Review of the Small Amount Credit Contract Laws – Consultation on the Regulation of Small Amount Credit Contracts and Comparable Consumer Leases (Sept/Oct 2015)

Lack of Substantive Industry & Consumer Data

The areas of most contention during the review of small amount credit contract laws in 2011/2012 centred on the permitted fees and charges, including the effective cap on the interest rates charged. The consumer and welfare groups argued for stricter regulation and low caps as a means to better protect vulnerable consumers and they cited available surveys to support this position. The SACC industry argued in response that there is increasing demand for SACC loans in Australia from a growing spectrum of consumers, including "middle class" borrowers. They argued that if the regulation imposed unduly low maximum fees and interest rates, this would undermine their ability to satisfy this demand on a commercially viable basis.[1]

The reforms made to the regulation governing SACC lending at the end of 2012[2] reflected a compromise position taking into account arguments made by the industry and consumer groups. However, I agree with Ali, McCrae and Ramsay that 'key changes to the original proposals do not take account of the recommendations of consumer and welfare advocates, and are more consistent with the views of the [SACC] loan industry.'[3] Notably, the Parliamentary Committee on Corporations and Financial Services concluded that it was not clear from the available evidence whether consumers of SACC loans are more vulnerable as a class than the general population.[4]

Loan Costs

In the Original Bill, the establishment charge for SACC loans was capped at 10 percent of the adjusted credit amount and the additional monthly fee was capped at 2 percent per month. By April 2012, the legislation provided for an establishment fee amounting to 20 percent of the adjusted credit amount[5] and an additional monthly interest charge of 4 percent per month.[6] This 20 percent establishment fee can be charged regardless of the lenders actual costs to assess and approve a loan application. Further, these combined costs exclude other fees and charges such as default fees.[7]

As might be expected, a review of comparator websites suggests that many SACC loan providers are using the maximum permitted charges. Moreover, the maximum permitted monthly fee of 2 percent can be charged for a period between 15-31 days or for days that extend beyond complete months. That is, the permitted maximum charges for a loan of 16 days (the minimum loan duration) is a 20 percent establishment fee and 2 percent interest, and the maximum charge for a loan of 1 month and 1 day is an establishment fee of 20 percent and 4 percent interest. From an economic perspective, these charges are high by any reasonable standard.

Longitudinal Household Survey Evidence

Published material on SACC loans includes policy reviews and submissions, research reports, and

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[1] No empirical data or evidence of the costs and profits of the industry was provided to support these claims.
[2] *National Consumer Credit Protection Amendment Regulation (No 4) 2012* (Cth).
[3] Paul Ali, Cosima McCrae and Ian Ramsay, 'The Politics of Payday Lending Regulation in Australia' (2014) 39 *Monash University Law Review* 411, 411.
[4] Parliamentary Committee on Corporations and Financial Services, Parliament of Australia, *Inquiry into Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011* (2011) [5.220].
[5] *Consumer Credit Legislation Amendment (Enhancements) Act 2012* (Cth) Sch 4 s 31A(2).
[6] *Consumer Credit Legislation Amendment (Enhancements) Act 2012* (Cth) Sch 4 s 31A(3).
[7] *Consumer Credit Legislation Amendment (Enhancements) Act 2012* (Cth) Sch 4 s 39B.

academic publications.[8] The common theme across this material is a lack of substantive data and evidence on the structure and profitability of the industry and its consumer base. To contribute to this informational gap, I conducted quantitative and qualitative research using data collected through a longitudinal household survey that monitors the financial position and attitudes of households across Australia.[9]

Data from the household survey for the period 2005-2015 validated the claims by lenders that overall demand for SACC loans is growing and the spectrum of consumers is expanding. Our models estimate that the value of the SACC sector in Australia in June 2015 was $670 million,[10] with industry growth continuing as new providers enter the market, including international entities. The proportion of SACC loans that are originated online are growing, with more than 40% of households now using the internet to find SACC providers and information. This shift to digital business models is allowing the industry to expand its client base. The penetration of SACC loans is moving from the traditional "battler" group to include younger families, stressed seniors, multicultural groups and rural areas. One might view these trends as indicative of a vibrant market that is satisfying the needs of consumers. However, I question whether these are positive trends for the consumers involved and for the nation as a whole.

Our analysis of the survey data highlighted the diverse nature of financially stressed and financially distressed households in Australia. It suggests there are some consumers who use SACC loans as a convenient service to assist with short term cash flow needs. Some households manage to repay these loans and are satisfied with the service provided. Nonetheless, one can legitimately characterise most users of SACC loans as vulnerable and or disadvantaged in some way. The vulnerability and or disadvantages of these consumers are multifaceted, including socio-economic, educational, literacy, language, financial competency and other factors. The household survey data and analysis indicated the following:

- Most households that use SACC loans have a relatively low income (with an average household income around $36,000 per annum);
- Most have an education limited to high school;
- Many have minimal or no assets and savings;

[8] There have been various studies done by consumer advocate groups and by university centres. See, eg, Dean Wilson, 'Payday Lending in Victoria' (Research Report, Consumer Law Centre Victoria, July 2002); Nicola Howell, Therese Wilson and James Davidson, 'Interest Rate Caps: Protection or Paternalism?' (Research Report, Griffith University, December 2008); Zac Gillam, 'Payday Loans: Helping Hand or Quicksand? Examining the Growth of High-Cost Short-Term Lending in Australia, 2002–2010' (Research Report, Consumer Action Law Centre, September 2010); Financial Counselling Australia, 'What Financial Counsellors Say about Payday Lending' (Research Report, October 2011) ('Financial Counselling Report'); Marcus Banks et al, 'Caught Short: Exploring the Role of Small, Short-Term Loans in the Lives of Australians' (Final Report, Social Policy Unit, University of Queensland, August 2012).

[9] The longitudinal DFA household survey has been running since 2003. It is an omnibus survey that seeks information on the financial position and attitudes of 26,000 Australian households each year. The communication with households is carried out by an independent research company and the approaches taken are in accordance with accepted survey and statistical methodologies and practices. The DFA data is encompassed within ongoing reports that are used extensively by leading finance sector participants. The Small Amount Credit Contract research and analysis was conducted by Gill and Martin North. Gill North is an Associate Professor in the Law School at Monash University and is head of the Finance, Investment and Taxation Group within the Centre for Commercial Law and Regulatory Studies. Martin North is the principal of Digital Finance Analytics. Digital Finance Analytics (DFA) is a boutique research, analysis and consulting firm providing commercial services to clients in Australia and internationally.

[10] Martin North, 'How Big Is The Payday Lending Market In Australia?', Digital Finance Analytics Blog, http://www.digitalfinanceanalytics.com/blog/how-big-is-the-payday-lending-market-in-australia/

- Many borrowers seek SACC loans out of desperation or because it is (or appears to be) the only available funding option;
- A significant proportion have English as a second language;
- Many appear to have a limited understanding of financial matters;
- Many measure the success of the SACC service based on minimising external pressure (rather than on long term financial outcomes);
- Many seek SACC loans for general household expenses and specific events (such as weddings, holidays and funeral expenses).

Importantly, most consumers indicate that they make decisions to use SACC loans based on convenience and desperation, rather than economically rational decisions based on research of the competitive offerings and comparative pricing. Most are not aware of the full economic cost of these services or the potential adverse long term consequences. Among the households who are aware of these factors, some believe they have no alternatives.

Competition & Innovation

Education, financial literacy and behavioural factors play an important role in consumer financial decision-making and the utility and efficiency of competitive markets. When the educational level and financial literacy of a household are low and the perceived or actual need for funds are high, the capacity of these consumers to rationally benefit from competitive and innovative markets, and to make well informed decisions in their best long term financial interest, are strictly limited.

Imbalances of power often arise between credit providers and consumers. When consumers are vulnerable and or disadvantaged, these imbalances are significantly heightened and the risk of predatory or exploitative conduct are much greater. The risk of adverse outcomes are also significantly higher when the households taking on new debt are already in a weak financial position, with little or no buffer to withstand foreseeable (and unforeseeable) personal and external events and circumstances.

Economic & Financial Context

When considering the appropriate balance between consumer protection and industry factors, policy makers should consider the broader economic and financial context. The levels of consumer debt in Australia are at record levels (including all forms of borrowing).[11] These levels of indebtedness may appear benign in an environment of record low interest rates and continued economic growth. However, the financial and social position of households are likely to deteriorate significantly should one or a series of the following events occur:

- deteriorating economic conditions in Australia and or globally;
- an increase in the unemployment levels in Australia;
- a significant increase in rental charges;
- a fall in the level and scope of welfare payments;
- a significant tightening in credit markets;
- a shift to higher lending rates.

The likelihood of one or more of the outlined events arising within the next decade or so is a real rather than remote possibility. As Wayne Byres the Chairman of the Australian Prudential Regulatory Authority noted earlier this year,

[11] Reserve Bank of Australia, Chart Pack Graphs on the Australian Economy and Financial Markets (released 7 October 2015, data updated to 1 October 2015). See Household Finances Graph at http://www.rba.gov.au/chart-pack/household-sector.html. This graph shows the level of household debt as a per cent of household disposable income for the period 1985-2015. Disposable income is after tax and before the deduction of interest payments.

> ‘The current economic environment … is characterised by heightened levels of risk, reflecting a combination of historically low interest rates, high household debt, subdued income growth, unemployment that has drifted higher, significant house price growth, and strong competitive pressures. Many of these features have been emerging over a number of years …’[12]

The segments of the Australian population that are likely to be most adversely impacted, should negative personal and or external events arise, are households with low incomes, minimal or discretionary income and assets, significant rent commitments, and high levels of debt (in any form). As already discussed, a high proportion of the households who use SACC loans present with these characteristics.

The Appropriate Balance between Consumer Protection & Industry Viability

Question 1 of the review consultation paper seeks feedback on the need to balance the protection of consumers with the viability of the SACC industry and continued access to credit. While there is considerable empirical evidence that points to the need for consumer protection in this regulatory space, I have been unable to locate reliable industry data that discusses the viability or profitability of the industry. Given the considerable evidence on:

1. the potential and actual vulnerabilities and disadvantage of many households who seek SACC loans,
2. the large imbalances of power between the industry and their consumers, and
3. the potential harm to borrower households and the broader economy as the sector grows and the risks of adverse personal and external events increase,

the regulatory framework should err on the side of strong consumer protection.

Households that lack financial buffers and resilience are highly vulnerable to personal or external financial shocks and there has been a rise in the absolute number and relative percentage of financially distressed and financially stressed households in Australia over the last decade. Most households use SACC loans to pay for ongoing essentials or one-off events and this debt combined with other liabilities exacerbates their ability to potentially transition to a sustainable financial position. Should the external environment in Australia weaken, the financial position of these households may deteriorate rapidly. When a significant portion of a community is unable to afford basic essentials and or cannot pay their debts, this can have long term detrimental impacts on the economy and the social fabric of the nation. These effects were evident in many parts of the world following the global financial crisis in 2009. While some countries and some parts of the financial system have recovered in the ensuing years, other nations and areas of finance are still weak. Interest rates around the world are low and the levels of both private and or public debt are generally high. Consequently, the ability of the global community to respond to future financial crises by lowering interest rates and other monetary policy levers are now significantly more limited.

While some commentators may argue that it is not the role of governments to interfere with competitive markets and the profitability of an industry, I suggest that the area of SACC loans is one that requires strong intervention given the potentially severe long term consequences on individuals, households and the broader community. Anecdotally, the continued growth of the industry and the emergence of multiple new entrants suggest that the industry is highly profitable and claims about its possible extinction may be exaggerated. However, without firm industry evidence, the profitability or otherwise of the existing business models is unclear. As such, any claims or issues concerning the viability of the industry should be evidence based. Policy makers should require comprehensive and independently audited data on the viability of the SACC industry, including likely efficiencies achieved as a result of the shift to online lending.

[12] Wayne Byres Chairman APRA, ‘Sound Lending Standards And Adequate Capital: Preconditions For Long-Term Success’, (Speech to COBA CEO & Director Forum, Sydney, 13 May 2015).

Conclusion /Recommendations

- When balancing the need to provide consume protection and the viability of the industry, policy makers should err on the side of consumer protection, given the vulnerable and disadvantaged nature of most users of SACC loans.
- Any policy determinations that consider the viability of the industry should be evidence based. Further, industry viability factors should be assessed on a reasonable SACC provider that has established scale and that provides most loans online.[13]
- The SACC industry is one that should be highly transparent and that should not operate, or be seen to operate, in the shadows. Comprehensive data should be required to enable monitoring of the industry trends and practices, to assess the financial position and outlook of consumers using SACC loans, and to ensure that regulators are aware of these trends, practices and positions as they develop, as well as systemic issues and areas of misconduct.
- The maximum monthly interest charge should be applied proportionately to days less than a month and days that extend beyond complete months.
- Given the industry transition to digital based services, the establishment fees should be generally limited to costs incurred;
- The maximum monthly charges should be reviewed now (and on an ongoing basis) based on an assessment of the returns being achieved by efficient SACC loan providers.

Associate Professor Gill North
Deputy Director - Finance, Investment & Taxation
Centre for Commercial Law & Regulatory Studies
Faculty of Law
Monash University
15 Ancora Imparo Way, Clayton Campus, Clayton
VIC 3800 Australia

Tel 61 3 9905 8034
Mobile 0478 418 629
Email gill.north@monash.edu /gill@gillnorth.com

To view latest publications & profile see http://gillnorth.com/

MONASH University
Centre for Commercial Law and Regulatory Studies

Submission emailed to consumercredit@treasury.gov.au (15 October 2015)

[13] See National Australia Bank, 'Do you Really Want to Hurt Me? Exploring the Costs of Fringe Lending – a Report on the NAB Small Loans Pilot (March 2010). This small loans pilot scheme found that the economics of providing small loans depend on the size of the loan, loan volume, the duration of the loan and the portfolio size. This pilot scheme tested personal loans of amounts of $1000-5000 and was aimed at a different market from small amount credit contract (SACC) loans. Nevertheless, similar correlations are likely when considering the viability / profitability of SACC loan providers.