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The impact of interest rate ceilings

The evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia

Anna Ellison and Robert Forster

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Executive summary

Detailed supporting evidence is cited in the main body of the report.

Regulatory approaches to high cost lending in other markets

- In both the US and UK high cost small sum lending has been the subject of intense regulatory scrutiny and public concern in both markets.
- In the process the impact of rate ceilings has been closely examined and views have evolved significantly in the light of the increasing body of evidence and understanding that has arisen as a result.
- In Australia the debate on rate ceilings is polarised, with lenders and consumer advocates on opposing sides of the case for and against a ceiling.
- This is not the case in other markets where the issues have been examined.
- The World Bank and the CGAP[1] both advise against rate ceilings as damaging to the interests of the poor and their communities.

US

- Regulators are largely moving to control and regulate payday lending rather than seeking to eliminate it, with legislation introduced to facilitate payday lending now in a majority of states.
- Activists seeking to bracket high cost payday lending with predatory lending are increasingly challenged by researchers from the Federal Reserve banks and by evidence-based researchers and academics.

UK

- After exhaustive scrutiny the UK government, and later the Competition Commission, rejected the introduction of a ceiling as likely to damage vulnerable borrowers and open the door to illegal lending.
- Consumer protection and poverty groups, the debt advice services and credit unions combined to argue against the introduction of a rate ceiling as likely to damage low income and disadvantaged consumers.
- There is also a cross party consensus that rate ceilings run the risk of creating significant detriment for low income borrowers.
- This approach is adopted in parallel to a significant social lending operation focused on those on welfare and a concerted effort to stimulate the growth of third sector not for profit lending.

[1] The Consultative Group to Assist the Poor – An association of 33 development agencies set up as a global resource to support the development of a sustainable micro-finance sector and best practice lending in poor communities.

The demand side dimension – why low income households borrow and the role of small sum cash credit

- Demand for credit among those on low incomes is shaped by an irreducible need to borrow, most pronounced among families.
- The same patterns of irreducible demand can be demonstrated internationally at remarkably consistent levels, with Australia in line with other markets.
- Credit, particularly small sum credit, is used by low income households primarily for essentials and to ensure the effective functioning of household finances.
- In all markets in which payday lenders operate, including Australia, payday lending is used primarily by low to middle income borrowers in work:
    - Majority of users have other credit options and payday is used alongside other borrowing to meet a specific need for short term small sum credit.
    - Key source of credit for those on low incomes and the third of payday users in Australia for whom this kind of lending is their only source of credit.
    - There is no evidence that payday lending is creating a debt spiral, indeed users employ payday loans to manage through, and avoid, difficulties.
    - Payday borrowers themselves take the view that, despite the high cost of credit, payday lending works to ameliorate and prevent financial difficulties.
- Increasingly, mainstream credit users are fed into the non standard sector as a result of adverse credit history.
- A significant minority of low income Australians already encounter difficulties in accessing mainstream credit.
- Credit exclusion creates hardship and leaves individuals exposed to cash crises and prevents them obtaining items that they need.

The impacts of interest rate ceilings on credit supply

- Lenders cannot afford to cross subsidise high risk borrowers without risking their competitive position.
- In markets without price controls specialist lenders meet demand for small sum credit, typically provided at high cost to high risk borrowers.
- Such lending models do not develop or lenders withdraw in markets where price controls are introduced.
- The impact of price controls is evident in both the diversity of credit products offered in a market and in the extent of credit rationing.
- Where ceilings are effective in containing price, lenders withdraw from markets where they cannot lend profitably.
- Lenders in these markets also set minimum lending levels higher than is appropriate to the needs of low income households and high risk borrowers.
- The constrained credit product mix in price capped markets leads borrowers to use products which are less suited to their needs and expose them to greater risk
- Where ceilings are imposed those without options are diverted to pawn – and illegals – while others are primarily diverted to mainstream revolving credit.
- Illegal lending tends to arise in a credit vacuum, is frequently associated with other criminal activity and is both very high cost and damaging to victims

These effects are readily observed in markets with and without ceilings, as are the differences in outcomes for consumers.

UK

- The picture of credit use among low income households in the UK is close to that of their counterparts in the domestic Australian market.
- Wide mix of credit products used by low income consumers with majority of those using high cost non standard lending also using mainstream credit.
- Minimal credit exclusion, largely because of presence of high cost lenders lending to high risk borrowers who would otherwise have no credit options.

US

- In states with ceilings, there is clear exclusion of the highest risk borrowers and the unbanked. Total lending falls, rising for revolving credit and pawn.
- Clear diversion effects: Total debt per head for those still able to borrow identical in states with and without ceilings, but share of debt represented by different credit vehicles varies significantly between states with and without ceilings.
- Levels of delinquency and default are higher in states with ceilings as is the incidence of credit related over-indebtedness and insolvency, with this effect exacerbated with down-turns in the economic cycle.

Europe (as represented by the largest credit markets of France and Germany)

- The French and German markets are shaped by rate ceilings but have evolved in different ways because of differences in emphasis in the regulatory framework.
- Both feature the narrow credit product mix typical of rate capped markets
- Illegal lending is much higher in the rate capped markets of France and Germany than in the UK, where there is no ceiling.

Germany

- Germany features high levels of credit exclusion among those on the lowest incomes and high potential risk borrowers.
- The social banking sector, with a social remit intended to compensate for price controls, has moved upmarket.
- Regulatory disincentives to default have led to a risk-averse lender set unwilling to tolerate the delinquency associated with revolving and card based credit.

France

- The French lenders have used revolving credit aggressively to extend their penetration of lower income households.
- The resulting account delinquency has resulted in the long term financial exclusion of large numbers of low income borrowers.

Japan

- In the wake of the recent sharp reduction of the rate ceiling, acceptance of consumer loan applications has fallen by close to two thirds in two years.
- This has been accompanied by rapid growth in illegal lending, in large part run by organised crime.
- Bankruptcies have risen sharply as consumer credit has been withdrawn from higher risk borrowers. Bankruptcies had previously shown a trend decline

Australia

- The prominence of cash advances on credit cards as the leading source of cash credit for low income Australians suggests a rate ceiling in Australia will create a shift from a UK style market to a French style market as borrowers move from high cost short term credit to revolving credit.
- This would seem likely to result in an increase in account delinquency and default and thus in both credit exclusion and insolvency.

The impact of ceilings on the cost of credit to the consumer

- The evidence suggests that shifting low income Australians to low APR revolving credit will not necessarily reduce the cost of credit and may increase it for some
- In a rate capped environment some borrowers are shifted from high APR to low APR vehicles (others are denied credit).
- Lenders will structure product and pricing structures to accommodate the constraints of the ceiling, shifting charges from APRs to back end charges:
  - Behaviour-driven pricing allows lenders to fine tune risk pricing to the behavioural profile of the individual borrower.
  - For high risk borrowers behaviour-driven pricing rests primarily on uneven payment records and a tendency to extend payment terms on revolving credit.
  - Payment irregularity is endemic among low income households and can be observed both in Australia and internationally.
  - Ancillary fees and behaviour-driven charges represent a very significant share of lenders' profits, particularly for non prime card segments.
  - These two effects in combination achieve a price for the lender that is commensurate with risk, regardless of the headline APR.
- The cost to the borrower of low APR products can be very similar to that of high APR credit and under uneven payment conditions can be significantly higher.
- These effects can be observed in a number of markets with ceilings:
  - In the US, in states with ceilings delinquency payments on revolving credit have been significantly and consistently higher than in states without ceilings over many years.
  - In France behavioural effects on revolving credit cards can be the major driver of credit cost, often significantly higher than the headline APR.
- Shifting the balance of emphasis within pricing structures to non interest rate components of price compromises price transparency for consumers.
- Patterns of payment irregularity in the Australian market suggest that the pricing effects described would have a significant impact in a domestic context:
  - Some four in ten low income Australians miss payments on mainstream loans and credit agreements, rising to half of credit card revolvers.
  - Total outgoings on debt service are near identical for users of payday loans and those taking cash advances on credit cards.
  - However payday borrowers miss fewer mainstream credit payments than other low income credit users.
  - Some payday users appear to be making rational use of high cost credit to avoid even more expensive default, overdraft or reconnection charges.

The impact of ceilings on debt and over-indebtedness

- Rate ceilings do not appear effective in preventing over-indebtedness and indeed appear to make it more likely and to exacerbate its effects:
  - The rate ceilings in France and Germany have not prevented significant and rising levels of problem debt, over-indebtedness and insolvency.
  - Over-indebtedness in the UK is low and the major indicators of problem debt have declined over a long period, with recent rises from a low base.
  - Outgoings on debt service are very similar in all three countries but in France and Germany:
    - Debt is significantly higher and over-indebtedness is significantly more likely.
    - More debt is open ended and long term, leaving individuals more exposed in the event of a down-turn in fortunes or the economic cycle.
  - Consequences of problem debt, both short and long term, are significantly more damaging in France and Germany than in UK:
    - Lenders are less tolerant of payment difficulties, in large part because of the lack of flexibility associated with price controlled products.
    - The consequences of delinquency are more serious and the sanctions for default more rapidly applied.
    - As a result, in both France and Germany, those with credit difficulties are more likely to prioritise debt service over essentials to avoid sanctions.
    - Those with payment difficulties are more likely to suffer fuel poverty and to undermine their financial security by not paying rents.
    - Insolvency is more likely to follow payment problems.

The impact of ceilings on credit market growth

- Interest rate ceilings have an impact beyond those on low incomes and outside the credit market:
  - Higher rates of credit market growth have seemed to be accompanied by higher GDP growth over the past two decades
  - The UK, Australian and French economies have benefited from the stimulus to consumption provided by credit growth, the UK and Australia to a greater extent than France.
  - German credit growth has been particularly weak. The German recovery has been constrained partly as a result.
  - Japan has seen consumption fall in part as a consequence of shrinking credit supply, providing little support for the fragile recovery from ten years of economic under-performance
  - There are other factors explaining faster rates of economic growth. Australia in particular has experienced an export boom but strong internal demand boosted by rapid credit growth has had a substantial impact

Conclusions and policy implications for Australia

- The evidence does not support the assumption of a debt spiral and consumer detriment associated with payday lending which the rate ceiling proposed is intended to address.
- The evidence would also appear to suggest that a rate ceiling will not necessarily reduce the cost of credit for low income borrowers. There is indeed a risk that some borrowers, under uneven payment conditions, will pay more for credit.
- A rate ceiling would appear unlikely also to prevent over-indebtedness. It is more likely to increase the indebtedness of low income borrowers and to simply shift more of debt into revolving credit vehicles being repaid over extended terms.
- It would appear likely that credit exclusion will result from the imposition of a ceiling and that the consequences will include significant hardship for excluded households who will no longer be able to access small sum cash credit to manage cash emergencies or peaks of expenditure or to enable them to spread the cost of major purchases.
- Other borrowers now using high cost credit will be diverted to revolving credit, with cash advances likely to become a higher proportion of credit card use. This will likely result in increased delinquency and default and in low income individuals being at greater risk of financial breakdown and insolvency.
- As a consequence, more individuals will acquire adverse credit history and find themselves unable to obtain credit, increasing the hardship and exclusion effects referred to earlier.
- There is also a significant risk of creating the conditions for unlicensed lenders to enter the market, a development likely to be highly damaging and which is likely to greatly increase the cost of credit for borrowers unable to obtain credit legitimately.
- In the event that a rate ceiling is imposed, it would seem likely that there will be a significant need for alternative social lending. The experience of other countries who have pursued this route is that establishing a social lending operation is highly challenging, slow to establish and scale and, for most governments, prohibitively expensive.
- The better way forward in protecting vulnerable consumers would appear to be a greater focus on ensuring best practice in consumer lending, eliminating unfair and exploitative practices and achieving greater transparency on pricing, terms and conditions.
- The most effective way to reduce prices for low income borrowers may be to foster an environment which stimulates competition.

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The impact of interest rate ceilings

The evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia

1.0 Introduction and background

The background to the report is the public debate around how most effectively to enhance consumer protection in the consumer credit market

The background to the report is the public debate in Australia around how most effectively to enhance regulation of the consumer credit market and improve consumer protection, particularly for low income and vulnerable credit users. This debate takes place against a background of rapid growth in both consumer credit use and the indebtedness of Australian households. Credit growth has been driven primarily by the expansion of revolving credit – and of credit card balances in particular. The issues of debt and indebtedness, particularly in relation to credit cards, are of some considerable concern both to policy makers and the public more widely. Much of the impetus for regulatory reform arises however not so much out of concerns about the growth of the mainstream credit market but from the parallel development of the “non standard” or “fringe” lending sector.

The immediate impetus for change is not only a generalised concern about indebtedness but specific issues relating to the activities of the payday lenders

The debate about credit market regulation occurs in the context of a wider debate about poverty and social exclusion and the role of credit in the lives and finances of those on low incomes. The issue for policy makers and those concerned with consumer protection in Australia is the activities of the “payday” lenders, who are seen as exploitative in extending high cost credit to vulnerable low income borrowers. Use of high cost lenders is believed to create significant consumer detriment for low income Australians, resulting in a “debt spiral” which compromises vulnerable borrowers’ ability to manage household finances effectively, increasing the risk of financial breakdown.

Australia appears to be moving towards a significant tightening of the regulatory environment and the introduction of price controls

Against this background, Australia appears to be moving towards a significant tightening of the regulatory framework which governs consumer credit. Various of the Australian states[2] are either considering or at an early stage of putting in price controls, in the form of an interest rate ceiling, seen as a solution to the perceived problems associated with payday lending. It is hoped that rate ceilings will protect low income borrowers and be effective in forcing the cost of credit down to levels seen as more socially acceptable.

[2] The thrust of the recommendations of the Rogerson Committee at the end of the 1960s was that credit transactions should be regulated on a national basis. The Consumer Credit Code which eventually resulted in the 1990s was in effect a blueprint for national legislation but implementation has been left to the states. There is still pressure from some quarters for consumer credit to be regulated at a federal level much as banking is, but this does not seem likely at the moment.

Various states have embarked along the road towards the introduction of interest rate ceilings but the impacts of these moves have yet to be tested

The Queensland government currently proposes to introduce subordinate legislation in the form of special provisions regulation[3] in 2008 which would place a formal APR cap of 48% on smaller credit contracts[4]. The Queensland regulations if introduced would follow on very shortly from similar regulations introduced last year in NSW[5]. In NSW the late 2007 adaptations sought in part to close a loop-hole in the law which had rendered a previous effort to impose a ceiling in the state ineffective, in that lenders were able to circumvent it. The new legislation, the effect of which is therefore untested at the time of writing in early 2008, will now make it very difficult for "payday" lenders to operate in the state going forward.

Victoria drew back from closing loop-holes allowing fringe lenders to operate on the basis that to do so would be detrimental to low income consumers

Victoria conducted a formal Credit Review in 2006 which decided against adopting the NSW approach of including fees within the interest rate cap on the specific basis that this would drive fringe lenders out of the market. Potentially this was deemed to be sufficiently detrimental to low income households dependent on such borrowing to preclude closing all the loopholes in the regulatory regime for credit.

New Zealand has rather adopted a light touch regulatory approach closer to that adopted in the US and UK markets

The New Zealand approach to consumer credit regulation, on the other hand, has been closer to that prevalent in the UK and US, in that it has been more market based. The emphasis of the Credit Contract and Consumer Finance Act 2003 was on regulation and disclosure so that "fringe" lenders are able to operate legally.

Changes to regulatory frameworks have potentially significant impacts felt beyond the credit market in the real economy and wider social environment

Australia thus potentially stands poised on the brink of what may be significant change, and not only in the field of consumer credit regulation. The impact of any regulatory changes is unlikely to be confined to the credit markets. Changes in credit market regulation have potentially significant impacts which reach beyond the credit market itself. Change will tend to shape directly related factors such as indebtedness, consumption and levels of insolvency, and can do so both rapidly and to a significant degree. Equally however, changes in patterns of consumption or increases in indebtedness can play out also in the wider economy and the social environment, having a knock on effect on economic activity and even performance. It is for these

[3] Consumer Credit (Queensland) Special Provisions Regulation 2008 (Draft), made under the Consumer Credit (Queensland) Act 1994.

[4] The level of the proposed cap is the same as that in place in NSW, Victoria and the ACT.

[5] The historical background to the current round of regulation is the provision made for interest rate ceilings in the Consumer Credit Code which resulted from the Australian Uniform Credit Laws Agreement in 1993. The Code was the basis of a model law first enacted by the Queensland Parliament in 1994 and subsequently enacted by all states with the exceptions of Western Australia and Tasmania. While the Code was intended to rationalise and liberalise the credit markets in Australia, the status quo had previously been the maximum interest rate of 48% set by the Moneylending Act as far back as 1927. Victoria very quickly returned to that status quo within its 1995 enactment of the Code and the ACT followed with regulations restoring the 48% cap the following year. The same cap was re-introduced by regulation in NSW in 2002 but only for short term loans with terms of up to 62 days. The 2007 regulations extended the operation of the cap to longer loans as well.

reasons that operation of the regulatory levers in consumer credit markets carries a wider range of both social and economic risks than is sometimes appreciated.

This study seeks to demonstrate the impact of rate ceilings around the word and relate these effects to the Australian domestic context

Against this background, this study seeks to pull together an evidence base around the operation and impact of interest rate ceilings in other countries to help inform the public debate and gain some insight into how the Australian credit markets might develop going forward and the impacts these developments might have across a number of dimensions. It seeks to relate the international experience to the context of the domestic credit market and patterns of credit use among low income Australian households. The intention is to explore how the effects observed elsewhere might play out in a domestic context and the conclusions that might be drawn about how most effectively to protect the interests of vulnerable borrowers and users of high cost credit.

2.0 The evidence base

2.1 Markets examined

The markets to which this study refers are those of the USA, UK, Japan, Germany and France, selected both because these countries represent large and important credit markets but also because each has adopted very different approaches to credit market regulation, despite regulators' sharing broadly common objectives:

- In the United States, there is effectively a national market for credit cards and loans which are sold across state boundaries.
- A mix of approaches has been adopted to the growth of the payday industry in the US but the broad trend is towards regulating and facilitating payday lending with a good majority of states (37) having either liberalised rates generally or specifically moved to enable payday lending[6].
- France and Germany have long-established rate ceilings set at low levels, albeit with a slightly different emphasis and focus in each case:
    - France focuses on price controls and managing over-indebtedness.
    - Germany focuses on price transparency and creates disincentives to lenders to risk default.
- The UK has adopted the most market-based approach to credit regulation in Western Europe and has no rate ceiling.
- The French regime is highly specified while Germany and the UK rely on a tradition of self regulation and statements of broad principle.
- Japan has progressively reduced rates over the decades since the Second World War, and very sharply in the most recent round of legislation, combining one of the strictest interest rate ceilings in the advanced economies with a cap on total lending per borrower[7].

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[6] Six states have deregulated completely and have no state usury cap (Delaware, South Dakota, Idaho, Nevada, New Hampshire and Wisconsin). A few of the states with historically strong usury frameworks have implemented special provisions to allow payday lending under conditions (i.e. Maine) but others have not changed their stance (most of the North East). Other states have regulated in favour of allowing payday (Oklahoma, Alabama, Virginia). Only one of the states with a historically liberal approach has drawn back from allowing payday to operate normally (Oregon). A handful of the Southern states have reacted to their rapidly growing payday industries by implementing bans (Georgia, South Carolina and Washington DC)

[7] An amendment to the Money Lending Business Control and Regulation Law passed in December 2006 has reduced the interest rate cap from 29.2% to 20% and will shortly make lenders responsible for the affordability of their loans to individuals (broadly the debt service burden should represent no more than 1/3 of income).

2.2 The evidence base

The study draws on extensive research sources as outlined below:

Domestic market and low income Australian credit users

- Qualitative research with low income consumers based on three focus groups with low income credit users, users of payday lending and those with a background of credit related problems, undertaken in part to support quantitative research design.
- Quantitative research with a nationally representative 500 sample of low income consumers and a little over 400 low income credit users. This was undertaken by telephone in January 2008 in Adelaide, Brisbane, Melbourne, Perth and Sydney.
- Quantitative research with a nationally representative sample of a little fewer than 320 low income users of payday loans, also undertaken by phone in January 2008 in the same cities.

International markets

- Data in relation to consumer behaviour and credit use in US States with and without interest rate ceilings and with and without legislation designed to regulate and control payday lending rests on:
  - Interrogation of a sample of anonymised transactional records extracted from the consumer credit reference database of “TransUnion”, the national US credit reference bureau. Analysis was based on a sample extract of 380,000 US consumers.
  - A survey of the regulatory authorities and legislatures undertaken with the state banks in each of the US states to establish the details of the regulatory framework operating in each state.
  - A survey of mainstream lenders in every state to establish rates for test examples of credit pricing on auto loans (1646 rates checked) and personal loans (591 rates checked).
- Data relating to the European markets rests on consumer research originally undertaken to inform the deliberations of the UK government in the framing of the 2006 Consumer Credit act in the United Kingdom. Consumer research was undertaken with a sample of 2717 low income consumers falling into the bottom 20% of household incomes in the UK, France and Germany. Where other consumer research surveys are cited, these are detailed separately.
- Data for Japan is sourced primarily from public statistics and trade lending data.

Key features of the regulatory frameworks in the countries examined

US

- Regulation of credit markets largely devolved to states
- Main exceptions are national banking and credit cards since *Marquette* decision in 1979
- Most states regulate price of credit differently for different types of provider
- Small loans are the most common exception to the main interest rate control regime
- 6 states have deregulated completely and no longer have an interest rate cap
- In addition 31 states allow payday subject to a maximum charge per $100 lent over a 14-day period. Oregon has recently extended the minimum payday term to 31 days.
- The remaining 12 states do not allow payday lending. A couple of these allow pawn-broking at rates above the cap.

UK

- Light touch, market-based approach
- No interest ceiling (with single exception of not for profit lending)
- No constraints on credit models offered to market
- Lenders licensed as “fit”
- Tightly specified requirements on contracts, presentation of price
- Requirement for clarity, transparency
- Requirement to lend responsibly
- Agreements subject to “unfair” credit test

France

- Tightly specified ceiling set at 33% above average rate set quarterly by Banque de France
- Rates differ for 3 categories of loans
- Top rate peaked 27.09% in 1993:
    - All compulsory charges must be included in APR
    - Optional insurances and administrative expenses associated with default not included in APR
- Statutory formula for default charges, which may exceed legal maximum APR
- Comprehensive delinquency register (FICP) managed by Banque de France
- Creditors bear whole risk of lending to registered individuals and financial institutions required by law to register payment incidents

Germany

- Largely self-regulation
- Credit law does not specify interest rate ceiling
- Court defined ceiling of 2 x average rates
- Little variation in some years, maximum 2006 21.1%
- "Discomfort zone" rather than fixed point
- Main requirement for transparency on charges
- APR more loosely defined than in France:
  - Compulsory charges included in APR
  - Various transactional charges not included in APR
  - Optional insurances and administrative expenses associated with default not included
- Comprehensive single national credit reference database (SCHUFA)

Japan

- Dual regulatory regime until 2007: banks and consumer finance houses treated differently
  - Bank regulatory regime (Interest Rate Restriction Law) had stepped maximum legal rates for different sizes of bank loan, from 15% for loans over Y1M to 20% for loans under Y100,000
  - Maximum rate for non bank lenders progressively reduced from 109.5% in 1983, to 40%, 29.2% (with consumers' voluntary agreement) up to December 2006.
- New legislation introduced phased tightening from December 2006 to 2009 to introduce one of tightest regulatory regimes in advanced economies:
  - Separate non-bank regime abolished
  - Rates reduced to 20% by 2009
  - Ceiling includes all ancillary charges
  - Cap on lending per head[8]
  - Net assets required for registration as moneylender raised[9]
  - Financial Services Agency to have increased powers of investigation and enforcement

[8] If lending from single lender exceeds Y500,000 (including amount of new loan) or total borrowing from all lenders exceeds Y1M lender must ask borrower to produce proof of financial means. New lender must also ensure that total loans do not exceed 1/3 of borrower's annual income.
[9] Net assets required for registration raised from Y5M to Y20M by mid-2008 and again to Y50M at same time as implementation of total borrowing limits for individuals.

3.0 Regulatory approaches to high cost lending in the UK and USA

Summary

- In both the US and UK high cost small sum lending has been the subject of intense regulatory scrutiny and public concern in both markets.
- In the process the impact of rate ceilings has been closely examined and views have evolved significantly in the light of the increasing body of evidence and understanding that has arisen as a result.
- In Australia the debate on rate ceilings is polarised, with lenders and consumer advocates on opposing sides of the case for and against a ceiling.
- This is not the case in other markets where the issues have been examined.
- The World Bank and the CGAP[10] both advise against rate ceilings as damaging to the interests of the poor and their communities.

US

- Regulators are largely moving to control and regulate payday lending rather than seeking to eliminate it, with legislation introduced to facilitate payday lending now in a majority of states.
- Activists seeking to bracket high cost payday lending with predatory lending are increasingly challenged by researchers from the Federal Reserve banks and evidence-based researchers and academics.

UK

- After exhaustive scrutiny the UK government, and later the Competition Commission, rejected the introduction of a ceiling as likely to damage vulnerable borrowers and open the door to illegal lending.
- Consumer protection and poverty groups, the debt advice services and credit unions combined to argue against the introduction of a rate ceiling as likely to damage low income and disadvantaged consumers.
- There is also a cross party consensus that rate ceilings run the risk of creating significant detriment for low income borrowers.
- This approach is adopted in parallel to a significant social lending operation focused on those on welfare and a concerted effort to stimulate the growth of third sector not for profit lending.

The US and UK have been through a similar experience to that now developing in the domestic Australian market

This section seeks to examine other credit markets where high cost lending is a major feature of the credit landscape and where the activities of the high cost lenders have been the focus of regulatory scrutiny and public debate[11]. In this respect the examples of the United States and the UK are of particular interest, in that the US

[10] The Consultative Group to Assist the Poor – An association of 33 development agencies set up as a global resource to support the development of a sustainable micro-finance sector and best practice lending in poor communities.

[11] In the US, the OCC stopped national banks from participating in arrangements with payday lenders in 2003, FDIC issued revised guidance in 2005 to banks engaged in payday lending to move repeat payday customers (over 6 loans in a 12 month period) to long-term credit products and the Talent Nelson amendment to the Defence Authorization Bill in 2006 capped interest rates at 36% for loans made to military personnel.

has a large and fast growing payday lending market, which has become established virtually from a standing start over a 15 year period. Payday lending is much smaller in the UK, partly because the UK features a large and very long established high cost small sum credit model known as "home credit", which itself has been the focus of very considerable scrutiny by regulators and consumer protection bodies[12].

The high cost payday lenders in the US and the home credit industry in the UK have been the subject of intense public interest and regulatory scrutiny

In both territories, the debate around high cost credit has been high profile with the lenders having been the focus of extended campaigns by consumer activists[13]. Prominent among these have been proponents of interest rate ceilings as the perceived solution to what is judged to be the socially unacceptable phenomenon whereby the poor tend to pay more for credit. This latter theme is one which has tended to generate considerable media attention and thus public interest and concern, which itself has provided some of the impetus for scrutiny of the high cost sectors in both countries. This in turn has result in detailed examination of the evidence in the case for and against rate ceilings as a means to protect low income credit users by regulators, legislators, various consumer protection bodies, in the US by various state legislatures, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currencies and in the UK most recently, the Department of Trade and Industry, the Office of Fair Trading and the Competition Commission.

There is greater diversity of views on the desirability and potential impact of interest rate ceilings in other countries facing similar issues

The debate on rate ceilings in Australia has been somewhat polarised with the consumer protection establishment groups, poverty campaigners and consumer activists ranged on one side, arguing the case for a rate ceiling with suppliers on the other, making the case that rate ceilings will not only damage the industry but also work against the interests of those the legislators are seeking to protect. This is not necessarily the case in other advanced credit markets where high cost lenders operate and the issue of rate ceilings has been examined, though it was perhaps more characteristic of the position at the early stages of the debate in some of these jurisdictions. There is as yet also relatively little in the way of a domestic Australian evidence base[14] around the use of high cost credit or of the dynamics of credit use

[12] Policis for the Department of Trade and Industry, UK (2004) *The effect of interest rate controls in other countries;* National Consumer Council, Whyley and Brooker (2004) *Home Credit: An investigation into the UK home credit market;* NCC Super-complaint on home credit made to Office of Fair Trading on 14 June 2004; OFT issued its response to super-complaint on 10 September 2004 and referred issue to Competition Commission; Competition Commission (2006) *Home credit market investigation: Inquiry Final Report*; Collard and Kempson for the Joseph Rowntree Foundation (2005) *Affordable credit: The way forward.*

[13] Prominent among the anti usury activist groups are the Centre for Responsible Lending in the US, which positions itself as "a resource centre for opponents of predatory lending" and Debt on Our Doorstep in the UK, an organisation whose central agenda is the introduction of a rate ceiling as part of a long standing campaign opposing the UK's high cost home credit lenders. Activist groups in Europe are less high profile, although there is a strong anti-usury culture. The most long-standing voice has been Professor Udo Reiffner's IFF (Institut for Finanzdienst Leistungen). The Coalition for Responsible Credit, was set up in 2006 by IFF and Debt On Our Doorstep of the UK, among others, as an umbrella group for European consumer activists concerned with financial exclusion and positions its mission specifically as offering "a voice to people at risk of predatory and extortionate lending".

[14] MISC Australia commissioned by Consumer Affairs Victoria (2006) *Consumer Credit Report*; Howell, Centre for Credit and Consumer Law, Griffith University. By the same author, CCCL background Paper (2005) *High Cost Loans: A Case for Setting Maximum Rates. Managing the cost of consumer credit in Queensland*, Discussion Paper submitted to Office of Fair Trading, Queensland, 2006. Dean Wilson Consumer Law Centre Victoria *Payday Lending in Victoria* 2002. Rosanna Scutella and Genevieve

among low income households, with those studies that have been undertaken being generally small scale.

Reservations have arisen about both the effectiveness of ceilings and the potential social and economic risks attached to price controls on credit

In the US and UK, as greater scrutiny of both the high cost sector and the issues increased the body of robust and independent evidence available to legislators and other interested parties, the terms of the debate have changed as understanding of the role that high cost credit plays in low income households and communities has increased. With this understanding has largely come some acceptance that, despite the indubitably high cost of such credit, there is a real need for small sum credit for households on tight budgets and that non standard lending, has, on balance, a positive role to play in meeting this need, albeit at high cost. Reservations have arisen also not only about the effectiveness of a rate ceiling but also about the desirability of price controls in credit markets more generally, which are increasingly seen as likely to damage not only the interests of the poor but also to create social and economic risks for the wider population and economy.

In the UK the consumer protection establishment, debt advice agencies and social lending bodies combined to campaign against the introduction of a cap

In the UK, consumer protection and poverty groups, the debt advice services and credit unions combined to argue against the introduction of a rate ceiling as likely to impact negatively on low income and disadvantaged consumers. Exhibit A which follows contains the headlines of a round robin letter to legislators on the eve of the final reading of the consumer credit bill in the UK parliament urging legislators to reject the introduction of an interest rate ceiling in the UK. It is written on Citizen's Advice Bureau letterhead (the largest debt advice service in Europe) co-signed by representatives of the other major debt advice services, the major consumer protection body, the domain expert members of the UK Financial Inclusion Task Force, the leading independent public policy research bodies and the credit union trade body, effectively therefore the entire consumer protection establishment in the UK[15].

There is also a cross party consensus on this issue in the UK, with the Labour government, Conservatives[16] and Liberal Democrats all opposed to a rate ceiling on the grounds that illegal lending would thereby be encouraged. As a result the approach in the UK has been to focus on establishing social lending alternatives to high cost credit and as a resource for the credit excluded, against the backdrop of recognition that commercial high cost credit has a role to play.

Sheehan *To their credit: Evaluating an experiment with personal loans for people on low incomes*, Brotherhood of St Lawrence, 2006.

[15] Citizen's Advice Bureau, Advice UK, National Consumer Council, The Consumer Association, The Association of British Credit Unions, The Public Policy Research Institute, The Personal Finance Research Centre at Bristol University, various members of the Financial Inclusion Task Force.

[16] The Conservative Party's Social Justice Policy Group (2006) *Breakdown Britain*

Exhibit A: Letter from the Citizens Advice Bureau to UK legislators urging the rejection of an amendment that would introduce a rate ceiling to the UK

21 October 2005

I am writing on behalf of a wide range of organisations that are expert in the field of financial inclusion and represent, or work with, low-income and vulnerable consumers.

We urge you to oppose the introduction of any amendment that would introduce an interest rate ceiling in the UK. We believe that rather than delivering cheaper credit to low-income borrowers, it would instead exclude from the credit market those who already have little choice.

Supporting Organisations:

Advice UK

Association of British Credit Unions Ltd

Geoffrey Cooke, Member of the Financial Inclusion Taskforce

Institute of Public Policy Research

National Consumer Council

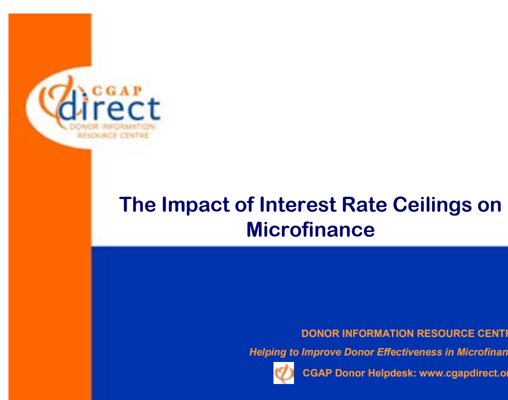
Professor Elaine Kempson and Sharon Collard, Research Fellow, Personal Finance Research Centre, University of Bristol

Which?

Domain experts on micro-lending are embarked on an educational campaign to demonstrate that rate ceilings are damaging to the interest of the poor

This is the stance adopted also by the World Bank and the CGAP (the Consultative Group to Assist the Poor – An association of 33 development agencies set up as a global resource to support the development of a sustainable micro-finance sector and best practice lending in poor communities) who both advise against rate ceilings as damaging to the interests of the poor and poor communities. Exhibit B shows the opening and closing slides of a presentation given by CGAP staff as part of its educative mission to donor bodies and nations which summarises its position on rate ceiling as damaging to the interests of the poor.

Exhibit B: CGAP Educative presentation to donors on impact of rate ceilings



Summary

- Interest rate ceilings generally hurt the poor
- The most powerful mechanism for lowering interest rates in microfinance is competition
- Greater efficiency and scale can also lead to lower interest rates
- Alternatives to interest rate ceilings include consumer protection laws and transparent disclosure of loan costs
- Donors should foster competition and growth and promote consumer protection measures

The US has also featured something of a polarised debate with activist lobbyists facing challenges from Federal Reserve studies rather than lenders

The US is perhaps the most important market for considering regulatory approaches to payday in that is the major territory where payday lending is a key source of high cost credit. The debate in the US has seen considerable high profile campaigning by activist groups focused on the payday lending industry who have gained significant media traction in the process. These campaigners have sought to assimilate issues around small sum credit and payday lending within the umbrella term "predatory lending"[17]. Such approaches and the premises on which they are based are increasingly being challenged by evidence-based researchers from, among others, the Federal Reserve Banks of Chicago and New York, and various academics and domain experts[18].

US regulators have taken a pragmatic approach and are largely seeking to control and regulate payday rather than eliminate it

Whatever the tenor or merits of the background debate, in practical terms regulators in the US have taken a pragmatic approach and are largely moving to control and regulate payday lending rather than seeking to eliminate it, with legislation introduced to facilitate payday lending now in a good majority of states. As the payday industry has grown and matured, driven by consumer demand, the regulatory trend has been to seek to embed best practice and eliminate unfair and exploitative practice rather than to create conditions which make it difficult for the lenders to operate. The trend in recent years has been for the various states to put in specific "payday enabling" provision relating to small sum loans, with a gradual increase in the number of states adopting this approach to the point where some 37 states now have such provision[19]. It would seem that the most recent political climate surrounding the subprime crisis has led to an overall tightening of conditions imposed on payday lenders, however, so that the broader trend just described may suffer some reversal[20].

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[17] Predatory lending has a pejorative connotation and is more usually associated with the sub-prime mortgage market and a set of quasi criminal activities in which mortgage lenders knowingly set out to exploit consumers, in the clear expectation of a negative outcome for the consumer which will benefit the lender. The classic example might be mortgage funds advanced to a borrower with no real prospect of repayment, in the expectation of ultimate repossession and sale of the property at a significant profit.

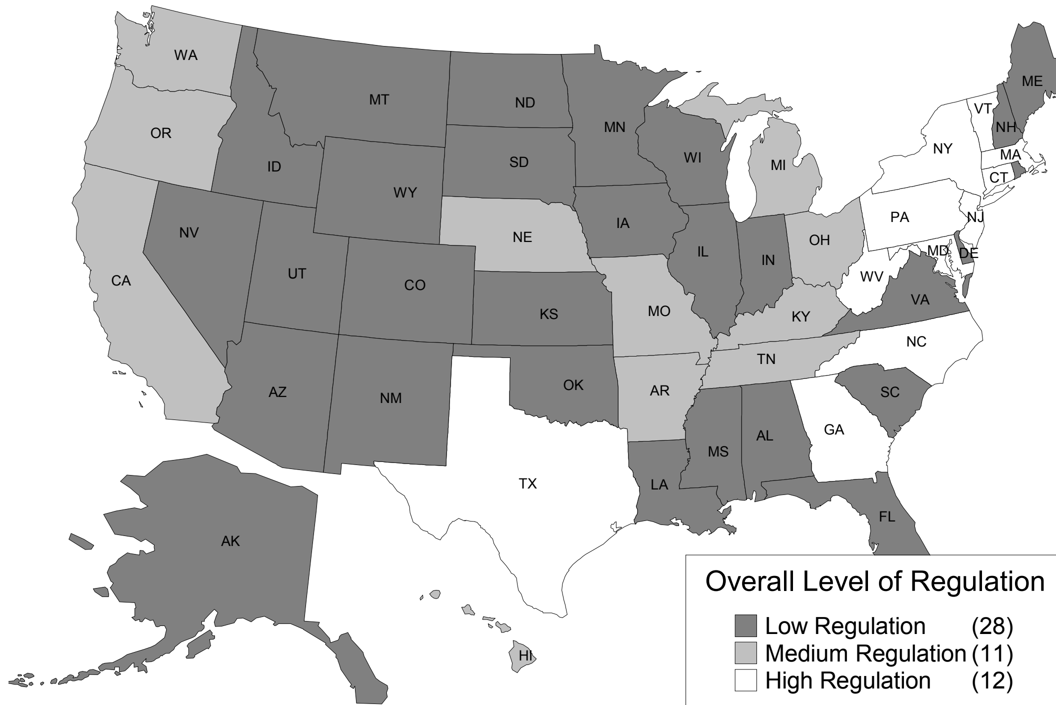
[18]Morgan, New York Federal Reserve Staff Report no 273 (2007), *Defining and Detecting Predatory Lending*;
Morgan and Strain, New York Federal Reserve Staff Report no. 309 (2007) *Payday Holiday: How Households Fare after Payday Credit Bans*
Federal Reserve Bank of Chicago (accessed 20 February 2008) *Controlling Interest: Are Ceilings On Interest Rates a Good Idea?* http://www.chicagofed.org/consumer_information/controlling_interest.cfm.
Staten, George Washington University (2007) The Impact of Credit Price and Term Regulations on Credit Supply. Elliehausen, Credit Research Center Working Paper #69 (2006) *Consumers' Use of High-Price Credit Products: Do They Know What They Are Doing?*; Durkin & Staten (2002) *The Impact of Public Policy on Consumer Credit;* Mann *(2006) Credit Cards, Consumer Credit and Bankruptcy.*

[19] The main form of regulation has been specific provision for small sum credit, usually relating formally to "deferred presentment" allowing payday subject to conditions, the principal of these usually being a maximum fee on a $100 loan. There are 5 more states with specific enabling regulation than there were at the beginning of 2004 (32 compared with 27 four years ago). This is the balance of 6 states introducing legislation and 1 which previously had enabling legislation making payday lending near impossible in September 2007 (Washington DC is treated as a state for the purposes of these calculations).

[20] In July 2007 the state of Oregon tightened the conditions of operation to the extent that most payday operators are expected to withdraw. In addition, Ohio was considering proposals in early 2008 which would make payday lending uneconomic in the state and the South Carolina senate was considering a bill tightening operating conditions for payday lenders although it rejected an outright ban.

Legislation enabling payday lending either by general small loans provisions or specific legislation facilitating payday have been introduced in 37 states

Figure 1: Overall Level of Regulation in Consumer Credit Market in 2008, US States

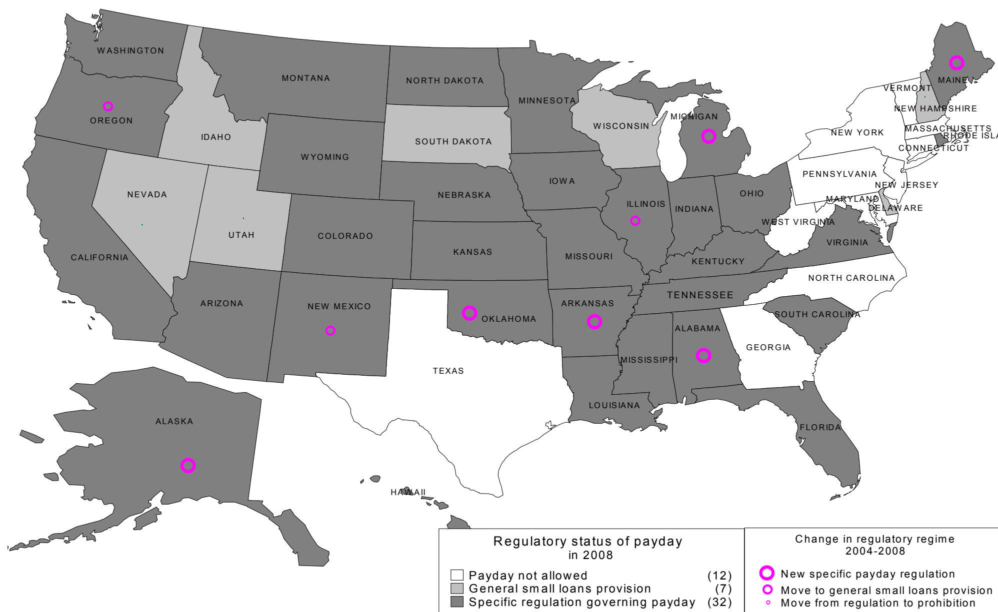


Classification Rules:

1. Maximum small loan APR ≥30% and payday lending allowed = "Low Regulation"
2. Payday lending illegal = "High Regulation"
3. Neither 1. nor 2. = "Medium Regulation"

There is something of a regional skew in approaches to Payday lending with the broadly less affluent states more inclined to facilitate payday

Figure 2: Regulatory status of Payday in 2008



The UK government decided against the introduction of an interest rate ceiling in the 2006 Consumer Credit Act

Extensive consumer research in countries with and without rate ceilings undertaken for the Department of Trade and Industry[21] to inform the UK 2006 Consumer Credit Act was part of an evidence base that informed the UK government's conclusion that a rate ceiling would create credit exclusion among the poor and that it would also open the door to unregulated illegal lenders (some of this evidence is reviewed in sections following). In response to lobbying from the credit union sector who had found their ability to serve high risk borrowers constrained, the same Act doubled the interest rate ceiling applicable to social lending, the only rate ceiling that does now pertain in the UK.

An enquiry by the competition authorities also came out against a ceiling and took the view that APR an unhelpful measure of the cost of small sum credit

The issue of the high cost of home credit was also the focus of an exhaustive two year enquiry by the Competition Commission. This concluded that there was a lack of effective competition in the market[22,] The Commission further took the view that APR was an inappropriate – and from the consumer perspective unhelpful - measure for describing the relative cost of small sum credit, whether in relation to other small sum credit loans or in relation to comparisons with the cost of other credit vehicles. The Commission instead preferred the Total Cost of Credit (TTC) as the most appropriate measure for low value loans over short periods. Remedies put in place include compulsory data sharing between lenders and measures to stimulate price sensitivity among consumers through provision of facilities for price comparison. Significantly, however, the Commission took the view that a price cap carried too great a risk of increasing illegal lending and thus of damaging both those who might fall victim to illegal lenders and the wider communities in which lenders might operate.

Significant effort has been focused on creating social credit alternatives to high cost credit but these remain small relative to high cost credit

A light touch approach to regulation has been accompanied by a parallel focus on creating social credit alternatives to high cost credit, in the form of third sector not for profit lending and the Social Fund, which provides small sums in the form of interest free advances on welfare payments repaid by direct deductions through the benefits system. Despite significant expenditure on the Social Fund – available only to certain categories of welfare recipient - and considerable effort focused on growing social lending in the form of credit advanced by credit unions and CDFIs, social credit remains small relative to commercial high cost credit[23].

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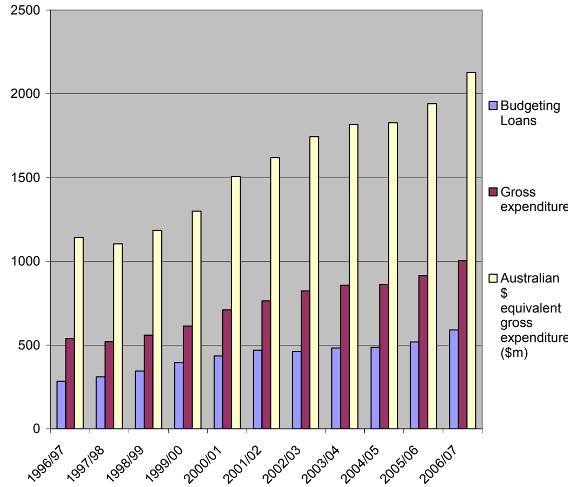
[21] Policis for the DTI (2004) *The effect of interest rate controls in other countries*

[22] The Inquiry ruled that consumers were being charged £7 more for every £100 borrowed than would the case in a competitive market. It is worth nothing a further aspect of this judgement for the cost of delivery of expensive credit in the implication that the total credit charge for a £100 could be as high as £58 and still be consistent with a normal range of profits in a normally competitive market.

[23] The Credit Working Group of the Financial Inclusion Task Force seeks to build scale and sustainability in third sector lending, with a vision of some £400m p.a. lent to 1m customers p.a. in all 200 UK local authority areas with a need for affordable credit. It is recognised that this may take some 10 years to achieve, however. The Working Group estimates the need for affordable credit to be £1.2b lent to 3m borrowers p.a. Source: *Towards a step-change in 3rd sector lending coverage and capacity*. Report of the third sector credit working group of the Financial Inclusion Task Force, 2008. The UK's Competition Commission Inquiry into the high cost home credit sector found that it served some 2.3m customers p.a, lending £1.5 bn in 2004.

Interest free Social Fund budgeting loans represent an important source of credit for welfare recipients

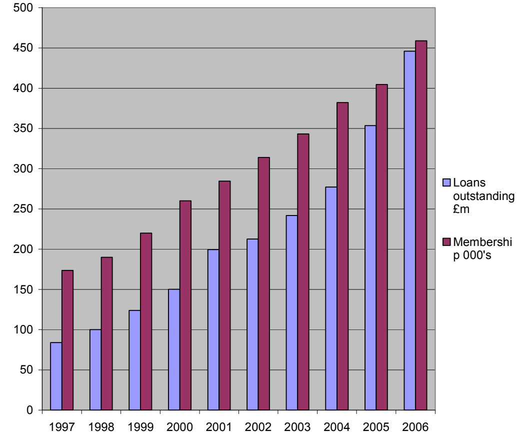
Chart 1: Trends in UK Social Fund advances on Budgeting Loans and gross expenditure year 1996/97-2006/7
Australian $m equivalent and UK £m



Source: DWP

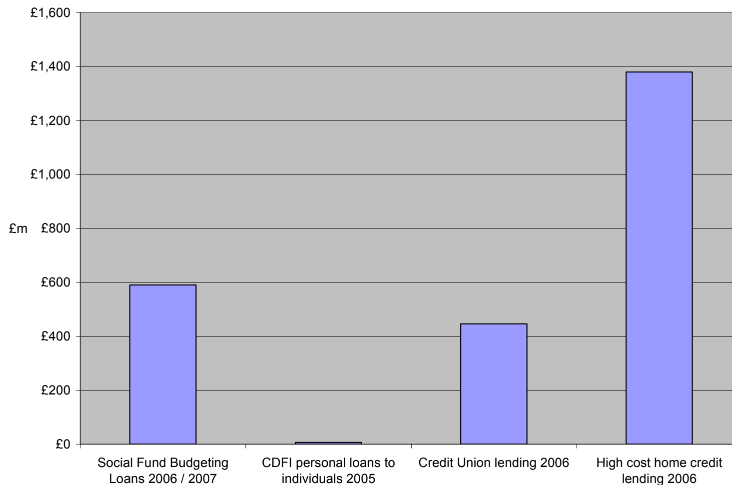
The UK government has devoted significant effort to stimulating growth in not for profit lending

Chart 2: Growth in UK credit union lending and membership 1997 - 2006



Social lending remains small relative to the high cost credit sector

Chart 3: Value of Social Fund lending, Credit Union lending, Community Development Finance Institutions lending to individuals, high cost Home credit lending in the UK 2006



Source: DWP, CDFA, ABCUL, Home Credit Lenders Reports and Accounts

Overall the thrust of regulation on both sides of the Atlantic has been to regulate and control high cost lending while increasing consumer protection

Taken together therefore, the overall thrust of regulatory activity in relation to high cost credit in both the UK and US has been to come down in favour of regulating and controlling this type of lending, while strengthening consumer protection and seeking to create an environment which fosters competition as the key to reducing prices. In the UK, though not in the US, recognition of the role of high cost credit is paralleled by an effort to create social alternatives to it.

4.0 The demand side dimension – why low income households borrow and the role of small sum cash credit

Summary

- Demand for credit among those on low incomes is shaped by an irreducible need to borrow, most pronounced among families.
- The same patterns of irreducible demand can be demonstrated internationally at remarkably consistent levels, with Australia in line with other markets.
- Credit, particularly small sum credit, is used by low income households primarily for essentials and to ensure the effective functioning of household finances.
- Payday lending is used, both in Australia and internationally, primarily by low to middle income borrowers in work:
    - Majority of users have other credit options and payday is used alongside other borrowing to meet a specific need for short term small sum credit.
    - Key source of credit for those on lowest incomes and the third of payday users for whom this kind of lending is their only source of credit.
    - There is no evidence that payday lending is creating a debt spiral, indeed users employ payday loans to manage through, and avoid, difficulties.
    - Payday borrowers themselves take the view that, despite the high cost of credit, payday lending works to ameliorate and prevent financial difficulties.
- Increasingly, mainstream credit users are fed into the non standard sector as a result of adverse credit history.
- A significant minority of low income Australians already encounter difficulties in accessing mainstream credit.
- Credit exclusion creates hardship and leaves individuals exposed to cash crises and prevents them obtaining items that they need.

Understanding how a rate ceiling might play out in Australia requires some understanding of the role that credit plays in the lives and finances of those on low incomes and the mainstream credit excluded.

Credit has an important role to play for all households in facilitating cash flow and funding major purchases but is most important for those on low incomes

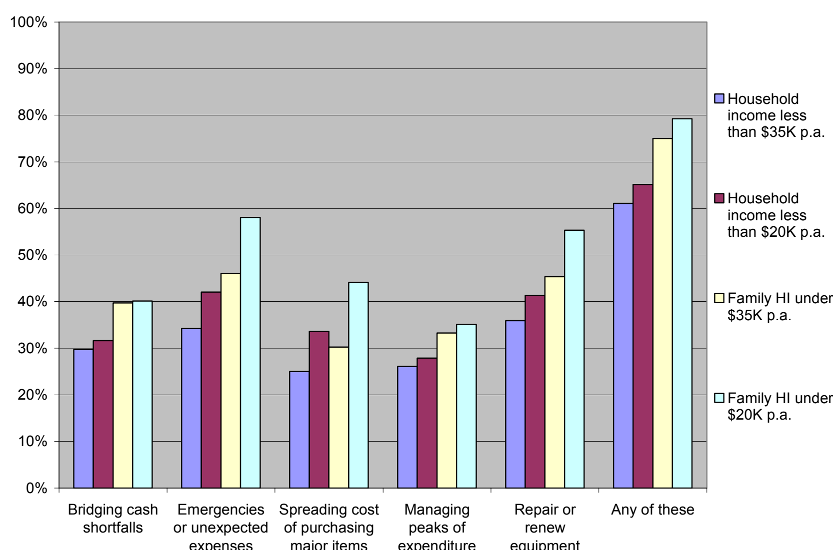
There would appear to be an irreducible need for credit, particularly among low income borrowers, who have no savings safety nets. For all credit users, credit has a role to play in facilitating cash flow and managing peaks of expenditure, spreading the cost of large purchases and enabling the leverage of income to acquire assets. The balance between these various applications tends to vary between more or less affluent credit users. Some credit use is clearly discretionary, supporting spending on entertainment or holidays for example. Other applications for credit are critical to the effective functioning of household finances, being able to make ends meet through expensive times of year, for example, repairing or replacing essential equipment in the event of breakdown or meeting cash emergencies and dealing with unanticipated expenses. Alternatively, households may spread the cost of purchasing high ticket but essential items that they would otherwise be unable to afford. The more affluent the individual, the more likely it is that credit is used to create assets or to fund discretionary spending. For those on low incomes, however, the role of credit is weighted towards essentials and managing cash flow.

Many low income households would find it difficult to accommodate a series of commonly experienced financial pressure points without borrowing

Many low income households in Australia depend on credit to manage their finances and to help them through the many common financial pressure points experienced throughout the year and would find it difficult to manage without borrowing. Eight out of ten family households would have difficulty in managing at least one of a number of the most common financial pressure points without borrowing. Four in ten (42%) of households with income of less than $35,000p.a. say they find it difficult to deal with unanticipated expenses or cash crises without borrowing. A little over a third (34%) find it difficult to buy things they need but can't afford to pay for all at once without borrowing. Three in ten (28%) could not repair or renew major items around the home without borrowing, and a similar proportion have difficulties in managing peaks of expenditure without borrowing. Almost a third (32%) have to borrow to make ends meet when they run short of cash. These stresses are most keenly felt by family households, for whom borrowing plays a key role. Nearly six in ten of those with families and household income of less than $35,000 p.a. would find it difficult to manage a cash emergency without borrowing and 55% would be unable to renew or repair essential equipment without borrowing.

Low income households, particularly families will find it difficult to manage through a range of situations without borrowing

Chart 4. Pressure points in managing household finances that credit required to fund by income and household type
% saying find difficult to cope without borrowing for each eventuality



Base: Low income households in Australia
Source: Synovate Research for Policis, 2008

Six out of ten low income families are unable to manage relatively minor cash crises without borrowing and two thirds cannot save for a major purchase

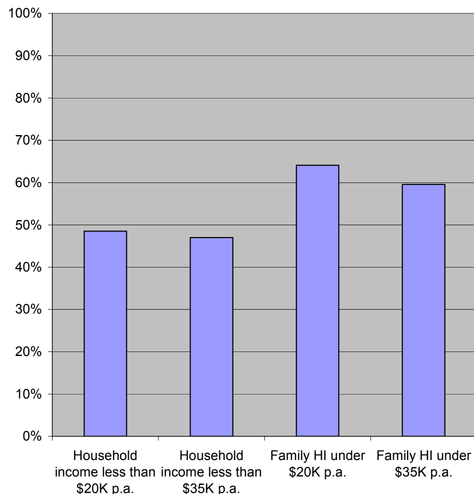
If the need for credit is measured by the need to borrow there would appear to be an irreducible need for credit in a high proportion of low income households. Almost half of consumers in both households with income less than $20,000 p.a. and households with less than $35,000 p.a. (49% and 47% respectively) say that they would find it difficult or impossible to raise $500 – 700 in an emergency without borrowing. Six out of ten in both income ranges would find it difficult or impossible to save $1000 for a special purchase. Again, this pattern is strongest in family households where there is greater pressure on household budgets. Six out of ten family households with income

of less than $35,000 would not be able to raise $500- 700 in an emergency without borrowing with almost two thirds unable to save $1000 for a major purchase. Similar patterns and similar levels of need for credit have been found among low income households in other markets.

A majority of low income households have neither savings safety nets nor the means to fund the purchase of big ticket items

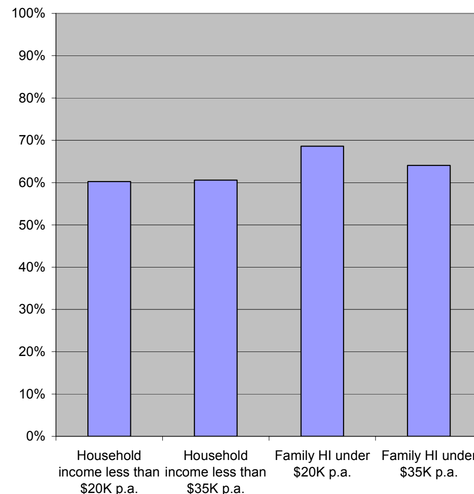
Charts 5a and 5b. The need for credit, by income and household type

% would find it difficult or impossible to raise $500 – 700 in an emergency



Base: Low income households in Australia
Source: Synovate Research for Policis, 2008

% would find it difficult or impossible to save $1000 for a major purchase



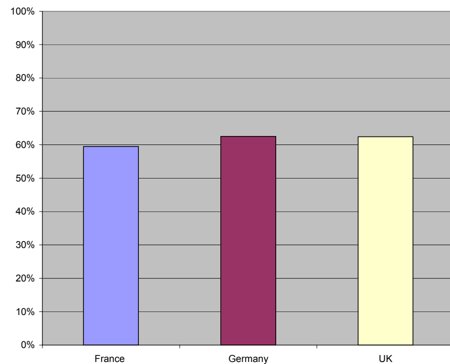
Base: Low income households in Australia
Source: Synovate Research for Policis, 2008

International comparisons indicate an irreducible need for credit with levels of demand strikingly consistent among low income households

The case that there is an irreducible level of need for credit is further strengthened by comparing the domestic situation with data from the international markets, where very strikingly similar patterns emerge. In the lowest income quintile in the UK France and Germany six out of ten households would find it difficult to raise the equivalent of AUS $500 – 700 in an emergency and more than three quarters would find it difficult or impossible to save the equivalent of $1000 for a special purpose.

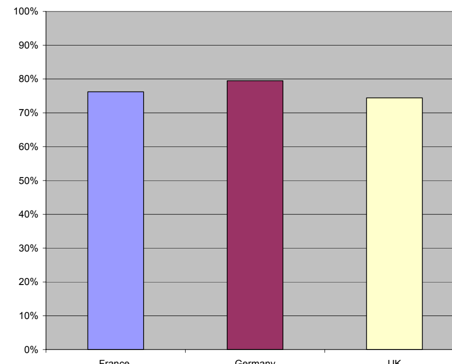
Demand, as measured by the need to borrow, is strikingly consistent across territories

Chart 6: Able to raise A$500 - 700 for cash emergency without borrowing



Base: All in lowest quintile of household income
Source: Taylor Nelson Research for Policis 2004

Chart 7: Able to save A$1000 for a special purpose without borrowing



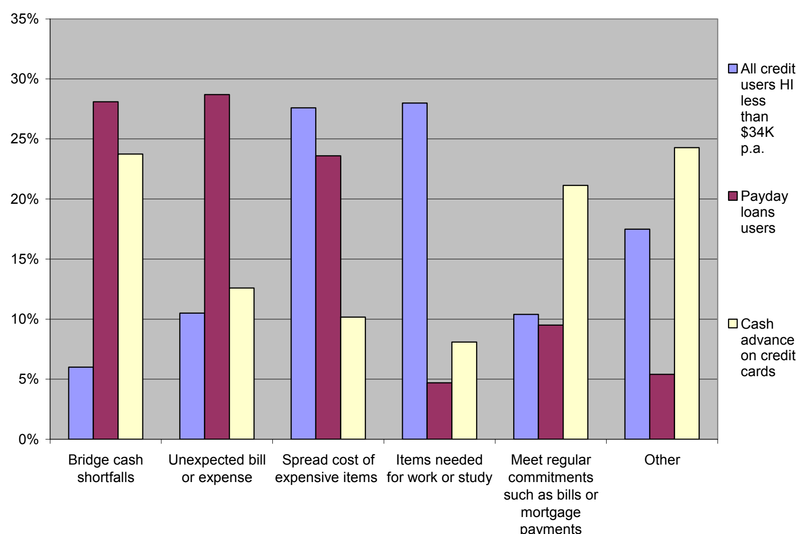
Base: All in lowest quintile of household income
Source: Taylor Nelson Research for Policis 2004

Patterns of small sum cash credit used by low income households in Australia reflects these borrowing needs

Small sum credit appears to be playing a more important role in smoothing peaks of expenditure and enabling cash flow through crises than other types of credit. Slightly less than one in three (28%) loans could be described as distress borrowing, with cash loans being used to make ends meet or for a cash emergency. A similar proportion (29%) is used for managing unexpected bills and expenses and is more likely to be used for this purpose than other types of credit. A similar proportion of payday borrowing is used to spread the cost of major purchases (24%) and to keep up with regular commitments and bills (9%) as is the case with other forms of credit used by those on low incomes. Cash advances on credit cards are particularly likely to be used to bridge cash shortfalls or to meet bills, rent or mortgage payments that might otherwise be missed.

Payday loans and cash advances on credit cards are key to keeping on top of bills and managing cash flow

Chart 8. Application of small scale cash credit



Base: Low income Payday loans users in Australia
Source: Synovate survey of Payday users for Policis, 2008

Payday borrowers themselves take the view that despite the high cost of credit payday lending works to ameliorate and prevent financial difficulties

The evidence suggests that, on balance, users of payday lending in Australia believe that use of high cost credit benefits their financial management rather than the reverse. More than twice as many payday borrowers on low incomes felt that if they didn't use payday lending they would be more likely to get into financial difficulties (42%) than felt that they would be less likely to get into financial difficulties (19%), with the proportion who believed they would be more likely to get into trouble financially rising to six out of ten for those who had no other credit options. This group were also twice as likely to believe that they would have trouble affording essentials if they didn't borrow from payday lenders (48%) as believed they would find it easier to afford essentials (24%). Four out of ten low income payday users claimed that they were more likely to miss paying bills or be unable to meet commitments compared to a little over a quarter (28%) who felt they would be more likely to be able to keep up with bills. Six out of ten of those who had no other credit options felt that they were more likely to fall behind on bills and commitments if they didn't use payday lending. When asked whether, given the high cost of borrowing in this way as well as the flexibility it afforded, payday lending had a positive or negative impact on household finances, three quarters of payday borrowers were of the view that payday had a positive impact on finances, a view most strongly felt by those without other credit options.

Payday users believe that the withdrawal of payday borrowing will make it more difficult to manage their finances and keep up with commitments

Impact of withdrawal of payday lending on ability to keep finances on track

Chart 9a. Ability to afford essentials without payday lending:
Easier/More difficult

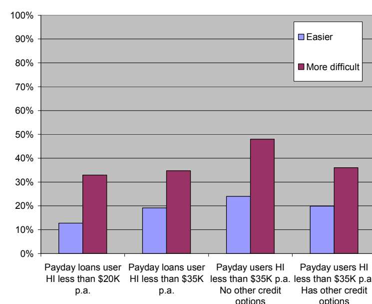


Chart 9b. Likely to get into trouble financially without payday lending:
More likely/Less likely

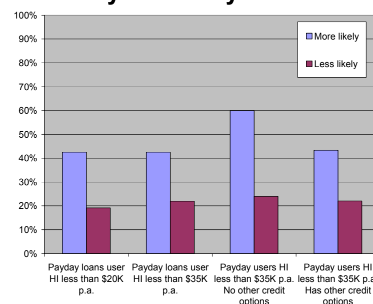
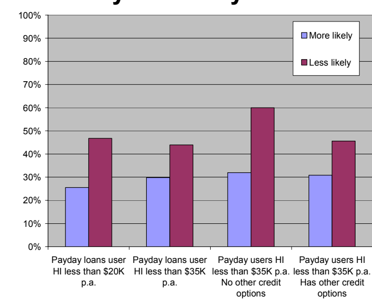


Chart 9c. Able to keep up with bills and commitments without payday lending:
More likely/Less likely



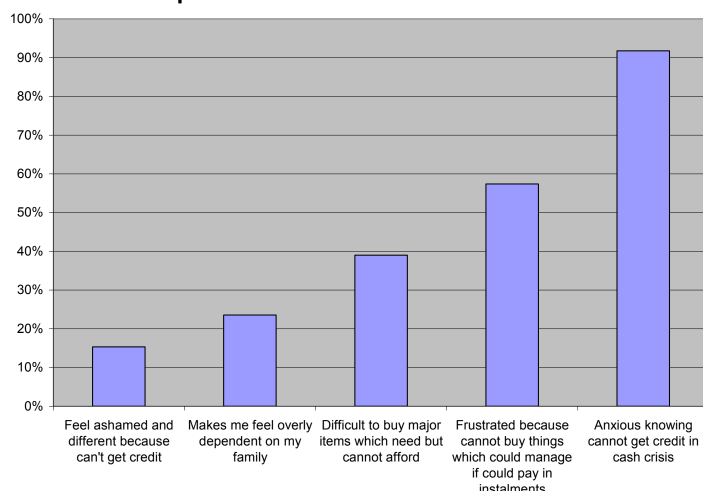
Base: Payday users with household incomes of less than $35,000 pa, Australia

The experience of credit exclusion in Europe suggests that it creates a pervasive sense of anxiety and prevents individuals obtaining items they need

Evidence of how a restriction of supply potentially arising from the impact of some form of price control might impact low income households in Australia is perhaps provided by the experience of excluded low income households in Europe. More than nine out of ten feel anxious knowing they cannot get cash credit in a crisis and six out of ten suffer frustration from not being able to buy things which they could afford to pay for if they were able to spread the cost of purchase. Four out of ten have to do without major items which they need but cannot afford. Almost a quarter feel overly dependent on their family.

The evidence from Europe suggests that credit exclusion results in hardship

Chart 10: The impact of credit exclusion



Base: All in lowest quintile of household income
Source: Taylor Nelson Research for Policis 2004

The evidence suggests an irreducible need for credit

Taken together, the evidence would appear to suggest that there is an irreducible level of demand for credit, and particularly small sum credit, among low income households. This can be observed not only in Australia but in other markets, with a remarkably consistent level of demand evident across territories. This would tend to indicate that the pressure of competing priorities on tight budgets is part of the universal experience of those living on low incomes.

Small sum credit is playing a key role in financial management – loss of access would seem likely to create hardship and even financial difficulty

Small sum credit, whether in the form of cash advances on credit cards or payday lending is being applied to a full range of essential applications to enable households to manage common pressure points but is more likely than other types of credit to be used to manage through cash flow shortfalls or unanticipated expenses. Those using payday loans take the view that this kind of short term credit supports keeping their finances on track, rather than the reverse. Without access to small sum credit, borrowers would be likely to suffer hardship and may have trouble avoiding financial difficulties.

5.0 The impacts of interest rate ceilings on credit supply

The impacts of interest rate ceilings on credit supply

- Lenders cannot afford to cross subsidise high risk borrowers without risking their competitive position.
- In markets without price controls specialist lenders meet demand for small sum credit, typically provided at high cost to high risk borrowers.
- Such lending models do not develop or lenders withdraw in markets where price controls are introduced.
- The impact of price controls is evident in both the diversity of credit products offered in a market and in the extent of credit rationing.
- Where ceilings are effective in containing price, lenders withdraw from markets where they cannot lend profitably.
- Lenders in these markets also set minimum lending levels higher than is appropriate to the needs of low income households and high risk borrowers.
- The constrained credit product mix in price capped markets leads borrowers to use products which are less suited to their needs and expose them to greater risk
- Where ceilings are imposed those without options are diverted to pawn – and illegals – while others are primarily diverted to mainstream revolving credit.
- Illegal lending tends to arise in a credit vacuum, is frequently associated with other criminal activity and is both very high cost and damaging to victims

These effects are readily observed in markets with and without ceilings, as are the differences in outcomes for consumers.

UK

- The picture of credit use among low income households in the UK is close to that of their counterparts in the domestic Australian market.
- Wide mix of credit products used by low income consumers with majority of those using high cost non standard lending also using mainstream credit.
- Minimal credit exclusion, largely because of presence of high cost lenders lending to high risk borrowers who would otherwise have no credit options.

US

- In states with ceilings, there is clear exclusion of the highest risk borrowers and the unbanked. Total lending falls, rising for revolving credit and pawn.
- Clear diversion effects: Total debt per head for those still able to borrow identical in states with and without ceilings, but share of debt represented by different credit vehicles varies significantly between states with and without ceilings.
- Levels of delinquency and default are higher in states with ceilings as is the incidence of credit related over-indebtedness and insolvency, with this effect exacerbated with down-turns in the economic cycle.

Europe (as represented by the largest credit markets of France and Germany)

- The French and German markets are shaped by rate ceilings but have evolved in different ways because of differences in emphasis in the regulatory framework.
- Both feature the narrow credit product mix typical of rate capped markets
- Illegal lending is much higher in the rate capped markets of France and Germany than in the UK, where there is no ceiling.

Germany

- Germany features high levels of credit exclusion among those on the lowest incomes and high potential risk borrowers.
- The social banking sector, with a social remit intended to compensate for price controls, has moved upmarket.
- Regulatory disincentives to default have led to a risk-averse lender set unwilling to tolerate the delinquency associated with revolving and card based credit.

France

- The French lenders have used revolving credit aggressively to extend their penetration of lower income households.
- The resulting account delinquency has resulted in the long term financial exclusion of large numbers of low income borrowers.

Japan

- In the wake of the recent sharp reduction of the rate ceiling, acceptance of consumer loan applications has fallen by close to two thirds in two years.
- This has been accompanied by rapid growth in illegal lending, in large part run by organised crime.
- Bankruptcies have risen sharply as consumer credit has been withdrawn from higher risk borrowers. Bankruptcies had previous shown a trend decline

Australia

- The prominence of cash advances on credit cards as the leading source of cash credit for low income Australians suggests a rate ceiling in Australia will create a shift from a UK style market to a French style market as borrowers move from high cost short term credit to revolving credit.
- This would seem likely to result in an increase in account delinquency and default and thus in both credit exclusion and insolvency.

It is sometimes argued that interest rate ceilings will cause lenders to cross-subsidise high risk borrowers but this is unlikely in modern credit markets

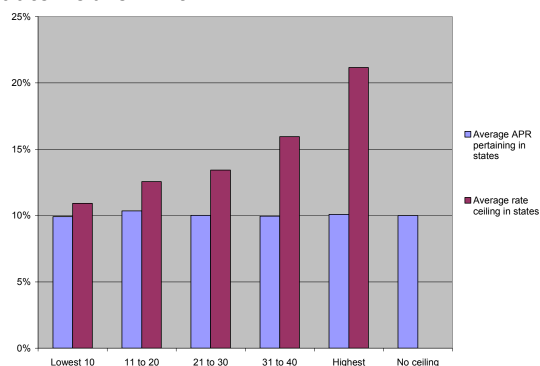
There are a number of points to make about the impact of rate ceilings on credit markets and credit pricing. Perhaps the most fundamental of these is that it is competition not interest rate ceilings which is the most important determinant of consumer pricing. The view is sometimes put forward that interest rate ceilings will allow, or force, lenders to operate a degree of cross subsidy between more or less high risk borrowers in order to accommodate the ceiling without shrinking the amount of credit supplied, an effect which would cause prices to drift towards ceilings wherever these were in place. However the evidence is unequivocal that this is not the case and that interest rate ceilings only impact the supply and price of consumer credit to high risk, usually lower income borrowers. Provision to low risk borrowers and pricing on mainstream credit products is not impacted in any discernible way because in an intensely competitive environment lenders cannot afford not to offer the most competitive rate.

Lenders cannot afford to cross subsidise high risk borrowers without risking their competitive position

A highly influential exercise was undertaken in the US in 1971 for the US National Commission on Consumer Finance in which credit prices for what was taken to be a typical mid range value personal cash loan and what was taken to be a typical higher value personal auto loan were checked across states, with and without rate ceilings. Regardless of the interest rate ceiling applying in each state, the research revealed near identical prices. The Commission concluded that rate ceilings do not influence the price of credit for low risk borrowers. Policis repeated this exercise for the UK Department of Trade and Industry (DTI now the Department of Business, Enterprise and Regulatory Reform BERR) in 2004, as part of their investigation into the impact of rate ceilings in the US states to inform the framing of the UK Consumer Credit Act. However, a check on the prices of 2,240 mainstream personal and auto loans in fifty states again revealed near identical prices on a $3,000 personal loan and a $12,000 auto loan, regardless of the rate ceiling operating in each state. The consistency of the result over a more than thirty year period in which credit markets have evolved substantially would appear to indicate that there is little scope for lenders to operate cross subsidy in highly competitive markets, and that this is particularly unlikely in modern, technology-driven, finely segmented credit markets.

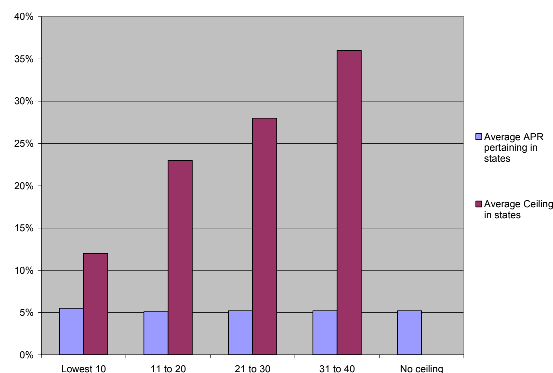
The evidence over a 30 year period suggests that competition rather than rate ceilings determine the price for mainstream credit

Chart 11: $3,000 36 month loan for new automobile in 1971



Source: National Commission on Consumer Finance 1971

Chart 12: $12,000 36 month loan for new automobile 2003



Source: Bankrate.com 2003

Interest rate ceilings therefore impact only high risk borrowers and lenders will lend only where they can achieve an acceptable price for risk

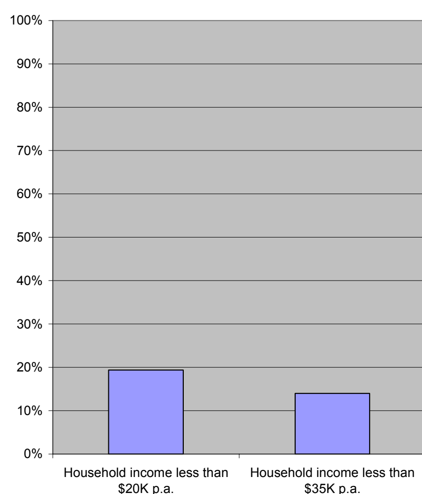
We here seek to throw some light on the likely profile of the population that might be impacted by price controls and to understand the potential scale of the effect. As demonstrated in Charts 11 and 12 preceding, in the absence of any potential for cross subsidy, the impact of a rate ceiling will fall exclusively on higher risk, mainly low income borrowers. From a supply side perspective, borrowers on low incomes pay more for credit because they are judged higher risk by the lenders, on the basis of their greater tendency to account delinquency and default, with lenders seeking therefore to increase the price of credit commensurately. Where lenders cannot achieve a price for credit which they judge to be commensurate with risk, they will withdraw supply i.e. if they cannot lend profitably to a given segment of the market, they are likely not to lend.

A significant minority of low income Australians already experience difficulties in accessing mainstream credit

This syndrome can readily be observed under existing market conditions. This is what occurs in the mainstream market whereby modern credit scoring techniques allow lenders to fine tune both the degree of risk they are prepared to accept and the pricing of that risk with a high degree of accuracy. There are already significant numbers of low income Australians who are experiencing rejections from mainstream lenders, either because they do not meet income or employment criteria for mainstream borrowing or because they have acquired an adverse credit history. Around a quarter of credit users with household incomes of less than $35,000 have been refused credit by a mainstream lender, rising to around three in ten (28%) of credit users, a third of those using non standard lending and one in four of those who describe themselves as likely to find it impossible to borrow from a mainstream lender currently. We estimate that around 800,000 low income Australian borrowers have been refused mainstream credit, a number likely to rise significantly in the event of the imposition of price controls. The global credit crunch has the potential to increase the numbers encountering difficulties in accessing mainstream credit substantially.

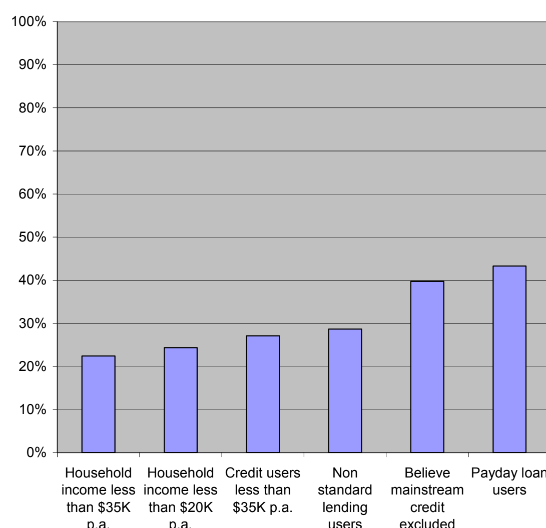
As credit use has expanded and higher risk borrowers have gained access to new credit products, an increasing number are acquiring adverse history

Chart 13a. Perceived lack of access to credit mainstream
% believing could not borrow in credit mainstream currently



Base: Low income households in Australia
Source: Synovate Research for Policis, 2008

Chart 13b. Mainstream credit refusals by borrower type and by income
% experienced refusals from mainstream lender



Base: Low income households in Australia
Source: Synovate Research for Policis, 2008

In markets without price controls specialist lenders have emerged to meet demand for small sum credit, typically provided at high cost

In markets without price controls specialist non standard lenders have tended to emerge to service those borrowers whom the mainstream lenders are unwilling to serve. Historically these lenders have been pawnshops, advancing cash against goods deposited and the "Tally-man", who sold goods and advanced small sum cash credit within small communities with repayment spread over many weeks, typically collected in person by the lender. These forms of credit have evolved, in some cases emerging in modern forms - home credit in the UK having grown out of the old Tallymen businesses, for example. Others have been challenged by, or are in the

process of being replaced by, new forms of credit. EBay and the rapidly growing payday lending businesses in Australia and the US, for example, are both absorbing some of the demand for small cash sums among those with constrained credit options that historically sustained traditional pawn-broking. What all of these forms of credit focused on high risk borrowers share is that they tend to advance small sums, supported by cost and resource intensive, "high touch" customer and collection management.

The scale of this "non standard" lending and the socio-economic profile of borrowers varies in line with the availability of mainstream credit

The socio-economic profile of those borrowing in this way and the scale of this type of borrowing within the wider picture of credit use tends to vary in relation to the extent of access high risk borrowers have to mainstream credit. The most dramatic example is provided by Japan. In the years immediately after the Second World War, the Japanese banks were almost exclusively focused on commercial credit as part of the national effort to re-build corporate Japan and the industrial infrastructure – and indeed have had little presence in the personal lending market until relatively recently. Japan's "salary-men", effectively very low risk borrowers with job security for life – and indeed very small businesses - had very little access to credit in any form. The credit vacuum was filled by small scale black market credit – the "Sarakin" (meaning salaryman) lenders, originally many thousands of very small scale lenders but over time increasingly consolidated under the control of organised crime in the form of the powerful Japanese "Yakusa". This was the origin of the consumer finance industry in Japan and for many years effectively represented the major part of the personal and small business lending market[24].

Some users of non standard lending switch to cheaper mainstream credit as their circumstances change or it becomes more available to them

A more pedestrian and less extreme example is provided in the UK, which has historically had relatively low levels of banking penetration among low income households, compared to its European neighbours. For many years this has limited low income high risk borrowers' access to credit in that repayments could not be made by the low cost, automated and electronic means required by most low cost models. Under these conditions the high cost home credit lenders thrived, lending small sums - with weekly payments collected in cash from borrowers' homes - to more than three million, largely working class customers. Increases in banking penetration, partly as a consequence of financial inclusion initiatives by the UK government, opened up access to the credit mainstream for the better off and more reliable end of the home credit market. As a consequence, the scale of the sector – based essentially on an ultra mature credit model - has been in gradual decline. This decline would have been significantly more precipitate, however, if it had not been for a second phenomenon occurring in parallel to the migration of some customers to new lower cost products and new channels. This phenomenon, mirrored in sub-primed markets around the world, is the influx to the non standard lending market of those ejected from the credit mainstream, by reason of their adverse history.

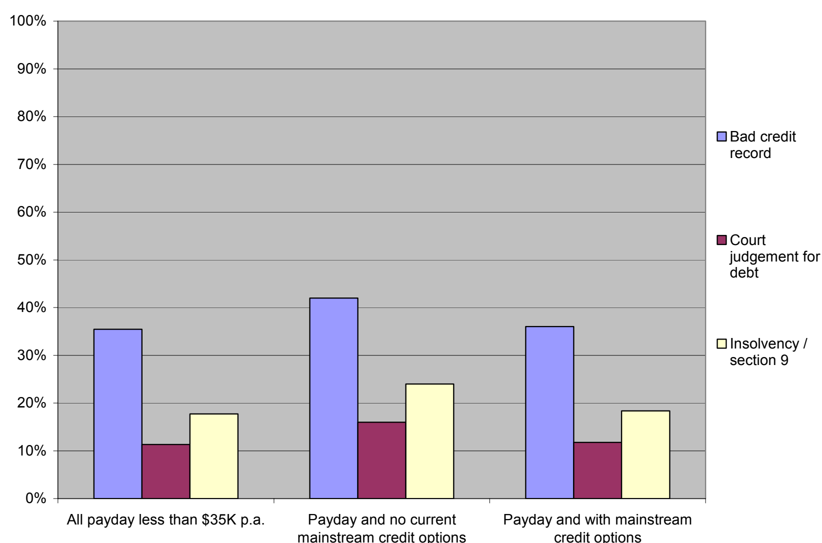
[24] These origins are a long way from the modern consumer finance industry which nowadays is dominated by a handful of large listed companies, which continue to be known as "Sarakin" lenders. The history is in large part the explanation for both the pervasive antipathy of the Japanese public to the modern consumer finance industry and the staggering scale of black market "Yamikin" lending in contemporary Japan, which continues to be Yakusa dominated.

Increasingly, however, mainstream credit users are fed into the non standard sector as a result of adverse credit history

Indeed this is one of the most important phenomena to take account of in assessing the likely impact of price controls. Increasingly in all credit markets where there is a non standard sector, mainstream credit users are fed into the non standard sector as a result of adverse credit history, most typically arising from use of revolving credit on credit cards. In the event of economic downturns or changes in the availability of credit – such as is occurring at the time of writing in global credit markets as a result of the credit crunch – this process is accelerated, creating opportunities for non standard lenders. In the event of the imposition of any shrinkage of supply in the non standard sector, the enforced shift from mainstream to non standard will rather become a transition to credit exclusion. A significant proportion of payday users in Australia are already using payday lenders because they cannot borrow elsewhere (29%). A significant minority of low income users of this type of credit in Australia also have a history of problematic mainstream debt and a significant adverse credit rating.

Problem arising with credit cards have been a major factor in creating exclusion

Chart 14. Payday users background adverse history



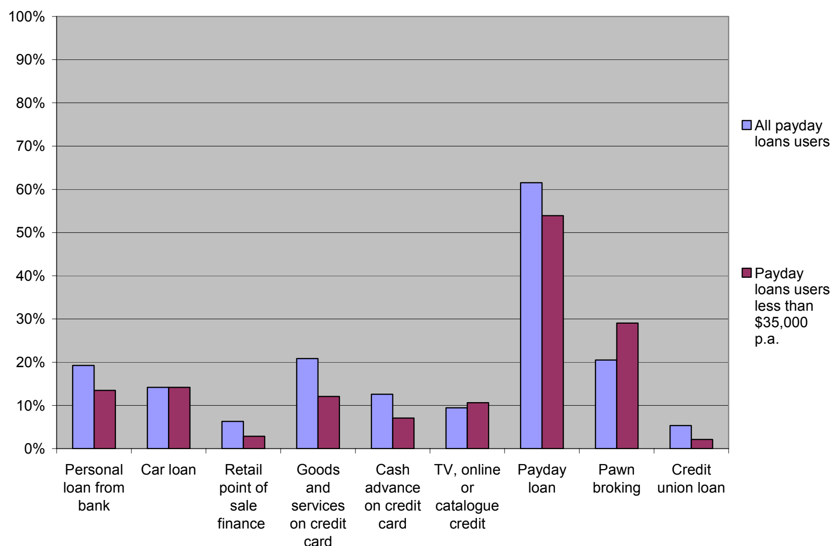
Base: Payday users with household incomes of less than $35,000 pa, Australia

In Australia, as in the UK and US, payday lending and small sum credit is used also by those with mainstream credit options

A further important factor in discussing the likely impact of the imposition of ceilings is the degree of cross-over between uses of standard and non standard lending. There is frequently a misconception that users of non standard lending have no other credit options and that users of small sum high cost cash credit are using these credit vehicles because they have no other credit options. This is true of a minority of payday lender users in Australia (three in ten as discussed earlier). However seven in ten do have other credit options and use small sum cash credit for specific purposes alongside standard lending. This pattern can be observed similarly in other credit markets where payday is a feature. In the UK and US, non standard lending is used increasingly alongside mainstream credit.

Payday loans users in Australia are using a range of other credit product types along side non standard lending

Chart 15. Types of credit products used, payday loans users



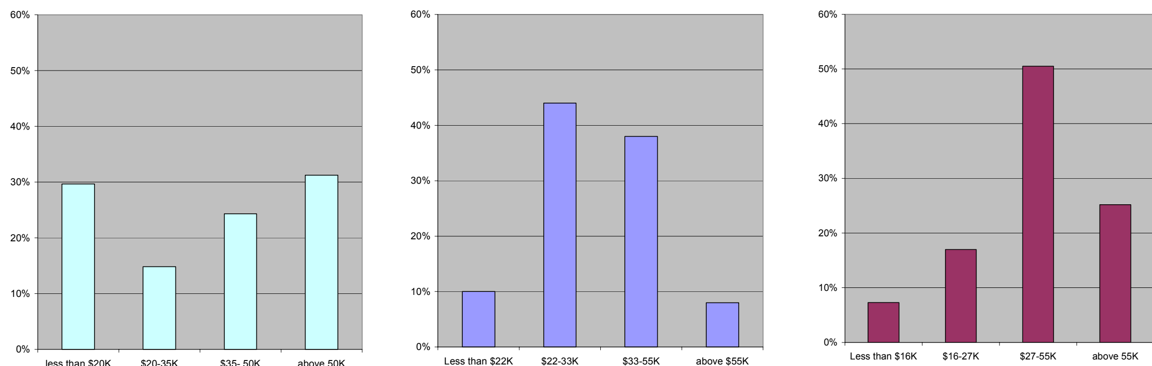
Base: Low income Payday loans users in Australia
Source: Synovate survey of Payday users for Policis, 2008

Indeed, the profile of users of non standard lending, both in the domestic Australian market and internationally, includes both relatively upmarket as well as low income consumers and those both with and without other credit options.

Users of payday loans in all of the markets where these lenders operate are primarily low to middle income workers rather than the poorest credit users

Chart 16: Profile of payday customers by income bracket in Australia, the UK and the US

% of payday customers in Australia | **% of payday customers in the UK** | **% of payday customers in the US**



Any restriction of non standard credit supply will impact low and middle income workers as much as it will the lowest income credit users

Clearly the introduction of a rate ceiling into Australian credit markets will impact high cost credit users with and without credit options very differently. As will be discussed in the sections following, the impact of the introduction of a rate ceiling will be felt not only among low income households but also among the low to middle income workers who represent six out of ten payday users in Australia.

Price controls create a number of rationing and displacement effects which have a significant impact on credit use and the outcomes of credit use

The impact of rate ceilings can be observed both in those markets where rate ceilings have been introduced and in those markets where they have been in place for an extended period. Credit rationing, whereby those seeking credit are unable to obtain it because lenders are unwilling to lend within the price constraints imposed by an interest rate ceiling can be observed both in markets where ceilings have been newly introduced and those where they have been a feature for a long time. Examples of both phenomena are provided in examples drawn from the US and Japan (see paragraph following), in the wake of newly imposed ceilings and in Germany, where ceilings, albeit those imposed by the courts rather than by statute, have been in place for many years.

Price controls create credit rationing and constrain the diversity of products in a market

Price controls result not only in rationing but also impact on the diversity of credit products in a market and patterns of use of different credit product. Given a free choice in a free market, borrowers will choose to use non standard products alongside products from the credit mainstream. In markets where choice is constrained – or more strictly where supply has been rationed and the product range available edited to accommodate price restrictions – the pattern of product use is markedly different. So too, as we will show in following sections, are the outcomes for consumers.

Credit rationing occurs in the wake of a the imposition or a tightening of a ceiling

There are a number of examples around the world of lenders withdrawing from a market or rationing credit supply in the event of the imposition or tightening of price controls. This can be illustrated most dramatically in Japan following the passing of an amendment to the Money Lending Business Control and Regulation Law in December 2006. The majority of the provisions came into force in December 2007 and considerably tighten the regulatory regime governing credit suppliers in Japan. A new ceiling of 20% has been imposed instead of the 29.2% which was the effective maximum for certain types of lending previously. Further restrictions have been introduced making lenders responsible for the affordability of a loan and lenders will now need to show four times the level of net assets than previously in order to operate legally. The changes were widely flagged in advance so that their impact precedes them.

The sharp tightening of the interest ceiling in Japan has resulted in a two thirds reduction in consumer lending in a two year period

The impact of the tightening of the cap in particular has been brutal for the industry, with many players withdrawing from the market, but there has also been a clear effect on the amount of credit made available by those providers remaining. This downward pressure on availability is likely to grow as more of the new provisions are enforced. What has effectively happened is that lenders have had to narrow their risk pool, and indeed were doing so in anticipation of the new regime even before it was put in place, so that higher risk borrowers will now find it increasingly difficult to obtain credit. Applications have decreased significantly in any case due to a significant decline in marketing spend by the lenders. For those who do apply, approval rates have declined from 63% to 36% on average. The two factors

combined have resulted in a reduction in borrowing from the consumer finance industry of around two thirds in 24 months.

As lenders anticipated the impact of the forthcoming legislation loan acceptance ratios have declined precipitately

Chart 17a: Loan applications and new customer numbers Jan 06 – Nov 07

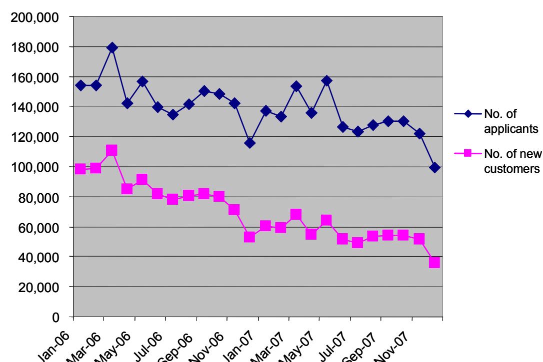
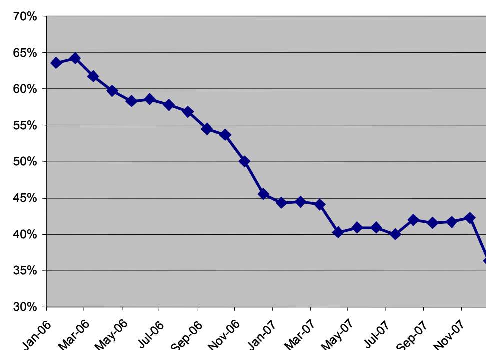


Chart 17b: Loan acceptance ratio on consumer lending Jan 06 to Nov 07



Source: "Big Four" Consumer Finance houses: Acom, Promise, Aiful, Takefuji

The full provisions of the 2007 Money Lending Business Control Law will not be fully implemented until 2009. However research[25] indicates that some more than 50% of current borrowers will be affected by the cap on individual lending, which restricts borrowing to one third of income, some 4.6 million of the 9.2 million Japanese users of consumer finance lending.

In the US where changes in regulatory conditions have made it effectively impossible for payday lenders to operate, they have withdrawn

Similar effects of supplier withdrawal have been observed in US states imposing payday bans. When Georgia legislated to make payday lending impossible in 2004, for example, although rearguard actions were fought through the courts over the year following, the whole payday industry in the state was effectively closed down nearly overnight. Bank West for example, a leading lender, offered payday loans through 89 centres in Georgia prior to 2004, all of which were closed in that year. Effects on the availability of credit to low income households will, however, have been lessened by the explosion in subprime credit cards which was happening around that time.

Lenders also set minimum lending levels higher than is appropriate to the needs of low income households and high risk borrowers

Lenders not only reject borrowers who fail the credit score required for any given lending model, they also set lending minimums at a level at which set up and administration costs are not disproportionate to the sum advanced, with this varying according to the pricing model concerned. Typically however, such levels are set significantly above where high risk low income borrowers would want to borrow. The effect of this policy is either to exclude such borrowers from the credit mainstream or to lead them to borrow more than they might otherwise. This occurs most frequently in regulatory environments where lenders are particularly risk averse (as in Germany where the mandatory reduced interest rate applied to delinquent loans has caused

[25] Research by Professor Hiroshi Domoto of Tokyo University of Information Sciences, based on an internet survey of 1100 consumer finance users, 2007. Reported in *Behavioural Analysis of Consumer Loan Users*. Regional Banks Monthly Report October 2007

lenders to avoid lending to those most likely to exhibit delinquency). It also occurs more generally in price capped environments, which, as seen in the preceding examples, result in lenders rationing credit supply to those whom they judge to be an unacceptable risk.

Those seeking small sum credit are shut out of the market where lending minimums are out of scale to needs

The following example (shown in Table 1), drawn from the German market, provides a good example of the syndrome of credit rationing and market exclusion by virtue of setting a minimum value for lending that is inappropriate for the needs of those on the lowest incomes. It is particularly significant because it relates to lending by the "Sparkassen" the mutual savings banks network set up with a specific social remit as a counter-weight to the relatively tight regulatory regime and the interest rate ceiling applied to the market in Germany. As Chart 18 and Chart 19 illustrate less than 10% of lending even to those in the lowest income quintile is to borrowers on the lowest incomes, with these individuals unlikely also to have ready access to overdraft finance. The savings bank model – and that of the Sparkassen in particular - is cited by proponents of price controls as an example of how lending institutions with a social remit can succeed in offering credit to those who might otherwise find it difficult to borrow under price capped conditions. The evidence would seem to indicate that it stops some way short of credit inclusion[26].

Table 1: Sparkassen minimum loan values are now set at a level significantly above that which a low income borrower would wish to service

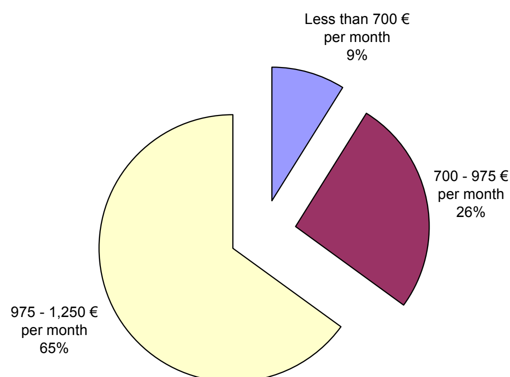
Type of Loan	Minimum loan size ($AUS)	
Allzweckkredit	4800	Berlin
Privatkredit	8100	Koln
Privatkredit	8100	Munich
Privat-Darlehen	4000	Hamburg
Sparkassen-Privatkredit	4000	Leipzig
Sparkassen-Privatkredit	8100	Dresden

Source: Sparkassen in major German cities as per table

[26] The tendency for lenders originally set up with a social remit is often to move upmarket with time and scale. This would seem to be what has occurred in Germany. The German "Sparkassen" (Savings Banks) were set up originally with a social remit but are now commercially focused. They are moving strategically away from servicing the low income customer groups which have made up their historical customer base, as this excerpt from the strategy statement in the 2003 Sparkassen annual report makes clear: "In view of the low profitability per customer, the focus of the retail business must be on minimizing costs at the given service level and maintaining standardized sales processes where this meets the customers' needs. Given that the business potential in private-sector business has often not been fully identified or only partially exploited, the focus must be on wealthy customers and customers with profit-making potential."

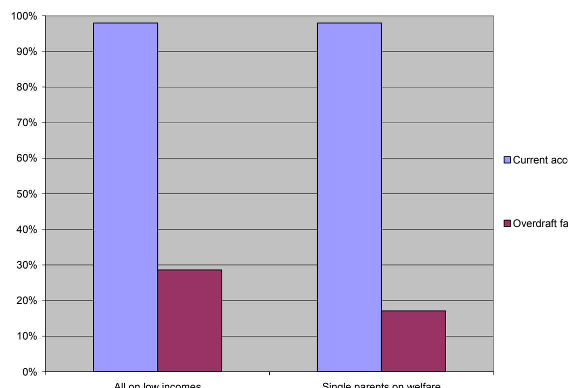
Those on low or irregular incomes will now find it difficult to borrow even from the Sparkassen, unless they are able to offer a guarantor

Chart 18: Share of Sparkassen lending to high risk borrowers by income range



Base: Low income borrowers from Sparkassen
Source: Taylor Nelson Sofres Research for Policis, 2004

Chart 19: Access to overdraft facilities among low income German consumers



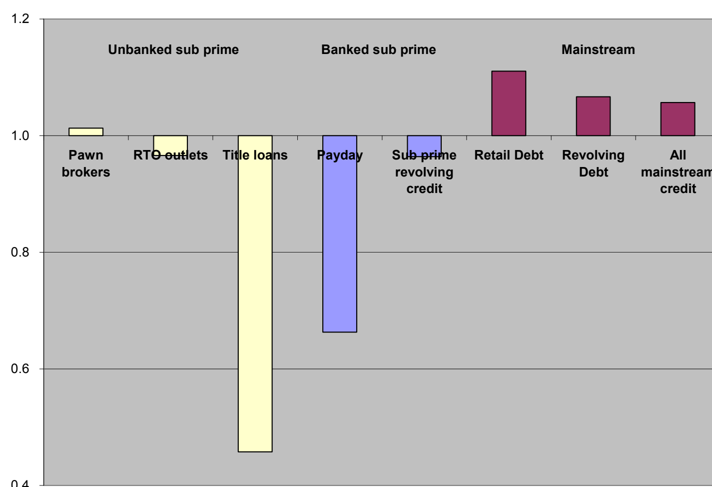
Base: All in lowest quintile of household income
Source: Taylor Nelson Research for Policis, 2004

Where ceilings are imposed those without options are diverted to pawn – and illegals – while others are primarily diverted to mainstream revolving credit

The differences between the choices which consumers make in markets in which free choice of credit products is and is not constrained by interest rate ceilings is best illustrated by comparing the patterns of credit use in those states with more or less tightly regulated and closely enforced regulatory regimes in the USA. As can be seen in Chart 20, in US states with tight regulatory regimes (i.e. with interest rate ceilings with no specific payday enabling legislation), use of sub prime small sum cash credit in the form of title loans[27] and payday loans fall sharply. Those who are banked are diverted to the credit mainstream, primarily revolving credit, while the unbanked (a significant minority among low income households in the States particularly among certain ethnic groups) are diverted to pawn-broking

Credit use falls significantly across all sub prime product categories in states with ceilings; banked diverted to mainstream, un-banked to pawn-broking

Chart 20: Average debt per head of population by product category for states with ceilings and no payday enabling legislation relative to all US states



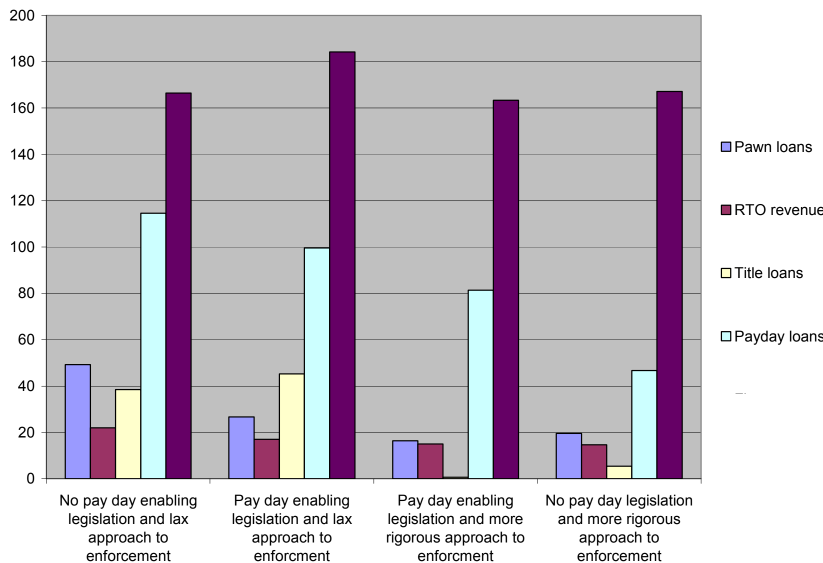
[27] A US credit product type in which small cash advances are secured on the ownership documents of automobiles

There is a clear displacement effect in that debt per head remains constant for those who can borrow but is diverted to alternative product categories

Significantly, although total use of credit falls significantly in states with ceilings (see Chart 21), total debt per head for those who can still borrow remains constant in states with and without ceilings (see Chart 22). This would indicate a clear displacement effect. The consequences of this displacement for consumers are discussed in following paragraphs covering the cost of credit to consumers and the impact on delinquency and problem debt.

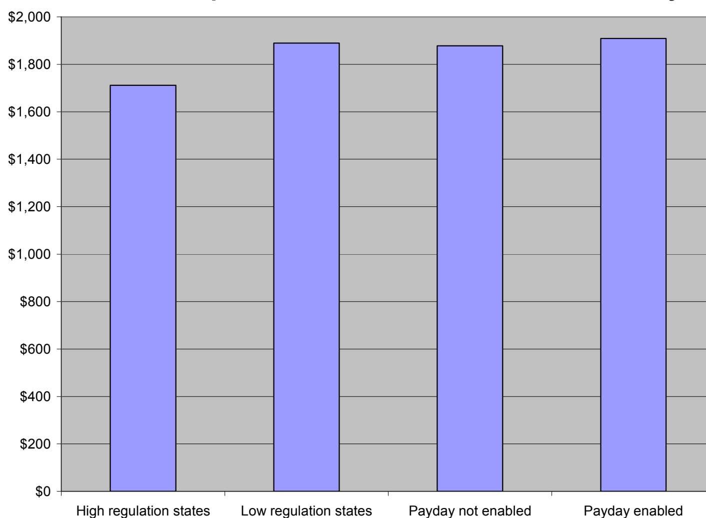
Credit use falls significantly across all sub prime product categories in states with ceilings; banked diverted to mainstream, un-banked to pawn-broking

Chart 21: Average debt per head of population by product category, regulatory framework and relative rigour of enforcement



Total debt per head for those who can borrow remains constant in states with or without ceilings

Chart 22: Total debt per head for low value US credit users by regulatory framework



Source: TransUnion

The impact of price controls is evident in both the diversity of credit products on offer in a market and the extent of credit rationing within it

We turn now to illustrate some of these effects in various international credit markets and compare the patterns found in these markets with those of the Australian domestic market. We also discuss how the various effects described might play out in an Australian context were an interest ceiling to be introduced.

In markets without ceilings low income borrowers use a range of credit models, mainstream and non standard, in many cases for different purposes

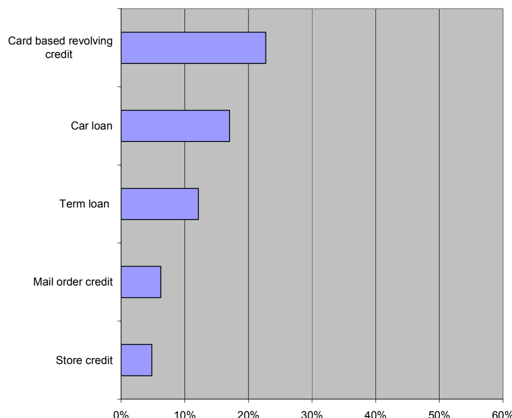
The credit rationing effect as a result of an interest rate ceiling can be found both in the diversity of credit products offered to those on low incomes in markets with and without ceilings and in the experience of borrowers and credit markets in the wake of an introduction or tightening of a ceiling. In markets with ceilings, the market for sub prime high cost credit products is unable to develop. In modern markets borrowers who might otherwise use sub prime high cost products instead typically use low APR revolving credit, both for purchase of goods and services and for small sum cash credit, or they use term loans or catalogue credit, where these products are available to them. In markets without rate ceilings, high risk and low income borrowers use a wider range of products, and where they have access to mainstream credit, use mainstream credit alongside sub prime high cost loans, often for different purposes.

The French and German credit markets are characterised by the narrow range of products on offer to low income and high risk borrowers

In France, where the highly efficient and expansionist providers have focused on card-based revolving credit as their vehicle of choice for extending credit to higher risk borrowers, revolving credit is the dominant credit product type for credit users in the bottom quintile of household income (see Chart 23). In Germany where the likely incidence of delinquency on revolving credit is too high for the risk averse German lenders to tolerate (see section on payment behaviour following), card based credit is not made accessible to those on low incomes for whom the primary credit vehicle is fixed term loans, where these are available to such borrowers (see Chart 24). In both markets those with adverse history have no legitimate credit options.

Revolving credit dominates the credit use of low income borrowers in France

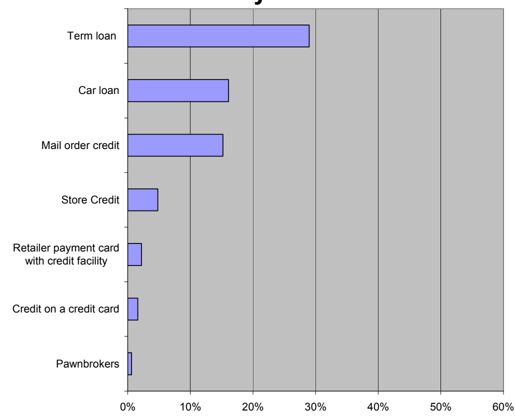
Chart 23: Credit product mix for low income consumers in France



Base: Low income users of commercial credit in past five years
Source: Taylor Nelson Sofres Research for Policis, 2004

In Germany low income borrowers rely on term loans and mail order

Chart 24: Credit product mix for low income consumers in Germany



Base: Low income users of commercial credit in past five years
Source: Taylor Nelson Sofres Research for Policis, 2004

The differences between the French and German case are shaped by differences in emphasis in the regulatory framework

It is helpful to understand the regulatory dynamic which has shaped the big differences in the credit products on offer in the French and German markets, not least because these lead to big differences in outcomes for consumers and to a lesser extent for the wider economy also. There are also important implications in these differences for the conclusions which may be drawn about the likely impact of regulatory changes to the credit market in Australia. While there is an element of culture in the mix, the differences between the two markets hinge on differences in emphasis within the regulatory environment operating in each country.

In Germany disincentives to default have led to a risk averse lender set unwilling to tolerate the delinquency associated with revolving credit

In Germany the emphasis within the regulation is on preventing default. Direct disincentives to the financial institutions to risk default are encapsulated in a mandatory lower rate of interest applied to accounts in difficulty, combined with a duty on the lender not to do anything which would worsen the situation of the debtor in difficulties. This arises in part because of a cultural effect to do with the historically draconian German bankruptcy regime, only modernised in 1999. The regime previously allowed for the period of bankruptcy to last for some thirty years, with bankruptcy thus being a catastrophic outcome for the individual and one to be strenuously avoided at all costs. This background, the generalised conservatism of the German banker set, a cultural distaste for risk-adjusted pricing on social equality grounds and the strong regulatory disincentive to risk taking on a borrower which might become delinquent has caused lenders both to reject high-risk borrowers and to shy away from offering low income households products, such as revolving credit, which tend to increase the risk of delinquency and default. As a result credit exclusion is significantly greater in Germany than in France. As a further effect the development of the wider credit market has also been held back, because not driven by revolving credit, which has been a prime driver for growth in high growth credit markets (such as that of Australia, the UK and US).

The French lenders have used revolving credit aggressively to extend their penetration of lower income households

The more enterprising French lenders on the other hand have sought to grow the market for credit provision to low income borrowers aggressively, offering even consumers on the lowest incomes card-based revolving credit. They have indeed relied on delinquency-induced, behaviour-adjusted pricing to adapt the price for risk for lower income borrowers (See Section 6.0 on cost of credit following).

The resulting account delinquency combined with an inflexible over-indebtedness regime has resulted in the credit exclusion of large numbers of borrowers

The net outcome in France is not the pattern of exclusion and a narrow product range seen in Germany but another, perhaps no more desirable outcome, which in part arises from the consumer protection and over-indebtedness “Interdit Bancaire” regime administered by the Banque de France. This is structured in such a way that those who miss payments or bounce direct debits are quickly registered with the Interdit Bancaire regime - and consequently prohibited from participating in the mainstream banking system - unless they are able to make good within a very short

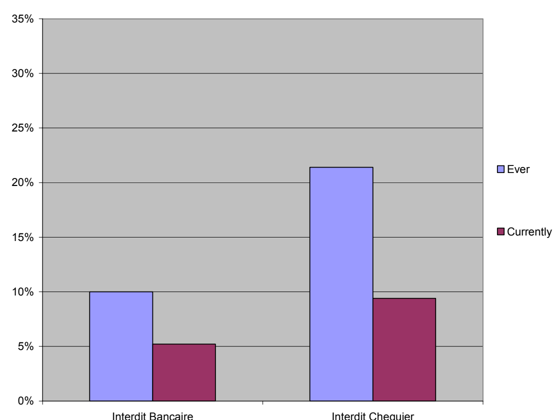
period[28]. The payment irregularity that tends to be associated with low income borrowers' use of revolving credit shuts large numbers out of the banking systems each year, resulting in not only their credit exclusion but their exclusion from the financial mainstream more widely.

In France payment delinquency on revolving credit cards shuts large numbers out of both the banking mainstream and access to credit

Significant and rising numbers of largely low income individuals in France are effectively shut out of mainstream banking and financial services, including access to credit by account delinquency on current accounts and revolving credit cards. Numbers so affected have risen in line with the increase in use of revolving credit. Millions of individuals and a significant proportion of the population of working age have been exposed to Interdit Bancaire sanctions. The consumer research indicated that one in five of those on low incomes in France, rising to more than 3 in 10 of low income families, has been registered Interdit Bancaire or Interdit Chequier at some point. All of these people will be effectively barred from commercial borrowing by the regulatory provisions which decree that the whole risk of lending to such registered individuals will be borne by the lender. Registration is long term, though less so than historically, the term of registration having been reduced from 10 to 5 years in 2001.

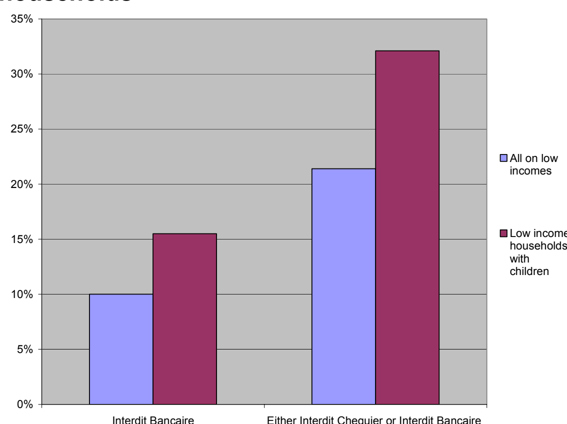
One in five low income households in France have at some time been registered under the Interdit Bancaire regime because of account delinquency

Chart 25a: Registered under jurisdiction of Interdit Bancaire regime



Base: All on low incomes
Source: Taylor Nelson Sofres Research for Policis 2004

Chart 25b: France Incidence of Interdit Bancaire registration for high risk and low income households



Source: Taylor Nelson Sofres Research for Policis 2004

The picture of credit use among low income households in the UK is much closer to that of their counterparts in the domestic Australian market

By contrast the picture of credit use in the UK, where there is no ceiling, is much closer to that of low income borrowers in Australia. See Charts 26 and 27. In both countries low income borrowers use a wide range of both long and short term

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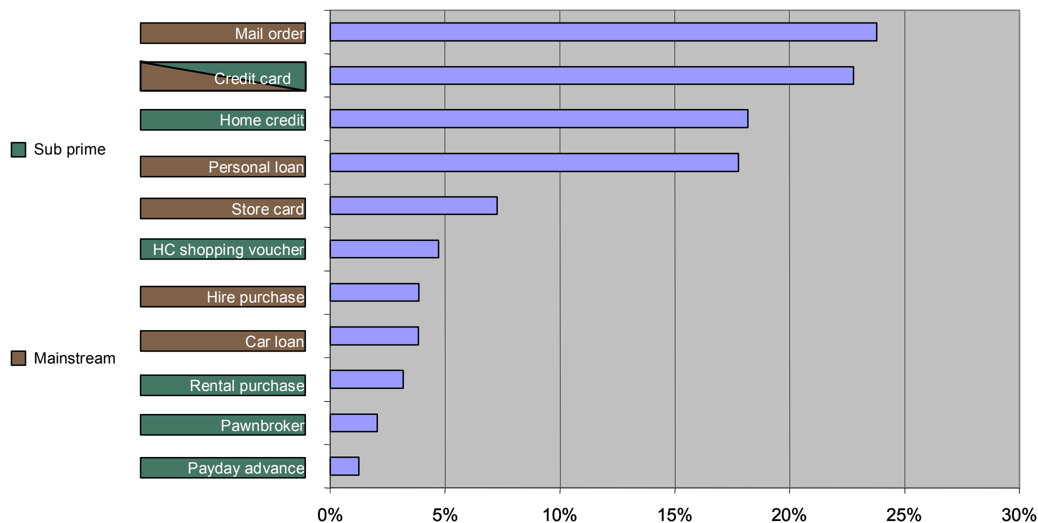
28 Banks are required to advise the Banque de France of any incidents of delinquency (funds being unavailable to meet obligations, bounced cheques etc) with incidents not made good within a prescribed period (30 days) resulting in registration on the FICP as either "Interdit Chequier" or "Interdit Bancaire". Registration in either category restricts the defaulting individual's right to use their bank account or to open another account. The term for such registration has recently been reduced from 10 years to 5. Individuals who have been registered Interdit Chequier can recover their ability to write cheques, either by making good within two months, or thereafter, on payment of a penalty, currently set at 22 euros per 150 euros or part thereof. These penalties are doubled if there have been 3 payment incidents within a 12 month period. Penalties are payable in addition to the sum owed in the original payment incident.

products and a high proportion of those using non standard lending also use mainstream credit.

In the UK, where the product mix is not constrained by price controls, high risk borrowers use both new and traditional sub prime product types

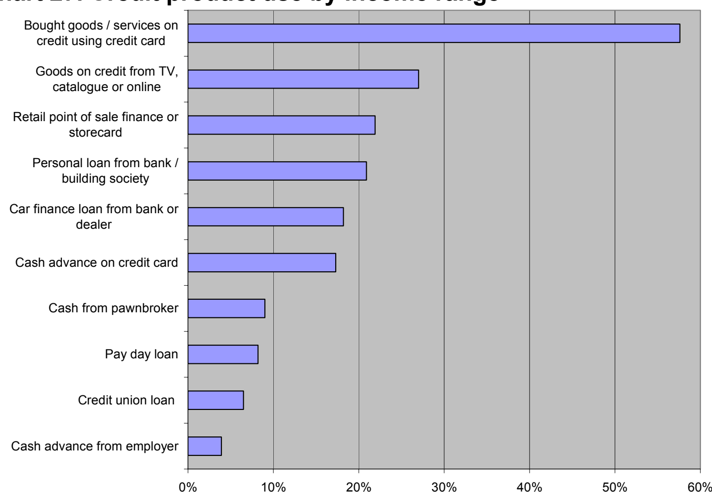
Chart 26: UK credit users' product repertoires
% using in last 12 months



Base: Low income users of commercial credit in past five years
Source: Taylor Nelson Sofres Research for Policis 2004

Low income borrowers in Australia use small sum non standard lending alongside mainstream credit where they have access, as in the UK

Chart 27. Credit product use by income range



Base: Low income credit users in Australia
Source: Synovate research for Policis, 2008

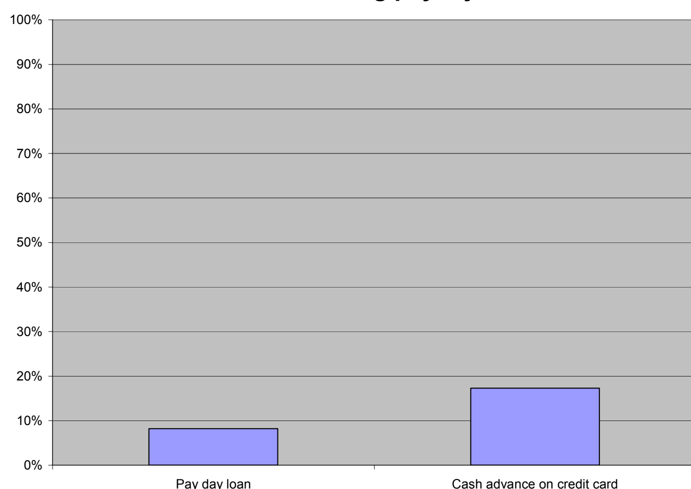
The prominence of cash advances as the leading source of cash credit suggests a rate ceiling in Australia will create a shift to a French style market

Current patterns of credit use among low income and high risk borrowers in the domestic Australian market suggest that the impact of the imposition of a rate ceiling in Australia would be likely to shift the pattern of credit use among low income consumers in the domestic market to one much closer to that of the French market described above. This is primarily because credit cards are already well embedded in the domestic credit culture in Australia and in patterns of credit use among low

income consumers. Cash advances on credit cards are already the most important source of small sum credit for low income consumers in Australia, being about 4 times more important than payday lending.

Low income borrowers in Australia are more likely to use cash advances on credit cards rather than payday loans to access small sums

Chart 28: Sources of small sum cash credit used by low income households in the domestic Australian market
% of low income households using payday loans and cash advances on credit cards



Base: Those with household incomes of less than $35,000 pa in Australia
Source: Synovate research for Policis, 2008

A switch to a French style market would seem likely to result in an increase in delinquency and default and thus credit exclusion

Any switch to a French style market in which cash advances on revolving credit become a more significant component of low income consumer credit use would seem likely to result in an increase in delinquency, in that current patterns of delinquency on credit cards among low income households (see chapter on the cost of credit following), would seem likely to rise – as happens in the US in those states where users of high cost products are diverted to revolving credit. This syndrome would likely be followed in turn by an increase in default, and thus in exclusion from the mainstream credit market.

Illegal lending tends to arise where there is a credit vacuum and is frequently associated with other criminal activity

An analysis of supply side impacts of rate ceilings would not be complete without some consideration of the impact of exclusion. Where credit exclusion arises, most people simply do without credit or rely to a greater extent on informal borrowing from family and friends. A proportion, however, will turn to unlicensed lenders, who tend to be not only very high cost but also to exhibit a series of undesirable characteristics, being frequently associated also with a wider range of criminal activities.

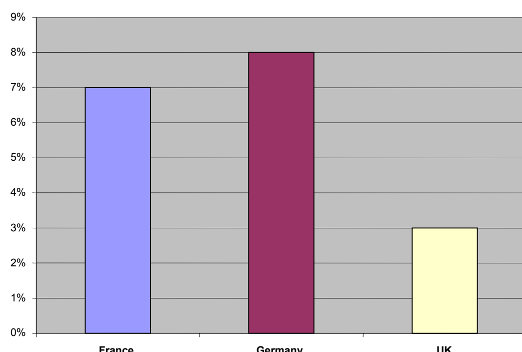
Illegal lending is most closely associated with those experiencing credit refusals in the mainstream credit market or who are excluded because of adverse history

Illegal lending occurs in markets where a credit vacuum arises and is highest among those who have experienced credit refusals or who have an adverse credit record. Illegal lending is significantly lower among low income households in the UK than among low income households in both Germany and France, where the incidence is

respectively three and two and a half times that found in the UK. The explanation lies with the greater degree of credit exclusion in these markets and specifically with the difficulties that those with any adverse credit history will have in raising legal credit.

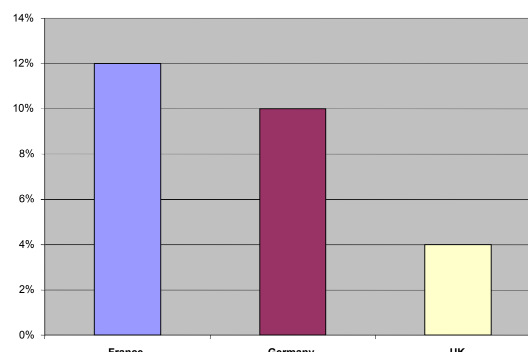
Illegal lending is significantly lower in the UK than in France or Germany

Chart 29: Illegal lending, France, Germany, UK
Incidence of illegal lending in France, Germany, UK among the credit impaired



Base: Credit impaired
Source: Taylor Nelson Research for Policis 2004

Chart 30: Illegal lending, France, Germany, UK
Incidence of illegal lending in France, Germany, UK among those experiencing credit refusals



Base: Those who have been refused a loan
Source: Taylor Nelson Research for Policis 2004

The most extreme example of illegal lending arising from credit exclusion can be found in Japan where there have been some 1m arrests in a five year period

The most extreme example of illegal lending filling a credit vacuum arises in Japan where the Yakusa-run black market is large, sophisticated, highly visible and associated with highly aggressive collection methods. To provide some sense of the likely scale of the illegal sector, there were more than one million arrests in the five years leading up to the passing of the latest credit market legislation, with these arrests said to indicate the tip of the ice-berg by domain experts. The scale of credit exclusion in Japan – and the long period during which banks eschewed consumer lending – is in large part the explanation for the involvement of organised crime, in that the credit vacuum and resulting market opportunity is that much larger.

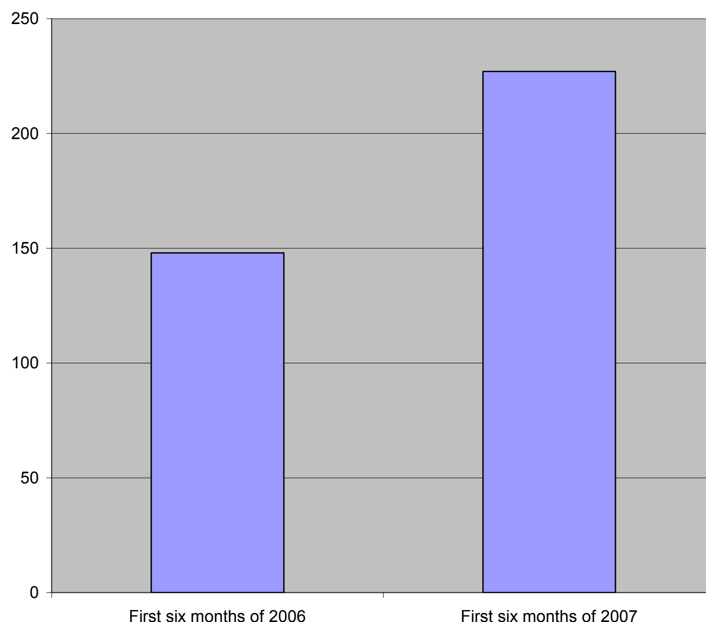
Following the tightening of the Japanese rate ceiling in 2006 enquiries to victims' support groups and arrests for illegal lending have risen rapidly

Developments in the Japanese market also provide evidence of the impact of the withdrawal of credit to those previously able to borrow in the wake of the imposition or tightening of a rate ceiling. Anecdotal evidence on the streets and from those working with victims of illegal lenders, rapid rises in the numbers of enquiries to specialist agencies set up to support victims[29] and sharp increases in the number of arrests for illegal lending point to a significant increase in illegal lending having followed the sharp reduction in lending by the Japanese consumer finance houses in the lead up to the well flagged legislation and in the year following the introduction of the new law (illustrated in Chart 17b earlier). Over the same period figures from the National Police Agency indicate that arrests for illegal lending had risen 50% between the first half of 2006 and the equivalent period in 2007. See Chart 31.

[29] Council for Victims of Credit and Consumer Lenders based in Chiyoda ward Tokyo received 89 enquiries for help from victims of Illegal lending in year 2007 to May, nearly double the number received in the whole of 2006.

Illegal lending appears to have risen sharply in Japan in the wake of the recent regulatory tightening despite strenuous efforts to contain and control it

Chart 31:Nos of Illegal lending cases in Japan First six months 2006 and 2007



Source: Japanese National Police Agency

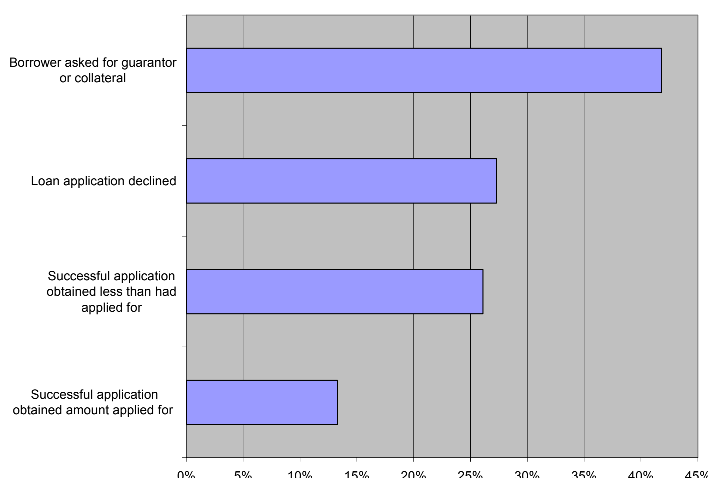
Consumer research in Japan indicates that the increase in use of loans sharks arises among consumer finance users now shut out of the legitimate market

Consumer research[30] undertaken with Japanese would-be borrowers now unable to obtain credit from those consumer finance companies no longer lending to higher risk borrowers indicates that use of illegal lenders has risen rapidly among borrowers who have become shut out of the market as the result of the changes in the regulatory environment. The incidence of those admitting to having contacted a loan shark in the last twelve months among those who had not been able to borrow as much as they had wanted from the legitimate consumer finance lenders (26%) was double that for those who had been able to obtain the amount of credit they had wanted (13%) . It was similarly high (27%) among those who had been declined by legitimate lenders and rose to 42% among those who had been asked to provide guarantors or collateral.

[30] Research by Professor Hiroshi Domoto of Tokyo University of Information Sciences, based on an internet survey of 1100 consumer finance users, 2007. Reported in Behavioural Analysis of Consumer Loan Users. Regional Banks Monthly Report October 2007

Resort to loan sharks is greatest among those refused legitimate credit

Chart 32: The impact of credit rationing arising from 2006 reduction of the ceiling on Japanese consumers' use of loan sharks
% consumer finance users in Japan having contact with loan sharks (Yamiken lenders) in last 12 months 2006 - 2007



Base: Consumer finance users in 2006 making new applications to consumer finance lenders in 2007
Source: Survey of 1100 consumer finance users, 2007

In countries with rate ceilings more middle income borrowers are refused credit, creating more attractive opportunities for illegal lenders

The Policis consumer research in France, Germany and the UK showed that in all three countries use of illegal lenders is concentrated among those who have experienced credit refusals from legitimate lenders. This pattern is confirmed also in Japan, where research undertaken by the JFBA[31] with victims of illegal lenders also indicates that borrowers from illegal lenders typically have a history of credit problems and credit refusals.[32] However, where high cost credit is not available, as in territories with price controls in place, more middle income borrowers are refused credit. In France and Germany the profile of those experiencing credit refusals is significantly better off than in the UK. This reflects the greater access to credit in the UK for high-risk borrowers and the credit impaired and the difficulties that middle income borrowers who have experienced credit problems in Germany and France face in obtaining credit. As a consequence, users of illegal lenders in France and Germany are more up-market than users of illegal lenders in the UK, being more likely to be male, to be in work or to be short term unemployed. In Japan, where credit exclusion also impacts middle income borrowers and there is no legitimate credit option, the same pattern can also be observed, with over-indebted borrowers turning to the illegal market in the wake of credit refusals in the credit mainstream tending to be male and in work, often self employed. Users of illegal lenders in the UK, on the other hand, are more likely to live in conditions of entrenched poverty and are overwhelmingly long-term unemployed, with the profile of illegal lender users having a strong female bias, being often single mothers living in social housing.

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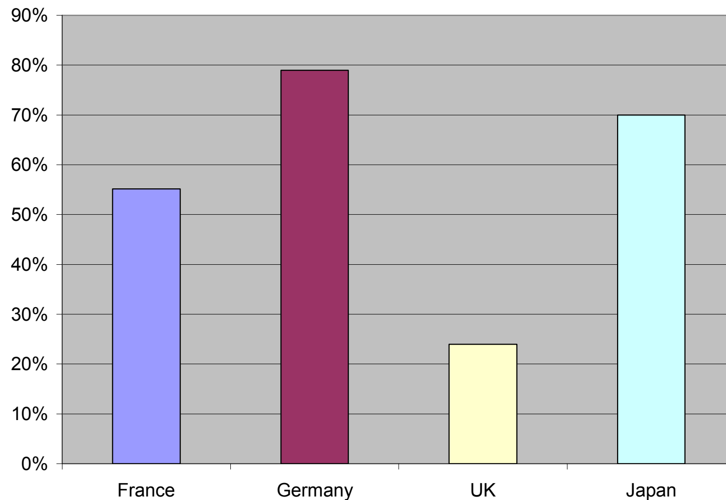
[31] JFBA (Japan Federation of Bar Associations). This highly influential association of attorneys in Japan is the leading consumer activist group both campaigning for change to the regulatory framework governing the credit market and providing practical assistance and support to victims of illegal lenders.

[32] The sophisticated and high tech illegal lenders in Japan are widely reported in the press as actively targeting the over-indebted and those experiencing credit refusals, reportedly by dint of buying lists of those refused credit. In a more recent development, illegal lenders have been reported as buying up the customer lists and even the ongoing receivables of those small lenders currently being forced out of business or closing to new business as a result of the recent regulatory changes.

In markets with ceilings illegal lenders are able to target more affluent middle income credit-impaired or over-indebted borrowers in work

Chart 33: Proportion of (%) users of illegal lenders in work UK, France, Germany, Japan



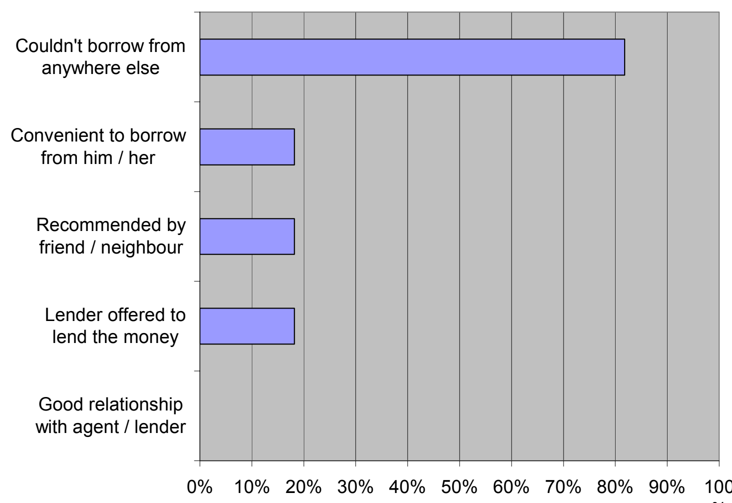
Source: TNS research for Policis 2004 for France, Germany, and UK
JFBA research with illegal lender victims 2002, Japan

Illegal lending in the UK is very low by international standards and where it occurs it is in areas not served by the high cost lenders

There is a low level of illegal lending in the UK by international standards, primarily because of the presence of the high cost home credit lenders. Illegal lending in the UK is overwhelmingly concentrated in those postcodes in the most deprived communities which the high cost lenders will not serve on safety grounds and among consumers who are either too high risk for the legitimate high cost lenders or those who have defaulted on a high cost credit line. In the few areas where the high cost lenders do not operate, most people do without credit but where they do not, loan sharks are the leading source of cash credit.

Borrowers turn to illegal lenders only when they have no other credit options

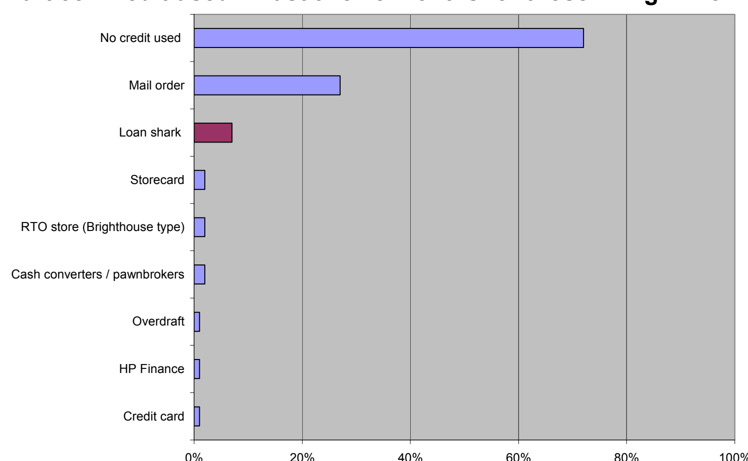
Chart 34: Reasons for using illegal lending



Base: Illegal lender users
Source: Policis / PFRC research for UK DTI Illegal Lending in the UK 2006

In areas where the high cost lenders do not serve most do without credit but loan sharks are the leading source of cash credit

Chart 35. Credit used in last twelve months for those living in home credit excluded areas



Base: those living in areas not served by the home credit lenders in the UK
Source: Policis / PFRC research for UK DTI Illegal Lending in the UK 2006

Credit advanced by the illegal lenders tends to be much higher cost than even the highest cost legitimate products offered by regulated lenders

Generally speaking, credit offered by unlicensed lenders is much higher cost than regulated credit. Research[33] undertaken by Policis to support the UK government's efforts to tackle loans sharks in poor communities indicated that on average credit from illegal lenders was three times that of the highest cost legal lenders. In Japan the 2007 National Police Association mid year summary of major cases of illegal lending reports lenders charging between 7 and 288 times the maximum legal interest rate.

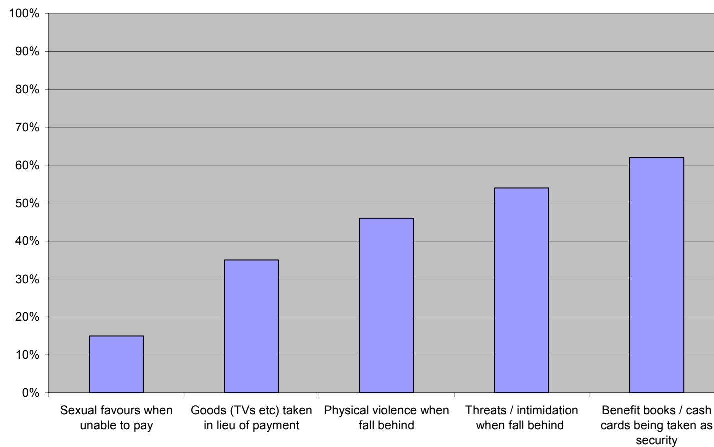
Unregulated lenders are not only high cost but also tend to support collections through intimidation, violence and harassment

The high cost of illegal lending – often effectively little more than outright extortion - can work to hollow out the finances of victims. However it is not only the cost of such credit that damages both borrowers and the communities in which lenders operate. Collection management is typically sustained by a degree of aggression and intimidation that would not be tolerated in – or countenanced by - regulated lenders. The UK research found that illegal lenders collection practice featured not only intimidation but also a series of damaging and exploitative practices (see Chart 36 following). In Japan, research[34] with victims of illegal lenders indicates that constant harassment, supported by aggressive collection and threats of violence by black market lenders is a common-place and widespread tactic. There have indeed been a number of high profile cases in which individuals have been driven to suicide[35] as a result of the pressure exerted by illegal lenders.

[33] Policis and PFRC Ellison, Collard and Forster *Illegal Lending in the UK* for the DTI, 2006.
[34] Source: JFBA
[35] Most notably in a much publicised case in 2006 which caused wide-spread public outrage in which several elderly members of the same family threw themselves beneath a bullet train, leaving behind a note explaining that they could no longer live with the pressure being exerted by Yamiken lenders.

The collection management practice of illegal lenders rests on threats, intimidation, violence and various forms of exploitation

Chart 36. Collection management practice of illegal lenders in UK



Base: Users of illegal lending in deprived communities in UK
Source: Consumer research by Policis and PFRC for Department of Trade and Industry, 2006

There can be little doubt that opening the door to unregulated lending in Australia would be a deeply undesirable development

Clearly, if a rate ceiling were to open the door to unregulated and uncontrolled lenders, this would be a deeply undesirable development for vulnerable Australian borrowers and indeed for the communities in which they live.

6.0 The impact of ceilings on the cost of credit to the consumer

Summary

- The evidence suggests that shifting low income Australians to low APR revolving credit will not necessarily reduce the cost of credit and may increase it
- In a rate capped environment some borrowers are shifted from high APR to low APR vehicles (others are denied credit).
- Lenders will structure product and pricing structures to accommodate the constraints of the ceiling, shifting charges from APRs to back end charges:
  - Behaviour-driven pricing allows lenders to fine tune risk pricing to the behavioural profile of the individual borrower.
  - For high risk borrowers behaviour-driven pricing rests primarily on uneven payment records and a tendency to extend payment terms on revolving credit.
  - Payment irregularity is endemic among low income households and can be observed both in Australia and internationally.
  - Ancillary fees and behaviour-driven charges represent a very significant share of lenders' profits, particularly for non prime card segments.
  - These two effects in combination achieve a price for the lender that is commensurate with risk, regardless of the headline APR.
- The cost to the borrower of low APR products can be very similar to that of high APR credit and under uneven payment conditions can be significantly higher.
- These effects can be observed in a number of markets with ceilings:
  - In the US, in states with ceilings delinquency payments on revolving credit have been significantly and consistently higher than in states without ceilings over many years.
  - In France behavioural effects on revolving credit cards can be the major driver of credit cost, often significantly higher than the headline APR.
- Shifting the balance of emphasis within pricing structures to non interest rate components of price compromises price transparency for consumers.
- Patterns of payment irregularity in the Australian market suggest that the pricing effects described would have a significant impact in a domestic context:
  - Some four in ten low income Australians miss payments on mainstream loans and credit agreements, rising to half of credit card revolvers.
  - Payday borrowers miss fewer mainstream credit payments than other low income credit users.
  - Some payday users appear to be making rational use of high cost credit to avoid even more expensive default, overdraft or reconnection charges.

Lenders will structure product and pricing structures to accommodate the constraints of the ceiling, shifting charges from APRs to back end charges

As demonstrated in Section 5.0 earlier, where lenders cannot achieve a commensurate price for risk and interest rate ceilings are effective in controlling price, lenders will leave the market. The more likely outcome, however, is that lenders simply adapt their product and pricing structures to accommodate the ceilings, shifting the emphasis in pricing from front end interest rates to back end charges. It is for this reason that the attention of regulators around the world is increasingly focused on terms and conditions as much as price.

Behaviour driven pricing allows lenders to fine tune risk pricing to the behavioural profile of the individual borrower

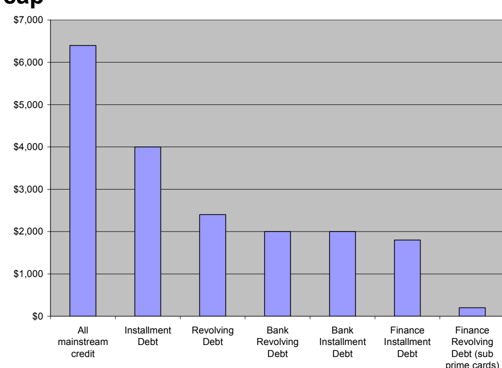
This exercise is greatly facilitated by the phenomenon of behaviour-driven pricing, which is one of the central trends in credit markets around the world. Lenders achieve the price they need to accommodate the risk they are taking on by structuring price so that it is driven by behaviour in the form of “charging events” such as exceeding a credit limit or missing a payment when due. There are more or less aggressive forms of such behaviour-driven charging, with charges in markets with free banking tending to be higher than those where banking is charged for and the fees attached to similar behaviours adjusted also for products targeted at more or less high risk segments. In the United States this approach has been taken to an extreme, with some products in the market structured so that a missed payment on say a utility or phone bill works to increase the rate levied on an unrelated credit card.

Ancillary fees and behaviour driven charges now represent a very significant share of lenders’ profits, particularly for non prime card segments

Whatever approach is adopted, supplementary fees and charges now represent a significant component of card issuers’ profitability. As a component of revenue these effects are more important for sub prime products and those aimed at high risk borrowers. This effect is clearly demonstrated in Chart 37 following which shows the relative levels of delinquency (a.k.a. charging events) associated with sub prime cards as compared to the credit market overall. It also demonstrates the extent to which behaviour driven fees will be disproportionately applied to the small balances typically extended only to the highest risk borrowers.

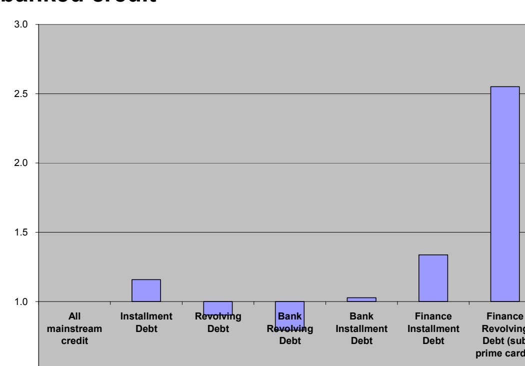
Pricing on sub prime cards in the US is driven by high rates of delinquency triggering penalty charges which are high relative to small balances

Chart 37: Average outstanding balances per cap



Source TransUnion https://products.trendatatu.com

Chart 38: Delinquency ratio relative to all banked credit



Source TransUnion https://products.trendatatu.com

Payment irregularity is endemic to the account management of low income households and can be observed both in Australia and internationally

One of the key mechanisms driving the increase in the cost of credit to higher risk borrowers using credit products with apparently low headline APRs is the high incidence of delinquency among low income credit users. Payment irregularity is endemic to the account management patterns of borrowers on tight budgets, and can be observed in credit markets worldwide. Significantly, however, it can be observed to a very similar degree in markets with and without ceilings and for borrowers using very different credit vehicles, even where there are financial disincentives to avoid making late and missed payments in the form of penalty charges. This would seem to

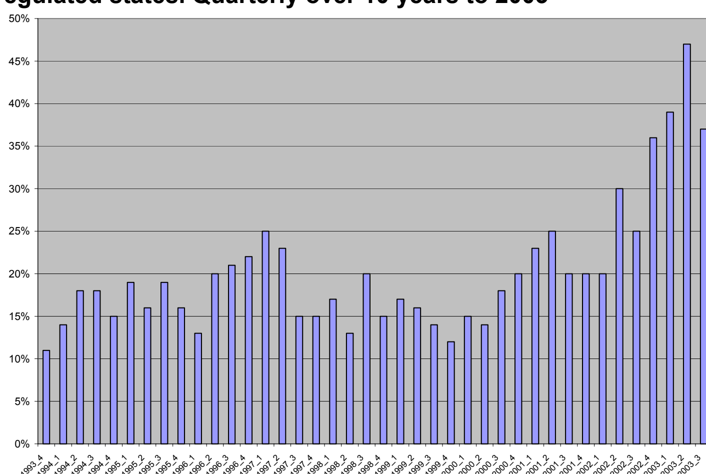
imply, given the financial downside of account irregularity, that it arises primarily from competing priorities within tight budgets rather than from any other cause.

In US states with ceilings late payment and delinquency charges on revolving credit have been significantly and consistently higher over many years

Understanding how a rate ceiling might work with the various payment patterns just discussed and how this would impact on the cost of credit is perhaps best illustrated with reference to the experience in the US. The net outcome of the various behavioural pricing effects just discussed combined with the impact of interest rate ceilings is most compellingly demonstrated by examining the differentials in delinquency – and thus charging events – between US states with and without ceilings. In those states with ceilings, delinquency - and delinquency related revenues – are significantly and persistently higher than in states where there are no rate ceilings, reflecting the fact that borrowers who would otherwise have used non standard lending vehicles have been diverted to revolving credit as discussed earlier. Lenders appear to achieve their price for risk through back end charges rather than upfront APR. This effect can be definitively and consistently demonstrated over many years. Chart 39 shows the effect quarterly over a full decade between 1993 and 2003. These effects have become more exaggerated over time as behaviour driven pricing has become more central to charging models. The effect is shown in Chart 40 for all users of revolving credit, but is significantly more pronounced for those on the lowest incomes.

Late payment – and thus behaviour driven charging – on revolving credit is consistently higher in US states with rate ceilings

Chart 39: Ratio by which late payments on non bank revolving credit is higher in tightly regulated states. Quarterly over 10 years to 2003



Source: TransUnion
Base: 340,00 US credit users
Source: Department of Trade and Industry UK, The Effect Of Interest Rate Controls in Other Countries, 2004

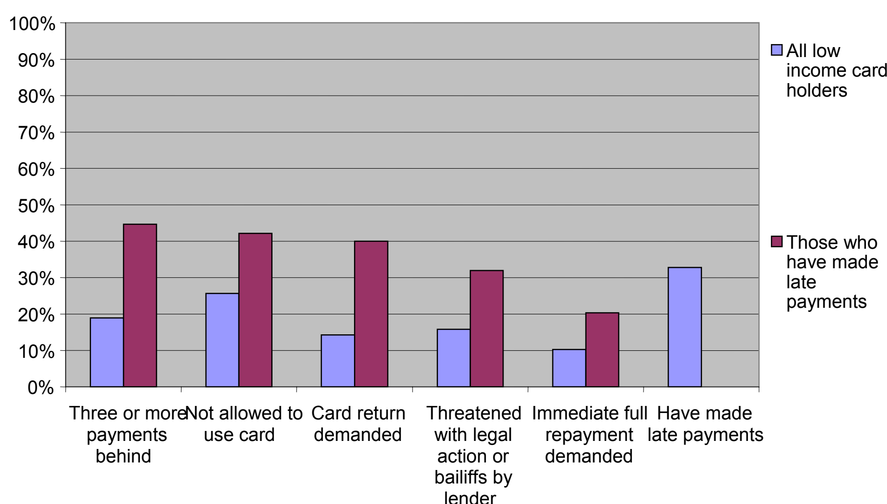
Another factor in inflating cost for high risk borrowers is their tendency to service maxed-out balances at minimum levels over long periods

It is not only delinquency charges which increase the cost of credit for high risk borrowers. For those on tight budgets, the tendency is to allow balances on cards to creep up to their limit (which itself is frequently increased in stages by lenders). Borrowers then find themselves able only to service the debt by making the minimum payment required but not able to pay it down except slowly. This then becomes an expensive way to borrow, as is illustrated by the outputs of the worked example in Table 2 following. A substantial minority of account holders are affected, with a

significant minority paying down card debt over a long period while gaining no further utility from it, in that cards could no longer be used because blocked as over-limit or as a result of payment delinquency. Three in ten French revolving credit card holders claimed that their cards had been frozen by their card issuer.

In France a significant minority of high risk borrowers using revolving credit fail to cope and find themselves exposed to sanctions and a range of charges

Chart 40: Incidence of payment delinquency and lender sanctions on revolving credit cards in France



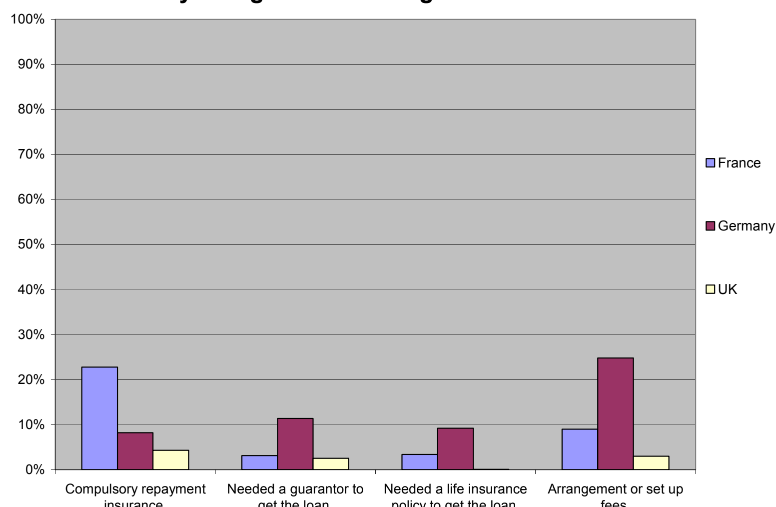
Base: Low income revolving credit card users in France
Source: Taylor Nelson Sofres Research for Policis 2004

Behaviour driven charges can be supplemented by additional revenues from quasi-compulsory product on-sales or transactional fees

Behaviour related fees are only one of the ways in which lenders re-engineer price when faced with price controls. Ancillary fees and quasi-compulsory dependent product sales can also be effective mechanisms for boosting revenues against a background of price controls. As is shown in Chart 43 following, low income credit users in France and Germany are significantly more likely to be charged for a variety of ancillary items than are those in the UK, where no price controls apply.

Credit users in France and Germany are more likely to be subject to a range of ancillary charges than their counterparts in the UK

Chart 41: Ancillary charges on credit agreements



Base: High risk borrowers
Source: Taylor Nelson Sofres Research for Policis 2004

Ancillary charges and insurances frequently push the effective APR significantly above the level advertised

The extent to which such practices as quasi compulsory sales are wide-spread across the market-place in price controlled markets is well illustrated by the results of a mystery shopping exercise conducted in Germany, which mystery-shopped a wide selection of banks and other lenders, both domestic and foreign owned, including the savings banks and mutuals. Table 2 below is a table sourced from a consumer publication which shows the results of that exercise which was undertaken by the leading consumer association in Germany. It revealed a series of ancillary on-sales which worked to significantly boost the cost of credit above the level of the headline APR.

Table 2: Results of mystery shopping test by German Consumer Association

	Test female customer 25-30 yrs old			Test male customer 25-30 yrs old			Test female customer 45 yrs old		
	Advertised Effective APR	Actual APR	Compulsory credit insurance	Advertised Effective APR	Actual APR	Compulsory credit insurance	Advertised Effective APR	Actual APR	Compulsory credit insurance
ABC Privatkunden-Bank	10.0	12.2	No	9.50	14.4	No	9.9	9.9	Yes
BBBank	9.0	9.8	No	16.60	16.6	Yes	9.4	10.6	No
BHW-Bank	9.9	9.9	Yes	9.90	9.9	Yes	9.9	9.9	Yes
CC-Bank	10.0	15.3	No	7.92	12.1	Yes	9	17.5	No
Citibank	No info	8.4	Yes	7.50	7.5	Yes	15.2	24.4	No
Commerzbank	9.9	14.0	No	9.80	14.0	No	9.8	16	No
Creditplus Bank	9.0	11.5	No	9.50	10.6	No	10	10	Yes
Deutsche Bank	11.1	11.1	No	11.30	12.1	No	13.2	14.4	No
Dresdner Bank	7.0	7.7	No	7.00	8.9	No	8.5	8.5	Yes
GE Money Bank	6.8	18.8	Yes	6.80	13.0	Yes	11.9	11.9	Yes
Hypovereinsbank	11.0	15.9	No	No info	17.5	No	11	11	Yes
norisbank	8.5	14.2	No	9.00	10.1	No	11	11	Yes
Postbank	8.0	8.0	Yes	8.00	9.4	Yes	8	8	Yes
SEB	8.0	9.5	No	8.00	9.5	No	7	8.1	No
Frankfurter Sparkasse	10.5	11.0	No	10.50	11.1	No	10.5	11.6	No
Frankfurter Volksbank	7.7	13.1	No	7.70	10.6	No	7.6	16.4	No
Hamburger Bank	10.1	12.1	No	10.10	11.3	No	10.1	12.1	No
Hamburger Sparkasse	7.4	7.4	Yes	7.40	7.4	Yes	6.8	6.8	Yes
Sparda Bank Hessen	11.0	11.9	No	13.90	22.6	No	No info	9,0	Yes

Source: Stiftung Warentest

In France behavioural effects on revolving credit cards can be the major driver of credit cost, which can be much higher than the headline APR suggests

These various pricing effects are probably best understood when crystallised with some worked through examples.

The worked example in Table 3 following is an attempt to shed light on the effects of these various behavioural components through the modelling[36] of the cashflows involved in different repayment patterns which correspond to specific forms of borrower behaviour. The different forms of borrower behaviour used are those revealed in the French consumer research as typical of the significant minority of revolving credit users making late or missed payments or taking an extended credit term. The model illustrates the effect both of payment delinquency and of taking a very long time to pay down a card balance.

The example below is that of the payment card offered by the French supermarket chain Carrefour. It is a revolving card product with an APR (17.16%) quite close to the French usury ceiling. There is an annual fee of €6.86 for the most basic card and payment protection insurance costs 0.45% of the outstanding balance at the end of each month. The standard charge for missed payments is €15 if the unpaid amount is less than €50, €20 if the amount is between €50 and €150 and €25 if the amount is above €150. We have assumed an initial purchase price of €1,400, being an average balance for low income borrowers, and a repayment amount of €60 per month decreasing to €30 per month when the outstanding balance passes below €800.

Table 3: The impact of behavioural factors (missed payments and extended repayment term) on the cost of credit to the consumer

Example is based Carrefour Carte PASS
Main effects on price of different APR components

	Modelled APR		Cost of Credit	
Components of price	**Component APR**	**Cumulative APR**	**Component Cost**	**Total Credit Cost**
Advertised APR	17.2%	17.2%	384.26	384.26
Annual fees	1.2%	18.4%	40.12	424.39
3 late payments in the 1st year made good following month	6.9%	25.3%	144.31	568.70
2 more late payments in the 2nd year (5 in all)	3.7%	29.0%	78.66	647.36
Payment Protection Insurance	6.2%	35.1%	251.00	898.36

[36] We use the “Modelled APR” term to describe the annualised price which would have been observed had the modelled series of cashflows upon which it was calculated been real observations. The mathematical method used in our calculations is strictly the same as that used in the officially prescribed pricing formula, using a time-weighted rate of return.

Effects on Term and Outstanding Balances of different APR components

	Term		Balance outstanding after number of years				
Components of price	**Additional number of monthly payments**	**Total number of months**	**1 year**	**2 years**	**3 years**	**4 years**	**5 years**
Advertised APR	-	46	865.23	557.28	265.40	0	0
Annual fees	1	47	873.16	574.50	293.52	0	0
3 late payments made good following month	4	51	1024.27	651.52	383.75	70.03	0
2 more late payments (5 in all)	2	53	1024.27	692.01	431.18	125.60	0
Insurance	5	58	1099.73	743.05	529.04	264.61	0

Source: Carrefour Pass card

The total cost of credit to the consumer is significantly influenced by behaviour with the advertised APR an inadequate indicator of total cost

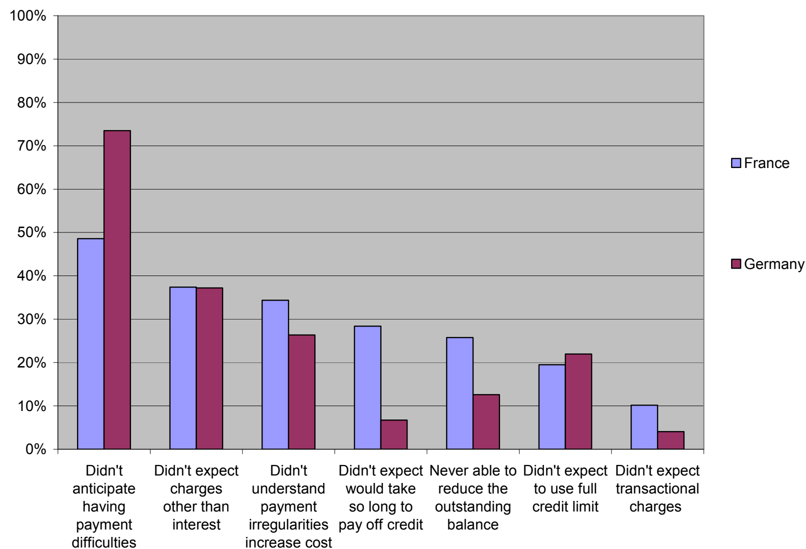
The table clearly shows how different components impact on the price of credit. In the French market only the first two price components keep the overall price under the usury limit. All the other components push the cumulative APR well beyond this limit and in the final case of 5 late payments over a 2 year period, the resulting APR is more than twice the advertised rate.

Shifting the balance of emphasis within pricing structures to non interest rate components of price compromises price transparency for consumers

It would appear therefore that price transparency can be compromised in markets where price controls create an incentive for lenders to shift the balance of pricing to non interest rate components of price. From the consumer perspective, credit ends up being more expensive than anticipated, particularly for low income borrowers who are the most likely to generate behaviour-driven charges. On the whole, consumers do not enter into credit agreements in the expectation of account delinquency, so in most cases, the increase in price results partly because borrowers do not anticipate having payment difficulties. Clearly, however, as can be seen in Chart 42 following, they also do not anticipate that missed payments will have as much of an impact as they do and do not anticipate the extent to which extended payment terms or transactional charges will add to the cost of credit.

Consumers do not anticipate or understand the impact of non interest charges

Chart 42: Perceived reasons why credit cost more than anticipated at point of sale



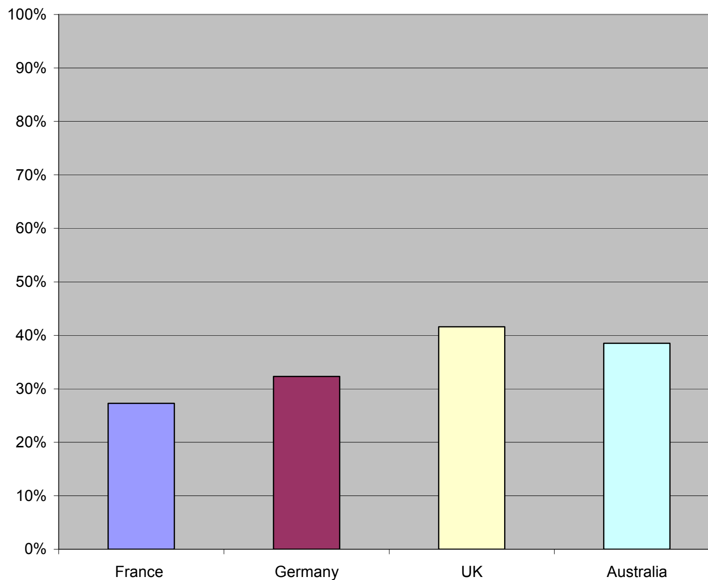
Base: Those who felt credit more expensive than anticipated at point of sale
Source: Taylor Nelson Sofres Research for Policis 2004

Patterns of payment irregularity in Australian market suggest that the pricing effects described would have a significant impact in a domestic context

In order to understand how these effects might play out in the context of a rate ceiling applied to the domestic Australian market, it is instructive both to observe the levels of payment irregularity occurring already among low income credit users and to compare these as they arise between different groups of credit users. Three features are immediately striking. There is clearly a high degree of payment irregularity among low income consumers, comparable to that occurring in the UK, where the pattern of credit product use is similar to that of Australia and slightly ahead of that in France and Germany, where there are greater disincentives for missing payments. Secondly it is clear that the highest incidence of payment irregularity on mainstream credit products occurs among revolving credit users while users of payday loans have a lower incidence of payment irregularity and exposure to penalty charges on mainstream credit vehicles than other low income credit users. Taken together, this would tend to suggest that in the event that low income credit use became further concentrated on revolving credit and payday loans were no longer available as a means of keeping up with commitments, borrowers would become significantly more exposed to delinquency related charges.

Levels of credit account irregularity among low income households in Australia, the UK, France and Germany are remarkably similar

Chart 43: % making missing or late payments on loans, credit cards or credit agreements



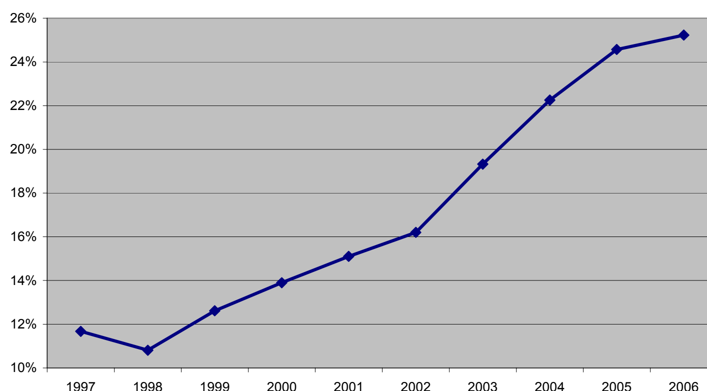
Base: Low income households in UK France Germany (lowest quintile of household incomes) and Australia (household income less than $35,000 pa)
Source: TNS research for Policis, Europe 2004, and Synovate research for Policis, Australia 2008

Some four in ten low income Australians miss payments on mainstream loans and credit agreements, rising to half of credit card revolvers

This effect can be observed in Australia as much as in other credit markets. A significant number of low income Australians are already impacted by the cost effects of payment irregularity, exposed not only to penalty charges on loan agreements and credit cards where payments are missed, but also incurring bank charges and sometimes overdraft fees in addition to the lender's charges. A little less than 4 in 10 (39%) low income credit users miss or make late payments on loan or credit agreements. This rises to around half (51%) of low income card revolvers. For those who do miss credit payments, the average number missed is a little over three times per year.

As is the case in markets internationally, card related fees have become an increasingly key component of bank revenues in Australia

Chart 44: Credit card fees as a % of total fees paid by households to banks 1997 – 2006



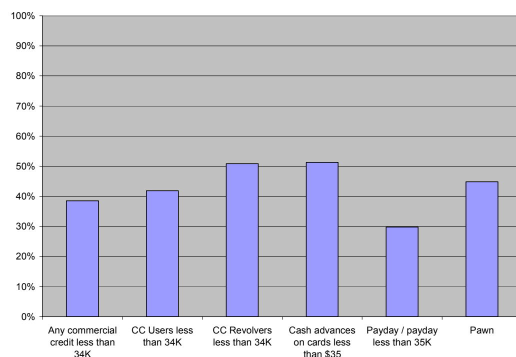
Source: Australian Reserve Bank

Payday borrowers miss fewer mainstream credit payments than other low income credit users

This effect is particularly significant for consideration of the likely impact of any shrinkage of supply in short term payday lending and the potential effects of payday borrowers being diverted to cash advances on credit cards or indeed to greater use of revolving credit more generally. It is worth noting in this context that low income payday loans users are 20% less likely to miss payments on loan or credit agreements than other low income credit users, despite being 50% more likely to be revolvers. Perhaps more significantly, payday loans users are 40% less likely to miss credit card payments than their counterparts sourcing small sum credit via cash advances on their credit cards, despite both groups having very similar incidences of revolving credit (in both cases 50% more than for all credit users) and very similar ratios of debt to household income (45% in each case), a level much higher than other credit users. Where payday users do miss payments on mainstream credit, they also miss fewer payments than other low income credit users.

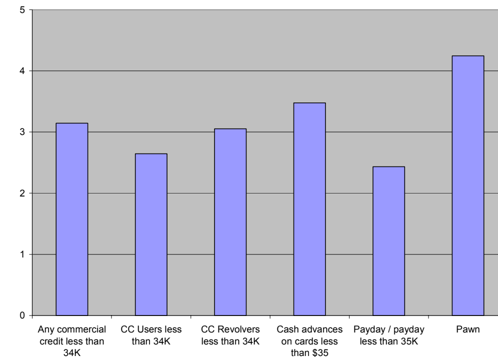
Payday users have significantly lower incidence of late payments on mainstream credit than other low income credit users

Chart 45. Incidence of delinquency on loans and credit agreements



Base: Low income households in Australia
Source: Synovate Research for Policis, 2008

Chart 46. Frequency of missed / late payments on loans and credit cards p.a



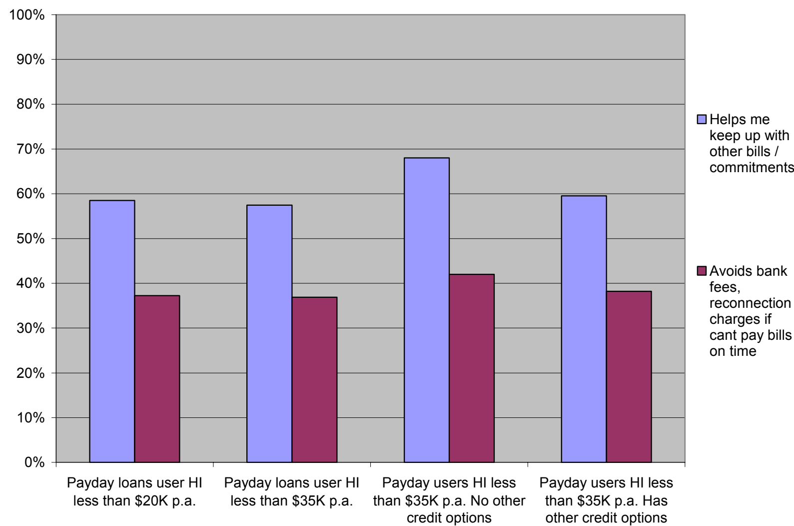
Base: Low income households in Australia
Source: Synovate Research for Policis, 2008

Payday users may be making rational use of high cost credit to avoid an even more expensive series of default charges

The reason for the lower incidence of penalty charges and account delinquency on mainstream credit agreements for users of payday rests with one of the key applications of funds raised using payday lenders. Four out of ten payday users cited the desire to avoid bank fees, penalty payments or reconnection fees as a reason for using payday lending. Six out of ten low income payday users claim to use payday loans to keep abreast of household bills and other commitments.

Payday users use short term high cost cash to meet financial commitments and avoid default charges

Chart 47. Reasons for using payday loans
% citing relevant reason for using payday loans



Base: Payday users with household incomes of less than $35,000 pa, Australia

Worked examples provide concrete examples of how the cost effects of ceilings will play out in the domestic credit market

Finally, to put some substance on the cost and behavioural effects here described, we put these into the context of domestic Australian credit product use among those on low incomes and provide some worked examples. These are based on products widely available in the domestic market and average values and typical behaviours as revealed in the consumer research. Taken together they illustrate the extent to which behaviour-driven charges can quickly escalate the cost of low APR revolving credit to levels similar to that of payday borrowing.

The first scenario represents the leading payday lending product while the second relates to a shorter tem loan offered in the domestic payday market place. The three following are based on credit card products, average charges across the product set available in the market place and average borrowing values and behaviours for those taking out cash advances on revolving credit. The same exercise demonstrates the impact of very short term contracts on APRs and illustrates why TCC is often put forward as a more useful comparator for price for short term loans.

Scenario 1. Four week payday loan paid to contract term

We assume that the borrower takes an average loan rounded up to the nearest $100 for those with household incomes of less than $35,000 and that it is paid four weeks later to term, with assumptions on the basis of the market leading lender's pricing at time of writing.

Key conditions	
Fee per $100 borrowed	$ 35.00

Key results	
Cost of Credit	$ 105.00
Fees	$ 105.00
Cost per $100	$ 35.00
Observed APR	146.0%
Amount advanced	$ 300.00
Over term	4 weeks
Remaining balance	$ -

Scenario 2. Two week payday loan paid to contract term

Assumptions

We assume that the borrower takes on the average loan for those with household income of less than $35,000 p.a. of $300 and that it is paid two weeks later to contract term. This again is based on another product sold by a leading payday lender in the Australian market place.

Key conditions	
Fee per $100 borrowed	$ 20.00

Key results	
Cost of Credit	$ 60.00
Fees	$ 60.00
Cost per $100	$ 20.00
Observed APR	969.9%
Amount advanced	$ 300.00
Over term	2 weeks
Remaining balance	$ -

Scenario 3. Pay day loan with extended term

Assumptions

We assume that the borrower takes on the average loan of $300, as above, but that the payments are rescheduled twice (a little more than the average of 1.7 times). A significant proportion of loan re-schedules do not incur charges, but we assume in this case that charges are applied once (as was the case in two thirds of cases revealed by the research).

Key conditions	
Fee per $100 borrowed	$ 20.00

Key results	
Cost of Credit	$ 120.00
Fees	$ 120.00
Cost per $100	$ 40.00
Observed APR	411.0%
Amount advanced	$ 300.00
Over term	6 weeks
Remaining balance	$ -

Scenario 4. Cash advance on a credit card

For the purposes of this example, to enable ready comparisons with the payday case, we take the probably unrealistic scenario of the card holder not having any outstanding balance and raising a cash advance equivalent to the average payday loan four times over the course of a year, again the average number of times a payday loan is taken out. We assume orderly payment and that payments are partial but above the minimum and in line with the debt service outgoings revealed by the consumer research with low income card holders raising cash advances on credit cards.

Key conditions	
Minimum payment (% of balance)	2%
Actual monthly payment	$ 50.00
Interest rate	16.28%
Own network ATM fee ($)	$ 1.88
Own network ATM fee (%)	2.2%
Other network ATM fee ($)	$ 2.16
Other network ATM fee (%)	2.1%

Key results	
Cost of Credit	$ 575.89
Fees	$ 52.69
Interest	$ 523.20
Cost per $100	$ 23.04
Observed APR	17.5%
Amount advanced	$ 2,500.00
Over term	2 years
Remaining balance	$ 1,875.89

Scenario 5. Cash advance on a credit card

For the purposes of this example, we again assume cash advances taken out over the course of the year but in this case assume there is a background credit card balance in line with that for the average for those raising cash advances on credit cards and having household incomes of less than $35,000.p.a.

Key conditions	
Starting balance	$5,500.00
Main interest rate	14.69%
Minimum payment	2%
Actual monthly payment	$200.00
Interest rate	16.28%
Own network ATM fee ($)	$1.88
Own network ATM fee (%)	2.2%
Other network ATM fee ($)	$2.16
Other network ATM fee (%)	2.1%

Key results	
Cost of Credit	$1,619.04
Fees	$20.90
Interest	$1,598.14
Cost per $100	$24.91
Observed APR	15.7%
Amount advanced as cash	$1,000.00
Total credit	$6,500.00
Over term	2 years
Remaining balance	$3,319.04

Scenario 6. Delinquent payment pattern on a credit card

For the purposes of this example, we assume an existing balance in line with the average for households with incomes less than $35,000 p.a., as in the previous examples, but in this case also factor in three missed payments per year, again in line with the average for those who miss payments, over a period of five years.

Key conditions	
Starting balance	$6,443.80
Main interest rate	18.50%
Minimum payment	2%
Actual monthly payment	$200.00
Fees	
Annual fee	$35.00
Bounce charge	$20.00
Late Payment fee	$25.00

Key results	
Cost of Credit	$4,954.77
Annual fees	$175.00
Bounce charges	$300.00
Late payment fees	$375.00
Interest	$4,104.77
Cost per $100	$76.89
Observed APR	22.4%
Total credit	$6,443.80
Over term	5 years
Remaining balance	$2,398.57

The evidence suggests that it is far from clear that a rate ceiling will reduce the price of credit for low income borrowers and may work to increase it for some

In light of the evidence and the patterns and impacts here described, it would seem far from certain that the introduction of a rate ceiling would reduce the cost of credit to low income borrowers. Some borrowers may indeed gain access to cheaper credit, but there is a substantial risk that, under the uneven payment conditions endemic among low income borrowers, the cost of credit will increase in a price controlled environment for a significant minority of borrowers. All those currently using high cost short term credit as means of meeting longer term credit commitments must be assumed to be at risk of paying substantially more for their mainstream credit as delinquency rises on their accounts.

7.0 The impact of ceilings on debt and over-indebtedness

This section describes the trends on consumer debt, over-indebtedness and bankruptcy in France, Germany and the UK. It discusses the drivers of these trends and the extent to which the regulatory levers have influenced patterns of debt and over-indebtedness. We examine the outcomes of over-indebtedness in each territory and the consequences of default for over-stretched debtors under each regime.

Summary

- Rate ceilings do not appear effective in preventing over-indebtedness and indeed appear to make it more likely and to exacerbate its effects:
  - The rate ceilings in France and Germany have not prevented significant and rising levels of problem debt, over-indebtedness and insolvency.
  - Over-indebtedness in the UK, where there is no ceiling, is low and the major indicators of problem debt have declined over a long period, with recent rises from a low base.
  - Outgoings on debt service are very similar in all three countries but in France and Germany:
    - Debt per head for low income borrowers is significantly higher and over-indebtedness among low income borrowers is significantly more likely.
    - More debt is open ended and long term, leaving individuals more exposed in the event of a down-turn in fortunes or the economic cycle.
  - Consequences of problem debt, both short and long term, are significantly more damaging in France and Germany than in UK:
    - Lenders are less tolerant of payment difficulties, in large part because of the lack of flexibility associated with price controlled products.
    - The consequences of delinquency are more serious and the sanctions for default more rapidly applied.
    - As a result, in both France and Germany, those with credit difficulties are more likely to prioritise debt service over essentials to avoid sanctions than they are in the UK.
    - Those with payment difficulties are more likely to suffer fuel poverty and to undermine their financial security by not paying rents.
    - Insolvency is more likely to follow payment problems.

France, Germany and the UK have adopted different approaches to responsible lending & over-indebtedness with markedly different outcomes for consumers

Over-indebtedness has been a key focus of policy makers' discussion and decision making across the EU and for policy makers globally. Clearly over-indebtedness is deeply damaging for individuals, whatever their income or socio-economic background. However over-indebtedness afflicts those on low incomes disproportionately and so has also been a major focus of measures intended to combat poverty and social exclusion. France, Germany and the UK have taken very different approaches to responsible lending and over-indebtedness, with very different outcomes for consumers.

The German lenders' success in containing default has not of itself contained over-indebtedness which has risen steadily over time

The German regulatory focus on preventing default has succeeded in keeping default very low by international standards, with this being a major focus of the domestic German banks' lending strategies. The low default rate has not however in itself prevented a steady increase in over-indebtedness over the past decade. It is estimated, based on a survey undertaken periodically that over-indebtedness affected some 3.4 million households in 2006, equivalent to 8% of the population.

Over-indebtedness has been rising steadily in Germany

Chart 48: Trend rise in over-indebtedness in Germany

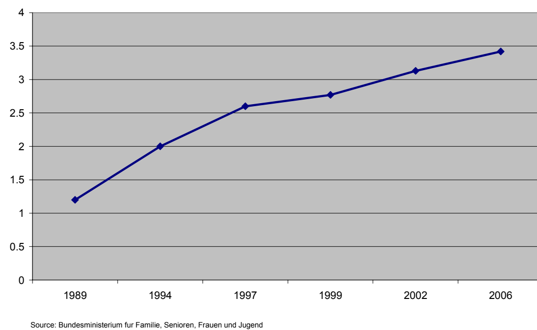
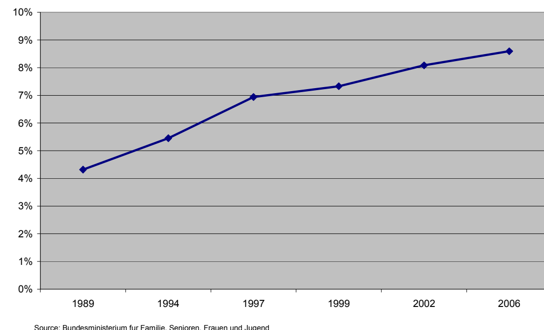


Chart 49: % of all households over-indebted for some years

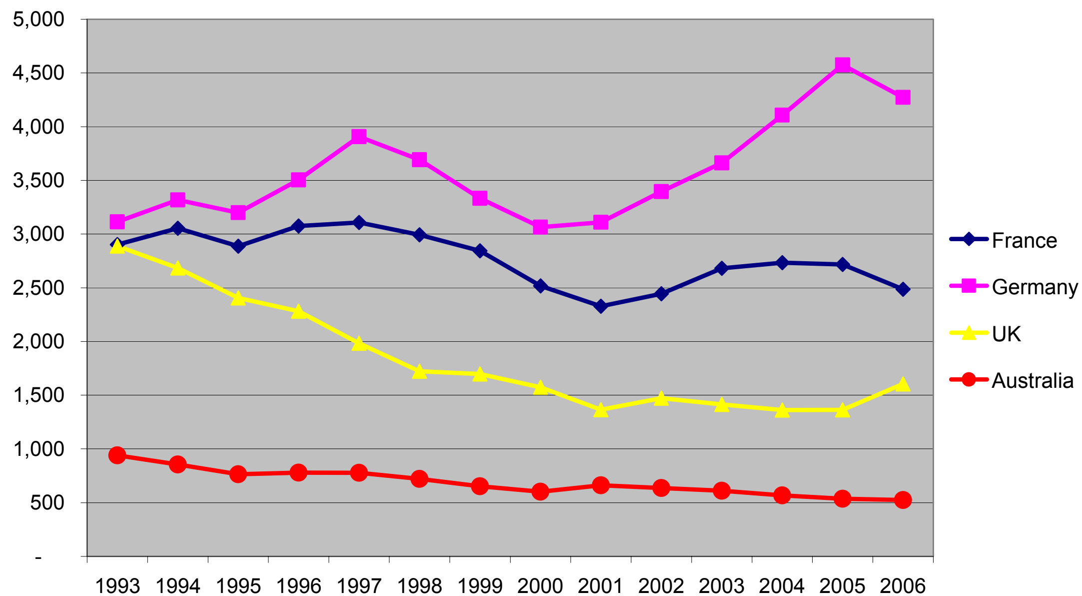


Rising over-indebtedness reflects the poor performance of the economy over the decade up to 2005, itself constrained by low consumption partly arising from a weak credit market

The primary explanation for the steady rise in over-indebtedness is the consistently poor performance of the economy, which has constrained income growth and employment. The weak economy is in part a function of weak credit market growth, arising in good measure from lender conservatism.

In Germany over-indebtedness reflects strong unemployment growth until 2005

Chart 50: Unemployment trends in France, Germany, the UK and Australia



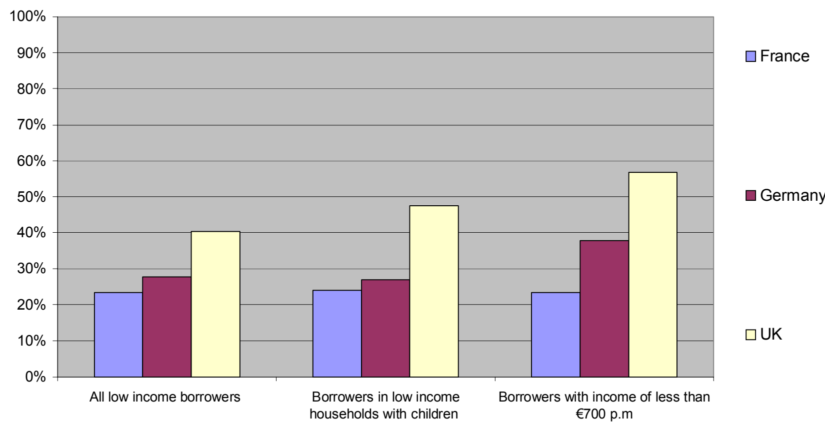
Source: OECD

Low income households in Germany are no less likely to encounter debt problems than in France or UK despite having more restricted access to credit

Despite the fact that low income households in Germany are much more likely to be credit excluded, the incidence of adverse credit registration among individuals on low incomes is very similar in all three countries. However, the reasons for registration in Germany differ from those in France or the UK, being more likely to be unpaid utility, telephone or housing bills. The explanation is that in Germany, in the absence of small scale credit, spare cash can often only be created by borrowing from funds allocated to bills. As a consequence low income households in Germany are more vulnerable than those in the UK and France to fuel poverty. In the UK, where the high cost lenders have built some flex into their business model, on the basis that long term relationships with borrowers on tight budgets require some tolerance and flexibility in the face of competing priorities, borrowers are much less likely to prioritise debt over essentials.

In the UK the high cost lenders have build flexibility on payments into their business model so that essentials are not prioritised over essentials

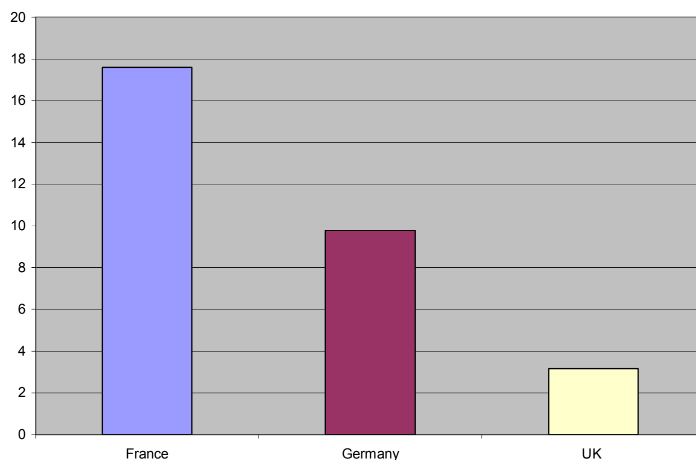
Chart 51: % agreeing that lender would understand if urgent bills came before loan repayment



Base: credit users
Source: Taylor Nelson Sofres Research for Policis 2004

In the UK credit users are less likely to "borrow" money from utilities than those in France and Germany where there are fewer small sum credit options

Chart 52: Utilities cut off for non-payment of bills



Base: Those on low incomes
Source: Taylor Nelson Sofres Research for Policis 2004

UK high cost lenders' relative tolerance on missed payments allows customers' budget to flex so that can cover essentials without hardship

Chart 53: Any coping strategies when having difficulties with HC payments

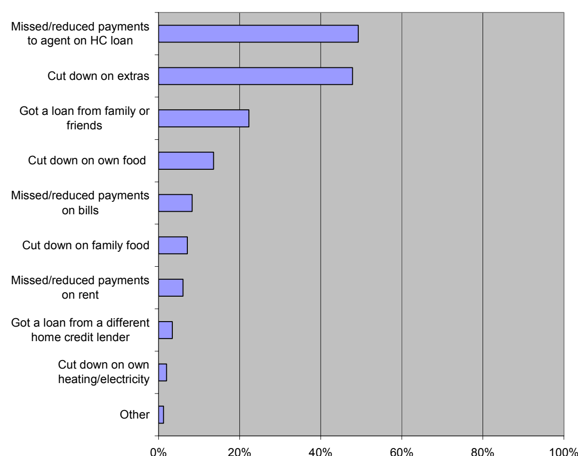
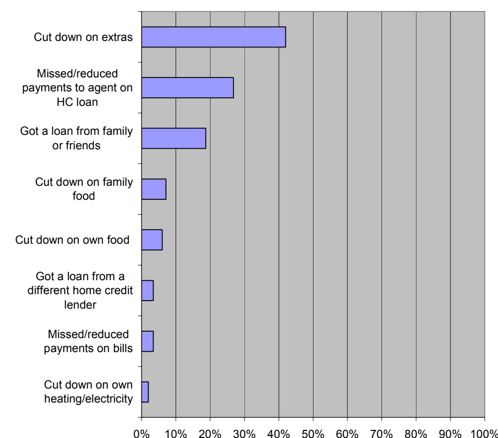


Chart 54: Most frequent coping strategies when having difficulties with HC payments



Source: TNS survey for Policis nationally representative sample of 1441, low income and benefit dependent credit users, 2004

In France the pattern is of a steep rise in over-indebtedness, following rising default on revolving credit newly extended to higher risk borrowers

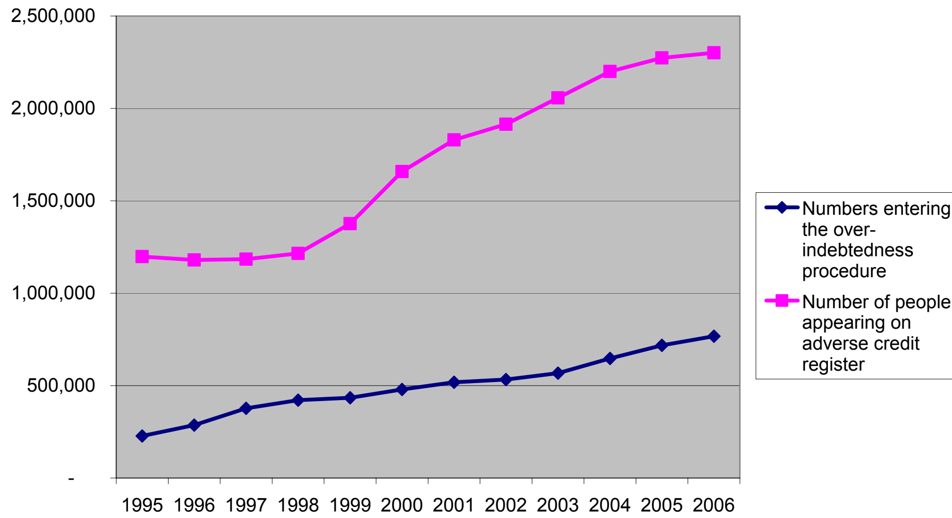
France has also experienced a trend rise in over-indebtedness but the pattern of increase is different to that seen in Germany because the underlying drivers are different. The rise in over-indebtedness in France arises in part from the rapid growth in revolving credit use among low income households from the late nineties onwards. This was accompanied by a rapid rise in default, primarily among higher risk borrowers. It would not seem overly pessimistic to suppose that a similar pattern might pertain in Australia if users of high cost short term credit were to shift to greater use of revolving credit. The potential scale of the increase might perhaps best be judged in relation to the increase in delinquency and default on revolving credit products in US states without ceilings relative to those without (illustrated in Chart 39 in Section 6.0 preceding), where levels of delinquency on credit cards in states with ceilings were on average 13% higher than in states without ceilings over the entire decade illustrated in the chart, peaking at 17% as the cycle turned down in 2001/2.

The number of individuals going through the over-indebtedness procedure in France rose by 50% in 5 years to 2005 in line with the rise in revolving credit

The French consumer protection, delinquency management and over-indebtedness process mandates that borrowers experiencing payment delinquency and default quickly find their financial affairs subject to management by the Banque de France. Entry into the Interdit Bancaire and over-indebtedness management regime is rapid and relatively automatic and can be precipitated by relatively minor payment problems if these cannot quickly be made good. In 2006, of the 2.3 million individuals registered with the FICP, some 0.77 million individuals were registered on the FICP as being at various stages of the over indebtedness procedure. Of these, the overwhelming majority (0.5 million) were in the process of reaching a (Banque de France mediated) agreement to repay their creditors to an agreed schedule.

The rise in over-indebtedness has been steeper in France than in Germany and tracks increases in revolving credit use among those on low incomes

Chart 55: Trend rise in over-indebtedness in France



Source: Banque de France / FICP

The major indicators of serious problem debt have been trending downwards over a long period in the UK, with a recent rise from a low base

The major indicators of problem debt, being the most serious level of adverse credit registrations (County Court Judgements, CCJs, and money judgements), which are particularly good indicators for those on lower incomes, and mortgage arrears and repossessions, which are the most telling indication for the high proportion of the UK population who are home owners, have been trending downwards over a very long period, essentially since the housing price crash of the early 90's. There has been a very recent rise in both the latter, but from a low base, potentially indicating that some borrowers are struggling in the wake of recent interest rate rises.

The key indicators of serious problem debt have trended down over a long period

Chart 56: UK over-indebtedness trends
County Court Judgements and Money Claims

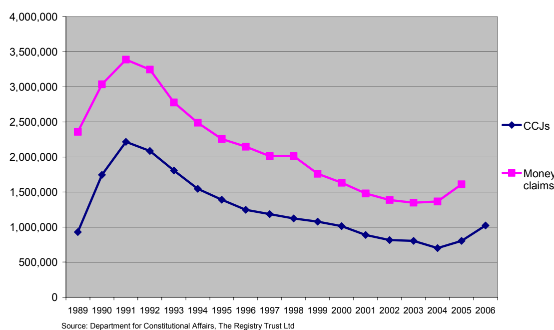
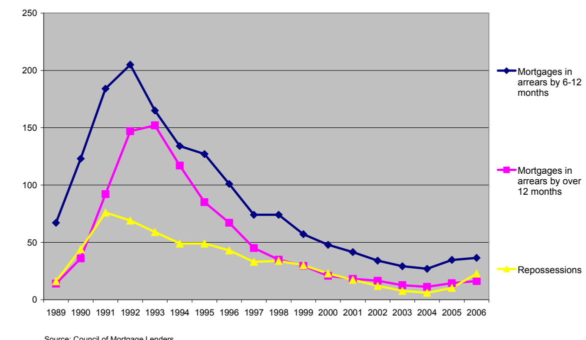


Chart 57: UK over-indebtedness trends
Mortgage arrears and repossession trends



Taking the most serious level of adverse credit registration as a proxy for trends in struggling with debt, it is clear that, on an annualised growth basis, the last few years have seen rising over-indebtedness in France and Germany, though to some extent for different reasons, and a long decline in the UK, though the indicators there have turned upwards over the last two years.

Problem debt has risen most strongly in France, more gradually in Germany while falling in the UK over the past decade despite a sharp recent rise

Chart 58: Over-indebtedness trends, France, Germany, UK

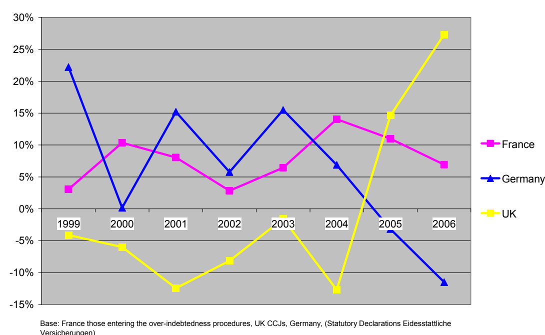
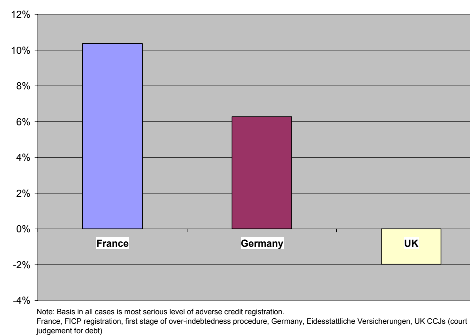


Chart 59: % annualised growth in most serious level of adverse credit registration 1996-2006 in France, Germany, UK

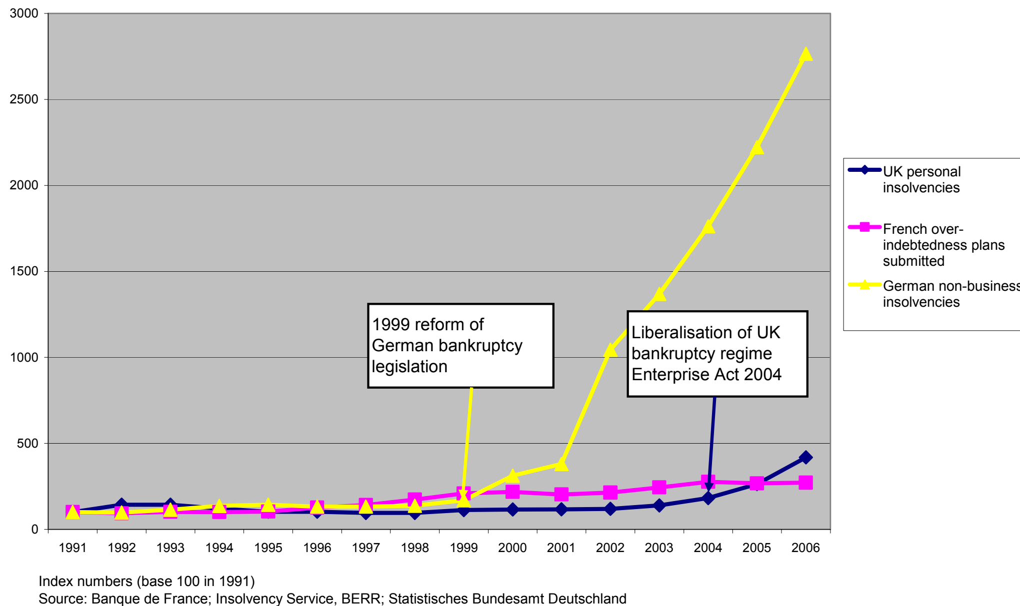


Bankruptcy trends in both Germany and the UK have been heavily impacted by changes to the bankruptcy regime

Bankruptcy trends in both Germany and the UK have been influenced by changes to the bankruptcy laws and so are discussed separately from the previous discussion on over-indebtedness trends. There is no exact equivalent to bankruptcy under the French regime, though the over-indebtedness procedure, shown in the Charts following alongside UK and German insolvencies comes closest to it. The antiquated and previously fairly draconian German bankruptcy laws were modernised in 1999, which resulted in an immediate rise in bankruptcies, which have continued to rise steeply because of the combination of pent-up need held back by the deterrent effect of the previous regime and the continuing impacts of poor economic performance. In the UK, changes were made to the bankruptcy regime in 2004, as part of the Enterprise Act 2004, allowing for a new rapid discharge from bankruptcy after twelve months. This has had the immediate impact of encouraging into bankruptcy a small bulge of those without significant assets and struggling with debt, with only 8% of those declaring bankruptcy in 2005 (the year when the impact of change was first felt) having residential property compared to some seven out of ten of the wider population.

Bankruptcies have climbed sharply in Germany following reform of the regime, with the 2005 liberalisation in the UK also stimulating an increase

Chart 60: Insolvency procedures, France, Germany, UK



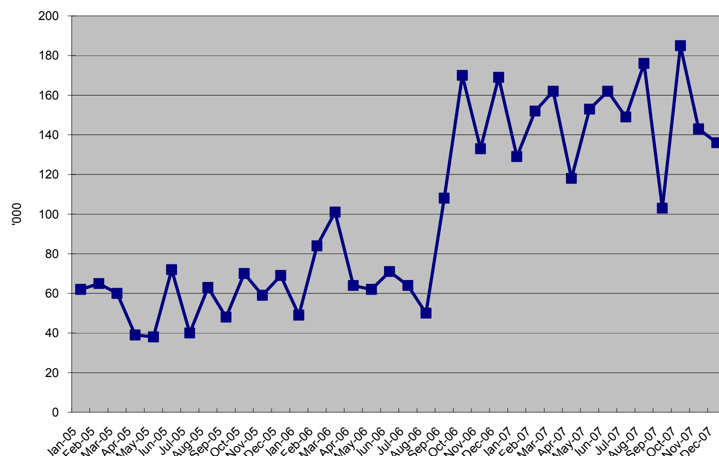
Index numbers (base 100 in 1991)
Source: Banque de France; Insolvency Service, BERR; Statistisches Bundesamt Deutschland

The Japanese experience suggests that increasing bankruptcies can arise from sudden credit exclusion as much as from a shift to revolving credit

The Japanese experience has been of a sharp increase in bankruptcies following the enactment of the reduction in the interest rate ceiling, particularly among small businesses, who previously depended heavily on consumer finance companies. As consumer advances have fallen by two thirds in the two years since the law was enacted (see Charts 17a and b), so also have bankruptcies risen sharply, particularly among the self employed who had relied heavily on consumer finance lending. It is worth noting that this occurred (see chart below) after a period in which bankruptices had previously been falling as a result of the modernisation of the bankruptcy laws.

Rise in bankruptcies parallels the rationing of consumer credit

Chart 61: Self-employed bankruptcy numbers in Japan 2005-2008

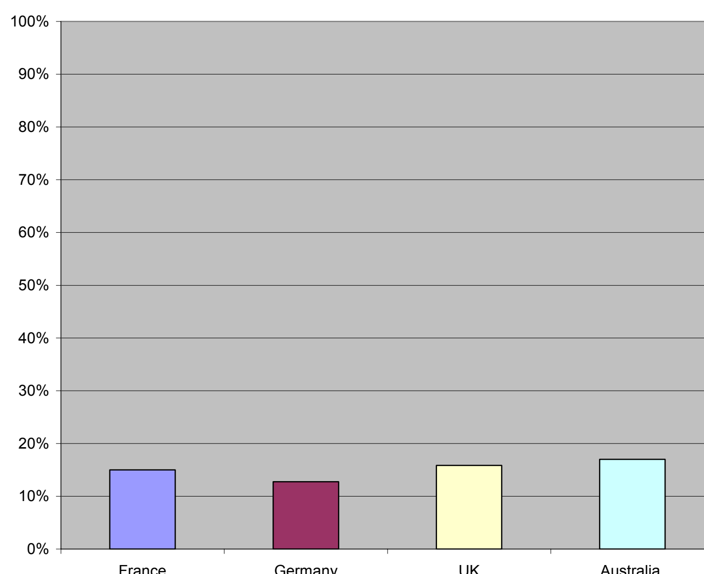


Payments on debt service appear to be remarkably consistent in markets with and without ceilings and for those using different credit vehicles

We turn now to the consumer experience of debt and over-indebtedness. Overall payments on debt service as a proportion of household income tend to be very similar in both rate capped markets and those with no price controls, with the same being true also of those using different credit vehicles. This would tend to indicate that judgements on the affordability of debt are made on the basis of outgoings rather than the risk associated with the amount of debt carried. Debt service as a proportion of outgoings for low income households is very similar in the UK, France, Germany and Australia.

There is little difference between the markets with and without rate caps in expenditure on debt service

Chart 62: Debt service as % of annual household income for low income households



Base: Low income borrowers
Source: TNS for Policis consumer research with 2717 low income consumers (lowest household income quintile) in UK, France and Germany 2004. Synovate research for Policis 503 low income consumers Australia 2008

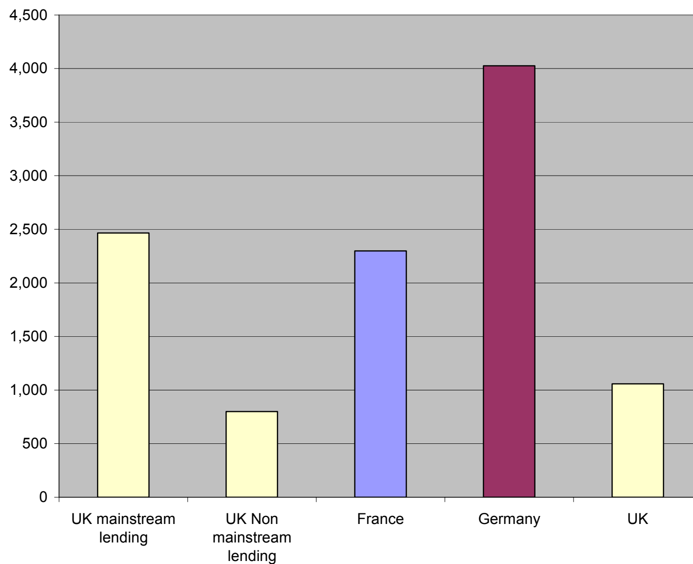
Low income borrowers in France and Germany appear to carry more debt primarily because product structures are scaled for higher value lending

However the indebtedness being carried by low income consumers appears significantly higher in both France and Germany than it is in the UK where the high cost small sum sub prime lenders seek to lend sums in scale to the incomes of their customers. The evidence is that, in markets without ceilings, low income consumers tend to become less indebted if using term products and short term small sum credit than if using revolving credit, because of the tendency for debt to edge up towards the limit of an available credit line when funds are tight. In markets with price controls, two linked effects work to escalate debt. Firstly, individuals are more likely to be diverted to revolving credit, where these products are available, thus in any case increasing the likelihood that indebtedness will be higher. For those able to access fixed term loans, however, high minimum lending levels will also work to escalate debt. As a result, low income borrowers tend to take on more debt than they might otherwise need simply to qualify for a loan[37].

[37] This effect is particularly marked in Germany. See minimum lending levels for Sparkassen in Table 1.

Debt per head among low income borrowers able to access credit is significantly higher in France and Germany than in the UK

Chart 63: Value of most recent personal loan €



Base: Low income borrowers
Source: Taylor Nelson Sofres Research for Policis 2004

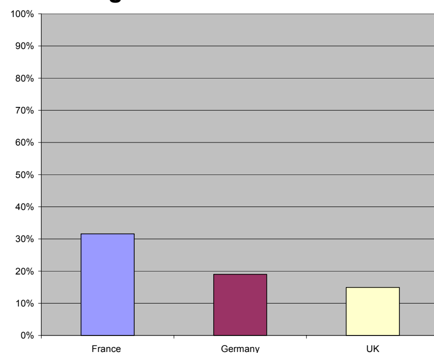
Lenders reduce their risk in capped markets by mechanisms which make it easier for them to recover funds in the event of payment difficulties

Lenders reduce their risk in rate capped markets not only by pricing adaptations and credit rationing but also by a whole series of mechanisms designed to reduce risks, such as requiring guarantees from third parties, side contracts which provide for the right to garnish income or assets. Provisions which allow lenders to apply to employers for direct deductions from salary or to access bank accounts directly to appropriate payments are common. Lenders also appear less likely to be flexible in the event of difficulties arising. Low income borrowers in both France and Germany were more likely than those in the UK to feel that borrowers were aggressive in recovering debt and less likely to feel that lenders were supportive in the event of payment difficulties.

Lenders in France and Germany appear to be less tolerant of payment difficulty than those in the UK

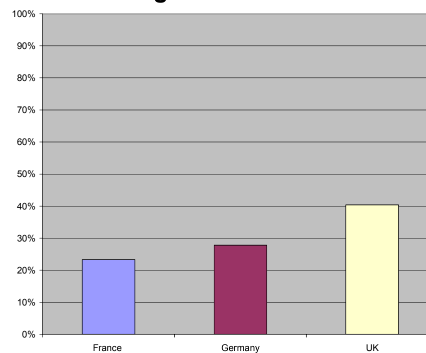
% agreeing with statement

Chart 64: Lenders are aggressive in recovering their debt



Source: Taylor Nelson Sofres Research for Policis 2004
Base: Low income borrowers with payment difficulties

Chart 65: Lenders are supportive and understanding in the event of difficulties



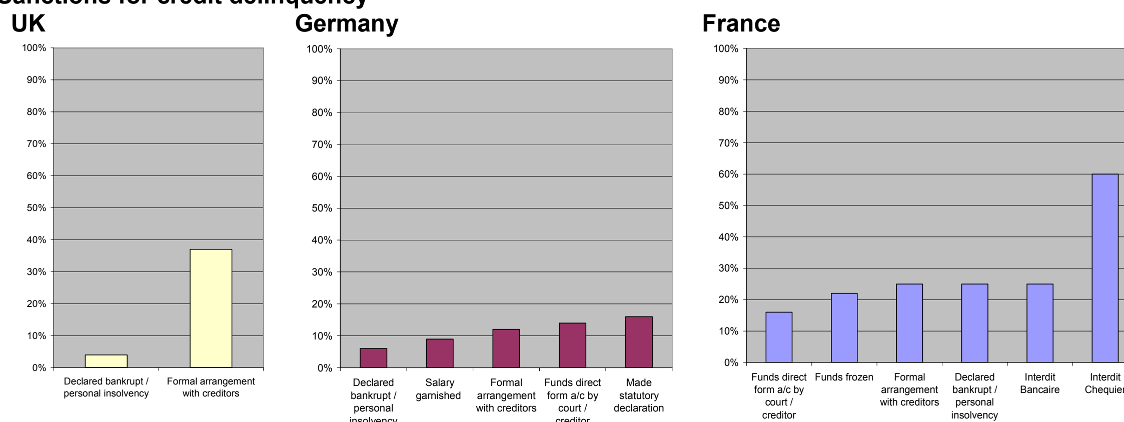
Source: Taylor Nelson Sofres Research for Policis 2004
Base Low income borrowers with payment difficulties

Low income borrowers in difficulties in France and Germany appear more likely to face insolvency than their counterparts in the UK

As a result, low income borrowers in difficulties in the UK appear much more likely to make an arrangement with their creditors and much less likely to lose control of their financial affairs. In France over-indebted consumers running into financial difficulties will quickly find themselves moved into the Banque de France administered over-indebtedness regime, which leads not only to some loss of control over financial matters but also to a degree of banking exclusion. Partly as a consequence it would appear that low income borrowers are more exposed to insolvency in rate capped markets. Insolvencies in the UK have risen sharply since the research in Europe was undertaken. That said, among the low income borrowers interviewed for the consumer research, only 4% of those with credit problems in the UK had declared bankruptcy. This compares to 25% claiming to have experience of personal insolvency in France, reflecting the relatively automated processes and interventionist nature of the consumer regime. In Germany 6% of those with credit problems had faced personal insolvency, with 16% making a Statutory Declaration to their creditors (Eiedesstattliche Versicherung – effectively the new fast track insolvency process).

Chart 66: Sanctions for credit delinquency are more readily and rapidly applied in France and Germany with insolvency a more likely outcome than in the UK

Sanctions for credit delinquency

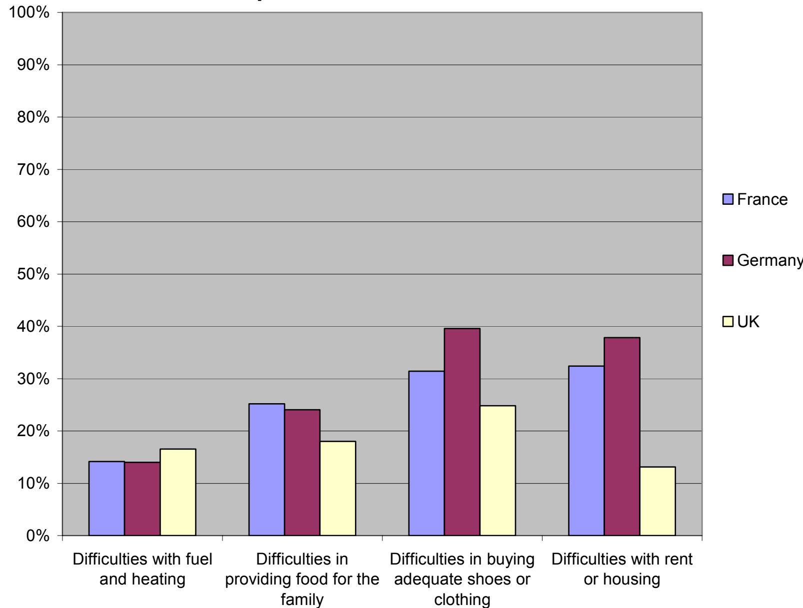


Base: Those with credit repayment difficulties
Source: Policis consumer research with 2717 low income consumers (lowest household income quintile) in UK, France and Germany 2003

This syndrome would in part appear to explain why low income borrowers in France and Germany are more likely to suffer hardship in the event of financial difficulty than their counterparts in the UK. In the effort to avoid loss of control over financial affairs, borrowers in difficulties are more likely to go without essentials or to prioritise debt service over payments of rent or utilities, potentially placing themselves at some risk to their overall wellbeing.

Those experiencing credit difficulties in France and Germany are more likely to prioritise debt service over essentials in the effort to avoid sanctions

Chart 67: Difficulties experienced as a result of difficulties with debt



Source: Taylor Nelson Sofres Research for Policis 2004
Base: Low income borrowers with credit repayment difficulties

Patterns of debt and debt service in Australia suggest a similar relationship between debt service and levels of debt on different credit product types

Patterns of indebtedness and of debt service would suggest that a similar dynamic exists in the domestic Australian market and that under rate capped conditions, the risk of insolvency for the most exposed individuals would rise. A similar effect to that described earlier in Europe can be observed when the total outgoings on debt service of low income borrowers taking small sums as cash on credit cards are compared to that of users of payday loans. Outgoings are strikingly similar despite the mix and structure of credit products being used in each case being different. As in the effects just discussed in Europe, however, those choosing to raise small sum cash via revolving credit cards are significantly more indebted than their payday counterparts. They also tend to pay down their credit card balances more slowly than do payday borrowers paying down credit card debt.

Outgoings on total debt service among low income Australian borrowers are strikingly similar for those taking cash advances on cards and payday users

Chart 68: Monthly value of debt service on all borrowings

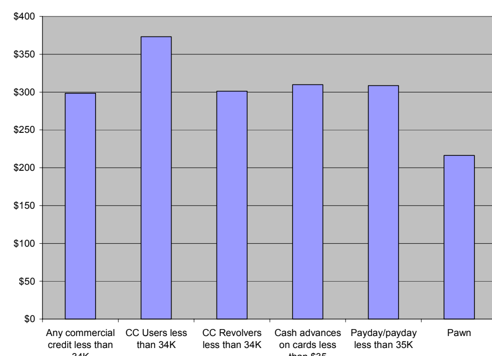
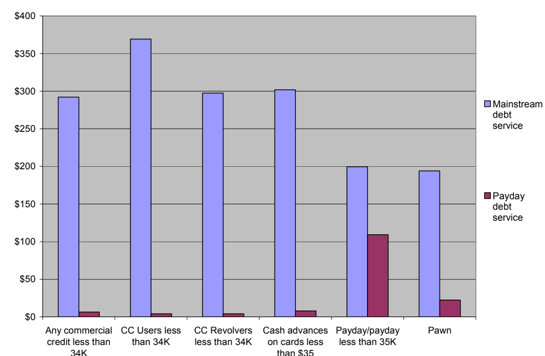


Chart 69: Monthly debt service on mainstream credit and short term payday lending



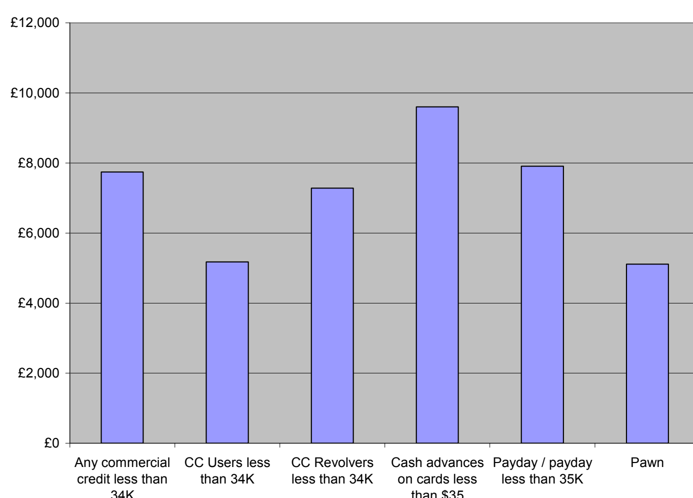
Base: Low income households in Australia
Source: Synovate research for Policis 2008

Indebtedness is higher for those taking cash advances on credit cards than it is for other low income credit users in Australia

Overall indebtedness is significantly higher for those taking cash advances on credit cards than it is for other low income borrowers. That levels of debt service are broadly in line with those of other low income credit users is explained by their having a higher incidence of "revolving" on credit cards i.e. of making partial payments on outstanding credit card balances. Payday borrowers have a similar ratio of debt relative to incomes and a not dissimilar proportion of credit card users revolving their balances, suggesting that the two groups are under similar levels of financial pressure. It would seem likely therefore that if payday borrowers were to rely to a greater extent on cash advances on credit cards in the absence of a short term small cash option, that their levels of indebtedness would rise to a level at least in line with that of other cash advance users, provided always that they have access to mainstream options which, as discussed earlier, is not always the case.

Card cash advance users have the highest level of indebtedness despite their disadvantage relative to other mainstream credit users

Chart 70: Value of total debt outstanding



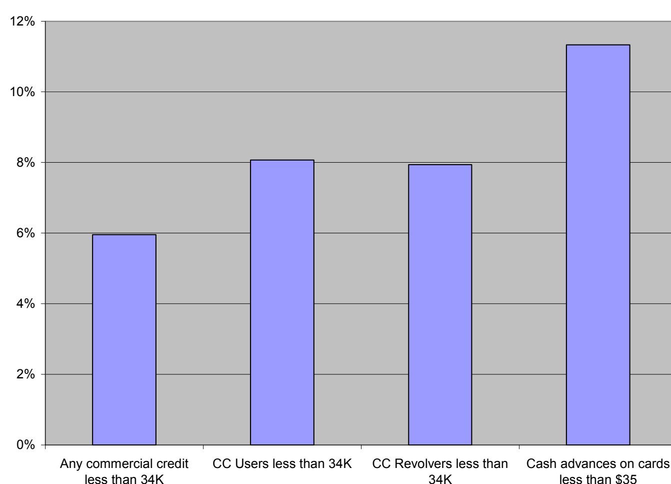
Base: Low income households in Australia
Source: Synovate research for Policis 2008

These borrowers are also those most exposed to the risk of financial breakdown

Those taking cash advances on credit cards not only owe more than other credit user types but also are the least likely to have savings safety nets while also being more likely to be subject to irregularity in income flows, arising from insecure employment. Being highly geared on credit cards and loans exposes those susceptible to payment difficulties to greater risk in the event of a reversal in fortunes, a shortfall or delay in cash inflows or an income shock. Low income borrowers using revolving credit on credit cards are twice as likely (6%) to have a court judgement for debt as all card holders (3%). Low income credit card users are more than 40% more likely than all credit users to become insolvent. Low income borrowers taking cash advances on credit cards are nearly twice as likely (90% more likely) to become insolvent than other low income credit users. It would seem likely that diverting further high risk borrowers to cash advances on credit cards and revolving credit will only increase their exposure to the risk of financial breakdown, and result in rising levels of insolvency.

Those taking cash advances on credit cards are significantly more likely to face insolvency than other low income credit users

Chart 71: Experience of insolvency among low income credit users
% experiencing Section 9 insolvency or bankruptcy



Base: Low income households in Australia
Source: Synovate research for Policis 2008

These effects are exaggerated when the economic cycle turns down with low income households often first affected and most deeply impacted

The pattern of greater delinquency on revolving credit in US states with ceilings, shown in Chart 38 and 39 earlier, indicates that the effects described are exacerbated in those years in which there is a down-turn in the economic cycle. Sharp upturns in delinquency coincide with low points in the cycle, indicating that low income borrowers diverted to mainstream credit are particularly exposed to the risk of default in the event of an adverse change in economic circumstances. This may be a particularly important consideration for regulators at the time of writing (early 2008) against the background of the global credit crunch and growing fears of a potential down-turn. The pattern of indebtedness and insolvency just described for those taking cash advances on credit cards suggests these borrowers are likely to be particularly exposed in the event of any deterioration in the wider economy.

There is every possibility that price controls will lead to an increase in over-indebtedness and bankruptcy rather than the reverse

Taken together the evidence suggests that any substitution of open ended revolving credit and long term loans for small sum short term credit will likely give rise to an increase in delinquency, default and ultimately in financial breakdown and insolvency among low income consumers. Against this background the likelihood is that, on balance, price controls will likely lead to an increase in indebtedness and bankruptcy.

8.0 The impact of ceilings on credit market growth and economic prosperity

This section covers trends in credit market and economic growth in France and Germany on the one hand, and the UK and Australia on the other. It discusses the differences between the four markets, the role of interest rate caps in creating the different outcomes and the reasons for the differences between the two European markets in which rate ceilings are in operation.

Summary

- Interest rate ceilings have an impact beyond those on low incomes and outside the credit market:
  - The UK, Australian and French economies have benefited from the stimulus to consumption provided by credit growth, the UK and Australia to a greater extent than France
  - German credit growth has been particularly weak. The German recovery has been constrained partly as a result. The price for achieving low default in Germany may be to reinforce structural rigidities
  - The difference in performance between the two states with rate ceilings rests on the disincentives to lenders to risk default in the German regulation
  - Interest rate ceilings may be acting as a constraint on prosperity and progress towards the oft-repeated European Union goals of enhanced employment & growth

Credit market growth and economic prosperity

UK and Australian credit market growth has been significantly faster than in France and Germany

There are significant differences between the two sets of markets in terms of credit growth. The UK and Australia have experienced more rapid growth than either France or Germany, with Germany exhibiting particularly slow growth in recent years. Both the UK and Australian credit markets have grown at an annualised rate of around 10% in the period 1995 – 2006, compared to 6.3% in France and 0.9% in Germany. Consumer credit per head has grown quickest in the UK with an annualised rate of 9.5% over the period but growth in Australia was barely lower with a rate of 9.1%.

Credit market growth in Australia and the UK has been significantly faster than in France or Germany

Chart 72: Credit Market Growth, Australia, France, Germany, UK 1995-2006, Consumer credit in Billion US Dollars

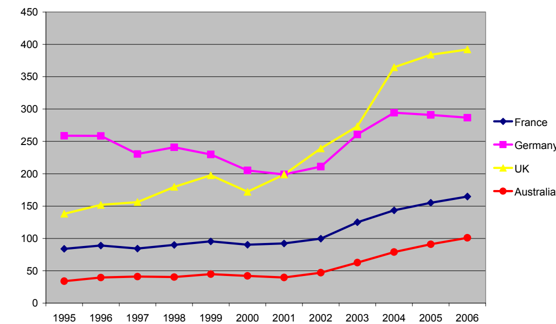
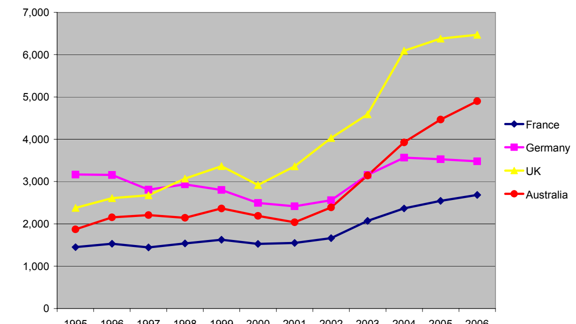


Chart 73: Consumer Credit per head, US Dollars

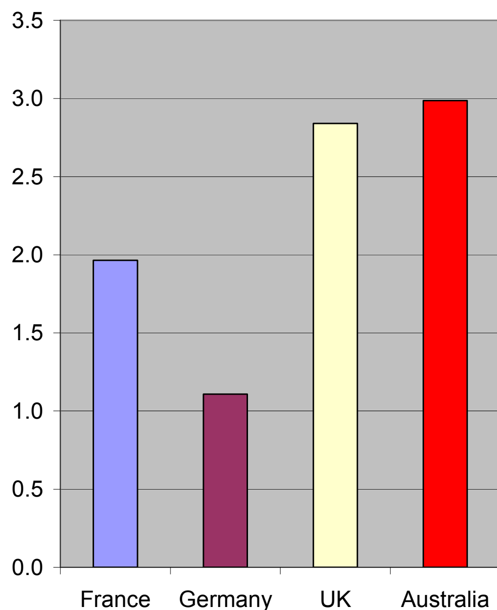


Germany has experienced particularly weak credit growth

The UK has overtaken Germany as the largest credit market in Europe, and is also the most developed and fastest growing. The UK credit market (US$392bn) is now significantly larger than that of both Germany (US$287bn) and France (US$165bn), despite the UK having a working age population that is 73% the size of that of Germany and the same as that of France. Australia has experienced credit growth rates which are almost identical to those of the UK over the same period.

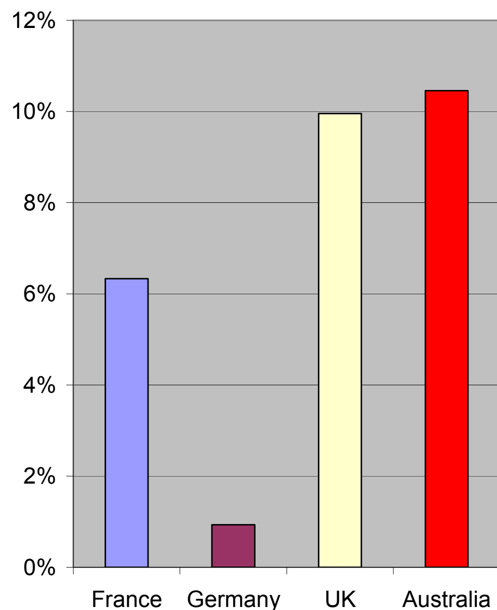
Australia and the UK have experienced annualised credit growth of 10% compared to 2% for Germany

Chart 74: Credit market growth, ratio over period 1995-2006



Source: Australian Reserve Bank, Cadran de Cofidis, Bank of England, Bundesbank, Banque de France, OECD

Chart 75: Credit market growth, annualised growth rate 1995-2006



Source: Australian Reserve Bank, Cadran de Cofidis, Bank of England, Bundesbank, Banque de France, OECD

Part of the explanation will lie with cultural attitudes and the relatively strong performance of the UK and Australian economies

Part of the explanation for this differential will lie with cultural attitudes to debt and a greater acceptance of credit in both the UK and Australia. The strong economic

performance of both Australia and the UK relative to that of both France and Germany will have influenced consumers' willingness to take on debt as will the rapid asset inflation of the housing markets in both "Anglo-Saxon" economies over recent years whereas the relatively high savings rates in France and Germany can be seen as a sign of depressed domestic demand or of general worries about the future. Housing ownership is high in the UK (68%), France (63%) and Australia (65%) compared with Germany (43%) and the UK and Australian savings rates are actually negative (-0.1% and -3.6% respectively) whereas rates in both France and Germany are above 10% (11.5% and 10.7% respectively). Consumers' sense of their personal prosperity and income prospects will influence their willingness to take on debt and thus demand for credit. Similarly, demand for credit will in part be shaped by the availability of savings.

Demand differs little between the two sets of markets so that the drivers would appear to be supply-side, with interest caps acting to restrict supply

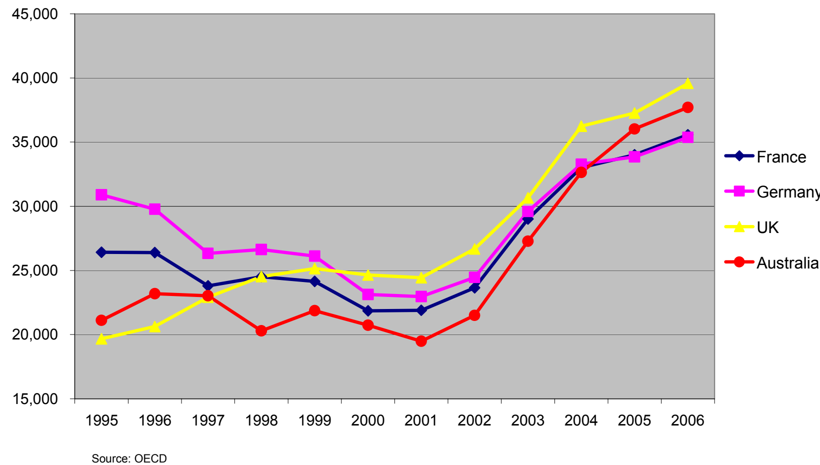
That said, consumer research undertaken by Policis in 2004 in all three European countries and in 2008 in Australia indicates that demand for credit, as measured by the claimed need to borrow among low income high risk groups, does not vary significantly between the four countries. If demand is constant, the more significant drivers would therefore appear to be on the supply side. While other factors will be also be an influence, it would appear that the interest rate ceilings in the French and German markets have played a role in restricting credit market growth compared to the UK and Australia.

Both the Australian and UK economies, in the case of the latter to a large extent fuelled by consumption, have performed more strongly than either France or Germany

Just as the availability of credit is seen as critical for business investment, the supply of credit plays an important role in fuelling consumption by households, which is itself one of the key is drivers of wider economic growth. The UK and Australian economies have both enjoyed significantly faster growth and more rapid increases in income per capita over the past ten years or so than either France or Germany. Over the years 1995 – 2006 the UK has experienced a 7% annualised increase in GDP and a 6.7% annualised increased in gross income per capita, with Australia showing comparably high growth rates of 6.6% and 5.4% respectively. This compares with significantly lower rates of 3.3% and 2.8% respectively for France and 1.3% and 1.4% respectively in Germany.

Economic growth has been greatest in the UK and Australia, with France outperforming Germany despite sharing many of same structural problems

Chart 76: Economic growth, GDP per capita, France, Germany, UK, Australia 1995-2006, $



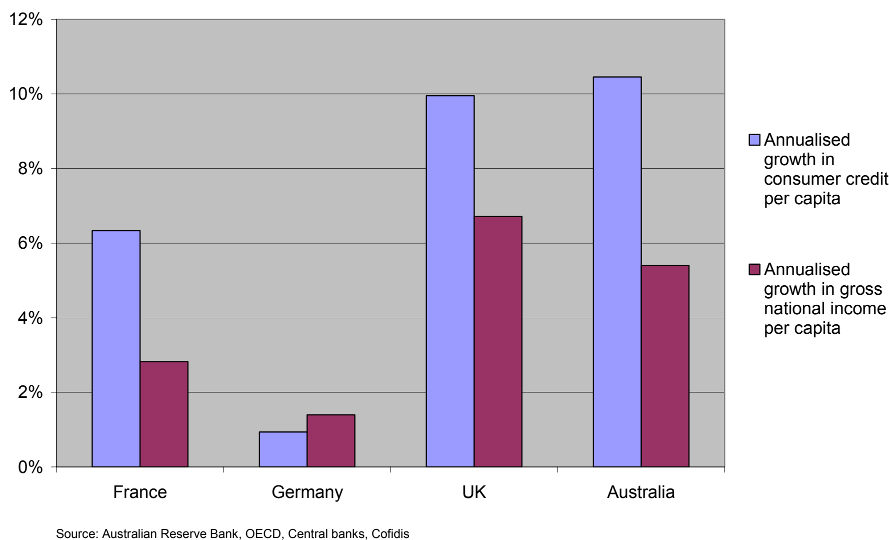
Source: OECD

Part of explanation for superior performance of "Anglo-Saxon" economies and differential between France and Germany, is stimulus to consumption arising from credit growth, to a larger extent in the UK than in Australia however

Clearly there will be a series of factors which will have influenced the economic performance of both Australia and the UK and for the differences between the performance of France and Germany. On this basis, one could argue that the French economy and personal prosperity have benefited to a greater degree from credit growth than the German economy, which has not experienced the same degree of stimulus to consumption.

Growth in personal prosperity has been significantly faster in the markets with faster credit growth

Chart 77: Credit Market Growth and Personal Prosperity, annualised growth rate consumer credit per head and gross national income per head, 1995 - 2006, France, Germany, UK, Australia



Source: Australian Reserve Bank, OECD, Central banks, Cofidis

The differences in outcome between France and Germany

The explanation for the differential in growth between France and Germany rests on differences in focus of regulation as distinct from the rate ceiling itself

If, on the hypotheses advanced in the previous section, the interest ceilings operating within France and Germany have to some extent constrained both credit market and economic growth relative to the "anglo-saxon" economies, other factors then need to be found in order to explain the differences between France and Germany. In both countries regulation reflects a deep-seated anti usury stance but also cultural ambivalence on credit, particularly in Germany. Policy debate in both countries has centred on the avoidance of over-indebtedness, particularly in relation to the alleviation of poverty.

The more rapid credit growth in France, where the ceiling is more tightly specified and the regulatory focus is explicitly on price control, warrants some explanation. In our view, a plausible explanation rests on the differences in the nature of the regulatory focus within each market as much as with the presence of the usury ceiling, particularly the greater emphasis in the German regulation on the prevention of problem debt. This in particular appears to have had a substantial effect in shaping the mix of credit products and the nature of consumer relationships with suppliers in the German market, with there being significant differences between the French and German markets in these regards. These differences in turn appear to have been instrumental in determining relative credit growth.

The disincentive to risk default implicit in the German system of reduced rates for defaulters has resulted in a highly risk averse lender set

The interest rate ceilings operating in each market constitute only one element of the total regulatory framework, which itself is the product of, and in turn reinforces, cultural tendencies and prevailing social attitudes. The weak growth of the German credit market appears in part to be driven by the regulatory focus on the avoidance of default, and in particular the disincentive to lenders to take risks inherent in the reduced rate payable by delinquent borrowers. This has resulted in a lender set that is conservative and risk averse, particularly with regard to the possibility of default. Most German banks strive to keep their default rates below 2% or even 1%, with these rates having largely remained stable over many years. The emphasis placed on the avoidance of default and the presumption that default is an outcome to be avoided at all costs may in itself be a hang-over from the formerly draconian insolvency regime which the 1999 reform of the German bankruptcy legislation replaced. Prior to the reforms, the consequences of bankruptcy were indeed not only catastrophic for the individual concerned but also very long term, in that a bankruptcy term could extend as long as 30 years.

Resistance to card based credit and risk based pricing among Germany's conservative lenders has held back development of the credit market

The other part of the explanation for the differential between France and Germany rests on the product mix available in each. Credit cards have been a major driver of growth in credit markets globally, including that in France, where revolving credit has grown rapidly over a ten year period. Conversely, credit cards are a relatively unimportant part of the mix in Germany and are for the most part confined to the relatively affluent. In addition, the cultural emphasis placed in Germany on treating all customers equally has held back the development of risk-based pricing, which in turn has played a large part in the German banks' reluctance to develop credit cards or to extend card based credit to a wider cross section of the population. The US owned

Citibank, which introduced a form of risk based pricing related to borrowers incomes to the German market in the 1990s, was widely criticised for "violating" pricing norms, reinforcing other lenders' conservatism in this regard.

In France, credit growth has been achieved by growing card based revolving credit and expanding the risk pool to take in higher risk borrowers

In France, by contrast, market growth has largely resulted from the aggressive expansion of the consumer finance arms of the major French banks. This has been achieved primarily through growing card-based revolving credit and, in line with global credit trends, widening the risk pool to take in higher risk groups and introducing differential pricing. The expansion of the French credit market was initially achieved through partnerships and joint ventures between lenders and retailers, with the latter providing a distribution channel for lending to a wider universe of customers and at higher margins than had been typical historically in the personal loans market. Given the stellar growth of revolving credit in Australia, the likely outcome of a strict enforcement of rate ceilings there is a further widening of the risk pool along French lines, with the all the implications that has for transparency and flexibility.

Interest rate ceilings may be acting as a constraint on wider prosperity and growth

In summarising this section, although other factors are also at play, it would seem that the primary explanation for the more rapid growth in the credit market in Australia and the UK than in France and Germany lies with the absence until now of an effective interest rate ceiling in those markets. To the extent that credit growth drives consumption and economic growth, the greater increases in prosperity in Australia and the UK relative to France and Germany, and in France relative to Germany, appear to rest at least in part on faster credit growth. It follows that the operation of a rate ceiling in France and Germany may be acting as a constraint on wider prosperity and growth, though other factors will also be at play.

The price for achieving the low default rate that is a feature of the German market may be to further reinforce structural rigidities

The other conclusion that can be drawn from this analysis is the extent to which credit markets are shaped by the overall emphasis and focus of regulation rather than ceilings alone. The focus of the German regulation on the avoidance of default has certainly succeeded in keeping defaults very low by international standards. The price for this appears to be a market and lender set which is so conservative as to limit innovation and market development. This in turn may work to reinforce other structural rigidities, potentially further inhibiting growth not just of the German credit and financial services markets but of commerce and consumer aspiration more widely. The French emphasis on the management of default – as distinct from its prevention - and on the protection of the consumer from the consequences of over-commitment appears to have resulted in a very different credit market from that of Germany, despite the similarities in the anti usury stance of the two countries. The French experience is rather of a rising tide of default to be managed but in which the wider population and the economy has benefited from the enhancement to prosperity created by the growth of the credit market.

9.0 Conclusions and policy implications

- The evidence does not support the assumption of a debt spiral and consumer detriment associated with payday lending which the proposed rate ceilings are intended to address.
- The evidence would also appear to suggest that a rate ceiling will not necessarily reduce the cost of credit for low income borrowers. There is indeed a strong risk that some borrowers under uneven payment conditions will pay more for credit.
- A rate ceiling would appear unlikely also to prevent over-indebtedness. It is more likely to increase the indebtedness of low income borrowers and to simply shift more debt into revolving credit vehicles being repaid over extended terms.
- It would appear likely that credit exclusion will result from the imposition of a ceiling and that the consequences will include significant hardship for excluded households who will no longer be able to access small sum cash credit to manage cash emergencies or peaks of expenditure or to enable them to spread the cost of major purchases.
- Other borrowers now using high cost credit will be diverted to revolving credit, with cash advances likely to become a higher proportion of credit card use. This will likely result in increased delinquency and default and to low income individuals being at greater risk of financial breakdown and insolvency.
- As a consequence, more individuals will acquire adverse credit history and find themselves unable to obtain credit, increasing the hardship and exclusion earlier effects referred to.
- There is also a significant risk of creating the conditions for unlicensed lenders to enter the market, a development likely to be highly damaging for borrowers and likely to greatly increase the cost of credit for borrowers unable to obtain credit legitimately.
- In the event that a rate ceiling is imposed, it would seem likely that there will be a significant need for alternative social lending. The experience of other countries who have pursued this route is that establishing a social lending operation is highly challenging, slow to establish and scale and, for most governments, prohibitively expensive.
- The better way forward in protecting vulnerable consumers would appear to be a greater focus on ensuring best practice in consumer lending, eliminating unfair and exploitative practices and achieving greater transparency on pricing, terms and conditions.
- The most effective way to reduce prices for low income borrowers may be to foster an environment which stimulates competition.