Submission on discussion document: Consumer Credit Regulation Review

Your name and organisation

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Organisation	Save My Bacon Limited

Responses to discussion document questions

Regarding the excessive cost of some consumer credit agreements

1	Do you agree that the problems identified with high-cost lending (even where it is compliant with the CCCFA) are significant? Do you have any information or data that sheds light on their frequency and severity?

We agree that the problems of HCSTC are fairly stated in the Discussion Paper, but make the following additional comments:

It is clearly not acceptable for a loan of, say, $500 grow to a debt of $2,500 over a short period of time. If a borrower is having difficulty repaying a $500 loan, then there is little prospect of them repaying $2,500. However, in practice, loans can only grow in this manner if there has been non-payment, i.e., default. The key issue, therefore, is the affordability of the loan both at the outset when advanced and during its lifecycle (especially where the borrower has had a change of circumstances).

In our view, the regulatory changes introduced in 2015 set the framework for much improved lending practices and have generated better outcomes for people who use high-cost short-term credit (**HCSTC**). In particular, the existing laws provide the necessary tools to prohibit unaffordable lending practices and outcomes such as that described above. We believe that better enforcement actions targeting those lenders who operate business models that rely on loans falling into arrears and generating additional default based income would best address and curtail the perceived harms of HCSTC.

Problem potentially overstated

We believe much of the evidence of harmful lending practices is anecdotal and represents outlier scenarios and do not reflect the outcomes for the vast majority of users of HCSTC. Our experience shows that:

- there is strong demand for alternative "non-traditional" credit sources;
- borrowers can responsible use (and re-use) these products without adverse financial outcomes; and
- borrowers "self-select" the product that best suits their needs and objectives, even if this product carries a higher interest rate.

We have discussed the number of complaints received in relation to the HCSTC sector with our dispute resolution service provider and were advised that during the 2016/17 period:

- 83 complaints were received in relation to lenders, which represented 35% of the total number of complaints received by our dispute resolution service provider;
- Out of these 83 complaints, less than 5 complaints were connected to HCSTC providers.

These figures support our view that we are not dealing with an endemic issue, but a case of a few rogue operators. We further believe that in any industry of scale, there will always be operators that chose to ignore laws and place profits ahead legal or ethical practices. When seeking to make broad regulatory changes to curtail the practices of a few, much care is needed to ensure that the wider market is not damaged and those that offer and use HCSTC responsibly are not unintentionally locked out of the market and suffer greater aggregate harm.

Our view is that the harm is more a consequence of the failure of the affordability assessment process and operators with business models that rely on default to generate profits, than the cost of credit per se.

Frequent use of HCSTC and debt spirals

We believe that a loan's structure has a material impact on its propensity to go into default. In this regard, we would draw an important distinction between short-term instalment payment loans (that are prevalent in the New Zealand HCSTC market) and the more traditional "payday" style loan that is repaid in a single lump sum (balloon) payment (that were more prevalent in the US and UK HCSTC markets prior to their respective reforms). Instalment loans are inherently more affordable as they should generally require a lesser proportion of a borrower's uncommitted income to service each loan repayment.

Balloon payment loans are more likely to create payment shocks that lead to rollovers and a multiplicity of fees. Rollovers and extensions work to advantage of lenders who deliberately lend money in the expectation that the borrower might not be able to repay the loan as contractually agreed. A borrower could inevitably find themselves in a "debt trap" faced with unaffordable repayments and having to choose between defaulting, rolling over or skipping other financial obligations like basic living expenses such as rent, food and medical care.

Prior to the regulatory changes brought in by the Financial Conduct Authority (**FCA**) in the UK in 2015[1] and more recently by the Consumer Financial Protection Bureau (**CFPB**)[2] in the US, the UK and US HCSTC markets were characterised by lenders providing short term loans with large balloon style repayments at the end of the loan term. In both markets, a significant number of borrowers would not be able to make these payments which would result in the borrower being required to take a new larger loan with additional costs.

In 2013, the UK's Office of Fair Trading (**OFT**) in 2013 identified that competition in the HCSTC market had been adversely effected because lenders were overly focused on those customers most likely to take out a series of loans.[3] They further found that this behaviour resulted in bad outcomes for those consumers that repeatedly rolled over or entered into new, larger loans.

The OFT found that 28% of loans were rolled over or refinanced at least once and provided

[1] https://www.fca.org.uk/publications/policy-statements/ps14-3-final-rules-consumer-credit-firms

[2] "CFPB finalizes rule to stop payday debt traps" – October 5, 2017 - CFPB issued its final rule for governing the underwriting of certain personal loans with short term or balloon payments structure - CFPB Fact Sheet

[3] "Payday Lending: Compliance Review Final Report" OFT (2013), page 2.

50% of lenders' revenues. In addition, many lenders were receiving significant additional fees, primarily from late payment fees. They estimated that only 60% of total revenues came from the originally contracted interest payments. They further found that in terms of behavioural economics, some consumers exhibited optimism bias, whereby they would overestimate their ability to repay. In many cases they took out a single-period balloon payment loan expecting to be able to repay it on their next payday, but only to find that this was not possible, leading to late payments and loan rollovers.

Better alignment of incentives for borrowers and lenders was a major policy objective of the changes in regulation for the HCSTC sectors in both countries. The policy objective was to design a well-functioning consumer credit market where lenders' incentives were aligned with those of consumers so that lenders did not benefit from unaffordable lending decisions.

We believe any changes in New Zealand should have the same policy objective. The proportion of a lender's total income arising from the originally contracted payments, therefore, becomes a key metric to identify lenders operating business models that are reliant on defaults and debt traps, which should be prohibited.

SMB has prohibited rollovers for its Mini loan product since it was established in 2010 and regularly reaches out to borrowers under its "Responsible Lending Programme" that exhibit a pattern of consecutive use. Remedial actions include:

- allowing borrowers to obtain reduced payments over an extended period of time with no additional fees and interest; **and**
- requiring the borrower to be placed on stand-down for a period of 90-days upon completion of their loan. The stand-down process stipulates that if the borrower re-applies within this period, then a full assessment must be conducted and there must be a fundamental improvement in the borrower's financial circumstances if the loan is to be approved.

This process is aimed at preventing borrowers from falling into a long-term debt cycle and, if in a debt cycle, break the pattern of behaviour at a reduced cost. However, it does not necessarily cut-off access to credit, which is of grave concern to borrowers that use HCSTC as a liquidity management tool.

Uncompetitive rates

The Discussion Paper highlights the "excessive cost" of some consumer credit agreements as a core problem with HCSTC.

We accept that HCSTC products are commonly viewed as expensive, particularly when measured in terms of an annualised interest rate (**AIR**). Any consumer that has ready access to conventional, low cost credit sources (due to a good credit rating and higher than average wages) might naturally question the headline rates charged by the HCSTC lenders. However, we would dispute that these high rates are a consequence of an uninformed, uncompetitive market. We make the following comments:

- In our view, the AIR is an **inappropriate** measure to compare short-term credit products (i.e., those with durations of less than 12-months). In our view, the total cost of credit is a more useful single-point estimate to measure a loan's cost where a loan's duration is less than 12-months. Different products will meet different consumer needs, but arguably what matters most to consumers is the amount of credit that can be accessed and the total cost of doing so[4].

[4] "Impact of regulation on High Cost Short Term Credit: How functioning of the HCSTC market has evolved", Consumer Finance Association (UK), page 19.

- In the HCSTC market, AIRs are very inflammatory and often produce triple digit interest rates. However, such rates should never eventuate if the loan is repaid as agreed. For example, a $100, 14-day short-term loan with an AIR of 547.5% would incur interest of $21, i.e., a 21% interest cost (which is hardly an outrageous return relative to the principal advanced[5]).
- SMB caps interest is on its "Mini Loan" product after a maximum of 60-days and still operates viably. Disclosure of an annualised interest rate is, therefore, potentially misleading as we are contractually prohibited from charging such a rate. The AIR for our Mini Loan is 547.5%, however our contractual maximum interest rate is really 90%.
- In their report on the maximum total cost of borrowing, the Advisory Board for the Ontario Payday Lending Industry noted the following point: [6]

  "…most stakeholders agreed … the inappropriateness of an annual percentage rate of interest as a way to measure payday-loan borrowing costs. Both the industry and social advocacy and consumer groups were of one mind on this question. We regard this as a significant issue, as reference to annualized rates has tended to distort perceptions of the cost of borrowing."
- The servicing of the HCSTC market is complex and expensive: it requires trained and experienced staff that can undertake appropriate credit assessments and systems tailored to this segment. As a result, in order to service this segment both responsibly and responsively, and to operate at scale, a lender must make a significant and sustained investment in its technology, people and processes. Traditional financial institutions do not service the small, short-term loan segment and non-prime[7] consumers. We can only speculate as to the reasons for this position, but we suspect it is partly due to:
  - the cost of servicing high volume, low value loans being prohibitive; and
  - concerns about the adverse attention that might arise from charging the sort of higher interest rates that would be needed to operate profitably in this market.
- The cost of assessing and approving a short-term loan can require considerable effort, especially given the perceived vulnerability of the customer base. However, the establishment fees for HCSTC loans are relatively low compared to other forms of consumer debt, e.g., establishment fees of $25 compared with $275 for personal loans. The amount of work to assess both loans might be comparable, but it is not commercially feasible to charge a fee of $275 for a loan of, say, $500. The higher establishment costs need to be recouped over the short duration of the loan and drives the need for interest rates that appear very high when annualised.
- In the FCA's recent update on the High-Cost Credit Review,[8] they recognised that the high cost of subprime credit is in part driven by the underlying economics of serving its customers.

  "There is a spectrum of credit products and pricing across the consumer credit sector

[5] Clearly, if one wishes to foster outrage and sensationalism then it is better to focus on the AIR rather than the nominal cost of credit. The AIR focus misdirects the question away from the true cost of credit to some theoretical number that should never apply.

[6] "Capping Borrowing Costs – A Balanced Approach to Payday Loans in Ontario", Maximum total Cost of Borrowing Advisory Board for the Ontario Payday Lending Industry, 6 February 2009, page 13.

[7] A Non-prime (or sub-prime) consumer are those with an adverse credit history or 'thin' credit file.

[8] "High-cost Credit Review – update" - Financial Conduct Authority – January 2018 – page 9

aimed at different consumer circumstances and needs. High prices for lending to subprime customers are driven, to an extent, by the underlying economics of serving these customers.

Making small loans over relatively short periods is inherently higher cost. It can also be costly to assess the risk of lending to customers with thin credit files."

- There are a number of main stream financial products, such as credit cards and overdrafts (both arranged and unarranged), that typically have AIRs that appear to be significantly lower than HCSTC but have a similar total cost of credit due to differences in usage patterns. This point was made by the UK Consumer Finance Association[9] who found that HCSTC users may pay a higher interest rate, but the cost of credit over a year is relatively less as they pay off the debt more quickly and there are few other fees involved.

"The cost of access to credit depends not just on the APR, but also on how credit is used, which means the distinction between 'high cost credit' (with relatively high APRs) and mainstream credit can be quite misleading—as mainstream credit can create a high cost for consumers if overly used."

2 Do you support any of the extensions of Cap Option A? What would be the impact of these extensions on borrowers, lenders and the credit markets? Do you have any information or data that would support an assessment of the impact of these extensions?

Re-drawings, re-financings, and loan term

SMB currently offers two unsecured loan products. A small short-term loan (the Mini Loan) and a mid-sized, mid-range duration person loan (the KickStart Loan). Loan amounts range from $100 to $3,000 and interest rates between 0.26% to 1.5% per day. Although both loan products are materially different, they are both likely to be classed as HCSTC.

The Mini Loan cannot be rolled over or extended (except on a concessionary basis due to financial hardship). However, the KickStart loan product allows a borrower to request additional credit under their open loan agreement, provided that the request is within their existing credit limit. Additionally, the borrower can also request to increase their current credit limit. For each such request a new affordability and suitability assessment is performed to ensure further funding will remain manageable for the borrower based on their circumstances. If approved, then the borrower's credit limit is revised and a new loan agreement is executed.[10]

A borrower under a KickStart Loan could conceivably hold a loan for a substantially longer period than their original loan term and incur a significantly higher total cost of credit. However, this feature provides greater flexibility to a borrower and enables them to better tailor their use of credit to their specific requirements and avoids forcing borrowers to drawdown a larger amount of credit than is actually needed at that time. This flexibility must be preserved follow any law change.

For example, the borrower may be eligible for $3,000 on day one, however they only require $1,000 to cover the cost of their car repairs. If the car repairs turn out to be costlier than initially expected, then the borrower may require further funding to cover the additional cost so they reapply for further credit. SMB would then undertake a new credit assessment to determine whether the additional funding remains manageable for the borrower. The key

[9] "Impact of regulation on High Cost Short Term Credit: How the functioning of the HCSTC market has evolved" - page 19

[10] It is important to note that the KickStart product is a zero fees product with the only return to SMB being from interest charged. So no additional fee income is generated from such requests.

protection is the need to conduct a fresh affordability and loan assessment and not a blanket ban on features that, despite the potential for harm if abused, actually benefit the borrower.

We make the following further observations:

- Restrictions on rollovers and extensions should be targeted at loans that are in default as this circumstance is where the harmful practices are prevalent.
- A clear distinction should be drawn between: (a) loans being drawdown in a series of tranches (be they extended or refinanced with new loans); and (b) new loans being used to repay a loan that is in default.

  The UK Consumer Credit Sourcebook (chapter 5A cost cap for high-cost short-term credit) allows for a lender to extend credit within a credit limit. However, in this scenario, a borrower will not be able to drawdown against a credit limit where the loan is currently in default and/or the new creditworthiness assessment precludes the borrower from accessing additional credit under the existing credit limit or increasing the amount of credit available.
- The UK has extensively considered the position of re-financings and extensions and has applied a two times limit on the number of times a loan can be rolled over or refinanced.[11] The FCA noted[12]:

  "It is clear to us from the responses to the consultation that there is a consensus that some sort of restriction on rollover is necessary, but there is a debate centring on how many should be allowed. We understand the concerns raised by consumer groups about the impact of rollovers on consumers, and in particular the negative effect on consumers of loans being rolled over numerous times that were not affordable at the start.

  We also recognise that there is a need for some flexibility for consumers to roll over their loans if they are unable to repay on time as a result of unexpected circumstances, such as being paid late. However, it is clear to us that the benefits of this flexibility diminish rapidly and the cost to the consumer increases sharply. Repeated rollovers can exacerbate financial difficulties. If a customer has run into unforeseen financial difficulty which prevents repayment even after a rollover then the best way to address it is forbearance and the agreement of an affordable repayment plan, not extending the loan and increasing the debt."
- Often borrowers might miss payments when other cash flow demands take precedence (for instance, around Christmas, Easter, birthdays, etc). The borrower might miss a loan repayment and then make the next payment and continue making regular payments as they fall due. The loan is technically in arrears (default), but in substance the missed payment(s) operate as an unarranged extension of the loan.
- The 100% cost of credit cap should be reset after the expiry of a prescribed period, especially for loans that have been extended or rolled over multiple when not in default (i.e., due to repayments and redraws causing the loan to operate more like a revolving credit facility). For instance, on each anniversary date of the original loan drawdown, the cap could refresh.

SMB operates a no loan rollover policy in the case of borrowers struggling with their repayments. New loans (from either the current or another lender) should not be granted to any borrower who is experiencing repayment difficulties and is unable to meet their

[11] "Consumer Credit Sourcebook (Release 24 Feb 2018)" – Sections 6.7.17- 6.17.23- Rules of refinancing
[12] "Arrears and Forbearance in High-Cost Short-term Credit" - FCA; TR15/3

repayment obligations. These borrowers should be granted appropriate forbearance and appropriate new loan schedules adopted that are reflective of their (changed) circumstances. Rolling a loan over until it reaches the potential total cost of credit cap will only cause financial distress to a borrower who realistically has no chance of making the repayments and will only see an increase in the level of debt they hold.

Previous defaults

Paragraph 109 of the Review of Consumer Credit Regulation (the **Review**) discusses the further step of prohibiting an offer of a high-cost loan to a person who has defaulted on an existing high-cost loan (or a loan that refinances that loan), and has not yet repaid it.

We believe that more stringent restrictions on providing loans in these circumstances would significantly curtail and/or eliminate the practices of lenders who are incentivised to originate loans to people who may not be realistically able to afford the loan. This restriction could equally apply to a borrower seeking a loan with another lender. That lender would need to assess the borrower's creditworthiness to determine whether granting a loan would be appropriate. The aim would be to reduce the risk of borrowers suffering financial distress because of something the lender could have reasonably foreseen at the assessment stage.

SMB does not lend to persons in default on an existing loan and would support such a restriction.

Loan limitation and cooling off periods

Paragraph 110 of the Review suggests going further still and limiting borrowings to one high-cost loan per borrower and a 'cooling-off' period between repayment of a high-cost loan and obtaining a new high-cost loan.

We believe that the issue of repeat and frequent borrowing of HCSTC can be better addressed by more prescriptive and comprehensive requirements for conducting affordability assessments.

In our experience, most borrowers use HCSTC as an ongoing financial service to meet emergency needs, temporary income shortfalls and occasional expenditure. However, a number of borrowers use HCSTC more regularly for what could be classed as foreseeable cash flow hurdles. The use of HCSTC provides an essential liquidity management tool for such persons and, while not the cheapest option, it suits their requirements and does not cause harm. However, withdrawing access to credit for such persons could place them under considerable financial stress when the need for short-term funding arises.

We agree that repeat borrowing could be an indicator of dependency on HCSTC that is harmful to the borrower. However, the extent of any harm depends on the circumstances of the borrower and their cash flow management practices. SMB addresses the issue of repeat borrowing through a number of policies and procedures that form part of its Responsible Lending Plan (**RLP**), including calls to repeat borrowers to better understand their circumstances. When receiving RLP calls, most borrowers explain they are happy with their use of the loan product and are more concerned that SMB might withdraw access to credit. They explain that a loss of credit would create significant cash flow management issues for them. We stress that in all cases loans remain affordable under SMB's credit and loan assessment policies.

On a similar theme, we observed a material number of SMB's borrowers migrating to our new longer term, more affordable loan product (the KickStart Loan) when it was introduced in November 2017. However, a large number of borrowers continue to prefer the short-term (Mini Loan) product, which they consider better meets their liquidity management requirements. The Mini loan is favoured because a smaller advance better suits the borrower's loan purpose and, although having a higher interest rate, carries a lower total cost of credit than a longer-term product.

Finally, we note that borrowers with poor credit histories need to be able access credit in the future so that they can rehabilitate their credit profiles. If a borrower has no means of accessing credit and proving that they can make regular, consistent payments on the terms agreed, then they have no means of improving their credit profile and will have no ability to migrate toward lower cost, traditional credit sources.

Application of total cost of credit cap to rollovers

The FCA addressed the issue of repeat borrowing (loans made by the same firm) and whether it was appropriate to bring this under the total cost cap in their 2014 Consultation paper.[13] The FCA concluded that including repeat borrowing within the total cap would result in significant constraints on lending and add considerable complexity to the price cap. For this reason, they proposed to not apply the total cost cap cumulatively to repeat loans. They also explored a number of other options including:

- capping the number of times a borrower can borrow from the same lender in a given period; and
- capping the number of times a borrower can borrow from any lender in a given period.

Both were considered very stringent measures and likely to lead to greater risks of lender exits and potential closure of the HCSTC market. The FCA, therefore, concluded that the most appropriate way to use the price cap to deal with repeat borrowing was by applying the price cap in the same way as for the first loan. They stated that other tools were better placed to deal with the detriment caused by repeat borrowing, primarily robust supervision of affordability requirements.

This viewed is shared by SMB.

A lender has the responsibility to work with borrowers to create manageable and affordable repayment plans at loan inception and to develop specific policies and procedures that can help identify a borrower who may become dependent on repeat borrowing and be at a higher risk of suffering financial distress. Lenders must be able to demonstrate how they can identify high levels of repeat lending from borrowers whose behaviour suggest issues with affordability. Then, if the borrower encounters financial difficulties or financial hardship downstream, lenders should have sufficient protocols in place to assist the borrower in times of need to keep their repayments manageable.

3 Do you agree with our assessment of the costs and benefits of the options for capping interest and fees? Are any costs or benefits missing? Do you have any information or data that would help us to assess the degree or estimate the size of these costs and benefits?

Whilst there are number of benefits associated with capping interest rates, we remain of the view that this approach is a very blunt instrument. The World Bank promoted alternative mechanisms to interest rate caps for improving access to finance.[14] These included:

- the implementation of measures that enhance competition and product innovation,
- the improvement of financial consumer protection frameworks,

[13] "Proposals for a price cap on high-cost short-term credit" - July 2014 - page 41

[14] "Interest Rate Caps around the World - Still Popular, but a Blunt Instrument" - Samuel Munzele Maimbo Claudia Alejandra Henriquez Gallegos – World Bank Finance and Markets Global Practice Group October 2014

- increased financial literacy,
- the promotion of credit bureaus,
- enforcement around disclosure of interest rates, and
- promotion of microcredit products.

The costs and benefits of regulatory changes in the UK are highlighted in the recent briefing paper to the House of Commons[15]. This paper provides for a comprehensive assessment of the impact of the HCSTC revisions made in 2015. A number of findings are particularly relevant to the current New Zealand review, including:

- A major contraction in the HCSTC market occurred in 2014 immediately prior to the implementation of the changes.
- There was a clear and discernible decrease in loan approval rates, which dropped from 50% to 30% from the start of 2014 to the middle of 2015.
- Lenders had altered their business models in light of new regulatory requirements and particularly in regards to creditworthiness assessments.
- A dramatic reduction in the number of lenders whose main focus was on the HCSTC lending.
- A significant drop in the number of firms seeking authorisation to conduct HCSTC lending businesses, many at the direction of the FCA following consideration of the firm's authorisation applications. [We believe this outcome provides strong evidence of the benefits of a comprehensive licencing and supervision regime.]
- Lenders' revenues and profitability had materially dropped.
- Default rates had declined, lenders were seen to be rejecting the highest risk applicants, and tightened lending criteria had lessened the risks of default by borrowers.
- Material changes to the business models and product offerings of lenders, including a shift away from the traditional 30-day 'payday loan' product towards longer term instalment products. (The average initial loan duration in 2012-2013 was 30 days; at the beginning of 2014, it was 40 days; by June 2015, it had increased to 80 days.)
- The impact on access to credit was significantly greater than the FCA had expected. The FCA had estimated approximately 250,000 consumers per year would no longer have access to credit, but the actual decline was approximately 600,000 consumers per year. Evidence suggests that these borrowers were then unable to access formal sources of credit.

4	Do you have any suggestions for the design of options for capping interest and fees? If so, what would be the impact of your proposed design on borrowers, lenders and the credit markets?

The key issue is defining the meaning of "high-cost lender" and, therefore, the scope of the provisions. We think the better approach is to focus on the intended duration of the loan when imposing interest rate caps, particularly as the length of a loan will determine the level of interest accumulation.

We have segmented our market and offer different products (the Mini loan and KickStart

[15] "High cost consumer credit: the new regulatory regime" – briefing paper CPB-07978 31 31 May 2018 – pages 17-23

loan) to those market segments. Borrowers self-select the product that best suits their needs and, even though many applicants who would be eligible for larger loans with lower interest and instalment payments, they still chose to use the more expensive Mini loan product.

Accordingly, any interest rate caps imposed need to preserve the ability to viably offer these different products to meet the preferences of consumers.

If Options B and C are implemented, then we believe different "high cost lender" definitions should be applied to scope the application of these rules differently to different market segments. We would suggest loans with a duration of less than 90-days, from 90-365 days, and those above 365 days could, theoretically have different interest accumulation rules.

5 Which interest rate cap options, if any, would you prefer? Which interest rate options would you not support? Please explain how you made your assessment.

SMB prefers a 100% total cost cap as outlined in Option A, which is reflective of our current practices for both the Mini Loan and KickStart loan products. This option will promote competition on the basis of the total cost of credit, rather than an AIR which is meaningless, confusing and unnecessarily emotive for loans with durations under 12-months.

SMB's current costs cost caps for the Mini loan and KickStart loan are as follows:

Borrower interest accrual cap – Mini Loan

SMB applies an interest rate cap after a maximum of 60 days for the Mini loan product. As a result, a borrower should never pay more than twice the amount originally advanced under their loan agreement.

SMB also works with a borrower that is in default (or hardship) to bring the loan back on schedule and offers extended periods of grace, allowing the borrower to make a 'catch-up' payments or, in the case of financial hardship, an extended repayment period with interest 'turned-off' or capped.

Total cap on borrower interest and fees - KickStart Loan

SMB operates a total cap on borrower costs that limits the maximum amount that is payable by the borrower. This total repayment cap is set at twice the original principal amount. The total cost cap protects SMB's borrowers and provides both the borrower and SMB with a clear and transparent method of describing the maximum amount a borrower could conceivably be charged should that borrower need to reach a compromise arrangement with SMB.

Advantages Option A

We believe that a 100% cost cap will discourage lenders from operating business models that are dependent on defaults and the rapid accumulation of arrears income.

A total cost cap is simple to understand. This feature is essential for consistent application of the cap by firms and will help consumers identify breaches. The later point is important because it will be straightforward for consumers to work out if they have been charged more than twice the amount they have borrowed, which should greatly assist awareness of breaches and highlight when enforcement actions are needed.

In our view, setting the level of the cap at 100% strikes the right balance between limiting excessive charges and providing borrowers with operating freedom to innovate and offer different, longer-term lending products. Conversely, a total cost cap above 100% may not provide adequate protection against spiralling costs for those who struggle to repay. There would be no material impact to SMB's operations if a 100% cap were introduced.

Competition implications

Competition within the HCSTC market will be influenced by the level of the total cost of credit cap.

The FCA in their 2014 consultation paper[16] addressed the total cost of credit cap level at differing levels and the impact on competition.

"We modelled the impact of a range of total cost caps on firms' revenues, profits, number of borrowers served and value of loans. Our modelling suggests limited changes to the risk of exit between 75%, 100% and 200% caps, but a total cost cap of 50% would significantly increase the risk of large firms exiting. Taking into account a margin of error, 75% appears too close to levels at which more large firms could exit, which could significantly reduce access. We therefore judge that 100% is the appropriate level of protection, protecting nearly one third of the people not fully paying back their loans in our sample in addition to the limits imposed by the default cap, whilst allowing enough firms to continue offering HCSTC and for different lengths. […]

While the nature and degree of competition may be sustained even with few firms in the market (implied under a 50% total cost cap), this would increase the risk that firms could not adapt their business models following the cap to remain in the market, or otherwise compete."

We agree with your assessment of Option C that a cap of 30%-50% would effectively end the short-term lending industry and adversely affect a large number of responsible users of HCSTC. SMB has led to the development of a number of new innovations in the credit market (including a 100% digital application process, online signing, facilitating open banking by automating bank statement retrieval, evolving the credit scoring models of one of the leading New Zealand credit bureaus, etc) and helped transform the provision of HCSTC for the betterment of the consumer. If SMB's products were made unviable due to regulatory constraints and it did not exist, then these innovations and new ones to come may not have been brought to market as quickly or have been developed at all.

Improving lenders' behaviours

The introduction of a total cost of finance cap may not achieve the policy objective of improving the operating behaviours of the small minority of lenders that act unconscionably.

We believe that the key to addressing irresponsible and predatory lending is to identify lenders and practices that consciously seek to:

- profit from a borrower's misfortune;
- encourage recidivist borrowing and allow entry into long-term debt cycles;
- engage in misleading lending practices; and
- exploit and entrap the poorly educated and illiterate.

Loans should be demonstrably profitable from inception and not exhibit "loss-leader" characteristics that could only become profitable from recidivist borrowing or default income. Then, if a borrower experiences difficulty making their repayments, lenders should have a responsibility to ensure they are treated fairly and reasonably, including the provision of alternative arrangements or repayment plans and the freezing of interest and fees where appropriate.

Cap Option B and short-term loans

[16] "Proposals for a price cap on high‑cost short‑term credit" – Financial Conduct Authority July 2014 - page 41

We believe an AIR restriction of 200%-300% would significantly curtail the short-term loan (less than 30 days duration) market as such loans would become uneconomical to provide. We believe lenders would react by extending loan durations (and, therefore, interest accumulation periods) so that they can collect more income to make the provision of such loans viable.

For instance, a $100 loan with a daily interest rate of 0.8% (an AIR of 292%) and 15 day term would produce income of $12, which is unlikely to be an adequate return when coupled with the existing (cost recovery) fee guidelines. The loan's term would need to be extended to approximately 40 days or a larger amount advanced in order to become commerically viable. Consequently, some borrowers will be forced to take longer term loans or loans for more than they need and suffer an unnecessary increased total cost of credit.

In the UK, following the introduction of the 0.8% per day interest restriction, only a few HCSTC lenders still advertise one-month loans on their websites, although it is important to note that many consumers still effectively obtain a one-month loan by taking out a longer duration loan and then repaying it early. However, lenders may respond by not offering loan advances below $1,000 in these circumstances.

Regarding continued irresponsible lending and other non-compliance

6	If directors have duties to take reasonable steps to ensure that the creditor complies with its' CCCFA obligations, should any duties apply to senior managers?

Consumer credit laws should focus on setting and enforcing appropriate standards of behaviour for all credit providers, ethical behaviour will ultimately protect consumers best. In this regard, we would strongly support a "fit and proper" test for controllers and managers of lending businesses and the greater supervision that would come from a full licensing regime.

We believe a licensing regime would transform the manner in which the regulator engages with participants in the consumer credit industry. The perception of market participants is that the regulator approaches the sector only seeking an enforcement outcome. However, the policy objectives would be better attained by working with stakeholders for the betterment of the consumer and market participants alike. Our preference is for supervisory lead approach, i.e., one where the regulator works with market participants to improve standards across the industry.

An enforcement lead approach means market participants are reluctant to engage with the regulator as the focus is not on helping the industry to achieve compliance but on punishing those for any errors or omissions even where little consumer harm is caused. We would prefer a supervisory lead approach where issues are discussed and improvements are continuously made in a more collaborative manner. The regulator would be able to enforce behavioural changes when needed as continued bad behaviour or the identification of business models that are exploitative would lead to the loss of a lender's licence to operate. This consequence provides a strong incentive for lenders to engage and work constructively with the regulator.

We further believe that the cost of operating a full licensing model would not be prohibitive. Other industries are able to operate under the licensing model with viable funding models. We also not that the regulators enforcement abilities would be greatly enhanced, lower costs and improving outcomes, which provides a strong offsetting cost saving.

7	If there are to be more prescriptive requirements for conducting affordability assessments, what types of lenders or loans should these apply to?

We are firmly of the view that loans do not go bad, they start bad. Loan affordability is the key to producing better outcomes for both borrowers and lenders. In this regard, we note that:

- Affordability represents an upper bound on repayments that can be scheduled without engendering financial stress or default.
- Losses due to default are an integral part of any lending business. However, loans which are unaffordable at inception will inevitability end in default or in a repayment that causes significant financial hardship, a bad outcome for both borrowers and lenders.
- Business models are adaptable, but affordability is not. No amount of innovation or competition between lenders can make an unaffordable loan affordable.
- Business models should not benefit from poor outcomes for consumers. Lenders should receive the vast majority of their revenue from the contractual interest payments agreed with borrowers at the commencement of their loan, rather than revenue from late fees, default interest and/or rollovers (93.79% of SMB's total revenue is derived from originally contracted revenue and the balance from late fees and rescheduled interest which clearly demonstrates a business model that focuses on originating affordable loans).
- Affordability does not cease upon approval. If a borrower encounters financial difficulties further down the line and/or substantial hardship, then it is imperative that lenders have sufficient protocols in place to assist the borrower in times of need to keep their repayments manageable.

We concur that industry guidance needs to become more specific around what affordability (income and expenditure) testing is considered appropriate as market participants are adopting vastly different standards with some, in our view, comfortably exceeding the what we would consider an appropriate standard and others falling woefully behind. Consequently, the playing field is far from level and consumers are receiving very different experiences and outcomes. This variation is as much an enforcement failure as it is a policy failure.

Whilst mandatory or prescriptive requirements will increase certainty to both lenders and the regulator, it is equally important that a degree of flexibility be maintained to allow for a reasonable, proportionate, and risk-based assessment of individual cases.

We strong support a risk-based assessment approach.

The infographic appended to this document (recently proposed by the FCA) demonstrates an indicative assessment process and how proportionality (risk) would affect the level of affordability assessment that a lender would be required to undertake. The resulting affordability assessment pays close attention to the characteristics of the borrower and the nature of credit being provided. However, it is ultimately up to the lender to design the policies and procedures to address the risk and protect the borrower.

The FCA further describes[17] the risk and borrower characteristics that may affect the level credit assessment required as follows:

[17] "Assessing creditworthiness in consumer credit – Proposed changes to our rules and guidance" – Financial Markets Authority - July 2017 – page 35

Lower risk

Where 'mainstream' credit products are offered to 'prime' customers, with no evidence of financial difficulties apparent from the application or a credit check, and for small or moderate amounts of credit, it may be obvious that the credit is affordable without establishing or estimating income and expenditure. The lender would need to be able to demonstrate this conclusion if challenged.

Medium risk

Where it may not be obvious in the circumstances that the credit is affordable and so a more rigorous assessment is needed. This conclusion may, for example, be because of the amount or cost of the credit or the customer's existing indebtedness. The lender should consider what is appropriate and proportionate in the circumstances.

Higher risk

Where non-mainstream products are offered to non-prime customers, particularly those with low or uncertain income who may be more susceptible to income or expenditure shocks, we would ordinarily expect a lender's processes to reflect a more detailed assessment of affordability, with more reliance likely to be placed on income, expenditure information and verification.

SMB would be supportive of applying the same rules for affordability assessments under **all** applications for credit, including borrower requests for further drawdowns under a credit limit or significant increases in the amount of credit. Where a lender approves credit or significantly increases the amount of credit/credit limit, we would expect the lender to maintain a sufficient record of the transaction to demonstrate that an affordability assessment was carried out, as required.

8 Should there be any change to the requirement that lenders can rely on information provided by the borrower unless the lender has reasonable grounds to believe the information is not reliable? What would be the impact of such a change on borrowers, lenders and the credit markets?

The types of information necessary in any particular assessment will depend on the circumstances of the loan, including the nature of the product, the borrower, and proportionality as discussed above.

The onus must be on the lender to ensure that the information considered is sufficient to enable it to make a reasonable assessment. The lender must decide on the types and sources of information to adopt as part of its assessment and to the extent information is verified. Furthermore, a lender should take into account information it knows at the relevant time which indicates that the borrower is in, or has recently experienced, financial difficulties or is particularly vulnerable. A lender should also be expected to take into account information obtained during any previous dealings with a borrower and broader loan population data acquired overtime.

In terms of affordability assessments, lenders should be expected to take reasonable steps to verify information which:

- they suspect is inconsistent with other information that they hold on the borrower (e.g. a credit report or account information for existing customers that shows regular income or expenses that are significantly different to the stated income or expenses); and/or
- is outside standard benchmarks for an applicant with those attributes (e.g., where

	the income stated is far greater than would be expected for the type of work the applicant undertakes or their expenses are far lower than would be expected in the region, etc). This approach is similar to that adopted by ASIC in Australia.
9	Do you consider there should be any changes to the current advertising requirements in the Responsible Lending Code? If so, what would be the impact of those changes on borrowers, lenders and the credit markets?
	Advertising of any consumer loan product should be socially responsible and never trivialise the seriousness of taking out a loan. Furthermore, advertising should not: • suggest that loans are a suitable means of addressing ongoing financial concerns; • condone non-essential or frivolous spending; or • unacceptably distort the serious nature of consumer loan products. For example, advertising that focuses on the ease and speed of obtaining credit and is targeted at financially excluded or vulnerable consumers by including lines such as "*we will lend to you when others won't*" should be prohibited. In SMB's case, all advertising directs the consumer to SMB's website. The website contains multiple references to both the short-term and medium-term nature of SMB's loans and in what circumstances a short-term loan may not be the appropriate product for the applicant. We believe the website (and by incorporation the application process) is the best place for presenting risk warnings, as the warning can be prominently displayed in a time appropriate manner. In the case of certain advertising mediums, particularly online banner advertising, it is not reasonably practicable to include a risk warning on each banner as there is limited space available. Furthermore, SMB typically runs 30/15 sec radio ads, which does not allow time for voicing lengthy prescribed risk warnings. In all cases, the consumer must visit the SMB website where such warnings are prominent so this require is still achieved, but in a more appropriate manner. Other matters that we see as a concern include: • Using landing pages and websites that seek to hide the true identity of the lender. • Lenders advertising product features that do not exist in an attempt to attract new customers, including the use of "teaser" and interest free rates that are not representative of the actual rates obtainable. In this regard, we draw your attention to standards in the UK's financial advertising regulations that require disclosures around how many loans are written at the base "from" interest rate and details regarding the actual interest rates of loans written.
10	Do you agree with our assessment of the costs and benefits of the options to reduce irresponsible lending and other non-compliance? Are any costs or benefits missing? Do you have any information or data that would help us to assess the degree or estimate the size of these costs and benefits?
	De-risking At Save My Bacon Ltd (**SMB**), we are acutely aware that if a lender is proven to have breached a regulatory requirement, then the consequences in terms of sanctions and reputation can be severe or even existential. However, lenders are constantly dealing with a

complex web of circumstances when making lending decisions. They are required to form judgements and make decisions based on (often) imperfect information and changing facts, and without the benefit of hindsight. Yet enforcement outcomes are binary – you have either breached the law or you have not. We generally operate in a "grey" world with severe consequences if you get things wrong. Consequently, because of the significant downside from regulatory risk, SMB (and we are sure other large scale, reputationally savvy, HCSTC providers) are forced to take a very conservative approach to affordability and creditworthiness assessments and restrict credit unnecessarily and/or add unnecessary costs.

In order to promote competition and a well-functioning credit market, any changes need to be clear and easily applied in practice. We believe that enhanced rules around affordability assessments and greater guidance from the regulator to clarify the expectations around lenders' policies and procedures for assessing loan affordability will greatly assist in producing better consumer outcomes and a level playing field for competition.

De-risking also impacts lenders in the HCSTC market in other ways. For instance, essential services may be withdrawn by suppliers because of the perceived reputational risks of dealing with HCSTC providers. For example, large trading banks are increasingly withdrawing the provision of transactional banking services to HCSTC providers. While we are sympathetic of banks' needs to withdraw the supply of credit to this industry, the withdrawal of transactional banking services is draconian as it effectively prevents operators from conducting any business. Accordingly, the supply of such services is akin to the supply of electricity to those with medical dependence because without access to the transactional banking network a business simply cannot operate. Restricting business access and the resulting fall in competition (instigated and caused by a potential competitor) would be a very bad outcome for the credit market and consumers.

Insurance not available

We understand that the "finance company" industry now falls outside a number of insurers' reinsurance treaty guidelines for directors' liability cover. Consequently, insurers will not offer terms to indemnify these risks (at any price) because they cannot accept these risks under their reinsurance treaties. That is, it is not currently possible to acquire directors' liability insurance for (CCCFA) regulatory risks. The lack of such cover will make it very difficult to recruit and retain high calibre directors of finance companies.

11 Do you have any suggestions for the design of options for reducing irresponsible lending and other non-compliance? If so, what would be the impact of your proposed options on borrowers, lenders and the credit markets?

The borrower population contains a distribution of situations:

- for some, accessing HCSTC is the best suited means of smoothing their cash flow requirements, is affordable, and produces the lowest absolute cost of credit;
- whereas for others, access to any form of credit is not appropriate because they cannot afford the repayments, regardless of the cost of credit.

The needs of the second category are best met through the provisions of grants and other social services. The experience of the Good Shepherd's low and nil interest loan products is instructive in this regard. Despite a $60m funding commitment from the BNZ, the programme has only advanced approximately $2.5m[18]. This outcome suggests that lowering the cost of credit would not improve access to credit as it is simply unaffordable at any price.

[18] Drawn from comments made Fleur Howard at the Financial Inclusion Industry Forum, July 2018.

	No amount of financial engineering can make an unaffordable loan affordable. It follows that regulatory change targeting protection of the vulnerable would be better served: • strengthening the affordability requirements, rather than simply lowering the cost of credit; and • improving a borrower's rights to forbearance should their circumstances change. In his recent speech in May 2018, the Andrew Bailey (the Head of the FCA) addressed this point:[19] *"There is a group of consumers who are on such low or uncertain incomes or whose personal circumstances mean that any lending is likely to be inappropriate or unaffordable. Parts of the social welfare system are designed to provide assistance to them.* *There is another group of consumers who are on low incomes and may be financially vulnerable but are nonetheless able to sustain low repayments for small sums. However, the personal circumstances of these consumers can mean they are especially susceptible to unexpected changes to their income or expenditure demands, for example dealing with changes to their living arrangements at short notice. Reflecting risk of default, borrowing for these consumers is particularly costly, potentially further decreasing their ability to meet their wider financial obligations and increasing risk of harm from the consequences of default. This is particularly the case where they need to borrow to obtain essential household goods, such as a fridge or washing machine.* *Our view is that the provision of credit can nevertheless have a socially valuable function. High-cost credit users typically have low credit scores and many do not have savings but may need credit to make ends meet and avoid wider financial difficulties, for example, default on household bills or priority debts. They may also have very limited options for obtaining essential goods or for managing other larger purchases or bills. Consumers can benefit from using credit where repayments are sustainable and appropriate forbearance is shown if they have temporary repayment problems […]"*
12	Which options for reducing irresponsible lending and other non-compliance would you support? Which would you not support? Please explain how you made your assessment.
	[Insert response here]

Regarding continued predatory behaviour by mobile traders

13	Do you agree with our assessment of the costs and benefits of the options for covering additional credit contracts under the CCCFA? Are any costs or benefits missing? Do you have any information or data that would help us to assess the degree or estimate the size of these costs and benefits?
	[Insert response here]
14	Do you have any suggestions for the design of options for covering additional credit contracts

[19] https://www.fca.org.uk/news/speeches/high-cost-credit-what-next

	under the CCCFA? If so, what would be the impact of your proposed options on borrowers, lenders and the credit markets?
	[Insert response here]
15	Which options for changes to cover additional credit contracts would you support? Which would you not support? Please explain how you made your assessment.
	[Insert response here]

Regarding unreasonable fees

16	If prescribed fee caps were introduced, who should they apply to, and what process and criteria should be used to set them?
	[Insert response here]
17	Do you agree with our assessment of the costs and benefits of the options for capping interest and fees? Are any costs or benefits missing? Do you have any information or data that would help us to assess the degree or estimate the size of these costs and benefits?
	[Insert response here]
18	Do you have any suggestions for the design of options for reducing unreasonable fees? If so, what would be the impact of your proposed options on borrowers, lenders and the credit markets?
	Default fees should not reward a lender's failure to properly assess the affordability of loan, nor should a lender benefit from the deterioration of a borrower's financial position. However, we believe the existing laws, and Commerce Commission's transaction-specific approach, are adequate to ensure that lenders are merely recovering costs associated with a borrower defaulting on their loan and not profiting from these outcomes. We do not consider it to be fair and reasonable to prevent lenders from recovering the costs they incur when a borrower fails to repay on time, so long as those costs are not excessive and they treat borrowers in default or arrears difficulties with forbearance and due consideration. However, having said that, a lender should not be able to continually charge default fees for repeated defaults where it is clear a borrower cannot meet their repayment obligations in a timely manner. It is our view that lenders have a responsibility to ensure that borrowers experiencing loan repayment difficulties are treated fairly and reasonably, which means extending forbearance, waiving their strict contractual entitlements, offering alternative arrangements or repayment plans, and freezing of interest and charges where appropriate. These behaviours should form part of a lender's responsible lending obligations similar to those outlined in the UK Consumer Credit Sourcebook Chapter 7 - Arrears, default and

	recovery (including repossessions). We also note that, in our experience, the offer to waive default fees is a powerful incentive to motivate borrowers to make payments and bring their loans back on track.
19	Which options for changes to fees regulation would you support? Which would you not support? Please explain how you made your assessment.
	We believe that, if the Commerce Commission's guidelines are followed based on their transaction-specific approach, then fees should be readily assessable as reasonable. Lenders should have data available that supports and justifies the fees charged. SMB has undertaken extensive work following the guidelines provided by the Commerce Commission and, whilst this process was time intensive, the exercise was by no means difficult. The fees currently being charged by SMB on the whole are well below the permitted threshold of a cost recovery basis and in some instances are not being charged at all.
20	Have you seen issues with excessive broker fees, or other unavoidable fees charged by third parties, being added to the loan? If so, are there any specific changes that should be made to the regulation of third-party fees? What would be the impact of these changes on lenders, borrowers and third parties?
	SMB does not currently deal with any 3rd party brokerage firms or lead generators. However, we hold a number concerns about the role of some lead generators and a lack of transparency regarding their role and how they operate in the HCSTC market. We believe: • lead generators should be subject to the requirements of the Responsible Lending Code regarding advertising; and • a lender should be reasonable for ensuring that any marketing materials of a lead generator/3rd party broker comply with the requirements of the Code.

Regarding irresponsible debt collection practices

21	Is this an accurate picture of the problems for consumers experiencing debt collection? Do you have information that confirms or refutes these issues, or sheds light on how widespread or severe they are?
	[Insert response here]
22	What information should be provided to borrowers by debt collectors? When and how should this information be provided?
	[Insert response here]
23	Do you agree with our assessment of the costs and benefits of the options for addressing irresponsible debt collection? Are any costs or benefits missing? Do you have any information or data that would help us to assess the degree or estimate the size of these costs and benefits?

	[Insert response here]
24	Do you have any suggestions for the design of options for addressing irresponsible debt collection? In particular, what is an appropriate frequency of contact with debtors before (and then after) a payment arrangement is entered into? Please state the likely impact of your proposed options on borrowers, lenders and the credit market.
	It is important to note that reducing or limiting the amount of contact attempts that can be adopted by debt collection agencies and/or allowing the borrower to request the debt collector cease to contact them (as per the Australian model) could create a significant moral hazard and adversely impact the finance industry and New Zealand business as a whole. We believe the practices of debt collectors are best moderated by a code of practice that balances the needs of lenders recovering funds from recalcitrant borrowers seeking to evade their obligations and the harassment of borrowers in genuine financial difficulty. We also note that, if a lenders ability to chase a debt was constrained, then the only course of action available would be to pursue collection through the District Court, which has the potential to clog the legal system.
25	Which options for changes to the regulation of debt collection would you support? Which would you not support? Please explain how you made your assessment.
	We would support a code of practice for debt collectors and extending the scope of the CCCFA to debt collectors.

Regarding other issues

26	Are you seeing harm from loans to small businesses, retail investors or family trusts as a result of them not being regulated under the CCCFA?
	[Insert response here]
27	Do you think small businesses, retail investors or family trusts should have the same or similar protections to consumers under the CCCFA? Please explain why/why not.
	[Insert response here]
28	Are there any other issues with the CCCFA or its impact on vulnerable people that are not addressed in this discussion paper? If so, what options should MBIE consider to address these issues?
	[Insert response here]

Any other comments

We welcome any other comments that you may have.
Technology, innovation and digitalisation have the capacity to transform the availability and provision of credit for the better. The digitalisation of financial services is evolving rapidly and it is essential that regulation and regulatory practice is able to keep up with these developments. Supervisors must ensure an adequate balance between: • the need to maintain existing standards of consumer protection and mitigate risks to consumers, and • providing an environment for the benefits of technological advancement to be explored. Collaboration between the regulator and industry players in the field of digital credit can also help enhance knowledge and understanding of the market, the products on offer, and the degree of regulation required to provide the best possible protection for consumers. Regulators should regularly engage with the providers and innovators of digital credit products and new technologies in order to better understand the product features, distribution models, marketing strategies and other relevant information. This approach will help improve the ability of regulator to identify gaps in their regulatory frameworks and areas that may pose a current or future risk to consumers. Some countries have already put in place formal industry dialogue and co-ordination processes. For example, the FCA and ASIC, have established innovation hubs, where they assist and support industry with navigating the regulatory framework, and regulatory sandboxes where providers can test their new products and services in a live environment. The goal of these initiatives is to encourage innovation while also ensuring consumers are adequately and appropriately protected. In the UK, the FCA offers direct support through its innovation hub, which assists regulated and unregulated businesses in bringing innovative ideas, products, or business models into the financial services market, where these are in the interests of consumers. The FCA sandbox allows established businesses and start-ups to test innovative propositions in the marketplace while ensuring appropriate consumer safeguards are in place.