8. Credit Providers: An Overview

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8.1 Introduction

In thinking about credit providers it is often useful to distinguish between the *primary* and the *secondary* markets for credit. The former involves the initial provision of funds to a borrower and the creation of a loan (debt) contract. In the secondary market, such contracts are traded, to be held in asset portfolios of the purchasers (or on-sold to others if so desired). The initial provider(s) of funds, by selling the contracts, may thus not be the ultimate providers of funds. The *originator* of a loan or debt contract, by selling it, can recover the cash provided to the borrower and use that to originate further loans for resale.

In practice, those "resales" may involve creation and sale of different types of contracts such as occurs when intermediaries are involved – and this muddies the distinction between primary and secondary markets. Bond financing of companies is a good example of a relatively clear distinction between primary and secondary markets. But even there, take-up of unsold securities by an investment bank underwriter for subsequent sale into the secondary market creates an overlap. Securitisation is another example. It involves origination of loans (clearly a primary market activity) – but with the intention of repackaging them into a marketable form through an SPV to be sold as RMBS tranches to

investors. The initial sale of those tranches to investors is a primary market in those securities (which may be subsequently traded between investors in the secondary market).

Figure 1 provides a schematic overview of the "Credit Market" illustrating the diversity of institutions and agents involved. Figure 2 illustrates the types of regulation and compliance activities with which they are confronted

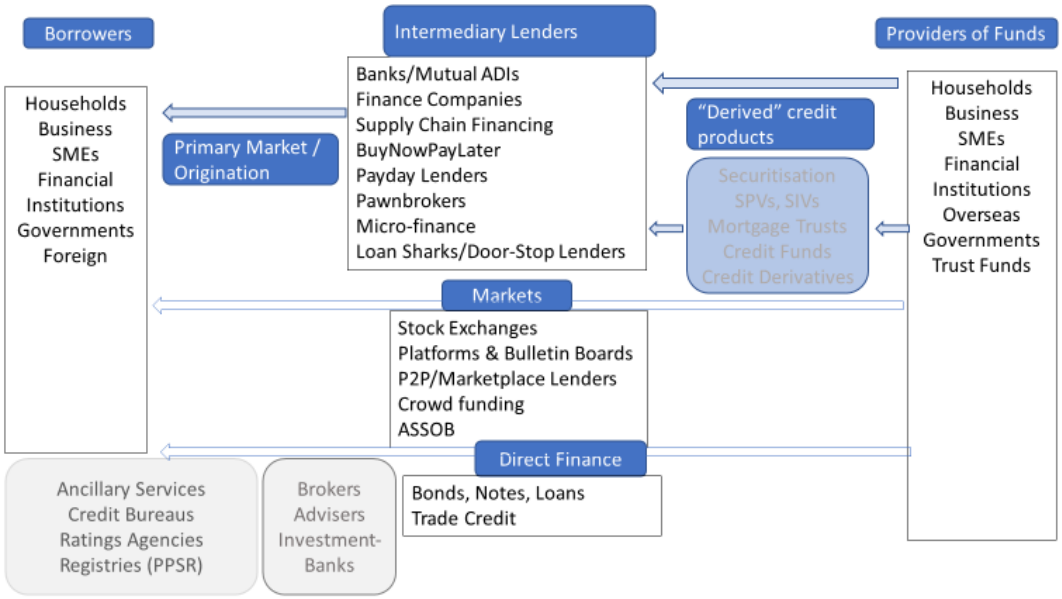


FIGURE 1: CREDIT MARKET STRUCTURE

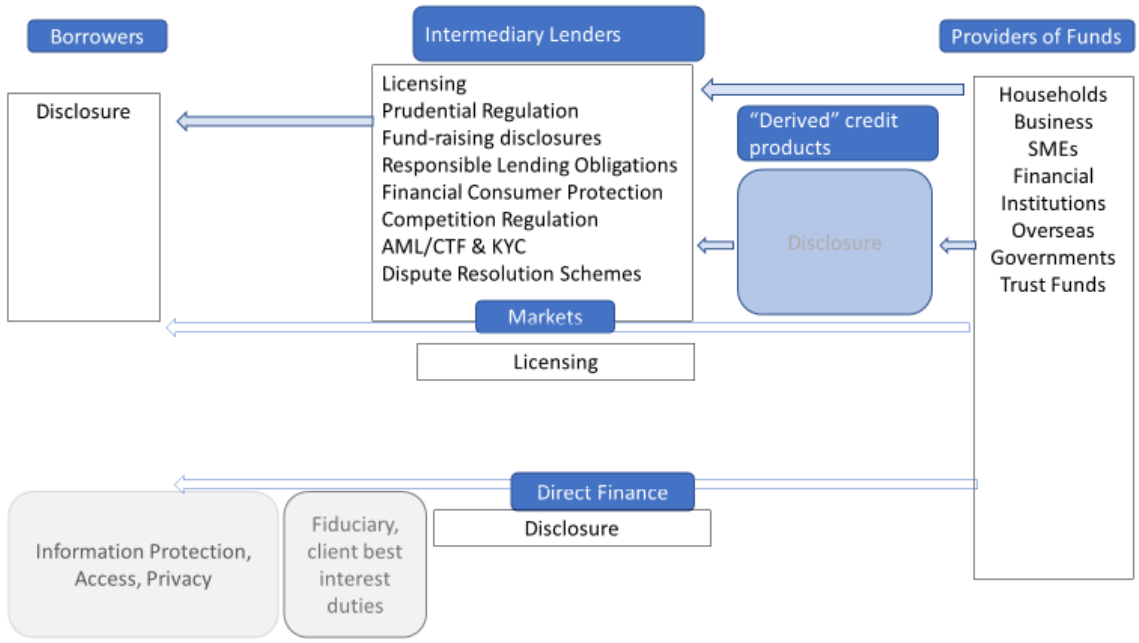


FIGURE 2: CREDIT MARKET REGULATION

There are numerous examples of "derived" credit products, where loans are transformed into another form for purchase by investors. One example is securitisation, where a package of loans is sold by the originator to a *Special Purpose Vehicle* which finances the purchases by issuing *asset backed securities (ABS)* to investors. ABS are claims promising various priorities of entitlement to the cash flows of the loans it has acquired. Another example is a *mortgage trust*, which purchases (or could originate) mortgage loans and offers investors in the units it issues a pro rata claim on the portfolio of assets it holds.

While some originators provide the initial funds to the borrower and often retain ownership of the loan, others may act more in a *brokerage* role, bringing together potential lenders with the borrower. Investment banks, for example, in managing a corporate bond issue, are connecting the borrower with potential investors, and not providing the finance themselves (except perhaps via some contingent exposure as part of the underwriting agreement). In recent years, the emergence of peer-to peer (P2P) lending platforms provide a similar service for retail or SME borrowers (and there have always been finance brokers whose role has been to connect borrowers with potential lenders).

The origination process can involve multiple parties. Banks may use the services of mortgage brokers who advise potential borrowers about loan options available, and collect information required for a loan application which is submitted to a chosen bank. In recent years in Australia around half of bank residential mortgage loans have been made via the "broker channel" (rather than via applications direct to the bank). The role of mortgage brokers has not been without its critics, because of concern that commissions paid by banks to brokers can create a conflict of interests. This could manifest itself in brokers, acting in their own rather than customer interests, directing customers to banks paying the highest commissions. The Hayne Royal Commission recommendations aimed at preventing this were not accepted by the Government.

Of course credit is also created (loans are made) without the involvement of financial institutions. Individuals may borrow from friends or family (the "bank of mum and dad"). Firms can provide facilities for retail customers to defer payment for their purchases of household goods (although this is more often done by arranging for the customer to receive credit from a finance company, or under Buy Now Pay Later (BNPL) schemes). Businesses extend *trade credit* to other businesses when they allow purchasers of their goods to pay at some later date (such as 30 or 60 days). Trade credit is an important source of credit for many companies, and most are both trade creditors (extending credit to purchasers of their output) and trade debtors (owing payment on purchases of inputs from other firms). There are many examples of financial firms providing services competing with such *direct finance*, by interposing themselves between the two end-parties. *Factoring* involves a financial firm (the factor) purchasing yet to be paid invoices of a buying firm from the selling firm – providing

immediate cash to the latter and collecting from the former when the invoice is due. *Buy-now-pay-later (BNPL)* schemes such as Afterpay provide an alternative to store provision of credit (deferred payment) to retail customers.

The primary focus of this section is upon the originators operating in the primary market. As well as providing the initial financing, they determine characteristics of the loan contract - such as price, term, collateral provided. But the importance of participants in the secondary market for credit should not be ignored. Securitisation vehicles transforming (particularly mortgage) loans into asset-back-securities (ABS) are important. Managed funds investing in loans (such as mortgage trusts) are also relevant, and some are also participants in the primary market – originating new loans as well as purchasing existing ones.

A Taxonomy of Credit Providers

There are many different types of financial institutions that provide credit (as well as performing other economic functions). Alternative ways of categorising them could include:

- To whom do they provide credit (households v business v other financial institutions, etc)?
- What types of credit do they provide (short term v long term v revolving facilities/lines of credit)?
- What are the common features of the credit contracts used (secured v unsecured)?
- How do they fund their lending (deposits, wholesale borrowings, owner's equity)?

Unfortunately, while there are some specialist lenders who could be categorised in one such way, many span large parts of the range. Banks are an obvious example. Hence most analyses are based on institutional distinctions. However, there are also analyses of the involvement of various lenders in particular types of lending such as that of residential property market lending – such as in this RBA Bulletin article September 2017.

There are a number of non-ADI institutions engaged in providing credit or originating loans in Australia. These include: institutions who are primarily securitisers; peer to peer or market place fintech lenders; finance companies; individuals such as solicitors managing trust or other funds for clients; private equity firms; hedge, and other managed, funds. Some, such as payday lenders, pawnbrokers, "loan sharks", micro-finance associations, buy-now-pay-later providers are focused almost exclusively at the retail market for personal lending.

A relatively recent lending model, which doesn't fit neatly into the usual categories, is that of Athena which commenced business in 2019 and provides home loans, and funds those via investments from

superannuation funds and other wholesale sources which provide it with "warehouse" funding. It offers only home loans, and emphasises its "no-fee" model, including no exit fees, which limits its ability to adjust the variable interest rate charged to existing borrowers such that its loans are more expensive than available elsewhere. It offers innovative features such as reduction in the interest rate charged as borrowers pay down the loan to reduce their loan/valuation ratio. It is perhaps best categorised as a specialised finance company, and may securitise loans at some point in the future. As a non-bank institution Athena is not subject to APRA regulation nor, being a private company, is disclosure of its balance sheet and income statement metrics required.

In 2020, Athena sold $296 million of its mortgage loans to Newcastle Permanent Building Society, reducing the call on its warehouse funding and thus enabling it to make further loans. (A further loan sale of $246 million occurred in 2021). Under the loan sale agreement, Newcastle pays Athena (who maintains the customer relationship) a fee for ongoing management of the loans, and as owner of the loans is entitled to the revenue arising from borrower payments on those loans.

8.2 Finance Companies

Finance companies are non-bank providers of credit financed by sources of funds other than deposits (which only banks are allowed to offer). Their funds may come from wholesale issues of debt (including securitisation) or loans from large investors or through issues of secured or unsecured debentures into retail markets. Debentures can only be issued under a prospectus, and finance companies come under ASIC's oversight. In 2012 ASIC introduced Regulatory Guide RG69 imposing "If not, why not" requirements for such prospectuses, aimed at assisting investors in assessing potential risks. These require companies to disclose if various operating and financial characteristics differed from usual industry and regulator-preferred benchmarks, and if so why. It is not obvious what, if any, effect these requirements have had.

Historically in Australia, finance companies grew substantially in the post-war era when banks were subject to heavy regulation including interest rate ceilings. Finance companies were able to offer higher interest rates for funds and charge higher interest rates on loans which enabled them to finance more risky borrowings. Most of the Australian banks had finance company subsidiaries that were largely unregulated. Often restrictions on the amount of first mortgage financing from a bank would result in the borrower also taking out second mortgage financing from that bank's finance company subsidiary at a significantly higher interest rate. Following the deregulation of the 1980s, and with Basel capital requirements applying to the banking group (including subsidiaries), there was little value for banks to maintain separate finance company subsidiaries to avoid regulation.

Finance companies undertake a variety of forms of credit provision. As well as personal and mortgage lending, they provide finance by way of leasing and credit cards. Illustrative of a smaller finance company financial structure and activities is Balanced Securities which had $164 million of secured notes on issue and over $214 million of mortgage loans (in around 37 loans) at June 2021. It also held cash of around $40 million and had equity funding of around $104 million.

Probably the largest finance company operating in Australia is Latitude Financial (formerly GE Finance) which as well as direct lending (personal loans and vehicle loans) also offers credit facilities including BNPL through arrangements with major retailers. In late 2019, an IPO was mooted, but did not proceed, prior to a successful launch and ASX listing in April 2021. At December 2021 it had total assets of around $8 billion (largely consumer loans – having 2.6 million customer accounts) and borrowings (primarily from wholesale markets) of $6 billion. The equity/assets ratio was around 20 per cent (having increased substantially due to the capital raising and ASX listing. In 2021 it announced a take-over (for $200 mill) of a much smaller "fintech" lender, Symple, partly to acquire use of its proprietary lending platform technology to replace Latitude's older loan system.

At December 2021, RBA data indicated 102 finance companies operating in Australia with a total of $295 billion of assets (substantially less than the size of the resident loan portfolios of each of the major banks, which APRA data indicate ranged between $400 to $600 billion in April 2020).

Over the years there have been numerous failures of finance companies and a deal of regulatory and community concern that retail investors were not aware of the risk to their funds. Some of these failures were particularly relevant for regional communities where their business was concentrated.

Following post-GFC failures, including that of *Banksia finance company* in October 2012 with $663 million raised from debenture holders, APRA introduced restrictions on Finance Companies in 2013.[1] These included:

- Can't use word "deposits" in fund raising
- Precluded from issuing "at-call" liabilities. This implies preclusion from providing transaction facilities (access to ATMs, EFTPOS) unless done by way of a credit card.
- Can't use the term bank.[2]

[1] This was done under arrangements whereby APRA gave registered finance corporations exemption from complying with Section 8 of the Banking Act (which precludes non-banks from carrying out "banking business" of taking deposits and making loans) provided there was compliance with conditions set out in the exemption order.

[2] The prohibition on use of the term bank also has meant that since an APRA determination in 2012 registered financial corporations cannot call themselves "merchant bank" and that "investment bank" is also not a permitted term unless an exemption is granted by APRA (as it has done for several foreign entities). While various directories list investment banking firms, only ANZ Investment Bank uses the term in its name.

- Precluded from issuing retail debentures with under 31 days maturity,

8.3 Supply Chain Finance

The objective of this section is to explain the activities of financial institutions known as "supply chain financiers". In essence, they intermediate between trade creditors and their trade debtors, providing an alternative to direct financing of a purchaser of goods and services by the seller over the period between sale and payment being made. Often, as in the case of banks, this activity will be one of many forms of financial services associated with working capital and cash management (including lines of credit and short term loans).

Precisely defining supply chain financing is problematic, since there are a range of techniques potentially involved. The *Global Supply Chain Finance Forum* produced a document in 2016 offering some standardised definitions. Udell (2015) provides a valuable framework of "lending technologies" for categorising and explaining use of different types of lending (focusing on SMEs) within which various types of trade finance and supply chain finance fit.

Among the providers of supply chain finance have been Greensill (headquartered in London and founded by an Australian – and which collapsed amid controversy in 2021), TIM Finance, Fifo Capital, and the major and other banks. Whereas banks can rely on their deposit base and other borrowings to fund the credit provided, non-bank financiers will rely on own funds (equity), wholesale market borrowings, or securitisation solutions using trade invoices as the underlying assets. Many of the providers are unlisted companies.

Unfortunately, there are no official statistics available for Australia on the size of the supply chain finance sector, nor on the size of aggregate outstanding trade credit amounts or flows. In part that may reflect the problems of precise definition, and the variety of types of supply chain financiers. There are also accounting presentation complications (see Stebbens, 2020) since some trade finance solutions could (or perhaps should) lead to the amounts being presented on company balance sheets as debt rather than as accounts payable (and receivable). Nevertheless, the amount of credit outstanding via domestic (ie ignoring international trade) trade credit arrangements (either via direct financing or intermediated) is large. Udell (2015) notes that "Berger and Udell (1998) show that in the United States, trade credit provides 31 per cent of debt financing to SMEs, nearly as much as commercial banks (37 per cent)" and that this phenomenon is "globally ubiquitous".

Cash and Working Capital Management

Companies face a time lag between payments for purchases of inputs of goods and (labour) services and receipts from sales of output. This creates an ongoing need for funds to bridge the "cash cycle" gap which could be met by funds provided by the owners or by borrowed funds. Some part of the gap reflects characteristics of the physical production process affecting the time between acquiring inputs and production of final output, while some part reflects payments practices. (See here for a brief discussion). The longer the gap, the more costly it is for the firm.

Changing the nature of the production process, such as "just in time" inventory management can affect the timing of cash flows, as can changes in payments practices such as time taken to pay invoices for goods supplied. Thus, the nature of the "cash management" problem reflects both physical supply chain features and supply chain finance features.

Value creation from shortening the cash-cycle: an illustration

Consider one product cycle and assuming that the company operates its finances via a bank overdraft. As production proceeds (starting at date 0) the overdraft increases until the product is produced and sold at date T for a total cost and sale price of say $X. (For simplicity assume zero profits).

If expenses were incurred smoothly over that period, and payment immediately made by the purchaser at date T, the average overdraft over the T day production period would be $X/2. Interest costs incurred in financing production and sale of the product would be r.T.(X/2), where r is the interest rate charged by the bank.

If payment by the purchaser is delayed till T + t, the company will incur the extra cost of the bank overdraft which at date T is $X for the additional t days, giving total interest costs of r.T.(X/2)+ r.t.X. If the payment lag (t) can be shortened, the company benefits from lower interest costs.

Alternatively, suppose the company can defer payments for its inputs by t days (but still gets paid by the purchaser t days after sale). Then, the overdraft only starts to accrue at date t until it reaches $X at date T+t, when payment by the purchaser reduces it to zero, giving an average overdraft over T days of $X/2. The company benefits from lower interest costs from deferring payments to its suppliers.

Deferral of payment by a purchaser from the company leads to the company being a *trade creditor*, reflected in the value of invoices issued to purchasers which have not been settled. Conversely, its deferral of payments to providers of inputs leads to it being a *trade debtor*, reflecting invoices it has received but not yet paid. Most companies will simultaneously be both trade creditors and trade debtors.

In issuing invoices, companies will typically specify a payment due date (such as 30 or 60 days) and may offer some discount on the invoice amount for early payment. Setting of that discount rate will reflect a range of factors including the financing cost to the company from extending credit to the purchaser. But, in practice, the payment terms can also be specified by the purchaser if they have substantial bargaining power, such as arises if a large company is purchasing inputs from one among many possible small suppliers. As well as offering a low price to a possible supplier, it may also specify extended payment terms (such as 90 days).

This issue of possibly unfair use of bargaining power by large companies in dealing with small suppliers attracted substantial media and political attention in Australia in 2018 and 2019. An Inquiry and Final Report by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) ultimately led to the introduction into Parliament in May 2020 of the Payment Times Reporting Bill 2020. The Act, which came into effect at the start of 2021 requires large companies to report on their payments practices with the objective of preventing them from exploiting their market power to impose costs of extended payments terms on small counterparties.

The company selling goods and issuing invoices allowing deferred payment is providing liquidity to its trade debtors, but is also exposing itself to default risk should the trade debtor be unable or unwilling to make payment. There are a range of institutional trade credit facilities provided by banks and other intermediaries which facilitate trade. As well as loans or revolving credit facilities to finance the company's costs prior to receipt of payment for goods supplied, there are a range of facilities which enable the company to reduce its exposure to default by the purchaser. These are particularly important in international trade where the default risk of an overseas purchaser may be hard for the company to assess. Bank letters of credit, guarantees and arrangements with correspondent banks in the purchaser's country to ensure funds are available and will be released to the selling company following receipt of goods are common. Financial institutions such as banks may be better able to assess the default risk associated with the purchaser and more able to bear that risk than the selling company.

Another common technique is for the seller of goods to sell the invoices it has issued to a bank or other financial institution for an immediate cash payment. That sale, at some discount to face value

of the invoice, could be either "with recourse" or "without recourse". Both provide the company with immediate cash, but in the "with recourse" case, if the trade debtor defaults the company will still be exposed to the loss. This process is generally referred to as "factoring". Figure 1 provides an illustration of the process. When there is no recourse, generally referred to as "forfaiting", the bank (or "factor") takes on the risk of loss from default.

Specialist companies and banks provide such factoring services, essentially acting as financial intermediaries between trade creditors and trade debtors. Rather than the trade creditor providing loan finance (via deferred payment) to the trade debtor, the intermediary pays the amount owed (less some discount) to the trade creditor and provides the loan finance to the trade debtor using its own funding. Among the economic efficiencies which can make this viable are: lower cost of funding for the intermediary than for the trade creditor, improved payments processing arrangements, better debt collection/enforcement techniques (if the trade debtor is not meeting their obligations), better assessment of credit risk and ability to diversify credit risk across many trade debtors. Also relevant can be the information acquired about the trade creditor and trade debtor.

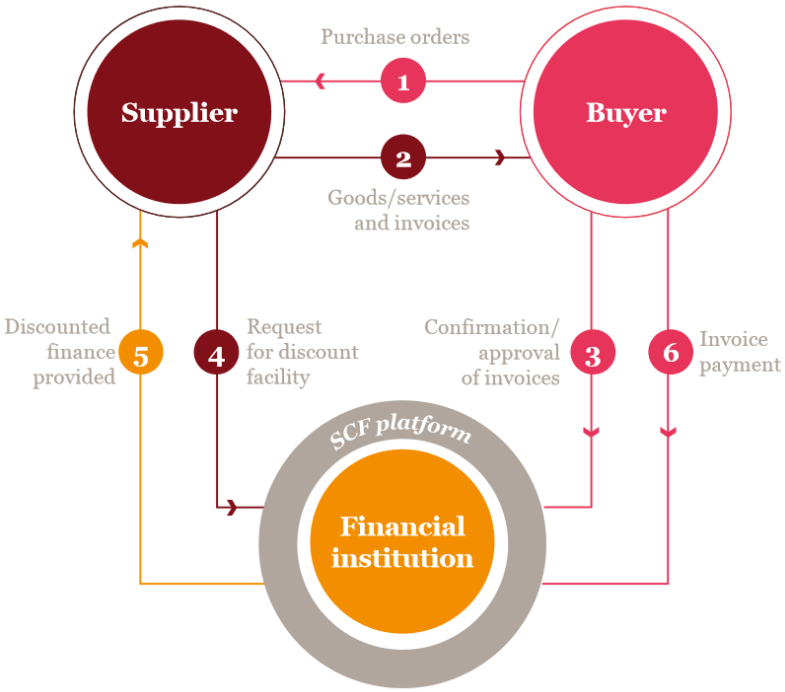


FIGURE 3: SUPPLY CHAIN FINANCE (SOURCE PWC)

Another option for trade creditors is to take out *trade credit insurance* offered by insurance companies. QBE is one company offering such insurance in Australia, details are here.

An overview of the market for supply chain finance and techniques used in Australia can be found in the ASBFEO report published in March 2020. One feature of the market has been the growth of what is referred to as *reverse factoring.* This differs from traditional factoring in which the trade creditor is the initiator, discounting invoices it holds with a financial institution (the factor) for immediate cash rather than waiting for eventual payment by the trade debtor. In reverse factoring, a company which is regularly purchasing inputs from, and becoming a trade debtor to, many suppliers, establishes a facility with a supply chain financier. That facility enables its creditors to discount the invoices from the company that they hold for immediate payment by the supply chain financier. This can reduce the transactions costs for the creditor and possibly reduce the discount required by the supply chain financier (since it has a relationship with the trade debtor). Figure 4 illustrates.

Reverse Factoring

Establishing the Program: A Buyer company will enter into an early payment program for its suppliers with a third-party SCF provider. An 'application programming interface' (API) is installed on the buyer company's internal systems which interacts with the buyer's ERP systems, providing visibility of supplier invoices.

Joining the Program: The buyer company, not the SCF provider, approaches suppliers about their interest in opting into the program.

Invoice Approval and Advice: When the buyer approves the supplier's invoice, it is visible to the SCF third party finance provider who contacts the supplier and notifies them of their commitment to pay the invoice immediately.

Supplier action: The supplier effectively "sells" the receivable / sales invoice to the SCF third party finance provider at a discount and the buyer pays the third party the full amount on the due date.

SCF Third Party Provider: The supplier is paid the lesser value and the buyer reimburses the SCF provider at the end of the standard payment term. The financing of the early remittance is through the aggregation of receivables into financial products, such as bonds. The terms reflect the credit rating and risk profile of the buyer, as this reflects the buyer's ability to reimburse the SCF provider at the end of the buyer's standard payment term.

FIGURE 4: REVERSE FACTORING ARRANGEMENTS (SOURCE, ASBFEO, 2020)

In practice, in Australia, one of the concerns leading to the ASBFEO inquiry was evidence that large companies were simultaneously increasing their payment terms (eg to 90 days) and setting up reverse factoring facilities with a specified SCF intermediary. Doing so, increased the funding costs imposed on small suppliers who either had to wait longer for payment or accept a larger discount for immediate payment from the supplier chain financier. Whether this involves anti-competitive behaviour is unclear (and the report recommended a review by the ACCC), but it does raise issues of fairness. The ASBFEO report also expressed concerns about the purported use by SCF intermediaries of information technology which enabled them to gather information about the financial condition of a trade creditor in order to determine the largest possible discount it could impose on the trade creditor.

It is worth noting the similarities and differences between SCF and BNPL schemes or consumer leases and hire purchase. In all cases, someone receives goods in exchange for deferring the payment. In SCF, however, the purchaser is generally perceived as setting the terms (and policy concerns focus on treatment of the supplier – such as the SMEs that ASBFEO is concerned with). In BNPL, consumer leases, and hire purchase, the BNPL intermediary or the goods seller sets the financing terms (and policy concerns focuses on the impact of the financial arrangements on the buyer of goods).

8.4 Pawnbroking

Pawnbroking is a long standing credit industry common to most countries based on provision of very small, short term, loans to retail customers with liquidity needs. These are secured by the pledging of some durable good (the "pawn") which the pawnbroker holds and can sell (and retain some or all of the proceeds) in the event of default.

Throughout time and across countries, the principal features of pawnbroking are common, albeit with differences reflecting regulatory, social, and economic factors. The standard pawnbroking loan is characterized by: short term maturity (weeks or months); small scale (average size of around $100 in countries such as the USA and Australia); lodgment (pledging) of durable goods (of value well in excess of the loan amount) as security with the pawnbroker; minimal documentation; relatively high default rates. Pawnbroking customers are typically those in immediate need of cash, and unable to access other sources of funds. They potentially include those without proper title to goods proffered as security (ie stolen goods), who seek immediate cash in exchange for goods which they have no intention of redeeming.

Transactions costs of the lender are reduced by the reduced need for *a priori* investigation of the borrower's credit status and *ex post* collection costs. Monitoring costs during the life of the loan are avoided. The contract provides the lender with assets available for sale in the event of default, but the lender faces the risk that poor quality of goods which was not recognized when the loan was granted reduces the resale value. The pawnbroking contract can be seen as a precursor to modern repurchase agreements.

Traditionally, pawnbrokers operated as small shopfront stores, often as a sole trader/owner who supplied the finance for on-lending to customers. Operating costs (lease of premises and wages being the main items) were relatively high compared to the amounts lent. Thus interest rates charged had to cover operating costs as well as the financing costs and allow for default and other risks. Paradoxically, customer default was not necessarily to the disadvantage of the pawnbroker – if receipts from sale of forfeited goods exceeded the amount which the customer owed. But another

risk faced was that stolen goods accepted as pledges might be reclaimed by their rightful owner (or the police) or that defective goods might not bring a sufficient sale price.

The relatively high operating costs mean that pawnbrokers need to charge high interest rates to make profits. 10 per cent per month might not be sufficient to break even, and such high interest rates generate community perceptions of "usurious" behavior. Combined with perceptions of pawnbrokers as possible "fences" for stolen goods , pawnbroking has often not had a good public image. Consequently governments in many jurisdictions have imposed significant regulations on pawnbrokers. Among commonly found operational restrictions are:

- Minimum holding period requirements (of goods before resale is allowed)
- Disposition of sales proceeds (borrowers entitled to excess over amount owed)
- Recording, Reporting and Policing (of loans and possibly customer ID)
- Borrower protection: documentation, bonds and capital requirements (to avoid borrower loss of goods with value above amount owed should pawnbroker fail)
- Entry Restrictions (licensing)

A particularly common restriction has been imposition of maximum allowable interest rates. A natural response has been to restructure transactions as a sale of goods by the customer who then has an option to repurchase the goods at a later date.

A "Fair" Pawnbroking Interest Rate

For the pawnbroker to achieve a required return on funds employed, a simple model of pawnbroking indicates the following condition needs to hold:

$$(1+r)L(1-p) + p.\theta V - C = (1+j)L$$

The LHS shows the gross return on a portfolio of loans of $L at an interest rate of r% per month, where there is a default probability of p, a recovery amount following default of θV (where V is value of goods pledged and θ is the resale value rate), and C is monthly operating costs. The RHS is the gross return required if the cost of funds is j% per month.

Using realistic estimates for the various components of

L (loans outstanding) = $100,000

V (goods pledged) = $200,000

p (probability of default) = 0.2

θ (resale value) = 0.7

C (operating costs per month) = $15,000

j (opportunity cost of funds per month) = 0.01 (12% p.a.)

Then solving:

$(1+r)100{,}000.(0.8) + 0.2.(0.7).200{,}000 - 10{,}000 = 1.01(100{,}000)$

Gives: r =0.10 (10%) per month!

Paradoxically, higher default rate may reduce "fair" loan rate if sale proceeds are high relative to amount owed. It can be seen that the dominant influence on the "fair" loan rate is the size of operating (real) costs.

In recent years, in a number of countries, large companies have emerged operating chains of pawnbroking stores often in conjunction with second hand dealers activities. *Cash Converters* is an obvious example in Australia (and elsewhere). Technology has also affected pawnbroker operations, with forfeited goods able to be sold on-line to a wider potential market than previously available when goods were generally only sold from the shop-front.

8.5 Payday Lending and Small Amount Credit Contracts (SACCs)

Payday lending is generally defined as short term, relatively small, loans made to individuals to be repaid when funds are available from a subsequent wage income receipt. In this sense they are loans with collateral provided by way of a claim on the future income stream of the borrower. Whereas this once involved the borrower signing a post-dated check due on the payday related to the loan maturity, electronic transfer facilities can achieve the same outcome by establishment of a direct debit. (In the USA, the fact that many low income households do not qualify for a cheque account, meant that the post-dated cheque approach was not feasible for them).

While the ability of individuals to access credit for small amounts for a short term can in principle be privately valuable to assist household liquidity management, there have been many concerns about the nature of the industry. These include high fees or interest rates and the apparent tendency for many borrowers to "roll-over" loans leading to an escalating debt spiral.

SACCs involve more than payday loans, including for example consumer leases, rent to buy schemes (for amounts less than $2,000 and terms of 2 years or less). Continuing credit contracts such as credit cards are excluded from this definition.

In September 2015 ASIC released a report in which it found that the implied interest rate on consumer loans was as high as 884% p.a. (for a clothes dryer). In June 2019 ASIC reported that two payday lenders were charging interest rates as high as 990 per cent p.a. and stated that it would use its new product intervention powers against them. The lenders were escaping the restrictions of the National Credit Act because credit was provided for less than 62 days, and high fees were charged for provision of collateral/arrangement services by an associated company under a service contract. After a protracted legal battle ASIC had by mid 2022 succeeded in preventing such behaviour by those lenders and issued an intervention order to prevent such behaviour more generally. .

Lists of payday lenders operating in Australia can be found at https://www.finder.com.au/payday-loans or https://www.ratecity.com.au/payday-loans.

In Australia, a Government Review of Small Amount Credit Contracts (SACCs) reported in March 2016. It made 24 recommendations. Draft legislation was released in November 2017, following the government response to the Review released on 28 November 2016. Major features of the legislation are shown in the box below.

- imposing a cap on the total payments that can be made under a consumer lease;
- requiring small amount credit contracts (SACCs) to have equal repayments and equal payment intervals;
- removing the ability for SACC providers to charge monthly fees in respect of the residual term of a loan where a consumer fully repays the loan early;

- preventing lessors and credit assistance providers from undertaking door-to-door selling of leases at residential homes;
- introducing broad anti-avoidance protections to prevent SACC loan and consumer lease providers from circumventing the rules and protections contained in the Credit Act and the Code; and
- strengthening penalties to increase incentives for SACC providers and lessors to comply with the law.

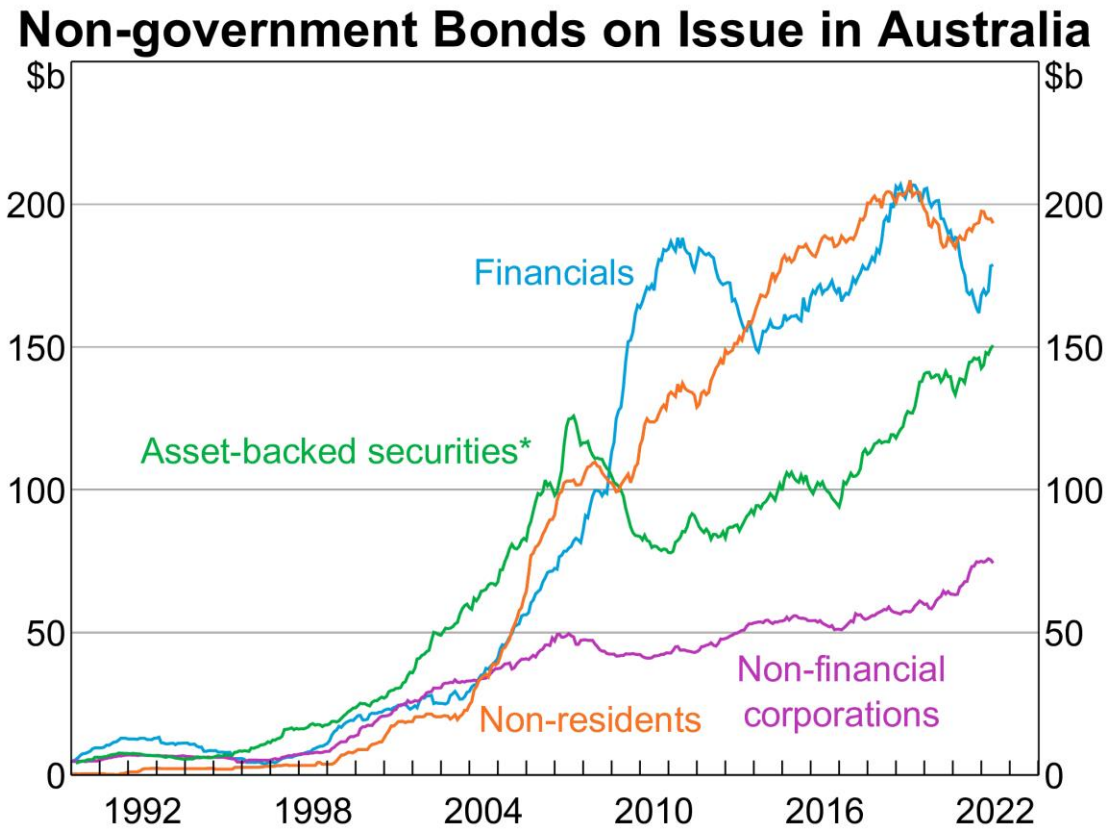
Source : https://treasury.gov.au/consultation/c2017-t229374

However, the Bill was never introduced to Parliament by the Government, done so by an independent member, but abandoned (pending the outcome of the Royal Commission) but not subsequently reintroduced. On 22 February 2019 the Senate Standing Committee on Economics released its Report on its Inquiry into "Credit and financial services targeted at Australians at risk of financial hardship" recommending reintroduction of the Bill and on 18 February 2019 the Labor opposition introduced a Bill replicating the original draft legislation which was not successful. Subsequently, the Bill was reintroduced into the Senate in December 2019 and referred to the Senate Economics Legislation Committee to report back by September 2020. That Report recommended that the Bill not be passed, with a dissenting report to the contrary by 3 of the Committee members.

8.6 Securitisers

Securitisation involves the establishment of a Special Purpose Vehicle which acquires mortgages from the originating entity, pools those mortgages, and issues a range of securities promising cash flows to investors based on payments by the mortgagees. The securitisation vehicle could be established by an ADI and acquire loans issued by that ADI, or established by a non-ADI originator of loans. Often there will be a number of separate programs (corresponding to a particular pool of mortgages) associated with a particular securitiser. At December 2019, the ABS collected data from 127 different securitisers as part of its Australian National Accounts: Finance and Wealth data (Cat. No. 5232.0, Table 25: see also Cat.No. 5232.0.55.001)

The marked downturn in securitisation after the GFC can be seen in the figure below (from the RBA Chart Pack) which shows the stock on issue. That decline reflects the drying up of new issues and maturing of existing issues. Since 2016 the market has started to grow significantly, involving both traditional securitisations and covered bonds. Note that these figures exclude internal securitisations by banks which were created for eligibility for use as collateral for the CLF.



* Excludes ADIs' self-securitisations.

Sources: ABS; Bloomberg; KangaNews; Private Placement Monitor; RBA

Many of the larger operators in this market (as at 2020) are shown in Figure 5. One of the longest standing securitisation programs has been the PUMA program, operated by Macquarie Bank. Figure 6 shows issuers of Asset Backed Securities (ABS). The main assets involved in these securitisations are auto loans, credit card receivables, and consumer loans.

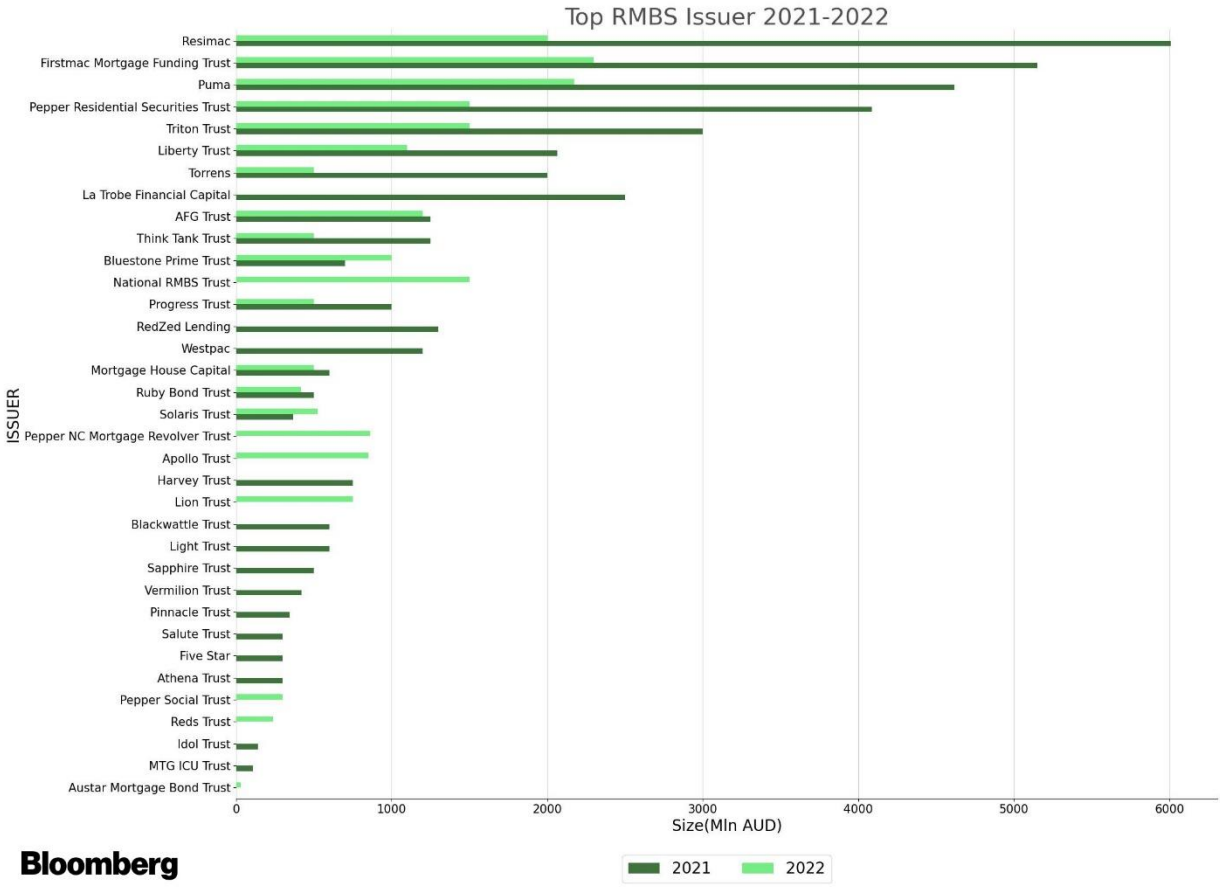


FIGURE 5: MAIN AUSTRALIAN SECURITISERS (SOURCE: ASF)

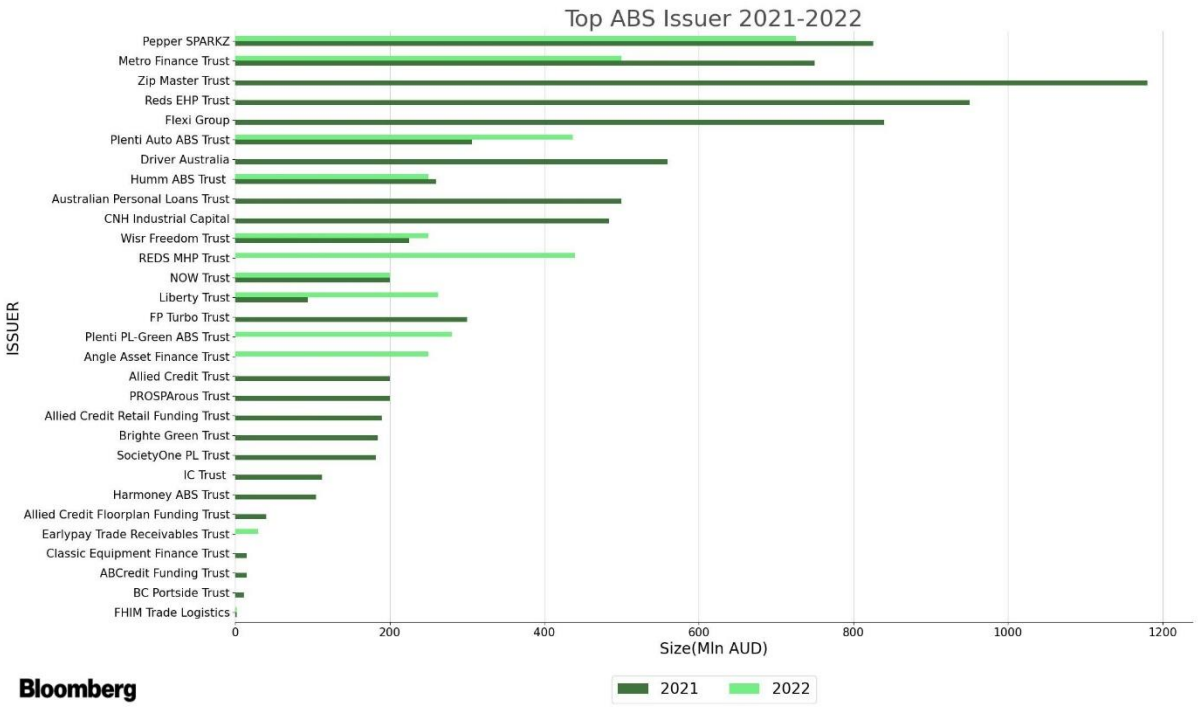


FIGURE 6: MAIN ABS ISSUERS (SOURCE ASF)

8.7 Consumer Credit and Buy Now Pay Later (BNPL)

The BNPL sector has seen remarkable growth and prominence in recent years as new companies have used fintech to develop new ways of providing short term finance to individuals for purchases of consumer goods. (This RBA article provides information and this Financial Technology Partners report provides a global perspective on the rapid growth of providers and products). Provision of such finance is not new, but the ways of providing it are different from more traditional approaches. Those traditional approaches include:

- *In-store credit*, where a retailer (such as a furniture store) offers terms for deferred payments (such as monthly payments). Some large retailers offer customers a store (credit) card. Often the credit will be provided by a finance company rather than the store itself, such that the store is not regulated under the National Consumer Credit Protection (NCCP) Act, and is not required to hold an ACL.
- *Car dealer finance* (see this Royal Commission background paper for more information), is an important category of finance where a dealer can earn a commission by arranging for the customer to get finance (including via a leasing arrangement) from an associated finance company. The dealer may hold an ACL, or be an authorised representative of the finance company, but more generally rely on the "supplier of goods/point of sale" exemption in the NCCP Act. The Hayne Royal Commission recommendation 1.7 was for removal of this "point of sale" exemption.[3]
- *Consumer Leases,* where the consumer gets immediate use of the goods, in exchange for a regular series of lease payments. At the end of the lease period, the consumer may have the right to obtain legal ownership by payment of a further amount. *Hire Purchase* is a term which was commonly used for this type of finance, but differed from a lease in that the consumer was required to complete payments and take ownership.

The emergence of BNPL providers such as AfterPay has attracted much attention both regarding the nature of its activities and the stock market valuation of the company (see Figure 7).

[3] The Government response to the RC recommendations agreed to this, but as at mid 2021 did not appear to have produced draft legislation for consultation.

FIGURE 7: AFTERPAY STOCKMARKET VALUATION

Using Afterpay as an example, it provides consumers with the ability, arranged virtually instantaneously at the point of sale, to purchase (even quite low value) items from participating merchants for a series of deferred payments. These payments are made electronically to AfterPay, and if made on time involve no fees or interest charges to the customer, such that the deferred payments amount to the purchase price of the item. Afterpay requires customers to make 4 equal fortnightly repayments (25% up front) and charges a late fee = $10 (or more for large amounts, subject to a cap of $68). The only penalty for default is removal from platform (with no reporting to credit bureau). Afterpay applies a maximum purchase amount, initially in the order of $350 for new customers, which increases with a successful history of on-time repayments. AfterPay pays the merchant the purchase price at (or soon after) the time of the sale, but with a discount (currently 4 per cent) applied. (These discounts or "merchant fees" are significantly higher than the costs (of around 1 per cent of transaction value incurred by merchants when credit cards are used for payment). Afterpay's profits arise from the value of the discount more than compensating for the provision of finance to the consumer, and from any fees and charges to customers due to late payments, less any losses from default by those customers. Although AfterPay was initially making losses, its share price increased rapidly. In mid 2021, acquisition of Afterpay by SQUARE, which provides payments services to small businesses, was announced. A diagrammatic representation of its history and of its system linking purchasers and merchants is shown in the box at the end of this section.

Other BNPL operators include Zip, Humm, Sizzle, Openpay, Splitit. Lists of BNPL providers operating in Australia can be found here or here. The models of each differ, and involve differential reliance on merchant fees versus customer account fees, charges and late fees. While BNPL has attracted much

publicity, it is still only used for a relatively small proportion of transactions with BNPL purchases being in the order of 2 per cent of debit and credit card purchases. In 2020 there were 6 million BNPL accounts in Australia, although that figure includes multiple accounts held by consumers at different BNPL providers.

This approach can be seen as a new form of *factoring*, where a merchant's accounts receivables were sold at a discount to a financier (a *factor*). See here for an explanation while Figure 8I llustrates the cash flows in BNPL finance. The BNPL provider takes on credit risk (of the consumer defaulting) and liquidity risk (if payments are late). Since the BNPL provider is providing funding to merchants before it receives payments from consumers, it must fund this gap in some way. Equity is one source of funding, but warehouse (or other) loans from banks is an important source of funding. Although not observed yet in Australia, another potential source of finance could be by way of some form of securitising the receivables due from consumers.

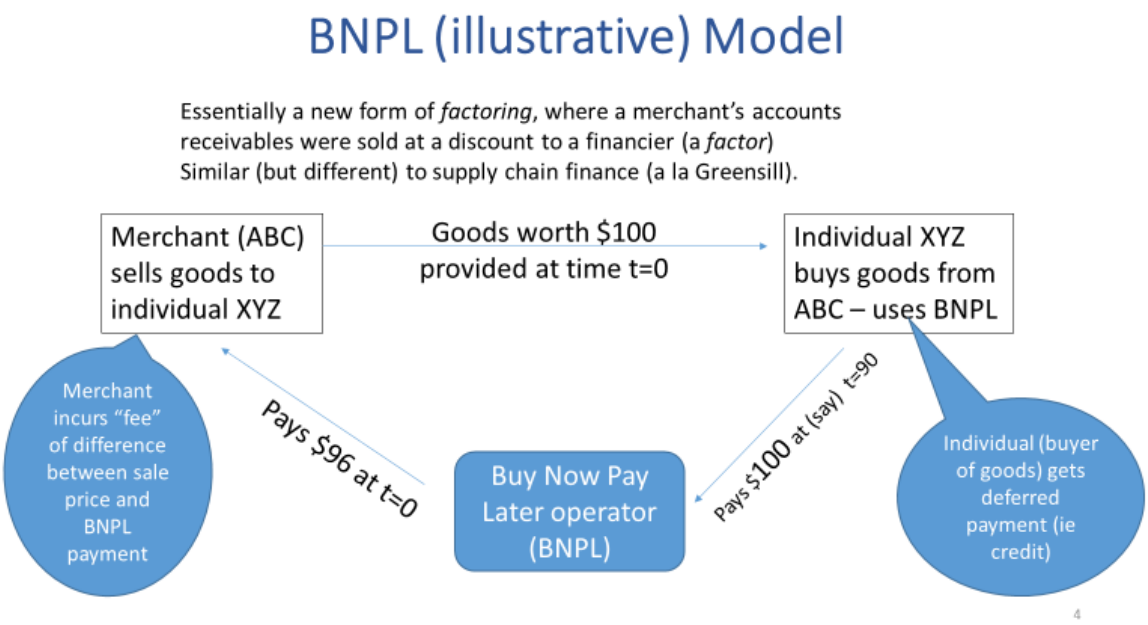


FIGURE 8: BNPL ARRANGEMENTS

Its new model, means that it is not covered by "traditional" regulation – it is not subject to NCCCP or required to have an ACL nor have membership of an external dispute resolution body.[4] It has prompted some community concerns (particularly among financial counsellors) regarding its potential

[4] An entity is not under NCCP Act 2009 and doesn't need an ACL or to comply with Responsible Lending Obligations If: (a) no charge for credit or (b) credit is for less than 62 days, fees are < 5% of amount of credit, and interest charges < 24% p.a., or (c) only include an upfront fee or periodic fee that is fixed, not related to credit amount and less than some specified amount.

to facilitate excess spending, relative to income, among particularly younger members of the community (much as ready availability of credit cards has in times past).

Consequently there have been a number of official examinations of the business model and its consequences, including a December 2018 ASIC Review and a 2019 Senate Economics Committee Inquiry. As at early 2023 no specific regulations or legislation had been introduced but a Treasury Options Paper was available. The ASIC review recommended that regulation could be achieved by application of its product intervention powers, as did the Senate Committee, which also recommended application of the (then) soon to be introduced Design and Distribution Obligations (DDO's) as well as development of an Industry Code of Practice. In November 2020, ASIC released Report 672 reviewing the experiences of users of BNPL services, which found that 21 per cent of users had missed a payment over the past 12 months. BNPL operators who are members of the finance industry association AFIA have developed a BNPL Code of Conduct.

One significant impact of BNPL has been to induce banks and other financiers to examine and introduce new types of consumer credit. The include new types of credit card accounts where there is no interest charged. Instead, a fixed fee is charged only if the card is used for purchases in a particular month and/or the account has an outstanding balance at the end of the month. Banks and financiers have also taken equity stakes in a number of BNPL operators.

BNPL Prospects

It is worth considering possible scenarios for the future growth of BNPL. Stock market and analyst valuations of existing operators are high, based on assumptions of future growth and profitability. That is despite most operators currently operating at losses, as is common in new fintech ventures. However, there are a number of possible impediments to future growth which warrant mention. One is the current BNPL models have emerged and prospered in a low interest rate environment, where current levels of merchant fees (the discount applied) are compatible with the interest cost involved in providing credit to consumers. If a high interest rate environment emerges, the willingness of merchants to accept the higher fees necessary for BNPL profitability may be in doubt. Whether offering BNPL facilities has sufficient benefits in terms of customer attraction to offset such fees is open to question. In 2021 the RBA recommended that the BNPL sector should not be allowed to preclude merchants from applying a surcharge to purchases using BNPL. As at early 2023, the government was considering submissions to a Treasury consultation in developing BNPL legislation.

Another potential impediment to growth is the existence of significant competitors, as banks react with new forms of consumer credit. In the terms of practitioner analysts, it is not clear that BNPL operators have a wide "moat" – particular characteristics or special advantages that can protect them

from competitors.[5] BNPL offerings have appealed particularly to younger consumers, but how much customer loyalty exists is yet to be tested.

One risk arising from increased competition for customers between largely unregulated BNPL operators and with other credit providers, is a "race to the bottom" in credit standards and resulting higher defaults. Another risk is the possibility of increased regulation resulting from concerns about financial consumer protection which may, by imposing new costs, reduce the viability of some of the business models being used.

Perhaps the main impediment to future growth and profitability exists from the fact that BNPL involves both the provision of consumer credit and involvement in the payments mechanism. Compared to a consumer using some form of credit card provided by one of the banks, the BNPL model inserts an additional "middleman" in the payments system. The merchant and the customer both deal with the BNPL operator, and all deal with the banks who provide their accounts. The BNPL operator arranges a transfer of funds from its bank account to the merchant's bank account. The scheduled consumer payments involve transfers from the consumer's bank account to the BNPL operator's bank account. This involves more complexity than use of bank credit cards (see Chapter 13). While electronic payments systems have markedly lowered transactions costs, this additional complexity must involve some extra cost. BNPL operators have been able to offset such costs via the attraction of the "new" financial product to consumers enabling charging higher merchant fees (and/or consumer fees and charges). As major participants (banks) in the payments system develop equally attractive consumer credit products, the viability of the independent BNPL operator business model will be challenged. The financial product of BNPL will undoubtedly survive in various forms. But the future of independent BNPL operators is less certain. Takeover by banks or other major financial institutions, who see opportunities for customer acquisition or use of the technology developed by the operator, seems a likely outcome for the more successful operators. In 2021 this became apparent with the takeover of AfterPay by Square.

[5] The term is derived from the use of a "moat" surrounding a castle as a way of preventing successful attack.

AFTERPAY Touch Group (ASX Code: ATG)

Comprises Afterpay and Touch products – merger of Afterpay and Touch in May 2017 (announced Feb). Expansion into US and in 2019 into UK under Clearpay brand

TouchCorp started in 2005 (but was developing systems etc since 2000), listed on ASX in Mar 2015, Co registered in Bermuda. Provides a platform for consumers to buy from merchants – revenue from transaction and integration fees – in mobility & Payments, Health & Government, Retail Services. Integrates with POS devices (eg doctors). Profitable prior to merger. Contribution (as "Pay Now" segment) still likely positive but small (given growth of Afterpay).

Afterpay platform for buy and receive now and pay later, on web page or mobile phone app for use on POS. Two components – Transaction Integrity Engine (assess customer – using information that can be garnered from transaction/payment request – or stored data), Afterpay Operating System – developed by Touchcorp. Established 2015, IPO May 2016. NAB secured receivables funding facility obtained Dec 2016. No AFSL, obtained ACL in Aug 2016 but not needed. Loss making prior to merger

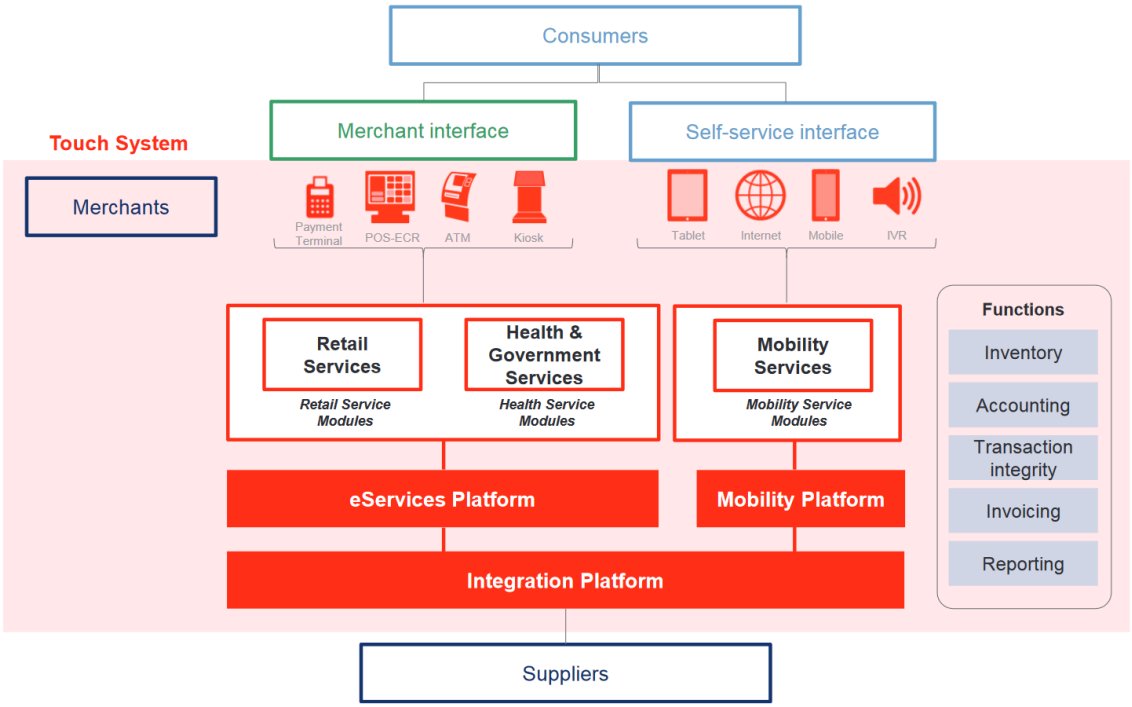


FIGURE 1
A DIAGRAMMATIC REPRESENTATION OF THE TOUCH SYSTEM PLATFORM

https://www.afterpaytouch.com/images/TCH_ASX-Announcement_Touchcorp-Scheme-Booklet_Combined-Final.pdf

(Other good examples of flow of payment instructions etc are in this document)

8.8 MicroFinance Institutions

As the name suggests, microfinance institutions deal in financial transactions of small scale. They are more common in less developed economies catering to individuals (or groups of individuals) not able to access funding from traditional/ mainstream financial institutions. The main activity for which they are recognised is very small scale self-employed business lending, and the most prominent example is the Grameen Bank established in Bangladesh in 1983, which styles itself as a "bank for the poor" with the founder winning a Nobel Peace Prize in 2006.

Loans made by such organisations are typically very small, such as for the purchase of a sewing machine by (typically) a woman wishing to establish a business enterprise. While the Grameen Bank and many other such institutions are not-for-profit, and some relying on charitable donations or government subsidies for funds to be lent, there are others which see such small-scale lending as able to provide a sufficient rate of return on funds invested in the enterprise. Thus, there are examples of "for-profit" microfinance organisations, although the costs associated with making small scale loans generally means that interest rates charged are relatively high, and these organisations generally make larger size loans than not-for-profit organisations. The initial enthusiasm about micro-finance as an important facilitator for economic growth and development has waned somewhat over time as discussed by Cull and Morduch (World Bank, 2017). As they note, the focus of policy is more on increasing *financial inclusion*, embracing facilitating savings, insurance, payments services as well as access to credit.

An important feature of the lending process is the loan contracting mechanism employed to encourage loan repayment. While a loan may be made to an individual, the obligation of repayment may apply to all members of the community to which that individual belongs. As well as the direct effect of spreading the non-repayment risk across a number of obligors, this structure can increase the social and moral pressure on the individual to repay the loan. Also, default by one member of a community may reduce the chances of other members receiving loans in the future.

The term "micro-finance" tends to be applied wrongly to any form of small scale lending. It is best reserved for lending to very small enterprises (in developing countries) and where the loan terms and conditions have special features such as referred to above. Payday lending is completely different, as are BNPL schemes.

In Australia, microfinance is relatively limited and a critique of its applicability for Australia can be found here (and a contrary view here). Lending activities such as those operated by welfare groups such as Good Shepherd probably qualify. No Interest Loans (NILs) of up to $1500 are available for low income households in financial hardship for essential goods and services (but not food, rent, or to

repay other debts). The NILs scheme is based on a $130 million pool of funds which has been provided by NAB.

8.9 Government Credit Institutions: The NHFIC

Governments sometimes establish special institutions to raise funds from the private sector and to on- lend those funds to designated types of borrowers. (Development Banks charged with providing finance to sectors not attractive to private lenders but deemed worthy of government support are a common example). One such institution in Australia is the National Housing Finance and Investment Corporation (NHFIC) established in 2018 which, among other functions, operates an Affordable Housing Bond Aggregator. In this role the NHFIC raises funds by bond issues and uses the funds raised to make loans to community housing providers (CHPs). These providers and developers of social and affordable housing (operated by governments, welfare organisations, and commercial businesses) are each of insufficient scale to raise funds in bond markets. Because NHFIC can raise funds relatively cheaply, the loans made to CHPs can be at better rates than available on bank loans. (There have been concerns, noted in a recent review of the NHFIC), that the collateral required by NHFIC, such as a first mortgage over all the CHP's assets, reduce their ability to also attract bank funding). Because it raises long term funds via its bond issues, it is able to make longer term loans to CHPs than are typically available from banks.

The housing bond aggregator operates a bit like a securitiser, but with two major differences. Like a securitiser it aggregates a large number of individual loans to CHPs until a sufficient scale is reached to issue a bond which ultimately funds those loans. In the interim its "warehouse funding" is the ability to draw upon a special account provided by the Federal government. The pool of loans provides the collateral for the bonds issued – but this is actually, of little significance. The reason, and also the reason that the NHFIC can raise cheap bond funding, is that the bonds are issued with a government guarantee. The guarantee is one difference to a typical securitisation. The second difference is that the bonds issued have a fixed term with regular interest coupon payments and principal repayment at maturity. In effect, the NHFIC operates like a financial institution, making loans and raising funds via the bond issues. It therefore has to manage such risks as credit risk associated with its loans, liquidity (or funding risk), and interest rate risk. The special housing policy role of the CHPs and the special account available to the NHFIC make the nature and management of these risks somewhat different to those faced by other financial institutions.

As at mid 2021, the NHFIC had made five fixed rate bond issues, mainly to Australian asset managers such as superannuation funds. Each of the issues was for greater than AUD 300 million and for maturities of between 10 and 15 years. While the bonds are AAA rated, reflecting the government

guarantee, the lack of secondary market maturity is likely to be one factor explaining why they offer an interest rate of 20 or more basis points over equivalent maturity government bonds.