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Hunter's Corner

Tim Hunter

How destructive regulation works

The Commerce Commission is showing its bad side in targeting peer-to-peer lender Harmoney

Lots of people don't like maths. There is even a mathematics anxiety rating scale (MARS) developed in 1972 by psychologists Frank Richardson and Richard Suinn, which attempts to measure "feelings of tension and anxiety that interfere with the manipulation of numbers and the solving of mathematical problems."

One consequence of high maths anxiety, wrote Cleveland University academic Mark Ashcraft, is that sufferers avoid maths and "espouse negative attitudes toward math."

Rather than use a basic mathematical technique to solve a problem, for example, a screaming 10 on the MARS scale might prefer to draft vague and subjective legislation, leading to strife down the track as people try to figure out what it means.

The Commerce Commission put a cost on that strife in 2013, when it told a parliamentary committee it had spent $1 million that year on litigation to clarify the meaning of the Credit Contracts & Consumer Finance Act (CCCFA) 2003, and expected to spend a further $2.1 million the following year.

Although the act has been reviewed many times since it came into force in April 2005, the spending continues.

This week the commission announced it was going back to court to seek guidance on how the act applies to peer-to-peer lender Harmoney, which could keep our learned friends employed for many months.

The consequences for Harmoney are severe. The company has spent millions setting up its lending platform and recruited overseas investors to back its business model, with the apparent blessing of the Financial Markets Authority and the commission.

The legal action means disruption for its fee structure, loss of confidence for its investors, potential difficulty raising capital and a long period of distraction and cost as management deal with the court case.

A regulator could scarcely be more destructive without procuring a giant wasps' nest, agitating it vigorously and releasing it into the previously calm interior of its victim's compact Parnell office space.

Yet all this would be unnecessary if we were prepared to be a bit more numerical in our approach.

Here's why.

HARMONEY'S FEE STRUCTURE

Borrowers pay*	$375 per loan
Lenders pay**	20% of interest earned on loans up to $9999
	17.5% of interest earned on loans up to $49,999
	15% of interest earned on loans of $50,000+

*Since December 3, 2015; ** Since June 13, 2016

HARMONEY'S PERFORMANCE*

Revenue	$8.6m
Net loss	$14.2m
Contributed capital to date	$26.9m
Net equity	$6.8m
Total loans arranged to date	$298m

*Year to March 31, 2016

Intermediary

Harmoney is set up on the basis that it is not itself a lender. Rather, it facilitates transactions between Joe Lender and Fred Borrower and charges a fee for the service.

This idea is explicitly recognised by the Financial Markets Authority, which says peer-to-peer lending "involves an intermediary, the peer-to-peer lending service, bringing borrowers and lenders together, and charging a fee for the service."

The Financial Markets Conduct Act and Regulations, which came into force in 2014, make specific provision for peer-to-peer lenders and vests the FMA with powers to license them.

Harmoney was the first such lender to be licensed in July 2014.

Now let's look at where the Commerce Commission is coming from.

It has asked the High Court for a declaration on whether Harmoney's "platform fee," which is charged to borrowers, is a "credit fee" within the meaning of the CCCFA.

The platform fee was initially 2-6% of the amount borrowed, with a $375 minimum but changed in December to a flat fee of $375.

It sounds like bland bureaucratic nitpicking but it isn't because, under the CCCFA, a credit fee must not be "unreasonable" – and according to the Supreme Court's May decision in a case involving the commission and retailer Sportzone, that means it can be set to recover only the costs specific to a lending transaction.

For an online provider like Harmoney, whose business is based on trying to make the cost of each transaction close to zero, the consequences of that restriction would be significant.

But is it a credit fee?

Under the CCCFA, a credit fee is charged by a lender to a borrower but, if Harmoney is an intermediary, it can't be a lender, right?

Not according to the Ministry for Business, Innovation and etc because compliance with the CCCFA requires the lender to be identified to the borrower, and Harmoney couldn't identify its lenders in that way, so set up a trust to take the money from individual lenders and act as the named lender.

That means, says MBIE in its advice to Minister Paul Goldsmith, either Harmoney or the trustee is the lender and "we consider that having the provider of the peer-to-peer lending service as a creditor under the CCCFA would be most appropriate." So there.

FMA and MBIE disagree

The same advice, dated February 2016, reveals the FMA thought this idea was nuts, although it didn't put it like that.

"The FMA disagrees with the position taken by the Ministry and the Commerce Commission on the issues above," it said – the issues being unreasonable fees and who is a creditor.

Not only that, the FMA reckons even if the commission insists its position is right, "it would be unreasonable to penalise these newly licensed entities, or to require them to defend their position in court, when the interpretation of the CCCF Act is not clear and was not highlighted to them prior to their licence applications."

Nonsense, the law is the law, says the ministry, with the flexibility of a breeze block.

Underlying its concern, it seems, is the notion that borrowers should be able to compare loan terms easily.

"Limiting fees is necessary for borrowers to be able to compare interest rates, and therefore readily compare the cost of credit," the ministry says.

The goal of comparability is a good one but not if it inhibits the development of low-cost business models that compete with traditional lenders such as the big banks. Harmoney is not the finished article by any means but it is a promising innovator in financial services that could go far.

If only there were another way. Oh wait, there is.

As the Supreme Court noted in the Sportzone case: "Parliament's rejection of the approach requiring disclosure of the overall cost of credit (as was required under the Credit Contracts Act 1981) means that comparing competing offers is more difficult under the 2003 act than under the previous legislation."

The legal action means disruption for its fee structure, loss of confidence for its investors, potential difficulty raising capital and a long period of distraction and cost as management deal with the court case

That's right – the CCCFA made it harder to compare loan terms by eliminating the requirement to disclose the finance rate, also known as the annual percentage rate or APR, in previous legislation.

The APR is the standard comparison in jurisdictions such as the UK and the US, and boils the cost of a loan including fees down to a single figure.

It takes a bit of maths but it is a hell of a lot easier than spending months in court.

thunter@nbr.co.nz