

Key Points

- High-cost short term loans, commonly known as payday loans, typically lend around \$200-500 for a term of two to four weeks at interest rates that equate to over 400% per annum.
- These loans are generally used by low income earners to pay basic, recurrent costs. Repayments are secured through direct debits which take a first stake on borrower's income, severely limiting low income borrowers' ability to afford essentials like food and rent. This exacerbates financial stress and prompts further lending and spirals of debt.
- NSW, Qld and ACT each have comprehensive interest rate caps which prevent lenders charging annual percentage rates over 48%. Elsewhere, regulation does not adequately protect consumers from the harm caused by these loans.
- Responses to fringe lending will be considered through phase two of the national consumer credit reforms. We recommend the Australian Government take this opportunity to legislate a 48% comprehensive interest rate cap.

Introduction

Most Australians would be surprised, if not shocked, to hear that thousands of their compatriots regularly borrow money at interest rates equivalent to 400% per annum or more. They may be further surprised to discover such borrowers are often on very low incomes and generally use the money to pay for recurrent basic expenses, such as food and electricity. This kind of lending is perfectly legal, and business is booming. This paper summarises a 2010 report by Zac Gillam and the Consumer Action Law Centre (Consumer Action) which sought to:

- **update empirical research** into the economic and social impact of high-cost short term lending in Australia, in particular the 2002 report *Payday Lending in Victoria* by Dean Wilson of the Consumer Law Centre Victoria Ltd; and
- **examine the economic arguments** for regulation of the high-cost short term lending industry, including the effect of comprehensive interest rate caps.

The report, prepared with funding from Consumer Affairs Victoria's Consumer Credit Fund, drew on two pieces of commissioned primary research, case studies from financial counsellors, an in-house literature review and a number of other sources.

What are high-cost short-term loans?

High-cost short term loans are often described as '**payday loans**'. Lenders also describe them in a variety of ways, from '**short term finance**' to '**cash advances**' to '**personal finance solutions**'. Loans are commonly for amounts between \$200 and \$500, advanced to individual consumers and are designed to be paid back within a short period of time, generally 2 to 4 weeks.

High-cost short term loans typically attract an annual percentage rate, or APR, of 400% or more. APR is an industry standard method of measuring the annual cost of credit including both interest and fees and charges. By making more costs transparent to a consumer at point of sale, APR allows consumers to objectively compare the relative cost of competing credit products.

The problem

High-cost short term loans are harmful because, where used other than as a one-off, they worsen rather than improve the consumer's financial position. Although these loans are marketed as a one-off solution to temporary problems, the annual reports of large Australian payday lenders and a great deal of evidence from the US indicate that repeat borrowing is common and necessary for viability of the lenders' business.

Consumers overwhelmingly use high-cost short term loans to meet basic needs.

Consumers overwhelmingly use high-cost short term loans to meet basic needs. Consumer Action's 2008 research found that 22% of users of high-cost short term loans used the money to pay for car repairs or registration. The next most common reason was to pay utility bills (21%), followed by food or other essentials (18%) and then rent (11%).

Providers of high-cost short term loans use direct debit agreements to secure payment of instalments which withdraw the debt repayment as soon as pay or benefits are deposited into the borrower's account. When a borrower is already on a limited income (the majority are, as discussed below) this impinges on their capacity to pay for essentials like food or rent, prompting additional financial stress and further borrowing.

The combination of customers using loans to meet basic recurring costs and lenders requiring payment by direct debit actively promotes repeat borrowing and spirals of debt for low income borrowers.

The customers

According to Consumer Action's 2008 survey, the core market for high-cost short term loans is low-income borrowers in their 20s and 30s. Slightly under half (45%) have a dependent child or children and 45% are in full-time employment. When borrowers are in employment, 73% report income levels below the average wage, with 23% reporting incomes of less than \$20,000.

Customers are largely unaware of the cost of high-cost short term loans, either in interest rate or dollar terms. Only 9.4% of customers in our 2008 survey said they chose a particular lender based on price, compared to 54% who decided based on location, and 17% because they had a prior relationship with that lender. Taken together, the lack of price awareness and the fact that purchase decisions are rarely based on price suggests that there is little or no pressure on lenders to compete on cost.

All users of high-cost short term loans participating in our 2008 research had also used at least one other form of credit in the previous 12 months. Sixty-three per cent had used a credit card, 38% had sought loans from family and friends and 28% had accessed Centrelink Advance payments.

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The industry

The high-cost short term lending industry has grown explosively since the first Australian lender of this type was launched in 1998. As an indicator of the pace of growth, Cash Converters (the industry's largest operator) has experienced a 973% increase in principal loaned between the 2002-03 and 2008-09 financial years (rising from \$11.6 million to \$124.5 million) and a 51% increase in average loan size (increasing from \$200 to \$303).

Lenders typically conceal the cost charged on the principal loaned, generally by characterising interest as a 'fee', which is itself rarely advertised. Online lenders generally avoid disclosing the cost of the loan on their home-page and most require the consumer to at least request a loan before disclosing the cost. Others do not disclose cost until the consumer has had direct contact with a sales representative. This further reduces price competition.

Lenders typically conceal the cost charged

Marketing is aggressive and continues over a long period. If consumers begin but do not complete an application, they are often subjected to significant follow-up emails and text messages urging them to complete the sale. Survey participants report frequent contact from lenders they have borrowed from previously - letters, birthday cards, offers of rewards for referrals - to encourage them to borrow again.

Current regulation and upcoming reform

Regulation of consumer credit has traditionally been the responsibility of the States and Territories, resulting in significant variation between jurisdictions. The Uniform Consumer Credit Code (UCCC), introduced in all jurisdictions in 1996, sought to address this inconsistency, however it has had mixed success and offers little protection for users of high-cost short term credit.

In addition to the UCCC provisions, Queensland, New South Wales and the Australian Capital Territory have all introduced comprehensive interest rate caps set at 48% APR. A comprehensive rate cap is one that includes interest as well as applicable fees and charges. This can be contrasted to an interest only cap, which ignores fees and charges. Interest only caps, such as the one in Victoria, are easily circumvented by lenders simply characterising costs as fees or charges rather than interest.

Phase One of COAG's national consumer credit reforms came into effect on 1 July 2010. These reforms included requirements for lenders to obtain a licence and to join an ASIC approved external dispute resolution scheme. In addition, new responsible lending obligations require lenders to make an assessment of whether the loan they are offering is 'not unsuitable' for the consumer.

Although these reforms are welcome, we believe they will have little impact on the high-cost short term lending industry. For example, the high-cost short term loans are, in isolation, unlikely to be considered 'not unsuitable' for borrowers because of the small amounts lent, despite the harm caused by repeat borrowing. Further, where borrowers are driven by financial desperation and borrow to meet basic needs, they will be likely to mislead lenders to obtain a loan (and lenders may be inclined to be misled).

In the near future, the Australian Government will decide either for or against a national interest rate cap as part of Phase Two of the national consumer credit reforms. Legislation giving effect to this decision is expected to be in place by mid-2012.

Analysis of arguments against comprehensive interest rate caps

Comprehensive interest rate caps are often proposed as a method to restrict or prohibit high-cost short term lending. Common arguments against such a cap are examined below.

Argument:

Consumers need high-cost short term loans to help them solve financial problems.

Response: Payday loans are unavailable in most countries and have only existed in Australia since 1998. The driver for demand of these loans - insufficient income - exists in all countries and existed in Australia before 1998 without the need for payday lending.

Response: High-cost short term loans do not solve the problem of insufficient income; they perpetuate it, generating more demand for the product.

Argument: *The introduction of a rate cap will result in a surge in illegal lending.*

Response: Despite rate caps existing in many jurisdictions both in Australia and elsewhere, no credible evidence has ever linked such caps to a surge in illegal lending. This claim is often based on one survey, the findings and methodology of which have since been widely questioned.

Response: Even if a cap did increase illegal lending, this market would be restricted by the criminal law and so be far smaller than the current rapidly growing market.

Argument: *Restricting access to high-cost short term credit will increase the welfare burden for governments.*

Response: Many users of these loans already do access welfare, and there is no evidence of a link between the introduction of a cap and an increased welfare burden.

Response: As above, these loans do not solve the problem of low income, they exacerbate it.

Argument: *Payday loans reduce overall indebtedness by reducing reliance on other forms of credit.*

Response: Our research indicates that borrowers use high-cost short term loans as a last resort after all other credit options are exhausted, not as a substitute for other credit.

Response: There is no causal link between payday lending and household debt levels. High levels of debt exist in countries with this kind of lending, and low levels exist in countries without it.

We recommend the Australian Government legislate a 48% comprehensive interest rate cap through phase two of the national consumer credit reforms

High-cost short term lending creates significant harm to the most vulnerable consumers. It should be prohibited through a legislated 48% comprehensive interest rate cap, for the following reasons:

A cap would have a targeted, measurable impact and carries little risk. A 48% cap carries little risk either for the broader consumer credit market (the vast majority of operators lend at well below 48%) or for governments (there has not been a single case of popular support for the removal of a cap, either in Australia or elsewhere, once one has been introduced).

The timing is appropriate. Phase Two of the national credit reforms provides a unique opportunity to introduce a cap at a time of significant change, lending administrative efficiency to the process and ensuring a nationally consistent approach.

A comprehensive interest rate cap has been consistently shown to be the only mechanism that works to address the harm caused by high-cost short term loans. Payday lenders are likely to suggest further responsible lending requirements, cooling off periods, extended payment plans, maximum loan amounts and limits on the number of loans per borrower as alternatives to a cap. However, experience in different jurisdictions in the US has shown these options to be ineffective and wherever regulators have tried these options, they have been circumvented, undermined and frustrated by industry practitioners.