Target market determinations for small amount credit contracts

Report 754 | December 2022

About this report

This report summarises ASIC's work in a targeted review of compliance with the design and distribution obligations by some Australian credit licensees offering small amount credit contracts. It highlights areas for improvement to help small amount credit contract lenders to consider, review and improve their target market determinations.

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Overview

Small amount credit contracts are short-term, high-cost loans that can lead to debt spirals and over-indebtedness in financially vulnerable consumers.

Note: This issue has come to the attention of regulatory and government bodies: see the Revised Explanatory Memorandum to the Consumer Credit Legislation Amendment (Enhancements) Bill 2012, paragraph 4.7.

The design and distribution obligations, which commenced on 5 October 2021, require Australian credit licensees who offer small amount credit contracts (referred to as 'SACC lenders' in this report) to have a consumer-centric approach when designing and distributing these loans.

This report outlines our work during the pre-commencement and early stages of the DDO regime. It highlights improvements to SACC lenders' TMDs following ASIC's intervention. SACC lenders and providers of credit more broadly should consider this work when reviewing and formulating TMDs for their products.

The design and distribution obligations require an ongoing commitment from SACC lenders to make continued improvements and refinements to their TMDs, product governance arrangements and small amount credit contracts as they identify and respond to poor consumer outcomes resulting from these loans.

ASIC will continue to review TMDs, governance documents, and data collected by SACC lenders from their periodic and trigger reviews, and act where we see consumer harm that is not being addressed. Where we identify serious compliance failures, we will consider our full regulatory toolkit, including court-based enforcement action, disruption, and the DDO stop order power.

As at 6 December 2022, ASIC had issued 21 interim stop orders under s994J of the *Corporations Act 2001* (Corporations Act), where ASIC had concerns about compliance with the design and distribution obligations.

ASIC has also been carrying out work in the small amount credit space, to ensure that consumers who take out small loans are not being charged prohibited fees, noting the high cost of this type of credit.

Meeting the design and distribution obligations

What are the obligations?

The design and distribution obligations were introduced by the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* and commenced in October 2021.

To help industry prepare for these new obligations, ASIC:

- issued Regulatory Guide 274 *Product design and distribution obligations* (RG 274), and
- sent information on RG 274 to the SACC industry association for circulation to their members.

ASIC also met with individual SACC lenders and one SACC software provider to:

- discuss the scope and nature of the design and distribution obligations, and
- give high level feedback on draft TMDs before the obligations commenced.

What must issuers do?

To meet the design and distribution obligations, issuers of a financial product (including credit) must:

- determine the appropriate target market or class of consumers for whom the financial product is likely to be consistent with their likely objectives, financial situation and needs
- set out the target market, distribution conditions, and information relating to reviews and monitoring of the financial product in the TMD, and
- take reasonable steps to distribute the financial product only to consumers in that target market.

Issuers must also:

- monitor and review outcomes for consumers who have obtained the financial product, and
- consider whether changes to the product are required, the way it is distributed or to whom it is being provided (in particular, how the financial product performed for specific consumers and whether it resulted in poor outcomes for those consumers).

ASIC's observations

Given the focus of these obligations on the targeting and distribution of financial products, and the use of small amount credit contracts by financially vulnerable consumers, ASIC considers there should be a reduction over time in the level of lending to cohorts of consumers who are more at risk of financial harm from these loans.

This includes consumers who:

- are in a financial situation that indicates they are likely to default on a small amount credit contract
- enter a debt spiral where they repeatedly use these loans to supplement their income or meet everyday expenses, or
- have recently defaulted or made consistently late payments on other credit and debt commitments.

Having reviewed several SACC lenders' TMDs, we highlight the following areas of concern that lenders need to consider in meeting the design and distribution obligations for small amount credit contracts.

This is consistent with ASIC's guidance in RG 274 as noted in this report.

> Issuing and distributing financial and credit products now requires a consumer-first mindset. This means providers genuinely considering the likely objectives, financial situation, and needs of their consumers. These obligations are not a box ticking exercise, but a new page in the regulation of financial products in Australia.

Sean Hughes | ASIC Commissioner

Areas of concern

Specifying key attributes: SACC lenders must specify in their TMDs the details of the small amount credit contracts they provide (e.g. minimum and maximum amounts lent, and fees charged), and the repayment periods actually offered and any other features that would impact the product's suitability for a class of consumers.

Defining the target market: A target market based on broad descriptions (e.g. 'Consumers who need a loan for any legal purpose') is unlikely to meet the requirements to define a target market.

Identifying consumers in the target market: The use of objective and tangible parameters, such as minimum income levels or a limit on the number of other recent or concurrent small amount credit contracts by the consumer, is more likely to demonstrate that a SACC lender has appropriately defined their target market.

Excluding consumers from the target market: We expect SACC lenders will consider identifying groups of consumers who should be excluded from the target market of their small amount credit contract.

Setting review triggers: Review triggers should test for patterns or clusters of harm, and be specific and appropriate, with explicit review triggers that address high-risk consumer groups.

Notifying ASIC of significant dealings: SACC lenders should include a review trigger relating to the occurrence of a significant dealing.

Setting review periods: Review periods must be reasonable and based on the length of the small amount credit contract offered.

Improving target market determinations

Specifying key attributes

SACC lenders should set out in the TMD the key attributes of the small amount credit contract being offered.

The key attributes are the features and attributes of a product that affect whether the product is likely to be consistent with the likely objectives, financial situation and needs of consumers in the target market: see s994B(8) of the Corporations Act and RG 274, Key terms.

> 'The design and distribution obligations require an issuer of financial products to consider the design of its product (including its key attributes) and to determine an appropriate target market for the product, including whether one exists—that is, whether there is a class of consumers for whom the product, including its key attributes, would likely be consistent with their likely objectives, financial situation and needs.' (RG 274.8)

All TMDs we reviewed used the legislative definition of a small amount credit contract as the main definition of the key attributes of the product. In most cases, this is unlikely to properly describe the attributes of the actual loan issued by these lenders.

The features and attributes of the particular small amount credit contracts issued by the lender should be described in the TMD, including features such as the minimum and maximum loan amounts, repayment periods and the fees charged on those loans (including default fees).

The TMD must describe how these key attributes will be likely to be consistent with the likely objectives, financial situation and needs of consumers in the target market.

Improvement to TMD: Key attributes included

One TMD we reviewed described the key attributes of the small amount credit contract in a manner that closely mirrored the legislative definition, i.e. repayment periods of up to 12 months, establishment fee of 20%, monthly fee of 4%, and loan amounts from $300 to $2,000.

After ASIC intervention, the SACC lender updated their TMD to more directly reflect the particular loan offered, including repayment periods from 3 months to 12 months, establishment fee ranging from 6% to 20%, monthly fee from 2% to 4% (depending on the credit history of the customer), and loan amounts from $500 to $2,000.

Defining the target market

SACC lenders must describe the class of consumers that comprise the target market for the small amount credit contract: see s994B(5)(b).

This target market should be identified with sufficient granularity to enable the SACC lender to determine that the small amount credit contract is likely to be consistent with the likely objectives, financial situation and needs of an identifiable class of consumers in the target market: see RG 274.83.

All small amount credit contract TMDs we reviewed included descriptions of target markets. However, some used descriptions that were too broad to be meaningful such as 'Consumers who need a loan for any legal purpose'.

A broad consumer class (as in the example above) is unlikely to be sufficient to define the target market for such loans. This is because a target market based only on a broad objective or preference is unlikely to be specific enough for the SACC lender to reasonably conclude that the small amount credit contract (including its key attributes) would likely be consistent with the likely objectives, financial situation and needs of consumers in the target market: see RG 274.84.

A SACC lender who has a broad description of the consumer class as their target market is also at risk of including consumers who should not be in that target market (including high-risk consumers such as those who have repeat loans, or those who are at risk of being in a worse financial position as a result of receiving a small amount credit contract).

Identifying consumers in the target market

Some SACC lenders demonstrated better insight into their target market by using more specific attributes, such as minimum income levels, to describe consumers in the target market.

If the target market has an income level floor, SACC lenders must have a reasonable basis for expecting that consumers on that income can pay such a loan back, and not be in a position where they have to take out repeat loans.

The following may help SACC lenders in setting the minimum income level:

- publicly available data on the national minimum wage published by the Fair Work Ombudsman or the poverty line from the Henderson Poverty Index,
- reviews of the data held by the SACC lender of the income level of consumers who have taken out these loans previously, and
- consideration of whether poor consumer outcomes, such as higher levels of default or extended repayment periods, may have occurred at particular income levels.

In addition, it is unlikely that a target market will be appropriate or reasonable if it includes consumers whose income is below the minimum wage at a level:

- indicating that the consumer will be living in poverty, or
- where the SACC lender's data demonstrates consumers have consistently been unable to pay back such a loan according to its terms.

Excluding consumers from the target market

In some cases it will be simpler or even necessary in meeting the requirements in s994B(5) and (8) to define the target market as excluding some classes of consumers: see RG 274.85.

SACC lenders should consider the nature and degree of harm that might result from issuing small amount credit contracts to consumers who have had poor outcomes with these loans in the past: see RG 274, Table 3.

Some examples of exclusions might be consumers who have had several of such loans (e.g. 'No more than three loans to the same customer within a 12-month period'), consumers who have very low incomes (e.g. consumers on welfare payments such as Newstart), or consumers who intend to use the funds for purposes that are not appropriate or have a high risk of financial harm (e.g. to pay existing debt obligations or for gambling purposes).

Improvement to TMD: High-risk consumers excluded

A TMD reviewed by ASIC contained no information about consumers who the small amount credit contract was *not* suitable for, or were outside the target market, despite this information being on the SACC lender's website.

After ASIC intervened, the SACC lender updated the TMD to provide details of consumers who are outside the target market, including:

- consumers who are solely reliant on Centrelink benefits such as Newstart or Parenting Payments
- consumers who gamble excessively and make inconsistent repayments on existing credit facilities, and
- consumers looking to refinance existing loans into a new loan.

Setting review triggers

SACC lenders must specify review triggers: see s994B(5)(d). Review triggers are events and circumstances that would reasonably suggest that the TMD is no longer appropriate. They are a prompt to stop distributing the small amount credit contract until the TMD is reviewed: see RG 274.102.

Review triggers that are specific, appropriate, and based on objective measure such as a level or rate of change that suggests there is a need for a review will help SACC lenders ensure the TMD is likely to be consistent with consumers' likely objectives, financial situation and needs.

Review triggers relating to defaults and financial hardship are particularly relevant for small amount credit providers as consumers acquiring these products are more likely to be at risk of being in financial stress.

The lack of a review trigger around default and hardship requests means SACC lenders are not monitoring data they hold about the rate or level of these events, or circumstances, to adequately test if the product is being distributed outside its target market.

Review triggers that are set at a level—or based on a rate of change in complaints or default rates, for example—that is unlikely to be reached will not demonstrate the SACC lender is taking reasonable steps to ensure consistency with the TMD as required under s994B.

Improvement to TMD: More appropriate review trigger set

A TMD reviewed by ASIC stated that the SACC lender would review the TMD *'If the total number of hardship applications is greater than 20% of the total number of loans entered into in the previous quarter'*.

After ASIC raised concerns that this may be an inappropriate level for the review trigger, the SACC lender reviewed data on hardship applications for the previous 12 months and updated the trigger in the TMD to 3% to reflect a more appropriate and realistic proportion of hardship applications.

Testing for patterns or clusters of outcomes

Review triggers should not just be based on aggregate data, but should also test for patterns or clusters of outcomes that suggest the TMD should be reviewed. For example, defaults in payments that occur shortly after the small amount credit contract is entered into, or hardship requests that are made within the first month or two after such a loan is provided, are likely to be strong indicators of the need for a review.

Similarly, if a SACC lender includes financially vulnerable consumers in their target market (e.g. consumers who already have such loans or other debts), different review triggers are needed for those high-risk groups to ensure that loan is meeting their likely needs, objectives and financial situation. For example, the default rate on such loans to consumers receiving Centrelink benefits may be high enough to trigger a review, even though the overall default rate across all loans is relatively low.

Some SACC lenders included review triggers in their TMDs that were not specific enough to determine when a review of the TMD would be triggered. For example, a TMD that describes a review trigger as a 'significant' number of complaints does not give sufficient clarity to the SACC lender about when the trigger is reached: see s994C(4).

Generally, SACC lenders stated that their product is for short-term or unforeseen expenses that cannot be met from regular income. SACC lenders who include consumers who are repeat borrowers in their target market (noting this is a high-risk group) need to test whether the product is being provided consistently with this purpose, given that repeat use may indicate consumers are using the loans to meet regular expenses.

SACC lenders who ignore relevant data about outcomes for a high-risk consumer group (including the number of small amount credit contracts the consumer is entering into) are likely to breach the appropriateness and/or review requirements.

Notifying ASIC of significant dealings

SACC lenders must give written notice to ASIC of a significant dealing in a small amount credit contract that is not consistent with the TMD as soon as practicable, and in any case within 10 business days after becoming aware of the issue: see s994G.

ASIC expects SACC lenders to include a review trigger relating to the occurrence of a significant dealing in their TMDs: see RG 274.105.

In our review, where we identified a TMD without this review trigger, we required the SACC lender to update their TMD accordingly.

While 'significant dealing' is not defined in the legislation, we expect the actual or potential harm to consumers, including the amount of any financial loss, resulting from consumers who are not in the target market acquiring the small amount credit contract, will be relevant for SACC lenders when determining whether a significant dealing has occurred: see RG 274.159.

Setting review periods

Most SACC lenders nominated an initial period of one year to review the TMD. When establishing a review period, SACC lenders should consider the average repayment period of the small amount credit contract they are offering, noting the law requires that review periods are reasonable in the circumstances: see s994B(5)(e)–(f) and RG 274.108.

SACC lenders who offer shorter term small amount credit contracts of less than a year may need to undertake, for example, six-monthly reviews to satisfy themselves that the TMD remains appropriate. Otherwise, a review at least once a year is likely to be sufficient.

Improvement to TMD: More appropriate review periods set

A TMD ASIC reviewed for a small amount credit contract with a repayment period of 12 months stated that an initial review would occur two years after the TMD was introduced and then subsequently every two years.

After ASIC intervened, the TMD was updated to reflect the initial review being undertaken after six months, and subsequent reviews at 12-month intervals.

Key terms and related information

Key terms

Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
credit licence	An Australian credit licence under s35 of the National Credit Act that authorises a licensee to engage in particular credit activities
credit licensee	The holder of an Australian credit licence
design and distribution obligations (DDO)	The obligations contained in Pt 7.8A of the Corporations Act
distributor	A 'regulated person', as defined in s994A(1) of the Corporations Act **Note:** An issuer can also be a distributor.
issuer	A person who is subject to the TMD requirements in s994B (including sellers in a regulated sale situation), unless indicated otherwise
National Credit Act	*National Consumer Credit Protection Act 2009*
RG 274 (for example)	An ASIC regulatory guide (in this example, numbered 274)
SACC lender	A credit licensee who provides small amount credit contracts
s994E (for example)	A section of the Corporations Act (in this example numbered 994E), unless otherwise specified
small amount credit contract	Has the meaning given in s5 of the National Credit Act
target market	The class of consumers described in the TMD for the product under s994B(5)(b) of the Corporations Act
target market determination	Has the meaning given in s994B of the Corporations Act
TMD	A target market determination document

Related information

Headnotes

Credit provider, design and distribution obligations, lender, small amount credit contract, target market determination

Legislation

Corporations Act 2001, s994A(1), 994B, 994C(4), and 994G

National Consumer Credit Protection Act 2009, s5 and 35

Revised Explanatory Memorandum to the Consumer Credit Legislation Amendment (Enhancements) Bill 2012

Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019

ASIC documents

RG 274 *Product design and distribution obligations*