Clarification of my position in response to submission by Min-it Software to the Senate Economics Legislation Committee: Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011

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In the submission by Min-it Software, it is alleged that I have stated that I would rather see no credit than credit at a high cost (as I recall it, that statement was actually made by Loretta Kreet of Legal Aid Queensland, but I do agree that potentially harmful credit products probably have no place in the market), and that if even one person is disadvantaged as a result of being a recipient of fringe credit, then fringe credit providers should be "legislated out of existence." I don't think I have ever used those words.

This paper sets out in some detail the position that I have sought to articulate in relation to fringe credit. I have considered the role that fringe credit plays in society, and the need for small amount credit to be available to low income consumers, but have argued that that credit should be provided on safe and affordable terms. If fringe credit providers are unable to provide credit on the basis of charging reasonable costs and interest, and allowing reasonable repayment periods so as not to 'set borrowers up for a fall,' then regulatory measures which may impact upon their viability as businesses are justified.

On the face of it, these fringe lenders are performing a valuable service, in providing credit to people who would otherwise be denied access to it. They are in effect 'filling a gap'. There are concerns, however, regarding the harms associated with this form of credit, particularly given the vulnerability of many of the borrowers accessing it. A distinction tends to be drawn between non-mainstream lenders who operate for purely commercial purposes, and who would fall within the 'fringe lender' category, and those non-mainstream lenders who operate for a social purpose of addressing financial exclusion and alleviating poverty through microfinance.[1] These latter lenders would fall outside the ‘fringe lender’ category, and include credit unions, Community Development Finance Institutions (such as Foresters Community Finance for which I currently serve as chair of the board) and community sector organisations.

Fringe credit in Australia

The fringe credit industry, concerned with providing very short term payday loans as well as longer term small amount credit, has become a significant industry in Australia over the last decade.[2]

The National Financial Services Federation (“NFSF”), which describes itself as ‘the peak industry body representing micro-lenders and payday lenders in Australia,’[3] divides the lending undertaken by its members into ‘payday loans’ and ‘micro loans’. It defines a payday loan as:

> A small, short-term loan, they usually have a 2 to 4 week duration and are designed to meet unexpected expenses. They are not suited for long-term borrowing or continuing financial needs, and are best reserved for temporary cash flow problems.[4]

It defines micro loan as:

> A loan with a duration of two months to two years. They are generally for amounts of $500 or more, with an industry average principal of $1000. These loans are generally used to meet larger expenses such as replacing whitegoods, car registration, rental bonds, dental expenses and unexpected travel.[5]

Consistent with this, a study by the Queensland based Centre for Credit and Consumer Law (“CCCL”) into interest rate capping, divided fringe loans into payday

[1] See discussion in Market Intelligence Strategy Centre, 'Consumer Credit Report' (MISC Australia, 2006), 10-11.
[2] Market Intelligence Strategy Centre, above n 1.
[3] National Financial Services Federation, 'Submission to Financial Services and Credit Reform Green paper' (National Financial Service Federation, 2008),1.
[4] Ibid, 2.
[5] Ibid, 2.

and non-payday loans.[6] For purposes of analysis, it also divided loans into small loans (in the vicinity of $300) and large loans (in the vicinity of $1000), and found that whilst few micro-lenders were prepared to offer the large loan on a payday basis (defined in this study as 'short term lending for personal, domestic or household purposes of up to 2 months duration')[7], there were some who would lend the larger amount on a short-term basis.[8] The study surveyed 40 members of the NFSF operating in Queensland and noted that seven of the survey respondents offered large payday loans for amounts in the vicinity of $1000, for loan periods ranging between one and eight weeks.[9] The data collected indicated an all-inclusive (that is, inclusive of fees and charges) annual percentage rate of interest of between 300 per cent and 3380 per cent for the payday loans products. The non-payday loans, having durations of more than eight weeks, had an all inclusive annual percentage interest rate of between 114 per cent and 580 per cent.[10]

How big is the fringe credit industry in Australia? A report prepared by Market Intelligence Strategy Centre ("MISC") in 2006 noted the discrepancies in, and lack of reliable sources for, estimates as to the size of the industry.[11] According to the NFSF, payday loans products and micro loans products jointly 'represent $500 million in loans throughout Australia per annum'.[12] In its report, MISC takes the approach of projecting US data onto the Australian market and population, and estimating a 'potential domestic market flow of $10 billion' in micro-credit transactions annually.[13] This estimate takes into account 'micro lending market segments of pawnbroker, car title lender, payday and online as well as cheque cashing'.[14]

Given the large scale on which fringe credit products are available in Australia, and the suitability of these products for meeting small amount credit needs, one might argue that this aspect of financial exclusion has already been addressed by the market

[6] Howell, Wilson and Davidson, 'Interest Rate Caps: Protection or Paternalism?' (Centre for Credit and Consumer Law), 34-45.
[7] Ibid, 37.
[8] Ibid, 34-35.
[9] Ibid, 38.
[10] Ibid, 39.
[11] Market Intelligence Strategy Centre, above n 1, 50-56.
[12] National Financial Services Federation, above n 3, 2.
[13] Market Intelligence Strategy Centre, above n 1, 57.
[14] Ibid, 57.

and that there is no need for the involvement in the marketplace of the other actors, whose potential roles were explored in the previous three chapters. The problem with this suggestion is that it ignores the potential harms of fringe credit products to low income Australians. Burkett and Drew note that the market response to financial exclusion in this country has been the provision of exploitative and expensive credit options, involving 'difficult conditions' for borrowers.[15]

The harms of fringe credit

The evidence is of a growing fringe credit industry in Australia, which has been recognised as causing harm to at least some Australian consumers. In this part I identify the key harms of fringe credit, which make it an inappropriate solution to the problem of financial exclusion. I will focus on two key harms: first, diminishing capacity to save due to high cost and drawing income from people and communities who can least afford it; and second, debt spirals leading to 'debt traps' due to features such as loan rollovers and a failure to assess capacity to repay. Both of these harms only exacerbate over-indebtedness, leading to serious economic consequences, whereas the provision of safe and affordable credit, structured on terms that a borrower can afford to repay, will avoid over-indebtedness and address financial exclusion in a positive way.

Diminishing capacity to save and drawing income from people and communities who can least afford it

This section argues that where low income people are paying a high cost for credit, their capacity to save and to invest in their communities is inevitably diminished. Lenders are in effect 'sucking dry' low income households and communities, and this will only serve to burden social welfare systems or reduce facilities and services available within these communities.

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[15] Ingrid Burkett and Belinda Drew, *Financial Inclusion, Market Failures and New Markets: Possibilities for Community Development Finance Institutions in Australia* (2008) Foresters Community Finance Limited <http://www.foresters.org.au/site/DefaultSite/filesystem/documents/PossibiltiesforCommunityDevelopmentFinanceInstituionsinAustralia.pdf> at 11 February 2009, 31.

Where consumers are focused on using their incomes to meet debt repayments, it has been noted that 'getting ahead becomes almost impossible. As a result the *status quo* is perpetuated and it becomes more difficult for lower income consumers to improve their status.' [16]

There is a clear and obvious inequity in those who can least afford it paying the most for credit, and as a result finding their low economic status entrenched. \

Further, given the high costs associated with fringe credit products, default or 'failure' is more likely than if the credit products were priced more affordably, thus perpetuating the perception that low income borrowers are more risky than more affluent borrowers. Fringe borrowers are said to become ensnared in a 'negative feedback loop' where higher prices lead to higher failure rates.[17] This is particularly likely to be the case with payday loans because of their very short term nature, almost dooming borrowers to failure:

> Borrowers start out with an extremely small surplus. To give them only two weeks to accumulate enough money to pay off a loan and to leave them with nothing to pay for emergencies that may arise during the life of the loan, is an untenable position.[18]
>
> Meanwhile the household's capacity to meet other expenses is further strained, perpetuating the feedback loop…[19]

Fringe borrowers become entrenched in a cycle of over-indebtedness, unable to save or 'get ahead', and unable to improve their positions so that they might access more affordable, mainstream credit products. High cost credit has the potential to oppress those on low incomes in the sense of preventing them from improving their financial

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[16] Lynn Drysdale and Kathleen Keest, 'The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society' (1999-2000) 51 *South Carolina Law Review* 589, 665 citing Swagler, Roger, 'The Alternative Financial Sector: An Overview', (1995) 7 *Advancing the Consumer Interest*,7, 9.
[17] Ibid, 663.
[18] Charles Bruch, 'Taking the Pay out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders' (2001) 69 *University of Cincinnati Law Review* 1257, 9.
[19] Drysdale and Keest, above n 16, 665.

positions. The problems that arise due to ‘repeat borrowings’ and the consequent over-indebtedness of low income consumers[20] will clearly have an impact on their purchasing power and ability to acquire assets. This harm is closely linked to the concept of the ‘debt spiral’ defined as ‘revolving and increasing debt’.[21]

Debt spirals

The use of fringe credit products, and in particular the shortest term payday loans, can lead to borrowers becoming ‘trapped’ in a ‘debt spiral’ where high fees are paid on an ongoing basis with little reduction in the debt itself.

The evidence is that fringe borrowers will often need to renew loans ‘resulting in significant durations of indebtedness’.[22] Bruch asserts that ‘payday loans trap borrowers in a usurious and unconscionable cycle of debt.’[23] Whereas accessing affordable credit can assist people to asset build, high cost credit can lead to ‘debt traps’.

Loan rollovers are regarded as a particularly harmful aspect of payday loans leading to debt spirals. A loan is rolled over where a borrower, who is unable to repay the loan at the end of the loan period, pays a further fee to renew the loan, thus extending the repayment period. The loan rollover can become inevitable due to the short term nature of the loan coupled with the high cost. Repayment in full within the loan period is impossible for the low income borrower who will have ongoing expenses to meet with his or her income. This will leave insufficient funds to completely extinguish the debt within the time period allowed.[24]

Considerable amounts can be paid in rollover fees over time, without the borrower making any reduction in the principal amount owing. This model whereby loans are renewed or rolled over upon payment of a fresh loan fee, has been described as ‘the

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[20] See discussion in Nicola Howell, 'High Cost Loans: A Case for Setting Maximum Rates?' (Centre for Credit and Consumer Law, 2005) ,23-24; see also Udo Reifner, 'Micro-Lending- A Case for Regulation' (Undated),3.

[21] Neil Ashton, 'Payday Lending Report- Draft Literature Review' (Consumer Action Law Centre, 2008), 26.

[22] Paige Marta Skiba and Jeremy Tobacman, 'Payday Loans, Uncertainty and Discounting: Explaining Patterns of Borrowing, Repayment, and Default' (Research Paper No 08-33, Vanderbilt Law and Economics, 2008), 6.

[23] Bruch, above n 18, 5.

[24] See for example discussion in Michael Berticsdoc, 'Fixing Payday Lending: The Potential of Greater Bank Involvement' (2005) 9 *North Carolina Banking Institute* 133, 138.

foundation of the payday lending business model'[25] while at the same time being the feature most likely to lead a borrower into a 'debt trap' from which they will find it difficult to escape. A study of 100,000 payday loan borrowers in Texas, U.S., between 2000 and 2004 showed that many people use payday loans on a recurrent basis, renewing or 'rolling over' loans rather than paying them in full.[26] The study noted that:

> Many borrowers turn to payday loans on a regular basis for liquidity. On average customers borrowed 5.5 times per year that we observed them; 25 per cent borrowed 10 or more times and 10 per cent borrowed 20 or more times. Renewing loans is common, rather than paying the loans in full, resulting in significant durations of indebtedness. Almost half of the loans in our sample are renewed.[27]

Notwithstanding that payday loans tend to be small, given the tendency towards 'rollovers' and other instances of 'repeat borrowing', payday loan recipients have been found to have a bankruptcy rate six times the average rate in the U.S. [28] Although payday loans themselves are relatively small, people who use payday loans in the U.S. are already financially stressed and borrow repeatedly at high cost, therefore suffering a higher than average rate of bankruptcy. [29] This might be regarded as the inevitable culmination of the 'debt spiral'. While this has not been fully tested in the Australian market, given similar features of payday loans offered in Australia to those offered in the U.S., it is likely that accessing payday loans will involve similar risks of bankruptcy.

While most of the data and studies on the 'debt spiral' phenomenon derive from the U.S., concerns should be raised about essentially identical products being offered to Australian consumers. Some consumers may manage payday loans and other forms of fringe credit well but the risk of harm to at least some other consumers needs to be

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[25] Uriah King, Leslie Parrish and Ozlem Tanik, 'Payday Lending Sinks Borrowers in Debt with $4.2 Billion in Predatory Fees Every Year' (Center for Responsible Lending, 2006), 3.
[26] Skiba and Tobacman, above n 22, 2-6.
[27] Ibid, 6.
[28] Ibid, , 11.
[29] Ibid, 1.

taken into account in deciding whether the fringe credit industry is one which plays or could play a positive role in addressing financial exclusion.

While the availability of fringe credit might meet an immediate need for credit, the high cost and prospects of loan renewal associated with fringe credit mean that the positions of those on low incomes become entrenched and there is little scope for them to improve their positions through accessing the credit. This can be contrasted with the experiences of those accessing no interest or low interest loans from the community sector, or those accessing affordably structured loan products from Community Development Finance Institutions, which include benefits to self-esteem and broader social inclusion.[30]

The benefit of fringe credit in the marketplace: meeting a need

This section outlines two possible benefits of having fringe credit products available to Australian consumers. The first is that these products fill a 'gap' left by mainstream lenders who do not service the low income market. There is therefore a risk that should fringe credit providers abandon the market, for example because of an unfavourable regulatory regime, low income Australians will either have nowhere to turn in order to have their small amount credit needs met or will be driven into the arms of even more unscrupulous 'black market' lenders. The second benefit is said to be the approachability of fringe lenders from a consumer perspective and the convenience associated with quick approval processes. I argue that not for profit lenders seeking to engage in this market could learn from fringe credit product design and processes, but that it cannot be accepted that high cost fringe credit is the best that can be done to meet the small amount credit needs of low income Australians.

Filling a mainstream gap

Financial exclusion in Australia is about lack of access to mainstream financial services. There is a 'gap' in the market, not being met by mainstream financial institutions, in the provision of safe and affordable small amount credit to low income

[30] Valerie Ayres-Wearne and Janet Palafox, 'NILS. Small Loans- Big Changes' (Good Shepherd Youth and Family Service, 2005), 36.

Australians. Fringe credit providers argue that they are performing as essential service.

One study indicates that the very availability of credit, even at high cost, is a benefit in itself. This was a study undertaken in South Africa, involving one of the largest and most profitable fringe lenders in that country.[31] This lender was described as offering 'small, high interest, short-term, uncollateralized credit with fixed repayment schedules to a working poor population'.[32] The study involved loan applicants who had been rejected by the lender, termed 'marginal rejects' not 'egregious rejects'. Approximately 40 per cent (335 in number) of those marginal rejects were then extended the credit that they had applied for. These were referred to as the 'treatment group'. The other marginal rejects totalling 462 in number remained rejected and were treated as a control group.[33]

The average loan size in this experiment was $127 which was 40 per cent of the average borrower's gross monthly income. Most members of the treatment group (98 per cent) received a loan at a rate of 11.75 per cent per month (or 200 per cent per annum) charged on the original balance over four months and paid as four equal monthly instalments.[34] The most common loan purpose was to pay off other debt; followed by clothing and transportation expenses, both enabling the loan recipient to work; followed by educational and housing expenses. [35] It seems likely that the loan purposes may have had some impact on the findings in terms of impact of the loans, for example, it is understandable that loans enabling a person to work will assist in quality of life. This was noted in the study.[36]

Over a six to 12 month period following the making of the loans, it was found that those in the treatment group were significantly more likely than those in the control group to be in employment, and also that they had significantly higher incomes. They

[31] Dean Karlan and Jonathan Zinman, 'Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts.' (2007).
[32] Ibid, 7.
[33] Ibid, 11.
[34] Ibid, 7-9.
[35] Ibid, 20-22.
[36] Ibid, 21.

were also less likely to experience hunger and were more likely to have positive outlooks with respect to their prospects and position. Interestingly though, the research found negative impacts on mental health amongst the treatment group, including higher incidences of depression and anxiety.[37] This was not able to be explained. Those in the control group had not been able to access credit elsewhere.[38]

The researchers report as follows:

> Our results corroborate the presence of binding liquidity constraints and suggest that expanding credit supply improves welfare. There are three key sets of findings. First, control applicants who were randomly denied by our cooperating lender did not simply obtain credit elsewhere; conversely, treatment applicants who were randomly assigned a second look increased their total borrowing and increased their lender type composition, in the 6-12 months following the experiment. Second, we find that treated applicants benefited from the expanded access. We use household surveys to measure a range of tangible and subjective outcomes 6 to 12 months following the experiment, and find significant and positive effects on job retention, income, food consumption quality and quantity, and household decision-making control and mental outlook. We find negative effects on other aspects of mental health (principally stress). But on net the impacts are significant and positive.[39]

It is notable that the loans in question, while high cost, were payable by instalments over a reasonable (namely four month) period of time. It may be that features such as the repayment period are more relevant to the question of affordability than the interest rate charged, in that such a loan is less likely than say a payday loan to lead a borrower into a 'debt spiral' as described above.

The argument here would be that access to some credit is better than none, when small amount credit needs arise. This needs to be balanced against the harms outlined in the previous part and the inherent unfairness and economic discrimination in offering credit on high cost terms on the ground of income. If a product can only be offered at high cost with the potential to cause harm to at least some consumers, one

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[37] Ibid, 5.
[38] Ibid, 31.
[39] Ibid, 31.

has to question whether this product is capable of having a positive impact with regard to financial exclusion.

Approachability and convenience

While it is generally accepted that the primary reason for borrowers accessing high cost credit is a lack of access to mainstream credit,[40]it has also been recognised that fringe credit providers offer borrowers a degree of convenience and respect not available to these borrowers from the mainstream financial sector. Anecdotal evidence suggests that low income borrowers feel comfortable approaching fringe credit providers, and are treated with respect in the manner of valuable customers. Ramsay notes that:

> …individuals may choose to deal with these high priced services rather than with the mainstream financial system. This may be because of factors such as convenience and the ability to obtain cash or goods immediately or dislike of dealing with banks.[41]

Loan products (with the obvious exception of the more rigid, short-term payday loan) can be flexible and payments structured so as to be manageable. Research has indicated that borrowers may be attracted to fringe credit providers because they offer:

- easy, quick and non-bureaucratic access;
- simple, straightforward and transparent products;
- manageable repayments, made on a weekly basis, that do not require banking facilities;
- no hidden charges or penalties for default;
- a flexible and sympathetic approach to repayments.[42]

[40] Elaine Kempson et al, 'In or Out? Financial Exclusion: A Literature and Research Review' (Financial Services Authority, 2000), 45; Elaine Kempson and Claire Whyley, 'Kept Out or Opted Out? Understanding and Combating Financial Exclusion' (The Policy Press, 1999), 39; Iain Ramsay, 'Access to Credit in the Alternative Consumer Credit Market' (Office of Consumer Affairs, Industry Canada and Ministry of the Attorney General, British Columbia, 2000), 17.
[41] Iain Ramsay, 'Access to Credit in the Alternative Consumer Credit Market' (Office of Consumer Affairs, Industry Canada and Ministry of the Attorney General, British Columbia, 2000), 17.
[42] Kempson et al, above n 40, 45.

Being able to borrow relatively small sums of money has also been identified as an attractive feature of fringe credit.[43]

In a newspaper advertisement advocating against interest rate capping in Queensland, Cash Converters, a short-term, small cash loan provider, has claimed to offer services with characteristics mirroring some of those described above.

> Cash Converters has helped over 85,000 Queenslanders to overcome financial hurdles by providing them with quick and convenient short-term credit…Our customers like the friendly service they receive. They like the fact that our lending policies are always fully and clearly explained. Most of all, they like the fact that they are never judged…Our customers welcome and appreciate the fact that everything about their loan is explained up-front and in full…84% of Cash Converters' customers rated our loan service as 'excellent' or 'good'.[44]

These are lessons which have been learned by Fair Finance UK in seeking to inject genuine competition to high cost lenders into the short-term small-amount loan market in the East End of London. Customers are attracted and defaults are minimised due in part to being able to tailor loan repayments to fit welfare payments, being flexible about holding off on payment debits if notified by the customer that there is a problem that week, and increasing repayment periods where necessary.[45]

In terms of convenience, Cash Doctors, an Australian based payday lender refers to its quick, convenient application process in justifying a 'convenience premium' charge on its loans:

> Clients of Cash Doctors are the only payday loan clients in Australia who benefit from accessing several hundred dollars within a hour or two by completing an online application form and digitally signing a contract without spending valuable time compiling application paperwork.[46]

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[43] Karen Rowlingson, *Money Lenders and their Customers* (1994), 6.
[44] Cash Converters, 'Short-term, small cash loans: 85,000 Queenslanders can't be wrong', Advertisement appearing in *The Sunday Mail*, Brisbane, 23 September 2007, 40.
[45] Interview with Faisel Rahman, London, September 2008.
[46] Cash Doctors, 'Payday Lending: Economic and Social Benefits Revealed' (Cash Doctors, 2007), 3.

Ramsay notes the lessons that banks, CDFIs and other not for profits engaging in small amount lending can take from this.

> Informality and flexibility are hallmarks of these forms of lending and this suggests that the design of any alternative to attract individuals away from using these institutions should pay close attention to this aspect if it is to be successful.[47]

To the extent that mainstream financial institutions, Community Development Finance Institutions and community sector organisations seek to compete with the fringe sector, the need to be approachable, respectful and flexible should be incorporated into product design.

The fringe credit sector has responded to a ‘mainstream gap’ in the market and provided small amount credit to meet the credit needs of those excluded from accessing mainstream credit products. This is, however, a response which involves economic discrimination, through the charging of high rates of interest in part due to borrowers’ income levels. Attempts at regulating fringe credit have to some extent sought to address this unfairness through regulating the cost of credit, and ensuring that the same legal protections are available to all consumers of personal credit products. I argue, however, that the inherent unfairness of this market response remains, and that a new market response to provide safe and affordable credit alternatives to low income Australians remains essential to address market failure.

Interest rate caps

In focusing on regulating fringe credit rather than on providing safe and affordable credit alternatives, governments in Australia have to date focused on regulating the cost of credit through interest rate caps. Government discussion papers and reports have been published exploring the benefits and disadvantages of such a regulatory response.[48] A 48 per cent per annum interest rate cap, inclusive of fees and charges,

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[47] Ramsay, above n 41, 18.

[48] See for example Queensland Office of Fair Trading, 'Managing the Cost of Consumer Credit in Queensland Discussion Paper' (2006), Ministerial Council on Consumer Affairs, *Long Term Regulation of Fringe Credit Providers Discussion Paper* (2003), Office of Consumer and Business

currently operates in New South Wales, Queensland and the Australian Capital Territory.[49] In Victoria there is a cap of 48 per cent per annum on unsecured loans, and 30 per cent per annum on secured loans, however fees and charges are not included in either cap.[50]

Fringe credit providers have complained that such caps will effectively put them out of business, leaving a gap in the market, as they are unable to operate profitably under the caps. [51] They have, however, managed to continue to operate in states with caps by exploiting loopholes. One example of this in Queensland was a fringe lender writing loans at 420 per cent per annum by framing the loan transaction as a pawnbroking transaction, allowing borrowers to use $1 CDs and DVDs as collateral.[52] This did not infringe the cap, as pawnbroking transactions are not covered by the UCCC.[53]

In 2008, a report was released by the Queensland based Centre for Credit and Consumer Law ('CCCL') in relation to the question of interest rate capping. [54] Key arguments against the introduction of an interest rate cap were stated to be: first, that a cap will exacerbate financial exclusion, by removing an option for people who cannot access credit through mainstream services; second, that interest rate caps are easily avoided, difficult to enforce and so waste regulatory resources; and third, that the loan amount in relation to one type of fringe credit product, the payday loan, is so small that even a high rate of interest does not equate to anything more than a minimal debt burden on the borrower.

Some argue that a cap will exacerbate financial exclusion by reducing the amount of credit available, asserting that 'policy makers and regulators must be mindful that

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Affairs, South Australia, *Payday Lending in South Australia- Options to Increase Consumer Protection: Discussion Paper* (2006)

[49] Howell, Wilson and Davidson, above n 6, 8-11.

[50] Ibid, 10.

[51] Ibid, 74-76.

[52] Patrick Lion, 'Loan Rip-Off. Sky-High Rates Exposed as Lenders Skirt Law', *The Courier Mail* (Brisbane), 16-17 August 2008, 1.

[53] Section 7(7) Uniform Consumer Credit Code.

[54] Howell, Wilson and Davidson, above n 6.

setting caps on fees or setting implied interest rates arbitrarily low could easily curtail or eliminate the flow of credit to the high-risk borrowers who need it most.'[55]

This argument was accepted by the UK government when it introduced the *Consumer Credit Act* 2006 without a cap:

> Introducing caps would harm the very consumers they are supposed to help. Caps would reduce the range of credit products available, force vulnerable consumers to use inappropriate alternative products or even to go outside the regulated market to loan sharks.[56]

Consumer advocates dismiss this argument noting that there is no benefit in having a product available in the market which is exploitative and causes harm:

> While individual consumers in financial hardship may very well desire the opportunity to obtain credit no matter how bad the terms, as a matter of policy it is not at all clear that the withdrawal of loans with exorbitantly high interest rates is a bad thing.[57]

This view is supported by the findings of a U.S. organisation that surveyed people in North Carolina following the termination of payday lending in that state, to ascertain whether the payday lenders were missed by those people.[58] The interviewees were comprised of 159 households that had had a recent financial crisis, and 240 households that had not. The findings of the study were that a lack of access to payday loans had no impact upon the majority of those households, with most stating that the absence of payday lending had had a positive effect on that household:

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[55] Michael Stegman, 'Payday Lending' (2007) 21(1) *Journal of Economic Perspectives* 169, 186-187.
[56] Department for Business Enterprise and Regulatory Reform, UK, *Frequently Asked Questions on Consumer Credit Act 2006* (2006) <http://www.berr.gov.uk/consumers/consumer_finance/credit_act_2006/FAQs/page244> at 8 December 2008.
[57] Ashton, above n 21, p9.
[58] Center for Community Capital, 'North Carolina Consumers After Payday Lending' (Center for Community Capital, 2007) .

> The vast majority of households surveyed – more than three out of four – said the elimination of payday lending had no effect on their household. This percentage declined only slightly for those families that experienced financial distress (71%) or who had been payday borrowers in the past (68%). The overwhelming majority of households – almost nine out of ten – said payday lending was a 'bad thing'. This strong negative rating held true for households that had experienced a financial hardship or had borrowed from a payday lender in the past. Respondents who felt they were better off without payday lending well out-numbered those who thought they were better off with it. For the full sample, twice as many respondents said the absence of payday lending has had a positive effect on their household than said it has had a negative effect. The 159 respondents who actually experienced a recent financial shortfall – arguably those most likely to consider a payday loan and miss its availability – had responses similar to the overall survey population...former payday loan borrowers generally felt the absence of payday lending to be a good thing, rather than a bad thing.[59]

The argument that a cap will exacerbate financial exclusion depends upon current high rates reflecting the true cost of fringe lending such that an interest rate cap will cause fringe credit providers to withdraw from the market. This is certainly the assertion of fringe credit providers themselves, for example Cash Doctors' assertion that:

> Cash Doctors' average cost for providing a loan to date is $100. If Cash Doctors charged a mainstream unsecured loan interest rate of 12% on a $200 loan over our average loan period of 24 days, $1.58 of gross revenue would be generated, resulting in a $98.42 loss on the loan. If Cash Doctors charged the proposed capped interest rate of 48% per annum, $6.31 gross revenue would be generated yielding a $93.69 loss on the loan.[60]

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[59] Ibid, 4.
[60] Cash Doctors, above n 46.

While most commentators accept that that is the case, there is no empirical evidence as yet to support the argument that fringe lending cannot continue on a sustainable basis under a 48 per cent cap, given sufficient loan volume and greater efficiencies in product delivery. Fair Finance UK is an organisation that is operating a sustainable small loans social enterprise in London at rates of between 28 per cent and 35 per cent per annum[61] and National Australia Bank engaged in an experiment in partnership with fringe lender Mobile Finance Pty Ltd trading as Money Fast which demonstrated the 'break even' lending rate was 28.25 per cent per annum.[62] Foresters Community Finance Limited is currently offering individual finance through its Fair Finance Australia program, on similar terms to those offered by Fair Finance UK.

There is evidence of interest rate caps leading to an absence of fringe credit providers in the market, one example being Quebec where there is a 35 per cent cap and where no payday lenders operate.[63] Such evidence 'may be used to illustrate the impact that regulatory decisions may have on the continued viability of the industry.'[64]

In relation to Quebec, however, Ben-Ishai cautions that the availability of credit through credit unions has impacted upon the presence of payday lenders. [65] Having a safe and affordable alternative may have had as much, if not more, impact on the presence of fringe credit than interest rate caps. It seems likely that a viable, safe affordable alternative to fringe lending may be just as effective in discouraging fringe lenders from entering or continuing in a market, as an interest rate cap, and this will be discussed below in terms of injecting greater competition into the small amount loans market.

New York is another example of a state without payday lenders. This is unsurprising given its general cap of six per cent per annum (with an exception allowing banks to

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[61] See Fair Finance UK, *Welcome to Fair Finance. Isn't it Time You Got a Fair Deal?* (2008) <http://www.fairfinance.org.uk> at 8 December 2008
[62] See National Australia Bank, 'Do You Really Want to Hurt Me? ' (2010)
[63] Stephanie Ben-Ishai, *Regulating Payday Lenders in Canada: Drawing on American lessons,* CLPE Research Paper 16/2008 (2008), 32- 33.
[64] Ibid, 33.
[65] Ibid, 33.

charge 16 per cent per annum).[66] This is clearly a rate aimed at prohibition, not just regulation.

In relation to the second argument, that interest rate caps are easily avoided, difficult to enforce and waste regulatory resources, it is undoubtedly the case that without adequate resources to properly enforce a cap, a cap will be ineffective in its goal of removing high cost exploitative lending from the market.

The effectiveness of the cap in New York in prohibiting payday lenders from operating there is said to be not so much about the cap, but more about effective enforcement. New York regulators believe that:

> New York has managed to exclude payday lenders only through conspicuously aggressive enforcement…the large national providers know that they would face litigation immediately if they opened stores in New York.[67]

Mann and Hawkins argue with regard to New York that ‘the difference, it seems, is not in the usury limit but in the ability of regulators to bring and prevail in litigation to enforce them.’[68]

To be effective, a cap must be accompanied by effective enforcement which, it should be acknowledged, is likely to be costly. Mann and Hawkins give the example of Texas as a state with a 24 per cent cap, but where the law is circumvented by fringe lenders operating in Texas but partnering with out-of-state banks.[69]

There are concerns regarding the ‘blunt’ nature of an interest rate cap, and suggestions that a ‘structured cap’ based on calculations of all costs (defined either under the

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66 Ronald Mann and Jim Hawkins, 'Just Until Payday' (2006) 54 *UCLA Law Review* 855,31.
67 Ibid,31-32.
68 Ibid, 32.
69 Ibid,29-31.

heading of 'fees' or 'interest') of lending, is preferable.[70] This would enable regulatory control over the costs of fringe credit, but in a manner informed by *actual costs* as demonstrated by empirical evidence. It could be argued that this would allow fringe products to remain available to consumers but on fairer terms.

A similar idea is to allow the fringe industry to put forward its own suggestion for regulation with a view to arriving at a regulatory structure acceptable to both regulators and the industry, enforced under a model of 'enforced self-regulation', described as the public enforcement of privately written rules.[71] Such privately written rules are likely to be well informed and therefore more effective and appropriate[72] and clearly less likely to lead to a departure of fringe credit providers from the market. Importantly in terms of regulatory efficiency, this model would be less likely to lead to attempts by the industry to circumvent or avoid regulation through loopholes. One example is what is described by Mann and Hawkins as 'explicit toleration'.[73] In the United States, a group representing major payday lenders, has prepared a model bill[74] which has been adopted in a number of States in the US, for regulating the payday lending industry.

> The model bill contains several notable features: loans can only be made for $500 or less, loans can only be renewed 3 times, borrowers can rescind a loan within a day, lenders must obtain licences to operate, lenders cannot use threats of criminal prosecution for check fraud, and most striking, fees are capped at 20% of the first three hundred dollars lent and 7.5% of any funds lent over three hundred dollars. [75]

Criticisms that might be raised against such a model would include the inappropriateness of setting a cap at the point where the products are profitable for

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[70] Ian Manning and Alice de Jonge, 'Regulating the Cost of Credit' (2006) 59 *National Economic Review* 1 <http://search.informit.com.au.libraryproxy.griffith.edu.au/fullText;dn=200700054;res=APAFT>ISS0813-9474> at 16 June 2008,26-27

[71] Robert Baldwin and Martin Cave, *Understanding Regulation: Theory, Strategy and Practice* (1999),133

[72] Ibid, 40.

[73] Mann and Hawkins, above n 66, 24- 25.

[74] The Deferred Deposit Loan Bill.

[75] Mann and Hawkins, above n 66, 24- 25

suppliers, as opposed to the point at which consumers are adequately protected against the risk of finding themselves in 'debt traps' and 'debt spirals'. The focus of any capping measure should be on what is reasonable and affordable for consumers, and will not cause harm to vulnerable consumers. If a product cannot be offered at such a rate then it is arguable that it should not be offered at all.

Consumer groups dispute the claim that, in the case of one type of fringe loan – the payday loan – the loan amount is so small that even a seemingly high rate of interest does not equate to anything more than a minimal debt burden on the borrower.

They refer to their own research which:

> ...indicates that 40% of payday loans are for $500 or more (and 14% for $1000 or more). When one considers that payday borrowers can borrow $1000 or more per loan, and take out several loans per year from the same lender or a different lender, it becomes clear that it is often not the case that payday loans are for small dollar amounts, and for this reason it is not reasonable to conclude that the debt burden from these exorbitantly priced loans is relatively low.[76]

A related argument is that it is not the cost of the original loans that are problematic, so much as the rollovers and renewals of loans, and that this should be the focus of regulatory intervention as opposed to a cap. It is argued that 'policymakers and regulators should focus more of their attention on ways to limit rollovers and back-to-back renewals of payday loans, rather than focusing on the price of a single short-term advance.'[77]

The CCCL identified as key arguments in favour of a cap, first, that caps are a means of protecting people from usury and exploitation; and second, that demonstrating a

[76] Ashton, above n 21,11.
[77] Stegman, above n 55,186.

demand for fringe products does not justify their continued supply, given their inherently harmful nature.

In terms of interest rate caps being a means of protecting people from usury and exploitation, Ramsay has commented that ‘ceilings are one attempt to ensure that individuals do not pay what are regarded as exploitative rates for credit.’[78]

This may be particularly important in a non-competitive market where borrowers find themselves in an unequal bargaining position with little choice as between products.[79] The fact that there is little price competition amongst fringe credit providers, who consistently charge high costs for their loans, is well recognised.[80] This will be discussed in further detail below in the context of the need for greater competition in this market.

By limiting the amount that can be charged for credit, those who can least afford to pay high costs for credit are protected from doing so, consistent with what has been described as ‘an ancient moral tradition sceptical of the advisability of high-cost loans to those with limited means.’[81]

In the US, one consumer organisation alleges that:

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[78] Ramsay, above n 41,20.
[79] See discussion in Geraint Howell, ‘The Potential and Limits of Consumer Empowerment by Information’,22-23, and in Ashton, above n 21,29.
[80] Competition Commission, U.K., *Home Credit Market Investigation* (2006) <http://www.competition-commission.org.uk/inquiries/current/homecredit/index.htm> at 14 October 2008, 7-8; Howell, Wilson and Davidson, above n 6, 34-45.
[81] Christopher Peterson, 'Over-indebtedness, Predatory Lending, and the International Political Economy of Residential Home Mortgage Securitization: Comparing the United States' Subprime Home Mortgage Lending Crisis to Home Finance in the United Kingdon, Germany and Japan' (2008) <http://ssrn.com/abstract_id=1083184> at 25 January 2008,6.

> Those states which enforce a comprehensive interest rate cap at or around 36 percent for small loans have solved their debt trap problem; realizing a savings of $1.5 billion for their citizens while preserving a more responsible small loan market.[82]

Consumer groups also argue that, even if interest rate caps have the effect of removing fringe credit from the market, demonstrating a demand for fringe products does not justify their continued supply. That is to say, we should not 'conflate demand with need….To argue…that wherever there is demand there ought to be supply, regardless of the social harm, is not helpful.'[83]

This is consistent with Bruch's comment that:

> Payday lenders say they are providing a valuable service that borrowers are entitled to receive. Those outside the industry heartily agree that payday lenders are providing a service; however, they submit that this service is predatory, usurious, and unconscionable, and that in some cases denying credit to an individual is in the individual's best interest.[84]

This is a difficult argument in that it presumes to 'know what is best' for low income consumers notwithstanding that they may be deprived of access to credit as a result. Financial exclusion, which in Australia is primarily about lack of access to mainstream credit and particularly small amount credit,[85] has been shown to have significant social consequences.[86] I argue that the provision of small amount credit is possibly an essential financial service or social right, which needs to be available to all members of the community in order to cover emergencies and smooth out the cost of large purchases.

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[82] Uriah King and Leslie Parrish, 'Springing the Debt Trap: Rate Caps are the Only Proven Payday Lending Reform' (Center for Responsible Lending, 2007),4.
[83] Ashton, above n 21, 30.
[84] Bruch, above n 18,1287.
[85] See discussion in Nicola Howell and Therese Wilson, 'Access to Consumer Credit: The Problem of Financial Exclusion in Australia and the Current Regulatory Framework' (2005) 5 *Macquarie Law Journal* 127,129; and Chant Link and Associates, 'A Report on Financial Exclusion in Australia' (ANZ, 2004),58.
[86] See discussion in Howell and Wilson, above n 85,130-131.

Perhaps a better approach is one that acknowledges the need to 'meet the demand' but to do so in a safe and affordable way through ensuring the availability of safe and affordable credit options. Therefore regulators need to construct a policy and regulatory environment to encourage and facilitate safe and affordable small amount lending to low income consumers, to offer real choice in the market place. In the meantime, limiting the availability of potentially harmful products through caps on interest rates is a reasonable response.

Can we regulate to 'keep' fringe credit while keeping consumers safe?

A question for regulators is whether it is possible to regulate fringe credit provision so that it can remain available to low income Australians, addressing financial exclusion without causing harm. Specifically, in this section I ask whether a fringe credit market could operate so as to positively address financial exclusion, either under an interest rate cap or in a more competitive environment in which prices were kept down and harmful practices were minimised or removed. I argue that it is unlikely that regulation can effectively change the nature of fringe credit providers so as to render them positive contributors to financial inclusion.

Fringe credit providers are in one sense providing a service that appears to be needed, and which is not being met by mainstream financial service providers. Fringe credit providers themselves maintain that they cannot operate profitably under a 48 per cent per annum cap on interest rates. If they could, and were prepared to structure repayments so as to meet low income borrowers' needs, financial exclusion in Australia would to a large extent be addressed, with previously excluded consumers being able to access credit on safe and affordable terms. Essentially, if fringe credit products could be offered at affordable rates and structured so as to be repayable without hardship, either through the imposition and effective enforcement of an interest rate cap and responsible lending requirement or driven by necessity in response to injected competition into the fringe market, then they would serve a valuable social role. If that is not possible, then their utility as a financial institution providing access to credit to people otherwise excluded from access to credit becomes doubtful.

There is currently a lack of competition in the fringe market which arguably permits excessive pricing and inefficiencies. A lack of competition is evidenced by a lack of price advertising by fringe lenders in Australia.[87] Most advertising by fringe lenders promotes features such as ‘easy access’, ‘no credit checks’ and ‘bankrupts okay’, rather than the cost of the product.[88] There do not seem to be competitive forces operating in the fringe market with respect to price, resulting in most fringe credit providers charging the highest rate that they are legally able to charge in any given jurisdiction.[89]

Evidence also suggests that fringe lending is a highly profitable business for suppliers,[90]and there is no clear evidence as yet to suggest that fringe credit products cannot be supplied sustainably at a lower interest rate, such as at the 48 per cent capped rate. An analysis of the fringe credit industry in the US notes the growth and profitability of this industry, and the relatively low risks associated with fringe lending.

> While risks exist – as in all industries – they are mitigated by loan collateral, excessive mark up in prices, and the socialization of losses among a class of borrowers. Put another way, enough people will make good on their payday loans to compensate for the bad ones – not difficult, given the extremely high industry-wide profit margins. In short, industry claims about the high risks associated with serving marginal populations are exaggerated.[91]

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[87] Dean Wilson, 'Payday Lending in Victoria- A Research Report' (Consumer Law Centre Victoria, 2002),77; Howell and Wilson, above n 85,136.
[88] Wilson, above n 87,49.
[89] Sheila Bair, 'Low-Cost Payday Loans: Opportunities and Obstacles' (The Annie E. Casey Foundation, 2005),29
[90] See discussion in Sue Lott and Michael Grant, 'Fringe Lending and "Alternative" Banking: The Consumer Experience' (Public Interest Advocacy Centre, 2002),14 , 22; and Bruch, above n18,1270.
[91] Howard Karger, *Shortchanged. Life and Debt in the Fringe Economy.* (2005), 11.

The vulnerable position and lack of choice of many of those who borrow from the fringe sector also contributes to an ability on the part of lenders to overcharge, or ‘rent seek’ in economic terms.[92] Drysdale and Keest ask:

> …how much of the higher price is compensation and how much instead may be opportunistic pricing. Opportunism may distort the market process because of unequal bargaining power, ‘information asymmetries’ (unequal information and understanding) and actual or perceived absence of choice.[93]

The operations of Fair Finance U.K. and the NAB/ Money Fast experiment referred to above add weight to an argument that fringe credit providers could operate profitably while charging lower rates of interest.

Berticsdoc describes the fringe credit market as one exhibiting the characteristics of a ‘persistent imperfect market’ where sellers have incentives to ‘engage in tacit price collusion and form an oligopoly.’[94] Those characteristics are that the industry is young with only a small number of competitors, where there is an inability on the part of buyers to price shop, and where competition within the industry is based on factors other than price.[95] He notes in terms of ‘rent seeking’ behaviour by payday lenders, that payday lenders have been shown to receive 24 per cent return on their capital, while banks make closer to 15 per cent return.[96]

An argument can be mounted that in an uncompetitive market regulatory intervention is both justifiable and necessary. Mann and Hawkins argue that ‘a government inappropriately cedes regulatory power to a private enterprise when it allows

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[92] See discussion in Michael Berticsdoc, 'Fixing Payday Lending: The Potential of Greater Bank Involvement' (2005) 9 *North Carolina Banking Institute* 133, 141.
[93] Drysdale and Keest, above n 16, 661-662.
[94] Berticsdoc, above n 92, 142.
[95] Ibid, 142.
[96] Ibid, 144.

businesses to define the terms of commerce with consumers in realms in which competitive forces do not constrain the terms.'[97]

If it is the case that fringe credit cannot be offered at a reasonable interest rate, structured over a reasonable repayment period, its failure to survive under an interest rate cap will be an appropriate outcome in that the product being lost to the market will have been shown as incapable of being offered on safe and affordable terms.

Conclusion

In assessing the potential role of fringe credit in addressing financial exclusion in Australia, I have considered the harms and benefits of having fringe credit products in the marketplace. On the one hand, there is inherent inequity in those who can least afford it paying the most for access to credit, making it difficult for those people to save or otherwise improve their financial positions, sometimes resulting in what have been termed 'debt spirals'. On the other hand, a demand for small amount credit products in the market is being met, notwithstanding that it is at a high cost. It may be that the high cost will not be problematic in itself provided the loan is 'affordable', in the sense that the loan term and loan repayments are structured so that the borrower can meet them without undue hardship. The question of inequity remains, however, in that scenario. Another key benefit being provided by fringe lenders is convenience in the sense of quick application processes and loan provision; approachability and a perception on the part of borrowers that they are being treated with respect, as valued customers, by those lenders. Other lenders seeking to engage in this market must seek to mirror those attributes in order to be successful.

If fringe credit products can be offered at affordable rates, whether under an interest rate cap or due to an injection of serious competition into their market, then they will serve a useful social purpose. Equally, if they can meet responsible lending

[97] Mann and Hawkins, above n 66,37.

requirements, through loans being structured so as to be capable of being repaid by borrowers without undue hardship, then they may have some social utility.

If fringe credit cannot be offered on these bases then setting and enforcing an interest rate cap with a view to removing these products from the market would be justified, on the grounds that having no products is preferable to having products available that are likely to cause harm to vulnerable consumers. There must however be a concerted regulatory effort to facilitate the availability of safe and affordable credit products on the market for those consumers.