

## Investing in consumer finance businesses

In the 1970s, Waltons Stores was the first mainstream business in Australia to discover that low-income borrowers unable to get credit elsewhere could be profitable. Door-to-door hawking of high interest credit left many pensioners in an ongoing cycle of debt, often requiring welfare assistance such as food parcels.

Lending to marginal borrowers is now big business, but at the core of this sector's success are a growing number of techniques designed to navigate around consumer protection laws. Fringe mortgage lenders sometimes require borrowers to sign that credit is for business purposes, thereby avoiding compliance with consumer laws. "Pay day" lenders have avoided the 48% maximum interest rate in some states by simply calling the high costs 'fees' instead of 'interest'. Others provide 'interest-free' loans but artificially inflate the value of the underlying collateral, thus increasing the size of the loan.

The Australian Financial Review (**AFR**) often canvasses issues relevant to investors or potential investors in consumer credit businesses. One of the most recent pieces looked at the prospects of Radio Rentals and Flexigroup [*Some credit where it's due*, AFR Market Wrap 19 April 2007]. While these companies do not attempt to avoid the consumer laws altogether, they construct their contracts to take advantage of the laxer rules for consumer leases, even when their agreements should be written as loans. Accordingly, the companies are not required to disclose to borrowers matters such as the interest rate or the total cost of the contract, and consumers lose protections relating to repossession and penalties for early termination.

Unlike commercial leases, consumer credit laws state that if the consumer has a right to purchase the goods, the agreement is a loan and must be documented as such. So, how do these companies get around these laws?

There are a number of very creative approaches to removing the 'right to purchase' from what is, in essence, a credit purchase contract. Radio Rentals do not give the consumer the right to purchase the goods, but the right to purchase 'similar' goods. One of Flexigroup's Flexirent contracts allows the consumer to sell the goods as Flexirent's agent, and to retain all but \$1 as sales commission.

As pointed out by the AFR, the purchasers under these contracts tend to be consumers on lower incomes. These consumers are, paradoxically, the people most in need of clear contract disclosure and protections against exploitative practices.

These techniques have not yet been tested in Court and consumer groups look forward to the opportunity to do so. Governments are also looking more closely at these practices, although they must take some responsibility for the time taken to plug legislative loopholes. Any prudent investor should be pricing in the increased regulatory risk that such companies necessarily carry.

More importantly, many ethical investment funds would already explicitly exclude businesses that target low-income consumers with products that avoid protections and encourage financial over-commitment. All investors should consider whether they wish to buy into the consumer law avoidance business.

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