ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 279

Flex commission arrangements in the car finance industry

March 2017

About this paper

This consultation paper seeks feedback on a draft legislative instrument (draft instrument) to prohibit the use of ‘flex commission’ arrangements in the sale of car loans to address the consumer harm resulting from this practice.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 3 March 2017 and is based on the National Credit Act as at this date.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. The draft instrument is provided for consultation on technical aspects only. The final version of the instrument may change as a result of the comments.

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The consultation process

You are invited to comment on technical aspects of our draft instrument to prohibit flex commission arrangements in the car finance industry: see Section B.

Your comments will help us finalise the instrument to ensure that it achieves its objective of addressing the consumer harm resulting from the use of flex commission arrangements in the sale of car loans.

Making a submission

You may choose to remain anonymous or use an alias when making a submission. However, if you do remain anonymous we will not be able to contact you to discuss your submission should we need to.

Please note we will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any personal or financial information) as confidential.

Please refer to our privacy policy at www.asic.gov.au/privacy for more information about how we handle personal information, your rights to seek access to and correct personal information, and your right to complain about breaches of privacy by ASIC.

Comments should be sent by Monday 27 March 2017 to:

FlexCommissions@asic.gov.au.

What will happen next?

Stage 1	3 March 2017	ASIC consultation paper released
Stage 2	27 March 2017	Comments due on the consultation paper Drafting of final instrument
Stage 3	April 2017	Final instrument released (with transitional period)

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A Prohibition on flex commission arrangements

Key points

Flex commission arrangements are a common form of commission in the car finance industry for remunerating intermediaries (e.g. car dealers and finance brokers).

Under these arrangements, the intermediary who sells the loan to the consumer is given a broad discretion to determine or recommend the interest rate for the loan, and earns a larger commission from the credit provider the higher the interest rate.

We consider that flex commissions create poor outcomes for consumers and that they operate in a way that is unfair under the *National Consumer Credit Protection Act 2009* (National Credit Act).

Following targeted consultation with lenders, car dealers and other stakeholders, ASIC is seeking feedback on a draft instrument to prohibit these arrangements, by using our powers to modify the National Credit Act.

How flex commissions operate

1 Lenders in the car finance industry use a form of remuneration called ‘flex commissions’ to pay their distribution network (primarily car dealers but also finance brokers).

2 Under these arrangements:

(a) the lender and the intermediary agree that the cost of credit is not fixed or specified according to objective criteria, and that a range of interest rates will be available to any consumer (from a base rate up to a prescribed maximum rate);

(b) the intermediary 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 the agreed base rate set with 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).

3 In a flex commission 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 or agreed minimum interest rate; and

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

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

The impact of flex commissions

5 Flex commissions can result in consumers paying significantly more in dollar terms. This is illustrated by a case study in which Consumer A is able to negotiate a loan at 7.99%, while Consumer B accepts a loan at a higher interest rate of 12.74%. Both consumers borrow $45,300.

6 One plan reviewed by ASIC would result in the following outcomes:

(a) Consumer A would pay $9,818 in interest charges, and the intermediary would receive only $453 in commissions.

(b) Consumer B would be disadvantaged as they would pay significantly more in interest charges ($15,212)—an extra $6,396–while the intermediary would receive $3,332 in commissions.

7 Table 1 sets out the difference in commissions for five additional transactions we reviewed, based on the amount payable under the base rate and the amount earned by the car dealer.

Table 1: 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	6.24%	13.04%	$346	$3,173
Consumer E	6.24%	8.99%	$209	$897

Source: ASIC

8 Table 1 demonstrates how, under these arrangements, compared to the amount payable if the contract was written at the base rate, intermediaries could earn commissions that were between:

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

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

9 We have also obtained data from some of the major lenders offering flex commissions to assess the extent to which consumers were charged higher interest rates. The data covered approximately 25,500 contracts written by seven lenders for May 2013. Our research found that about 15% of consumers (or approximately 3800 people a month) were charged an interest rate of 700 basis points or more above the base rate.

Note: The data from this month is considered typical.

10 In ASIC's view, a consumer who enters into a contract at 700 basis points or more above the base rate is likely to be financially vulnerable. If these consumers were price-sensitive and able to negotiate lower rates (as was the case with the remaining 85% of borrowers), there would be a much smaller percentage of contracts written at these higher rates.

Addressing the issue

11 ASIC considers that flex commissions operate unfairly because they:

(a) provide an incentive for intermediaries to increase the price of a credit contract in a way that can depend on the negotiating skills or vulnerability of the consumer; and

(b) create a risk of unfairness in any individual transaction.

12 As part of our review of this issue, we conducted two rounds of targeted consultations with key stakeholders, including industry bodies, lenders, car dealers and consumer groups: see Section C, Regulatory and financial impact.

13 Based on this review, we have decided to use our statutory power to modify the provisions of the National Credit Act through a legislative instrument to prohibit the use of flex commission arrangements: see Section B of this paper.

14 This means that the amount paid in commissions would not be linked to the interest rate and the lender would have the primary responsibility for determining the interest rate that applies to a particular loan.

15 We expect that the consequent development of more sophisticated pricing for risk models is likely to provide indirect benefits to lenders, including:

(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.

B Draft instrument to prohibit flex commission arrangements

Key points

We are seeking feedback on technical aspects of our draft instrument to prohibit flex commission arrangements in the car finance industry.

In particular, we are seeking stakeholders' views on whether any changes are needed to ensure the instrument achieves the intended outcomes.

ASIC Credit (Remuneration Arrangements) Instrument 2017/XX

Proposal

B1 We propose to modify the provisions of the National Credit Act by inserting a new section (s53) to prohibit the use of flex commission arrangements in the car finance industry, with a transitional period of around 18 months: see ASIC Credit (Remuneration Arrangements) Instrument 2017/XX in Attachment 1 to this consultation paper.

Your feedback

B1Q1 Would the prohibition as drafted apply to any unintended classes of transactions? If so, which ones?

B1Q2 Does the prohibition adequately address the risk of avoidance, or are there any ways in which its intended application could be circumvented? Should a specific anti-avoidance provision be included?

B1Q3 Are there other types of fees payable that are not credit fees or charges or consumer lease fees or charges and that should be included under s53(2)?

B1Q4 Should the instrument allow credit fees or charges or consumer lease fees or charges to be discounted, and if so should they be able to be discounted to $0?

B1Q5 Does the application of the instrument to consumer leases need to be varied because of their different legal structure?

B1Q6 Do you have any other feedback on technical aspects of the draft instrument?

B1Q7 What guidance (if any) would be helpful for industry in implementing and complying with the prohibition on flex commission arrangements?

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Rationale

16 As drafted, the instrument would operate in the following way:

(a) The prohibition would apply to all credit contracts and consumer leases regulated by the National Credit Act. While ASIC's market review has not identified any flex commission arrangements in other markets, the same policy considerations would apply, and so the prohibition should apply universally. Conversely, we consider that there would be a risk of avoidance if a narrower approach was taken and the prohibition was limited to specific classes of transactions (e.g. financing of cars).

(b) In relation to credit contracts, the prohibition would apply to the payment by a holder of an Australian credit licence of a benefit (including commissions) to another party (called a 'service provider') where the following two circumstances apply:

(i) the amount of the benefit is determined by reference to the annual percentage rate under the contract or the amount of any credit fees or charges; and

(ii) the annual percentage rate or the amount of the credit fees and charges has been determined, proposed or influenced by the service provider or an associated person.

(c) It would provide an exemption so that the service provider is not to be regarded as having determined, proposed or influenced the annual percentage rate or the amount of the credit fees and charges where this varies according to either:

(i) the type of car or goods being purchased or rented; or

(ii) the information forwarded by the service provider to the licensee in order for it to assess the application for credit.

(d) It would allow for the amount of the benefit to vary with a change in the annual percentage rate provided that it is only the result of a reduction in the interest rate by a maximum of 200 basis points: see s53(3). A licensee would still be able to offer additional discounts, but could not vary the benefit payable to the service provider.

17 The instrument would operate in a different way for consumer leases. We understand that flex commission arrangements do not currently operate in this sector. However, extending the application of the instrument to consumer leases would ensure regulatory neutrality and address the risk of arbitrage (e.g. intermediaries financing car loans through consumer leases rather than credit contracts if flex commissions were payable on leases).

18 The cost of a lease is not determined through the application of an interest rate. The prohibition would therefore prevent by reference to the total rental payable under the consumer lease, and applies where this amount can be determined, proposed or influenced by the service provider or an associated

person. No discounting would be allowed (given that this is not necessary to address current practices).

Flexibility for intermediary to reduce the interest rate

19 We recognise that car dealers should have a constrained discretion to discount the interest rate offered to the consumer (i.e. to a rate below that set by the lender).

20 Under the draft instrument, intermediaries would be able to reduce the interest rate by up to 200 basis points and receive a lower commission. Further discounting would be permissible, but only at the discretion of the lender (and without a reduction in commission). This would allow dealers to secure sales where this is contingent on being able to provide a reduction in the cost of credit. It would also avoid the onus being on consumers to regularly negotiate discounts where the discount could reduce the remuneration earned and therefore be more difficult to achieve (as would be the case if a higher level of discounting was allowed).

> Note: This is called 'reverse-flex' in that 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

Lenders to control amount charged for fee

21 We consider there is a risk that intermediaries may respond to a prohibition on flex commissions by arbitrarily increasing the amount currently charged in fees. Currently dealers commonly charge a fee to consumers for providing services in relation to arranging finance; these are usually described as 'dealer fees' or 'document fees'. The typical price range for these fees is $600–800, although it can be higher.

22 Under the draft instrument, lenders would be required to control the amount charged for these fees, and to ensure that the amount of the fees charged cannot be varied up or down for arbitrary reasons (to avoid a result where more financially sophisticated consumers pay lower fees).

Transitional period

23 We recognise the need to allow a reasonable period of time for lenders to develop different pricing models, with the interest rate linked to the risk of the individual transaction. Lenders and car dealers would also need to negotiate new commission models, and it is preferable for this to be done in a measured way.

24 The draft instrument sets a commencement date for the prohibition on flex commissions of 1 September 2018. In the interim, ASIC will monitor the interest rates set by lenders and identify which lenders are charging higher interest rates, with a view to considering whether further action is required.

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C Regulatory and financial impact

25 In developing the draft instrument, we have carefully considered its regulatory and financial impact. On the information currently available to us we think it will strike an appropriate balance between:

(a) addressing consumer harm from this practice; and

(b) allowing flexibility for industry to benefit consumers through a lower cost of credit.

26 In preparing the draft instrument, we have complied with the Australian Government's regulatory impact analysis requirements by:

(a) considering a number of different options, and the likely impacts of each option, including whether it would meet our policy objectives; and

(b) having a Regulation Impact Statement (RIS) approved by the Office of Best Practice Regulation.

27 The considerations addressed in the RIS include:

(a) the likely costs;

(b) the likely effect on competition; and

(c) other impacts, costs and benefits.

28 For more about our review of flex commission arrangements and the options considered, see the RIS in Attachment 2 to this consultation paper.