PART 1

HFC FINANCIAL SERVICES LIMITED

HFC Financial Services Limited (HFC) conducts throughout Victoria and in all other States a business of providing credit. That credit appears to be provided almost exclusively to individuals seeking it for personal as distinct from business purposes.

In terms of numbers of loans made, by far the majority of contracts entered into by HFC with Victorian consumers are for amounts not exceeding $20,000. Thus most of HFC's lending activities in Victoria are subject to the Credit Act 1984 (the Credit Act) and the Credit (Administration) Act 1984 (the Administration Act).

HFC requires a licence under the Administration Act in order to continue to carry on its business in Victoria. It applied for a licence on 10 April, 1985 and thereby became entitled, in effect, pursuant to section 37 of the Administration Act to continue to carry on its business pending the grant or refusal of its application. Objections to the granting of a licence to HFC were made by the Consumer Credit Legal Service Co-operative Limited (CCLS) and the Director of Consumer Affairs (the Director).

It is that application and the objections made thereto that have been the subject of the present proceedings.

The Corporate Structure

HFC is incorporated in New South Wales and is a wholly owned subsidiary of HFC of Australia Limited. Household Group Australia, Inc. which is incorporated in Delaware in the United States of America is the holding company of HFC of Australia Limited and is part of the Household group of companies of which the ultimate holding company is Household International Inc.

From 2 June 1981 to 30 June 1986 HFC was ultimately owned equally by the Myer Emporium Limited and Household International Inc., pursuant to an agreement which also gave Household International Inc. pre-emptive rights to acquire more equity in HFC. On 30 June 1986 Household International Inc. exercised its pre-emptive right and acquired from Myer all of the shares in HFC to which it was not then entitled. Household International Inc. has continued from 30 June 1986 onwards to be the ultimate owner of all of the shares in HFC.

In February 1985 HFC acquired all the shares in another finance company, BFC Finance Limited (BFC) which at the time of the takeover was conducting a business similar in nature to that of HFC throughout Australia.

The greater part of HFC's consumer lending business is conducted through a network of branches which it maintains throughout Australia. In Victoria, the number of branches has declined from a peak which occurred at the time of the acquisition of BFC. As at October 1988, there were 17 ordinary branches in Victoria, a centralised collections office, and a Branch at which all continuing credit business is handled and which is known as the "91 Branch".

The business of HFC

HFC provides three classes of credit in Victoria which are regulated by the Credit Act, namely -

personal loans
retail sales contracts
continuing credit contracts

Personal loans constitute the credit business of HFC which is directly written at branch offices. They include unsecured loans, loans secured by chattel mortgages and loans secured by mortgages of real property. Loans in the last category are referred to by HFC as real estate loans. Except where such loans are for amounts exceeding $20,000 and do not involve the refinancing of an earlier contract by HFC, all of the personal loans entered into by HFC since 28 February, 1985 are regulated loans for the purposes of the Credit Act.

Retail sales contracts is the term given internally by HFC to credit contracts introduced to HFC by retailers of household appliances and furniture with which HFC has entered into merchant agreements. In substance, HFC lends money to persons desiring credit to facilitate the purchase of goods from those merchants and all of those lending transactions constitute regulated loans within the meaning of the Credit Act.

The company's other class of lending business consists of credit provided under what are commonly known as "private label" credit card arrangements. For these purposes HFC enters into arrangements with various merchants under which HFC will provide credit to persons wishing to purchase goods or services from time to time from a particular merchant. The contracts between HFC and the consumer under these arrangements are in the nature of continuing credit contracts but the solicitation appears to invariably occur at the merchant's premises. A continuing credit contract so formed contemplates the provision of credit from time to time for the purchase of goods or services from that particular merchant only, and a credit card bearing the name of that merchant is issued to the consumer - hence the term "private label" credit card. It is possible for an individual consumer to be party to a number of continuing credit contracts with HFC each providing for the provision of credit for the purchase of goods or services from a different merchant.

At all times HFC has actively sought, at the time when consumers are entering into credit contracts with it, to induce the borrowers to take out credit insurance and term life insurance with one or both of its subsidiary insurance companies, Heritage Life Insurance Limited (Heritage Life) and Heritage General Insurance Limited (Heritage General).

After the proceedings were well under way it was announced by HFC that it proposed to establish an entirely new form of continuing credit business as its major form of regulated lending and in all probability to discontinue its fixed term lending operations. The proposed business is termed "revolving lending" to distinguish it from HFC's existing private label continuing credit business. It would involve the issue of an HFC card with which cardholders could obtain cash advances at branches and at automatic teller machines operated by one of the major banks. Cardholders would also be able to purchase goods and services from a range of merchants with whom HFC proposed to enter into merchant agreements.

PROFITABILITY OF HFC AND ITS SUBSIDIARIES

HFC is the holding company in Australia for 8 subsidiary companies. The subsidiaries and their respective contributions to HFC's consolidated group profit for 1987 are as follows:

	1987 profit after Tax $000
Heritage General	885
Heritage Life	4.421
BFC	1.683
HFC Leasing Limited	52
Eastrock Finance Corporation Pty. Limited	128
Household Building Society (Victoria)	3
Household Building Society (Tasmania)	(65)
HFC Superannuation Pty. Limited	-
	7.107

The profit of HFC itself in 1987 was $1.676M after tax.

Total shareholders' funds at 31 December 1987 for HFC and its subsidiaries were $66.134M represented by $32.492M in issued share capital attributable to the holding company and $33.642M in retained profits.

The profit objective for the HFC group is 15% return after tax on shareholders' funds plus 1.8% return after tax on assets. This is the basis upon which HFC aims to cost its funds and to price its products after taking into account the various cost components incurred in its business operations.

HFC'S Own Profitability

HFC does not accept deposits directly from the public and thus the cost to it of borrowing funds is higher than is the cost to banks. Funds are borrowed from domestic banks, from overseas banks operating in Australia and from other institutional lenders. A small proportion of those funds has been provided by the issue of debentures but there have been no recent debenture issues. There are presently no overseas borrowings other than a subordinated loan from the overseas parent.

The company produced evidence as to the average cost of funds and of branch and administrative costs and bad debts for each of its four classes of lending business, i.e. personal loans, retail sales contracts, revolving credit and real estate loans.

Applying these figures, the company has estimated the interest rate which it would be required to charge for each class of lending if a target of 15% return on shareholders' funds (after tax) is to be achieved for each class. Evidence was also led as to the actual rates of interest charged in each of the four classes of lending.
With the exception of real estate loans, HFC has been unable to achieve the desired results with its various classes of loans. The principal factors which enable the real estate loan business to meet the

company's target of profitability are a much higher average loan amount with consequential lower branch and administrative costs per dollar lent, together with a very much lower bad debt experience. In theory it should be possible for HFC to charge sufficiently higher lending rates for the other classes of lending business to achieve the desired profitability after allowing for the higher administrative and branch costs associated with smaller loans and worse bad debt experiences. However, market forces appear to preclude the charging of such rates and further, at least in Victoria in relation to loans secured by goods mortgages, the 30% maximum rate fixed by the Credit Act might be an impediment.

Indeed it appears that in 1987, again applying the company's own allocations of branch, administrative and bad debt experiences, not only did all classes of lending, other than real estate loans, not achieve target profitability, actual losses were incurred in each class of business. Mr. Miller in his evidence indicated that the results for 1988, particularly with respect to personal loans, would be worse than those for 1987 and that HFC itself would incur a loss for that year. He anticipated that 1989 would also produce an operating loss for HFC.

In more general terms, the recent financial history of HFC itself shows a picture of declining profitability. Retail sales contracts and revolving credit business have never been profitable. The personal loan business was profitable in 1986, was unprofitable in 1987 and is estimated by HFC to prove to be unprofitable in both 1988 and 1989. It is little wonder in these circumstances that the company is considering a major change in its credit business by winding down fixed term lending and replacing it with revolving lending. It hopes through the revolving lending venture to achieve much reduced overheads and higher average outstandings and thus restore profitability to HFC.

Profitability of the Group

From 1986 onwards, only four of the subsidiaries have made significant contributions to group profits -

BFC

Eastrock

Heritage Life

Heritage General

BFC was a major contributor in 1986, contributed significantly less in 1987 as its receivables ran down and its contribution to group profit will presumably thereafter diminish further. Eastrock made a major contribution in 1986 but an insignificant contribution in 1987. Heritage Life and Heritage General between them are making increasingly larger contributions to group profit, as the following table shows -

Year ended Dec.	Heritage Cos. profits as percentage of HFC Group profit
1985	40.6
1986	54.0
1987	64.6

By the end of 1987, Heritage companies were contributing well over 60% of group profit. Heritage's contribution in percentage terms may well be higher in 1988 and 1989, if only as a consequence of the lower profitability of HFC itself and the winding down of the profitable business of BFC.

It is clear to the Authority that HFC itself faces something of a challenge in regaining a state of regular profitability. Its future results depend upon the success of the new revolving lending project which will not commence in Victoria until the second half of 1989.

In the Authority's view, the future profitability of a licence applicant is a relevant consideration only to the extent that it may affect the likelihood of the applicant conducting its future business efficiently, honestly, and fairly. In the case of the present application, we merely note the considerable pressures that will exist to turn HFC's results around and that these pressures may not create the most ideal climate for a company which has admitted numerous past shortcomings and is pledging to make and maintain fundamental and costly changes to its business organisation and practices.

The Authority also notes, however, the pledges of further support from the American parent company to ensure that these changes are effected and maintained.

Finally on the subject of HFC's profitability, it will be noted that no regard has been had to the possiblity that HFC may suffer the loss of credit charges on past contracts which are the subject of HFC's section 85/86 application. In our view it is quite inappropriate for the Authority to engage in any speculation on that matter.