may require liquidity beyond current means. The more that lending is restricted, the harder it is for people to function in the face of their financial obligations.

In order to maintain a healthy national economy that is able to function within the global financial ecosystem, a seamless consumer credit system is vital. In the absence of affordable and accessible lending, people will seek alternatives. In most cases, these alternatives have repercussions for the economy while damaging the social fabric of a country.

How New Legislation Will Drive Lending Underground

Not everyone looking for a loan should be granted funding open-handedly. The level of education on matters of personal finance is not prevalent enough in our society to warrant dispersing unlimited credit. However, having the pendulum swing to the other extreme and stifling lending is also unwise.

People can be prone to imprudent use of funds regardless of their intelligence and social standing. This doesn't mean that they should be deprived of the ability to use lending as a form of funding. With the 2008 crisis, it became apparent that financial imprudence on the part of large financial institutions was enough to throw the global economy into a tailspin. These were the very same institutions that are considered pillars of finance and wag their finger at citizens.

What Forms Can Underground Lending Take?

Underground lending, also referred to as informal lending, can take several forms. Some are illegal, others walk the fine line of legality and others are downright criminal. What is important to understand is that the main differentiating factor between sanctioned lending through financial institutions and underground lending is in the terms of the loans given.

Underground lending comes with higher interest rates, often in the realm of the unbearable for loan-seekers. Credit checks are usually not utilized in these agreements and the loan term can be arbitrarily changed by the issuing entity. Informal loans can be given by money lenders, quick cash providers, shopkeepers, pawnshops, loan sharks and even friends and relatives. Depending on which kind of lender the loan-seeker turns to, the potential negative effects on that individual can vary.

The Social Consequences of Underground Lending

The consequences of underground lending are more far-reaching than government regulators can see when drafting consumer credit legislation. Many of the effects are not immediately apparent in the economy's gross domestic product, growth rate and other metrics but rather start to rear their ugly heads in other reports. Increases in crime rates, drug addiction, mental illness and drops in indices that monitor people's happiness and contentment are all places to look for the effects of tighter credit conditions.

In places like Southeast Asia and South America, high rates of inflation that border on hyperinflation make lending practically impossible. Even in countries that are not in financial dire straits, restrictions on consumer credit that have passed into law are already showing negative signs on the real economy and the fabric of society.

In April of 2014, the Milken Institute published a report on underground lending in Asia. Among the research and data, the report highlights the level of crime that is associated with informal lending. The scenes of loan sharks sending ruthless debt collectors to raid people's houses that we see in films may pale in comparison to actual instances of violence committed. Even in the West, it isn't uncommon for parties operating outside the law to enforce debt collection on their own terms.

In 2019, China criminalized loans carrying annual interest rates of over 36 percent, (100% in NZ). This is a concerted attempt by the Chinese government to crack down on private lending which has run amok for decades. However, despite the fact that this will curb excessively high-interest lending by questionable entities, it will certainly have negative consequences as well. These consequences can only be mitigated if the government provides affordable alternatives for loan-seekers. In an authoritarian state, a solution like this may not become available unless officials offer it of their own accord. No amount of pressure or lobbying will bring it to pass if the central government of China does not deem it necessary.

Fortunately, we live in a free society where discourse is encouraged and the synthesis of opinions results in better legislation for all. The policymakers in New Zealand need to take a hard look at the data and carefully weigh the potential outcomes of the lending regulations that they are drafting. They also need to hear the logical voices that are presenting arguments against the Credit Contracts and Consumer Finance Amendment Regulations.

Legal Alternatives That Pose Threats to the Banking System

The threats that are posed by harsh overregulation of the consumer credit market do not only threaten the people. The lawmakers and large financial institutions may experience irreversible side-effects.

Political parties that pass this new legislation will end up alienating a significant part of their constituency. In years to come when people are called upon to vote during the next election cycle, fringe political entities will be sure to use this overbearing piece of lawmaking against the incumbents in order to win votes.

A threat that policymakers and big banks alike may not be aware of is the introduction of new technologies that are set to hit the lending space shortly. The blockchain space and open banking are sources of innovative financial technology that will bring peer to peer lending and personal banking to the masses. If people find that they cannot access affordable credit through the financial institutions they have trusted until now, a switch to fin-tech alternatives facilitated by cryptocurrencies and open banking will almost be certain.

Keeping Lending Responsible

The prudent alternative to imposing exorbitant restrictions on lending is to create an agreeable credit framework for all. Allowing a greater percentage of the population access to affordable credit while providing helpful education on personal finance and measures of assuring best practices are followed is the way forward. Holding loan-seekers accountable for their actions is a way of treating people like adults while being respectful of their personal sovereignty.

No one is advocating for unrestricted, uncontrolled lending. That would be a recipe for disaster. However, moving to the opposite end of the spectrum and imposing restrictions only an authoritarian regime would mandate is equally as dangerous. We need to engage in an open discussion with all relevant decision-makers and stakeholders to produce the best solution for loan-seekers and our economy

When Overregulation Does More Harm Than Good

Recently, changes to the Credit Contracts and Consumer Finance Amendment Regulations were drafted to augment laws regarding consumer credit. It is clear that the government wishes to impose a tighter legal framework pertaining to lending.

Credit unions, more so than any other financial institution that engages in lending, have the best interest of the consumer at heart. It is the position of any ethical organisation operating in the consumer credit space to oppose overregulation that will be detrimental to the public-at-large.

In light of this proposed legislation, it is important to understand the reasons behind it. Also, the potential consequences and examples of similar legislation in countries around the world will paint a better picture of what we can expect. It is of vital interest to the lending industry and to the financial health of consumers that a level-headed and rational argument is made in favour of the public.

What is the Goal?

The goal of the lending industry should be to provide capital to those in need in accordance with their financial means. The changes drafted for the Credit Contracts and Consumer Finance Regulations will restrict lending for a significant segment of the population. By restricting lending, those that do not meet the criteria set forth by this legislation will be left without vital capital.

Is There a Lack of Regulation?

While it is understandable that the nature of government is to legislate so as to make their constituents' life better, often this well-intentioned exercise ends poorly. If the 2008 financial crisis that originated in the United States is to teach us anything, it's that such a crisis can arise from insufficiently imposing existing laws, not from a lack of stricter ones.

The legal framework in 2008 was enough to prevent the subprime mortgage crisis if the irresponsible parties been held accountable by the authorities. Instead, the blame was passed on to the “irresponsible” loan-seekers and the bill was footed by the taxpayer. Meanwhile, inadequate credit checks conducted by large lenders led to the repackaging of toxic loans. These subprime loans were then sold off to funds as high-quality, cash-bearing assets. In no part of that process was additional legislation required in order to stop the ensuing financial calamity.

The Political Cost of Overregulation

Overregulation of the lending market will bring a high political cost for the government officials that pass these drafted amendments into law. By restricting lending for a large section of the population, the political parties that cosign these regulations run the risk of receiving a significant electoral blow. In the concrete examples listed below, it is abundantly clear that these stifling regulations not only hurt consumers but also the politicians' reelection efforts.

Examples of Overregulation in Consumer Credit

There are several well-documented cases in which excessive regulation of consumer lending has led to adverse effects for the citizens of a country. There are also instances where stiff opposition to such legislation is voiced by central bankers. Looking at some of these cases will serve to clarify why further deliberation is needed before enacting draconian lending laws.

Australia

The Australian housing market, once a booming real estate paradise, is experiencing a downturn over the past few years. The Reserve Bank of Australia has urged banks not to overly restrict lending during the deflation of the housing bubble so as to avoid negative ripples on the greater economy.

The deputy governor of RBA, Guy DeBelle, states that the availability of lending during an economic slowdown is an important lesson that lawmakers have taken from the 2008 financial meltdown. Free-flowing credit keeps an economy from drying up unexpectedly, catching governments by surprise.

Slovenia

In October of 2019, the Slovenian Bank Association warned against new restrictions being placed on consumer lending. The SBA noted that over 300,000 people would be excluded from receiving necessary loans. The association also suggested that economic growth in the European nation would suffer as a result of the new measures.

According to the SBA, among the hardest-hit segments would be pensioners and wage earners in the lower strata of the economy. The Bank Association is also quick to add that without providing alternative credit sources, the government could be triggering broader social problems.

Eurozone

In 2010, and while the financial crisis was strengthening within Europe, the European Central Bank published a paper discussing the impact of applying constraints on bank lending within the Eurozone. Their findings indicate that constraints placed on the supply side of lending, namely by the banks, negatively affect several economic metrics.

It's no secret that the countries that suffered the most from the 2008 financial meltdown were the ones that had extreme restrictions placed on lending. In countries like Greece and Cyprus, the harsher the constraints placed on the flow of credit, the deeper these economies plunged into recession.

Capital controls and restrictions on the outflow of capital also meant that lending was nearly non-existent. Conducting business became practically impossible and private citizens found their savings drained without having a lender of last resort.

Many people sought out underground lending options which only served to make the social crisis more severe. Absurdly high-interest rates from illegal entities brought more and more upstanding citizens within the reach of criminals. Suicide rates skyrocketed with most cases being attributed to financial difficulty and the inability to receive emergency liquidity.

Is it Doom and Gloom?

Amending existing laws on consumer credit seems harmless enough. After all, it is the end consumer's well-being that policymakers have in mind. It may seem like any adverse effects will dissipate after the first few months. A few people may protest their inability to access credit and that should be all, right?

As has been exhibited in countries that suffered during the financial crisis of 2008, the restriction of credit to a significant percentage of a population is a major ingredient of economic downtrends. Countries in South America are still feeling the effects of plummeting currency values that simultaneously mean a lack of access to affordable credit. Any policymaker that does not weigh the negative outcomes of the Credit Contracts and Consumer Finance Amendment Regulations into their thought process is overlooking a potential threat to the New Zealand economy.

Achieving Better Lending for Everyone

When governments have progressive, humanitarian values coupled with a libertarian rationale based on data, great things can happen. Easing off on excessive regulation can positively transform society in more than just lending. In some cases, the results are spectacular and life-changing for the citizens of a country. Perhaps the most notable example of this in recent years is the decriminalization of drugs in Portugal.

While other western nations have been ramping up legislation over the “war on drugs,” the Portuguese government took the brave stance of focusing on the cause of the issue at hand. By providing drug addicts with social reintegration and support, the government gave people a renewed reason to live fulfilling lives. This innovative program reduced the number of addicts by approximately 60 percent while also drastically reducing the prevalence of dangerous STIs and drug-related crime.

Even though access to affordable credit and addiction are two separate issues, it isn't a far stretch to conclude that people respond better when treated with dignity. Overregulation leads people to seek out questionable solutions and in the case of consumer credit, the negative effects of these laws will carry over to the real economy.

By educating citizens on personal finance while keeping access to credit open to as many people as possible, our government can help bring much-needed lending to a greater amount of people while safeguarding their financial health. Extensive credit checks, limiting lending on poor credit rating and proper education will go much further than placing a choke-hold on lending.

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