Proposal to prohibit Rule of 78 in computation of HP interest will not impact banks significantly, says PwC

BY **CHERYL POO**

The proposal to do away with the Rule of 78 method in calculating hire purchase (HP) interest, in order to modernise HP financing practices to align with current operating conditions and regulatory developments while also being fairer to consumers, is not expected to impact banks with large HP portfolios significantly, says PwC Malaysia.

Last Wednesday, the Consumer Credit Oversight Board Task Force (CCOB Task Force) in its second public consultation paper (CP2) proposed the removal of Rule of 78, a method of calculating HP contracts in which interest is calculated on the total principal without taking into account that after each repayment, the borrower owes the bank/company less each month.

The formula for calculating term charges or interest rate in relation to a HP agreement is set out in the Hire Purchase Act 1967 (HPA), whereby the Rule of 78 method is required to be used by HP providers offering flat rate loans.

Given that the interest charges are front-loaded in the earlier months of the loan tenure, Rule of 78 puts borrowers who make early settlements at a disadvantage, compared with other methods of calculating interest payments, such as the reducing balance method.

With the change, the reducing balance method, which charges interest on the outstanding balance of the loan each month, will be used by HP providers in calculating interest. HP providers will still be able to offer HP loans based on fixed or variable rates.

"The benefit of a fixed rate loan is that the interest rate imposed is fixed and will remain the same throughout the loan tenure compared with a variable rate loan, which may seem cheaper when the overnight policy rate is low. However, the loan will become more expensive once the OPR increases as the interest rate will also increase accordingly," the CCOB Task Force said in an FAQ.

The change will need to be effected through amendments to the HPA and will be tabled in parliament in the fourth quarter together with the Consumer Credit Bill.

"There should not be significant financial implications for the bank, save perhaps some operational changes," PwC financial services leader Elaine Ng tells *The Edge*.

Ng, who was consulted by the task force on the accounting aspects of the proposal, explains that banks have been recognising interest based on effective interest rate (EIR) as mandated under the Malaysian Financial Reporting Standard (MFRS) 9, which was adopted in January 2018.

The standard replaces MFRS 139 "Financial Instruments: Recognition and Measurement", introducing some changes including the classification and measurement of financial assets, but retains key principles such as the measurement of financial liabilities, PwC explains on its website.

Note that EIR is the rate of interest actually earned on a loan over the course of a year, including the effects of compounding. Therefore, an investment with a stated interest rate of 5% may actually have a higher EIR once compounding is factored in.

Ng illustrates: "Going by Rule of 78, a stated interest of 2.5% may have EIR of 4.5%. Therefore, the bank already recognises 4.5% instead of the contractual interest rate of 2.5%. Hence, I don't foresee major implications for the bank other than the fact that those with a separate system catering for Rule of 78 will eventually do away with the system. Most institutions have a core banking system to calculate interest anyway."

However, some financial practitioners suggest that moving away from Rule of 78 could make consumer HP less attractive for players such as Public Bank Bhd, Malayan Banking Bhd (Maybank) and Hong Leong Bank Bhd, which have substantial HP portfolios.

"[The proposal] could water down interest income for banks," notes a former banking analyst.

Could this then denote a shift from automotive loans as a major earnings generator, or banks reducing their resources going towards the segment, given that most financial institutions are still using Rule of 78?

"The chances are there but since vehicle financing contributes to loan growth, banks will continue to do it," a banker points out.

HP receivables make up about 14.1% of Maybank's total loans, and 16.1%, 4.85% and 11% for that of Public Bank, RHB Bank Bhd and Hong Leong respectively.

RHB says it will not be impacted by the new calculation as it bases its HP calculation on reducing balance.

"RHB has been a proponent of the reducing balance method for auto financing. We believe this will provide flexibility to the borrower to save on interest and also spur product innovation in this space," says RHB Banking Group managing director of group community banking Jeffrey Ng, adding that the group has observed "increasing volumes of hire purchase and growth in submission over the years, with a CAGR (compound annual growth rate) of 4.24% over the last four years".

RHB, which has a market share in excess of 5% in the auto segment, expects its HP applications to grow 13% this year.

Needful and timely for consumers

Financial planners *The Edge* spoke to concur that the proposal is needful and timely for borrowers, the majority of whom are regarded as being unaware of banks' internal workings of HP.

"Generally, Rule of 78 loans were always a problem for [the reasons stated above], so it's good to see this move. [The proposal] follows best practices around the world from a consumer protection angle, and borrowers enjoy lower effective borrowing rates, especially when they choose to settle their loans early.

"Right now, consumers who are aware of the differences have resorted to increase their borrowing on housing loans (under the reducing balance calculation) to finance car purchases should the opportunity arise," says Felix Neoh, director of financial planning at Finwealth Management Sdn Bhd. Neoh says that several banks have offered hire purchase loans using the reducing balance method of calculation under variable interest loans pegged to the base lending rate, however, the take-up for these loans are lower relative to traditional HP loans.

"The HP rate has a lower headline interest rate compared with that of the reducing balance method. Therefore, when you go to dealers who are often unfamiliar or uneducated about the difference, they tend to recommend HP, which appears to be cheaper," he explains.

"Considering that there are still a number of Malaysians who are resorting to withdrawals from their EPF (Employees Provident Fund) savings (which should be the last resort), I would say that pockets of Malaysians continue to face cash flow issues," Neoh says.

Meanwhile, the proposed changes to the HPA also include the acceptance of digital and electronic signatures for HP agreement processes.

Rule of 78 has been recognised globally to be unfair to borrowers and is prohibited in Australia, New Zealand, the UK and some states in the US.

According to the CP2, the proposed enhancements will only apply to new HP contracts signed after the relevant provisions in the revised HPA are enacted and come into effect.

Existing borrowers will continue to be bound by the terms of their HP contract. E

CP2 sets out proposed licensing requirements, governance and conduct expected of non-bank credit providers, including BNPL operators

Last Wednesday, the Consumer Credit Oversight Board (CCOB) Task Force issued its second public consultation paper (CP2), inviting feedback on the proposed regulatory framework for credit businesses and credit service businesses.

This followed the first consultation paper issued on Aug 4, 2022, on the new Consumer Credit Act (CCA) that will regulate consumer credit services.

The CP2 covers the requirements on authorisation, governance and conduct expected of all non-bank credit providers and credit service providers that are currently unregulated. In particular, this refers to businesses carrying out buy now, pay later (BNPL) activities, leasing and factoring services, debt collection agencies (DCA), impaired loan buyers (ILB) and debt counselling and management services (DMA).

The scope of CP2 covers, among others, proposed key licensing requirements, including minimum financial requirements, governance and shariah requirements for Islamic credit businesses. It also sets out professional conduct and responsible lending standards that must be met by potential licensees.

The proposed minimum shareholders' fund (SHF) for BNPL, factoring, leasing and ILB activities has been set at RM2 million, while DCA and DMA are required to have SHF of RM500,000, or SHF of RM250,000 and professional indemnity insurance coverage of RM250,000.

Shareholders (or controller), directors and senior management of businesses involved in the consumer credit industry must meet high standards of ethics and professionalism in order to build trust among the public. As such, in authorising persons who intend to carry out consumer credit business, the CCOB must be "satisfied that controllers, directors and senior management are able to carry out their roles and responsibilities effectively, honestly and with integrity".

Appendix 2 of CP2 sets out the fit and proper requirements for the licence applicants under the CCA, in relation to the organisations, shareholding composition and key personnel.

An organisation's directors, chief executive, controller, senior management officer and compliance officers' fitness and probity will be based on, at minimum, factors relating to probity, personal integrity and reputation; competency and capability; and financial integrity.

It is worth noting that the written approval of the CCOB is required for the appointment of a credit business' chief executive, to "ensure that the candidate is fit and proper and suitably qualified to assume the position".

Furthermore, any vacancy in the position must be filled within three months.

The appointment of directors may be done without the prior approval of the CCOB. However, the credit service provider must undertake the necessary due diligence to ensure the suitability of the candidate.

CP2 defines "controller" in relation to a licensed credit provider or registered credit service provider as a person who:

(a) is entitled to exercise, or control the exercise of, not less than 33% of the votes attached to the voting shares in the licensed credit provider;

(b) has the power to appoint or cause to be appointed a majority of the directors of the licensed credit provider or registered credit service provider; or

(c) has the power to make or cause to be made, decisions in respect of the business or administration of the licensed credit provider or registered credit service provider and to give effect to such decisions or cause them to be given to.

Public feedback on the proposals must be submitted to the CCOB Task Force by May 15, 2023.

The task force is supported by the Ministry of Finance, Bank Negara Malaysia and the Securities Commission Malaysia.

The CCA, which will provide for the establishment of the CCOB as the competent authority for the credit industry, is targeted to be enacted by the end of this year.

The immediate focus of the CCOB in Phase 1 (2024–2025) will be on non-bank credit providers and service providers that are currently not subject to direct regulation by any authority within Malaysia, namely non-bank leasing and factoring companies and entities offering new forms of credit such as BNPL.

Phase 2 (2025–2030) covers activities such as moneylending, pawnbroking, hire purchase and credit sales, while Phase 3 will see the establishment of an integrated conduct regulator for the credit industry.