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ASIC's inquiry into flex commissions and its impact on automotive finance industry

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Introduction

There is an increasing level of regulation around the provision of finance to motor vehicle consumers, with the Australian Securities and Investments Commission (ASIC) currently reviewing commission arrangements in the car finance market, a review which has been ongoing for a number of years.[1] There remains a focus on enhancing regulation in the automotive industry, which has seen the Australian Government consult[2] on the continued scope of the point of sale (POS) exemption for car dealers, exempting them from holding an Australian credit licence (ACL) under the National Consumer Credit Protection Act 2009 (Cth) (NCCP), and the suggested prohibition on financiers paying motor dealers commissions that are funded by the borrower and capitalised into the loan or that vary depending on the interest rate payable under the finance contract. In particular, this article focuses on what appears to be one of ASIC's priorities, being the payment of what has been termed "flexed commissions" to automotive dealers. In basic terms, flex commissions are commissions that are set by virtue of the consumer's end interest rate, which is set by the dealer. This article describes ASIC's key review focus on commissions, the likely outcomes and resulting consequences for the automotive and finance industries and their legal advisors.

Background — POS exemption in the automotive dealer context

With the introduction under the NCCP of the requirement for persons who engage in credit activities to hold an ACL or otherwise be authorised,[3] automotive dealers that arrange finance with a lender or lessor in connection with the provision of sale of motor vehicles are engaging in credit activities and would ordinarily need to obtain an ACL and meet NCCP obligations, including responsible lending requirements.[4] However, the government decided that vendor introducers such as car dealers would be exempt from the NCCP, pending a review of the sector. The exemption was effected through the National Consumer Credit Protection Regulations 2010 (Cth)[5] and is generally referred to as the "POS exemption".[6] At the time, the legislators intended that the POS exemption be an interim position for 12 months to allow the government to consider the market and processes in greater detail.[7]

Potential regulatory gaps in POS exemption

Despite the interim intention of the exemption, POS is still heavily relied upon in the automotive finance industry to sell finance to purchasers of motor vehicles. Given the nature of the POS exemption, it applies to car dealers even where the dealer may have a significant role in product selection, including when the dealer is acting in a similar role to finance brokers who are required to hold an ACL.[8] On this basis, concerns have been raised that the exemption results in distinct consumer and competitive disadvantages[9] and regulatory gaps regarding the conduct of exempt car dealers. With economic pressure on dealerships to maximise profits when selling cars at a loss or break-even price, car dealers could be compelled to earn more profit on the transaction through the finance commission and the sale of additional items such as insurance.[10]

In circumstances where POS vendors are not compelled under NCCP to hold membership with external dispute resolution bodies, there is concern that there are limitations on the consumer's ability to access remedies for the conduct of dealers arranging their finance. Further, consumers who opt to use POS finance may be likely to approach the finance decision as an incidental matter once the primary decision to purchase has been made, potentially causing consumers to make decisions on basis of convenience and not price and product.[11]

At the heart of ASIC's concern is automotive dealerships who have arrangements with financiers to receive flex commissions, in which the higher the interest rate above the base rate, the greater the commission earned by the dealership. This presents a concern to ASIC that such arrangements can influence the way a dealer selects an interest rate, and could encourage them to earn more by selecting a higher interest rate in conflict with the interests of the consumer. Flex commissions can also result in the terms of the contract being settled by the dealer, by first determining the maximum amount of repayments the consumer can afford, and then proposing an interest rate that will result in that level of payments.

This may result in the consumer being provided with finance they cannot afford, or which would be unsuitable under the NCCP.[12]

In addition, there is an added layer of financial benefits that a dealer could receive from financiers which increases according to the volume of business placed with the financier through volume bonus or offset arrangements, which could potentially result in further conflicts of interests between the dealer's own interests and those of the consumer.

Given POS finance dealers are not required to be licenced, they do not have to meet any of the requirements that apply to other ACL holders undertaking similar activities, and any dealer who engages in misconduct or proceeds even where conflicts of interest are present, cannot be excluded from the industry by ASIC.[13]

ASIC's focus on automotive finance and commissions

ASIC's review of the POS exemption and commission arrangements in the car finance market has been ongoing for some years, with a discussion paper on POS being released by the Treasury as early as January 2013 (January 2013 paper).[14] Despite the January 2013 paper, the POS exemption remains in force, however is still very much on ASIC's radar. Then in August 2014, in *Financial System Inquiry Interim Report: Submission by the Australian Securities and Investments Commission*[15] (FSI Interim Report), ASIC provided car financing and flex commissions as example of how it might use broader intervention power. ASIC said in the FSI Interim Report that flex commissions create an incentive to supply car finance at higher interest rates to consumers, an example of a market that is characterised by supply-side competition with "significant conflicts of interest" for intermediaries. The FSI Interim Report went on to describe how:

> If ASIC were able to apply broad intervention powers to address this situation, we could, for example, seek to prevent flexible commissions from operating or apply a cap on the commission payments payable to dealers by financiers.[16]

December 2015 ASIC proposal

In December 2015, ASIC notified the automotive industry of its proposal to ban flex sales commissions on car finance and eliminate origination fees for dealers on car loans. It is clear that ASIC would like to see consumer interest rates being set by the financier and not the car dealer, to avoid the evident conflict of interest and potentially unfair interest rates for consumers. ASIC did not, however, suggest that all commissions would be banned as a result of their review. ASIC's proposal to eliminate origination fees was said to prevent finance companies and dealers from substituting flex commissions into the origination fees.[17]

ASIC gave the automotive industry until 29 January 2016 to respond and 18 months to make the transition should the government agree with their proposals. Industry executives who have seen the December 2015 paper say that ASIC has taken the view that car finance companies and car dealers have for years been systematically breaching the NCCP by charging flex commissions which are based on the interest rate charged on each car loan. The higher the interest rate, the higher the commission; ASIC takes the view that this creates consumer harm due to uncompetitive interest rates and conflicts of interest for dealers.[18]

February 2016 ASIC reports

Two further examples of ASIC's keen focus on the automotive finance industry and following ASIC investigation into the purchase of add-on insurance by consumers purchasing motor vehicles through dealerships authorised under Australian financial services licence (AFSL) holders, are two reports released by ASIC in February 2016, titled "*Buying Add-On Insurance in Car Yards: Why it can be hard to Say No*"[19] (Add-on Insurance Report) and "*The Sale of Life Insurance Through Car Dealers: Taking Consumers For a Ride*"[20] (Life Insurance Report).

ASIC is critical in these reports of add-on insurance and in particular, life insurance products sold through car dealerships. ASIC expresses concern about the potential for an unfair climate for consumers, where dealers are given strong commission incentives to up-sell insurance to consumers, which can sometimes be more profitable for dealerships than the motor vehicle being sold. According to ASIC, there is a lack of transparency and training standards in the sale of life insurance through dealerships.[21]

ASIC found that most consumers were not prepared or knowledgeable about add-on insurance products before going to a dealership, which were offered at a point in the sales process where consumers were generally exhausted and felt pressured by sales staff, with many consumers not remembering the products they purchased and at what price.[22] It also formed a view that insurers charged consumers substantially more for car yard life insurance than for ADI-distributed[23] life insurance and, among other things, that life insurance is sometimes sold to young consumers who are unlikely to need it and may not have wanted the product in the first place.[24]

As a result of the reports' findings, ASIC will take a number of steps to ensure consumers get value from car dealership life insurance, including supervision and monitoring of insurers and their authorised representatives, and considering taking enforcement action against individual insurers, review of training standards and requiring more detailed disclosure to consumers.[25] Building on their February reports, on 12 September 2016, ASIC released Report 492,[26] putting insurers on notice to address serious failures in the sale of add-on insurance through car dealers.[27]

June 2016 ASIC proposal

On the topic of flex commissions, ASIC had detailed discussions with automotive dealerships in June 2016[28] (June 2016 proposal), during which sought further views from stakeholders on introducing a prohibition on flex commission arrangements. ASIC sought responses from industry and representatives by 27 June 2016.[29] Despite comprehensive submissions from the automotive industry in response to ASIC's initial discussion paper, it appeared that ASIC had not moved from its stance on flex commissions in the June 2016 proposal.[30] The Australian Automotive Dealer Association summarised ASIC's major issues to include a continued view that flex commissions create an inherent risk of unfair conduct with the potential for negative impact on vulnerable consumers. It is ASIC's view that even a small gap between the base rate and the maximum interest rate causes financial harm to consumers, and there is further risk of origination fees being unfairly increased which would not be addressed simply by additional disclosures to the consumer.[31]

ASIC's proposed future action

The automotive and banking and finance industries are currently waiting for ASIC's announcement on automotive commissions, but it is expected that ASIC will propose a prohibition on flex commissions. In 2016, ASIC indicated that a ban could commence as early as 1 February 2018 with a transition period of 18 months. This aggressive timeline appears unlikely, however once imposed it is expected that during the transition period, ASIC will require interest rates to be set at no more than 150 basis points above the base rate. ASIC is preparing to address its concerns through a "legislative instrument" under the NCCP, which are subject to parliamentary oversight, but has acknowledged that its proposed changes will not affect novated leases and other commercial lending arrangements.[32]

Automotive industry impacts

ASIC's review and a ban on flex commissions will have a significant impact on the way car dealers continue to conduct business car finance operations.[33] Under the proposed ASIC model, the dealer will not be permitted to price for risk as banks do, which could result in dealers pushing back on car buyers who will no longer qualify for finance or are higher risk (for example, people with marginal credit records). The Motor Trade Association of WA, for example, "categorically reject[s] the proposal for the prohibition or limitation of finance incentives in the retail car market", according to its CEO, Stephen Moir.[34]

Some senior industry executives even predict that ASIC's intervention in how dealers recover commissions on finance could result in the new-car dealership closures, job losses and less new-car sales, with car sales being significantly done in some states, such as Western Australia, where industry already has enough pressure without a change in flex commission regulation. At the extreme, some in the industry argue that ASIC's proposed changes could force some consumers into used cars at considerably higher costs, which will disadvantage those consumers.[35]

Some in the industry are concerned that ASIC is targeting legitimate dealers without sufficient evidence of harm to customers, which has been described by Mr Moir as being akin to taking "a wrecking ball to a system which basically works" and may have "potential devastating impact[s] on businesses" when they should be focusing on driving new-car sales up.[36]

There is one view in the automotive industry that any move by ASIC to ban flex commissions under NCCP Regulations, rather than by an Act of Parliament, could also prompt a response from the banking and finance institutions to have the matter tested in court. Of interest to banking and finance lawyers might be the risk to lenders that a ban on car dealers and car finance companies charging interest rates that reflect risk, could be broadened by ASIC at the stroke of a pen to the entire Australian banking and finance industry. Essentially, what industry wants and needs is more structure and detail around what ASIC would like to achieve, other than an outright ban on flex commissions and origination fees.[37]

Conclusion

ASIC's focused review on the automotive industry and commissions will have a significant impact on the way dealers conduct or continue business operations.[38] At the date of writing this article, the automotive and finance industries remain in suspense about ASIC's conclusions and actions following their papers and reports. While it is anticipated that ASIC's decision will be released any day now, late in 2016 it was said that a prohibition on flex commissions could commence as early as 1 February 2018. ASIC has indicated that it will allow a transition period of 18 months, during which time the interest rate should be set at no more than 150 basis points above the base rate. As ASIC prepares to address its concerns through a legislative instrument under the NCCP, changes which are subject to parliamentary oversight, the automotive industry continues to consult with ASIC and prepare itself for a change in the way it sells and is remunerated for financing motor vehicle consumers.[39]

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About the author
Leonie Chapman's experience extends to banking and finance, consumer credit and mortgage lending, contract negotiation, trade practices and fair trading legislation, intellectual property and trade marks, corporate and financial services. After completing her Bachelor of Laws and Bachelor of Commerce in 2002, Leonie went on to work both in private practice and as senior in-house lawyer supporting a specialist lender and then for 6 years, Macquarie Bank Ltd. Having achieved a Master of Laws in 2009 specialising in banking and finance law, Leonie's main focus now as Principal of LAWyal Solicitors is on regulation and compliance for banking and financial institutions.

Footnotes

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2. Australian Securities and Investments Commission *The Exemption of Retailers from the National Consumer Credit Protection Act 2009* Discussion Paper (January 2013) 1 para 1.
3. National Consumer Credit Protection Act 2009 (Cth), s 29.
4. Above n 2, at 1 para 2.
5. National Consumer Credit Protection Regulations 2010 (Cth), reg 23.
6. Above n 2, at 1 para 3.
7. Commercial Asset Finance Brokers Association of Australia, *CAFBA Supports ASIC's Investigation into Providers of Consumer Finance that may Mislead Customers*, 28 October 2015, www.cafba.com.au/cafba-news-cafba-supports-asics-investigation-into-providers-of-consumer-finance-that-may-mislead-customers/.
8. Above n 2, at 1.
9. Above n 7.
10. Above n 2, at 3 para 14.
11. Above n 2, at 4 para 17.
12. Above n 2, at 8 para 28.
13. Above n 2, at 8 para 27.
14. Above n 2.
15. Australian Securities and Investments Commission *Financial System Inquiry Interim Report: Submission by the Australian Securities and Investments Commission* (August 2014).
16. Above n 15, at 24 (example 2).
17. Above n 1.
18. Above n 1.
19. Australian Securities and Investments Commission *Buying Add-On Insurance in Car Yards: Why It Can Be Hard to Say No* Report No 470 (February 2016).
20. Australian Securities and Investments Commission *The Sale of Life Insurance through Car Dealers: Taking Consumers for a Ride* Report No 471 (February 2016).
21. C Teese, *ASIC Releases Two Reports Scrutinising Motor Vehicle Dealers' Insurance Products*, 30 March 2016, www.hwlebsworth.com.au/latest-news-a-publications/publications/automotive/item/1966-asic_releases_two_reports_scrutinising_motor_ vehicle_dealers_insurance_products.html.
22. Above n 19.
23. Authorised deposit-taking institution (ADI) has the meaning given in s 5 of the NCCP.
24. Above n 20.
25. Above n 21.
26. Australian Securities and Investments Commission *A Market that is Failing Consumers: The Sale of Add-On Insurance through Car Dealers* Report No 492 (September 2016).
27. Australian Securities and Investments Commission "16–301MR ASIC puts insurers on notice to address serious failures in the sale of add-on insurance through car dealers" media release (12 September 2016).
28. Australian Automotive Dealer Association, *Dealer Bulletin: Australian Automotive Dealer Association (AADA) Response to ASIC's second consultation paper proposal to ban Flex-Commissions on Motor Vehicle Finance*, 16 June 2016, http://aada.asn.au/dealer-bulletin-16-june-2016/.
29. Above n 28.
30. J Mellor "ASIC digs in on dealer car loans" (2016) 11 *GoAuto News Premium* 3 http://goautomedia.cdn.on.net/gan_premium/GoAutoNews_Premium_Newsletter_011.pdf.
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33. Above n 1.
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35. Above n 34.
36. Above n 34.
37. Above n 30.
38. Above n 1.
39. Above n 28.