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# TRENDS IN THE AUSTRALIAN SMALL LOAN MARKET

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# Executive Summary

## OUR BRIEF

This paper was funded by a small grant from the Australian Centre for Financial Studies. The paper's brief was to respond to the following matters:

- Provide an overview of the 'payday lending' market in Australia.
- Investigate the impact of unsecured, short-term, small amount lending in Australia and the issues involved in regulating this sector.
- Who are the users of payday lending? Is there evidence suggesting that the main users of small amount loans are financially excluded?
- Explore the potential alternatives to payday loans.

## *METHODOLOGY*

Research of the Australian small loan market has been hampered by the lack of an industry-wide dataset specifying, for example, the number of loan contracts written or revenue received, customer profiles and borrowing frequencies, default rates or the sector's employment levels. Recent studies have therefore been based on secondary data such as company reports, or customer surveys and interviews with industry stakeholders (Banks et al. 2012; Connolly, Hems & Wolfson 2011; Gillam 2010). This report applies a similar methodology.

A desk review of secondary data included: recent international and Australian academic studies, government reports and industry papers about the sector, and the broader consumer finance market; Australian company annual reports; and shareholdings of ASX listed payday lenders. We have also drawn upon a number of datasets, including quantitative data from an ARC Linkage Project (LP0990992), survey responses from Victorian financial counsellors conducted in January 2014, and data from an RMIT survey of online borrowers undertaken by Dr Marcus Banks in August 2014 (with the support of Money3 and LoanRanger). Primary data was collected through interviews with a small number of key stakeholders. Dr de Silva sourced eight interviews with executives of leading payday companies and consumer finance advocacy agencies.

## *REVIEW OF SMALL AMOUNT CREDIT CONTRACT AND CONSUMER LEASE LAWS*

**This overview is timely**. On 6th August 2015 the Federal Government established a review of the small amount credit contract laws, in accordance with section 335A of the National Consumer Credit Protection Act 2009 (the Credit Act). The review is being chaired by Ms Danielle Press, CEO, Equipsuper. The panel members for the review are Ms Catherine Walter AM, deputy chair of Funds Management Victoria, and Mr Stephen Cavanagh, Partner at HWL Ebsworth.

The review will run until the end of 2015 with a report submitted to the Assistant Treasurer. The panel will consult widely with a range of stakeholders, call for submissions from interested parties and make recommendations about the effectiveness of sections of the Credit Act, including:

- the requirement of a small amount lender to consider a consumer's bank account statements;
- the rebuttable presumption that a loan is unsuitable where the consumer is in default under another small amount credit contract (SACC) or has held two other SACCs in the past 90 days;
- the cap on fees and charges, including the maximum of a 20% establishment fee and of a monthly 4% fee;
- the power to introduce specific protections for consumers who receive 50% or more of their income under the Social Security Act 1991;
- the requirement that consumers who default under a SACC must not be charged an amount that exceeds twice the amount of the relevant loan;
- whether a national database of SACCs should be established and if so, by whom and how it should be funded; and
- whether any of the provisions which apply to SACCs should be extended to regulated consumer leases.

Our paper, assessing the Australian small loans market within international regulatory and business trends, aims to contribute to this vital policy debate.

## OVERVIEW AND FINDINGS

The market for small-amount credit has grown dramatically in recent decades. Since the introduction in Australia of new regulations in 2013, loans up to $2000 for periods between 16 days and 12 months have been termed Small Amount Credit Contracts (SACCs). This report focuses on the Australian SACC market and provides a snapshot of domestic and international trends. Our findings are presented in three sections: context, complexity and policy considerations.

## CONTEXT

1. **The domestic market has grown significantly in recent decades.** In Australia there has been a twenty-fold increase in demand for short term, small amount loans in the last decade (Packman 2014). While industry-wide data is not available, over one million Australians are estimated to have taken out a SACC-type loan in 2012, generating contracts valued between $800 million and $1 billion (Banks et al. 2012). This growth is not just in terms of volume or value. The market has also grown in terms of product variation including a strong online presence.

2. **Domestic growth reflects international trends.** In general, the demand for payday loans in the last two decades has been associated with rising levels of income inequality (Beech et al. 2014: 18), increasing rates of casualisation in the labour market, and a lack of alternative credit products that can be viably accessed by consumers. However, a degree of caution

needs to be exercised when comparing domestic and international trends. Differences in state welfare arrangements, financial frameworks and social factors significantly shape local markets, and so the Australian industry is best described as growing in parallel with other national markets rather than simply converging to a global common denominator.

3. **The regulatory environment has a critical impact on the market.** Across the globe the scale and character of local markets have been heavily influenced by jurisdictional policy parameters. For example, recent changes in UK policy are predicted by the regulator to reduce the number of firms to three online providers and one high street company (FCA 2014). A similar market sensitivity to policy changes is found in Australia. In the week following the announcement by the Federal Government of the sector's review, the share prices of major Australian lenders dropped by over 20% (Eyers 2015).

## COMPLEXITY

SACC providers operate in a complex market. Particular characteristics on the supply side were found to be:

1. **SACC providers operate in what is known as the Alternative Financial Services (AFS) market.** The AFS market is comprised of firms usually offering multiple lines of services and products to meet the needs of low-income and precariously employed households: payday loans, pawnshop services, rent-to-own household products and other forms of consumer leases, in-house used car loans, 'check-cashing' services (especially in the United States) and low-income insurance products (Stoesz 2014). SACC firms in Australia compete within this broader, complex market by offering a product that has four features which, in combination, make them uniquely attractive to low-income consumers:

   - The credit comes in the form of cash, either as physical notes or a deposit in a bank account;
   - There is fast access to this cash;
   - There is a relatively low emotional or psychological cost to the borrower, compared to other forms of credit; and
   - There is a comprehensible and relatively simple repayment cycle that is aligned to a borrower's income flow, minimising their financial exposure to more indeterminate and risky debt repayment options such as credit cards (Banks et al. 2015; Bhutta, Skiba & Tobacman 2015; Carter 2015; Soederberg 2014).

2. **Business models vary.** A common characteristic of all small loan business models is that, because start-up costs are high and margins low, SACC revenue lines only tend to become profitable after the second or third loan. A lender's start-up costs include establishing a clear risk profile for each customer, developing an agreed method for checking a customer's credit history, and meeting the initial administration costs required to comply with regulations. In general, profits appear to be derived from chronic borrowers–and the international industry is built around maximising repeat business. SACC firms in Australia have adopted a range of models that take different approaches to minimising default risk,

encouraging repeat borrowing, sourcing new customer groups, leveraging value from customer interactions, and instituting administrative and compliance efficiencies. This paper focuses on two models: online-only lenders; and firms offering a suite of storefront, online and other financial services. A case example of the variety and complexity of approaches is illustrated by the three ASX-listed companies with a significant presence in the Australian SACC market.

## CONSIDERATIONS

We offer a range of observations for policy consideration by stakeholders and specific recommendations for the current review into the SACC and consumer lease market.

## OBSERVATIONS

a. The high demand for small loans is associated with changes in socio-economic circumstances, especially increases in income inequality and precarious employment.
b. SACC products meet this demand in ways that other current credit alternatives do not.
c. The relatively high cost of small loans is a reflection of the higher risks of default in this segment of the market.
d. The creation of more 'affordable' small loan alternatives that are priced at similar Annual Percentage Rates to secured loans or credit cards would require policy interventions and innovations.
e. Policy makers and advocates need to be realistic about what can be achieved through tighter regulation of this industry. We suggest that tighter regulation is, at best, one part of the policy options. Lowering fee caps, for example, may have the unintended consequence of encouraging illegal lending activity, and so other policy initiatives should be trialled.
f. The particular policy mechanism to fund more affordable small loans needs further investigation and trialling. Proposals raised by stakeholders in this report include a small surcharge on larger loan transactions that would be used to fund community credit providers or banks entering this market.
g. If policy is to be effective, a greater degree of transparency is required. This should include more access to data around credit performance (% of applicants rejected,% of defaults) as well as a greater communication between lenders.
h. A wider review of the Alternative Financial Services market in Australia is required. New sub-markets are constantly emerging that intersect with the small loans sector and can increase the risk of financial hardship, especially among low-income households. For example, the emerging 'credit repair' industry unrealistically promises, for a large upfront fee, to make debts go away and expunge black marks on credit records. Most of these companies are unregulated, and require licencing and other compliance measures to minimise the risks they pose to consumers and other AFS firms.

## RECOMMENDATIONS

We make the following recommendations for the review to consider.

a. That the review of small amount credit contracts and consumer leases considers strengthening reporting obligations either in the form of a national database or a tightening of the comprehensive credit reporting regime (CCR).
b. Strengthening reporting obligations would have two purposes:
    i. A viable policy framework for the small loans (and consumer lease) sector requires an evidence-based understanding of these industries. Currently there is a lack of publicly available market data on customer numbers, loans issued and their amounts, borrowing frequency rates, default rates and levels of compliance with regulations.
    ii. Small loan providers would better meet their responsible lending obligations if the industry had access to a real-time database of current loans being serviced by a customer.
c. Tighten lender compliance to meet the 'presumption of unsuitability' rules. Industry stakeholders interviewed observed that a small proportion of the SACC industry is not complying with its responsible lending obligations, resulting in instances where consumers in receipt of Centrelink payments have multiple SACC loans.
d. A recognition that any call to eliminate this sector does not remove the need for cash to meet the day-to-day living expenses of a significant proportion of the population (Negro, Visentin & Swaminathan 2014: 700). Alternative sources of cheap, readily accessible credit would need to be instituted prior to any regulations that may make the current small loan market unviable. We strongly suggest that the review recognises that regulations that simply address market-based issues in the sector are insufficient. A broader understanding is required that growing income inequality and poverty are the crucial drivers for the growing demand for small loans (Montgomerie & Packman 2014).

# Context

## INTRODUCTION

Consumer demand for unsecured, small-amount and short-term credit has boomed in the last two decades. For a growing number of households with low or precarious incomes, this type of credit is now accessed from firms in the form colloquially called a 'payday loan'. Originating in the United States in the late 1980s, the term 'payday loan' initially referred to the practice of borrowing cash for a fee with full repayment on the borrower's next payday–usually 2 or 4 weeks (Karger 2005).

The industry is now a globally significant player in meeting the demand for consumer credit and has developed unique business models to mitigate lending risk and maximise repeat business. The consumer credit market is dynamic, complex, highly sensitive to regulatory change, and noted for innovative product design that rapidly responds to new market opportunities (Ali, J & Banks 2014). Key trends include the growth of the online market, and firms offering an increasingly integrated range of financial products tailored for consumers with particular needs in their lifecourse. Profits in the sector–like other forms of small-amount consumer credit such as credit cards–are primarily sourced from customers servicing embedded and ongoing levels of debt (Brody 2015; Pew 2012). Since the early 1990s, innovations in product design for 'payday loans', 'cash advances', 'top up loans' and 'fast cash' have resulted in new lead-generator sub-markets that source and on-sell loan applications to lenders, longer repayment periods, loans that may be larger than a typical customer's pay, revolving lines of credit, pathways to secured loans and other products (Ali, J & Banks 2014; Packman 2014; PEW 2013).

The Australian industry has experienced a strong growth trajectory. In the last decade there has been about a twenty-fold increase in demand for small, short-term loans (Packman 2014). While robust industry data of customer profiles, loan volume and value are unavailable, a 2012 academic study of the sector estimated that approximately 1.1 million Australians took out, on average, three to five SACC-type loans per year, generating fee and interest revenues of around $1 billion (Banks et al. 2012: 1). Most significantly, the study found that 40% of respondents (N=112) were likely to be in constant debt to their lenders as they had taken out more than 20 loans in the previous two years.

The domestic industry–like comparable businesses in other developed countries–operates as a component of the broader Alternative Financial Services (AFS) market (Stoesz 2014). The AFS market is comprised of firms usually offering multiple lines of services and products to meet the needs of low-income and precariously employed households: payday loans, pawnshop services, rent-to-own household products and other forms of consumer leases, in-house used car loans, 'check-cashing' services (especially in the United States) and low-income insurance products.

Some analyses consider that the AFS market has a 'countercyclical' relationship to economic conditions, in that higher levels of poverty are the main drivers for demand (IBISWorld 2015).

Poverty factors are important, however the complexities of the market cannot be reduced to this metric. Susan Soederberg (2014) and David Stoesz (2014) highlight that there are more geographically and institutionally specific dynamics at play, such as the prevalence and characteristics of a country's casual labour markets, domestic consumer protection laws, local variations in social welfare provision, the regulatory environment within which financial markets operate, as well as the levels (and changes) of income inequality.

The unsecured, small-loan sector has grown in most countries, including Australia. Analysing the country-specific factors driving this growth and shaping demand in Alternative Financial Services markets (particularly welfare arrangements and financial regulation) are crucial for understanding the scale, scope and trends in the small loans industry. This section situates the **context** of the Australian market within key international trends. The second section of this paper details the Australian payday industry's **complexity**, located within a discussion of the AFS market. The final section briefly raises a number of policy **considerations**.

## INTERNATIONAL SMALL LOAN MARKETS

The short term, small amount loan market in Australia mirrors international developments, though there are there are specific spatial and institutional drivers for growth within each jurisdiction. A snapshot of payday markets in the United States, Canada, the United Kingdom, New Zealand and other countries below is followed by a summary of global regulatory trends.

### USA

The US payday loan industry has become progressively more established as a result of the maturation of the industry, technological innovations and the involvement of mainstream financial institutions (IBISWorld 2015; Stoesz 2014). Buttressing the growth of the sector has been the tripling of average household balances on unsecured loans between 1980 to 2007 from 3% to 10% of household consumption (Bethune, Rocheteau & Rupert 2015: 77).

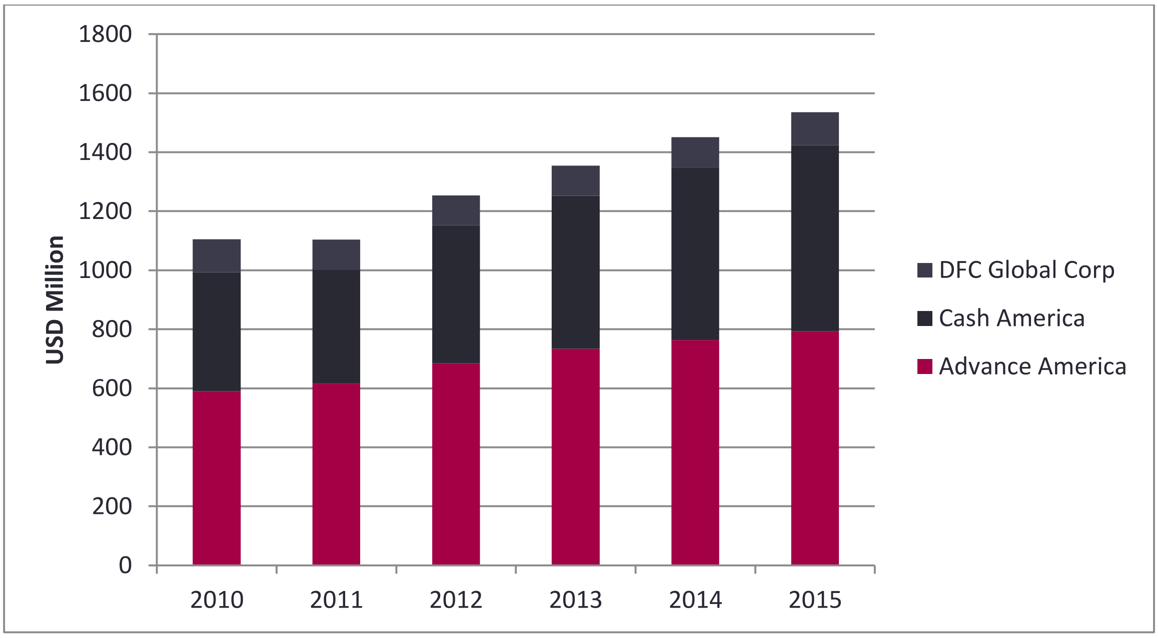
The number of loan stores in the United States increased from 200 in 1990 to about an estimated 20,193 retail outlets in 2015–more than Starbucks and McDonalds combined. This particular sub-prime financial services industry in the United States generates more than USD38 billion in revenue by offering payday loans to an estimated 12-19 million Americans each year (CashAmerica 2015; CFPB 2014; IBISWorld 2015; Zinman 2010).

Cash America–one of the largest payday lenders in the United States–exemplifies the trend towards overlapping product options for consumers. Cash America's 859 stores lend, on average, $123 to a consumer through a mixture of pawn loans and unsecured cash advances (CashAmerica 2015). The level of a customer's interaction between product lines is heavily influenced by their rate of repeat borrowing. Well-accepted research by Susan Carter has found that low-income borrowers who roll over payday loans at least three times are more likely to use pawnshops and payday loans together than other borrowers (Carter 2015: 2).

A vigorous online loan market has grown from USD 5 billion turnover in 2006 to USD 18.6 billion in 2012 (Hecht 2013). This market is quite distinctive from traditional storefront lending. A survey conducted by Enova–a lender with a large storefront and online presence–showed that only 6% of their customer base borrowed from both platforms. 73.0% of consumers still obtain payday loans exclusively at storefronts–a far higher proportion than in Australia where the market is approximately evenly divided between online and store borrowers, according to an industry representative interviewed for this study. However, the trend in the United States is towards online lending, which largely explains an expected 0.8% annualized decline in the number of store-front outlets over the five-year period, to an estimated 20,193 in 2015 (IBISWorld 2015).

There is a low level of market share concentration in the United States, with the top four companies (all listed corporations) accounting for only 16.5% of total industry revenue in 2015 (IBISWorld 2015). The steady growth of the market is shown in the recent revenue figures of three major lenders–DFC Global Corp (operating as Dollar Financial), Cash America and Advance America (Figure 1). Revenue for these corporations has gradually increased from USD 1.1 billion in 2010 to USD 1.5 billion in 2015 (IBISWorld 2015).

**Figure 1 US Payday Loan Market Revenue (USD million)**




*Source: (IBISWorld 2015)*

## CANADA

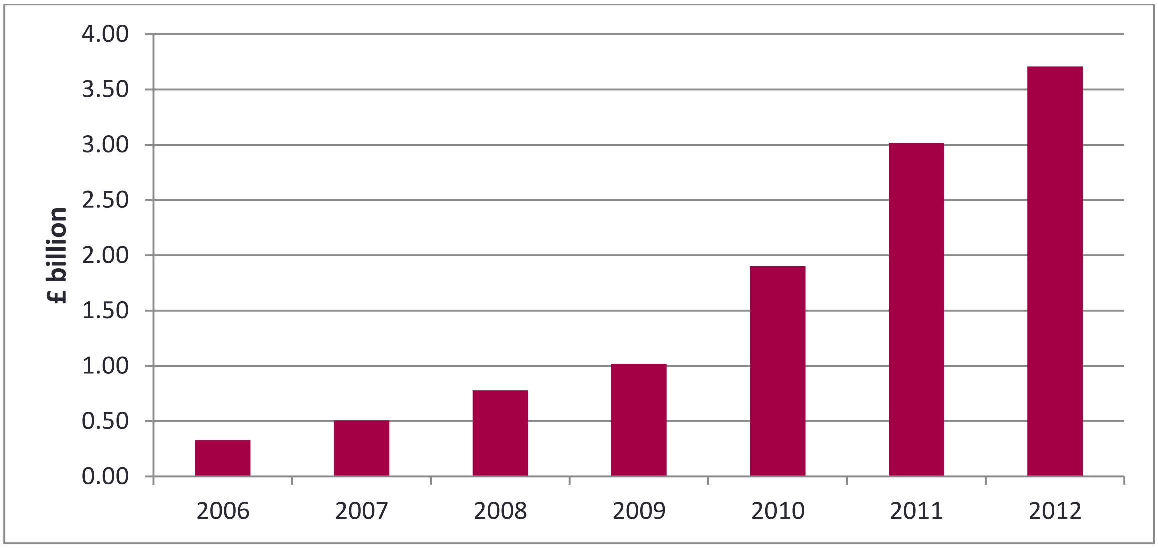
The Canadian AFS market has a similar proportion of consumers to that in the United States. The Canadian Payday Loan Association, which represents most licensed lenders, claims nearly two million customers per year are borrowing from online providers or from one of the 1400 outlets operating in all Provinces (CPLA 2013). Loan volume was valued at CAD 2.5 billion in 2014 (Acharya & Yew 2014). The most rapid growth of the industry occurred between 2000 and 2010. Since then, the general trajectory of the sector has be flat or declining. The CPLA has attributed this stagnation to their members facing greater regulatory risks (Grant & McFarland 2015).

## UK

The UK has had a flourishing payday loan market that grew by 500% between 2007 and 2012 (Marketline 2013: 17). A study by the Association of Chartered Certified Accountants assessed that there were around 1,800 stores in the UK providing payday loans as part of their product offering (Beddows & McAteer 2014). Firms such as Wonga and The Money Shop are now household names. The Financial Conduct Authority, the national regulator, estimated that 1.6 million customers took out 10 million loans in 2013, with the average customer borrowing 6 loans valued at £260 each (FCA 2014: 6). Similar levels of customer demand were found in another study that estimated more than a million UK households take out at least one loan per month (Populus 2013).

Four companies were found to have had yearly turnovers of more than £100 million in 2013– Wonga, CashEuroNet UK (trading as Quick Quids and Pounds to Pockets), Instant Cash Loans (The Money Shop and AdvanceBritain.com) and MEM Consumer Finance (Payday UK and Month End Money) (Warren 2013). Firm market shares in the UK are more concentrated than in the United States. Wonga, for example, has a 40 percent share of the market (Bachelor 2014). The online market has also boomed in recent years (CFA 2013) with estimates that two thirds of loans now originate online rather than through storefronts (Beddows & McAteer 2014). The three largest online lenders (Wonga, Dollar Financial and Cash America) accounted for around 70% of the online lending market in 2010 (Office of Fair Trading 2011). Figure 2 below shows the loan value growth of the UK online market.

**Figure 2 United Kingdom Value of online short-term cash loans issued 2006-2012 (£ billion)**




*Source: (Beddows & McAteer 2014: 7)*

## NEW ZEALAND

Industry data–even estimates–are less available in New Zealand than other countries reviewed here. Two desk surveys conducted by the Ministry of Consumer Affairs in 2006 and 2011 shed some light on market changes. The 2011 survey identified 218 companies offering unsecured, small-loan services–a similar figure to the number of firms operating in 2006. There was, however, a significant turnover, with about half (95) the lenders in 2006 having exited the market and 127 new lenders entering. There was a sharp (60%) growth in outlets from 210 in 2006 to 336 in 2011. The 2011 survey also found that up to 40% of lenders appeared to be operating illegally as unregistered financial service providers, though the report considered that this was 'perhaps due to a lack of awareness among small sole traders rather than any unlawful intent' (Ministry of Consumer Affairs 2011).

## OTHER COUNTRIES

The industry has also been expanding within and across other countries (Settle 2013). Cash Converters, an Australian online and storefront multinational, operates 750 stores across 18 nations and is rapidly entering markets in EU states, South Africa, Mexico, the Middle East, and Malaysia, Singapore and Thailand (Cash Converters 2014). Dollar Financial Global, a U.S. company, has online platforms and 1,507 retail outlets operating in Canada, the United Kingdom, Europe and the United States. Over 89% of the company's revenue comes from its international operations (IBISWorld 2015).

Many African countries have significant small loan markets and are at the leading edge in technological innovation. South Africa and Uganda are the only two nations in the world that have comprehensive databases of consumer borrowing frequencies and amounts. The small loans industry in Uganda, for example, has responded to low literacy levels–and bypassed standard customer identification procedures in developed countries–by introducing retina- and palm-scanning technology that is then aggregated into a national database.

Latin American banks offering ‘payroll loans’ (with an automatic deduction from the customer’s next one or two payslips) account for 60% of all consumer credit in Brazil, and Mexico is experiencing a 32% annual growth rate in payday loans (Guthrie 2013).

More generally among developing countries, microcredit is increasingly being provided by commercial, rather than not-for-profit, Microfinance Institutions (MFIs). These for-profit MFIs have very different social roots to small loan firms operating in developed countries (Banks & Marston 2015). The original social aim of the first MFI—the not-for-profit Grameen Bank established in 1980 by Muhammad Yunus—was to provide financial support to low-income groups wishing to start new businesses (Ek 2011; Janda & Zetek 2014). In the last decade there has been a significant ‘mission drift’ (Mersland & Strøm 2010) away from this social justice goal towards offering what Rick Settle (2013) considers are essentially payday advances. However, since most commercial MFIs have emerged out of not-for-profit MFIs, these for-profit lenders continue to be subsidized by governments.

## INTERNATIONAL ASPECTS OF DEMAND

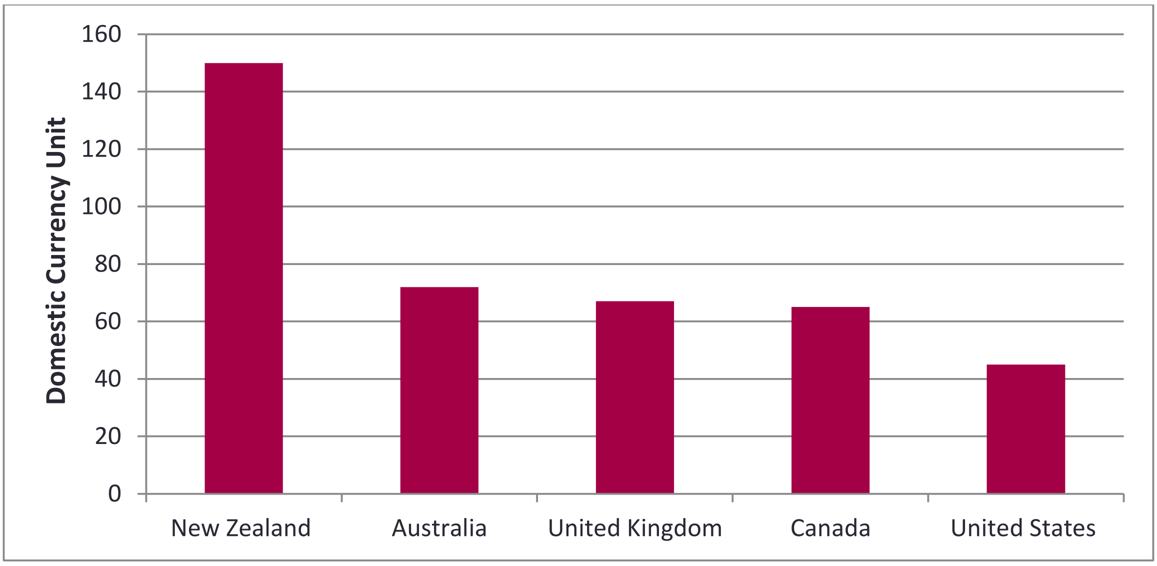
There are some common dynamics in the ways those with modest means or precarious incomes in developed countries access small loans, the amounts they borrow, and the financial circumstances they face. It now typically takes less than 15 minutes for a consumer in North America, Europe or Australasia who has at least some paid work, a bank account and a smart phone to apply and receive a payday loan. Those without paid income, who dislike online borrowing or do not have a bank account, use shopfront lenders.

Store-front borrowers in Australia, the United States, the United Kingdom, Canada and New Zealand are consistently in the bottom or second-to-bottom income quintile. In the US, for example, the median income of borrowers is $22,476. (TNS BRMB & Competition Commission 2014: 12). A 2012 Australian study found that 78% of store-based borrowers were in receipt of a Centrelink income support payment or pension (Banks et al. 2012). Online borrowers are employed and so tend to have higher incomes than store-front borrowers. A major Australian online-only lender estimated that their customers’ average income was $54,500. Most borrowers have restricted access to other forms of credit available to those with more regular or higher incomes (CFPB 2013: 18; Melzer 2011). Unsurprisingly, the street lending side of business tends to cluster in lower-income areas (Ali, P, McRae & Ramsay 2013; Warren 2014). Most consumers (normally over 90 percent in every country) either do not have a credit card or have no credit on their card (Banks et al. 2012; Beddows & McAteer 2014; IBISWorld 2015; Pew 2012).

If we consider both the shopfront and online markets, the typical payday amount borrowed appears fairly similar in these countries[1] —falling in the narrow bandwidth of AUD 413 in Australia, AUD 491 in Canada, AUD 537 in the United States to AUD 580 in the United Kingdom (Beddows & McAteer 2014; Cash Converters 2014; Deloitte 2014; IBISWorld 2015).[2]

The overall cost of taking out and repaying a AUD 300 loan over four weeks is also not dramatically different, except in New Zealand (see Figure 3). Fees and charges range from AUD 45 in the United States to AUD 72 in Australia. New Zealand's much higher fees and charges (AUD 150) are discussed on page 18.

**Figure 3 Typical repayment costs of a loan of 300 (units) repaid over 4 weeks**




*Sources: (Banks et al. 2015; CFPB 2013; FCA 2015; Justcash 2015; myCanada 2015).*
*Note: these are nominal calcultions based on relevant domestic currency units (NZD; AUD; UKP; CAD; USD) . No adjustment has been made, for example, for exchange rates or local cost of living expenses.*

## REGULATIONS DIFFER ACROSS JURISDICTIONS

In the last two years key jurisdictions have imposed significantly tighter regulations on the short-term, small-loan sector. A number of countries have also rolled out new regulatory agencies, such as the Consumer Financial Protection Bureau in the United States and the Financial Conduct Authority in the United Kingdom. An outline of these policy and institutional initiatives is detailed below. A discussion of how recent changes in in the global regulatory environment may influence Australian policymakers occurs in the final section of this paper.

[1] New Zealand average payday loan figures not available
[2] Conversions to AUD on 29/9/15

## USA

In the United States there is very limited federal payday loan regulation (Odinet 2015: 268). The Truth in Lending Act (1968) requires lenders to disclose the cost of credit, including the Annual Percentage Rate (APR). The John Warner National Defense Authorization Act (2006) restricts the ability of payday lenders to make loans to military personnel and their families. States apply different restrictions on the industry: 32 states have little to no effective cap on the interest rate a lender can charge; a small number allow some form of short term storefront lending with restrictions; and 14 forbid the practice (CFPB 2015; Pew 2014).

However, in the wake of the 2007 Global Financial Crisis consumer financial protection has begun to receive enhanced attention from US policymakers. The Federal Deposit Insurance Corporation and the Comptroller of the Currency have issued 'informal guidance' that discourages banks from performing payment-processing services for payday lenders. The agencies warn that the 'reputational risk' of doing so is a threat to the banks' safety and soundness, and many have responded by discontinuing the service (Rubin 2014).

The Justice Department has achieved similar results through its '*Operation Chokepoint'* (Harkness 2015). The initiative's stated objective is stopping fraudulent businesses by cutting off their access to bank payment-processing services. Even the possibility of investigation has led many banks to stop doing business with payday lenders that the Justice Department deems 'risky' (Rubin 2014). Lenders such as Jamie Fulmer, an Advance America executive, have contended that the effects of these interventions 'severely restricts our ability to operate like any other business' (Harkness 2015).

In response to the GFC a national regulatory agency has also been created. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act established the Consumer Financial Protection Bureau (CFPB) in 2011 to improve enforcement of federal consumer financial laws and expand the scope of protective legislation (Bhutta, Skiba & Tobacman 2015: 223). In March 2015 the CFPB announced that it is considering proposing new rules to end small loan 'debt traps' by requiring that lenders take steps to ensure that consumers can repay their loans and not get caught up in a cycle of repeat borrowing (CFPB 2015). The proposals cover short-term credit products that require consumers to pay back a loan in full within 45 days. Typical short-term loans include many payday loans, deposit advance products, certain open-ended lines of credit, and some vehicle title loans. The CFPB will be convening a Small Business Review Panel (at a date yet to be announced) to seek feedback on the proposals before formally proposing new rules (CFPB 2015). Importantly, the key proposals do not include a loan price cap but rather borrowing limits, new assessment requirements and tighter restrictions on various lending and borrowing practices.

Under the CFPB's proposed new rules, lenders would first have to determine that the consumer:

- can repay the loan when due–including interest, principal, and fees for add-on products–without defaulting or re-borrowing, and
- could cover their basic living expenses while repaying loans.

Lenders could skip these 'means testing' requirements if they instead limited each person's total borrowing to $500. The CFPB is also proposing:

- The consumer could not have any other outstanding covered loans with any lender.
- After three loans in a row, all lenders would be prohibited from making a new short-term loan to the borrower for 60 days
- The consumer could not be more than 90 days in debt on covered short-term loans in a 12-month period (CFPB 2015)

For longer term loans of more than 45 days the CFPB is considering using existing lines in federal law for the coverage threshold, such as the Military Lending Act's 36% all-in annual percentage rate, which includes interest, fees, and add-on product charges (CFPB 2015).

Support for this new regulatory regime has come from consumer advocates, welfare support agencies and President Obama:

> *…the CFPB, announced today that it's going to take important steps towards protecting consumers from getting stuck into these cycles of debt. And the idea is pretty common sense: If you lend out money, you have to first make sure that the borrower can afford to pay it back. Don't lend somebody money if you know they can't pay it back. As Americans, we don't mind seeing folks make a profit. And if somebody lends you money, then we expect you to charge interest on that loan. But if you're making that profit by trapping hardworking Americans into a vicious cycle of debt, you got to find a new business model. You got to find a new way of doing business (President Obama 2015).*

## CANADA

To date, there is no national regulation of the industry nor is any pending. In 2006, the Criminal Code of Canada was amended to allow for Provinces to regulate the payday loan sector. The cumulative impact of provincial regulation has dampened industry growth rates since 2011 (Grant & McFarland 2015). While regulations vary across jurisdictions, typical rules include:

- A ban concurrent loans from a single lender
- A ban on rollovers
- An interest rate cap of between 17-23% of the principal;
- A cap of 30% on charges arising from a defaulted loan, and
- A borrowing limit of 50% of the net amount of the individual's next pay (Ali, P, McRae & Ramsay 2013: 415; Deloitte 2014: 17)

## UK

The British regulatory environment has experienced more critical and rapid change than the other jurisdictions discussed so far. Some of the key changes were adopted from Australian policy responses to the sector brought in during the last few years (see next page) while other restrictions go further.

A new regulator, the Financial Conduct Authority (FCA) came into existence in April 2013 as a successor to the Financial Services Authority. On April 1st 2014, regulation of consumer credit transferred from the Office of Fair Trading to the FCA (Rowe et al. 2014: 9).

On January 2nd 2015 the FCA introduced new rules–most drawn from the Australian regulatory model–that extend consumer protection and compliance in the unsecured small-amount loan market, including:

- An initial cost cap of 0.8% per day - interest and fees charged must not exceed 0.8% per day of the amount borrowed. For example, someone taking out a loan for 30 days and repaying on time will not pay more than £24 in fees and charges per £100 borrowed.
- A £15 cap on default fees - if borrowers default, fees must not exceed £15 but firms can continue to charge interest after default but not above the initial rate;
- A total cost cap of 100% - borrowers must never pay more in fees and interest than 100% of what they borrowed (FCA 2015).
- Individuals will only be able to roll over a loan twice before their balance becomes due
- Lenders limited to two failed continuous payment authority attempts, meaning they cannot keep trying to withdraw payment from consumers when the funds are not available. Instead, they must contact customers to find out about their situation and try to collect payment.
- Implementing a New Risk Warning and Debt Help Information link on all advertising and products (Consumer Affairs 2014)

## NEW ZEALAND

The New Zealand small loan market continues to have no interest rate cap or specified restrictions on fees charged to consumers. However, legislation has recently come into force that imposes new 'principles' lenders are expected to follow.

The main law to protect consumers in credit contracts is the Credit Contracts and Consumer Finance Act 2003. It covers all loan deals that are primarily for personal, domestic or household purposes. An amendment to the Act–The Credit Contracts and Consumer Finance Amendment Regulations 2015–came into force on 6th June 2015. The Responsible Lending Code set within these Regulations is a voluntary, principles-based list of expectations that firms offering short-term (up to one year), small amount loans:

- exercise the care, diligence and skill of a responsible lender when advertising, before agreeing to provide credit or finance or taking guarantees, and in all subsequent dealings with borrowers and guarantors
- ensure clients understand their loans and that they will be able to repay them without significant hardship.
- specify the information on fees and interest rates which lenders must make publicly available
- update model disclosure forms (to reflect the additional key information which lenders must disclose to borrowers prior to entering a credit agreement).(Consumer Affairs 2015)

## AUSTRALIA

Key Australian regulatory interventions into the short-term small-amount loan market occurred somewhat earlier than these other countries. There have been two phases of legislative reform of the industry: the *National Consumer Credit Protection Act 2009 (*the 'Credit Act'*)* and, more recently, the *Consumer Credit Legislation Amendment (Enhancements) Act 2012*. The Credit Act, seen as a watershed by industry, instigated a shift from state-based to Commonwealth law, and a national credit licensing regime overseen by a sole regulator – the Australian Securities and Investments Commission (ASIC) (Ali & Banks 2014). Short-term loans were divided into three categories:

- SACC loans–Small Amount Credit Contracts (up to $2000 for periods of between 16 days and 12 months),
- MACC loans–Medium Amount Credit Contracts ($2000 to $5000 up to 2 years), and
- Other loans–which have an all-inclusive cap of 48% Annual Percentage Rate.

The legislation requires licensees to comply with certain obligations, such as ensuring staff are adequately trained, have adequate internal dispute resolution procedures and have adequate arrangements for compensating people for loss or damage suffered due to a contravention of the Act. In 2013 interest rates on SACC loans were capped at 4% per month and establishment fees restricted to 20% of the principal. Credit licensees entering into a small amount credit contract with a consumer receiving at least 50% of their income as a Centrelink payment must also restrict the customer's repayment schedule to less than 20% of their fortnightly income (referred to as the 'protected income amount' in the legislation). MACC loan provisions allow a one-off establishment fee of up to $400, allowed, but all fees and charges must be included in a maximum annual interest rate of 48%.

The responsible lending provisions also introduced a 'presumption of unsuitability' that a small amount loan would be unsuitable if:

- the consumer is in default under another small amount loan, or
- the consumer has had two or more other small amount loans in the last 90 days (ASIC 2015).

However, while the regulations require the lender to make ‘reasonable enquiries’ to test whether a new loan would trigger the ‘presumption of unsuitability’ provisions, lender compliance to meet their responsible lending obligations is patchy. As an industry stakeholder observed, there are ‘a small but significant group of lenders’ issuing loans to applicants who have ‘three to six’ concurrent loans–placing these borrowers in severe financial hardship.

## WILL THE INDUSTRY BE CURTAILED BY THE NEW REGULATORY INTERVENTIONS?

It is still unclear how recent policy and institutional initiatives, especially in the United States and the United Kingdom, will impact small loan markets or firm revenues. There are early indications that these new or proposed credit regulatory regimes may have a significant dampening effect on growth.

### USA

Industry-aligned companies have come out strongly against the CFPB’s proposals. Credit reporting agency Clarity Services released a report in 2015 that found that the suggested rules would reduce the number of regulated loans by more than 70% and that monoline payday storefront businesses would cease to exist. Similarly, a report from global consulting firm Charles River Associates found that a full implementation of the new rules would have reduced the 2013 payday loan revenues of small lenders by 82% (Wheeler 2015).

The Community Financial Services Association of America (CFSA), the small loan industry’s peak body, is responding energetically to the CFPB’s proposals. A campaign entitled ‘Tell your Payday Advance Story’ has been initiated whereby payday loan consumers and employees of CFSA member organisations are being encouraged to ‘tell the CFPB why a payday advance is an important financial option for you. Tell the government what you think and stay in touch with us as we fight to keep access to credit alive’ (CFSA 2015). The ‘Tell your Payday Advance Story’ has strong similarities with the ‘No Cap’ campaign led by Cash Converters in an attempt to stop proposed Australian regulation in 2012.[3] Advance America executive Jamie Fulmer considered the proposed new rules ‘appear to be a validation of that concern that we’ve had all along’ that the CFPB is being ‘largely motivated and pressured by activist groups that seek to end this credit option’ (Harkness 2015).

### CANADA

Consumer advocates and sections of the media are increasing calls to have national regulations similar to the USA (Lang 2015). The danger, the industry argues, is that if regulations become too restrictive companies will go out of business. Canada’s largest player, Edmonton-based Cash Store Financial Services, declared bankruptcy in 2014, which it blamed in part on Ontario regulatory issues (Grant & McFarland 2015). Another possible contributing factor for the

[3] See http://www.nocap.com.au

company's exit from the industry was a court case against its Australian outlets instigated by the Australian Securities and Investment Commission (ASIC).

## UK

The regulatory changes introduced in 2015 have resulted in more than a third of payday lenders not applying for a new licence. Of 400 companies that had a payday licence only 247 have applied to the Financial Conduct Authority to continue offering small loans. The number of approved payday loans is down 70% from its peak in 2013, according to the Consumer Finance Association. Wonga, the largest lender, has posted its first losses last financial year (Dunkley 2015).

Prior to introducing the new regulations the Financial Conduct Authority estimated a number of impacts, including that:

- 11% of individuals (about 160,000 people a year) would no longer get loans
- Payday lenders will lose £420m a year or 42% of their revenue (BBC News 2014)
- A consumer's median saving per loan would be £14
- The market would likely be reduced to the three largest online firms and that 'it is possible that one high-street firm may be able to operate' (FCA 2014)

## NEW ZEALAND

Whilst the Responsible Lending Code introduced in June 2015 is voluntary, legal commentary considers that the regulations create a new 'negligence standard duty of care onto lenders in the way that they deal with their customers' as a 'mandatory obligation' (Vaughan 2014). Furthermore, aggrieved borrowers are now able to complain to the Commerce Commission, which will rule if there were any breaches of the Credit Contracts and Consumer Finance Amendment Act.(Edmunds 2015). Welfare agencies anticipate that they would have would have greater power to successfully argue their clients' cases at the Commerce Commission (Sunday Star Times 2014). Criticism of the new regulations has come from opposition parties, including the Greens and Labour Party, who have argued that the government's key failure was not to include interest rate caps for third-tier lenders (Vaughan 2014).

## Table 1 Key international legislative and market indicators

| | Australia | USA | UK | New Zealand | Canada |
|---|---|---|---|---|---|
| **Regulation** | National | State-based | National | National | Province-based |
| **Recent National regulatory responses** | Ministerial Review of the industry (August 2015) | 2015: New 'debt trap' rules proposed by CFPB for small loans less than 45 days(CFPB 2015). | 2015: FCA introduces price cap and other lender obligations (FCA 2015) | 2015: Responsible Lending Code introduced .No cap on loan amount, fees or interest (Consumer Affairs 2015) | None. Calls to have national regulation similar to the USA (Lang 2015) |
| **Regulatory impact on market** | Medium-High | Unclear | High (BBC News 2014; Dunkley 2015) | Low- Medium (Edmunds 2015; Vaughan 2014) | High |
| **Loan costs** | 20% of principal plus 4% per month. Maximum default charges 100% of principal (ASIC 2015b) | Costs vary by state. Average of \$45 for \$300 loan repaid within 28 days (Pew 2014) | 0.8% per day, £15 cap on default fees and total cost cap of 100% of principal (FCA 2015) | Uncapped. Approximately \$150-\$180 fees charged for \$300 loan repaid within 4 weeks (Justcash 2015; Payday Advance NZ 2015) | Costs vary by Province. Average of 17-25% of principal, repayable on next payday (myCanada 2015) |
| **Customers as a percentage of population aged 15-64 years old** | 6.5% (Banks et al. 2015) | 5.7-11.9% (CashAmerica 2015; CFPB 2014; Odinet 2015) | 3.6% (FCA 2014) | N/A | 8.3% (Acharya & Yew 2014) |
| **Loan volume estimates** | AUD 1.1 billion (Banks et al. 2012) | USD 38.5 billion (Odinet 2015) | £3.7 billion (Beddows & McAteer 2014) | N/A | CAD 2.5 billion (Acharya & Yew 2014) |
| **Cost of AUD 300 loan repaid over 4 weeks** | \$72 | \$45 | \$67 | \$150 | \$65 |

# Complexity

## THE AUSTRALIAN MARKET

In Australia there has been a twenty-fold increase in demand for short term, small amount loans in the last decade (Packman 2014). In 2012 approximately 1.1 million Australians were, on average, taking out three to five loans per year, generating SACC contracts estimated to be valued between $800 million and $1 billion. An estimated 40% of payday loan customers had far heavier borrowing practices–taking out more than 10 loans per year (Banks et al. 2012). Many SACC customers experience financial hardship, especially those who repeatedly borrow (Banks et al. 2015).

In meeting this demand, SACC providers operate in a highly complex market that both interacts and competes with other markets. This complexity is in part driven by consumer demand and in part by value-maximisation strategies deployed by lenders that have created new markets and found innovative strategies to operate in the current regulatory environment.

As a key player in the thriving Alternative Financial Services market, the small loan sector is responding to the demand for credit by large numbers of Australians working in secondary labour markets or reliant on Centrelink payments. This demand is largely unmet by traditional financial institutions and is unlikely to be met given the pressures of the Basel Accords towards raising capital requirements. The industry has consolidated from about 280 small independent operators in the mid-2000s to 30 in 2015 (Bryant 2015).

Over the last five years, the small loan sector's 7.73% annual growth rate in revenue (albeit from a smaller base) has far outpaced the 1.1% revenue growth rate of banking finance (IBISWorld 2014). The SACC market is also consolidating and internationalizing. In Australia, 13 companies have a 75% share of the market (ASIC 2015b), dominated by Cash Converters which is estimated to have a market share between 'the high 30s to 50%', according to an industry representative interviewed for this study.

Since government regulation in 2013, the sector has responded through innovation in product design, new risk assessment techniques and technologies, marketing and delivery and shows continued signs of growth. These trends include: the decline of some small independent providers; the consolidation of major payday providers; the emergence of split markets between low-income high street borrowers and a thriving online sector which caters for somewhat higher income earners; internationalisation; and moves that integrate the payday sector with other segments of banking capital and retail finance.

The following sections firstly situate the Australian SACC sector within the Alternative Financial Services market before drilling down to the firm level to investigate how different approaches to consumer demand have resulted in a significant variation in SACC business models.

## THE ALTERNATIVE FINANCIAL SERVICES MARKET IN AUSTRALIA

Companies offering a variety of financial products tailored to meet low-income consumer demand face competitive pressures from other providers in what has been termed the Alternative Financial Services (AFS) market (Stoesz 2014). Industries within this overall market are highly responsive to anticipating shifts in a jurisdiction's financial regulatory environment and have embraced innovative business models to maximise value capture. For example, in the wake of the 2007 financial crisis, small loan firms have seized the opportunities opened by the increased capital requirements imposed on banks by the Basel Accords. The near-complete withdrawal by Australian banks and credit unions offering higher-risk, sub-$1000 loans has strengthened the AFS market (Ali, J & Banks 2014).

AFS markets have geographically distinctive characteristics (Coe et al. 2007: 315) due to differences in state welfare arrangements and the locally specific ways low-income households engage in the 'mixed economy of credit'–a phrase used by Marston and Shevellar (2014) to describe how members of these households are engaged in the weekly process of wrangling various financial resources to make ends meet.

In Australia, for example, most individuals and families eligible for welfare assistance receive payments. In the United States, however, welfare reform initiatives from the 1990s contributed to reducing the take-up rate of low-income families eligible to receive the cash-assistance program Temporary Assistance for Needy Families from 84% in 1994 to 27% in 2010 (Stoesz 2014). This is one of the key drivers for the proportionally higher demand for payday loans in the USA compared to other countries.

There are also local variations in how low income households access credit which contribute to the demand for small loans. In the United States, a survey by the Federal Deposit and Insurance Commission found that 1 in 13 households (9.6 million) had no bank account in 2013 and that 20% of households (24.8 million) were underbanked, meaning that they had a bank account but also used alternative financial services (AFS) outside of the banking system (FDIC 2014). The United States has a thriving 'check cashing' services sector to meet the demand of low-income households who do not have a bank account, or cannot wait three days for the cheque to clear. These outlets are commonly co-located with payday stores, however retailers such as Wal-Mart are also entering this market (IBISWorld 2015). In the United Kingdom there is also a large proportion of low-income people (12%) that are unbanked or underbanked (Packman 2013). In contrast, a far higher proportion of Australians have a bank account (98%) mainly due to low-income households requiring one to receive direct payments from Centrelink (Connolly 2014).

In engaging with Australian AFS markets many low-income citizens are exercising constrained choices within the mixed economy of credit based on the location of different credit providers, cost, eligibility, speed and knowledge of available options. Research has also shown that many low-income consumers prefer the anonymity of payday loans to borrowing from family, friends or welfare agencies (Banks et al. 2015; Rowe et al. 2014).

It is no coincidence that nations which have instigated the most rapid changes in welfare arrangements, the fastest relaxation of financial rules and experienced some of sharpest increases in casualisation rates—mainly the developed Anglophone countries—have tended to generate some of the most fertile grounds for the growth of AFS markets (Soederberg 2014). In response to these complex risk factors, different, and overlapping, sub-markets have emerged. In most developed countries, for example, the thriving online loans market restricts its products to consumers who have at least some paid employment, whereas the storefront market is more tailored to issuing loans to lower-income and unemployed customers. Most payday firms have specialised, multiline business models designed to offer particular products, such as pawnbroking and payday services, brokering services, or a suite of vertically integrated loan options that extend from low-margin, high volume and higher-risk small loans to higher-margin, lower-risk unsecured and secured credit valued in the thousands of dollars.

## SOCIAL IMPACT

Socio-economic changes in the last two decades have strengthened particular financial 'drivers of vulnerability' which add to the complexity of how lower-income households manage risks and mitigate the hazards of poverty (Dayson, Vik & Aiden 2009: 4; Saunders & Wong 2012: 487). Median family incomes in the United States, for example, decreased by $5700 between 2007 and 2012 on an inflation-adjusted basis (Jacobson 2014). In Australia, a recent Reserve Bank analysis of disposable incomes found that income inequality has been gradually rising since the early 1990s (Beech et al. 2014: 18). In the last decade, more Australians who live alone, are elderly couples or single parents are needing to prepare and cope with intensified financial risks as poverty rates in these households rise (Melbourne Institute 2013: 26, Table 5.3; National Welfare Rights Network 2014).

The Australian Bureau of Statistics Indicators of Financial stress has found that 13.1% of Australians in 2015 were unable to raise $2000 in a week 'for something important' (ABS 2015). This percentage was similar in 2006 but inflation has reduced the value of $2000 to less than $1600 by 2015.[4] Inflation during this period has also more generally increased cost of living pressures on basic expenses (Muir, Marjolin & Adams 2015). The prices for food, housing, transport, health, utilities and education–which account for approximately 60% of weekly household expenditures–have risen relative to CPI over the last ten years (with the exception of transport) (NCOSS 2014: 7). The ratio of average debt to disposable income for low economic resource households has also risen over the last decade. In 2005 average household debt represented 0.6 years of income. In 2015 it represents 1.1 years of disposable income (Bankwest Curtin Economics Centre 2015: 43).

The demand for small, short-term loans is therefore driven by cash-poor and / or low-income consumers who have immediate financial needs. The promise of 'fast cash' is the small loan industry's key point of difference in the AFS market. These loans are mostly used by customers to pay for recurring expenses (Schmitz 2014: 71). Australian and international studies of the

[4] See http://www.rba.gov.au/calculator/annualDecimal.html

small loan market consistently show that the most common reason for taking out a small loan is not pay for a 'one-off' expense but rather to cover some of the unmet costs of bills, food or other regular outlays (Banks et al. 2012; Beddows & McAteer 2014; Burtzlaff & Groce 2011). Research by Pew in the United States shows that 69% of store-front borrowers and 73% of online consumers used their loan to cover a recurring expense, such as utilities, credit card bills, rent or mortgage payments, or food (Pew 2012).

A 2012 report from an Australian Research Council funded project into the sector found a very similar proportion of shop-front consumers (68%) took out a loan for day-to-day living, rather than one-off expenses (Table 2).

**Table 2 Aggregated reasons for taking out a loan (N=112)**
**(Regular expenses in tan)**

| | |
|---|---|
| To pay a bill | 44 |
| Had no money/not enough money | 32 |
| To buy food | 29 |
| To pay back another loan | 21 |
| To buy things for the kids, childcare or schooling costs | 21 |
| Medical (pharmaceuticals or regular hospital expenses) | 18 |
| Car repairs, maintenance, registration, repayments or fines | 18 |
| Housing (rent) | 14 |
| Household appliances and furniture | 13 |
| For gambling or due to gambling | 12 |
| Travel expenses | 10 |
| To lend money to another person | 9 |
| To buy birthday or Christmas presents | 9 |
| Housing (bond or relocation expenses) | 8 |
| Clothing or shoes | 6 |
| Car purchase | 5 |
| Entertainment (eg holiday or night out or books or CDs) | 4 |
| | |
| Other irregular expenses | 22 |
| Other regular expenses | 26 |
| | |
| **Total regular expenses** | **217** |
| **Total irregular expenses** | **104** |

*Source (Banks et al. 2012)*

Given the consumers' repeated need for credit to cover ongoing expenses, the small loan market is structured to meet this continuing reliance on their products. The average payday customer in the United States takes out eight loans a year, each valued at USD 375 (PEW 2013). In the United Kingdom it is an average of six £260 loans a year (FCA 2014). Australian estimates are very similar–with a median of $300 being taken out on average 4-5 times a year (Banks et al. 2015).

## ALTERNATIVE FINANCIAL MARKET PRODUCTS

The Australian and international literature convincingly show that the small-loan market has a number of features that, when considered together, make them uniquely attractive to low-income consumers compared to other Alternative Financial Services products:

1. The credit comes in the form of cash (either physical notes or a deposit in a bank account;
2. There is fast access to this cash either through 'old school' storefront lenders or the 'instantaneousness' offered by online providers;
3. There is a relatively low emotional or psychological cost to the borrower of a commercial small loan, compared to other forms of credit; and
4. There is a comprehensible and relatively simple repayment cycle that is aligned to a borrower's income flow, minimising financial exposure to more indeterminate and risky debt repayment options such as credit cards (Banks et al. 2015; Bhutta, Skiba & Tobacman 2015; Carter 2015; Soederberg 2014).

The fourth point–an understandable fortnightly cost that has a clear end point–is especially important to highlight. How consumers of small loans (and other AFS products) assess financial suitability has a critical bearing on their engagement with the Alternative Financial Services market. Total cost is obviously one key determinant of whether a particular form of credit is suitable compared to lower-cost alternatives. However, *time* is an equally important dimension. This aspect of consumer behaviour–especially for low-income households–strongly aligns with the sociology of money literature that finds poorer households have very distinctive money management practices.

For example, in her study of Swedish and Danish households, Pernille Hohnen (2007: 758) argues that financial timescales in low income households are not only far shorter than those in middle class families but are of a 'different kind'. Higher levels of income tend to structure 'financial time' as more distant and abstract in average-income families, who experience little of the cyclic spending patterns in lower-income households whose receipt of small monthly payments concretely alter the value of money in the latter weeks of the month as their finances tighten (pp. 758-760).

Hohnen's (2007: 758) pertinent observation that income levels influence scale and quality of the 'time of money' supports research conducted by the present authors Professor Russell and Dr Banks[5] that found lower-income participants tended to talk about money in more immediate and fortnightly terms than average-income participants. This factor is highly relevant as low-income consumers tend to assess affordability of credit by periods that conform to their fortnightly receipt of Centrelink payments.

[5] ARC Discovery Project 110103808 'What women need: unravelling the factors underlying women's financial decision-making behaviour'.

A lender interviewed for this paper stressed that higher income individuals eligible for online loans are also strongly attracted to the defined repayment periods and end-dates of small loans– especially if they have no further credit available on their credit card.

The range of credit and financing arrangements that are commonly presented as offering alternatives to unsecured small loans are detailed below. These alternatives are assessed against the four dimensions that make unsecured small loans attractive to low-income or casually employed households–access to cash, speed of transaction, relatively low emotional interactional costs and clear-cut repayment rhythm and period. They can be divided into two categories:

- Cash-type finance (credit cards, personal loans offered by credit unions and banks, and Centrelink advance payments); and
- Product- or service-specific type finance (consumer leases, the No Interest Loans Scheme, and interest-free repayment options offered by large retailers).

## CASH-TYPE FINANCE

### CREDIT CARDS

For most households without easily available savings, a personal credit card is commonly used to access credit. At a current average interest rate of 18% per annum,[6] purchasing an essential product through a credit card can be quite expensive, especially if the balance owing is not paid off within a short period of time.

Most low-income consumers of store-front small loans do not have this option. The Harmer Pension Review found that 53% of Australians reliant on Centrelink payments do not have a credit card. (Harmer 2008: 26). In 2011, less than 40% of Australian households with an income below $40,000 (typical of Centrelink customers) have a credit card (Connolly, C, Hems & Wolfson 2011: 18). Research of store-front borrowers conducted in 2012 found that only 7% possessed a credit card (Banks et al. 2012).

Higher-income consumers of online small loans may have a credit card, but they tend to be ‘maxed out’, as one lender working in sector commented. While data is not available of the proportion of Australian online borrowers who have available credit on their card, international research suggests that very few do. A study In the United States, for example, found that while 59% of payday loan applicants have a general-purpose credit card, nearly 80% of all applicants (including those without a card) have zero credit available on credit cards and 90% have no more than $300–the typical size of a payday loan (Bhutta, Skiba & Tobacman 2015: 233). Analysis by Veda–a leading credit reporting agency–suggests that a significant proportion of Australian households are likely to experience similar credit card pressures as 15% (or 2.3 million Australians) in July 2013 were at risk of credit default or other adverse credit event in the next 12 months (Veda 2013).

### PERSONAL LOANS

For a person looking to borrow an average size small loan of between $300 and $500 there are very few options apart from payday lenders. From research conducted for this paper we found no Australian financial institution regulated by the Australian Prudential Regulation Authority (APRA) that offers sub-$1000 personal loans. None of the major Australian banks offers a sub-$2000 personal loan, though certain customers may be approved for personal overdrafts of $100 or more. A small number of credit unions and building societies offer loans starting from $1000 but all require an applicant to join their organisation by taking out a savings account. For example CUA, the Victorian Teachers Mutual Bank and Newcastle Permanent Building Society

[6] The Australian Government’s MoneySmart website notes that the average interest rate of Australian credit cards is between 15 and 20 per cent. We take the median of this range https://www.moneysmart.gov.au/borrowing-and-credit/credit-cards/credit-card-debt-clock.

offer member-only loans of $1000 or more to an applicant if they can show they are currently employed, have a regular income and have a 'worthwhile' purpose for the loan.[7]

## CENTRELINK ADVANCE PAYMENTS

Most Centrelink customers can elect to receive a proportion of their future payments in advance[8]. Two income sources are available to customers seeking an advance: their Income Support Payment, and those with dependent children may access an advance on their Family Tax Benefit Part A. Eligible customers can access advances on both their Income Support Payment and Family Tax Benefit Part A. A customer receiving an allowance (such as NewStart) is eligible for one advance payment every 12 months. The maximum amount is $500 and the minimum is $250. A customer receiving a pension can take a larger advance payment at the maximum rate once every six months (or up to three advance payments at the minimum rate). The amounts available are detailed in Table 3.

**Table 3 Advance payment amounts for Centrelink Income Support recipients**

| Advance amount | Pension | | Allowance |
|---|---|---|---|
| | Single | Partnered | Single or Partnered |
| Minimum | $405.85 | $305.95 | $250 |
| Maximum | $1,217.55 | $917.85 | $500 |

A Centrelink payment recipient with dependent children can also elect to take a Family Tax Benefit Part A (FTBA) advance as a one off payment or as a regular advance. The maximum amount available for a one off advance is detailed below (Table 4).

**Table 4 Family Tax Benefit Part A. Maximum one-off advance payment available**

| Child | Advance Payment (per child) |
|---|---|
| Aged under 13 years | 400.22 |
| Aged 13–15 years (16-19 years for a secondary student) | 504.22 |

In summary, Centrelink Advances have a number of features that make them highly substitutable to commercial small loans: they come in the form of cash; they are readily and speedily accessed; repayment amounts and periods are fairly clearly defined; and there is rarely a need to explain to Centrelink staff why the advance is required. One limit is the low amount available for a person receiving an allowance or with no dependent children. Another limit for higher advance amounts is that the standard Centrelink Advance recovery period of six months

[7] http://www.cua.com.au/personal-banking/personal-loans/fixed-personal-loan , http://www.victeach.com.au/borrow/personal-loans/personal-loan and http://www.newcastlepermanent.com.au/Personal/PersonalLoans/tabid/101/Default.aspx

[8] *A Guide to Australian Government payments 20 March - 30 June 2015*. Department of Human Services. Australian Government. Accessed 15/4/2015 at: http://www.humanservices.gov.au/corporate/publications-and-resources/a-guide-to-australian-government-payments
*Advance Payment Options.* Department of Human Services. Australian Government. Accessed 15/4/2015 at: http://www.humanservices.gov.au/customer/enablers/advance-payment

may make the fortnightly reduction of Centrelink payments quite large–especially in comparison to the longer repayment options of NILS loans and some other credit alternatives.

## PRODUCT- OR SERVICE-SPECIFIC TYPE FINANCE

### COMMUNITY DEVELOPMENT FINANCIAL INSTITUTION (CDFI) SMALL LOANS

There are three Australian social microfinance organisations or CDFIs that offer sub-$1000 loans for specified purposes that cost less than commercial small loans. Two of the organisations are very small. Brisbane-based Foresters Community Finance (2014) has issued 328 microcredit loans since 2010. The organisation does not advertise how much fees and charges will be for these loans but a stakeholder interviewed for this paper commented that the rates were 'somewhat below' those offered by commercial lenders. Fair Loans Finance charges a set establishment fee of $200 for each $1000 borrowed but no monthly fees for a 12 month loan. However the lowest amount that can be borrowed is $1000 (far higher than the average payday loan of about $400), the time required to have the money deposited into an applicant's account is likely to be at least three days, and the loan must be for a 'worthwhile purpose', rather than for day-to-day living expenses.[9]

The most significant social microcredit product is the No Interest Loans Scheme (NILS), a community finance initiative run by 260 local not-for-profit organisations across approximately 650 localities in Australia. Approximately 23,000 NILS loans were issued in the 2012-13 financial year. NILS are small loans, typically worth up to $1,200 and repayable over 12-18 months. The loan carries no interest or fees. NILS has a number of features that tend to limit treating these loans as a straightforward credit substitute for consumer leases: loans are approved only to purchase specific products or services such as whitegoods and some medical and dental services. To obtain a NILS loan, applicants must hold a concession card (Health Care Card or Pension Card) or live on a low income, and must have lived in the same residence for at least 3-6 months. There is a five-step application process that typically takes at least three days to a number of weeks.

In summary, NILS products are a cheaper alternative than a commercial small loan, but do not meet three of the four dimensions that attract consumers to commercial small loans: cash is not provided as the loan is tied to a product or service; the loan process is complicated and slow; and applicants often perceive that the welfare aspects of the application process may expose them to a higher emotional cost than commercial loan procedures.

### CONSUMER LEASES

A consumer lease of a household appliance or furniture for a specified period of time (usually 6 months to 4 years) provides a way to access particular products for households unable (or unwilling) to purchase a product with savings. In this sense they have some analogy to a form of

[9] http://www.fairloans.org.au/

credit but have limited substitutability to SACC loans in a number of dimensions: consumer leases are not cash; access to a product, however, is fast and exposes the consumer to low emotional costs; the repayment periods are fairly clearly defined, however the end date is less clear - especially the complicated options offered by many consumer lessors to retain customer obligations. The total costs of renting a product through a consumer lease can be four or more times its retail value. However, on a fortnightly basis, rental costs are often more affordable than repayments of a six-month Centrelink advance or short-term small loan to purchase the same item.

## INTEREST FREE PERIODS

Some large retailers offer 'buy now, pay later' options for customers seeking to purchase a household product. Harvey Norman, for example, offers three interest free options that are attached to a variety of credit cards that are issued with these options.[10] Most attract a one-off $25 establishment fee and a monthly $4.95 account-keeping fee if the outstanding balance is greater than $10. Any outstanding balance remaining after the 6 month, 12 month, 24 month, 48 month or 50 month options for specified products that are on offer usually attract interest that is charged at 29.49%.

The requirement for a consumer to have and use a credit card to make these purchases runs up against the more general issues of low-income and cash-poor households relationships with credit cards. Against the four dimensions that make commercial small loans attractive, interest-free period products do not offer cash; are relatively fast to access; but most significantly expose the consumer to a high emotional risk of being rejected by the retailer due to their credit history or–even if accepted–becoming re-embroiled in a credit card system that is highly problematic for many of these consumers.

## PAWNBROKING

Unlike the short-term, small loan market, pawnbroking services mainly come under state regulation in Australia. Brokers are able to determine their fees and charges, though the unjust provisions in the Australian Credit Code provides consumers a legal right to request a Court to consider whether a pawnbroker is charging unconscionable interest and other fees. Cash loans in exchange for a pawned item at Cash Converters, for example, attract a 35% interest rate per month (Rawlinson 2015). There is often a high emotional cost associated with pawning jewellery and other items, the repayment periods appear simple but can be severely disrupted by a missed payment, the end date is also unclear–especially when or whether the pawned item will be returned.

[10] Harvey Norman Interest free options available on 20/5/15 http://www.harveynorman.com.au/customer-service/finance-options/interest-free

## SUMMARISING AFS PRODUCT ALTERNATIVES

Using a ‘traffic light’ method, Table 5 below compares the four key characteristics that make small loans attractive to low-income consumers–access to cash; fast transactions; relatively low emotional cost; and a simple, clear-cut repayment period–with other credit alternatives. Green denotes that the credit alternative is **likely** to accommodate a key characteristic sought by a low-income consumer. Red flags that this credit alternative is **unlikely** to meet the consumer’s requirement or is **unavailable**, and amber indicates that the credit alternative is **somewhat unlikely** to fit in with a low-income consumer’s expectations.

Only storefront SACCs is consistently green-lighted, with consumer leases (three green ‘lights’) its nearest equivalent. Interest free retail schemes, MACC loans, credit cards and secured credit are coded red as they are typically not available or viable for these consumers.

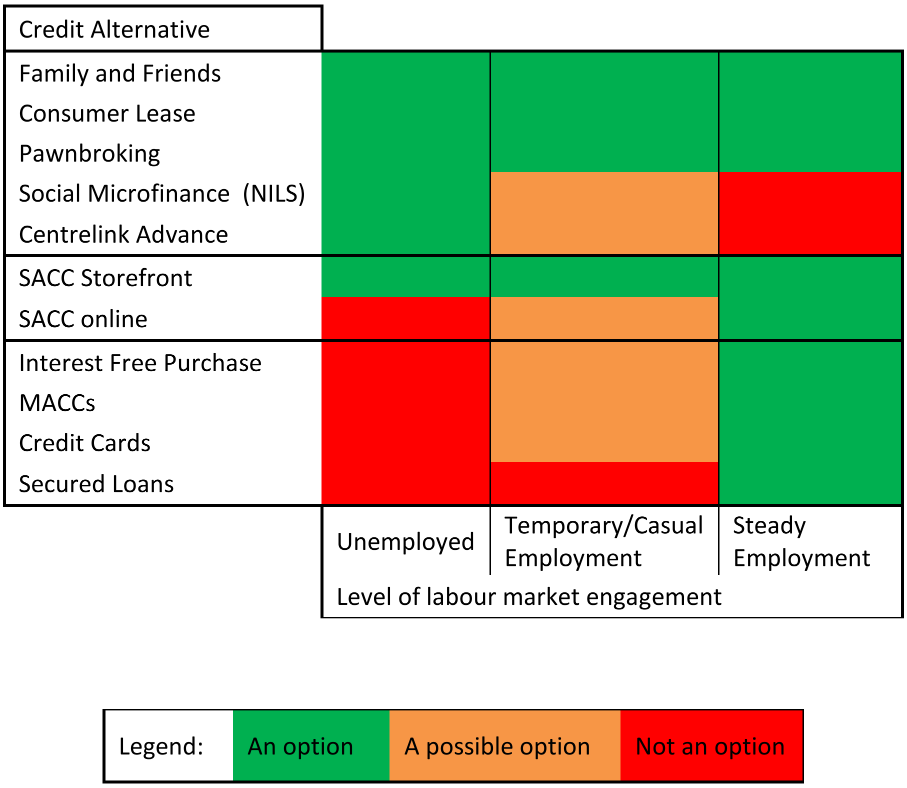
**Table 5 Comparing the four key characteristics that attract low-income consumers to payday loans with credit alternatives**

| Credit Alternative | Access to cash | Fast transaction | Low emotional cost | Regular and clear cut repayments |
|---|---|---|---|---|
| Family and Friends | | | | |
| Centrelink Advance | | | | |
| Pawnbroking | | | | |
| Social Microfinance (NILS) | | | | |
| Consumer Lease | | | | |
| SACC Storefront | | | | |
| SACC online | | | | |
| Interest Free Purchase | | | | |
| MACC | | | | |
| Credit Cards | | | | |
| Secured Loans | | | | |

| | | | | | |
|---|---|---|---|---|---|
| | Likely | | Somewhat unlikely | | Unlikely or unavailable |

Overall, the credit alternatives in the AFS market can also be illustrated by its interaction with the labour market. The options available for a consumer are highly conditioned on their level of labour market engagement.

**Table 6 Alternative Financial Services credit options by labour market engagement**



## CASE STUDY. ACCESSING A REFRIGERATOR

*Aisha is a single parent with one dependent child who is solely reliant on Centrelink payments. Included in these fortnightly payments are Newstart Allowance at the dependent child rate ($561) and Family Tax Benefit Part A ($177)*[11]*. The motor on her refrigerator burnt out this morning and she urgently needs a new fridge before her frozen food perishes.*

*As she has no savings a number of credit and financing options are explored. A search on a major consumer lease website uncovers that a Westinghouse 420 litre FF Top Mount Fridge can be rented for $28 per fortnight with free delivery on a 48 month lease (excluding fees, charges and insurance).*[12]

*Aisha goes to ASIC's MoneySmart website*[13] *and uses the 'Rent vs buy' calculator to discover that the total cost to rent this fridge would be $2912. She finds that the fridge can be purchased through an online retailer for $929–less than a third the total costs of the consumer lease.*[14]

*Aisha has a poor credit history and does not have a credit card that could potentially be used to purchase this product outright. She confronts a similar barrier with entering into a 48 month interest free plan to purchase this fridge from a major retailer as this would also require that she use a credit card provided by the retailer to make repayments.*[15]

*Aisha has three remaining options.*

*Taking out the maximum allowable Centrelink advance payments from her Newstart Allowance ($500) and Family Tax Benefit ($400) would cover most of the fridge costs. However, Aisha would need to forgo about $70 a fortnight from her Centrelink payments for the next six months–which she considers unaffordable.*

*The fortnightly costs of a two year NILS loan ($18) is by far the cheapest option. However Aisha considers that the process of applying and waiting a week or more for a decision is too long.*

*Finally, Aisha discovers that a 12 month SACC loan would cost her $60 a fortnight.*

*Aisha is very tempted simply to rent the fridge at $28 per fortnight but realizes that she is committing herself to an expensive four year contract that does not even guarantee she will own the fridge at the end of this period. She finally opts for the payday loan because she can get the fridge the next day, the fortnightly costs are $10 cheaper than getting cash through the Centrelink advances–especially since she does not have the extra $29 at hand to cover the purchase price of the fridge.*

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[11] Australian Government, Department of Human Services, '*A guide to Australian Government payments 20 March - 30 June 2015'* available at: http://www.humanservices.gov.au/corporate/publications-and-resources/a-guide-to-australian-government-payments

[12] As advertised on 24/6/15 at: https://www.radio-rentals.com.au/kitchen/refrigerators.

[13] https://www.moneysmart.gov.au/tools-and-resources/calculators-and-apps/rent-vs-buy-calculator

[14] As advertised on 24/6/15 at: http://www.appliancesonline.com.au/top-mount-fridges/?f_426604=Westinghouse

[15] For example, see Harvey Norman Interest free options available on 24/6/15 at: http://www.harveynorman.com.au/customer-service/finance-options/interest-free

## SMALL LOAN BUSINESS MODELS

A common characteristic of all small loan business models is that, because margins are low, revenue lines only tend to become profitable when loan books are large. A second key factor that enhances profitability is when customers repeatedly borrow. A study by the PEW Charitable Trusts found that 60% of payday loans go to people taking out at least 12 loans per year and 97% go to people taking out three or more loans per year (PEW 2013). Australian research in 2012 (prior to legislation aimed at restricting repeat borrowing) showed a similar pattern, where over half the respondents in the study (N=112) had taken out more than 10 loans in the previous two years (Banks et al. 2012).

A UK study has found that the first two or three small loans are ‘loss-leaders’ and are part of the business’s Customer Acquisition Costs (Beddows and McAteer 2014: 17). That is, a lender’s start-up costs, such as checking a customer’s credit history, the administration required to comply with regulations, sourcing underwriters to finance the business, establishing a clear risk profile for each customer (and adopting strategies to lower these risks), are higher than the relatively small amount of extra money that the borrower initially repays. Profits are overwhelmingly derived from chronic borrowers and the international industry is built around maximising repeat business (Ernst, Farris & King 2003; Pew 2012; TNS BRMB & Competition Commission 2014).

SACC firms in Australia have adopted a range of models that take different approaches to minimising default risk, encouraging repeat borrowing, sourcing new customer groups, leveraging value from customer interactions, and instituting administrative and compliance efficiencies. This paper focuses on two aspects of these models: online-only lenders and firms offering a suite of storefront, online and other financial services. A case example of the complexity of models is illustrated by the three ASX-listed companies with a significant presence in the Australian SACC market.

### ONLINE VS PHYSICAL

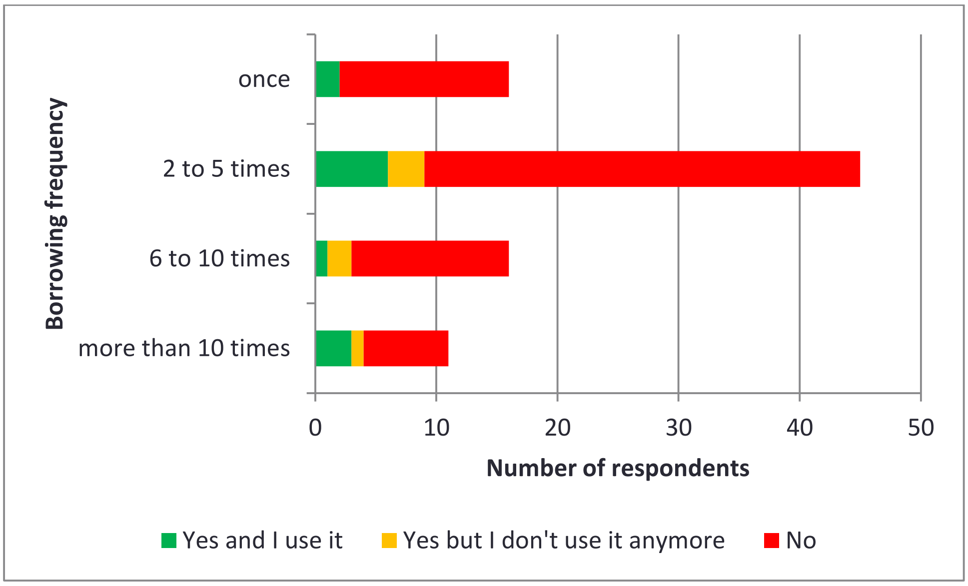
Nearly all Australian lenders have an online presence and only some have retail stores. Industry stakeholders estimate that 70% of SACC loans are currently transacted through storefront providers and that online SACCs will constitute 50% of the market within three years. Due to their distinct models and customer bases, different risk mitigation strategies are applied by storefront and online lenders.  For example, a new customer applying for a loan in a retail outlet is commonly provided a very low first loan–typically $50 to $100–to assess their capacity to repay. Slightly more may be lent on the second or third application as the staff get to better know the customer’s circumstances. Longer-term credit relationships may include ‘migrating’ a customer’s credit options to include MACC or secured loans. The risk approaches adopted by online lenders are quite different. Software–often developed in-house–assesses risk and complies with Responsible Lending Obligations through the customer’s online application, interrogating their account history, and evaluating the customer’s circumstances through investigating their social media interactions. The software algorithms, which are calibrated to minimise risk, reject approximately 90% of applications in Australia. Online lenders on-sell the data in the rejected applications as 'lead-generators' to other lenders willing to take on higher-risk customers and to other markets such as consumer product retailers. One leading online industry stakeholder estimates that the lead-generation market is now larger in Australia than the small loan market.

A major attraction of online loans is, as one stakeholder observed, their 'instantaneousness'. Successful applicants (80% of whom use a phone app to apply for the loan) receive money in their account within 5 to 15 minutes.

Publicly available data on the borrowing practices of online and storefront borrowers is extremely limited. A small study conducted by an author of this paper found some interesting commonalities.[16] A survey of online borrowers applying for loans on the websites of two leading Australian companies was conducted in August 2014, generating 127 responses. After removing customers who had never taken out a loan from either a storefront or online lender, 107 respondents remained.

The borrowing frequency pattern of the online respondents was very similar to storefront customers, confirming an observation from an online lender that 78% of his company's customers were repeat borrowers. Figure 4 shows that of respondents who had taken out a loan in the previous two years, 51% had taken out 2-5 loans and 31% had more frequent borrowing practices (a total of 82% of respondents). Only 20% had a credit card, and a third of these respondents indicated that they did not use their card anymore.

**Figure 4 Credit card ownership and small loan borrowing frequency in the last two years**




The amount borrowed was also very similar to storefront practices. The last loan two thirds (63%) of respondents had taken out was less than $500. Half the respondents had incomes

[16] Marcus Banks and Jasmine Ali (2014). What is the scale, scope and business model of the Australian online small amount, short-term credit industry? RMIT Project No. 0200312804.

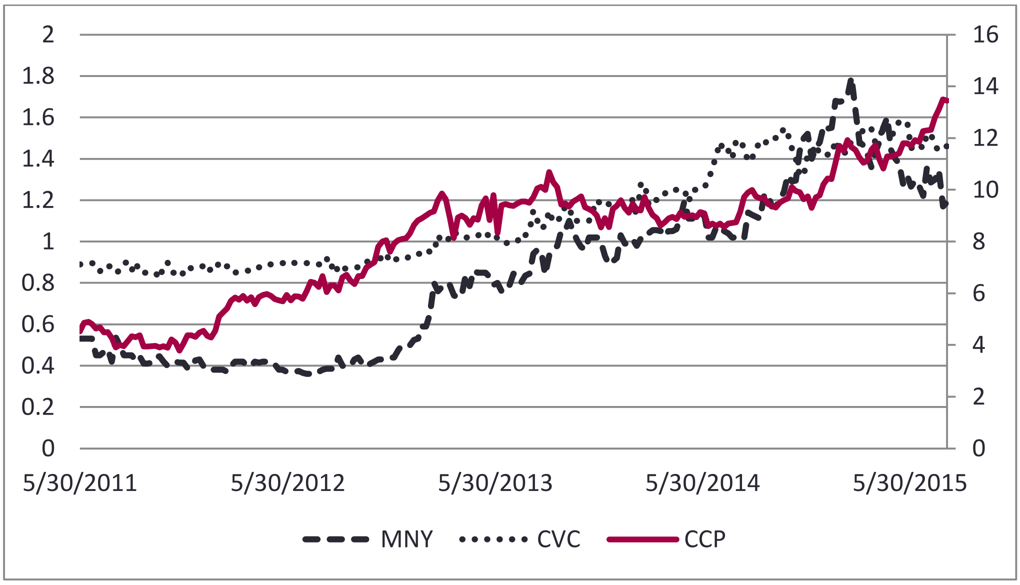
below $30,000 and a third between $30,000 and $70,000. However, as suggested by the research of the tendency for lower-income consumers to use storefront provider, only a quarter of respondents with incomes less than $30,000 used online loans exclusively, compared to two thirds of those earning $50,000 to $70,000.

## CASH CONVERTERS, CREDIT CORP AND MONEY3

The complexities of small loan business models is illustrated by an overview of the three publicly listed companies with a significant presence in the market–Cash Converters, Credit Corp and Money3. All three companies have recorded higher annual revenue growth in the last five years than the industry average of 7.73%–at 29.7%, 19.6% and 15.2% respectively (IBISWorld 2014a, 2014b; Money3 2014). Industry stakeholders consider that Cash Converters has a 40% to 50% share of the SACC market though regulators place the share higher–at about 60-70%.

Since the micro-credit cap came into operation in July 2013, all three companies have continued to show growth in the sector. Figure 5 indicates that the new regulations did not unduly affect their share prices. The right hand side of the graph shows share price data for Credit Corp (CCP) and the left hand side data for Money3 (MNY) and Cash Converters (CCV). It is unclear, however, whether the continued revenue growth is due to increasing market share or through service efficiencies. The descriptions of these companies below shows how their market strategies and business models distinctively intersect with the Alternative Services Market.

**Figure 5 Credit Corp, Money3 and Cash Converters. Percentage change in ASX share price October 2011 to July 2015**




### *CASH CONVERTERS*

Cash Converters International Limited is a Perth-based public company that generates revenue from franchised and company owned retail stores, and online platforms, that provide second-hand goods, pawnbroking services, SACC and MACC loans and car leasing services (IBISWorld 2014a). The company operates 750 stores across 21 countries (140 in Australia) and is rapidly expanding into EU countries, South Africa, Mexico, the Middle East, and Malaysia, Singapore and Thailand (Cash Converters 2014).

The company's core business is the franchising of retail stores which operate as retailers of second hand goods. Australian revenue grew 21.6% to $332 million in the 2014 financial year (Cash Converters 2014). The company derives income from SACC products in multiple ways

The 2014 Annual Report noted that the volume of SACCs advanced and margin per loan initially dropped in first six months after the introduction of the new price cap and other regulations in July 2013 before recovering in the second half of the financial year. Overall SACC customers increased by 15.2% to 535,738, the average loan amount rose from $341 to $413, and the total principal increased by 1.3% to $238.8 million–implying a small drop in repeat borrowing per customer. Overall, EBITDA for SACC products fell 28.3% to $9.6 million in the 2013-2014 financial year. However, the highest pressures on lending margins occurred in the first half of the year, with second half EBITDA ($5.1 million) up 13.3% on the first half results. This trend appears to have continued in the 2014-2015 year. SACCs written in the 2015 March quarter increased to $60.2 million–up 2.4% on the previous March quarter, with online SACCs up by 29.2% (to $2.7 million).

SACC loans generate a significant but minority component of Cash Converter's complex income streams. Revenue from personal loan interest and establishment fees (which include both SACC and MACC type products) account for about 42% of company revenue, with second hand good sales (34%), franchising fees, commissions, pawnbroking services and vehicle leasing and trade sales constituting the majority of revenue streams (Cash Converters 2014: 46).

### *MONEY3*

Mony3 commenced trading in June 2000 and listed on the Australian Stock Exchange in October 2006. The company has 68 retail outlets and an Australia wide network of 150 brokers. Revenue increases by 91% in the 2013-2014 financial year, with profit before tax and estimated to be $20 million in the 2014-15 year (Annual report). The company has a suite of loan products, including SACCs, MACCs and secured loans. The company has a large low-income customer base, with 80% of loans issued less than $1000. However, this has placed pressure on Money3 margins as only 21% of revenue comes from these loans while expending 64% of operational costs in the 9 month period to March 2015 (Bryant 2015). In contrast, loans of more than $3000, which account for only 7% of all loans, generated 63% of revenue. However, as one industry stakeholder observed, the company's consumers of low-value SACCs provide a significant leveraging opportunity to migrate lower-risk customers up the company's product range. In this sense, SACCs can be seen as low-margin 'loss-leaders' to higher-margin MACC and secured loans.

## CREDIT CORP

Credit Corp Group Limited is a sub-prime consumer debt specialist that combines a debt ledger business with an emerging consumer lending operation. Listed since 2000, the principal activities of the group are debt purchase and collection, mercantile collections, litigation services and consumer credit. In 2014 revenue increased by 26% to $174 million, with underlying net profit up 16% (Credit Corp 2014). The main business focus of the company has been to purchase credit impaired accounts from financial institutions and manage the repayment obligations of debtors ‘unable to access mainstream credit from banks and major finance companies’ (p. 4 Annual Report). Credit Corp has more than 120,000 customers making regular payments pursuant to mutually-agreed repayment plans.

In 2014 the company expanded into the consumer finance sector under the Wallet Wizard brand, offering SACC, MACC and other loans up to $5,000 (Wallet Wizard 2015). While generating only 20% of total revenue ($35 million) the consumer lending business delivered 40% of the company’s revenue growth in 2014 (Credit Corp 2015). Wallet Wizard is an online-only product that competes on price, charging a monthly fee of 2% rather than 4% (plus the standard 20% establishment fee). Another difference with other lenders is that Wallet Wizard sets the repayment period. For example, a $300 SACC loan requires 8 fortnightly or 17 weekly repayments (of $48 or $22.59 respectively). The table below shows the tight loan repayment windows for SACC loans (though the actual repayment period is set by the company).

| Loan Amount | Term between: | |
|---|---|---|
| **$150 - $600** | 4 months | 6 months |
| **$601 - $1,200** | 4 months | 9 months |
| **$1,201 - $2,000** | 6 months | 12 months |

Increased loan repayment periods are becoming common across the sector. It appears that Wallet Wizard is leading this trend with the average SACC loan repayment period of 8 months. Thus, while the 2% monthly fee is half the industry norm, the company’s margins are increased by the longer repayment periods. For example, a typical $300 loan from Cash Converters repaid over 4 weeks costs the consumer $72 in fees and charges. In contrast a $300 loan from Wallet Wizard (set at 17 weeks or 8 fortnights) costs $84 in fees and charges.

# CONSIDERATIONS

We offer a range of observations for policy consideration by stakeholders and specific recommendations for the current review into the SACC and consumer lease market.

## OBSERVATIONS

a. The high demand for small loans is associated with changes in socio-economic circumstances, especially increases in inequality and precarious employment.
b. SACC products meet this demand in ways that other current credit alternatives do not.
c. The relatively high cost of small loans is a reflection of the higher risks of default in this market.
d. The possibility of more affordable small loan alternatives that are priced at similar APR levels to secured loans or credit cards will only be realised through policy interventions and innovations.
e. Policy makers and advocates need to be realistic about what can be achieved through tighter regulation of the industry. We suggest that tighter regulation is, at best, one part of the policy options. Lower fee caps may have the unintended consequence of encouraging illegal lending activity, and so other policy initiatives should be trialled.
f. The particular policy mechanism to fund more affordable small loans needs further investigation and trialling. Proposals raised by stakeholders in this report include a small surcharge on larger loan transactions that would be used to fund community credit providers or banks entering this market.
g. If policy is to be effective, a greater degree of transparency is required. This should include more access to data around credit performance (% of applicants rejected,% of defaults) as well as a greater communication between lenders.
h. A wider review of the Alternative Financial Services market in Australia is required. New sub-markets are constantly emerging that intersect with the small loans sector and can increase the risk of financial hardship, especially among low-income households. For example, the emerging ‘credit repair’ industry unrealistically promises, for a large upfront fee, to make debts go away and expunge black marks on credit records. Most of these companies are unregulated, and require licencing and other compliance measures to minimise the risks they pose to consumers and other AFS firms.

## RECOMMENDATIONS

Section 335A of the Consumer Credit Legislation Amendment (Enhancements) Act 2012 (Cth) requires the Federal government to conduct an independent review of the small loans industry as soon as practicable after 1 July 2015. The Act specifies that the review consider whether a national database of small amount credit contracts be established, and whether any additional provisions relating to small amount credit contracts should be included in legislation.

The Review was announced by the Assistant Treasurer on 6th August 2015. The review will run until the end of 2015 with a report submitted to the Assistant Treasurer. The panel will consult widely with a range of stakeholders, call for submissions from interested parties and make recommendations about the effectiveness of sections of the Credit Act, including:

- the requirement of a small amount lender to consider a consumer's bank account statements;
- the rebuttable presumption that a loan is unsuitable where the consumer is in default under another small amount credit contract (SACC) or has held two other SACCs in the past 90 days;
- the cap on fees and charges, including the maximum of a 20% establishment fee and of a monthly 4% fee;
- the power to introduce specific protections for consumers who receive 50% or more of their income under the Social Security Act 1991;
- the requirement that consumers who default under a SACC must not be charged an amount that exceeds twice the amount of the relevant loan;
- whether a national database of SACCs should be established and if so, by whom and how it should be funded
- whether any of the provisions which apply to SACCs should be extended to regulated consumer leases

We make the following recommendations for the review to consider.

a. That the review of small amount credit contracts and consumer leases considers strengthening reporting obligations either in the form of a national database or a tightening of the comprehensive credit reporting regime (CCR).
b. Strengthening reporting obligations would have two purposes:
    i. A viable policy framework for the small loans (and consumer lease) sector requires an evidence-based understanding of these industries. Currently there is a lack of publicly available market data on customer numbers, loans issued and their amounts, borrowing frequency rates, default rates and levels of compliance with regulations.
    ii. Small loan providers would better meet their responsible lending obligations if the industry had access to a real-time database of current loans being serviced by a customer.
c. Tighten lender compliance to meet the 'presumption of unsuitability' rules. Industry stakeholders interviewed observed that a small proportion of the SACC industry is not complying with its responsible lending obligations, resulting in instances where consumers in receipt of Centrelink payments have multiple SACC loans.
d. A recognition that any call to eliminate this sector does not remove the need for cash to meet the day-to-day living expenses of a significant proportion of the population (Negro, Visentin & Swaminathan 2014: 700). Alternative sources of cheap, readily accessible credit would need to be instituted prior to any regulations that may make the current small loan market unviable. We strongly suggest that the review recognises that regulations that simply address market-based issues in the

sector are insufficient. A broader understanding is required that growing income inequality and poverty are the crucial drivers for the growing demand for small loans (Montgomerie & Packman 2014).

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# APPENDIX

For this study semi-structured Interviews were conducted with industry practitioners and consumer advocacy groups. The list below shows the scope of the topics discussed.

**Lenders**

- Their business
  - Size
  - Employees
  - average loan amounts
  - loan repayment periods
  - business model - products, product interactions (eg customer migration), repeat business
  - Risk management strategies
  - Growth plans
- The market
  - Market share - is the market growing or shrinking?
  - IBISWorld report on the US market considers the industry to be ‘predominately countercyclical in nature, with rising poverty rates benefiting demand levels substantially’ - what is your view of the Australian industry drivers?
  - Views on the Alternative Financial Services market - credit cards, NILS, consumer leases etc
  - Online vs storefront
  - Who are your main competitors?
  - Any comments on P2P lending?
  - Views on how consumers manage their debts - eg ‘mixed economy of credit’? Or put another way, are pawnbroking services seen as an indirect competitor?
  - Which companies are growing - which declining?
  - Changes to bank underwriting?
- Regulation
  - Views on the upcoming Ministerial review
  - Attitude to ASIC - is it doing a good job? What should its role be?
  - Any views on the international regulatory environment - relevant to Australia?
  - Views on appropriate regulation - do you think some of your borrowers are caught in ‘debt traps’? If so - because of their interaction with your business?
- The future
  - Viability of the industry in the next 5 years

**Consumer Advocates**

  - Is ASIC responding effectively/appropriately to the industry?
  - Views about the online database (see cp198)
- The market
  - Market share - is the market growing or shrinking?
  - IBISWorld report on the US market considers the industry to be 'predominately countercyclical in nature, with rising poverty rates benefiting demand levels substantially' - what is your view of the Australian industry drivers?
  - Views on 'poverty industry' - credit cards, NILS, consumer leases etc.
  - Online vs storefront
  - Changes to bank underwriting?
- Regulation
  - Views on the upcoming Ministerial review
  - Any views on the international regulatory environment - relevant to Australia?
  - Views on appropriate regulation
- The future
  - Viability of the industry in the next 5 years