ASIC
Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

Flex commission arrangements in the car finance market

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About this Regulation Impact Statement

This Regulation Impact Statement (RIS) sets out ASIC's proposals to address the consumer harm resulting from the use of 'flex commission' arrangements in the sale of car loans.

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A Executive summary

1 This Regulation Impact Statement (RIS) sets out ASIC's proposal to address the consumer harm resulting from the use of 'flex commission' arrangements in the sale of car loans.

2 Flex commissions are arrangements which incentivise a higher cost of credit to the consumer. This is because the intermediary who sells the loan to the consumer (generally a car dealer):

(a) is given a significant discretion to determine or recommend the price of the loan; and

(b) earns a larger commission from the credit provider the higher the interest rate above a benchmark (called the 'base rate').

3 It is not unusual for the intermediary to have a discretion of 700 basis points or more when determining the interest rate.

4 The way in which flex commissions can operate in a way contrary to the consumer's interests can be demonstrated by a case study illustrating the outcomes for two consumers who both borrow $45,300: Consumer A is able to negotiate a loan at the base rate of 7.99%, while Consumer B accepts a loan at a higher interest rate of 12.74%.

5 In this example, as set out in Table 1, the impact of flex commissions meant Consumer B had to pay an additional $6,396 in interest charges compared to Consumer A, while the intermediary was able to earn an additional $2,879 in commissions from the transaction.

Table 1: Difference between base rate and contract rate on consumer loan of $45,300

	Interest rate	Commission paid to intermediary	Interest paid by consumer
Consumer A	7.99%	$452	$9,817
Consumer B	12.74%	$3,331	$15,211
Difference	**4.75%**	**$2,879**	**$6,396**

6 The effect of flex commissions is that the interest rate charged to the consumer is not related to their credit rating or the risk of default, but to their financial sophistication, degree of financial literacy and capacity to negotiate to protect their interests.

7 ASIC has obtained data to assess the scope of the practice. Based on 25,500 finance contracts written by seven major car lenders for May 2013 we found that about 15% of these consumers (or approximately 3800 people a month) were charged an interest rate of 700 basis points or more above the base rate.

8 ASIC considers that a consumer paying 700 basis points or more is likely to be vulnerable, given that a well-informed consumer would be likely to either arrange their own lender (presumably at a lower interest rate in the absence of the price distortions created by flex commissions) or be able to negotiate an interest rate below or close to the base rate.

9 ASIC's view is therefore that flex commission arrangements are a remuneration structure that:

(a) provides an incentive for sales intermediaries to increase the price of a credit contract in a way that does not relate to the credit risk of the particular consumer;

(b) is not transparent for consumers; and

(c) can operate unfairly in any individual transaction.

10 ASIC has conducted two rounds of targeted consultations and received written responses from key stakeholders, including industry bodies, lenders, car dealers and consumer groups.

11 We have considered three responses to this issue:

(a) *Option 1*—This would prohibit flex commissions (while still allowing other forms of commissions to be paid).

(b) *Option 2*—This would allow flex commissions, but restrict the permitted gap between the base rate and the contract interest rate to 300 basis points.

(c) *Option 3*—The would address the issue through enforcement action—for example, by taking action against intermediaries for engaging in conduct that is unfair in contravention of s180A of the *National Consumer Credit Protection Act 2009* (National Credit Act), or against licensees for breaching the obligation in s47(1)(a) of the National Credit Act to engage in credit activities fairly.

12 ASIC's view is that Option 1 is preferred for the following reasons:

(a) It is a more effective way of addressing the identified consumer harm than either Option 2 (which would only minimise the harm from higher interest rates) or Option 3.

(b) It is expected to result in a reduction in average interest rates, as a result of more visible competition through advertising (given the constraints from the discretion under flex commissions in lenders being able to advertise interest rates), more efficient pricing models, and lower losses through defaults.

(c) It produces better outcomes for consumers relative to Option 2, while resulting in a similar level of costs being incurred by industry.

(d) It provides a comprehensive and competitively neutral solution where all licensees have to change their commission arrangements in the same way at the same time.

13 In particular, ASIC anticipates that a prohibition on flex commissions would encourage lenders offering finance through car dealers to develop more accurate pricing for risk models than currently exists, in which the cost of credit is more closely linked to the consumer's financial circumstances and background.

14 This is likely to provide indirect benefits to lenders. These may include:

(a) being able to better assess the creditworthiness of their pool of loans and so better manage the risk of default (including by lending less money to higher-risk borrowers and conversely lending more money to lower-risk borrowers than is currently the case);

(b) potential reductions in both the rate and dollar value of defaults; and

(c) the capacity to negotiate a lower cost of funds from investors for lending to consumers.

15 ASIC proposes to implement Option 1 through a legislative instrument that modifies the National Credit Act using our statutory power in s109(3)(d) of the Act.

16 A transitional period of approximately 18 months would allow for an orderly and efficient renegotiation of remuneration arrangements, minimising disruption to business during this period.

B Introduction

17 This section of the RIS outlines:

(a) the nature of the car finance market in Australia;

(b) the remuneration arrangements common in this market; and

(c) the current regulatory framework that is relevant to flex commissions.

Nature of the car finance market in Australia

18 Approximately 1.38 million cars were sold in Australia in 2015, including:

(a) 985,000 new cars; and

(b) 400,000 used cars.

19 We understand that 90% of all car sales are arranged through finance. Of these sales about 39% (or approximately 480,000 sales per year) are financed through the dealership and 61% of car sales are financed from other sources. Of these 480,000 sales, it is estimated that:

(a) approximately 25% were for business purposes, so that any credit was not regulated by the National Credit Act; and

(b) the remaining 75% were for personal use and would therefore be affected by the proposal in this RIS.

20 ASIC understands that there are over 1500 new car dealers in Australia that operate around 2600 new outlets. Dealerships range from family-owned small businesses to larger businesses, including two public companies operating in regional Australia and capital cities across all States and Territories. The franchised dealer network generates revenue in excess of $72 billion, employs more than 66,000 people, pays wages in excess of $5.6 billion annually and has invested around $17 billion in facilities.

21 In Australia, the total value of personal commitments relating to consumer car finance as at November 2016 was $1,442 million.

Note: See Australian Bureau of Statistics, 5671.0 Lending finance, Australia, November 2016.

22 The Australian car market is highly competitive. The profit margin of car dealers relies not only on car sales, but on ancillary services, including the sale of spare parts, after-sale services (e.g. ongoing servicing) and the sale of finance and insurance. This profit margin is generally considered on a whole of transaction basis, rather than on individual components (i.e. sale of the car, accessories, finance, insurance and other services).

23 Default rates on car loans are low:

(a) The proportion of car loans where consumers are 30 days in arrears will typically be 2% of all loans (or less).

(b) The proportion of loans that result in the lender repossessing the vehicle will be less than 1% of all loans.

24 Fitch Ratings publishes data on car loans on a regular basis based on a $13 billion pool of loans that have been bundled up and sold to investors. The banks behind the loans include Macquarie Group, Westpac and Bank of Queensland.

25 In the June 2016 quarter the proportion of automobile loans that suffered a loss after lenders sought to repossess the vehicle was 0.62%. This represents an increase in repossession rates from earlier periods, and was the highest level since the index started in 2010.

Note: See 'Car loan losses hit six-year high, says Fitch Ratings', *The Sydney Morning Herald*, 6 September 2016.

26 If a car is repossessed, the loss relative to the amount borrowed can be very high (50% or more of the amount of the loan), as in these transactions the value of the car will generally be low.

Remuneration arrangements in the car finance industry

27 Car dealers have two main sources of finance-related income from a sale:

(a) They receive a range of financial benefits from lenders, including upfront commissions for individual loans, volume bonuses according to the level of business arranged with a lender, and soft dollar benefits.

(b) They can charge the consumer a dealer origination fee for assisting in the provision of finance (this is referred to as a 'dealer fee' in this RIS).

28 The car finance industry has historically developed a practice of using 'flex commission' arrangements to remunerate their distribution network (primarily car dealers but also finance brokers). This practice has been in place for over 25 years. Under these arrangements:

(a) the lender and the dealer agree that the cost of credit is not fixed and that a range of interest rates will be available to any consumer;

(b) the dealer has the discretion to determine or recommend the interest rate for a particular loan within that range and will earn a greater upfront commission from the lender the higher the interest rate; and

(c) the discretion to increase the interest rate from a 'base rate' specified by the lender is not determined by objective criteria and so can result in opportunistic pricing arrangements (rather than consumers with similar credit risk levels obtaining similar price outcomes).

29 In a flex sharing arrangement, the commission payable on a particular contract is determined by the 'flex amount'. This term describes the amount of the interest charges payable according to the difference between:

(a) the base rate (i.e. a nominated minimum interest rate); and

(b) the contract interest rate under the loan provided by the lender.

30 The lender and the intermediary share the flex amount according to a formula agreed in the commission plan. The percentage of the flex amount that could be retained by the intermediary can vary significantly from plan to plan, and can be up to 80% of the interest charges.

31 The base rate is generally treated by lenders as a wholesale rate, and is only relevant for the purpose of calculating flex commissions. It is neither a minimum rate, nor an average rate. Most lenders will have multiple base rates that vary from transaction to transaction, depending on factors such as whether the vehicle is new or used, its type/model and price. These factors are substitutes for an assessment of the risk at an individual level based on a more detailed evaluation of the consumer's financial circumstances and history.

32 While the use of flex commission arrangements is prevalent in car finance, ASIC understands that it is not used in any other distribution channels. This has been confirmed through consultations with industry associations that cover the wider credit market, including the Australian Financial Conference, the Mortgage & Finance Association of Australia and the Finance Brokers Association of Australia.

Current legislative framework

33 The main ways in which the National Credit Act addresses conduct relevant to the operation of flex commissions are by:

(a) setting out different legal capacities in which car dealers may engage in credit activities;

(b) imposing obligations on holders of an Australian credit licence (credit licensees);

(c) requiring commissions to be disclosed; and

(d) providing remedies for consumers for unjust contracts or unfair conduct by intermediaries.

34 The National Credit Act applies to loans or credit contracts that finance the sale of the car to the consumer where it is for personal use (but does not extend to business-use transactions).

35 The National Credit Act also applies to some, but not all, car leases for personal use:

(a) It applies to consumer leases where the goods are hired for personal use and where the amount the consumer would be expected to pay is more than the value of the goods.

(b) There is an exemption for leases under which goods are hired by an employee in connection with the employee's remuneration or other employment benefits (called 'novated leases' in this RIS)—this type of finance has become increasingly common through salary packaging arrangements.

Different legal capacities in which car dealers engage in credit activities

36 Car dealers engage in credit activities by arranging finance for the consumer. They can have three different roles under the National Credit Act:

(a) They may hold an Australian credit licence in their own right (and so be subject to a broad range of conduct obligations).

(b) They may be appointed as credit representatives by lenders to act on the lenders behalf (usually with a reasonable degree of autonomy for their day-to-day conduct, with credit licensees required to specify in writing the limits of their authority to act on their behalf).

(c) The dealer may rely on the 'point-of-sale' exemption in reg 23 of the National Consumer Credit Protection Regulations 2010 (National Credit Regulations), which is available to suppliers of goods or services where they only engage in credit activities for the supply of those goods or services.

37 ASIC understands that the majority of car dealers engage in credit activities by relying on the point-of-sale exemption, rather than as credit licensees or as credit representatives. However, they will usually be acting as a 'representative' of the credit licensee. Where a licensee has obligations under the National Credit Act in relation to the conduct of its representatives it will need to comply with those obligations for car dealers.

> Note: The fact that the dealer is acting as a representative of the lender does not, by itself, make them an agent of the lender rather than the consumer.

38 Flex commission arrangements exist regardless of the status of the intermediary, so that even car dealers or brokers who hold a credit licence are parties to arrangements under which they can be incentivised to charge higher interest rates.

Licensees required to act fairly

39 Under the general conduct obligation in s47(1)(a) of the National Credit Act, a credit licensee is required to 'do all things necessary to ensure that the credit activities authorised by the licence are engaged in efficiently, honestly and fairly'.

40 To comply with this obligation, a credit licensee needs to do all things necessary to ensure their representatives also engage in credit activities in a way that is efficient, honest and fair.

41 This means that lenders are under an obligation to ensure that car dealers exercise their discretion to determine or propose interest rates in a way that is efficient, honest and fair.

42 A breach of the general conduct obligations may give rise to ASIC taking action against a credit licensee, including the imposition of conditions or the suspension or cancellation of their credit licence.

Licensees required to prevent disadvantage from conflicts of interest

43 Under the general conduct obligations in s47(1)(b) of the National Credit Act, a credit licensee is also required to 'have in place adequate arrangements to ensure that clients of the licensee are not disadvantaged by any conflicts of interest that may arise wholly or partly in relation to credit activities engaged in by the licensee or its representatives'.

44 This obligation deals with the situation where there is a conflict (including conflicts arising from the payment of commissions) between:

(a) an interest of the credit licensee or their representative; and

(b) a legal obligation or duty that person owes to the consumer (including the general conduct obligation to act efficiently, honestly and fairly, as discussed above).

45 If there is a potential conflict between these interests and obligations, the credit licensee must have in place adequate arrangements to ensure that consumers are not disadvantaged by that conflict.

46 In the context of flex commissions, lenders are therefore under an obligation to ensure that conflicts of interest do not result in a consumer being disadvantaged by or as a result of that conflict (e.g. by entering into a contract with a higher interest rate).

Disclosure of commissions

47 The National Credit Act imposes obligations on lenders and intermediaries for the disclosure of commissions payable between these parties.

48 In summary, while there are a number of different disclosure obligations under the National Credit Act, the content of this disclosure is limited in that there is no requirement for disclosure of the relationship between the interest rate and the amount of commissions that can be earned. Further, while not comprehensive, ASIC's review of disclosure documents provided to consumers has not identified any instances where lenders or dealers made voluntary disclosure of how flex commissions operate in a way that would enable a consumer to understand the extent to which they can negotiate the cost of credit on an informed basis.

49 Lenders are required to disclose the fact that commissions will be paid to an intermediary. However, this information is subject to limitations on both the timing and content of the disclosure:

(a) The disclosure is usually provided when the consumer has already decided to enter into the credit contract, with the consumer therefore making their purchasing decision about the credit without being aware of the intermediary's financial incentives.

(b) Lenders do not need to disclose the amount of the commission if it is unascertainable when the contract is entered into. Where volume bonuses are payable (as is usually the case), the dollar value of the total remuneration (both the upfront commission and the applicable volume bonus) is unknown when the contract is entered into. As a result, consumers are only told that a commission is paid and are not given any information that would enable them to understand the amount of the commission or assess its impact on the conduct of the intermediary.

50 Importantly, car dealers who fall within the point-of-sale exemption are under no statutory obligation to disclose their commissions.

51 Intermediaries who operate as credit licensees or credit representatives are required to provide a number of disclosure documents to the consumer (e.g. a quote, a credit proposal document and a credit guide). However, while these will include a statement of the commission expected to be earned expressed as a dollar amount, there is no requirement to explain the way in which flex commissions operate, or that the intermediary has considerable discretion to determine the amount to be paid as commissions and the consequent impact on the interest rate for the consumer.

52 It is also possible that consumers who are charged a dealer origination fee by the car dealer may assume that the dealer is therefore not receiving additional payments through commissions, given the limited and delayed way in which commissions are disclosed.

Consumer remedies for unjust contracts and unfair conduct

53 The National Credit Act provides two broad remedies for consumers:

(a) in relation to lenders, where the contract is unjust; and

(b) in relation to intermediaries (including car dealers), where the intermediary engages in conduct that is unfair or dishonest.

54 The application of these remedies to transactions involving flex commissions has not been the subject of litigation. ASIC considers that these remedies are clearly capable of being used to address the adverse financial consequences to consumers caused by this remuneration structure.

> Note: In ASIC's view, litigation could assist individual consumers to obtain redress. However, it would not be an effective means of driving systemic change in this area, or delivering comprehensive benefits to consumers generally: see the discussion on Option 3 in Section E.

55 Section 76 of the National Credit Code provides for a court to reopen a transaction that gives rise to a credit contract where it is 'unjust'. In determining whether a term of a contract is unjust in the circumstances in which it was entered into, the court must have regard to the public interest and all the circumstances of the case, as well as specific matters in s76.

56 Section 76 specifically contemplates that a contract can be unjust because of excessive interest charges: see s76(2)(o). The effect of flex commissions is that consumers with similar financial circumstances buying similar cars with the same lender can enter into contracts with significantly different interest rates. This outcome could result in a consumer charged the higher rate being able to set aside the contract as unjust under s76, given that the higher level of interest charges is *prima facie* excessive.

57 Section 76 also directs the court to specifically consider a number of other factors where the operation of flex commissions could result in a finding that the contract is unjust. These factors include:

(a) whether or not at the time the contract was entered into its provisions were subject to negotiation—the higher the interest rate above the base rate, the greater the inference that there was no negotiation on the cost;

(b) whether or not it was reasonably practicable for the consumer to negotiate for the alteration of, or reject, any of the provisions of the contract—if the consumer is unaware of the discretion the intermediary has to set the interest rate, it will not be practicable for them to negotiate on an informed basis;

(c) whether or not the credit provider or any other person exerted or used unfair pressure, undue influence or unfair tactics on the consumer, and the nature and effect of that pressure, influence or tactics—the utter lack of transparency in the operation of flex commissions may constitute unfair tactics; and

(d) whether the terms of the transaction or the conduct of the credit provider is justified in light of the risks undertaken by the credit provider—the operation of flex commissions is not linked to the risk of default borne by the credit provider, and therefore the higher interest rate may be characterised as unjust, given that it cannot be justified by the risks undertaken by the credit provider.

58 Section 180A of the National Credit Act provides for remedies against brokers and other intermediaries for engaging in conduct that is unfair or dishonest, where that conduct has a result of the consumer entering into a contract they would not otherwise have entered into, or that has terms that are different from a contract the consumer would otherwise have entered into.

59 The remedy has a broad application, and extends to car dealers operating under the point-of-sale exemption.

60 The remedy for unfair conduct was introduced by an amendment to the National Credit Act in the *Consumer Credit Legislation Amendment (Enhancements) Act 2012* (Enhancements Act). The Regulatory Impact Statement for the Enhancements Act gave the following rationale for introducing the remedy:

(a) The National Credit Act does not provide a general remedy in relation to providers of credit services that is an equivalent to s76 of the National Credit Code (see para 9.239).

(b) The existing remedies in the National Credit Act do not adequately address common situations where consumers are at risk of financial detriment from misconduct by brokers and intermediaries (see para 9.240 and 9.243).

(c) Given the ability of brokers and intermediaries to earn significant financial benefits from unfair practices, this conduct is likely to continue, in the absence of a specific remedy (see para 9.251).

61 In determining whether conduct was unfair or dishonest, the court must have regard to the extent to which one or more indicia of unfairness existed. Section 180A specifically directs the court to find that it is more likely conduct was unfair or dishonest the more any of those indicia existed and the more any of them affected the consumer's interests.

62 Two of these indicia are common characteristics of transactions where flex commissions operate:

(a) whether the intermediary could determine or significantly influence the terms of a credit contract to which the conduct related; and

(b) whether the terms of the transaction were less favourable to the consumer than the terms of a comparable transaction.

63 The Explanatory Memorandum for the Enhancements Act provides the following explanation of what is meant by 'determine or significantly influence' (emphasis added):

> 2.49 The term 'determine or significantly influence' is used to describe situations where the provider of credit services has the capacity to actively influence the terms of a transaction beyond ordinary negotiations. It would clearly apply in situations where the provider of credit services may have an agreement with a third party *in which they can fix the price or cost within limits specified in the agreement*, or subject to a right of veto by the third party.
>
> Example 2.1
>
> A broker attracts potential customers through running wealth creation seminars. Attendees are encouraged to purchase investment properties, and to have finance arranged by the broker. However, the broker has an arrangement with the developer selling the properties that it will receive as commission 50 per cent of the amount of the purchase price in excess of a base price. The broker does not tell the consumer about this arrangement and it can be presumed that they were unlikely to have agreed to purchase the units, either at all or for the price for which they purchased it, had this been the case. This conduct would therefore be unfair or dishonest.

64 In relation to the concept of 'less favourable' transactions, the Explanatory Memorandum notes:

> 2.50 The final element the court must consider is whether the terms of the transaction were less favourable to the consumer than the terms of a comparable transaction [Schedule 1, item 10, paragraph 180A(4)(g)]. This factor recognises the role of the provider of credit services in arranging credit or consumer leases, and, commonly, in arranging other transactions as well (for example, for the purchase or supply of goods or services). If the consumer could have entered into a comparable transaction with more favourable terms, this may suggest that they entered into the less favourable contract as a result of unfair or dishonest conduct.

65 In summary, the way in which flex commissions function is likely to attract the operation of s180A by meeting two of the indicia of unfairness as follows:

(a) whether the intermediary could determine or significantly influence the terms of a credit contract to which the conduct related—this factor is invariably present; and

(b) whether the terms of the transaction were less favourable to the consumer than the terms of a comparable transaction—the extent to which this factor is present will vary according to the interest rate under the consumer's contract. As discussed in paragraph 88, research in 2013 found that 87.75% of contracts were written at an interest rate above the base rate, or on less favourable terms than other transactions provided by the same lender.

C Assessing the problem

How flex commissions operate

66 The parameters under which flex commissions operate mean that the lender does not determine the price at which credit will be offered to the consumer, but only sets a range of interest rates. Intermediaries then propose or recommend the interest rate.

67 This process necessarily limits the ability of lenders to price credit according to the risk associated with the transaction. The interest rate at which the contract is written will depend on the interaction between two factors:

(a) the desire or need of the car dealer to maximise the profit that can be earned from commissions for arranging finance; and

(b) the ability of the consumer to negotiate the lowest available interest rate.

68 In practice, this means that an interest rate can be set in a way that does not limit or reflect the credit risk borne by the lender. This is because:

(a) a person who is a good credit risk but has poor financial literacy can pay a high interest rate; and

(b) a person who is a poor credit risk but has good negotiating skills can pay a low interest rate.

69 ASIC is concerned that the effect of flex commissions means that:

(a) some consumers (particularly vulnerable consumers) are likely to be paying unnecessarily high interest rates for credit; and

(b) these consumers are cross-subsidising other consumers who can negotiate lower interest rates, including some who may be poor credit risks.

70 One consequence of flex commissions is that a person who is a poor credit risk but has good negotiating skills:

(a) may be able to borrow a larger sum than would be the case under a rating for risk assessment; and

(b) therefore increase both the risk of default and the dollar value of the loss to the lender should they default.

71 By comparison risk based pricing models can allow for more efficient allocation by lenders of their loan funds, consistent with capital regulatory requirements, and generally improved credit conditions for borrowers where good risks have better access to less expensive credit.

72 Finally, some lenders have advised ASIC that their preference would be to move away from flex commissions to a pricing-for-risk model. However, they have stated that they are unable to move unilaterally due to a 'first mover' problem, which would mean that any individual lender who attempted to introduce this business model unilaterally would be likely to face a flow of business to their competitors.

Consumer harm from flex commissions

73 The consumer harm from flex commissions can be highlighted by analysing the impact of flex commissions on:

(a) the amount received by car dealers in commissions; and

(b) the interest paid by consumers over the life of the loan.

74 Under flex commission arrangements, the discretion car dealers have to increase the interest rate is not based on or limited to objective factors. From information provided by industry participants, the pricing offered to consumers is opportunistic and depends on a range of factors. At a portfolio level, car dealers may be subject to constraints where the agreement with the lender requires them to write loans at a specified average interest rate.

75 Some of these factors can result in a lower interest rate (e.g. due to the negotiating skills of the consumer or the need to match highly visible offers by competitors). Other factors can result in a higher interest rate: some of these relate to consumer vulnerabilities (e.g. lack of awareness of the cost and availability of other forms of finance, or their capacity or willingness to negotiate a reduction in the cost of credit) while others may be particular to the individual (e.g. their eagerness to buy a specific vehicle).

Impact on amount received by dealers

76 ASIC has obtained information from lenders to assess the impact that increasing the interest rate above the lender's base rate can have on the amount of commission received by the dealer.

77 Table 2 sets out the difference in commission for six transactions reviewed by ASIC, based on the amount payable under the base rate and the amount earned by the car dealer. It shows that, compared to the sum payable if the contract was written at the base rate, intermediaries could earn commissions that were:

(a) between four to seven times higher than commissions received under the base rate; and

(b) between $1,246 and $2,827 higher in dollar terms.

Table 2: Comparison of commissions payable under base rate and contract rate

Example	Base rate	Contract rate	Commission if paid at base rate	Commission paid under contract rate
Consumer A	8.24%	10.95%	$303	$1,549
Consumer B	8.24%	12.99%	$316	$2,488
Consumer C	7.99%	10.45%	$354	$1,717
Consumer D	7.99%	12.74%	$453	$3,332
Consumer E	6.24%	13.04%	$346	$3,173
Consumer F	6.24%	8.99%	$209	$897

Source: Confidential information provided to ASIC

78 ASIC's view is that the dollar value of these financial incentives is sufficient to have a significant influence on the conduct of the intermediary, resulting in them offering credit at higher interest rates.

79 We note that car dealers can also earn additional payments through volume bonuses where they meet sales targets agreed to with the lender. Flex commissions do not have any impact on these payments, given that they are based on the total amount of credit arranged by the dealer across all borrowers during a set period of time.

Impact on interest paid by consumers

80 The financial impact of higher interest rates on consumers can be significant, as illustrated by Table 3, which sets out the additional interest payable by the six consumers in the transactions reviewed in Table 2.

Table 3: Comparison of interest payable under base rate and contract rate

Example	Interest payable at base rate	Interest payable under contract rate	Additional interest paid by the consumer	Commission as a percentage of the additional interest
Consumer A	$8,689	$11,669	$2,980	51.9%
Consumer B	$8,494	$13,695	$5,201	47.8%
Consumer C	$10,211	$13,468	$3,257	52.7%
Consumer D	$9,818	$16,214	$6,396	52.0%
Consumer E	$5,775	$12,697	$6,922	45.8%
Consumer F	$3,497	$5,145	$1,648	54.4%

Source: Confidential information provided to ASIC

81 This analysis shows that a significant amount of the increase in interest paid by the consumer is effectively used to pay higher commissions to the car dealer.

82 ASIC also undertook a broader analysis of the effect of increases in interest rates, using a larger number of transactions with a range of differences in interest rates and amounts borrowed. Table 4 sets out the additional amount payable in interest charges for these transactions, based on the difference between the base rate and the contract rate. In this table, a difference of 34 basis points means, for example, the base rate was 7.00% and the contract interest rate was 7.34%.

Table 4: Additional interest payable as a result of increases in interest rate

Difference in interest rate (basis points)	Amount financed	Additional interest paid by the consumer
034	$30,238	$243
045	$38,818	$727
084	$35,411	$1,235
099	$45,600	$951
100	$32,671	$925
130	$31,447	$1,134
155	$64,730	$3,630
255	$38,884	$3,432
246	$35,408	$3,257
271	$30,322	$2,800
274	$17,651	$528
275	$20,986	$1,648
276	$35,232	$2,597
300	$38,587	$2,591
340	$28,311	$4,118
400	$32,222	$3,700
412	$33,262	$3,973
414	$30,976	$5,408

Difference in interest rate (basis points)	Amount financed	Additional interest paid by the consumer
454	$32,461	$4,245
475	$31,687	$5,201
475	$45,391	$6,396
499	$26,144	$2,956
612	$15,389	$2,212
679	$31,193	$4,986
680	$34,653	$6,922
681	$15,618	$1,180
684	$28,499	$5,798

Source: Confidential information provided to ASIC

83 Table 3 and Table 4 demonstrate the following:

(a) Even a modest increase in the interest rate can result in the consumer paying significantly more in interest charges. In one instance, an increase in the interest rate of 84 basis points resulted in an increase in the amount payable of $1,235. There are also several examples of transactions where increases of less than 300 basis points resulted in the consumer paying more than $2,000 in additional interest.

(b) An interest rate of 600 basis points or more above the base rate resulted in those consumers who borrowed over $28,000 paying between $4,986 and $6,922 in additional interest.

84 The figures in Table 4 illustrate the degree of autonomy given to car dealers to set the interest rate, and the broad range of different financial outcomes that can arise from the exercise of this discretion

85 ASIC has also obtained data from some of the major lenders offering flex commissions to assess the extent to which consumers are charged higher interest rates. The data covered approximately 25,500 contracts written by seven lenders for May 2013.

Note: The data from this month is considered typical.

86 The data shows that:

(a) base rates ranged from 6.2%–8.5% p.a.;

Note: Bank indicator rates cited by the Reserve Bank of Australia for May 2013 were 6.2% p.a. for a standard housing loan, 14.2% p.a. for an unsecured fixed interest term loan, and 19.55% p.a. for a standard credit card. Car finance may be secured or unsecured. If secured over an eligible vehicle (e.g. no more than five years old), car

loans are generally offered at a lower interest rate (e.g. around 3-4% less than the standard unsecured fixed interest term loan).

(b) the lenders wrote 8.5% of contracts at the base rate;

(c) the lenders wrote 3.75% of contracts at an interest rate lower than the base rate;

(d) the average contract interest rate was 3.6% p.a. above the lender's base rate (i.e. at least 9.8% p.a.); and

(e) 9.2% of contracts were written at 800 basis points or more above the base rate (i.e. at least 14.2% p.a.) and around 15% of contracts were written at 700 basis points or more above the base rate (i.e. at least 13.2% p.a.).

87 Some stakeholders submitted to ASIC that consumers are knowledgeable about interest rates and make significant inquiries before purchasing the car to assess how much they should pay.

88 We accept that this may be true for some consumers. However, recent surveys of consumer behaviour found that: in 2013 approximately 29% only started making inquiries about finance after they had chosen the car or they had been introduced to a finance person at the dealership. In 2016, 19% of surveyed consumers had not spent anytime online researching finance options before purchasing a car.

Note: See *Automotive Finance Insight*, Research snapshot, p. 15 (October 2013) and Snapshot, p. 7 (December 2016).

89 We also consider that consumers who are well-informed on prices would either arrange their own lender or be in the group of borrowers who obtain an interest rate below or close to the base rate. The dollar value of the additional interest payable under the contract could be expected to prompt a reasonably informed consumer to explore cheaper options. For example, to use the last transaction in Table 4, it is not credible that such a consumer would agree to pay an interest rate 684 basis points above the base rate or an additional $5,798 in interest charges.

90 It follows that if all consumers were price-sensitive, there would be a much narrower spread of interest rates and a much smaller percentage of contracts written at rates of 700 basis points or more above the base rate. ASIC's view is therefore that a consumer who enters into a contract at 700 basis points or more above the base rate is likely to be financially vulnerable.

91 It can therefore be inferred that these consumers agreed to finance at these rates for other reasons (e.g. they were unable to negotiate a lower rate or they did not understand the disparity in cost between the interest rate they were being charged and other sources of finance).

92 This analysis is consistent with the findings of another regulator, the Consumer Finance Protection Bureau (CFPB) in the United States when investigating similar flex-commission policies. The CFPB's view is that:

> because of the incentives these policies create, and the discretion they permit, there is a significant risk that they will result in pricing disparities on the basis of race, national origin, and potentially other prohibited bases.
>
> Note: See CFPB Bulletin 2013-02, Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act (21 March 2013).

93 The CFPB's approach is consistent with that of ASIC in that it accepts that flex commissions can create distortions in the cost of finance for reasons other than the underlying credit risk, and that this may adversely affect particular classes of consumers, rather than all consumers equally. (We have not investigated whether particular ethnic groups are consistently charged higher interest rates as a consequence of these arrangements).

Impact on loan terms

94 One of the consequences of a higher interest rate can be an increase in the term of the loan, as, assuming, similar repayments, a larger proportion of each repayment will meet interest charges under the loan.

95 This can be illustrated by the following example, based on a consumer who borrows $25,000:

(a) If the loan contract has an interest rate of 17%, the repayments will be *$556 a month over six years*, or a total of $40,032.

(b) If the loan contract has an interest rate of 13%, the repayments will be *$569 a month over five years*, or a total of $34,140.

(c) If the loan contract has an interest rate of 10%, the repayments will be *$531 a month over five years*, or a total of $31,860.

96 Flex commissions have an additional impact in that consumers with very high interest rates are likely to have longer loan terms. This means that:

(a) it will take the consumer longer to own the vehicle or to obtain sufficient equity to readily trade-in the car for a new model; and

(b) the risk of default is greater, given that this risk exists for a longer period (due to the increase in the term of the loan) and that the repayments may be higher.

Summary of consumer harm

97 There is a significant risk of consumer harm resulting from flex commission arrangements due to the financial burden of higher interest rates. This risk is inherent in the structure of these arrangements, although it is higher for more

vulnerable consumers who are less aware of factors influencing the price of their loan and/or have a lower capacity to negotiate more favourable terms.

98 The harm to consumers can be assessed against two measures:

(a) *Base rate from the borrower's lender*—Some consumers can obtain finance at this cost, given that in May 2013, 12.25% of contracts were written at the base rate or a lower figure (although this rate would not be available to all borrowers with that lender).

(b) *Interest rate available from lenders operating independently from the car dealer*—This may be higher than the base rate depending on the individual transaction.

99 The harm under the 'base rate' measure can be readily measured as the difference between the base rate and the contract interest rate. The example in Table 1 in this RIS illustrates the different outcomes possible where:

(a) Consumer A is able to negotiate a loan at the base rate of 7.99%; and

(b) Consumer B is only able to arrange a loan at the higher rate of 12.74%.

100 Assuming that Consumers A and B have similar credit histories and financial circumstances, Consumer B has been disadvantaged by paying a higher interest rate and an additional $6,396 in interest charges.

101 Based on this example, in ASIC's view, there is a risk of harm with every transaction, as the terms on which credit will be provided are being negotiated. The dollar amount of the harm will vary depending on the terms of the transaction (especially the amount borrowed and the term of the loan).

102 Our analysis in Table 4 demonstrates that:

(a) consumers paying 600 basis points or more above the base rate can pay $6000 or more in additional interest over the life of the loan; and

(b) even a modest increase in the interest rate can result in the consumer paying significantly more in interest.

103 The harm under the 'independent lender' measure is not as readily quantifiable as it can vary according to factors such as the type of credit (e.g. secured or unsecured personal loan), the amount borrowed and the consumer's financial situation and history.

104 Irrespective of the measure adopted, flex commissions create the greatest level of harm for the pool of vulnerable consumers who are charged at a higher interest rate (i.e. 700 basis points or more above the base rate).

105 We consider that the harm to these consumers is greatest as:

(a) they are less aware of factors influencing the cost of their loan and/or have a lower capacity to negotiate more favourable terms; and

(b) the need for the car dealer to generate a profit falls disproportionately on them relative to other consumers.

106 The data from May 2013 showed that:

(a) 9.2% of contracts were written at 800 basis points or more above the base rate; and

(b) around 15% of contracts were written at 700 basis points or more above the base rate (i.e. at least 13.2% p.a.).

107 The level of harm can be illustrated using an example based on a loan of $25,000 over five years. The cost of the loan can be assessed using a difference in interest rates of 800 basis points (base rate measure), then a difference in cost of 300 basis points (independent lender measure—i.e. a conservative assumption of the difference between the contract rate and the rate available from an independent lender).

108 Based on these calculations:

(a) if the loan contract has an interest rate at a base rate of 8%, the repayments will be $507 a month, or a total of $30,415, with interest charges of $5,415;

(b) if the loan contract has an interest rate of 13%, the repayments will be $569 a month, or a total of $34,130, with interest charges of $9,902; and

(c) if the loan contract has an interest rate of 16%, the repayments will be $608 a month, or a total of $36,477, with interest charges of $11,477.

109 In this example, the level of harm is:

(a) $6,062 over the life of the loan using the base rate measure; and

(b) $1,575 using the independent lender measure.

110 Finally, there is an additional harm to consumers who are charged an interest rate of 700 basis points or more above the base rate. This is the increased risk of default as a result of consumers having longer loan terms or higher interest repayments. If a consumer defaults, they can be disadvantaged by the loss of the car (and any equity in it), and possible difficulties in obtaining a replacement.

111 Higher interest rates due to flex commissions mean that these consumers are likely to have either higher repayments or longer loan terms, or both, increasing the risk of default (although we note that default rates in this market are low).

D Consultations

The consultation process

112 ASIC consulted with the following industry bodies on the issue of flex commissions:

(a) the industry body for lenders in the car finance sector, the Australian Finance Conference (AFC);

(b) the two industry bodies for the broader loan distribution sector:

(i) the Mortgage & Finance Association of Australia (MFAA), which represents mortgage and finance brokers and other intermediaries, including mortgage management businesses, and both banks and non-bank lenders; and

(ii) the Finance Brokers Association of Australia Limited (FBAA), a national association representing finance and mortgage loan writers throughout Australia;

(c) the industry body that advocates for Australia's customer owned banking sector, the Customer Owned Banking Association (COBA), which represents mutual banks, credit unions and building societies;

(d) the national body for commercial equipment finance brokers, the Commercial Asset Finance Brokers Association of Australia Limited (CAFBA);

(e) the principal industry body representing franchised new car dealers, the Australian Automotive Dealer Association (AADA); and

(f) the Motor Trades Association of Australia Limited (MTAA), which represents the motor traders associations operating in each State and Territory whose membership includes both new and used car dealerships.

113 ASIC also consulted with:

(a) lenders who provide car finance, including authorised deposit-taking institutions (ADIs) and non-ADIs, lenders who specialise in this market, and lenders who offer a broad range of credit products, including car loans;

(b) a number of individual car dealers or dealer groups; and

(c) consumer advocates.

114 These consultations were primarily conducted through:

(a) consultation with targeted stakeholders in December 2015 (2015 consultation) and one in May 2016 (2016 consultation);

(b) consideration of written responses based on these consultations; and

(c) discussions with representatives of some of the consulted groups.

115 The responses to the 2015 consultation were used to develop more targeted or refined questions in the 2016 consultation. This allowed stakeholders to engage at a level of detail on the options being considered, and to fully articulate the impact on their businesses (as discussed further below).

116 Some stakeholders asked that their responses be treated as confidential. Where this was the case, their views have not been disclosed in this RIS. However, all responses were considered by ASIC in developing our views on this issue.

117 A RIS was not submitted to OBPR for early assessment before consultation. This is because ASIC's consideration of the issue has changed over time. The consultation started on an informal basis so that we could develop our understanding of the way in which flex commissions operate and their consequences for lenders, intermediaries and consumers, and whether there was a need for intervention.

118 In the 2015 consultation, ASIC proposed addressing this practice on an individual basis by applying conditions to the licences of lenders. This would have allowed licensees to contest the condition, including through an appeal to the Administrative Appeals Tribunal.

119 However, in their responses to the 2015 consultation, stakeholders indicated a clear preference for any changes to be implemented uniformly and consistently. As a result, in the 2016 consultation, we sought stakeholders' views on the disadvantages and disadvantages of implementing any changes through a legislative instrument.

120 Throughout the consultation to date, ASIC has not formed a final view on whether to progress with a regulatory solution. The consultation has been undertaken to enable consideration of this approach and other options on a fully informed basis, and to allow preparation of this RIS to inform a decision on whether to progress with any of those options.

121 In particular, in the 2016 consultation, we set out a series of questions seeking responses on key issues relevant to ASIC's consideration, including the nature and level of harm to consumers, and the changes in outcomes that could be expected from the introduction of a prohibition of flex commissions and from a 'collar and cap' approach: see Options 1 and 2 in Section E.

122 These options have been refined in response to matters raised by stakeholders as follows:

(a) The introduction of the reform through a legislative instrument, rather than by licence conditions (as proposed in the 2015 consultation).

(b) In the 2015 consultation, we proposed a blanket prohibition on the financing of dealer origination fees. Stakeholders generally opposed this position. ASIC accepts that the harm the proposals seek to address is not the charging of fees itself, but the charging of excessive or

arbitrarily priced fees (where different consumers could be charged fees for different amounts according to their ability to negotiate). Option 1 addresses this potential cause of harm in a nuanced way (rather than through a strict prohibition) that has been refined through consultation.

(c) In the 2016 consultation, we sought views on whether, if ASIC were to proceed with a prohibition on flex commissions, there should be a two-stage implementation process. We were concerned that any harm identified would continue during the transitional period. We sought views on whether this risk could be addressed by limiting the gap between the base rate and the maximum interest rate in the transitional period. In light of stakeholders' responses, we accept that the additional costs and business disruption in a two-stage process are not warranted.

(d) Finally, ASIC acknowledges that it would be desirable to allow car dealers a limited degree of flexibility to discount rates, so they can offer more competitive interest rates to secure the consumer's agreement for the car dealer to arrange finance. Option 1 therefore includes a proposal to allow discounting by 200 basis points, with a reduction in the commission payable, without this infringing the prohibition.

Summary of stakeholder views

123 During the consultations, ASIC received a broad range of responses from stakeholders. This RIS does not set out the views of stakeholders on each matter covered in our consultations.

124 The views of stakeholders on key topics are set out in detail as relevant under each option in Section E.

125 On the question of whether or not ASIC should intervene in relation to flex commissions, stakeholders' views fell into three categories:

(a) Some stakeholders supported or accepted the need for a prohibition on flex commissions.

(b) Some stakeholders rejected the need for a prohibition and proposed an alternative approach, in which there would be a restriction on the gap between the base rate and the maximum interest rate that could be charged. Some stakeholders suggested a restriction of 300 basis points, while others did not offer a specific range.

(c) Some stakeholders rejected the need for any intervention.

126 There was broad (but not unanimous) agreement on three issues:

(a) It was accepted that flex commissions caused harm, although there was disagreement about the extent of this harm, particularly as to whether it only applied to 'outlier' transactions with the highest interest rates or more broadly.

(b) It was accepted that it was desirable to have a collective and competitively neutral response to address the 'first mover' problem, and ensure that there was a smooth transition by lenders.

(c) It was accepted that if ASIC did prohibit flex commissions, there was a substitution risk, in that car dealers may seek to recoup lost revenue by charging higher dealer fees.

127 These issues are also discussed in Section E where relevant to each option.

Issues outside scope of changes to flex commissions

128 Some stakeholders raised a number of additional issues (set out below) where they considered that intervention by ASIC was also desirable. ASIC's view is that it was not appropriate for it to take action in these areas when addressing flex commissions.

Mandatory positive credit reporting

129 Some stakeholders considered that ASIC should facilitate moves to mandatory credit reporting, in order to improve the capacity of lenders to price credit for risk.

130 This issue was recently considered by the Government when responding to the Financial System Inquiry. The Government has stated that it would support industry efforts to implement the comprehensive credit reporting regime, but that it would not legislate for mandatory participation at this stage. ASIC does not consider it is appropriate to adopt a different or segmented approach for car loans.

Removal of the point-of-sale exemption

131 ASIC notes the views of some stakeholders that the continuation of the point-of-sale exemption means that the market is not competitively neutral. They argued that it means there is greater regulatory burden on licensees and credit representatives when arranging finance, compared to car dealers.

132 ASIC considers there would be merit in considering this issue further if the financial disadvantage from flex commissions was the result of car dealers who operated in reliance on the exemption. However, the practice is not limited in this way, and is engaged in by intermediaries who hold credit licences or have been appointed as credit representatives by a licensee.

Flex commissions for novated leases

133 Some stakeholders considered that any intervention should also extend to novated leases, even though they are not regulated by the National Credit Act: see paragraph 35(b).

134 Two reasons were put forward:

(a) It was considered that there was a risk that some businesses may seek to offer flex commissions in relation to novated leases, with the result that the cost of finance for these consumers continued to be determined on a discretionary or opportunistic basis.

(b) It may increase the flow of novated leases, with a consequent reduction in the number of credit contracts arranged through car dealers.

135 Given that lessors offering novated leases are not currently subject to licensing or conduct obligations under the National Credit Act, ASIC cannot regulate them in the same way. Dealers affiliated with novated lease providers would therefore be entitled to receive flex commissions.

136 However, ASIC could monitor conduct in this market to see if further reforms are needed in the future (and make recommendations to Government on this issue as appropriate).

E Options and impact analysis

137 This RIS considers the following options:

(a) *Option 1*—Prohibition on flex commissions and consequent changes to the financing of dealer origination fees (dealer fees), while still allowing other forms of commission to be paid.

(b) *Option 2*—Regulation of flex commissions by restricting the permitted gap between the base rate and the contract interest rate.

(c) *Option 3*—No change (status quo option).

138 This section:

(a) discusses the nature of each option in detail;

(b) sets out the impact of each option on lenders, intermediaries and consumers; and

(c) sets out stakeholders' views (see paragraphs 266–278, which cover all three options together).

139 ASIC's preferred option is Option 1 for the reasons set out in Section F.

140 The proposals in Options 1 and 2 only refer to the operation of flex commissions in relation to credit contracts. However, they are to be read as extending to consumer leases that are regulated by the National Credit Act. While ASIC understands that flex commission arrangements do not currently operate in this sector, extending the proposals to these products would ensure that there is regulatory neutrality and address the risk of arbitrage (e.g. intermediaries electing to finance car loans through consumer leases rather than credit contracts, as flex commissions are payable on leases).

Option 1: Prohibition on flex commissions and consequent changes to financing of dealer origination fees

141 Under Option 1, ASIC would use our statutory power to modify provisions of the National Credit Act to:

(a) prohibit the use of flex commissions so that the amount paid in commissions is not linked to the interest rate and therefore that the lender has sole responsibility for determining the interest rate that applies to a particular transaction; and

(b) make consequent changes to the amount that can be charged for dealer fees so that:

(i) lenders must set a maximum price for dealer fees (which is likely to be based on a reasonable reimbursement of the costs associated with arranging a loan); and

(ii) intermediaries are prohibited from influencing or proposing the amount of the fee, where any benefit to that person increases or decreases by reference to an increase or decrease in the amount of the fee.

Prohibition on flex commissions

142 A prohibition on flex commissions would not prevent lenders paying commissions to intermediaries. However, lenders would need to change their remuneration arrangements so that dealers would not be incentivised by the amount of commission to place consumers in loans at higher interest rates.

143 This would not prevent lenders from charging different interest rates for consumers with different credit risk profiles or paying intermediaries a higher amount of commission for higher risk/higher interest rate contracts. It would only remove the current discretion given to an intermediary to set the interest rate payable under the contract where the exercise of that discretion is directly related to the amount of remuneration they are paid.

144 The intended effect of the prohibition would be to make the credit provider solely responsible for nominating an interest rate. This would enable lenders to set rates according to their assessment of the risk for the transaction.

145 Stakeholders have submitted that it is important for car dealers to retain some discretion to discount the interest rate offered to the consumer (i.e. to a rate below that set by the lender). This would allow dealers to secure sales where this is contingent on being able to provide a reduction in the cost of credit.

146 In ASIC's view, it is desirable to facilitate a level of discounting, provided that this does not result in a 'reverse-flex' model where the consumer is consistently offered a higher interest rate, with commissions reducing if it is discounted.

> Note: This is called 'reverse-flex' as commissions would be discounted as the interest rate decreases, whereas under flex commission models the intermediary earns a higher commission as the interest rate increases relative to the base rate

147 ASIC therefore proposes to allow the following arrangements under which the dealer can offer a lower interest rate than the nominated interest rate:

(a) If the negotiated contract interest rate is *lower by 200 basis points or less* than the interest rate initially nominated by the lender, the amount of the commission can vary (so that the car dealer compensates the lender for lower interest charges through a lower commission).

(b) If the negotiated contract interest rate is *lower by more than 200 basis points* than the interest rate initially nominated by the lender, then the amount of the commission cannot vary. This would mean the lender needs to decide whether or not to provide a discount, given that they

would bear the entire amount of the reduction in revenue (whereas currently, under flex commission arrangements, the cost of this reduction is shared between the lender and the car dealer).

148 Controlling the amount of the reduction in this way should encourage credit providers to develop pricing models in which their interest rates are competitive, reducing the need to offer significant discounts on a regular basis (given that the lender will largely bear the impact of this reduction).

149 ASIC considers that this proposal balances the need to allow discounting with appropriate consumer outcomes in that it:

(a) gives car dealers limited flexibility to vary the price without going back to the lender; and

(b) minimises the risk of a 'reverse flex model' developing, by only allowing a small deviation from the proposed rate.

Consequential impact on dealer origination fees

150 There was a general recognition by stakeholders that there is a risk that intermediaries may respond to a prohibition on flex commissions by arbitrarily increasing the amount charged for dealer fees. These are fees charged for providing services in relation to arranging finance, payable in addition to commissions. The typical price range is $600 to $800, although it can be higher.

151 ASIC considers it is desirable to address the risk of unfair flexible pricing practices migrating from interest rates to dealer fees as this risk is both real and substantial. If this occurred, consumers would continue to be charged different amounts for reasons unrelated to the level or value of the services provided. More vulnerable consumers could be charged significantly higher fees, given that the analysis of interest rates in Section C shows that they are not price sensitive. We therefore propose to introduce a level of control over dealer fees under Option 1.

152 In the 2015 consultation, ASIC suggested a prohibition on dealer fees. Under this approach, lenders would need to factor the remuneration provided through these fees into the amount they paid as commissions.

153 Stakeholders did not support a prohibition and suggested a number of alternatives, including:

(a) setting a maximum price that could be charged;

(b) introducing specific disclosure obligations (which could either be a tailored form of disclosure or an extension of the disclosure requirements in the National Credit Act to car dealers operating under the point-of-sale exemption); or

(c) applying the same principles to origination fees as those developed for flex commissions to prevent arbitrary pricing of fees.

154 ASIC considers that setting a maximum price is problematic as it would be difficult to determine a sum that is appropriate to cover the range of possible transactions. This sum would also need to be monitored and updated from time to time.

155 In relation to the option of disclosure ASIC's view is that it shifts the onus for change onto the consumer by requiring them to analyse and respond to the information disclosed.

156 A possible disclosure requirement would be that the consumer must be provided with information about:

(a) what is a reasonable fee for the services provided (taking into account forecast commission revenue); and

(b) how much, if any, they have been charged in excess of this figure.

This information would need to be provided to the consumer in a timely manner so they can consider this information and act on it before making a purchasing decision.

157 ASIC does not support this approach. We consider that it is cumbersome, and if it is effective, would result in car dealers incurring significant costs in both providing the disclosure and negotiating with consumers on the amount of the fee.

158 ASIC also considers that disclosure should only be introduced if it will be effective in changing consumer outcomes. In our review of add-on products sold through car dealerships, we found that the sale context inhibited good consumer decision-making through factors such as decision fatigue and information overload: see Report 470 *Buying add-on insurance in car yards: Why it can be hard to say no* (REP 470).

159 We therefore consider that disclosure will not be effective in systematically driving better consumer decision-making or in addressing excessive or differential pricing. It is likely to operate inconsistently at best, depending on the skills and circumstances of the consumer.

160 ASIC's preference is for lenders to control these prices with intermediaries, given that this would only be a variation to the existing arrangements. This option leverages the suggested approach to flex commissions to address the risk of consumer harm from dealer fees.

161 Under this option we therefore propose to adopt a similar approach to the prohibition on flex commissions and introduce a requirement that lenders:

(a) set a maximum price for dealer fees (that would be based on a reasonable assessment of the value of the services provided); and

(b) stipulate that intermediaries cannot vary the price according to factors unrelated to the services provided.

162 This proposal would apply to dealer fees provided they are fees payable in connection with the credit contract, and irrespective of whether or not they are financed under the credit contract. This would mean that lenders need to have systems in place to prevent intermediaries recouping credit fees and charges above the limits they impose, whether paid through a disbursement from the loan or through other arrangements (e.g. cash).

163 It is possible that intermediaries may seek to increase fees for services unrelated to the provision of credit, but that are related to the provision of the vehicle. In this scenario, they would need to disclose these fees in the advertised price of the vehicle, given the single pricing requirements in Div 4 of Pt 3-1 of the Australian Consumer Law. The effect of this obligation is that persons advertising or promoting prices for products and services must clearly display a 'single price' which is the minimum total cost that can be calculated. This should include the price of all aspects of the final product and service, and all taxes, duties and extra fees.

164 ASIC would also monitor the amount charged for dealer fees to assess the effectiveness of these requirements and to determine if further intervention is necessary over time.

Transitional period

165 Industry participants have indicated that a period of 18 months would balance the time necessary for an orderly and efficient renegotiation of remuneration arrangements with the risk of loss of business for those who implement new arrangements at an early stage.

166 ASIC proposes to allow a transition period of around 18 months to enable industry to develop new pricing models and renegotiate remuneration arrangements. We acknowledge that there is a risk of continuing consumer harm during this period. However, this is a trade-off for longer-term benefits. ASIC would also encourage lenders to adopt voluntary measures to reduce the risk of harm during the transitional period.

Impact on industry

167 We sought stakeholders' views on whether a prohibition would result in:

(a) higher or lower average interest rates;

(b) higher or lower average amounts financed;

(c) higher or lower numbers of total credit contracts; and

(d) credit providers applying tighter or less restrictive eligibility criteria (with therefore either higher or lower numbers of credit contracts to marginal borrowers).

168 Based on this consultation and ASIC's own analysis we consider that lenders are likely to design rating for risk pricing within parameters which mean they receive a similar level of income in interest. There would be a smaller percentage of contracts written at very high interest rates.

169 We expect that there may be a small decrease in the average interest rate due to the following factors:

(a) the pool of consumers who are currently charged higher interest rates than the price they would be charged under a rating for risk model is similar in size but may be slightly larger than the pool of consumers who are presently able to negotiate lower interest rates; and

(b) there would be a reduction in the percentage of contracts where the consumer defaults.

170 A move to a more sophisticated model to assess the consumer's risk rating will interact with this approach and would mean that the average interest rate needs to reflect the risk rating of that category of consumers.

171 On the basis of this analysis, ASIC's view is that there is unlikely to be significant changes to lenders' eligibility criteria and that therefore:

(a) the total number of credit contracts may reduce slightly, although similar numbers of consumers will be eligible for credit; and

(b) the typical or average amount borrowed is unlikely to change (as this is determined by assessing the consumers' financial capacity and the amount of surplus available to them to meet repayments under the credit contract).

172 Accordingly, the following outcomes could be expected for financially marginal borrowers:

(a) There may be a small percentage of consumers whose risk rating is so poor that they would not be eligible for credit in the future (even though they currently are). However, if this group of consumers is significant in number, a second or third tier of lenders may emerge, who would offset the additional costs associated with a greater risk of default by charging higher interest rates and not paying commissions to intermediaries.

(b) There would be a relatively small number of borrowers who would be eligible for credit but unable to borrow as much as they currently can (as they would be charged a higher interest rate). While this may result in a minor reduction in interest charges earnt from these borrowers it would also mean that where they default the losses to the lender in dollar terms will be lower.

173 In ASIC's view, there is unlikely to be any significant change to the profit generated by lenders through interest charges, and there may be a small increase. We note that neither the AFC nor any lenders suggested that they were concerned that Option 1 would have an adverse impact on their revenue.

174 Finally, there may over time be a small increase in the number of car sales and consequent credit contracts due to two factors. The first is that lower levels of defaults will mean that more consumers own the vehicle at the end of the loan, and therefore have the option of trading it in for a better car.

175 The second factor is that fewer consumers will have longer loan terms (e.g. over five years), and therefore the number of consumers who trade in cars sooner will increase. As discussed in paragraphs 94–96, one consequence of flex commissions is that consumers with very high interest rates are likely to have longer loan terms.

176 Under Option 1, a small percentage of these consumers could be expected to have shorter loan terms. Some of these consumers currently buy replacement vehicles near the end of their loan term. If this behaviour continued on a shorter loan term, they may trade in their car earlier, resulting in a small increase in the overall level of sales by consumers in this pool.

Costs to lenders

177 The main impact on lenders would be a need to change the nature of the remuneration benefits payable to intermediaries, with the main costs being those incurred from renegotiating existing agreements, and internal costs in developing new commission models, reflecting different pricing structures.

178 The infrastructure is already in place for payments of commissions between these parties, reducing the costs that would be incurred in negotiating new agreements. This would also be a one-off cost rather than an ongoing cost in relation to each new transaction.

179 Similarly, lenders already have in place systems to control and monitor the amount intermediaries are charging for dealer fees, so that this option would formalise, but not substantially add to, those existing arrangements.

180 Based on ASIC's consultations, we consider that the main costs incurred by lenders under this option would be costs associated with developing new remuneration models and negotiating changes to existing arrangements with their car dealership network.

181 The assessment of these costs has been based on the following assumptions:

(a) the number of lenders that are currently active in this sector and provide flex-commission arrangements is 16;

(b) the number of agreements that would need to be renegotiated across all lenders is estimated as a minimum of 500 (noting that approximately 80% of dealers are represented by about 30 dealer groups); and

(c) lenders and car dealers would incur costs in renegotiating their distribution agreements in any event, so that it is only necessary to take into account the costs that result from the additional complexity arising from a prohibition of flex commissions.

182 We estimate the direct costs involved in implementation of Option 1 (based on legal and other expenses in involved in negotiations between lenders and dealers/dealer groups) would be $37,230,000. This includes costs for:

(a) legal and other expenses involved in renegotiation of remuneration arrangements ($2,030,000);

(b) system changes ($32,000,000); and

(c) training or education costs to ensure dealers are aware of the prohibition and new systems based upon the prohibition ($3,200,00).

183 As these are one-off costs, the estimated annual cost over a 10-year period would be $3,723,000.

184 ASIC would also introduce reporting requirements on lenders that would commence before the prohibition, to enable it to track changes in the distribution of interest rates charged by lenders, and the amount charged for dealer fees (as discussed in more detail in Section G). This requirement would apply to 16 lenders, and is expected to result in them being required to produce reports during the transitional period and the following two-year period (on either a quarterly or half-yearly basis).

185 It is anticipated that this requirement would impose an initial cost on each lenders of approximately $10,000–$15,000 to establish an automated reporting system. Once the reporting processes are in place there would be minimal additional staff costs.

186 We therefore calculate these costs as $20,000 for each lender or $320,000 in total, resulting in an increase in the estimated annual cost over a 10-year period to $3,726,200.

187 This assessment does not include other indirect costs that lenders may incur, including costs for the development and introduction of more sophisticated risk-based pricing models.

188 The development of such pricing models is a likely response by lenders to the proposed prohibition and one that some lenders have indicated they expect to implement. However, this is not a response that is required by the prohibition, nor the only response that could be taken. It would also be open to lenders to respond to set prices with minimal changes to existing practices, using simple credit risk assessment models.

Benefits to lenders

189 The way in which flex commission arrangements impact on interest rates creates a price distortion. A prohibition on flex commissions will assist those lenders who would prefer to abandon these arrangements, while ensuring that there is no competitive disadvantage (and so avoid the disadvantages resulting from a ‘first mover’ situation).

190 There are a number of indirect benefits to lenders that cannot be quantified from more accurate pricing for risk. These include:

(a) being able to better assess the creditworthiness of their pool of loans and so manage the risk of default (including by lending less money to higher risk borrowers and conversely lending more to better risk borrowers than is currently the case); and

(b) reductions in both the rate and dollar value of defaults.

191 The combination of these factors may assist some lenders to negotiate a lower cost of funds from investors for lending to consumers (noting that a broad range of considerations are likely to determine a lender's cost of funds). Alternatively, a reduction in costs may enable them to price the cost of credit more competitively.

192 ASIC would expect that:

(a) the structure of commissions would change, so that they are no longer payable based on the interest rate, and may be linked to other criteria, with, for example, payments linked to the performance of the pool of loans arranged by the intermediary; and

(b) the balance between upfront commissions and volume bonuses may change, or there may be lower upfront commissions and trail commissions payable, depending on the performance of the loan.

Impact on intermediaries (car dealers and finance brokers)

193 As discussed above, ASIC's view is that lenders will receive a similar level of net income under this option. It is not known whether or not lenders would reduce the amount paid to intermediaries in commission income.

194 Some lenders are largely dependent on this class of intermediaries for business and need to continue providing credit through this distribution channel if they are not to suffer a substantial drop in the amount they lend. Further, lenders already have a substantial investment in this distribution channel market (e.g. in training, software and financing of floor plans).

195 Accordingly, if lenders cut commissions by an amount that threatened the viability of intermediaries, this would have the following consequences:

(a) the lender would risk either:

(i) a reduction in the number of loans arranged and therefore a decline in their own income; or

(ii) the intermediary moving to a different lender who is prepared to offer more generous commissions and therefore a loss of business from that intermediary; and

(b) the lender would place at risk the value of their investment in intermediaries.

196 ASIC therefore expects that lenders would renegotiate remuneration arrangements on the basis that the total benefits payable would be sufficient for intermediaries to remain in business and to continue providing them with loan applications on a similar basis. Within these parameters, it is possible that the value of the remuneration will be less than under Option 2 or Option 3.

197 There are a number of ways in which car dealers may respond to any reduction in commission income from lenders. These include the following:

(a) *Increasing the price of the car or associated costs (e.g. dealer delivery fees or post-sale service charges)*—It is common for dealers to sell the car for a sum below the advertised price, in order to secure the sale. Car dealers may no longer be prepared to offer the same level of discounts, or may make lower offers for trade-in vehicles. If this is the case the difference in price need not be significant in order to generate significant additional revenue For example, if across 1 million cars sold annually there was either an increase in the price of $500 or a reduction in the level of discount of $500 this would generate additional income of $500 million.

Note: A comparison between the difference of an increase in the price of $500 and an increase in the amount payable through higher interest rates can be made by reviewing the transactions set out in Table 4. On this basis, even modest increases in the interest rates can result in the consumer paying more than $500: for example, an increase of 45 basis points on a loan of $38,818 resulted in additional interest charges of $727, and an increase of 100 basis points on a loan of $32,671 resulted in additional interest charges of $925.

(b) *Increasing the penetration rates of cars sold on finance*—A move to more accurate pricing for risk would allow lenders to advertise competitive interest rates more extensively than they currently do so (as the level of discretion given to car dealers restricts the ability to advertise specific rates). This may give consumers greater confidence in using car financiers, and encourage an increase in the number of consumers who use dealers to arrange finance.

(c) *Streamlining costs*—Car dealers may look to reduce their operating costs in light of the prohibition. For example, implementation of this option would reduce the level of discretion currently exercised by business managers, given that the interest rate would be set by the lender. This may result in a reduction in the salaries for staff employed in these positions over time.

(d) *Increasing revenue from the sale of add-on products*—Car dealerships currently earn additional revenue through the sale of add-on products, such as insurance that covers risks associated with either the car or the finance contract. Car dealers may respond to a prohibition by selling more of these products or seeking a greater return from individual sales (with a consequent negative impact on the value offered to consumers through claims when an insured event occurs).

(e) *Increasing commission revenue from credit contracts that are not regulated by the National Credit Act (primarily from business use borrowers)*—The National Credit Act does not regulate lending for business purposes. It is therefore possible that some car dealers may respond by seeking to increase the revenue from flex commissions on business loans, and that these borrowers may be charged higher prices.

Note: There are no equivalent remedies for borrowers for business use to those available to consumers under the National Credit Act (i.e. the remedies where the lender has entered into an unjust contract or where an intermediary has engaged in conduct that is unfair or dishonest). ASIC's power to intervene is therefore limited to transactions where, for example, the conduct in relation to flex commissions is unconscionable or misleading or deceptive under the *ASIC Act 2001*.

198 In view of this analysis, ASIC expects that the main impact on intermediaries would be costs arising from the need to renegotiate existing agreements (as with lenders). These costs are included in the amounts identified above.

199 Some responses argued that the effect of the prohibition would be a reduction in dealer income due to a decline in the level of car sales. ASIC's view is that consumer's need for cars will be constant, as it is not a function of access to finance. We consider that sales would reduce only if:

(a) any increase in the price of the cars was greater than the reduction in the cost of finance (we do not consider this is likely for the reasons set out above); and

(b) there was a significant reduction in the number of consumers who were not eligible for finance on any terms where arranged through the car dealership (we consider that the number of consumers affected in this way is likely to be very small; these consumers would presumably still buy a vehicle, but would only be able to finance a cheaper car).

Impact on consumers

200 The primary benefit for consumers is that they will no longer be charged higher interest rates driven by financial incentives that currently encourage intermediaries to charge such rates. The most significant impact would be on the pool of consumers who currently pay more than 700 basis points above the base rate. Option 1 could therefore be expected to provide significant benefits to approximately 15% of consumers who take out car loans, or about 3800 consumers a month.

201 The dollar value of these benefits is not possible to calculate, but the analysis in Section C demonstrates that even a modest reduction in interest rates of 100 to 300 basis points can result in a significant difference in dollar terms.

202 It is unlikely that there would be significant change to the number of marginal consumers who are unable to obtain credit, given that this would be a function of eligibility criteria not pricing.

203 It is possible that under new pricing for risk models that some consumers who currently obtain finance from mainstream lenders would no longer be able to do so. These consumers may have to use the services of a fringe lender. However, the level of financial disadvantage that may result is unlikely to be significant. Fringe lenders still need to manage the risk of default, and are likely to advance loans for smaller amounts. Consumers may therefore be disadvantaged, not by paying more in dollar terms but by owning a poorer quality or older vehicle as a result of the transaction.

204 In summary, it is expected that under Option 1 there will be:

(a) a pool of consumers who are charged a lower interest rate, as a result of moves by lenders to better price the cost of credit according to the risk;

(b) a pool of consumers who are charged a higher interest rate, as they are no longer able to obtain a lower rate based on their negotiating skills rather than their underlying credit rating; and

(c) an overall benefit to consumers, as a larger number of consumers will receive a discount rather than an increase in the cost of credit (compared to the prices they are currently charged).

205 The major benefit will be to those consumers who would have the most significant change, of a decrease in the interest rate of 500 basis points or more, with the balance favouring those who pay less. Based on our inquiries we expect that the pool of consumers who benefit from a substantial drop in price (of 500 basis points or more) will be about 14,400 larger than the consumers charged a higher price.

206 It is possible to calculate the likely savings for this pool of consumers. On an average loan of $25,000 over five years a difference in interest rates of 500 basis points (such as a reduction from 17% to 12%) would result in savings of $3,900 as:

(a) if the loan contract has an interest rate of 17%, repayments will be $621 a month, or a total of $37,260, with interest charges of $12,260; and

(b) if the loan contract has an interest rate of 12%, repayments will be $556 a month, or a total of $33,360, with interest charges of $8,360, or savings of $3,900.

207 We estimate a benefit to consumers of $56,160,000 based on average savings of $3,900 a loan across 14,400 contracts per year. These savings will accrue for each month of the loan contract and be spread out over the five-year term of the contract. The savings would therefore apply in full during years one to six after implementation of the prohibition.

208 However, in years seven to 10, the savings would be reduced by 20% each year. For example, a consumer who enters into a loan in year six would not pay off the loan in full by year 10, and so not obtain the full benefit of these savings in the 10-year period relevant for estimating savings under this RIS.

209 On this basis, we think it is reasonable to estimate the total savings as $449,280,000 or annual savings of $44,928,000. However, it is possible that the benefits to consumers could be lower (e.g. if the interest rate reduction for this pool of consumers was 200 basis points, rather than 500 basis points). Using this conservative assumption, this would still result in significant benefits to consumers of $181,059,840 over a 10-year period, or $18,105,984 annually.

210 There may be other impacts on consumers depending on how car dealers respond to any reduction in commission income from lenders (as discussed in paragraph 204). The potential impacts on consumers from these responses are as follows:

(a) *Increasing the price of the car or associated costs*—A reduction in the level of discounts offered to consumers would not result in significant disadvantage if the car was still sold at a price below or at the advertised price. In practice, this would result in operating costs of the dealership being allocated across all consumers, rather than being disproportionately derived from a smaller pool of those consumers. Any changes in fees would be disclosed in a way that is transparent to the consumer, given that the Australian Consumer Law requires intermediaries to clearly display the minimum total cost of the product and related service, including taxes, duties and fees.

(b) *Increasing the penetration rates of cars sold on finance*—An increase in penetration rates would be a sign of a better functioning market on price (as presumably consumers would be selecting advertised rates on the basis that they are competitive with other finance options).

(c) *Streamlining costs*—This would not have any negative impacts on consumers.

(d) *Increasing revenue from the sale of add-on products*—ASIC is seeking to improve the value offered to consumers from the sale of these products (see, for example, Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492)).

(e) *Increasing commission revenue from credit contracts that are not regulated by the National Credit Act*—This would have a negative impact on small business borrowers. However, the extent to which this may occur is questionable: some responses suggested that small business borrowers tended to be more financially literate and therefore better able to negotiate on price (we have not tested this proposition as part of our review).

Impact on government

211 ASIC would need to introduce arrangements to monitor changes in this area to assess whether the intended policy outcomes are being achieved. In particular, we would need to check the amount charged for dealer fees to assess whether it is necessary to amend the legislative instrument: see Section G. Table 5 sets out the estimated costs of Option 1.

Table 5: Regulatory burden estimate (RBE): Average annual regulatory costs (from business as usual)—Option 1

Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$3,726,200	$0	$18,105,984–$44,928,000	$14,379,784–$41,201,800

Source: ASIC

Option 2: Restrictions on permitted gap between base rates and contract rates

212 Under Option 2, ASIC would use our statutory power to modify provisions of the National Credit Act to regulate flex commissions so that:

(a) credit providers can enter into arrangements under which they can set a base rate and pay larger commissions the higher the interest rate charged above the base rate; and

(b) the maximum interest rate that can be charged is no more than 300 basis points above the lender's base rate.

213 The main difference under Option 2 compared to current flex commissions arrangements is that there would be a tighter restriction in the amount that could be charged above the base rate. This approach is referred to as a 'collar and cap' model.

214 Currently lenders generally offer multiple base rates that can reflect—but only in general terms—the risk rating of the transaction, using a broad assessment of the borrower's profile, the type of car being financed, and the structure of the finance (e.g. the loan-to-value ratio). These factors are substitutes for a more detailed assessment of the risk at an individual level, that would be derived to a greater extent from the consumer's financial circumstances and history.

215 The application of a collar and cap restriction to this model would result in an approach under which the interest rate could only exceed each such base rate by a maximum of 300 basis points. This could mean, for example, that:

(a) the lender could classify consumers and transactions into multiple grades, from those with the least probability of default to those with a higher probability of default;

(b) the base rate for each grade could only be exceeded by 300 basis points; and

(c) there could be an overlap between each grade so that, for example, a consumer at the highest range in one category could obtain the same interest rate as under the base rate in the next category or grade.

216 An alternative collar and cap model would be to require lenders to have a single base rate and therefore only allow interest rates to be set within the same band of 300 basis points for all transactions. It is considered this option is too inflexible to meet the needs of lenders and consumers, and it is therefore not explored further in this RIS.

217 Given the risk of legal action, ASIC would need to consider whether to state that lenders and intermediaries who arrange loans in accordance with the restriction are provided with a 'safe harbour', and are deemed not to have otherwise breached the National Credit Act.

218 The question of a safe harbour raises competing policy considerations:

(a) the desirability of providing lenders and intermediaries with business certainty that their conduct is not open to challenge; and

(b) the removal of the right of consumers to seek redress for conduct that is unfair.

219 Given that the motivation for ASIC taking action on flex commissions is to address the harm to consumers identified in Section C, we do not consider it is appropriate to provide lenders and intermediaries with a safe harbour. This approach would entrench the risk of harm (albeit within reduced parameters) and is therefore illogical from a policy perspective.

Impact on industry

220 As with Option 1, we sought stakeholders' views on the impact of this option on the volume and nature of lending in this market, including the likelihood of:

(a) higher or lower average interest rates;

(b) higher or lower average amounts financed;

(c) higher or lower numbers of total credit contracts; and

(d) credit providers applying tighter or less restrictive eligibility criteria (resulting in higher or lower numbers of credit contracts to marginal borrowers).

221 Under Option 2, lenders would only need to make minor changes to their pricing models (e.g. to identify several grades of consumers), rather than developing more detailed models to assess the risk for each consumer individually.

222 Lenders could elect to adopt a number of base rates that suit their business models. In general, this would be likely to mean that they select a relatively small number of base rates to minimise complexity in the model.

223 In ASIC's view, lenders are likely to design pricing models for each grade of consumers so that they receive a similar level of income in interest charges. This means that the revenue derived from those consumers who currently pay more than 300 basis points above the base rate would need to be recouped from the interest charged to all consumers, with the average interest rate therefore likely to increase slightly. This outcome may be achieved by adopting a grading system that meant a significant number of consumers were ranked in the category with the highest interest rates.

224 The broad nature of the pricing model is likely to mean that there are minimal changes to eligibility criteria, or to the average amounts financed or the number of credit contracts arranged through this channel.

225 Some stakeholders suggested that lenders would cease to lend to significant numbers of consumers, with a consequent significant reduction in income for bother lenders and car dealers.

226 For example, it could be argued that under Option 2 lenders would stop providing credit to all consumers who currently pay more than 300 basis points above the base rate. If this was the case, it would result in a significant drop in the number of contracts written.

227 However, we do not accept that this would be the outcome as it conflates eligibility with the size of the gap between the base rate and the contract interest rate. Our discussions with stakeholders suggest that lenders would not adopt such an extreme position, and would rather adjust their pricing models and continue to enter into similar numbers of contracts.

Lenders

228 The main costs incurred by lenders would be costs in renegotiating remuneration arrangements with representatives and making minor changes to their pricing models (compared with Option 1).

229 ASIC's consultations suggest that the cost of implementing Option 2 would be either substantially similar to Option 1 or slightly higher, due to greater complexities around governance, system changes, monitoring and reporting requirements.

230 These costs are estimated at $45,230,000, which, based on consultation responses, includes the same contract renegotiation and education costs as Option1 and slightly higher systems change costs ($2.5 million per lender compared to $2 million).

231 As each of these costs are one-off costs, the estimated annual cost over a 10-year period is $4,523,000.

232 Under Option 1, lenders would receive benefits that are not readily quantified from being able to better assess and manage the level of defaults in their pool of loans: see paragraph 170. These additional benefits would not be available to lenders under Option 2.

Dealers

233 Option 2 would operate in a similar way to existing arrangements in that pricing for risk would only be undertaken in a limited way. Car dealers would still have a significant (through lesser) discretion to manage the level of income they receive by being able to nominate the interest rate in a way that maximises the return they can achieve

234 Further, as noted for Option 1, it is expected that lenders would not make significant reductions to the amount of commissions that can be earned.

235 For these reasons, ASIC considers that car dealers would be likely to obtain a similar level of income under Option 2 as they receive under current arrangements.

Impact on consumers

236 Option 2 would restrict the ability of car dealers to offer loans with higher margins and so limit excessive pricing. It would therefore be effective in addressing the greatest level of harm for the least sophisticated consumers, who are currently charged more than 300 basis points above the base rate.

237 However, this option would continue to allow the use of discretionary variables for individual consumers within the permitted price range, and so would not comprehensively address the identified consumer risk.

238 ASIC expects that there would be a concentration of interest rates at or close to 300 basis points above the base rate to:

(a) maximise revenue (given the need to offset the decrease from revenue currently earned by writing loans at more than 300 basis points above the base rate); and

(b) enable car dealers the maximum scope to reduce the cost of credit to secure the sale (as nominating a high initial rate maximises the ability to discount downwards to the base rate to the extent this may be necessary).

239 On this basis we are not satisfied that a collar and cap would deliver better outcomes for consumers. In particular, we consider it likely that:

(a) vulnerable consumers, or those with poor negotiating skills, would continue to be charged similar high interest rates, with the rates charged clustering at the high end of the permitted range under a collar and cap; and

(b) there would be a reduction in the number of consumers able to negotiate lower interest rates, given that it would no longer be possible to discount the rate below the applicable base rate.

240 ASIC's view therefore is that while some consumers would benefit from lower interest rates that this would be offset by higher average interest rates, and therefore no net benefit to consumers.

241 Finally there would be an adverse impact under Option 2 in relation to business certainty, in that there would still be a risk that the conduct of the lender or the intermediary does not comply with the National Credit Act. In particular, consumers would still have the right to seek compensation for this conduct as a potential breach of the prohibition against conduct that is dishonest or unfair under s180A.

242 A consequence of this pricing approach with multiple and overlapping interest rate spreads would be that the same interest rate is charged to both:

(a) a better risk consumer in the category assessed as having the least risk of default, where they are charged an interest rate 300 basis points above the base rate for that category; and

(b) a lower risk consumer in the next category where they are charged the base rate for that category.

243 This model would allow a dealer to charge the same interest rate (or a very similar rate) to consumers who are assessed by the lender as having different risk profiles. This outcome would increase the risk to the car dealer of the transaction being considered unfair under s180A of the National Credit Act, and to the lender of the credit contract being unjust under s76 of the National Credit Code, and of it also being in breach of its obligation, as a licensee, to act honestly and fairly.

Impact on government

244 ASIC would incur slightly higher costs in monitoring Option 2 relative to Option 1, in that we would need to ensure that there was continuing compliance with the cap of 300 basis points: see Table 6. The costs would be higher given the more complex nature of the conduct being regulated, given that the way in which the cap would operate could vary from transaction to transaction, depending on the base rate that applies.

Table 6: Regulatory burden estimate (RBE): Average annual regulatory costs (from business as usual)—Option 2

Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$4,523,000	$0	No change	$4,523,000

Source: ASIC

Option 3: No change (status quo)

245 Under this option, ASIC would take enforcement action on flex commissions where related conduct breached the National Credit Act. This could include taking action where:

(a) the lender has entered into contracts that are unjust under s6 of the National Credit Act;

(b) the conduct of the intermediary is unfair under s180A of the National Credit Act; and

(c) the intermediary is a representative of the credit provider, the credit provider is:

(i) in breach of s47(1)(a) of the National Credit Act, which requires them to engage in credit activities fairly; and

(ii) in breach of s47(1)(b) of the National Credit Act, which requires credit licensees to have in place arrangements to prevent their customers being disadvantaged by a conflict of interest.

246 Action by ASIC could include:

(a) cancellation or suspension of credit licences, or imposition of licence conditions in individual cases; or

(b) action on behalf of individual consumers against car dealers or lenders.

247 ASIC has not considered any non-regulatory interventions under this option (e.g. providing guidance to consumers). As outlined in this RIS, consumers are unable to exert competitive pressure on lenders and intermediaries. Therefore, options such as guidance or educational materials are likely to have a minimal impact on consumer behaviour or outcomes.

Limitations on existing remedies as disincentives to unfair conduct

248 ASIC would be prepared to litigate these issues. However, we consider that Option 3 would not provide as effective or systemic a solution as Options 1 and 2. This is because:

(a) a significant period of time would elapse before the result of any court case would be known, with the harm continuing for consumers during this period (with the possibility of an appeal as well); and

(b) a successful court action would not provide a comprehensive or effective solution, in that it would result in a finding that flex commissions are not permissible. The constraints on lender conduct through the 'first mover' problem may continue to operate to discourage moves to pricing for risk and therefore lead to the development of different remuneration models that may operate in a way that does not deliver the benefits to consumers contemplated by Option 1.

249 These considerations have meant that ASIC has not yet taken enforcement action against car dealers or lenders in relation to flex commissions as our preference is for a systemic solution. However, this should not be seen as suggesting that ASIC does not consider that flex commissions cause financial harm, or that we have reservations about whether court action would be successful.

250 Some stakeholders queried the application of s180A of the National Credit Act to the practice of setting higher interest charges under flex commission arrangements, including on the grounds that:

(a) the dealer is usually acting as the agent of the lender and therefore is not acting unfairly where they set the interest rate; and

(b) fairness should only be tested on the 'independent lender' measure of harm, rather than the 'base rate' measure (as discussed in Section C).

251 ASIC does not accept these propositions for a number of reasons:

(a) some lenders specify that the car dealer is not their agent when they are arranging credit;

(b) there is case law that suggests that a car dealer is not the lender's agent simply because the dealer undertakes or performs some tasks on their behalf;

(c) s180A does not distinguish between different types of intermediaries according to whether or not they are agents of the consumer; and

(d) the unfairness derives from the explicit relationship between cost and commissions within the individual transaction.

252 ASIC does not accept the proposition that car dealers are usually acting as an agent of the lender rather than the consumer. We have made inquiries into this question, including a survey of lenders in 2014. This review found that lenders have inconsistent approaches to addressing this question in their agreements with the car dealer:

(a) At least one lender specifically provided that the car dealer was the agent of the consumer and not the lender.

(b) Some lenders explicitly stated that the car dealer does not act as the agent of the consumer.

(c) Many lenders did not address this question in their agreements, leaving the question open.

253 Regardless of the terms of such agreements, this question would still need to be determined by the court on a case-by-case basis. There have been some court decisions on this issue that have found that even where the car dealer performs some tasks on behalf of the lender that will not be sufficient to characterise them as being an agent of the lender rather than the consumer.

254 For example, in *Custom Credit Corporation Ltd v Lynch* [1993] 2 VR 469 the Victorian Court of Appeal found that the car dealer was not an agent of the lender even though it undertook tasks such as submitting financial information to the lender, completing details in the credit contract (e.g. the repayments and the interest rate), and providing a limited explanation of the effects of the contract. It also found that the payment of commissions to the car dealer was insufficient to make it an agent of the lender.

255 The Court of Appeal found that the performance of these tasks, and the payment of commissions, was consistent with the car dealer either acting on its own behalf (to secure payment for the sale of the vehicle), or acting on behalf of the consumer (to enable them to finalise the transaction). It would therefore be necessary for some further conduct or elements to be present if the car dealer was to be characterised as an agent of the lender.

256 Further, s180A applies to all intermediaries, without the wording in the provision drawing any distinctions in its application according to their role. ASIC's view is that what makes the conduct unfair is that the price for the consumer is driven up by the intermediary to secure higher commissions, rather than the price being based on objective criteria.

Note: There is a specific exclusion so that s180A does not apply to credit providers.

257 In relation to the argument that the conduct is not unfair where the interest rate is competitive compared to other forms of finance, ASIC's view is that this approach reads qualifications into s180A that are contradictory to the terms in which it is expressed, and in particular to the direction to the court that the more particular factors exist (including some factors that are intrinsic to the flex commission model), the more likely the conduct is to be unfair: see paragraphs 61–65.

258 Nevertheless, even if this argument is correct, it would only limit the application of s180A where the interest rate under the loan arranged by the dealer is competitive with the cost of finance through third parties. This would mean that consumers would be entitled to a remedy where flex

commissions provide outcomes that are unfair where this interest rate is excessive compared to other products. Even on the most favourable interpretation this position therefore supports ASIC's argument, albeit in a limited way.

Impact on industry

259 Option 3 is unlikely to provide an effective industry-wide position at least in the short-term, given that ASIC would not be in a position to resource action against all lenders or car dealers offering flex commissions.

260 A consequence of this approach is that enforcement action by ASIC would be likely to have a disproportionate adverse impact on the lenders or car dealers against whom ASIC takes action.

261 If successful, those lenders or car dealers would need to cease offering flex commissions and pay compensation to consumers. The effect on those lenders is likely to be a significant short-term reduction in the lending they can arrange, as car dealers can be expected to direct loan applications to other lenders who still offer flex commissions. Similarly the car dealers would be unlikely to be able to arrange loan contracts with any lender under flex commission arrangements. There would therefore be significant short-term business disruption.

262 While ASIC would seek to negotiate similar undertakings from other lenders and car dealers, the outcome of these negotiations would be less predictable and would take time. This option would therefore not provide a competitively neutral solution where all credit licensees have to change their conduct in the same way at the same time.

Impact on consumers

263 Relative to Option 1, this option is likely to result in more limited benefits for consumers as:

(a) there will be a significant delay before there are any changes to flex commissions while the issue is being litigated;

(b) there will be an uneven transition period to any new commission arrangements; and

(c) there is no certainty about what remuneration models would replace flex commissions, or whether they would continue to be structured in a way that primarily benefits car dealers rather than delivering fairer pricing to consumers.

Impact on government

264 Option 3 would involve significant costs for ASIC in relation to:

(a) continued monitoring of lenders to identify lenders that have flex commission arrangements, and assess which licensee or licensees should be subject to enforcement action;

(b) taking administrative action on the licensee's credit licence; and

(c) taking enforcement action on behalf of consumers.

265 It is not possible to estimate these costs as they will vary according to the way in which the licensee or licensees respond to any enforcement or administrative action.

Views of stakeholders

266 The positions of each stakeholder group were as follows:

(a) *Industry bodies for lenders and brokers*—These stakeholders supported, or were not opposed to, Option 1.

(b) *Lenders*—Most lenders did not provide individual responses as they were members of the AFC. Those that provided individual responses took a range of views, with support for each of the three options.

(c) *Car dealers and their industry bodies*—These stakeholders supported Option 3 (or, if ASIC decided on regulatory intervention, Option 2 in preference to Option 1).

(d) *Consumer groups*—These stakeholders endorsed Option 1.

267 The views of stakeholders on the three options largely depended on how they assessed the following two factors:

(a) providing better consumer outcomes; and

(b) the potential loss of income to car dealers.

268 For example, car dealers and their industry bodies were concerned about a reduction in income currently generated through commissions and considered that this should be the primary consideration in deciding how to address this issue. Conversely, consumer groups considered the primary concern should be to address the risk of harm through higher interest charges.

Industry bodies for lenders and brokers

269 Industry bodies that made public submissions expressed the following views:

(a) The AFC, while not accepting that flex commissions result in non-compliance with the law by its members, advised that its overriding

objective was that any intervention by ASIC should be effective, comprehensive and competitively neutral (by applying across all distribution channels and to both current and future participants).

(b) The FBAA supports banning dial-up flex commissions noting that such arrangements were potentially causing intermediaries to contravene their conflict of interest obligations under the National Credit Act and that lenders may be contributing to such breaches by incentivising such conflicts.

(c) CAFBA agreed with ASIC's approach to prohibit flex commissions. It considered that the risk of financial harm is increased as many car dealers operate under the point of sale exemption. CAFBA's position is that the point-of-sale exemption enjoyed by car dealers should be withdrawn and that sellers should have to obtain a credit licence or be appointed as a credit representative to be an intermediary of consumer credit products. By withdrawing the point-of-sale exemption, the problems of flex commissions would be resolved (where the risk is greater where the car dealer selects the lender and the cost of credit based on flex commissions), given that they do not need to meet responsible lending requirements to ensure that credit that meets the consumer's requirements and objectives

(d) COBA stated that it had no objection to ASIC's proposal to prohibit flex commissions, as it would have no impact on its members given that they do not use these remuneration arrangements. A number of its members observed that the practice could result in vulnerable borrowers being gouged on price.

Car dealers and their industry bodies

270 Car dealers and their industry bodies (and some lenders) either supported Option 2 or else were in favour of Option 3 (with the caveat that they considered Option 2 was preferable to Option 1 if ASIC decided to intervene).

271 A number of reasons were put forward for this preference:

(a) They were concerned that Option 1 would result in a significant reduction in the volume of remuneration payable to car dealers.

(b) Flex commissions deliver benefits to some consumers where the car dealer can arrange an interest rate that is significantly discounted (while also allowing dealers to maximise sales).

(c) They contested ASIC's views on whether the use of flex commissions would result in conduct that was unfair under s180A of the National Credit Act, or allow consumers to obtain redress.

272 ASIC's proposal for the prohibition or limitation of finance incentives in the retail car market was not supported by the MTAA. The MTAA represents the motor traders associations operating in each State and Territory.

273 The MTAA did not accept there was harm to consumers for a number of reasons, including that:

(a) consumers are knowledgeable about interest rates and know how much they would or should pay if they choose to arrange finance through a bank or an alternate provider; and

(b) the absence of any enforcement action by ASIC to address the alleged harm caused by flex commissions is itself an indication that there is no harm.

274 The MTAA suggested alternatives to a prohibition or 'collar and cap' should be explored, including new disclosure provisions and improved consumer awareness and education programs.

275 The MTAA was also concerned about the risk of unintended consequences should a prohibition result in car dealerships no longer being profitable. These consequences could include unemployment, increased price to consumers of other elements of the car sale transaction in order for the business to remain sustainable, and reductions in consumer choice due to fewer avenues of finance and less dealers.

Consumer groups

276 Consumer advocates expressed unequivocal support for a prohibition on flex commissions.

277 The Consumer Action Law Centre and the Financial Rights Legal Centre both considered that ASIC should take action to address the harm arising from these commissions given that:

(a) vulnerable consumers are more susceptible to overcharging on price when intermediaries are remunerated in this way; and

(b) arrangements where there is a link between the interest rate and the amount of commission earned by car dealers can generally lead to poor consumer outcomes.

278 They did not support Option 2 as it would enable commissions to vary according to the interest rate without the knowledge of the consumer, and continues to incentivise dealers to increase the interest rate unfairly or even dishonestly. They therefore considered there was still potential for significant consumer harm under this option.

F Conclusion and recommended option

279 In ASIC's view, Option 1 is preferred because it:

(a) is more effective in reducing financial harm to consumers;

(b) gives car dealers some flexibility to compete on price to secure the sale; and

(c) is likely to generate profits for lenders similar to current levels, with lenders offering new commission arrangements to car dealers and intermediaries that would be sufficient to ensure they are viable.

Reduction in financial harm to consumers

280 Option 1 addresses consumer harm comprehensively relative to Options 2 and 3 as it does not allow any financial incentives that would permit or encourage intermediaries to increase the cost of credit. By comparison, both Options 2 and 3 still allow pricing to be determined in this way with therefore a likelihood of ongoing harm.

281 ASIC's view is that the benefits to consumers will be significant, particularly for the class of vulnerable consumers currently charged 700 basis points or more above the base rate. As discussed in paragraphs 200–210, we have calculated that these consumers will benefit by approximately $44 million over a 10-year period.

282 We accept that Option 2 would address the most extreme cases where the harm is greatest, where the gap between the base rate and the contract rate is currently higher than 300 basis points. However, we consider it is preferable to prohibit this conduct in all circumstances and not just for these extreme transactions. Under Option 2, car dealers would continue to have the discretion and an incentive to offer loans to some consumers at a higher interest rate for reasons unrelated to the risk level of the consumer, reducing the net benefits to consumers.

283 Under Options 2 and 3, lenders would have no business certainty that their pricing model complies with the law. As set out in Table 4, even a small increase in the interest rate can result in the consumer paying several thousand dollars more in interest charges, creating a risk of court action based on a claim that this outcome is unjust under s76 or unfair under s180A of the National Credit Act.

284 If successful, such a claim would expose lenders and intermediaries to having to pay significant amounts in compensation to a broad class of consumers, and require lenders to change their commission arrangements in

a disruptive way, without the benefit of a transitional period, and with no uniformity about what constitutes permissible conduct.

285 We note that one lender recognised this risk and suggested that if ASIC proceeded with a collar and cap, we should confirm that compliance with this option gave the lender a 'safe harbour' from claims that it had breached the National Credit Act. This highlights the contradictions and limitations in Option 2, in that it does not comprehensively remove the risk of financial harm, nor therefore the risk of business disruption through litigation.

286 Finally, there is a risk that adopting Option 2 would institutionalise or embed a pricing structure based on flex commissions. The 'first mover' problem experienced by lenders in this market sector would continue to operate and so inhibit the development of pricing for risk models. There are long-term benefits to such models that are not readily quantifiable, including a better capacity to assess and manage defaults within the lender's pool of loans. Some lenders may also be able to derive indirect benefits from more accurate pricing for risk and potentially access to lower cost funding, on the basis that the creditworthiness of their pool of loans can be more accurately assessed.

287 One consequence of more accurate pricing for risk is that some consumers who currently meet a lender's eligibility requirements may no longer do so, as these requirements become more robust. The extent to which this may happen cannot be quantified, as it will vary from lender to lender and depend on their individual risk appetites. However, given that these consumers will still have a demand for cars, this is likely to result in the development of niche lenders who can offset the losses arising from defaults by paying smaller commissions to intermediaries.

288 In summary. ASIC considers that the use of a collar and cap model under Option 2 maintains the unfair features of Option 3 without providing any of the advantages of Option 1 in that:

(a) it will deliver consumer outcomes that are worse than under Option 1, including higher average interest rates;

(b) it does not facilitate a move to robust and individualised pricing for risk models;

(c) it has a continuing risk of consumers outcomes that are open to challenge under s180A; and

(d) it therefore adds complexity to the proposed regulatory outcome, without providing clear benefits to consumers.

Flexibility to compete on cost of credit

289 ASIC accepts that it is desirable to allow car dealers to compete on the cost of credit, in order to be able to secure a deal. However, we are concerned to ensure that this is done in a way that avoids the risk of 'reverse flex': see paragraphs 145–149.

290 Option 1 would still allow this, but does so in a way that places the onus on the lender to make the pricing decision and to bear the cost of any discount beyond 200 basis points.

291 Option 1 would allow discounting, through the intermediary accepting a reduced commission, within a narrower range than either Option 2 or Option 3. This would mean that consumers who can secure lower interest rates due to their negotiating capacity would be unlikely to secure a rate as low as they are currently able to do. This is likely to be a small number of consumers, given that the global data for May 2013 found that only 3.75% of contracts were written at an interest rate lower than the base rate.

Similar revenue for lenders and intermediaries

292 In our view, Option 1 is likely to result in:

(a) similar or lower average interest rates, due to the ability to better price the cost of credit against the underlying risk; and

(b) similar average amounts financed;

(c) similar or lower numbers of credit contracts; and

(d) lower rates of default.

293 We therefore expect lenders to earn either similar or lower incomes, but for their net profitability to increase.

294 Given the need for lenders to retain car dealerships as a distribution channel for their products ASIC would therefore also expect lenders to pay a level of revenue to car dealers and intermediaries that allows them to continue to be viable; if lenders sought to restrict payments beyond this, they would themselves suffer financial disadvantage: see paragraphs 193–199.

G Implementation and review

Modification of the National Credit Act by a legislative instrument

295 ASIC proposes to implement Option 1 through a legislative instrument that modifies the National Credit Act. The relevant power to modify the provisions of the National Credit Act is contained in s109(3)(d) of the Act.

296 While the 2015 consultation considered implementing any prohibition on flex commissions through a condition on the Australian credit licences of relevant lenders, stakeholders did not support this approach. They generally considered that any change needed to be comprehensive and ensure a level playing field: the prohibition should therefore apply to all existing financiers at the same time and to all future entrants in this market.

297 If the prohibition was implemented by ASIC imposing conditions on each lender's Australian credit licence, there would be a risk that new entrants could seize market share and disrupt existing arrangements by offering flex commissions until ASIC made changes to the conditions on their licence.

298 Given this clear and largely consistent view from stakeholders, ASIC proposes to implement the changes through a legislative instrument that would apply to all licensees.

299 In summary, the instrument would:

(a) prohibit the use of flex commissions (so that the amount paid in commissions is not linked to the interest rate), so that the lender has sole responsibility for determining the interest rate applicable to a particular transaction; and

(b) make consequent changes to the amount that can be charged for dealer fees, so that:

(i) lenders must set a maximum price for dealer fees that is based on a reasonable reimbursement of the costs associated with arranging a loan; and

(ii) intermediaries are prohibited from influencing or proposing the amount of the fee, where any benefit to that person increases or decreases based on an increase or decrease in the fee.

300 The prohibition would commence in approximately 18 months from the date of introduction, given the length of time that would be necessary for lenders to develop new pricing models and renegotiate commission arrangements with multiple car dealerships.

301 Introducing the changes through a legislative instrument would mean that the changes would:

(a) apply to all current licensees at the same time and to all future licensees, and so ensure competitive neutrality; and

(b) be subject to parliamentary scrutiny and also to disallowance under Pt 5 of the *Legislative Instruments Act 2003*.

Monitoring and reporting requirements

302 ASIC is concerned that there is a risk of avoidance and a substitution risk, where flexible pricing arrangements migrate to different parts of the transaction (noting that stakeholders have agreed that this is an issue that needs to be addressed if the integrity of the changes is to be maintained).

303 We therefore propose to monitor changes in this distribution channel by requiring lenders to report data to us. The nature of this reporting is likely to be along the following lines:

(a) the information would be at a global or portfolio level (rather than in relation to each individual contract);

(b) it would seek information on the range of interest rates offered, and the amount charged for dealer fees; and

(c) it would be done quarterly or half-yearly (depending on how often ASIC needs regular updates to respond to changes in the market).

304 This request for information would be introduced through specific requests to individual credit licensees, rather than under the terms of the legislative instrument. The terms of the request would be negotiated with lenders (possibly with the assistance of the AFC) so that it is targeted and straightforward to complete.

305 If any avoidance practices are identified it may be necessary for ASIC to respond by amending the legislative instrument, to ensure that it is effective in delivering the intended consumer benefits.

306 The transitional period of 18 months would provide a reasonable period of time to negotiate the precise content of the request and to enable ASIC to receive information before the prohibition commences. This would enable us to have a benchmark to measure changes against, and monitor the differences in consumer outcomes.

H Regulatory Burden and Cost Offset (RBCO) Estimate Table

307 Table 7 summarises the costs and benefits of the prohibition:

(a) costs to lenders and car dealers are estimated at $3,723,000 (see paragraphs 177–188); and

(b) benefits to consumers, through lower interest rates, are estimated at $44,928,000 (see paragraphs 200–210).

Table 7: Average annual compliance costs (from business as usual)

Costs ($m)	**Business**	**Community organisations**	**Individuals**	**Total cost**
Total by sector	$3,723	$	$	$3,723
Cost offset ($m)	**Business**	**Community organisations**	**Individuals**	**Total by source**
Agency	$	$	$18,105–$44,928	
Within portfolio	$	$	$	$
Outside portfolio	$	$	$	$
Total by sector	$	$	$	$
Proposal has costs offset? yes				
Proposal is deregulatory? no				
Balance of cost offsets $				$14,379–$41,201