

Independent Review of Code of Banking Practice

Submission by Credit Corp Group Limited (Credit Corp)

22 August 2016

Executive Summary

Credit Corp recommends the removal paragraph 32.3 of the Code of Banking Practice (the Code). The paragraph prevents debt sale in circumstances where an Australian Bankers' Association (ABA) member is considering a hardship application or where a consumer is complying with a previously agreed hardship arrangement.

Debt sale is acknowledged as an important part of the consumer credit market infrastructure which allows ABA members to extend more credit at lower prices. Accordingly, any limitations on its availability should be subject to appropriate scrutiny and questioning.

Paragraph 32.3 is anomalous and is inconsistent with the objectives of the Code. Unlike every other provision of the Code, the paragraph does not specify a standard of practice for the provision of a product or service, but rather specifies how a service is to be provided. ABA members should be free to use efficient service providers, such as debt purchasers, to provide hardship services to customers in the same way that they are free to make decisions about how any service is provided.

Paragraph 32.3 was inserted into the Code in 2013 in the belief that it would produce superior outcomes for consumers experiencing financial hardship. Credit Corp submits that this belief is no longer valid for the following reasons:

- It implicitly misconceives of debt sale as a divestment transaction rather than a form of outsourced service provision.
- The paragraph was inserted at a time when the advantages debt purchasers have in dealing with consumer hardship were not fully appreciated and the favourable hardship outcomes being delivered by debt purchasers were not as apparent as they are today.
- Regulatory developments since the paragraph was inserted into the Code have served to magnify the advantages of debt sale in producing better hardship outcomes for consumers.

Credit Corp recognises that there may be objections to selling hardship accounts to some debt purchasers with poorer reputations or track records of non-compliance. This, however, is not a justification to prohibit sale altogether. ABA members are cognisant of the importance of customer experience and its impact on their reputations. ABA members are sophisticated organisations with the tools and capabilities to assess and monitor all their service providers, including debt purchase partners, and can make sound decisions without the need for mandatory limitations on their operational structure.

The removal of paragraph 32.3 will enable ABA members to expand their use of debt sale to both extend more credit at lower prices and improve the experience of customers in financial hardship.

Company Profile

Credit Corp is Australia's largest provider of sustainable financial services to the credit impaired consumer segment. The company has been listed on the Australian Securities Exchange since 2000

and forms part of the S&P ASX 200. Credit Corp employs 1,000 Australians and the face value of its total receivables is \$5.5 billion across 800,000 consumers.

Credit Corp is the largest purchaser of charged-off debts from ABA members and has a proven track record of promoting financial inclusion through superior consumer hardship management.

In our core business of debt purchasing we work with consumers who have, for various reasons, found themselves in default of their credit obligations. We agree affordable repayment plans with our customers and improve their credit standing over several years as a pathway to financial inclusion. We maintain the most successful hardship program in the industry with a current portfolio of \$1.2 billion of defaulted consumer credit obligations, restructured into sustainable repayment arrangements across 150,000 individual customer accounts. Payments received pursuant to these voluntarily agreed hardship plans comprise 78% of Credit Corp's total monthly collections.

Credit Corp has an impeccable compliance record. Despite being the largest and longest-established debt purchaser in Australia, we have never been the subject of a regulatory order or undertaking. We have one of the lowest rates of External Dispute Resolution (EDR) complaints in the industry and have never incurred a reportable systemic issue. We work cooperatively with consumer advocacy groups on matters of industry concern and have a long term partnership with Kildonan Uniting Care.

Debt sale is important for banks, consumers and the economy

Debt sale is one of the most effective and efficient means for dealing with credit arrears and serves to reduce the price of credit for all consumers and promote its availability to the widest possible group of people. The national financial services regulator in the United States of America, the Consumer Financial Protection Bureau, recently acknowledged the industry as a *'critical part of the consumer credit market infrastructure'* which allows *'creditors to extend more credit at lower prices'*.¹

Debt sale achieves these economy-wide benefits by providing an immediate and superior return on otherwise fully-impaired assets held by ABA members. Debt purchasers are single purpose businesses operating very efficient and competitive business models which pass on these efficiency benefits to ABA members in the form of strong prices for charged-off consumer debts. The cash equity received through debt sale is combined with gearing by ABA members and lent back into the economy.

In addition to recycling otherwise impaired capital debt sale reduces general loss provisions, further increasing the pool of capital available for lending and enhancing the efficiency of ABA member balance sheets. Debt sale reduces the Loss Given Default ('LGD') used in provisioning calculations with the debt sale price serving as the minimum return on any projected defaults.

Any limitation on the pool of credit subject to debt sale results in larger impairments, lower and less timely cash inflows as well as higher provisioning. Such limitations reduce the ability of ABA members to extend more credit at lower prices. Accordingly, limitations on debt sale should be subject to appropriate scrutiny and questioning.

Paragraph 32.3 of the Code is an anomaly

One such limitation on debt sale appears at paragraph 32.3 of the Code. This paragraph prevents debt sale in circumstances where an ABA member is considering a hardship application or where a consumer is complying with a previously agreed hardship arrangement. Paragraph 32.3 of the Code is an anomaly and should be removed.

Paragraph 32.3 is anomalous and is inconsistent with the objectives of the Code. Unlike every other provision of the Code, the paragraph does not specify a standard of practice for the provision of a product or service, but rather specifies how a service is to be provided. ABA members should be free to use efficient service providers, such as debt purchasers, to provide hardship services to customers in the same way that they are free to make decisions about how any service is provided. The focus of the Code must be on setting the standards of service provision, not on placing unreasonable and inefficient limitations on the operational structure of members to produce uncompetitive outcomes which are to the detriment of all consumers.

Debt sale produces positive hardship outcomes for consumers

Paragraph 32.3 was inserted into the Code in 2013 in the belief that it would produce superior outcomes for consumers experiencing financial hardship. Credit Corp submits that this belief is no longer valid for the following reasons:

- It implicitly misconceives of debt sale as a divestment transaction rather than a form of outsourced service provision.
- The paragraph was inserted at a time when the advantages debt purchasers have in dealing with consumer hardship were not fully appreciated and the favourable hardship outcomes being delivered by debt purchasers were not as apparent as they are today.
- Regulatory developments since the paragraph was inserted into the Code have served to magnify the advantages of debt sale in producing better hardship outcomes for consumers.

Misconception of the debt sale relationship

The basis for paragraph 32.3 of the Code reflects a misconception of debt sale as a divestment transaction rather than a form of outsourcing.

Debt sale contracts exhibit the features of outsourced service provision rather than asset divestment. Most debts are sold pursuant to forward flow contracts which create an ongoing partnering relationship whereby debts are transferred on a monthly basis over periods of up to two years. The contracts contain substantial ongoing conduct obligations and restrictions imposed on the purchaser, which are supported by warranties, indemnities and other potential penalties. These conduct obligations deal with matters such as ongoing compliance with laws, codes, guidelines, data security, principles of fairness and policy directives of the seller. There are ongoing reporting obligations for matters including breaches, complaints and the identification of customers in sensitive circumstances. There are provisions for extensive auditing, on-site visits and regular review meetings to share emerging issues. Sellers retain substantial discretion to recall individual customer accounts at any time. These contractual elements create an outsourcing relationship granting the seller with substantial control over the ongoing conduct of the purchaser and the experience of individual customers.

It is Credit Corp's experience that ABA members exercise vigilance in their supervision of debt purchasers. Members apply their contractual rights to receive reporting and regularly conduct detailed on-site audits to monitor compliance. Members do recall individual customer accounts. From time to time members identify problems with certain debt purchasers and discontinue debt sale relationships in the same way they might terminate any underperforming service provider or non-compliant staff person. Members are in a constant dialogue with debt purchasers over emerging compliance and customer experience matters to proactively manage future issues.

Debt purchasers have responded by increasingly professionalising to meet the standards being set by ABA members. Several purchasers are ASX listed and have developed strong records for

compliance and sustainability in their own right. These larger operators are motivated not only to meet the conduct expectations of ABA members but also to enhance and protect their own positive reputations.

Advantages of debt sale in delivering positive hardship outcomes

Debt purchasers are specialists in dealing with and managing hardship. Unlike ABA members, debt purchasers almost exclusively interact with consumers in some form of financial hardship. Debt purchasers do not establish separate hardship teams and do not need to implement protocols and systems to identify hardship so that consumers can be forwarded to an internal specialist team. Rather, debt purchasers proceed on the basis that every customer is in hardship. This means that every consumer receives an empathetic and understanding experience designed to reach mutual agreement on a sustainable repayment arrangement.

Debt purchase business models are uniquely suited to the promotion of affordable and flexible long-term payment arrangements which most effectively respond to consumer hardship. Debt purchasing involves the assignment of permanent tenure to defaulted loans at prices which represent a substantial discount to the face value outstanding. These two features of debt sale allow debt purchasers to agree longer-term payment arrangements with lower and more affordable repayments. Permanent tenure allows the debt purchaser to take a patient approach to understanding a consumer's circumstances. The discounted purchase price paid by the debt purchaser relieves the pressure to deliver immediate lump sums to avoid impairment charges and allows the purchaser to be flexible by reducing or waiving interest and other charges. The biggest cost faced by a debt purchaser relates to staff and a big driver of staff costs is delinquency management on payment arrangements. The best way to minimise the cost of delinquency management is to properly understand each consumer's circumstances up-front so that agreed payment arrangements are affordable and sustainable.

Debt purchasers' focus on working constructively with consumers has led debt purchasers to take steps to improve their interaction with consumers experiencing financial difficulty. In particular, Credit Corp has worked with Kildonan Uniting Care over several years to develop programs to promote respectful customer engagement across its business. This has helped deliver both strong business outcomes, in facilitating a large book of ongoing repayment arrangements, and an improved customer experience.

The inherently flexible and patient features of the debt purchasing business model in dealing with consumer hardship can be contrasted with the pressures faced by ABA members and their agents. For ABA members the financial reporting imperative is to minimise impairments and this is achieved if immediate payments can be received to cure any arrears by making up all missed payments pursuant to the original credit contract. Once arrears proceed past the point where the debt is subject to a full specific loss provision, generally at 90 days past due, the imperative shifts to the receipt of lump sums to help offset the impact of the provision. Third party collection agents will commonly receive debts at 90 days past due and will often retain debts for just three months. In order to maximise commission revenue the agent will be motivated to collect immediate lump sums before the expiry of their limited tenure over the debt. The imperative to avoid specific impairment provisions and receive lump sums creates short-term time pressures and a motivation to receive amounts which may be unaffordable for the consumer in financial hardship.

While debt purchasers are not subject to the same pressures as ABA members, debt purchasers are subject to the same laws, codes and controls in respect of consumer hardship. Debt purchasers are subject to all the relevant provisions of the National Consumer Credit Protection Act 2009 (NCCP)

together with any delegated regulation and regulatory guides that apply to ABA members. Debt purchasers are required to hold an Australian Credit Licence (ACL), which involves mandatory membership of an Australian Securities and Investments Commission (ASIC) approved External Dispute Resolution (EDR) scheme. Importantly, if consumers are dissatisfied with a hardship outcome the matter can be escalated to EDR for a determination. Furthermore, a systemic failure to properly respond to consumer hardship can lead to sanctions by the EDR scheme and ASIC.

In addition to compliance with laws and guidelines, debt purchasers are also required to act in conformance with the ABA Code. Debt purchase agreements with ABA members impose a contractual obligation on debt purchasers to comply with the Code.

Credit Corp's statistics demonstrate the strong hardship outcomes that can be delivered by debt purchasers and show how positively responding to hardship has increasingly become a defining feature of the debt purchaser's business model. As noted above, Credit Corp presently has \$1.2 billion of defaulted consumer credit obligations, restructured into sustainable repayment arrangements across 150,000 individual customer accounts. Payments received pursuant to these voluntarily agreed hardship plans comprise 78% of Credit Corp's total monthly collections. This contrasts with the position in 2008, prior to the NCCP, where Credit Corp had only \$0.3 billion of defaulted credit obligations restructured into repayment arrangements across just 42,000 customer accounts comprising only 54% of total monthly collections.

In addition to the above statistics Credit Corp frequently receives strong positive feedback from stakeholders on its approach to consumer hardship. This feedback has been received from financial counsellors, EDR schemes and consumer advocates. At different times Credit Corp has participated in panel sessions at industry events with ABA members, where financial counsellors have suggested that ABA members should sell their hardship accounts to Credit Corp.

Recent regulatory developments favour debt sale as a hardship solution

The pressures on ABA members have only been exacerbated over time, with regulatory developments since the introduction of paragraph 32.3 of the Code making the effective management of hardship increasingly problematic for ABA members.

Since 2013 the Australian Prudential Regulation Authority (APRA) has issued guidance and undertaken increased monitoring of the process of re-ageing accounts by ABA members. Re-ageing refers to the practice of assessing the arrears status of accounts in accordance with the most recently agreed variation in repayment obligations. Over recent years APRA has definitively required that ABA members determine the arrears status of accounts with respect to repayment obligations pursuant to the original credit contract, ignoring any alterations pursuant to an agreed hardship variation. This has created a divergence between hardship practices and the recognition of impairments, which has served to increase the imperative for ABA members to receive lump sums and potentially unsustainable repayments.

Also since 2013 accounting standard AASB 9 has been re-issued. While certain elements of the standard won't be mandatory until 2018, ABA members will already be mindful of its impact on impairments and loss provisioning. The standard mandates that provisioning takes account of projected impairments expected to be incurred over the following 12 months and, in certain circumstances, over the remaining term of any loan. This development will exacerbate the divergence mentioned in the preceding paragraph and make it increasingly difficult for ABA members to deliver good consumer hardship responses.

Importantly, debt purchasers are unaffected by the preceding developments. Debt purchasers are not subject to prudential regulation, giving them ultimate flexibility in responding to consumer hardship. Furthermore, the discounted amount paid for debts acquired by debt purchasers already takes into account any past or future impairment of the face amount outstanding from the consumer. This removes the time, capital and financial reporting pressures from the dialogue with consumers. Debt purchasers are able to exercise patience and flexibly work with consumers over an extended period through an affordable repayment plan.

Amendments to the hardship regulation itself have also made the management of hardship more difficult for ABA members. At the time paragraph 32.3 was being conceived hardship identification was triggered by a formal written application from a consumer. It can now arise in any verbal discussion between a staff member and a consumer and in circumstances where the request for hardship may only be implicit rather than explicit. This has made the identification of hardship for referral to an internal specialist team more difficult for ABA members to execute. Debt purchasers do not face the same challenge because, as noted above, debt purchasers treat every customer interaction as a hardship dialogue.

Solution

Credit Corp recognises that there may be objections to selling hardship accounts to some debt purchasers with poorer reputations or track records of non-compliance. This, however, is not a justification to prohibit sale altogether. ABA members are cognisant of the importance of customer experience and its impact on their reputations. ABA members are sophisticated organisations with the tools and capabilities to assess and monitor all their service providers, including debt purchase partners, and can make sound decisions without the need for mandatory limitations on their operational structure.

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ⁱ Consumer Financial Protection Bureau Small Business Review Panel for Debt Collector and Debt Buyer Rulemaking, 'Outline of Proposals under consideration and alternatives considered', July 28 2016, p 1