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Review of the small amount credit contract laws

Submission to the consultation of small amount credit contracts and comparable consumer leases

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Executive Summary

Focus

- This paper presents the evidence from an international research programme looking at the outcomes for consumers of different approaches to regulation of small sum credit. The paper focuses primarily on online small sum credit markets in the US but draws also on the experience of the UK and Japan.
- In the US small sum credit is regulated at state level. The variety of approaches employed in different states thus provides an opportunity to understand how different approaches to regulating payday lending play out in the real world:
    - More or less restrictive or permissive approaches
    - More or less complex regulatory frameworks
    - Principle- based and specific, prescriptive approaches
- The analysis has focused on the consumer protection outcomes of different regulatory approaches and how effective different approaches have been in delivering regulatory goals. In particular analysis has considered outcomes in terms of:
    - Lender mix and conduct standards
    - Cost of credit
    - Over-borrowing and problematic debt
    - Whether outcomes are aligned with regulator intentions
    - Unlicensed, unregulated lending

Data sources

- This study rests on comprehensive, robust quantitative data sources i.e. two large transactional credit reference databases; analysis draws on direct interrogation of quantitative data drawn from a transactional database of 9.4 million small sum loan transactions from across the US over the years 2010-2014 and aggregated time-series data on 28.9m transactions for the years 2001-2011. Reference year for the analysis in this paper is 2012, unless otherwise stated.
- The study is important therefore because the patterns described here are not projections from a research survey or an economic model but actual loan transactions and real consumer experience, i.e. what has actually happened in the US.

Key findings

- In the US, the development of a large online market has been a game-changer for small sum lending. Technological trends – in combination with regulatory intervention which has created significant credit exclusion and therefore market opportunity for illegal lending – has resulted in the emergence of a large unregulated market for small sum lending alongside the licensed, regulated sector.
- It is clear, both from the US and from the experience of other markets, including the UK and Japan, that where supply is restricted, demand does not go away. The US experience is that demand is rather diverted from storefront to online markets and from the regulated to the unregulated sector. Where consumers cannot obtain credit from legitimate suppliers, unregulated lenders move in to take advantage of unmet demand. It is worth noting that in a digital world, from the perspective of the

consumer, the web sites of unlicensed lenders look just like those of licensed lenders and consumers cannot readily discriminate between the two.

- The US experience show that unregulated markets can emerge rapidly and achieve significant scale and that, once established, can prove very difficult to address. Since circa 2005 online small sum lending in the US has grown rapidly, with an unregulated sector developing in parallel to the licensed sector, but on a faster growth trajectory. By 2012 unlicensed lenders dominated the market, accounting for almost six in ten (59%) of all small sum online loans in the US, with 41% of these loans made by lenders operating offshore, from a wide variety of jurisdictions.
- The outcomes for consumers of using unlicensed lenders are significantly worse across a series of dimensions, including cost of credit, over-borrowing and problematic debt and aggressive debt collection techniques, than for those using licensed, unregulated lenders. At the extreme end of the spectrum, there is, according to state regulators, a cross-over between unlicensed lending and criminal activity, including extortion, fraud and identify theft.
- Different approaches to regulation appear to generate different degrees of credit exclusion, and thus a different balance between licensed and unlicensed lenders operating in each market. In the US states operating the more restrictive regulatory regimes, around three quarters (76%) of all small sum loans were made by unlicensed unregulated lenders in 2012. In the states with more permissive regimes, by contrast, a little over a third (35%) of all loans were made by unlicensed lenders.
- Bans on small sum lending appear particularly counter-productive. The share of total small sum lending occurring (licensed and unlicensed) in the 14 states which ban payday lending outright (or effectively ban it through price caps set very low) is close to these states' share of the US sub prime population. Strikingly, 24% of all small sum loans made online in the US are made in these states. Loans made in these states represent 37% of all unlicensed loans made online.
- The evidence is, moreover, that the unintended effects of credit exclusion are further exacerbated by the impact of certain approaches to regulation, which work to perversely create competitive advantage for the unregulated sector. States with complex regulatory frameworks, which overlay a series of regulatory requirements over each other or which tightly specify restrictive formulae for responsible lending, appear both to produce sub-optimal outcomes for consumers and unintended effects for regulators. Regulatory complexity injects delay into lender processes and inconvenience for the consumer into customer experience – for legitimate operators. Unlicensed lenders able to meet consumer demand for speed of decision making and rapid delivery of funds thus enjoy a powerful competitive advantage, sucking up demand and dominating these markets. As a result, borrowers in these markets overall pay more for credit, price is less transparent, cycle of debt issues and problematic debt are higher and consumers experience greater collateral damage to their financial well-being.
- Taken together the evidence from the US is that those states with a more restrictive regime, and particularly where it is also complex and prescriptive, achieved very significantly worse outcomes for consumers across a series of dimensions and few regulators realised their objectives.
- By contrast, the more permissive states, and those with relatively simple, focused regimes – even where price and other controls were set relatively low – achieved better outcomes for consumers and regulators largely achieved their goals. For example, in the permissive states the average cost of credit for small sum loans was $23 per $100 dollars borrowed, compared to $37 dollars in the more prescriptive

states. Debts in collection and debt write off (a solid proxy for irresponsible lending, unsustainable debt service and problematic debt) were 9% and 12% respectively in the permissive states compared to 15% and 20% in the restrictive states. The same pattern holds true across other indicators of consumer welfare.

Key implications for regulatory strategy

- As small sum lending increasingly shifts online (80% of the UK market is already online for example), digital is a game-changer as much for regulators as for lenders. It is clear that, given market opportunity, a parallel unregulated sector can emerge and rapidly acquire scale online and that, once established, unregulated lending markets are very difficult to tackle.
- The new reality for regulators is that this possibility is now a very real and present danger, and one that needs to be carefully considered. In crafting regulatory strategies. Regulators need to consider the potential impact of any intervention in the light of whether it would create market opportunities or competitive advantage to unregulated players.
- Fundamentally, the shift to online and the emergence of unregulated operators at scale in global credit markets imply an uncomfortable and inconvenient truth; Regulators may no longer be able to control all elements of the supply side. In the event that an unregulated market takes hold, they may indeed lose control of the core supply dynamics of the market.
- In a world in which licensed lenders may be competing not only with each other but with unregulated lenders, a new pragmatism is required which focuses on how most effectively to achieve the real world consumer protection outcomes that regulators seek.
- This is not to suggest that there should be any relaxation of high standards of lender conduct or any loosening of expectations on consumer protection, rather the contrary. The new reality requires that regulators focus clearly on the mechanisms and approaches which will best optimise the regulatory system to maximise consumer protection outcomes.
- An overly restrictive regime, and particularly one which is complex and highly specified with a series of detailed process requirements, is not only likely to be counter-productive in achieving regulatory goals but is likely to create damaging outcomes for those the regulators seek to protect.
- It will be particularly important to take steps to minimise credit exclusion, so as not to create market opportunities for unregulated lenders.
- Similarly, in order to minimise the potential for unintended effects and to avoid putting licensed lenders at a competitive disadvantage, it will be key to ensure that any new lender requirements, for example, around responsible lending or affordability, are either couched in terms of high level principles, or, where they rely on mechanisms, that these are so structured and sufficiently simple as to be readily incorporated into processes without injecting undue delay into underwriting activities or compromising customer service or experience.
- An elegant regulatory solution which best serves Australia's small sum borrowers and which will best deliver regulators' aims will be a simple and clearly focused regulatory framework which works with the grain of consumer and market dynamics and which allows licensed and compliant lenders working to high conduct standards to operate profitably and at scale.
- Australia may be at a tipping point with a narrowing window of time in which to act decisively to prevent the emergence of an unlicensed lending market of any scale. The review of the 2006 legislation may represent a golden opportunity to do so.

Contents

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Policis credentials, focus of the submission and the evidence base

1.0 Policis

This submission is made by Policis, a London-based think-tank specialising in evidence-driven policy making and focused on independent, high quality, public interest social and economic research to support effective policy development and positive consumer protection outcomes. Policis works primarily for Government departments and regulators, in the UK and internationally.

Policis financial services practice has a long track record of international research around financial services and credit market regulation and has a particular research interest in the provision of financial services to consumers on low incomes and high cost small amount credit. We have undertaken major consumer research programmes focused on consumer credit and optimising consumer protection in the UK, various Western and Central European jurisdictions, the US, various Asian markets and Australia. Policis undertook the research for the UK Government which informed the framing of the UK 2006 Consumer Credit Act and for the UK Financial Conduct Authority which supported the development of the 2014 consumer credit regulatory regime in the UK. “Emerging findings” from the research we present in this submission and some of the evidence on which this submission rests has also been presented to regulators, policy makers and a wide range of stakeholders in the UK, the US and Japan.

2.0 This submission

Our intention in making this submission is to provide robust evidence drawn from real world experience in other credit markets to inform the deliberations of the committee and wider public debate in Australia on how most effectively to optimise the regulatory framework and consumer protection in the small amount credit market.

2.1 Focus of the submission

The research and analysis on which we draw for this submission has focused broadly on how most effectively to produce optimal consumer protection outcomes while also maintaining access to credit, responsible lending, good lender conduct standards and an orderly, competitive and efficient market. It lends itself therefore to exploring the big questions and issues at high level.

Against this background, we have focused our analysis for this submission around the two central questions asked by the committee, Question 1, which seeks to understand how best to balance competing regulatory objectives, and Question 2 which seeks to understand how best to optimise the relative complexity / simplicity of regulatory requirements to deliver high standards of consumer protection and reduce the regulatory “burden” on industry. We have also addressed Question 5, which broadly asks how most effectively to address cycle of debt issues and ensure responsible lending. In the latter case, we have not sought to provide detailed answers to the highly specific sub-set of questions asked under question 5, but rather to demonstrate broad principles and show how different regulatory approaches to preventing problematic debt relate to real-world outcomes for consumers.

3.0 The evidence base

An international programme of research looking at the outcomes for consumers of different approaches to small sum credit regulation

The analysis we present aims to provide regulators, policy makers and stakeholders in Australia with insights arising from the experience of international markets, most importantly the USA.

The evidence on which this submission is based draws on data and analysis from an international programme of research looking at the outcomes for consumers of different approaches to the regulation of high cost credit markets. The research programme is one of a series of Policis occasional public interest project.

3.1 The key research questions

The broad direction of travel in small sum credit markets in recent years has been for regulatory reform and to tighten regulation and enhance consumer protections but regulators in different jurisdictions have taken very different approaches.

Regulators in all credit markets, and especially those used primarily by those on low incomes, seek to protect consumers from detriment, to prevent damaging over-reliance on borrowing, particularly high cost borrowing, and to prevent problematic debt and over-indebtedness. To achieve these aims, regulators seek to enforce high lender conduct standards and responsible lending and achieve transparency and fairness in product pricing and terms. Additionally, and again especially in small sum credit markets that tend to be high cost, regulators may also set out to control the cost of credit. Some regulators have indeed even sought to eliminate small sum lending.

On the other hand, regulators will also want to achieve competitive, innovative and properly functioning markets and to ensure that, for those who need it, there is an adequate supply of credit.

Against this background, the research programme set out to answer a number of key research questions:

- Do regulators achieve the outcomes they intend?
- Which approaches are most likely to deliver optimal outcomes for consumers and to deliver the consumer protection benefits regulators want?
- Are there any unintended effects arising from the wave of recent reforms of small sum credit markets?
- If so, what do these look like and on what scale are these occurring? How are such effects most effectively mitigated or prevented?

3.2 Data sources

Robust quantitative data from large transactional databases

The analysis we present in this paper is focused primarily on online small dollar lending markets in the USA where small dollar lending is regulated at state level. The wide variation in the regulatory regimes of the different US states facilitates researchers examining the impact – in terms of outcomes for consumers and achieving regulators' aims – of differing approaches to regulating small sum lending.

Further international context is provided drawing on data from both the Japanese and UK credit markets following reform of the regulatory frameworks for small sum credit.

The US data sources underpinning the Policis analysis are highly robust and reliable, being based on large quantitative data sets drawn from large transactional databases owned by the leading sub-prime credit reference agencies in the US. The primary quantitative data sources for the US analysis have been:

- Direct analysis of a representative sample of 9.4 million sub-prime, small sum credit transactions for the years 2010- 2014, from across the US, drawing on the Clarity Services Inc. database, the leading provider of credit reference analytics for the US online non-prime credit market.
- Analysis of aggregated data from a time-series data set of a representative sample of 28.9 million anonymised small sum credit transactions, over the period 2001 – 2011, also drawn from across the US, from Teletrak, the sub-prime credit reference agency.

It is important to emphasise therefore that the analysis we present is not based on projections from survey data or the outputs of an economic model but *rather actual loan transactions and real consumer experiences and outcomes. The patterns described in the analysis are what has actually happened in the US.*

The quantitative data sources were supplemented by a series of qualitative interviews with the US federal and state regulators, commissioners and supervisors from across the US, with interviews undertaken on an unattributable, anonymised basis to facilitate frank disclosure and discussion. The state regulators for interview were selected to provide a mix of more or less permissive or restrictive approaches to the regulation of small sum credit, to include states with notable or distinctive approaches to tackling consumer protection or detriment and even jurisdictions where this kind of lending was banned. This work covered a mix of different geographies and populations and both large and small markets.

We also draw on various data sources to provide further contextual insights from the Japanese and UK small sum credit markets, to illustrate the extent to which the patterns described as arising in the US can also be observed in other advanced credit markets following reform of the regulatory regime. Where we do so, data sources are cited separately.

3.3 The US regulatory environment

In order to understand the evidence about what has happened in US online lending markets presented in this submission, it is important to understand the broad structure of the US regulatory environment for small sum lending. The most salient features of the regulatory environment are these.

- The US small sum loan market is regulated at state level[1].
- There are a wide variety of regulatory approaches employed by the different states, which in part reflect historical origins and the local politics and nature of local populations.
- From the perspective of the US state and federal regulators small sum lenders must be licensed:

[1] A new federal regulator The Consumer Financial Protection Bureau (CFPB) , was established in 2011 and has been reviewing the payday market with a view to new regulatory provisions at federal level. In 2015 the CFPB announced that is considering proposing new rules, to be applied nationally, to address cycle of debt issues and ensure responsible lending, on which it is currently consulting.

    - Lenders lending into any of the US states must be licensed by that state if to lend legitimately to residents of that state.
    - Licenses to lend in one state cannot be used to lend into another state.
    - Lenders based outside the US require a licence for any state into which they wish to end.
- There is a complex mix of linked regulatory provisions which differ considerably between states:
    - 45 states have some form of usury cap or price control, set at varying levels
    - Many states also have controls on the value and term of loans, which vary considerably between states
    - 14 states either ban high cost small sum lending outright or set caps at a level which precludes authorised lenders offering small sum loans operating in the state
    - Only 3 states do not have any "responsible lending" controls
    - 14 states have a regulatory database to enforce compliance
    - 20 states have legislative provisions which make debt to unauthorised lenders void and uncollectable

3.4 Definition of terms

Throughout this submission we use a variety of terms, which we define here to enable readers to understand the evidence we present.

- **Lender compliance** is defined as conforming with regulatory restrictions as these apply in the state in which the borrower lives
- **Cost of credit,** is defined as the total cost of all payments made to the lender by the borrower in relation to a single loan (interest and documentation charges plus any penalty or refinancing charges)
- **Permissive** and **Restrictive** states are defined in relation to how strictly the regulatory regime controls the supply and cost of small sum credit (see appendix for list of states and categorisations)
- **Banned** states where small sum credit is either banned or restrictions are such that small sum lending is unprofitable* (see appendix for list)
- **Licensed lenders** are defined as those with a license to lend in the state in which the lending transaction takes place (defined by the residence of the borrower)
- **Unlicensed lenders** are defined as lenders which are not licensed to lend in the state in which the loan is made (defined by the residence of the borrower)
- **Offshore lenders** are defined as being based outside the US

Throughout "Share of lending" refers to the share of numbers of actual loan transactions

Reference year is 2012 unless otherwise stated.

* Detail of regulatory regime for each state is sourced from the US Conference of State Banking Supervisors, the central organising body of the state regulators.

3.5 Funding for this submission

This submission has been prepared in response to a request from Cash Converters, a leading small sum lender in the Australian market, that Policis contribute to the consultation underpinning the current review of the legislation covering small amount credit contracts in Australia. Cash Converters have asked Policis to share with the

Australian authorities and the committee reviewing submissions to the SACC Consultation the “emerging findings” from our research programme that we have been presenting in recent week to regulators in a number of international jurisdictions

Cash Converters have paid Policis for our time in preparing the submission. Cash Converters have, however, had no editorial input to the paper we present here, nor will they have had sight of it in advance of submission

The research and analysis on which the submission is based has been funded by Policis as a public interest project, with data provided by the data owners, Clarity Services Inc. Cash Converters have had no part in funding the research or in influencing the narrative arising from the analysis presented in this paper.

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The SACC consultation questions

4.0 Question 1. How is the need to protect consumers balanced with the need to ensure that the industry remains viable and consumers can still access credit?

4.1 Supply and demand dynamics

Understanding how most effectively to reach an optimal balance between consumer protection and maintaining both a viable industry and appropriate access to credit requires an appreciation of the dynamics of supply and demand and how these influence outcomes for consumers and the impact of regulatory intervention.

Regulators set out to control the supply side of credit markets – albeit that they may also seek to moderate demand

Essentially regulators and legislators set out to control the supply side of the credit market, by introducing regulatory requirements relating to the cost of credit, responsible lending practice, lender conduct and so on. Alongside this, Government, regulators and other stakeholders may also make efforts to influence demand via consumer education, the provision of money advice and financial capability building services, signposting to alternative credit sources, mandatory "health warnings" and similar provisions. Efforts may also be made to address detriment or hardship arising from use of credit, debt counselling for those with problematic debt or mechanisms for enabling consumers to challenge unfair or detrimental lender conduct or to claim compensation for unfair practice or miss-selling. Government, charities and other stakeholders may also seek to influence demand by seeking to set up low cost "affordable credit" alternatives for vulnerable or low income borrowers.

Outcomes for consumes hinge critically on demand dynamics – demand does not go away when supply is restricted

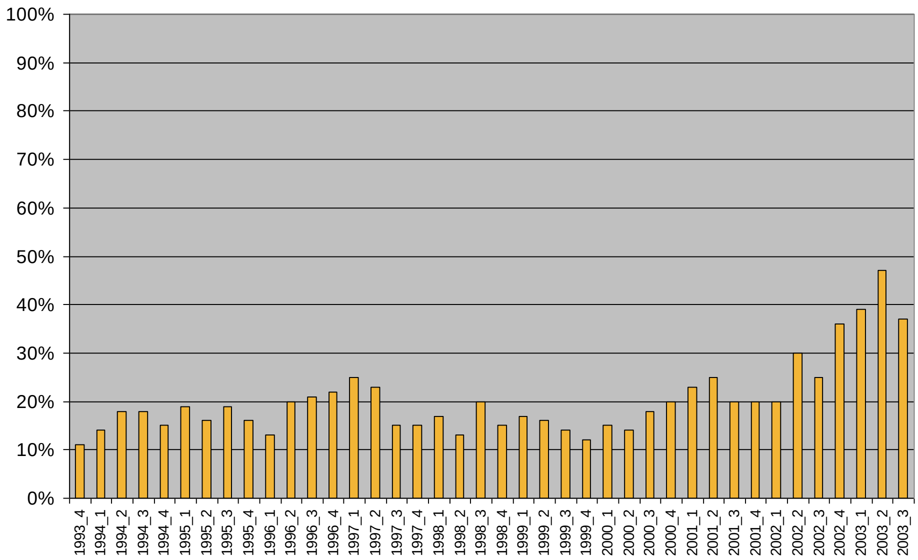
The evidence suggests, however, that the outcomes for consumers of regulatory activity hinges primarily on *demand dynamics*. Critically as supply is constrained by regulatory intervention**,** *demand may reduce but does not go away when supply is restricted*. What appears to happen is that lenders withdraw from the market or tighten their lending criteria in the wake of regulatory intervention which make some of their former lending activities not commercially viable or less profitable. Marketing spend falls and loan applications decline to some extent as the stimulus to "impulse purchase" is reduced. However, there remains an irreducible need for credit – to cover unanticipated expenses, peaks of expenditure, cash flow crises and so on – and this demand remains strong, regardless of developments on the supply side. We illustrate this phenomenon and how it has played out in the US, but the strength of ongoing demand in the wake of regulatory restrictions on supply can be seen in other markets also.[2]

[2] For example, the same phenomenon of sustained demand can be observed in the UK. UK payday lending volumes fell 35% in first 4 months of the new FCA regime for payday lending (Source: FCA press release 11/11/14) and have halved since inception of the regime – but payday applications are not falling significantly (https://assets.digital.cabinet-office.gov.uk/media/5435a640ed915d1336000005/Payday_lending_PDR_and_appendices.pdf), rather decline rates have been rising (Source: FCA PS14/16 PDF page 13)

Historically, when supply was restricted, demand was displaced to alternative credit sectors – where borrowers had other credit options

Historically, what has happened when supply of small sum credit has been restricted is that, for those borrowers who have any alternative credit options, demand has been "displaced" from the small sum credit sector to other credit products, typically revolving credit or overdraft borrowing, and to a lesser extent, instalment purchase and occasionally by borrowing from friends and family. These historical displacement effects are powerfully illustrated by some work Policis undertook in 2004 for the then UK Department of Trade and Industry which was in process of drafting what became the 2006 UK Consumer Credit Act. Using data from a large credit reference database, that of TransUnion, one of the leading credit bureaus in the US, Policis analysts investigated the differences in patterns of use of different credit types between US states that had restrictive provisions on payday lending and those that had "payday enabling" legislation. It was striking that, quarter on quarter, for the whole of the ten year period Policis examined, in the states which restricted payday lending, there was a sharp increase in the use of revolving credit (i.e. borrowing on credit cards) among those on low incomes. As a result of there being more low income, high risk borrowers using credit cards in these states, credit card delinquency was also significantly higher (averaging 17% higher over the ten year period across all of these states), as was indeed insufficient fund fees on bank accounts. This effect is shown in Chart 1 following which shows the increase in delinquency on credit card borrowing for states which restricted payday borrowing relative to the position in states with "payday enabling" legislation. As can be seen the pattern is consistent quarter on quarter for the full decade, being most marked in years of economic pressure. It represents a compelling example of the displacement of genuine market demand in action.

Chart 1. Historically clear and consistent pattern of displacement from small sum "payday loans" to revolving credit (on credit cards) throughout 1990s and early 2000s in USA
% by which account delinquency on revolving credit higher in states in which small sum lending restricted, quarterly 1993 – 2003



In states where small sum loans were restricted, low income, higher risk borrowers shifted to revolving credit and bank overdrafts. Credit card delinquency, unmet debits and unauthorised overdrafts (and associated fees) increased in step.
But this long-standing displacement effect broke down 2005 onwards as small sum internet lending takes off…

Today restrictions on supply rather displace demand from storefront to online lending

It appears however that this historic and long-standing effect has broken down in modern small sum credit markets because of the emergence and rapid growth of online lending, which now dominates small sum lending in many developed credit markets (80% plus of the UK small sum credit market was online in 2013, for example, with storefront lenders further retrenching throughout 2014 and 2015). In the US, the displacement effects from one credit product to another credit sector which could be observed in the nineties and early noughties have given way to one in which restriction of small sum credit supply has shifted demand from bricks and mortar distribution channels to online lenders. In 2012 Policis revisited the US and repeated the earlier analysis described above using a fresh sample of TransUnion time series data for credit transactions for the years 2002 – 2012. The pattern illustrated in Chart 1 preceding had broken down.

As online payday lending had taken off in the years after 2005, demand in states where payday was restricted had shifted not to other credit products but to online payday lenders, with a large online market for payday loans having developed in the US over the decade since the previous analysis had been undertaken. The online payday lending market is estimated[3] to have been approximately 35% of the total US payday lending market in 2012, and is expected to rise to circa 50% by 2016.

Regulatory reform and the technology trends have both played a part in the shift to online lending in small sum credit markets

As we will show, the shift to online lending has only partly been driven by innovation in technology and data analytics. The movement to online lending had also been given impetus by regulatory reform in many states. In the US, as indeed in Australia and the UK , the payday sector has increasingly been the subject of regulatory scrutiny in recent years, with the impetus for reform and the tightening of regulation of the sector having been driven not only by policy maker and regulators' concern for consumer welfare but also by high profile consumer advocacy and intensive media coverage. Public concern has tended to focus on what has been widely perceived as the excessive cost of small sum lending. In many US states, as in Australia, and now the UK, controls on the cost of credit have been introduced or tightened.

Demand is also displaced from authorised lenders to unregulated, unlicensed lenders operating online and sometimes offshore

In the US, in those states with price controls, caps on the cost of credit have been set at varying levels (between 10% and 75%). Different US states have a more or less complex or simple regulatory framework and combine cost controls with other restrictions and requirements (such as caps on term or value or restrictions on refinancing or multiple loans) in different ways. The combination of these controls and how these act *in sum* to generate a more or less challenging operating environment for suppliers and to constrain the potential for more or less profitable lending appears to drive the balance of bricks and mortar to online lending in different states. In the US, it has also had another, significant and unintended effect in displacing demand from licensed, regulated lenders to unlicensed, unregulated lenders operating outside of the authorised space and indeed, in many cases, outside of the US.

[3] Source: Stephens Inc. Alternative Financial Services: Innovating to Meet Customer Needs in an Evolving Regulatory Framework

As payday supply has been restricted by regulatory intervention, to different degrees in different states, a new breed of unlicensed payday lender has emerged in the US, for the most part operating online, outside the authorised space and often beyond the reach of the state regulators. The displacement effects arising from restricted payday supply are now not only from storefront to online but from state licensed, regulated lenders to unregulated, unlicensed lenders. This effect is most marked in those 14 US states where small sum payday lending has been banned or effectively banned. In the words of the US state regulators:

> *"Well, essentially, what happened is that the legislation got rid of the supply. I should say, got rid of the local supply, but it did nothing to address demand…well they turned to unregulated, you know, unlicensed lenders, primarily internet based. They don't follow the cap rate or anything along that line."*
> US state regulator

> *"You talk to the (named state) regulatory, they will probably tell you that they don't have payday lending in their state and everything is just fine. But, guess what, they do have payday lending in their state but it's just illegal online payday lending that they have."*
> US state regulator

In the US the online small sum credit sector is dominated by unlicensed lenders

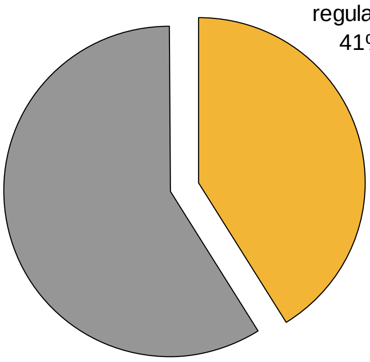
Policis sought to scale this phenomena by analysing transaction data from a specialist sub prime credit reference data base, that of the leading non-prime credit analytics provider for online lending in the US, Clarity Services Inc., covering some 9.4 million online small sum credit transactions across the US, between 2010 – 2014. The various lenders using the credit reference database to credit check potential customers were classified according to their regulatory status. For each loan on the database, the lenders were classified as state licensed or unlicensed according to whether they had a license to lend into the state in which the borrower lived. Where the lender had no state license and was operating from an address outside the US, they were classified as offshore lenders. Where lenders were not licensed to lend by the state in which the borrower lived but were claiming immunity from state or federal regulation[4] by means of "sovereign nation" status through affiliation with a Native American tribe, they were classified as "Tribal lenders". Charts 2 and 2a, which shows all small sum online lending in the US in 2012 illustrates the sheer scale of online small sum lending by unlicensed lenders in the US. Unlicensed lenders dominate online payday lending, with almost six out of ten (59%) of small sum online loans in the US being made by lenders which are not state-licensed, with four in ten of these (41%) being lenders operating offshore and from outside the US[5].

[4] A claim challenged by state regulators, a challenge that has been playing out in the courts, most notably in the case of the highly pro-active New York regulator.

[5] Some offshore lenders have recently been challenged in the US courts by the CFPB on the grounds of lending without a licence and seeking to collect repayment on debt which is legally unenforceable in actions in December 2014 and August 2015. In the UK, of the 400 companies that had a licence prior to the 2015 regulatory changes, including a new price cap, just 247 lenders have applied to the FCA for authorisation. Lending is down 70% from the peak of 2013 (Source: CFA)

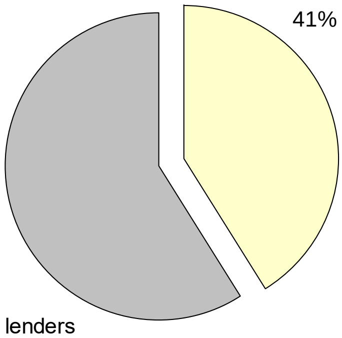
Unlicensed lenders now dominate online small sum lending in the US

Chart 2. Six in ten online lenders are unlicensed
Online small sum lending volumes by regulatory status of lender
% share of the online small loans market



Base: All online small sum loan transactions 2012

Chart 3. Four in ten lenders that are unlicensed operate offshore
Online small sum unlicensed lending volumes by type of unlicensed lender



Base: Online non-state licensed HCST loan transactions 2012

Policis estimates based on Clarity Services data

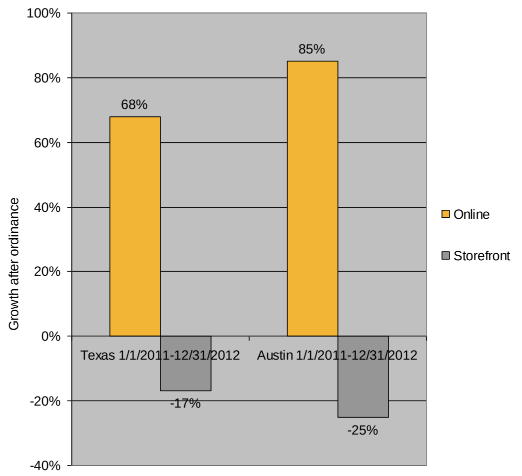
Taken together, these loans represent some 21 million small sum loans p.a. and some $9.7 billion dollars p.a. Online lenders are used by 2.4 million US consumers, primarily those borrowers who are more vulnerable.

> *"If you went to Google right now and you typed in payday loans, you'd probably get over a million results. And we license 1300. You do the Math…The challenge in regulating the lenders and, sort of implementing the regime, is the illegal activity that goes on, on the internet and online."*
> US state regulator

The displacement effect from storefront to online and from licensed to unlicensed lenders in the wake of regulatory tightening is illustrated in Chart 3 and 3a following. In January 2012, the State of Texas introduced a new payday ordinance which resulted in licensed payday lenders adjusting their lending criteria and some closure of storefront lenders as a result of new zoning restrictions. Applications for payday loans to storefront lenders fell and those to online lenders rose significantly, with this effect most marked in cities (a 65% increase in online applications YOY 2011/2012 state-wide but an 85% increase in Austin, the state capital). At the same time unlicensed lenders share of all lending in the state rose from 35% in 2011 to 44% in 2012.

In the US where state-licensed supply has been restricted – demand has been displaced from storefront to online and from state-licensed to unlicensed lenders – with this effect most marked in large cities

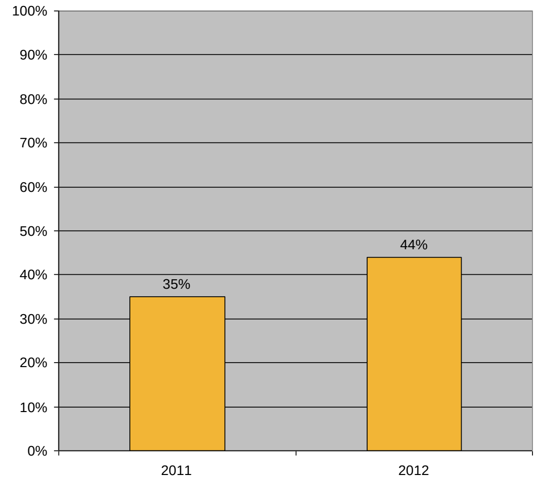
Chart 4. Changes in applications for payday loans by distribution channel Texas YOY 2011/ 2012



Texas: Following regulatory tightening January 1st 2012 demand was displaced from storefront to online and overall applications to lenders rose

Source: Tim Ranney blog Non Prime 101.based Clarity Services inc data.

Chart 5. Share of all online small sum high cost lending in Texas represented by unlicensed lenders 2011 / 2012



Texas: Following introduction of new regulatory restrictions January 2012 unlicensed lenders increased their share of online lending volumes

Source: Policis estimates based Clarity Services data.

In order to understand how different regulatory approaches in the US influenced the balance of licensed to unlicensed lenders online in each state, and to understand the differences in consumer outcomes arising from different regulatory approaches, we grouped the various states into three categories of more or less restrictive or permissive regulatory regimes, broadly as follows.

"Banned" states, which either:

- Banned small sum high cost lending aka payday loans outright
- Effectively banned such lending, by setting price caps at a level where licensed lenders cannot operate on a commercially viable basis.

"More restrictive" states, with this categorisation resting on:

- The relative comprehensiveness and complexity of the regulatory framework and the extent to which a series of restrictions are layered over each other (which makes granting credit more difficult for the lender and obtaining credit more difficult for the borrower.)
- The relative strictness of specific restrictions or price controls and other restrictions
- The degree to which restrictions are enforced (for example by means of a regulatory database or pro-active court action)

"More permissive" states, with this categorisation resting on:

- The number of restrictions and the relative simplicity of the regulatory framework
- Whether price caps or other controls are set at comparatively high levels relative to states taking more restrictive approach

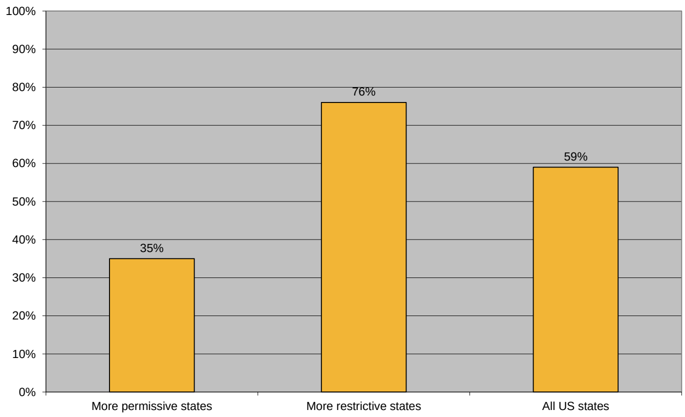
The categorisation for each state can be found in the appendix.

The share of all lending represented by unlicensed unregulated lenders was more than twice as high in the restrictive states than in the permissive regimes

Unlicensed lenders operate in all US states, including those where small sum payday lending is banned. They also compete with licensed lenders in states with more permissive regimes, some of which, such as California or Texas, are large and important markets, attractive to unlicensed lenders as much as the state licensed, regulated lenders operating in these states. In the more restrictive states, there are fewer licensed lenders operating in any case and those lenders that do operate and comply with state law in states where lending remains commercially viable and profitable can be at a competitive disadvantage compared to lenders who do not feel themselves constrained by state regulatory requirement (see section 5 for a more complete discussion of this phenomenon). As a result, the unlicensed lenders share of all online small sum loans in the restrictive states, where these lenders control more than three quarters (76%) of total lending, is much higher than in the permissive states, where unlicensed lenders control a little over a third of total lending (35%).

Unlicensed lending represents a much higher share of online lending in states with more restrictive regimes

Chart 6. Unlicensed lending as share of all online lending all, US states, more or less permissive / restrictive regulatory regimes



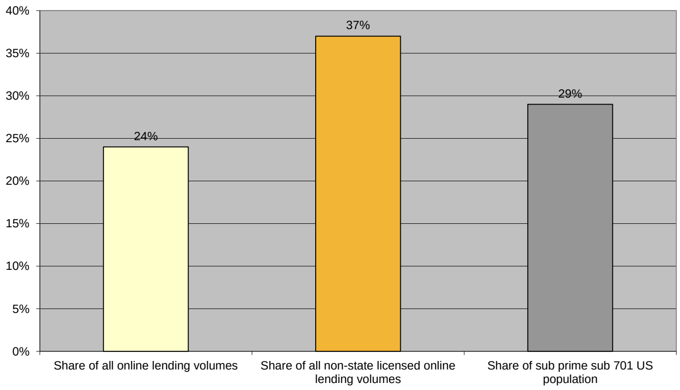
Base for restrictive regimes exclude those states where payday actually or effectively banned
Source: Policis analysis of Clarity Services data.

Almost four in ten payday loans made by unlicensed lenders in the US is occurring in states where small sum lending is banned

Perhaps even more striking is the scale of unlicensed lending in the states where small sum payday lending is banned or effectively banned. It illustrates vividly the power of demand. Taken together, these states' share of the US sub-prime population (i.e. that proportion of the population with a FICO credit score of 700 or less) is some 29%. Taking all small sum lending together in the US (i.e. loans made by both licensed and unlicensed lenders), these states share of total small sum lending is 24%, just slightly lower than the "natural" level implied by the share of the sub prime population. The states which ban small sum payday lending represent, however, some 37% of all unlicensed small sum lending in the US, a much higher share than would be implied by these states' share of the sub prime population.

Almost 4 in 10 unlicensed payday loans in US are being made in states where small sum credit actually or effectively banned

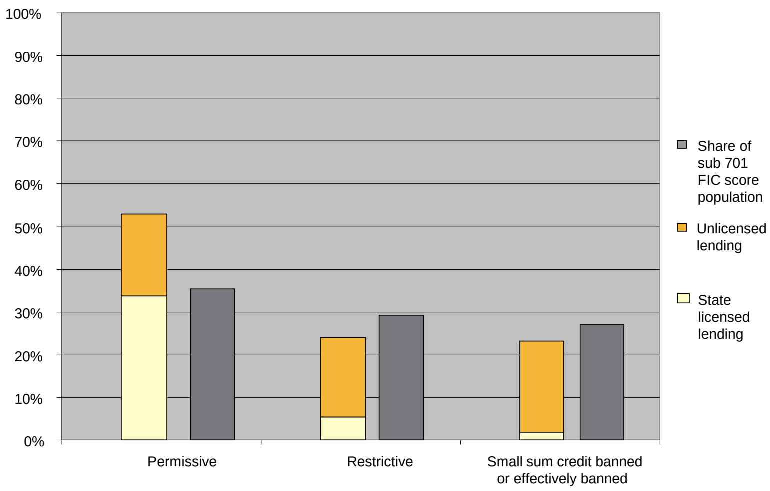
Chart 7. Share of all online and non-state licensed online lending in US occurring in 14 US states where payday lending banned or effectively banned



Base: 14 states where payday banned or effectively banned. Source: Policis analysis of Clarity Services data.

Indeed it is instructive to compare the share of all lending (licensed and otherwise) that is occurring in the states with the more or less restrictive regulatory regimes with the share of the sub prime population in each state. As can be seen in Chart 8 following, there is almost as much lending occurring in the restrictive states and those where small sum lending is banned as one would expect given their share of the sub prime population – but almost all of the lending is by unlicensed and unregulated lenders. Demand is depressed to some extent in these states but clearly remains strong and the need is simply met by unregulated lenders who have come in to fill the vacuum left by the relatively few legitimate lenders operating in these states. Clearly in the permissive states, there is more lending going on relative to these states share of the sub prime population – but the majority of it is regulated, licensed lending.

Chart 8. The power of demand: In "Restrictive" and "Banned" states, these states' share of total small sum lending is only slightly lower than these states' share of the sub prime population – but most is by unlicensed, unregulated lenders



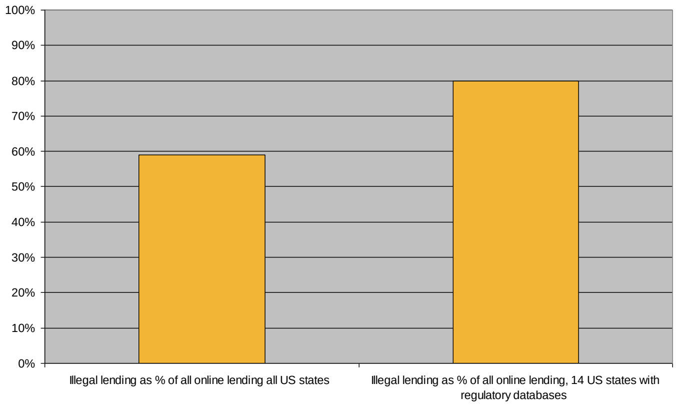
There are higher levels of borrowing in the permissive states – but the share represented by unlicensed lenders is relatively low

Source: Policis estimates based Clarity Services data

It is worth noting that where regulatory databases have been introduced to enforce compliance by licensed lenders, this effect is particularly marked. However, what appears to have happened in these states is that while mandatory regulatory databases have raised conduct standards among legitimate lenders they have also had the effect of diverting (in fact the higher risk and more vulnerable) borrowers to the unregulated sector. Some 80% of total loans made in these states in 2012 was by unlicensed, unregulated lenders. This would seem to suggest also that displacement to the illegal sector is higher the more effectively compliance is enforced.

The evidence is unequivocal that displacement to illegal lending is greatest where compliance among legal lenders is most effectively enforced

Chart 9. Proportion of online lending volumes which sourced from illegal lenders
All US states and 14 states with regulatory database to enforce compliance



Regulatory databases in 14 states enforce compliance and raise conduct standards among licensed lenders but also have the effect of diverting higher risk and more vulnerable borrowers to illegal lenders

4.2 Supply and demand dynamics key take outs

Supply and demand dynamics: Key take outs:

- **Demand may be reduced but does not go away when supply is restricted but is rather displaced in a clear waterbed effect.**
- **In an increasingly online lending environment for small sum credit, demand will likely shift from storefront to online**
- **Online lending provides greater opportunity for unregulated lenders to fill any vacuum of legitimate supply**
- **An unregulated market can develop rapidly and acquire significant scale**
- **The shift to online lending has created new challenges – and perhaps also new limits – to the efficacy of regulatory intervention and the achievement of regulatory goals**

4.3 Outcomes for consumers of different approaches to regulating small sum credit

Regulators across the US reported a series of benefits in the authorised space as a result of both regulatory reform and enhanced monitoring and enforcements. Regulators reported a series of positive effects among supervised lenders, including enhanced lender conduct, lower cost of credit, more responsible lending, more proportionate debt service to income ratios and reduced cycle of debt and over-indebtedness issues. They were also able to point to improved collection practice, fairer debt resolution and improved treatment of financial difficulties.

Policis then set out to understand, on the one hand, how far and how effectively the different regulatory approaches in the more or less permissive or restrictive states achieved regulators' goals and produced an outcome consistent with regulators' intentions. On the other, we sought to understand how the different regulatory approaches impacted real world outcomes for consumers, in terms of cost of credit, burden of debt service, problematic debt and so on.

As was shown in the previous section, different regulatory approaches in the US have generated different balances between licensed and unlicensed lenders operating in each state. The evidence is that this balance matters in determining outcomes for consumers. State licensed lenders appear to be lower cost than unlicensed, unregulated lenders. Customers borrow less. Lending is more responsible. There appears to be lower delinquency on lending by licensed lenders (See section on question 5 following), cycle of debt issues appear to be lower and, where problematic debt service or financial difficulties do arise, there appears to be less collateral damage to borrowers' financial well being. By contrast. among the unlicensed unregulated lenders, credit is higher cost and price is less transparent and loans are larger. Debt to income ratios are less sustainable. Cycle of debt issues are more problematic and consumers show greater signs of financial stress. We discuss these effects in section 7 following in more detail which focuses specifically on the future of illegal lending markets and the implications for regulators.

Policis analysed each loan made in each of the various US states in 2012 and considered whether the loans made were compliant with each state regulator's intentions and the regulatory restrictions operating in each state. We particularly considered compliance across three dimensions, the various states' loan value caps, terms caps and, most importantly, cost of credit controls. Perhaps unsurprisingly, it was clear that unlicensed lenders are far less likely to comply with regulatory restrictions than state-licensed lenders, on each of these dimensions. As can be seen from Chart 10 following, almost all (99%) state licensed lending complies with the states' loan value caps, compared with just 56% of unlicensed lenders. The picture is more positive on term caps, which have less influence on lender profitability, with 98% of licensed lenders complying with the various states' term caps and 87% of unlicensed lenders doing so. The more striking picture, and by some way the most important given regulators' collective focus on cost controls in small sum credit markets, is that on compliance with cost controls. Eight in ten licensed lenders (80%) appear to comply with the interest rate and cost controls in the various states. However, less than three in ten (29%) of the unregulated, unlicensed lenders do so.

Many unlicensed lenders do not comply with the states' regulatory regime. Licensed supervised lenders are much more likely to be compliant

Chart 10. States' loan value cap

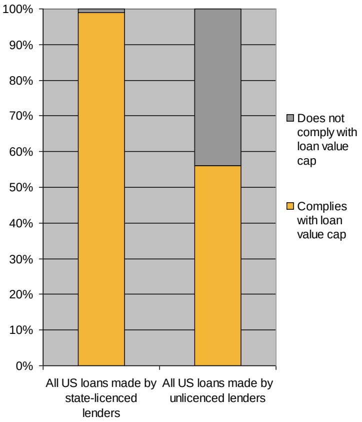


Chart 11. States' Loan term cap

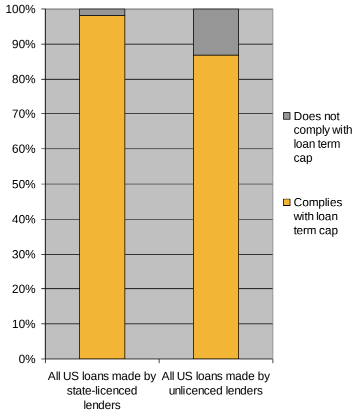
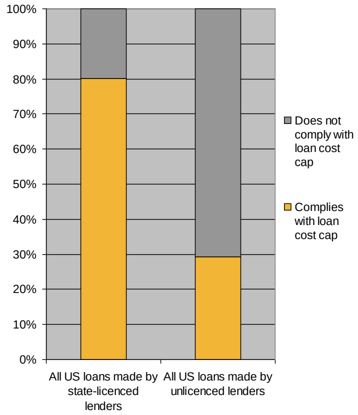


Chart 12. States' Loan cost cap



Base: All US online small sum loan transactions 2012
Source: Policis analysis of Clarity Services data

Against this background, Policis then analysed compliance with the regulators intentions and consumer outcomes for those states classified as having "more permissive" or "more restrictive" regulatory regimes and those states where small sum credit was banned or effectively banned.

Regulators in the "more permissive" states were more likely to generate loans that were compliant with regulatory requirements and, significantly, in these states consumers borrowed less overall. Nine in ten (90%) of all small sum loans in the permissive states were compliant with the regulators intentions and consumers took out an average loan of $419.

By contrast in the "more restrictive" states, just a little over six in ten loans (63%) complied with state regulators' requirements on loan caps and consumers borrowed more, with average loans of $499.

Regulators in the permissive states appeared better able to achieve their aim on restricting loan values because the lender population in these states contained a higher proportion of licensed lenders with a far higher propensity to comply with regulatory restrictions.

Because permissive states have a higher proportion of licensed lenders , regulators are more likely to achieve their aim on restricting loan values In permissive states, average loan values are lower than in restrictive states

Chart 13. Average small sum loan values, "permissive" and "restrictive / banned" states

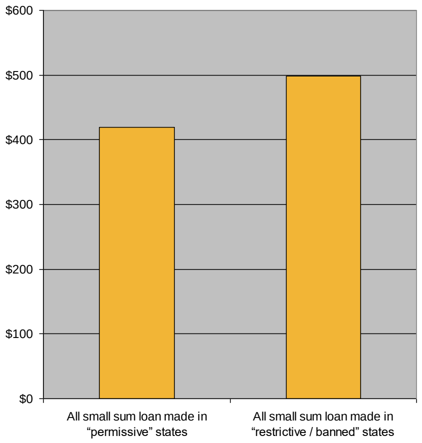
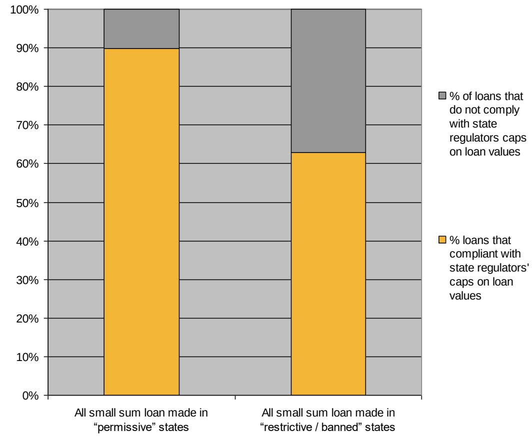


Chart 14. Compliance with state regulators' loan value caps, "permissive" and "restrictive" / "banned" states



Base: All US small sum online loan transactions 2012*
Source: Policis analysis of Clarity Services data
*for which loan value data available

The same analysis applied to the cost of credit is more striking still. Regulators achieve a much lower cost of credit for consumers in the permissive states (averaging 26$ per 100$ borrowed compared to $32 per $100 borrowed for all small sum loans across the US) with almost nine in ten (88%) of all loans made in these states compliant with the cost controls applying in each state. The average cost per 100$ borrowed in the more restrictive states, however, was 37$, with few loans complying with the regulators' intentions on costs. Just 20% of all loans in the restrictive states complied with interest rate caps and cost controls in these states.

Few loans in the more restrictive states and in states where small sum credit is banned comply with regulators' intentions on costs. Regulators achieve much lower costs for consumers in permissive states

Chart 15. Cost of credit per $100 borrowed, permissive and restrictive states

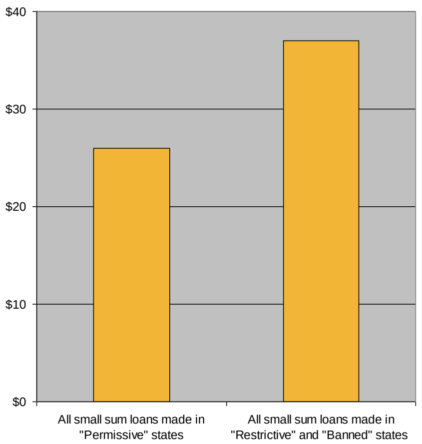
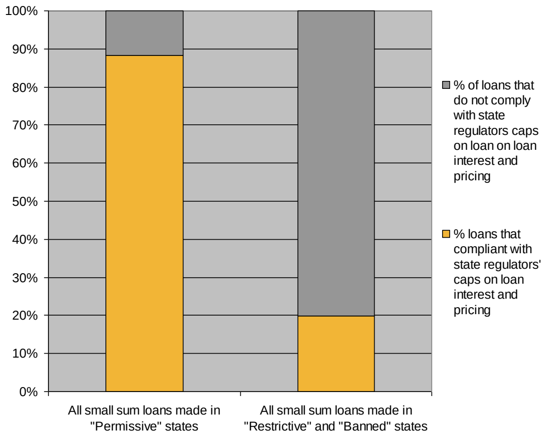


Chart 16. Compliance with state regulators cost of credit caps, permissive and restrictive states



Base: All US small sum online loan transactions 2012*
Source: Policis analysis of Clarity Services data
*for which loan value data available

On these key dimensions therefore, it would seem that the more permissive regulatory regimes in the US have produced better outcomes for consumers, particularly on the central issue of the cost of credit, and regulators are much more effective in achieving their goals. In the more restrictive states and those where small sum payday lending has been banned, few loans comply with the regulators intentions and outcomes for consumers are demonstrably worse.

This same pattern can be demonstrated in terms of problematic debt service and over-borrowing, as is discussed in section 5 following, which addresses Question 5.

4.4 Outcomes for consumers of different approaches to small sum credit regulation

Consumer outcomes of different regulatory regimes: Key take outs

- **The emergence of large online markets has been a game-changer for small sum credit markets and their regulators**
- **Unregulated markets can arise rapidly and at scale in the wake of regulatory intervention**
- **Where demand is not met by legitimate supply, unregulated supply can and will emerge to fill any vacuum of legitimate supply**
- **This phenomenon has changed the limits of the possible for regulators and the way that regulatory interventions play out**
- **Regulators no longer have the power to control supply end to end**
- **Given that demand appears only marginally reduceable, regulators who work with the grain of consumer demand will likely achieve better outcomes**
- **These effects can be seen to have played out in the US thus:**
    - **Regulators in the "more permissive" states largely achieved their goals with outcomes broadly aligned with the regulators' intentions**
    - **Regulators in the "more permissive" states also achieved superior outcomes for consumers, most importantly in terms of the cost of credit**
    - **Few regulators in the "more restrictive" states and states where small sum payday lending has been banned or effectively banned achieved the outcome they intended**
    - **Outcomes for consumers in the "more restrictive" states and states were small sum lending was banned or effectively banned were demonstrably worse across a series of dimensions, with the cost of credit significantly higher than in permissive states**

4.5 Summary answer to Question 1. Balancing consumer protection against the need to ensure access to credit and viable industry

QUESTION 1:

- **How is the need to protect consumers balanced with the need to ensure that the industry remains viable and consumers can still access credit?**

ANSWER:

- **In an increasingly digital world in which regulators can no longer control all elements of supply, the evidence is that an overly restrictive regulatory regime produces sub optimal outcomes for consumers and confounds regulators intentions on consumer protection, in the process damaging the interests of those consumers which such regimes were designed to protect.**
- **An optimal regulatory regime is one in which consumer protection benefits are maximised by enabling legitimate lenders, compliant with high but realistic conduct standards and controls which work with the grain of consumer demand and market dynamics, to operate profitably and at scale.**
- **Regulators in small sum credit markets need to be particularly careful that regulatory intervention does not result in the credit exclusion which creates market opportunities for unregulated lending.**

The evidence is unequivocal that an overly restrictive regulatory regimes produce worse outcome for consumers and thwart regulators' intentions on cost and consumer protection more widely, in part by creating opportunities for a black credit market to arise where demand is not met by legitimate supply.

An optimal regulatory regime is one in which consumer protection benefits are maximised by creating the conditions which allow legitimate lenders compliant with realistic conduct standards to operate profitably and at scale.

5.0 Question 2. Complexity: Could the current regulatory regime be simplified in a way that provides consumers with the same, or a higher level of, protection, while reducing the regulatory burden on industry?

5.1 The role of regulatory complexity in driving outcomes for consumers and achieving regulatory goals

The evidence is that layering of regulatory requirements in highly specified and complex regimes creates pernicious and unintended effects

The evidence presented in section 4.0 (and in section 6.0 following which focuses on cycle of debt and responsible lending issues) shows very clearly that consumer protection outcomes are worse in those states in which the more restrictive regulatory regimes are in place.

This evidence speaks also to the issue of complexity and proportionality in regulatory requirements. The US state regulatory regimes which we have described as “more restrictive” are frequently so characterised less because they set tight price controls but because these states set out to provide comprehensive consumer protection by layering a series of complex regulatory restrictions and requirements. In this section, drawing on the experience of the US market, we will show that, in combination, this layering of regulatory requirements and the mandating of highly specified processes is counter-productive and works against achieving regulators’ objectives.

As demonstrated in section 4, the more restrictive regimes in the US deliver sub-optimal outcomes for consumers which do not align with the regulators’ intentions in these states. The evidence in section 4 shows also those regulators in the more restrictive US states fail most evidently on the critical dimension of achieving a lower cost of credit for consumers. However cost of credit controls are only one of the component drivers of these unintended and perverse effects. In this section we seek to unpick the impact of price controls from that of regulatory complexity and to show how and why complex and highly specified regulatory regimes produce damaging outcomes for consumers and unintended effects for regulators.

Price controls in many restrictive and permissive regimes are at similar levels – it is the complexity of some restrictive regimes which drives perverse outcomes

As noted earlier the distinguishing characteristic of many of the restrictive states in the US is not only the relative strictness of any price controls that are operating but also the complexity of the regulatory regime. Indeed, in many cases the levels at which price caps have been set does not vary very significantly between the permissive and restrictive states. What distinguishes the restrictive from the permissive states where price controls are broadly similar – and most importantly what drives outcomes – is the complexity of the regulatory requirements in the restrictive states and how these feed into lender processes and interactions with consumers. Essentially in creating what are (in the jargon) essentially non-cost barriers to doing business for legitimate lenders, a competitive advantage is created for unregulated lenders who are not constrained in the same way.

Price controls will cause legitimate lenders to withdraw from the market or adapt their business models where controls impact profitability

The mechanism by which price or interest controls work to reduce lending volumes and create credit exclusion is well understood. Price controls which are set so low as to preclude legitimate lenders operating profitably will cause them to withdraw from the market[6]. Alternatively, where caps or other restrictions are set at a level where a much narrower range of risk can be accommodated within the lenders' business model, lenders may simply redraw their lending criteria and lend to fewer, lower risk borrowers. In both cases the size of the relevant credit market and the number of lenders in the market will fall, potentially dramatically and very rapidly[7]. In turn the shrinking of credit supply will create credit exclusion, which, as we have shown in section 4.0, may create a market opportunity for unauthorised lenders prepared to operate outside the regulatory regime, as has happened in the US at scale.

Complex requirements which imply significant compliance costs can also drive withdrawal or adaption to business models, creating exclusion in both cases

As with price controls, regulatory complexity has an impact on lender's compliance costs. Broadly speaking, complex requirements which require significant adaptations to systems and processes have the effect of increasing the costs and resource "burden" of compliance and thus depressing lender profitability, which may or may not cause licensed lenders to withdraw, depending on the viable and profitability of a compliant business model. The decision to withdraw or remain in the market will in turn be further influenced by both the resource and systems and legal expertise commanded by the lender (typically a function of lender size and capitalisation) and the scale of the market opportunity, large and more populous states offering greater potential for economies of scale in spreading the costs of compliance.

Complex requirements act to increase market concentration, confine lending to specialist players and act as a barrier to entry for mainstream financial services

Withdrawal in the face of complexity or an overly restrictive regulatory regime is most likely for smaller lenders which may not have the resource to invest in meeting compliance standards. Those licensed lenders that continue to operate or enter restrictive markets with complex regulatory requirements are typically either the larger lenders with the means to invest in compliance systems and processes or established lenders (large or small) with a long-standing – and therefore well-known and thus low-risk – client base.

It is worth noting, however, that complex regulatory requirements also impact the shape of market participation and the diversity of market participants in other ways. They tend in particular to reinforce the tendency of small sum credit markets to be the

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[6] A recent and striking example is provided by Japan where the sharp lowering of the interest cap rate in the 2006 Money Lending Business Law (MLBL) resulted in a shrinkage of consumer finance lenders of 85% between 2006 and 2014, with the number of registered lenders declining from 14,236 to 2,113. Source. FSA Money Lending Business Databook.

[7] There are no reliable national figures available for the US to show the impact of regulatory reform on the supply of small sum credit., not least because reform has been piecemeal and on a state by state basis. In the UK High cost short term credit (also known as payday lending was estimated to be worth £2.5bn in 2013 (Source: FCA CP- 14) but is estimated to have shrunk to £1.25bn by the end of 2015 (Source: Policis), following the introduction of a new regulatory reform for consumer credit in the UK in April 2014 and the introduction of new payday lending rules including a price cap in January 2015 . Details of the decline of small sum consumer finance loans in Japan following regulatory reform see footnote 7 following.

preserve of specialist lenders and act to work against mainstream financial services participation in the market. For lenders for whom small sum credit is only a small part of a larger financial services or lending operation, it is not worth investing either the funds or resource in a part of the business which is marginal to wider operations. Equally, complexity – and the requirement for new systems and processes – also deters mainstream financial services providers from entering or participating in the market. This tendency is of course greatly reinforced by what is perceived as a hostile regulatory environment and perceived reputational and regulatory risk around small sum lending.

Where licensed lenders remain in the market they may be at a significant cost disadvantage to unlicensed lenders who do not face the same compliance costs

Regulatory complexity drives perverse outcomes in a number of way. Compliance with a complex regime can carry significant costs, which in turn impact lender profitability and the range of risk that lenders are prepared to take on. Under these circumstances, unregulated lenders, who are not constrained by compliance considerations and the need to satisfy complex regulatory requirements enjoy a competitive and cost advantage..

Unlicensed lenders with a lower cost base are able to offer lower rates than licensed lenders to attract desirable low risk repeat borrowers

Unregulated lenders will benefit from lower costs than licensed lenders to a greater or lesser extent depending on how far regulatory requirements impact legitimate lenders' costs. Unregulated lenders derive competitive advantage from their lower cost base in one of two ways. When competing with licensed lenders for relatively low risk borrowers with proven track records of repeat borrowing (loyal repeat customers being a critical source of profitability) they are able to offer lower cost credit than is possible for licensed lenders. Such borrowers, often heavy credit users and frequent borrowers, tend to be fairly savvy and cost conscious. Unlicensed lenders can frequently post headline rates which appear lower than those offered by licensed lenders (albeit that such lenders may rely heavily on refinancing and penalty charges and, as evidenced in section 4, overall consumer pay more for credit when using unlicensed lenders). This approach is most likely in fact in permissive states where there is strong licensed lender presence, which exerts downward pressure on the price of credit and unlicensed lenders are forced to compete (see example for the Californian market following).

The lower cost base also enables lenders to serve a wider range of risk and a larger part of the market than is possible for licensed lenders

Unlicensed lenders willing to ignore cost controls can afford to serve higher risk borrowers who would be declined by compliant lenders because they cannot be served within the constraints of a compliant business model. Unlicensed lenders, unconstrained by considerations of complying with price controls, are thus able to charge high prices for these borrowers, in part because these borrowers are high risk but also because they do not have to compete for these customers with licensed lenders. It is this effect which works to expose the higher risk (and thus more vulnerable) borrowers to unregulated lenders and greater potential for higher costs and increased detriment.

In sum therefore, their lower cost base benefits unlicensed lenders' pricing strategy and disadvantages licensed lenders in two ways. On the one hand, lower costs enables these lenders to offer lower prices than licensed lenders where they need to compete for low risk customers. On the other, for higher risk borrowers, they are able to charge high prices with impunity, because untroubled by competition from licensed lenders.

Unlicensed lenders unconstrained by regulatory process requirements are able to meet consumer demand for rapid decision-making and delivery of funds

It is however, the non-cost barriers to doing business that arise in a complex regulatory environment, particularly highly specified mandated processes, which confers the real competitive advantage for unlicensed lenders and which drives reverse outcomes.

Critically, unlicensed lenders operating in an environment where compliant lenders face a complex and comprehensive set of regulatory requirements enjoy a critical advantage in being better able to meet consumer demand for speed of decision making, rapid delivery of funds to customer accounts and high service levels – plus a straightforward approval process for repeat or additional borrowing for existing customers.

Complex regulatory requirements inject delay into processes and compromise consumer experience with licensed lenders facing competitive disadvantage

Complex and highly specified regulatory requirements which impact lenders' underwriting and approval processes and lenders' and brokers' interactions with consumers, tend to inject process delay and inconvenience for consumers into the applications process as well as compromising the crucial "customer journey" and experience. A further effect will be a significant increase in decline rates, particularly where compliance is effectively monitored and enforced. All of these factors act to divert potential borrowers from licensed lenders to unlicensed lenders with the flexibility to match their approval process and service delivery to customer preferences for speed of decision making and fund delivery and minimum hassle.

In a highly competitive market, this syndrome places licensed, compliant lenders at a powerful competitive disadvantage. Where complex regulatory requirements additionally include mandated process delays – such as a cooling off period before cash can be received – or, in some states, even a requirement that proof of income or account status are cheques to cover payday advances are provided in paper form, the resulting further delays exacerbate this effect. If a further process layer is added in the form of a regulatory database, which effectively enforces compliance in the authorised space, this will further amplify the competitive advantage of unlicensed lenders.

5.2 Comparison of the outcomes of a simple and complex regulatory

Regulators with similar price controls and consumer protection goals but radically different approaches to complexity achieve very different outcomes

The impact of complexity in regulatory requirements – and the operation of perverse effects arising from it – is perhaps best illustrated with two case studies of large and populous states which have adopted radically different approaches to complexity in regulatory requirements while having similar consumer protection goals; California and Florida. California has a sub prime population roughly twice the size of that of Florida, but the proportion of each state's population which has a sub 701 FICO score is very similar. As we shall show, the outcomes for consumers and regulators in these two states are also very different, with the difference explained almost entirely by the unintended effects arising from the comprehensiveness of the regulatory requirements and the regulatory complexity inherent in the Florida regime.

California and Florida take not dissimilar approaches to the cost of credit and restrictions on refinancing and multiple loans

We have classified California, the most populous of the US states, as one of the “more permissive” lender set. California has a simple regulatory regime, albeit with a fairly low price cap (at an effective $17.5 per $100 borrowed), the lowest loan value cap in the US (at $300 per loan) and relatively strict controls on roll-overs (only 1 allowed per loan) with no fees allowed for extensions. Only one loan is allowed from the same lender at any one time. NSF (insufficient funds for payments) charges of $15 are allowed.

Florida regulators have not dissimilar aims to California in terms of consumer protection goals. Price controls are set only a little lower than those in California (at $16.11 per $100 dollar loan) but an additional verification fee is allowed, which must not exceed $5 per loan. Maximum loan values are higher than in California, at $500 per loan. Only one loan is allowed at any one time from any lender and roll-overs are not allowed. We have classified Florida as restrictive, however, not because of the price and lending value caps or the prohibitions on roll-overs, which, as discussed, reflect goals which are broadly in line with California, but because of the comprehensiveness and complexity of the regulatory requirements of lenders.

Florida’s approach is distinguished by its comprehensiveness captured in a series of mandated process requirements, enforced by a regulatory database

What primarily distinguishes the Florida approach from the California approach is the compliance process which has been put around lending and the provisions intended to enforce compliance and ensure delivery of the outcomes desired for Florida small sum borrowers. In their effort to protect consumers, the regulators have set out to cover all the bases and ensure compliance, creating a complex and comprehensive set of requirements which lenders must incorporate into their processes.

There is a mandatory 24 hour cooling off period before borrowers may access funds. There is also a regulatory database in place on which all licensed lenders must record details of all loan transactions and payments thereon. Lenders are obliged to check on the regulatory database that borrowers are eligible for a loan (that they do not have other loans outstanding for example) and to undertake a series of validations and verifications in relation to the borrowers ID and bank account.

As described in earlier paragraphs, compliance with the regulatory requirements injects delay into the applications, underwriting and approvals process. The requirement to log and verify eligibility for a loan through the regulatory database also enforces total compliance compliant loans being made. A side effect is that consumers are not able to take on multiple loans from licensed lenders.

California is among the most successful of the US regulators across a series of dimensions, with low cost of credit and high standards of responsible lending

Taking the outcomes for consumers and regulators in California first; California is on a number of measures among the most successful of the US state regulators in achieving positive outcomes for consumers and achieving their regulatory goals.

California has the lowest incidence of unlicensed lending in the US, with the off-shore lenders representing only a very small proportion of the market.

California regulatory regime has resulted in a state market with one of the lowest incidence of unlicensed lending in the US

Chart 17. The balance of state licensed and non state licensed lenders in the online small dollar lending market, California and US

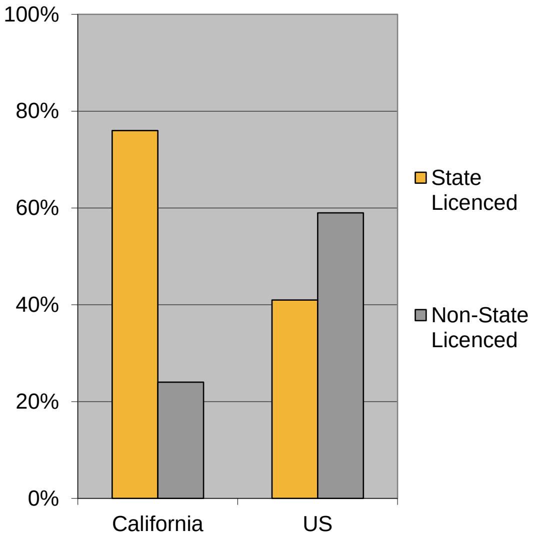
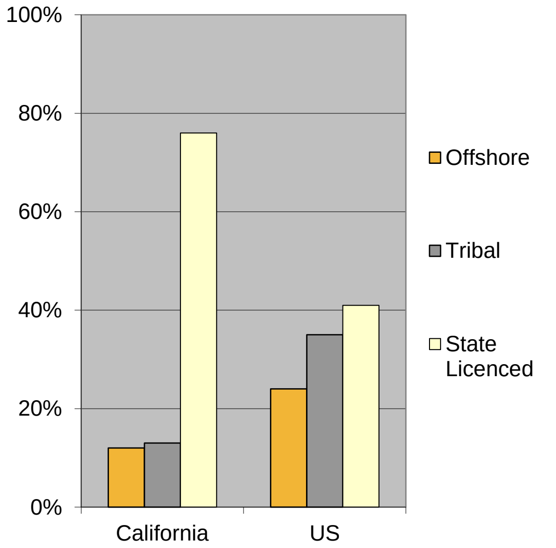


Chart 18. The lender mix in the online small dollar lending market by regulatory status, California and US



Californian consumers much more likely to be using regulated lenders than elsewhere in US

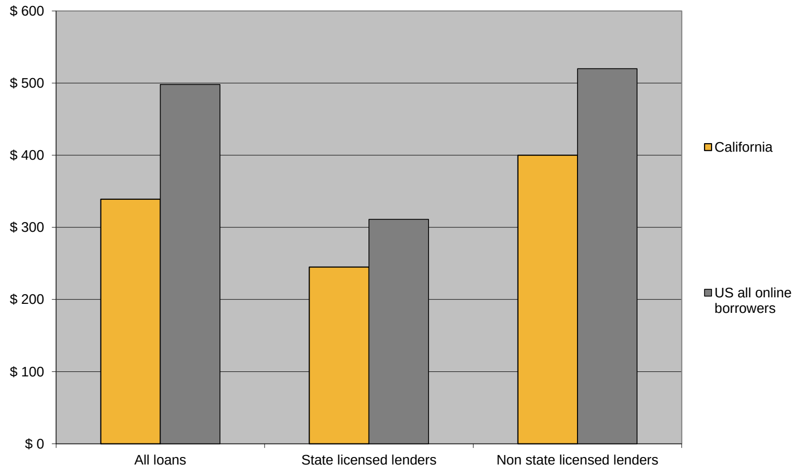
Eight in ten online loans issued by state licensed lenders, with most problematic offshore lenders representing only a very small share of the CA market

Source: Clarity Services

Moreover loans comply with regulators intentions on loan values in 92% of cases and fall within the price cap in 98% of cases. The average loan value for all loans in the state is $381. Unlicensed lenders in the state are offering loans in excess of the loan value cap, averaging $400. Nonetheless average loan values even for the unlicensed lenders in California are lower than the average for such loans for the US as a whole. It may be that the comparatively low loan value cap in the state may be driving some traffic to unlicensed lenders among those seeking larger loans.

Dominance of licensed lenders within Californian online market results in lower borrowing values

Chart 19. Average loan values, California, US all states
US all online borrowers, All California online borrowers 2012

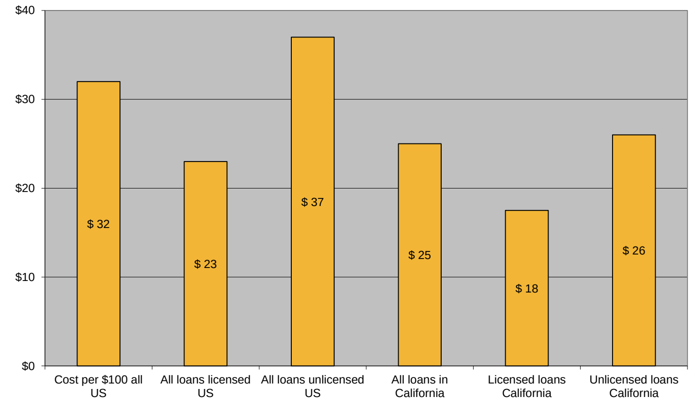


Source: Clarity Services

The average cost of credit per $100 borrowed is $17.5, significantly lower than for the US as a whole at 32$ per $100 dollars borrowed. Because so high a proportion of lenders operating in California are licensed lenders operating within the price cap, the competitive dynamic is such that unlicensed lenders are forced also to compete on cost, resulting in even unlicensed lenders offering much lower prices (averaging $26 per $100 borrowed) than unlicensed lenders in the US as a whole (at $37 per $100 borrowed). It is striking indeed that unlicensed lenders in California are lending at prices that are only slightly higher than those for licensed lenders for the US as a whole (at $23 per $100 borrowed).

Cost per $100 all US, All loans licensed US, All loans unlicensed US, All loans in California, licensed and unlicensed loans California

Chart 20. Cost per $100 all US, All loans licensed US, All loans unlicensed US, All loans in California, licensed and unlicensed loans California



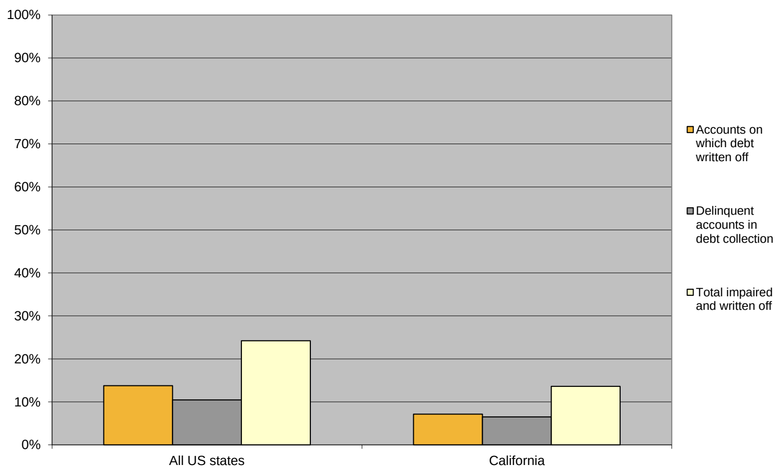
Source: Clarity Services

California borrowers have among the lowest levels of account delinquency and write of in the US, reflecting the predominance of licensed lenders

Small sum borrowers in California are also experience lower levels of write off and delinquency than borrowers elsewhere in the US, with 7% of small sum loans being written off and 6% of accounts being sufficiently delinquent to be subject to collection action, compared to 14% and 10% for all US small sum online loans. This is thus an overall impairment rate of 14% for small sum loans in California, compared to 24% for US online loans as a whole. The level of debt write off and account delinquency is lower also in California than in other states categorised as having a "permissive" regime, where the equivalent data is an average of 12% for write offs and 9% for loans in debt collection, and thus total impairment of 21%. This would seem to indicate that relatively few Californian small sum borrowers are taking on debt they cannot afford to service and fewer have unmanageable problematic debt. This in turn would seem to imply that, compared to US states as a whole, Californian lenders are achieving relatively high standards of responsible lending.

Write off and account delinquency on small sum loans, all US states and California

Chart 21. Loan impairment and write off, All US states and California



Base: All US small sum online loans 2012 / All small sum loans in California 2012
Source: Policis analysis of Clarity Services data

The outcomes in Florida are sub-optimal for both consumers and regulators – reflecting the dominance of unlicensed lenders in the state

The outcomes for consumers and regulators in Florida are very different and diametrically opposed to those achieved in California. It is clear that within the authorised space, Florida has achieved high levels of compliance. However, some 84% of all small sum loans made in Florida in 2012 were made by unlicensed, unregulated lenders[8], one of the highest proportions of any state in the US, excepting those states were small sum lending is actually banned. This is likely driven by consumers seeking the rapid cash they want from the unlicensed lenders willing and

[8] A provision in the Florida legislation rendering loans made by unlicensed lenders void and uncollectable was introduced in July 2014 with any impact on the incidence of illegal lending arising as a result not reflected in these 2012 data. As discussed in section 7.3 which examines efforts made in the US to tackle illegal lenders, however, such provisions have been largely ineffective in reducing illegal lending in other US states, primarily because they have been adopted by states seeking to employ a more comprehensive approach to consumer protection.

able to deliver instant loans and by borrowers wishing to take on more than one loan (whether repeat borrowing from the same lender or more than one loan from different lenders), again available from unlicensed lenders but not from those operating in the authorised space. As a consequence, regulators in Florida were less likely to achieve their goals and consumers experienced worst outcomes than those in California.

Seven in ten small sum loans in Florida do not comply with the regulators' price controls and barely two thirds complied with the state loan value cap

Just 65% of loans in Florida fell within the Florida loan value cap, albeit that this is set much higher than in California. The average loan value across all small sum loans made in Florida was $528, compared to $475 for all US small sum loans and $499 for loans made in other "restrictive" states.

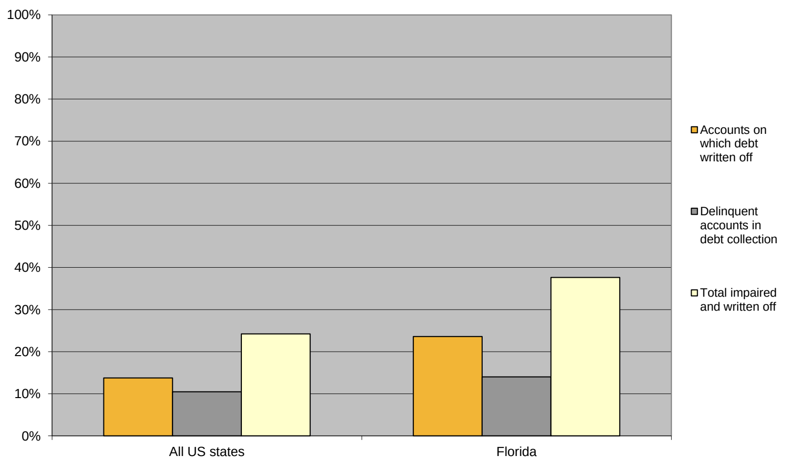
Some seven in ten small sum loans (71%) made in Florida also did not comply with the price cap operating in the state. with the average cost of credit per $100 borrowed being $34. This compares, however, to 32$ per $100 dollars borrowed for all US online small sum loans and $37 per $100 for small sum loans made in other "restrictive" states.

Credit impairment in Florida is much higher than in the US as a whole but in line with other restrictive states suggesting a pattern of irresponsible lending

The picture for delinquency and write off for small sum loans in Florida reinforces this wider picture of unintended effects and less than optimal outcomes for consumers. Some 14% of all small sum loans in Florida were sufficiently delinquent to have been passed to collection for action with 24% written off, given an overall impairment rate of 38%. This compares with 14% and 10% and thus 24% credit impairment for small sum loans for the US as a whole, but is only a little higher than other "restrictive" states, where the equivalent data for accounts in collection and debt write off are 15% and 20% respectively, with overall credit impairment therefore of 35%. This would seem to suggest that, taken as a whole, and outside the authorised space, lenders have been operating significantly lower standards of responsible lending than in California or the US as a whole.

Write off and account delinquency, all US states and Florida

Chart 22. Loan impairment and write off, All US states and Florida



Base: All US small sum online loans 2012 / All small sum loans in California 2012
Source: Policis analysis of Clarity Services data

The relative simplicity of the Californian regime works for licensed lenders and has delivered outstanding consumer protection outcomes

The differences in outcomes between California and Florida just described illustrate vividly how regulatory complexity and the over-layering of regulatory requirements can create unintended effects, particularly where these effects are reinforced by use of an enforcement mechanism such as a regulatory database. The evidence strongly suggests that a less prescriptive, simpler and more principled approach to regulatory requirements which is both realistic – in that it works with the grain of consumer behaviour – and which focuses on a small number of key requirements is more likely to generate better consumer protection outcomes.

The competitive disadvantage for licensed lenders created by regulatory complexity creates unintended effects and poor outcomes for consumers

Conversely, an overly complex approach with provisions embedded in a highly specified and comprehensive framework of inter-linked requirements can be profoundly counter-productive, producing not only outcomes which are other than those intended but also compromising consumer protection goals.

Chart 23 following pulls together the differences in outcomes between California and Florida across a series of dimensions.

Consumer protection outcomes and compliance with regulators intentions: California and Florida

Chart 23a. Lenders compliance with regulators' intentions, Florida and California

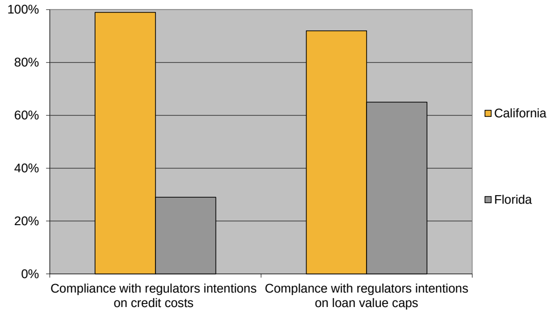


Chart 23b. Average Loan Values Florida and California

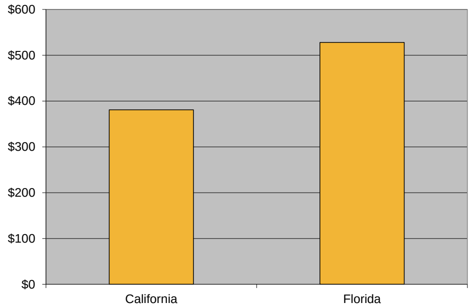


Chart 23c. Cost of credit, Florida and California

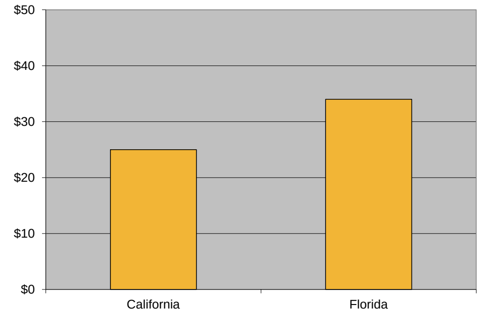
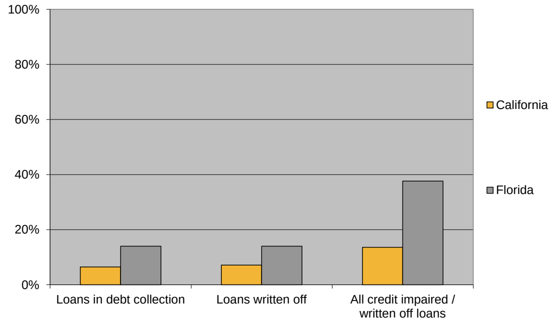


Chart 23d. Credit impairment and write off, Florida and California



Base: All small sums loans in Florida / California 2012

Source: Policis analysis of Clarity Services data

The very different outcomes for consumers achieved in California and Florida represent a powerful case for simplicity, clarity and focus in regulation

California and Florida thus represent important exemplars of how simplicity and clarity in the regulatory framework works to the advantage of consumers. Conversely, the very different outcomes for consumers in the two states also illustrate how complexity, and in particular the over-layering of requirements that slow lender processes and interrupt the flow of interactions with consumers, creating non-cost barriers to executing transactions, is profoundly counter-productive in the real world, working against the achievement of regulators' goals and creating negative outcomes for consumers.

Given the specific questions around how lender processes should be structured to achieve good responsible lending practice and address cycle of debt issues inherent in Consultation Question 5, we also investigate how similar provisions to those being considered in Australia incorporated into the regulatory framework in some US states have played out in section 6 following.

5.3 The impact of regulatory databases

The evidence is that where regulatory requirements are enforced by a regulatory database, the pernicious impact of complexity is amplified

Before leaving the issue of complexity and approaches to enforcement it is perhaps worth touching on the role and impact of regulatory databases. Section 4,chart 9 illustrated that the incidence of unlicensed lending was higher (at 80% of online lenders) in the 14 states with some form of regulatory database than is the case for US states overall (59%). The state of Wisconsin, which implemented a regulatory database on 1st July 2012, provides an opportunity to isolate the impact of the database from other aspects of regulatory complexity.

In the twelve months prior to the regulatory database going in, licensed lenders had a 22% share of all small sum lending in Wisconsin. At this time the average loan value in Wisconsin was $449 with an average cost of credit of $21 per $100 borrowed.

Twelve months after the regulatory database had been implemented, the lender mix had changed significantly, with the share of all small sum lending controlled by licensed lenders having fallen to 13%. Average loan values were slightly down, at $434, with the cost of credit having risen to $24 per $100 borrowed.

5.4 Key take outs on the impacts of regulatory complexity

Regulatory complexity: Key take outs

- **Simple regulatory regimes which rely on principle and a small number of focused controls, even where these are set relatively strictly, generate the best outcomes for consumers and appear to be more effective in achieving regulatory goals.**
- **The sub-optimal outcomes of overly restrictive regulatory regime rest not only on hard controls on price but rather on the complexity of the overall regime.**

- Regulatory regimes which layer a series of process requirements and highly specified process checks and validations generate pernicious and unintended effects in the form of degraded outcomes for consumers across a series of dimensions, including higher cost of credit and a greater tendency to problematic debt.
- Perverse effects arise both from the cost and resource burden of compliance with complex regulatory requirements but also from the competitive disadvantage arising for licensed and compliant lenders.
- Unlicensed lenders have the flexibility to meet consumer demand for rapid decision making and instant and repeat loans and suck up demand, while licensed lenders are handicapped by process delays and compromised customer experience.
- Where complex regulatory requirements are enforced by a regulatory database, unintended and perverse effects are amplified.

5.5 Summary answer to Question 2. Complexity and the potential for simplification of the regime while maintaining high standards of consumer protection

QUESTION 2:

- **Complexity: Could the current regulatory regime be simplified in a way that provides consumers with the same, or a higher level of, protection, while reducing the regulatory burden on industry?**

ANSWER:

- The optimal consumer protection outcomes for Australian small sum borrowers would be obtained by simplifying the regulatory regime and avoiding the use of highly specified process requirements in favour of principles or simple mechanisms which can be readily incorporated into lender processes without creating delay or customer inconvenience.
- In so doing, a simple, focused regulatory regime will reduce the regulatory burden on industry.
- Deploying complex and closely specified process requirements in relation to any regulatory or consumer protection goal increases the risk of poor consumer outcomes and unintended effects.
- Regulators should aim to craft elegant yet pragmatic regulatory solutions. These will need to acknowledge the realities of consumer demand and avoid placing compliant lenders at a competitive disadvantage while nonetheless requiring high conduct standards from lenders

6.0 Question 5: Restrictions on repeat borrowing

6.1 The responsible lending and problematic debt outcomes of permissive and restrictive approaches to regulating small sum

In our response to this question in the consultation rather than address the specifics of mechanisms that might be used to restrict repeat borrowing, we have rather sought to provide answers in terms of the principles around how best to address cycle of debt issues and preventing over-borrowing and problematic debt.

More permissive, less prescriptive regulatory regimes produce better outcomes in terms of ensuring affordable borrowing and preventing problematic debt

Section 4.0 demonstrated that overly restrictive regulatory regimes can produce worse outcomes for consumers across a series of dimensions. The same pattern can be observed also in terms of problematic debt. The permissive regimes and those which are simpler in concept (see section 5.0 preceding for examples) produce better outcomes for consumers in terms of affordability over-stretch on debt service and debt that becomes unmanageable. Across all online small sum loans in the US some 10% are sufficiently in arrears for the loan to have been referred to debt collection, with all that that implies in terms of stress for consumers. A further 14% of loans have been written off, implying a total impairment rate of close to a quarter of all loans (24%). Taking the states with the more "permissive" regimes as a whole, loan performance is a little better, with 12% write off and 9% of loans in debt collection, i.e. an overall impairment rate of 20% for the permissive states. Some of the permissive states with simple regulatory frameworks which encourage licensed lenders, achieve much lower levels of impairments, for example, California (see section 5 preceding for details). In the states with more restrictive regulatory regimes, however, credit impairment is much higher than in the permissive states, being 35% overall, with 15% of loans in debt collection and 20% written off.

Much higher levels of account delinquency and default for unlicensed lenders and in "Restrictive"/ "Banned" states indicative of higher incidence of irresponsible lending and greater consumer detriment

Chart 24. Loans subject to debt collection and written off, licensed and unlicensed lenders, All US online small sum loans 2012

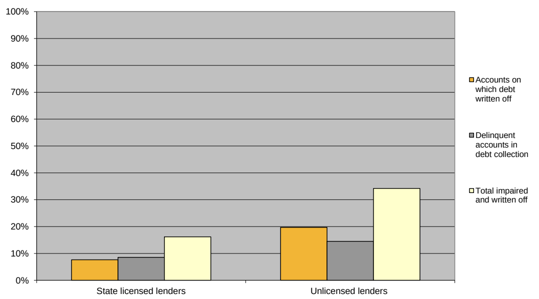
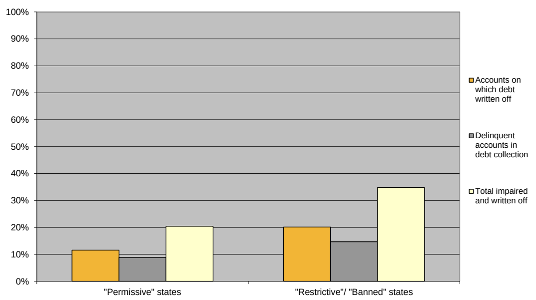


Chart 25. Loans subject to debt collection and written off, permissive and restrictive states, All US online small sum loans 2012



Significant consumer detriment is associated with account delinquency and default on loans from unlicensed lenders including high and often unanticipated refinancing and penalty charges, aggressive debt collection and collateral damage to the sustainability of bank accounts and consumers' financial resilience and well-being

Base: All US small sum online loans 2012
Source: Policis analysis of Clarity Services data

The evidence suggests therefore that simpler regulatory frameworks and a less prescriptive approach to responsible lending produce better outcomes for consumers. On the basis that debts in collection are a proxy for over-borrowing and difficulties in servicing debt on small sum loans and that debts written off as uncollectable are a proxy for unmanageable debt, lenders appear to be underwriting and lending more responsibly in the permissive regimes with less tightly specified regulatory frameworks.

The outcomes of specific restrictions on repeat borrowing in the US

Given the nature of the various solutions and restrictions being considered under Question 5, the research team has pulled together some examples of US states which have a series of prescriptive restrictions on repeat borrowing similar to those being considered in Australia. Here we focus our analysis on outcomes in terms of indicators of problematic debt, delinquent loans in collection and loan write off, as proxy for responsible lending outcomes/

The selected exemplar states are Illinois, Oklahoma, Virginia and Wisconsin. As Table 1 shows, these states employ a variety of restrictions on repeat borrowing and cooling off periods between loan applications and funds being received.

Table 1. Borrowing restrictions in selected US states

Illinois:

Cooling off period after loan application before loan can be granted:

- 7 days if consumer has been indebted on one or more loans for a period of in excess of 45 days.
- Instalment payday loans; 2 calendar days if loan is repaid in full before the last instalment is due, other than through refinancing.
- No payday loan can be made if the consumer has been indebted to one or more payday lenders for a period in excess of 80days.
- If the customer is on a repayment plan, 14 days after the repayment plan and all other payday loans must be repaid in full.

Maximum loan and income restrictions:

- No loan if the total of all payday loan repayments coming due with 1 month of the loan being taken out, when combined with the payments amounts of all other payday loans coming due within the month exceed the lesser of $100 dollars.
- In the case of 1 or more payday loans being taken out/ extant, repayments must not exceed 25% of gross monthly income.

Oklahoma:

Cooling off period after loan application before loan can be granted:

- Mandatory 2 day cooling off period if a customer has had 6 loans in a row without at least a 7 day break between any of them.
- 15 day cooling off period following completion of a repayment plan.

Virginia:

Cooling off period after loan application before loan can be granted:

- Next day in all cases.
- 90 days if following completion of a repayment plan of loan where term has been extended.
- 45 days if following completion of a 5th loan in a 180 day period.

Wisconsin:

Cooling off period after loan application before loan can be granted:

- 24 hour cooling off period required after repayment or renewal of a loan.

Maximum loan and income restrictions:

- Aggregate liability(principle interest and fees to all licensees) may not be more than $1500 or 35% of gross monthly income whichever is less.

Taking the US states as a whole some 24% of small sum loans made by both licensed and unlicensed lenders is in some form of default. Across these four states some 36% of loans are in default. As Chart 26 following shows, Across the US some 10% of all small sum loans online are in debt collection and 14% are in write off, making total credit impairment of 24%.

The equivalent figures for these four states with highly specified prescriptive requirements for responsible lending and restrictions on repeat borrowing are 13% and 23%, bringing the proportion of loans that are impaired in these states to 36%.

The explanation lies in the balance of licensed to unlicensed borrowers in these states, which in the case of Wisconsin, as discussed in section 5.0, has been worsened by the recent introduction of a regulatory database.

In the states with the most prescriptive restrictions on repeat borrowing and cooling off periods, problematic debt is higher than in the US as a whole

Chart 26. Loan impairment and write off, All US states and states with closely specified restrictions on repeat borrowing / responsible lending

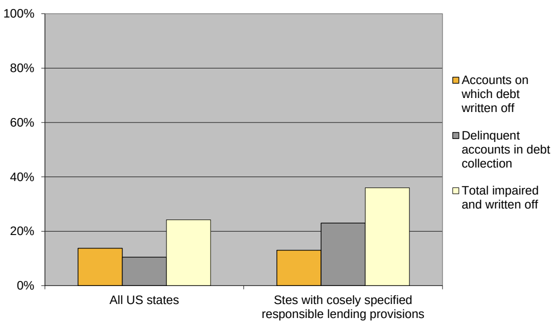
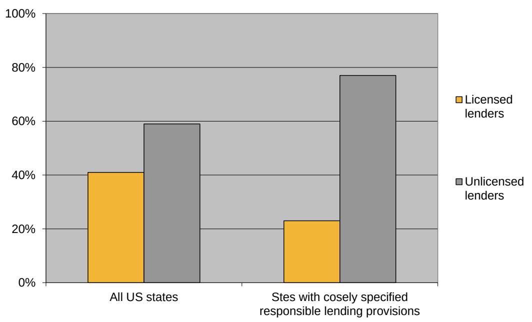


Chart 27. Balance of licensed and unlicensed lenders, All US states and states with closely specified restrictions on repeat borrowing / responsible lending



Base: All US small sum online loans 2012/ All small sum loans in Illinois, Wisconsin, Virginia and Oklahoma 2012
Source: Policis analysis of Clarity Services data

The various restrictions on repeat borrowing and specified debt to income ratios appeared to have a negative impact on responsible lending outcomes

Taken together therefore, it would appear that the various consumer protection restrictions on repeat borrowing, debt to income ratios and cooling off periods (which might also be by economists and lenders as non-cost barriers to doing business), have, in sum, had the impact of worsening responsible lending and problematic debt outcomes, in part by diverting consumers to the unregulated sector by creating competitive advantage for unregulated lenders unconstrained by restrictions on repeat borrowing and therefore willing to offer multiple loans, less sustainable debt to income ratios and instant loans.

6.2 Restrictions on repeat borrowing : Key take outs

Restrictions on repeat borrowing : Key take outs

- **Overly restrictive and complex regulatory regimes create worse outcomes for consumers in terms of responsible lending and problematic debt.**
- **Specific restrictions on repeat borrowing and formulas for capping debt to income ratios appear to have a counter-productive net impact, worsening problematic debt.**

6.3 Summary answers to Question 5. Restrictions on repeat borrowing

QUESTION 2:

- **Is a restriction on repeat borrowing necessary to protect consumers?**

ANSWER:

- **If regulators seek to prevent payday loans being used as a quasi line of credit product, encouraging the development of longer term, instalment type products would seem the most effective way to do so**
- **Highly specified restrictions on, or processes around, repeat borrowing or assessing affordability are likely to be counter-productive**
- **Any yardsticks for responsible lending should be kept as simple as possible and should be designed specifically not to inject delay into the lending process or disrupt the customer journey**
- **A high level or broadly couched duty of care or statement of responsible lending principles may generate better responsible lending outcomes for consumers than tightly specified formulae**

7.0 Illegal lending

Earlier sections have described how the emergence of a large scale unlicensed lending market online in the US has impacted regulators' ability to achieve their aims and degraded outcomes for US small sum borrowers. The scale of the unlicensed lending market and its growth to a position where such lending had come to dominate the online small sum lending market in a seven year period demonstrates both how rapidly such a market can become established and that it can quickly acquire critical mass and significant scale. In the narrative thus far we have focused on the US, but in this section we include also data and information from other markets to illustrate that the effects we have described in the preceding sections are not confined to the US. Our intention is to share with the committee and Australian shareholders insights around the nature of illegal lending in the future and the very real threat it poses to consumer welfare in small sum credit markets if an unregulated market of any scale is allowed to develop. We are also seeking to illuminate further the nature of the challenges facing regulators in an increasingly digital market for small sum lending.

In this section we illustrate what contemporary illegal lending looks like in the digital age, the potential nature of the threats to consumer welfare posed by unregulated lending and to show how, once established at any scale, such markets become very difficult to tackle.

7.1 The future of illegal lending

The emergence of large online market for small sum credit has been a game-changer for illegal lending, enabling a step-change in scale and reach

The emergence of online small sum lending combined with regulatory reform that has disenfranchised significant numbers of borrowers in small sum credit markets has been a game-changer for illegal lending. The future of illegal lending is online and at scale.

It is clear from the US experience and the evidence presented in previous chapters that a large online market can rapidly acquire scale and develop alongside the legitimate market for small sum loans.

It is credit exclusion which provides the stimulus for illegal lending to develop – with the most vulnerable borrowers those most at risk

Illegal lending appears to arise wherever credit exclusion is of a scale to create significant opportunities for lenders prepared to operate outside the legitimate regulatory framework Unfortunately, since those most likely to be credit excluded and to have few other credit options are the higher risk borrowers, those on low incomes and the financially troubled, it is often the most vulnerable borrowers who are most at risk of using illegal lenders. Against this background it will become increasingly important for regulators to optimise the balance between consumer protection and credit inclusion, so as not to create undue opportunities for illegal lending.

From the perspective of the consumer, unregulated lenders will look very much the same as licensed lenders

A brief review of how unlicensed lenders currently present themselves makes clear that for the future unlicensed lenders will look just like licensed lenders, and, indeed, will make every effort to resemble their licensed peers. Consumers are likely to find it very difficult to discriminate between licensed and unlicensed lenders. Typically unlicensed lenders either make little mention of their regulatory status or claim to be authorised by some other authority than that operating in the jurisdiction into which they lend.

To illustrate this phenomenon we provide here some examples of web sites for unlicensed lenders lending into the US (Figures 1 and 2) and UK (Figure 3) and illegal lenders operating in Japan (Figure 4). The first two examples are of web sites for unlicensed lenders lending into the US.

The first is an offshore lender, trading as USA Advance.com, which claims to derive its authority from the islands of St Kitts and Nevis.

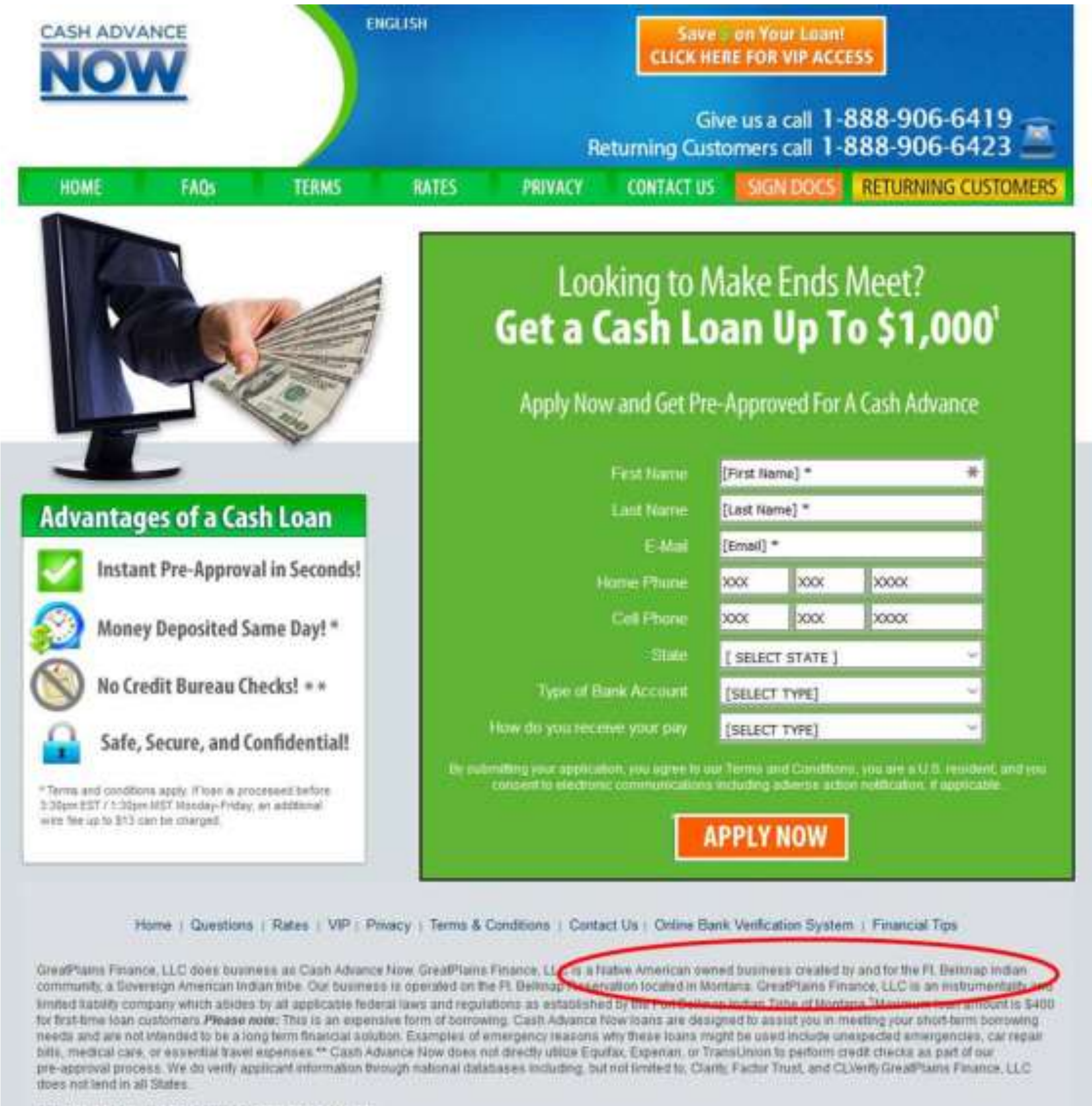
Figure 1. Example of offshore lender's website lending into the USA – USA Advance.com.

You have entered the legal domain of the Federation of Saint Christopher and Nevis. All aspects of and transactions on this site will be deemed to have taken place in the Federation of Saint Christopher and Nevis, regardless of where you may be viewing or accessing this site. This site does not constitute an offer nor solicitation for short term loans in all U.S. states. This service may or may not be available in your particular location. The locations this site services may change from time to time without notice.

http://www.usadvance.com/

The second example is the web-site is a tribal lender, trading as Cash Advance Now, which claims to derive its authority as a sovereign nation from the Fort Belknapp American Indian tribal community in Montana.

Figure 2. Example of a "tribal" lender lending into the USA – Cash Advance Now



GreatPlains Finance, LLC does business as Cash Advance Now. GreatPlains Finance, LLC is a Native American owned business created by and for the Ft. Belknap Indian community, a Sovereign American Indian tribe. Our business is operated on the Ft. Belknap Reservation located in Montana. GreatPlains Finance, LLC is an instrumentality and limited liability company which abides by all applicable federal laws and regulations as established by the Fort Belknap Indian Tribe of Montana.

https://www.cashadvancenow.com/default.aspx

The third example is a large offshore lenders that has been lending for some years in the US. This lender, now also targeting the UK market and UK payday borrowers, is trading as “Pounds till Payday” in the UK. In the UK all lenders are now required to be authorised by the Financial Conduct Authority, with an authorisation process now underway. Pounds till Payday claims to derive its authority from the island of Malta.

Figure 3. Example of offshore lender lending into the UK – Pounds till Payday

Pounds till Payday.co.uk is a trading name of Northway Financial Corporation Limited. Northway Financial Corporation Limited is regulated by the Malta Financial Services Authority. Level 5, Plaza Commercial Center, Bisazza street, Sliema – Malta. SLM1640

https://www.poundstillpayday.co.uk/

In the US and UK, unlicensed online lenders have thus far presented as “payday” lenders, with this sector in the US having developed scale and significant presence entirely within the last decade. Illegal lending models prior to this development were small scale, ultra local.

In Japan, however, Illegal lending has a longer history, albeit one also arising from credit exclusion. While web based illegal lending models have proliferated rapidly in recent years (see Figure 4), there are also bricks and mortar and phone based operations. Illegal lenders in Japan, broadly operate on one of three business models, i.e. “Yamikin”[9] lending (“loan shark style illegal lending operations run by organised crime groups, some of which can be large scale[10]), “monetised credit cards” i.e. cash loans based on a credit card credit line, with the cash released to the merchant and transmitted to the borrower (less deductions for interest and charges which can be substantial) via a fake “purchase”, and “Fake Pawnshops”, essentially a front for an illegal lending operation. By contrast to the situation in the US, there are relatively high levels of awareness of the existence of illegal lenders among Japanese personal loan users, with a significant minority prepared to admit to using illegal lenders of various types[11]. The credit excluded, with i.e. those that have lost access to credit following the market reforms, primarily low income borrowers, the self-employed and those in uncertain employment[12], are particularly likely to do so.

In figure 4 we provide some examples of Japanese consumer-facing illegal lending web-sites. Figure 4 shows the result of a Google search for one of the most common illegal lending models used by consumers – “monetised credit cards” [13], a form of lending that has emerged in the wake of the market reforms in 2006[14], which resulted in a significant decline in credit supply[15] and the credit exclusion of some borrower types.

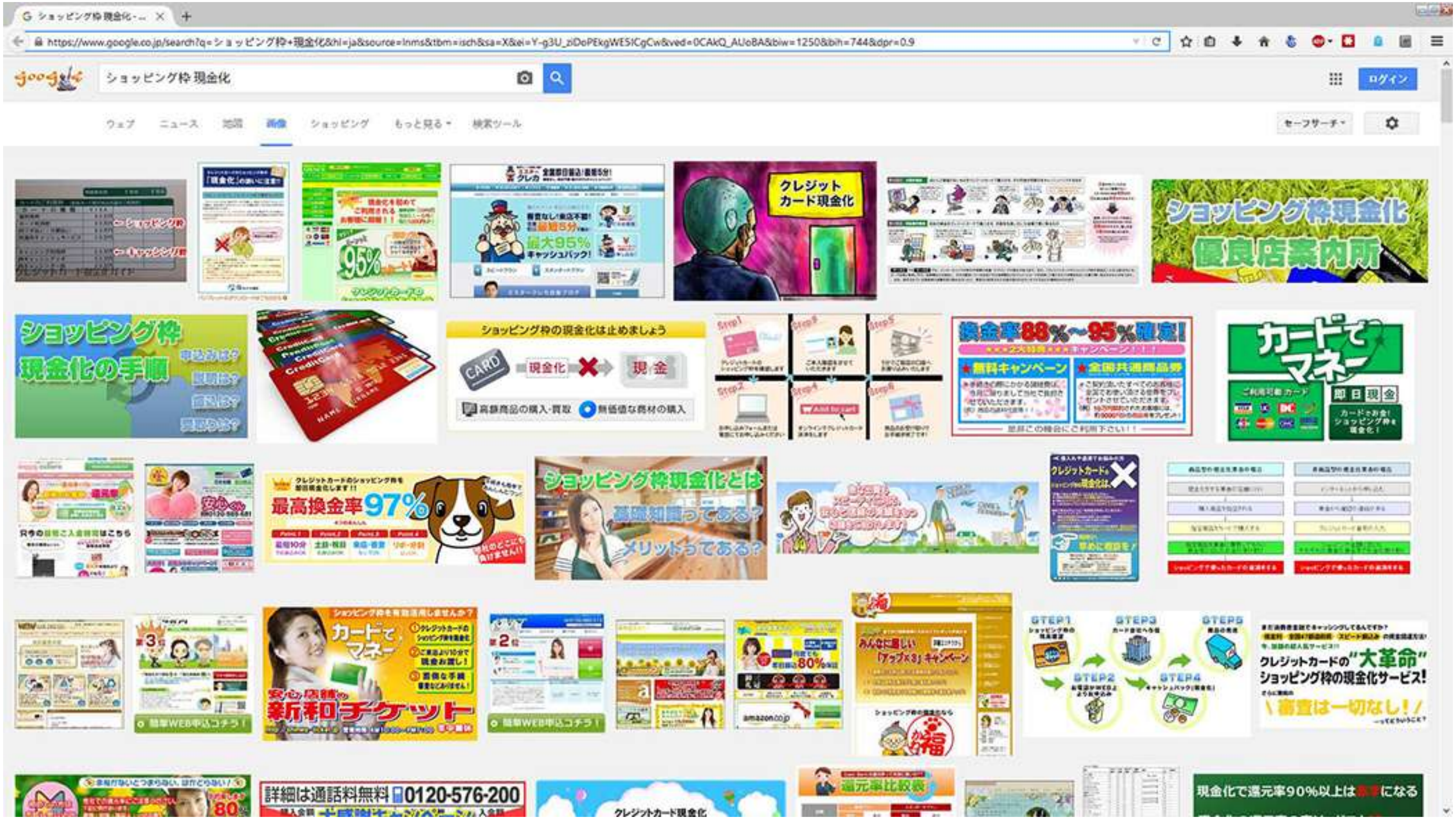
[9] Yamikin is an abbreviation of yami (shadow or darkness) and kin-yu (finance)
[10] Susumu Kajiyama of the Goryo-kai crime group had some 9.4 billion yen (approximately 115 million Australian dollars) of profit from his Yamikin business hidden in a single Credit Suise bank account when he was arrested in 2003. He ran a network of around 1000 branches through which illegal loans were made.
[11] Some 39% of current and past personal loan users are aware of the existence of “Yamikin” lenders, 33% are aware of the existence of Encashment lenders using a credit card shopping credit line while 16% are aware of “fame pawn shops” Source Japan Financial Services Association (JFSA)survey 2015. Some 16% of current or past personal loan users have had contact with or borrowed from a Yamikin lender, 22% have had contact with or used an encashment lender using a credit card shopping line and 8% have used a “Fake Pawn Shop”
[12] A consumer survey undertaken in 2013 for the Institute of Research for Credit Business, Waseda University, suggested that the self-employed and those working for small enterprises were more than twice as likely to be declined for credit than civil servants or employees of large companies and those that were able to borrow among the self-employed and employees of small enterprises were much less likely than those in large companies and public officials to borrow the sum that they requested.

[13] The original Japanese phrase from which the google search results are displayed is ショッピング枠 現金化 (Shoppingu waku genkinka)

[14] The Money Lending Business Law 2006, which was fully implemented in 2010. MLBL
[15] Between March 2006 and March 2014, outstanding balances reduced 70% from 20.9 trillion yen to 6.2 Trillion yen> Source@ FSA Money Lending Business Databook

Figure 4. A selection of “Credit card monetising” web-sites, in Japan, a popular business model for illegal lenders

The original Japanese phrase used to generate this Google search is ショッピング枠 現金化 (Shoppingu waku genkinka)



https://www.google.co.jp/search?q=%E3%82%B7%E3%83%A7%E3%83%83%E3%83%94%E3%83%B3%E3%82%B0%E6%9E%A0+%E7%8F%BE%E9%87%
91%E5%8C%96&hl=ja&source=lnms&tbm=isch&sa=X&ei=Y-g3U_ziDoPEkgWE5ICgCw&ved=0CAkQ_AUoBA&biw=1250&bih=744&dpr=0.9

7.2 The detriment arising from unlicensed lending

Unlicensed lending at any scale subverts regulators intentions and worsens market and consumer outcomes

The analysis earlier presented in sections 4, 5 and 6 shows how large scale unlicensed lending can subvert regulators' intentions and worsen consumer outcomes in terms of both the cost of credit and problematic debt service and unmanageable debt.

A spectrum of conduct risk – at one end price transparency and conduct standards may be compromised

There would appear however to be a spectrum of conduct risk associated with unlicensed lending, At one end of the spectrum, as we have seen lenders may ignore price or responsible lending controls. Products may also be structured to both disguise and increase true borrowing costs, potentially by relying heavily on income generated from roll-overs, refinancing or penalty charges. The state regulators in the US also reported issues around high pressure debt collection techniques and refusals to engage in structured repayment plans where consumers were in difficulty. Most problematic, regulators reported that lenders seeking to ensure payment could make multiple ACH (automatic clearing house) calls using bank account details which could tip consumers into overdraft, leave them with insufficient funds for essentials or compromise the bank account to the point where it could no longer be used.

> *"The ones that are not licensed are just loan sharks. They roll people over, they wipe out bank accounts and they do not respect any legal authority whatsoever."*
> US state regulator

At the other end of the spectrum there can be a cross over with criminal activity including extortion, unauthorised withdrawals from account & identity fraud

At other end of the spectrum regulators reported, and consumer advocates have claimed, that there is a cross-over with serious criminal activity, including unauthorised bank withdrawals, fraud identify theft and extortion.

> *"The real harm to the consumers is that they take an ACH (Automatic Clearing House payment) with your account and so the money is just removed out of your bank without your control and it's not a one-time event. They keep grabbing money out of your account. That can be very damaging to consumers and the collections element is very damaging to consumers. If you don't pay money into your bank then you're harassed into paying the debt collectors."*
> US state regulator

It is difficult to be sure of the scale of such activity[16] and the detriment arising and the credit reference data set does not offer any insights in this regard. Regulators are

[16] A study by Pew Research based on survey data (but with a small and potentially unrepresentative sample) suggested that 46% of online payday borrowers reported that lenders had made withdrawals that overdrew their checking account (twice the rate reported by storefront borrowers), 32% of online payday users reported an unauthorised withdrawal in connection with an online payday loan, 39% of online payday borrowers reported that their personal or financial information had been sold to a third party without their consent, 22% reported closing a bank account or having one closed by the bank in connection with an online payday loan and 30% reported being threatened by a lender or debt collector. The Pew researchers are clear that such behaviours are not associated with the large online licensed pay day users operating in the US. Clearly there are limits to the weight that can be put on data from a small and potentially unrepresentative sample so that

clear however that the overwhelming majority of complaints of egregious behaviour in the online payday sector relate to unlicensed lenders.

> *"I would say 99% of the complains that we get from consumers have to do with unlicensed internet lenders."*
> US regulator

7.3 Tackling illegal lending

Us regulators have adopted a wide range of measures to tackle illegal lending

US regulators have adopted a range of measures in the effort to enforce compliance and tackle illegal lending which have rested on a variety of approaches. These include consumer education and provisions in legislation to make loans from unlicensed lenders null and void and the debt uncollectable. Regulators have also pursued unlicensed lenders with cease and desist actions and pursuit through the courts[17] and efforts to provide court-mandated rebates and compensation for consumers. At the federal level, the Consumer Financial Protection Bureau (CFPB) and the Department of Justice (DOJ) have sought to "choke of" access to the payments systems and deny unlicensed lenders payment and banking services[18]. Alongside this, some states have made efforts to counter the restriction of supply through the provision of low cost alternative supply.

Many of these efforts have been fragmented and have proved ineffective in reducing illegal lending significantly

Clearly some state regulators are better resourced than others and some state regulators are more committed and pro-active than others, notably New York, where the regulator has pursued tribal lenders through the courts with some success. The political will to address the problem also varies from state to state. However, broadly speaking, with the exception of the federal regulators' and DOJ efforts to deny lenders payment services and recent court actions by the CFPB seeking redress from offshore lenders, most approaches, at least at state level, have been fragmented, small scale and largely ineffective.

Consumer education and awareness building does not appear to have been effective in moving consumers away from unlicensed lenders

Consumer education and awareness building seems to have had limited impact in deterring consumers from using unlicensed lenders. Figure 5 following shows the consumer-facing financial education web-site for the state regulator in Oregon. Despite these public warnings and the efforts to educate consumers on the risks of using illegal lenders, almost three quarters (74%) of all online small sum loans in Oregon in 2012 were by lenders not licensed to lend into the state.

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reliable conclusions cannot be drawn on scale. However the data is potentially indicative of the kinds of conduct risk that users of unlicensed lenders may face online. http://www.pewtrusts.org/en/research-and-analysis/reports/2014/10/fraud-and-abuse-online-harmful-practices-in-internet-payday-lending

[17] Most recently in December 14 and August 2015 the CFPB has pursued a number of offshore lenders through the courts with a view to putting these lenders out of business and seeking compensation for consumers.

[18] In a coordinated operation between the CFPB and DOJ launched in 2013, known as "Operation Coke-Point" which sought to deny payments services to unlicensed lenders. There has since been some row-back on the part of the authorities in the face of legal and other challenges.

Figure 5. Regulators' efforts to educate consumers on the risks of using unlicensed lenders have largely failed to stem the tide of consumer detriment

Illegal lenders represent 74% of all online small sum lending volumes in Oregon

Source: Policis analysis of Clarity Services data Oregon State Regulator's consumer-facing public education web-site

Source: http://www.stopunlicensedloans.com/victims_stories.html

Thus far compensation and redress actions have been small scale

Regulators report that compensation and redress schemes have been successful only on a very small scale and have required significant resource and funds to achieve. This may change with the recent court actions of the CFPB.

Regulators at state level report mixed success with "Cease and Desist" actions which some unlicensed lenders simply ignore

Cease and desist actions have also had mixed success, primarily because of difficulties in locating lenders and their owners. Regulators report however that even when they do make contact many unlicensed lenders simply ignore approaches from the regulators.

> *"Maybe 25% of the time they respond to us and take notice. Most of the time they don't."*
>
> US regulator
>
> *"We sent out Cease and Desist letters to these institutions asking them to stop. You're breaking the law, so basically don't do it anymore…Some of them said they have stopped. Some of them say they won't stop and some of them just said 'we don't have to listen to you because you don't, you can't do anything to us."*
>
> US regulator

Monitoring and pursuing unlicensed lenders is a resource intensive activity

Regulators report that they often lack the resource to pursue lenders adequately and that, while they publish enforcement actions, there remains limited awareness among the public so that the impact tends to be small scale.

> *"We try to keep track of them as best we can…in terms of you know serving them and subpoenaing them and that kind of thing, and auditing them. We are limited because of the lack of resources to go after them. But in doing that, what we do as*

well is we publish our actions and so what we hope is that people have enough presence of mind to just even Google the company that they're looking at and they'll see that there's a caution alert or even an enforcement action from our department and they might think twice about using them…you may maybe prevent a few hundred from getting into some kind of debt trap."
US regulator

Lenders may mutate identities to avoid challenge or pursuit

One of the more difficult aspects of seeking to identify and root out unlicensed lenders is that some lenders simply mutate identify when challenged. Offshore lenders are particularly difficult to reach and engage with.

It's like 'Whack-A-Mole'. Some of these folks they operate under several different business names and, you know, you may close down one and open up another and it's as easy as just getting a web-site."
US state regulator

"They open as Cash Ferry today and ABC lending tomorrow. You don't even know where they are operating from, Dubai, China…"
US state regulator

"It's been very ineffective with tackling the online payday lending and it's not from lack of trying…by the time you file the charges the company just kills that website and opens a new one…you can't get to the person who owns it and, if they're outside the country, it's beyond, you know, the long arm of the law."
US state regulator

Void and unenforceable provisions have thus far not proved a barrier to unlicensed lenders operating in states with these provisions

Even "void and unenforceable" provisions, by which unlicensed debt is legal uncollectable, part of the regulatory framework in 20 US states have proved ineffective. Indeed in these 20 states unlicensed lending represents a higher share of all online small sum (at 80%) than is the case in the US as a whole. The explanation would appear to be that such provisions tend to be part of a comprehensive and complex regulatory framework, which, as discussed in section 5, tends to disadvantage licensed lenders and provide unlicensed lenders with a competitive advantage. The CFPB are relying in part on these provisions, however, in their cases against offshore lenders currently working through the courts.

Attempts to target the payments infrastructure on which the lenders rely have had greater success but the indications are that this effect may be temporary

The most effective effort appear to have been "Operation Choke Point", the coordinated, multi-agency effort undertaken by DOJ in conjunction with the CFPB in 2013. This targeted the infrastructure on which unlicensed lenders depend (banking and payments services in particular). However, the evidence is that although the impact was initially dramatic, over time unlicensed lenders have adapted products and services and are rebuilding share, in part through new business models which rely on affiliations with tribal lenders and Native American tribes. It has also proved difficult to identify payments to unlicensed lenders within the billions of payments going through the payments systems with many legitimate lenders suffering collateral damage.

7.4 The future of illegal lending: Key take outs

The future of illegal lending – Key take outs

- The future of illegal lending is online and at scale.
- Black credit markets arise in the wake of credit exclusion to fill any vacuum of legitimate credit supply
- Reform which significantly increases credit exclusion may create a scale opportunity for unlicensed lenders (as can be observed in a number of markets)
- Black credit markets can develop rapidly and acquire significant scale in a relatively short period
- Illegal lenders in the future will likely look just like legal lenders and consumers may find it difficult to discriminate between them.
- Unlicensed lending has been associated with significant consumer detriment
- Once an illegal lending market of any scale becomes established it is extremely difficult to tackle
- It will be significantly less challenging to act now to prevent an illegal lending market arising in Australia than to have to tackle one which has become established and acquired any scale
- There may be a limited window of time in which to do so and the SACC review would appear to offer an important opportunity to address the potential for an illegal lending market to arise

7.5 Illegal lending: The challenge and the solution

THE CHALLENGE :

- Ensure adequate credit supply to minimise the risk of an illegal lending market arising in the wake of regulatory intervention

THE SOLUTION:

- Optimise the regulatory framework to enable licensed lenders with high conduct standards to operate profitably and at scale within a regulatory framework that works with the grain of consumer demand and market dynamics
- Avoid measures which create competitive disadvantage for licensed and compliant lenders or which may create opportunity for unregulated lenders to take business from licensed lenders
- In crafting regulatory solutions, consider carefully how any intervention may impact the potential for illegal lending to develop
- For the future, monitor both the authorised and unauthorised space and

evaluate developments both within and outside the regulated sector when reviewing the impact of regulatory interventions

8.0 Overall implications for regulatory strategy in Australia

- As small sum lending increasingly shifts online (80% of the UK market is already online for example), digital is a game-changer as much for regulators as for lenders. It is clear that, given market opportunity, a parallel unregulated sector can emerge and rapidly acquire scale online and that, once established, unregulated lending markets are very difficult to tackle.
- The new reality for regulators is that this possibility is now a very real and present danger, and one that needs to be carefully considered. In crafting regulatory strategies. Regulators need to consider the potential impact of any intervention in the light of whether it would create market opportunities or competitive advantage to unregulated players.
- Fundamentally, the shift to online and the emergence of unregulated operators at scale in global credit markets imply an uncomfortable and inconvenient truth; Regulators may no longer be able to control all elements of the supply side. In the event that an unregulated market takes hold, they may indeed lose control of the core supply dynamics of the market.
- In a world in which licensed lenders may be competing not only with each other but with unregulated lenders, a new pragmatism is required which focuses on how most effectively to achieve the real world consumer protection outcomes that regulators seek.
- This is not to suggest that there should be any relaxation of high standards of lender conduct or any loosening of expectations on consumer protection, rather the contrary. The new reality requires that regulators focus clearly on the mechanisms and approaches which will best optimise the regulatory system to maximise consumer protection outcomes.
- An overly restrictive regime, and particularly one which is complex and highly specified with a series of detailed process requirements, is not only likely to be counter-productive in achieving regulatory goals but is likely to create damaging outcomes for those the regulators seek to protect.
- It will be particularly important to take steps to minimise credit exclusion, so as not to create market opportunities for unregulated lenders.
- Similarly, in order to minimise the potential for unintended effects and to avoid putting licensed lenders at a competitive disadvantage, it will be key to ensure that any new lender requirements, for example, around responsible lending or affordability, are either couched in terms of high level principles, or, where they rely on mechanisms, that these are so structured and sufficiently simple as to be readily incorporated into processes without injecting undue delay into underwriting activities or compromising customer service or experience.
- An elegant regulatory solution which best serves Australia’s small sum borrowers and which will best deliver regulators’ aims will be a simple and clearly focused regulatory framework which works with the grain of consumer and market dynamics and which allows licensed and compliant lenders working to high conduct standards to operate profitably and at scale.
- Australia may be at a tipping point with a narrowing window of time in which to act decisively to prevent the emergence of an unlicensed lending market of any scale. The review of the 2006 legislation may represent a golden opportunity to do so.