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The dynamics of low income credit use

A research study of low income households in Australia

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Executive summary

The role of credit in low income households

- Demand for credit among those on low incomes is shaped by an irreducible need to borrow, most pronounced among families
- Credit is used by low income households primarily for essentials and to ensure the effective functioning of household finances
- Small sum credit in the form of cash advances on credit cards and payday loans appears to play a key role in the finances of those on low incomes
- More likely to be used for cash emergencies and meeting unanticipated expenses than other credit types
- Similar proportions of high cost borrowing used to spread cost of major purchases and keep up with commitments as other credit types
- Informal borrowing is inadequate as a substitute for commercial credit:
- Constrained credit options are likely to have a cost implication for the state in that these individuals are much more likely to seek social lending

Patterns of credit use

- Trends in domestic market mirror those of global credit markets:
  - Growth of revolving card-based credit
  - Parallel growth of non standard market for short term small sum high cost credit
- Commercial credit in some form used by 80% of low income Australians 18 – 65
- Credit cards now dominant credit vehicle for all income groups
- Low income consumers using diverse mix of credit product types
  - High degree of cross-over between use of different product types and between mainstream and non standard lending
  - Revolving credit, term loans, higher value long and low value short term credit used in parallel
- Most important source of small sum credit for those on low incomes cash advances on credit cards
- Payday lending used primarily by low to middle income borrowers in work:
  - Majority of users have other credit options and payday used alongside other borrowing to meet 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 only source of credit
- Significant minority of low income households have adverse history or would not qualify for mainstream credit
- We estimate 800,000 low income Australians could not get mainstream credit, 1 in 5 households with less than $20K p.a.,15% of households less than $35K p.a.
- A third of credit users with household income of less than $35,000 p.a. have been refused mainstream credit as have four in ten users of non standard lending

Debt and debt service

- Relatively small differences between users of different products in value of debt service, which shaped primarily by behavioural factors
- Outcomes of credit for those using cash advances on credit cards and users of payday loan very similar in some respects:
    - Amount spent on debt service near identical despite using very different credit vehicles
    - Ratio of indebtedness to income much higher (3x) than other credit users at 45% in both cases
- Those taking cash advances on credit cards are more indebted than other low income credit users in both absolute terms and relative to household incomes
- Payday users indebtedness in line with levels for all low income credit users
- Tension between high level of debt and need for low outgoings resolved by partial payments and extended payment terms on credit card debt
- Widespread payment irregularity among low income credit users but more serious arrears rare
- Those taking cash advances on credit cards exhibit series of behaviours which work to increase real cost of credit on revolving credit products:
    - Pay back over longer terms than other borrowers
    - Have the highest levels of payment irregularity
    - Have the greatest exposure to penalty charges
- Payday borrowers appear better able to manage mainstream credit:
    - Payment irregularity on mainstream credit lower than other credit users
    - Miss fewer payments when do miss payments
    - Pay back credit card debt quicker than other card users
- Lenders achieve price for risk, which driven by behaviour not APR:
    - There is little difference in the real cost of credit to the consumer in whether use credit cards or payday loans for small sum credit
    - Small sum credit advances on credit cards can be more expensive under uneven payment conditions
- Those taking cash advances on credit cards:
    - Most exposed to risk of breakdown of all low income borrowers (high debt, no savings, ongoing obligations)
    - Significantly higher levels of insolvency than other card users
    - Significant risk of becoming trapped in maxed out credit line
- Payday borrowers:
    - Payday lending used in part to avoid bank bounce fees, penalty charges, reconnection fees
    - Appears to have a role to play in keeping finances and credit record on track
    - Greatest financial pressures arising from historic revolving debt
    - Difficulties with credit card debt key driver of exclusion from financial mainstream

Policy implications

- Credit appears to be playing a positive role in the financial management of low income households
- Access to small sum credit appears to be a key component of low income consumers' needs in relation to credit
- There is no evidence of a debt spiral associated with high cost credit. Payday borrowing rather appears to play an important role in keeping finances on track
- Taking cash advances on revolving credit cards may expose vulnerable consumers to a series of risks to their well-being and financial security
- Lenders appear to achieve a price for credit commensurate with risk by alignment of pricing structures with behavioural drivers of enhanced cost
- APR may not be an appropriate guide to the real cost of credit for small sum short term credit, either for consumers or policy makers. The total cost of credit (TCC) might be more appropriately used
- Moves which seek to control price may fail to achieve reduced cost to the consumer while compromising price transparency
- Alternatively, users of high cost credit may be diverted to greater use of revolving credit which may in fact make it more difficult to manage financially
- If price controls result in a restriction of supply, those consumer groups most likely to be impacted are those with the greatest need for small sum credit.
- Those who become credit excluded are likely to suffer hardship and may be at greater risk of financial difficulties
- A credit vacuum may be filled by unregulated black market lenders, potentially both higher cost and more exploitative than the existing lender set

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1.0 Introduction and background

This study was undertaken against the background of public debate around how most effectively to modernise the regulatory framework for consumer credit and how best to enhance consumer protection in credit markets in Australia. Governments, at both national and state level, regulators and consumer protection groups are concerned particularly with the position and interests of those on low incomes, felt to be among the most vulnerable credit users.

Much of the debate has centred around the cost of credit for low income, high risk and excluded borrowers and the impact of high cost credit on the household finances, standard of living and quality of life of those borrowers who use “non standard” credit. Concerns arise around “fringe” lending in general and the activities of the “payday” lenders in particular. Although this sector of the market is small relative to the market overall, it attracts disproportionate scrutiny and comment, both because of the perceived vulnerability of the customer base and the high cost of this type of credit. The concern with this type of lending is that it is believed to create a dangerous spiral of debt, in turn damaging consumer finances and thereby creating significant consumer detriment. A series of other issues form the context to this debate, including public concerns around consumer debt and over-indebtedness, financial exclusion and poverty and social equality issues more generally.

To date little research has been undertaken with low income credit users or with users of very high cost credit in the domestic market, with much of the data and analysis relating to this segment of the credit market and how it operates sourced from abroad, primarily the US, where there is a large and rapidly growing payday lending market. This study is intended to address the knowledge gap and provide robust and authoritative data on the domestic Australian market for credit provision to those on low incomes, examining payday and non standard lending in this wider context. It is intended to provide the evidence base to support informed debate about the issues and potential ways forward in enhancing consumer protection and improving and modernising credit market regulation.

2.0 Research aims and methodology

2.1 Research aims

The research set out to explore:

- The credit needs of low income Australians and the dynamics shaping the need for credit and the application of borrowed funds
- The role of different types of credit within patterns of credit use:
    - The credit products used by low income consumers, the degree of choice open to them and the extent to which access to credit is constrained
    - The factors shaping low income consumers' choice of credit products and patterns of use of different credit product types
- The impact of use of different credit products on low income consumers' finances and wider financial well-being:
    - The relative cost of different types of credit and the cost of credit for different consumer groups
    - The effective management of household finances, standard of living and quality of life
    - The scale of debt, the risk of over-indebtedness and the potential for financial break-down
    - The extent to which high cost credit is creating consumer detriment
- How, from a demand side perspective, vulnerable and low income credit users might most effectively be protected through adaptations to the consumer protection and regulatory frameworks governing consumer credit

2.2 Research methodology

The study was based on qualitative and quantitative consumer research undertaken in three phases:

- 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.
- The research and data collection was undertaken by Synovate Australia.

3.0 The demand for credit – why low income households need credit and how they use borrowed funds

This section explores the demand for credit among low income households, why the need for credit arises and how borrowed funds are applied. It examines the differences between different household types, between those on more or less constrained incomes and those using more or less mainstream product types.

- Demand for credit among those on low incomes is shaped by an irreducible need to borrow, most pronounced among families:
  - 8 out of ten could not manage through at least one of five common financial pressure points without borrowing
  - Around half of low income households could not raise $500 – 700 in an emergency
  - Six out of ten could not save $1000 for a major purchase
  - Those without access to credit are likely to suffer hardship, particularly families
- Credit is used by low income households primarily for essentials and to ensure the effective functioning of household finances:
  - Managing cash flow through crises and peaks of expenditure and funding major purchases accounts for the overwhelming majority
  - One in ten dollars borrowed is spent keeping up with regular commitments, such as mortgages and bills
  - Credit-financed spending on discretionary items is relatively unimportant as a share of the total (10%)
- Small sum credit in the form of cash advances on credit cards and payday loans appears to play a key role in finances of those on low incomes:
  - More likely to be used for cash emergencies and meeting unanticipated expenses than other credit types
  - Similar proportions of high cost borrowing used to spread cost of major purchases and keep up with commitments as other credit types
- Informal borrowing is inadequate as a substitute for commercial credit:
  - Limited in value and availability
  - Informal lenders prepared to fund only narrow range of applications
  - Does not increase stock or flows of funds in low income communities
- Constrained credit options are likely to have a cost implication for the State:
  - Those on low incomes and unable to borrow commercially are ten times more likely than low income commercial credit users to seek social credit

For those on low incomes credit has a key role to play in the management of household finances

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

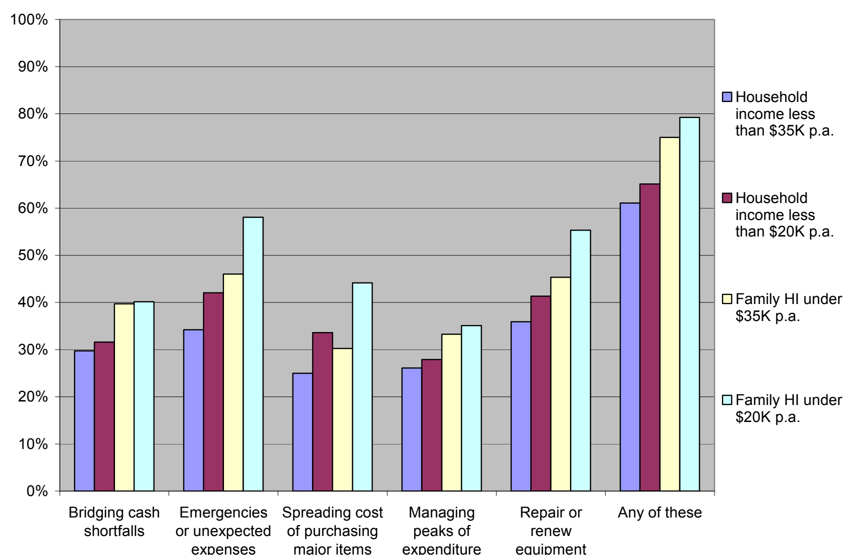
meeting cash emergencies and dealing with unanticipated expenses. Alternatively, households may spread the cost of purchasing high ticket but essential items that they would otherwise be unable to afford. The more affluent the individual, the more likely it is that credit is used to create assets or 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 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 difficult to manage through a range of situations without borrowing

Chart 1. 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



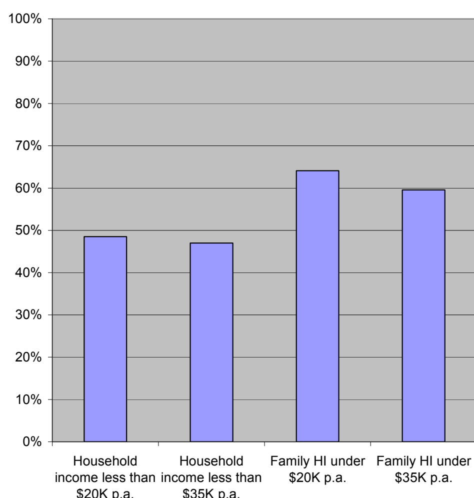
Six out of ten low income families are unable to manage relatively minor cash crises without borrowing and two thirds cannot save for a major purchase

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.

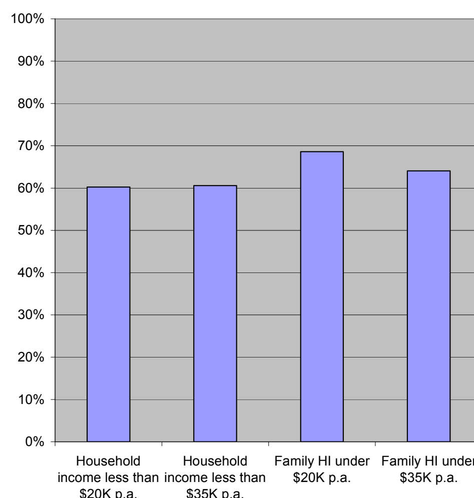
A majority of low income households have neither savings safety nets nor the means to fund the purchase of big ticket items

Charts 2a and 2b. The need for credit, by income and household type

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



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

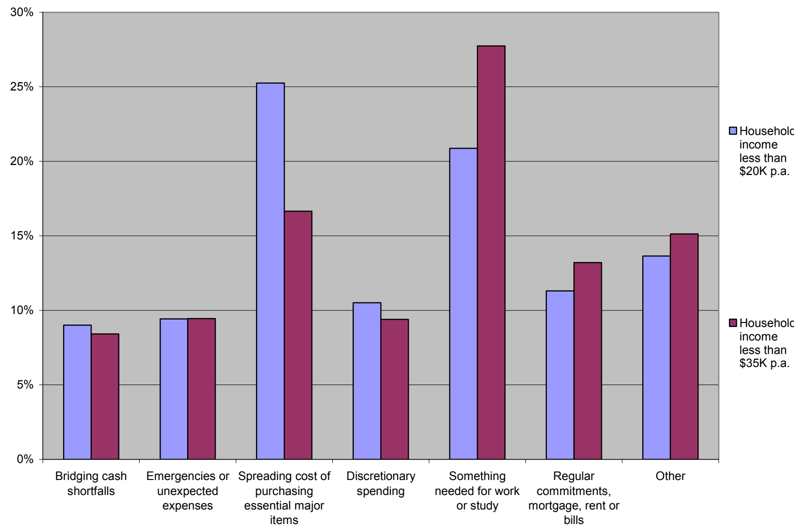


Patterns of application of borrowed funds reflect these needs with credit overwhelmingly used for essentials and to keep household finances on track

Patterns of application for borrowed funds reflect these background needs. Credit is being used for essentials and to keep household finances on track rather than for discretionary spending. Based on the application of funds related to the largest debt, a quarter of borrowing was used to spread the cost of a major purchase, such as a washing machine or furniture. Around a fifth of borrowing was distress or emergency to make ends meet or to cover an unanticipated expense. A little over one in ten used borrowed funds to ensure that regular commitments such as mortgage payments or bills were kept up. A further fifth of borrowing was investment spending in the sense that it was on something to support work or studies. Less than on in ten borrowed to fund discretionary spending, entertainment or holidays. For low income family households, borrowing is particularly important for spreading the cost of major purchases and managing peaks of expenditure.

Borrowed funds used to spread cost of purchases and keep up with bills

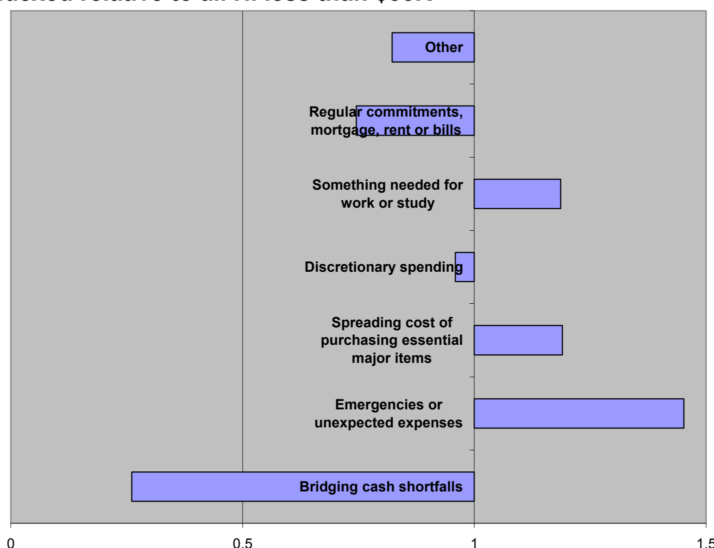
Chart 3. Application of borrowed funds (largest debt) among low income households



Family borrowers especially need to borrow to fund unanticipated expenses and spread cost of purchases

Chart 4. Application of borrowed funds (largest debt), families relative to other low income borrowers

Indexed relative to all HI less than $35K



1.0 = average for all low income borrowers

A similar pattern pertains for the most recent borrowing, with slightly more allocated to spending on something to support work or study, suggesting this kind of spend tends to be urgent (typically a car repair), and less allocated to major purchases, which tend to be more considered.

With a limited capacity to save and little or no cash reserves, low income households have a distinctive need to borrow small cash sums

Those on low incomes have distinctive credit needs, shaped by the relative tightness of budgets and the lack of savings safety nets, as discussed earlier. The lack of capacity to save and the lack of reserves against emergencies gives rise to a greater need for small scale and shorter term borrowing than for more affluent households. Longer term credit is more likely to be used to facilitate the purchase of items over

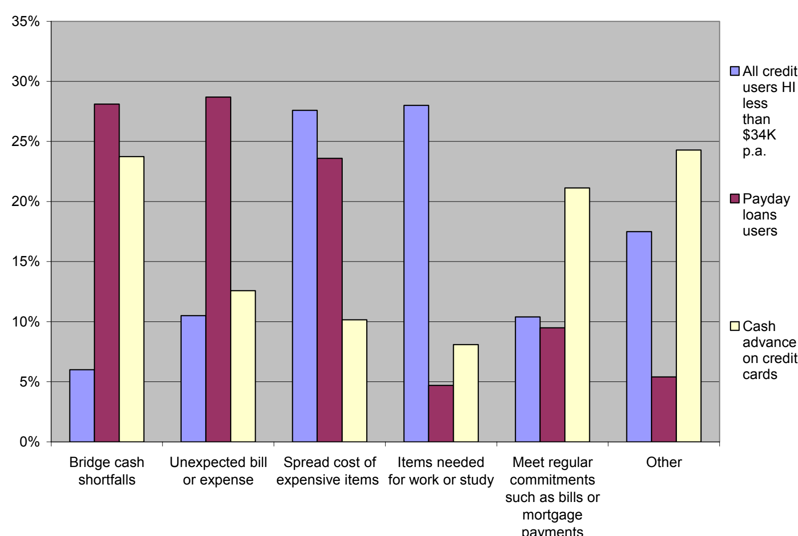
time which would otherwise be difficult to afford while short term low value loans have a key role to play in managing day to day finances and keeping these on track. As will be discussed in section 4.0 following which describes the use of credit products, those on tight budgets are much more likely to borrow low value sums. Whether in the form of cash advances on credit cards, payday loans or cash raised from a pawnbroker short term credit is more likely to be applied to making ends meet in the face of cash shortfalls or in meeting unanticipated bills or expenses.

Small sum cash credit is more likely to be applied to bridging cash crises and meeting unanticipated expenses than other types of borrowing

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 5. Application of small scale cash credit



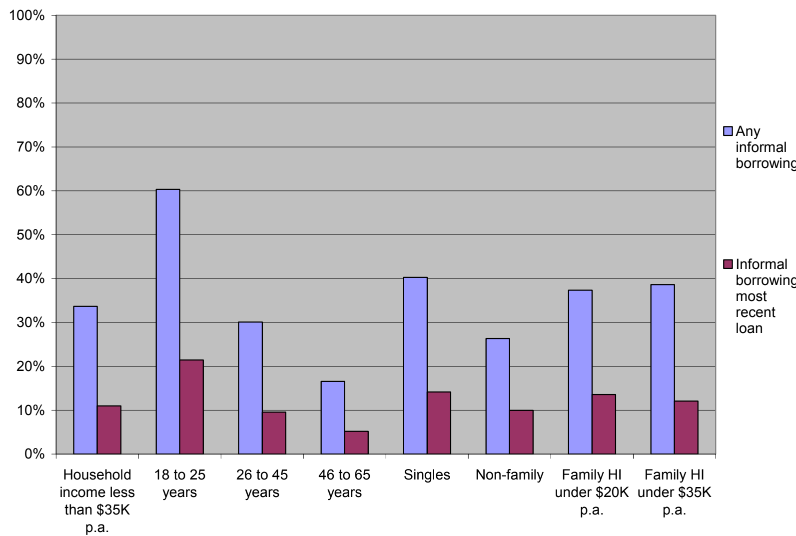
Informal borrowing is used alongside commercial credit, with the most likely informal borrowers the young and the credit constrained

Those living on low incomes have a relatively high incidence of borrowing informally from family and friends, though very few rely totally on informal borrowing as their sole source of credit. Where this is the case this tends to be either because individuals are young and reliant on parents or because they have no or limited access to commercial credit. Slightly fewer than four in ten of households with incomes of less than $35,000 borrow informally, with this having been the most recent loan for one in ten. The most likely informal borrowers are young single people, who rely heavily on parents at an early life-stage (more than six out of ten

low income individuals aged 18 – 25 borrow informally, with informal loans having been the most recent loan for about one in five). These borrowers aside, families are also more likely than non family households to borrow informally, reflecting their greater need to borrow, discussed earlier. Those over the age of 50 are more likely to be informal lenders than to borrow informally. Those without commercial credit options or with constrained commercial credit options have higher levels of informal borrowing than those who do have access to credit. A third of those on low incomes who are confident of their access to mainstream credit borrow informally compared to almost half of those who feel it would be difficult or impossible to borrow commercially and 55% of users of payday lending.

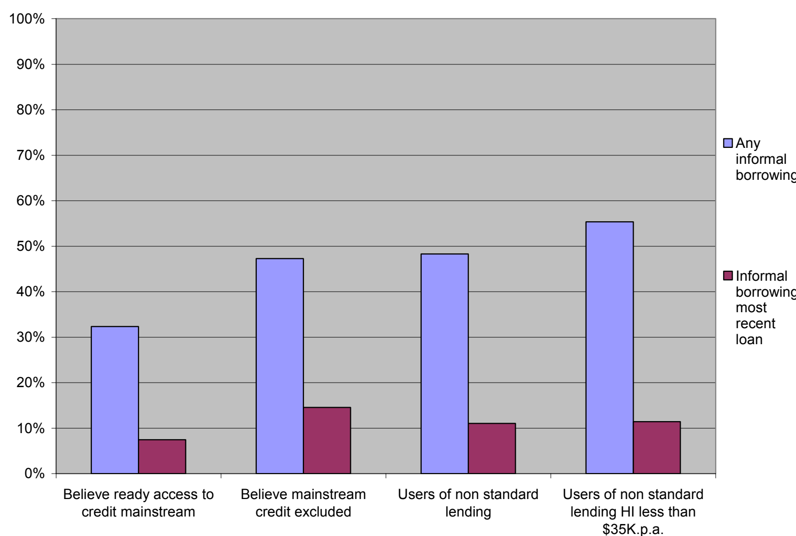
Informal borrowing is concentrated in the young and to a lesser extent young family households

Chart 6. Informal borrowing by income and household type



The credit constrained are more likely to borrow informally than other low income households

Charts 7. Informal borrowing by access to and use of credit by type, mainstream and non standard lending

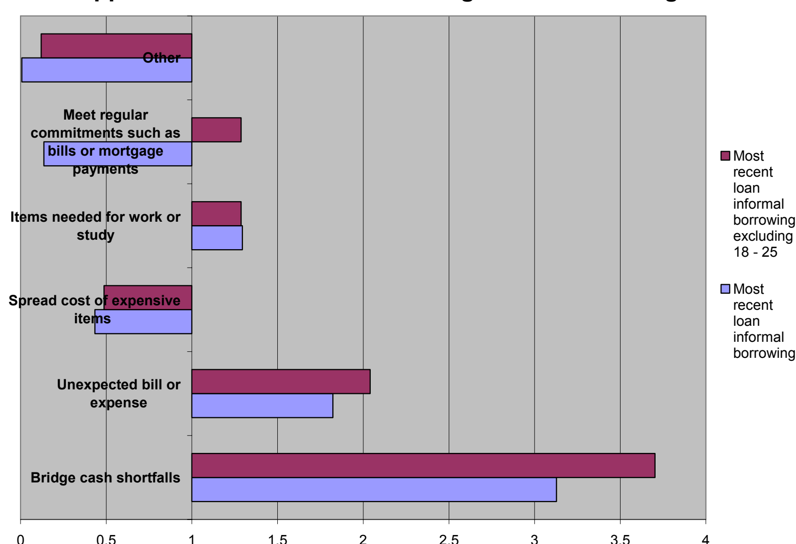


Informal borrowing tends to be low value and tends to be available only for limited applications, primarily cash crises

People tend to opt to borrow from commercial lenders rather than informally for a number of reasons, not least because many dislike asking friends and family for a loan. Informal borrowing would also appear inadequate as a substitute for commercial credit, however. The supply of informal credit is limited in any case and some individuals will not have informal borrowing options. The sums that can be borrowed informally also tend to be much lower value than can be obtained commercially. Informal lenders may also be reluctant to lend for purposes other than cash crises or unanticipated expenses. All of these factors limit the applications for which borrowing can be used. As a result informal borrowing is three times as likely to be used to manage cash emergencies compared to other times of credit but only half as likely to be used to fund major purchases. One in five recent informal cash loans were used to make ends meet when individuals had run out of cash and a further one in five was used to meet an unanticipated expense. Only one in ten loans was used to spread the cost of major purchases with more than three in ten loans being for something that was needed for work or study, reflecting the greater incidence of informal borrowing among young people.

Informal borrowing three times more likely to be used for cash emergencies and only half as likely to support spreading the cost of major purchases

Chart 8. Applications of informal borrowing relative to average for all commercial credit types



1.0 = average for all low income borrowers

Informal borrowing appears inadequate as a substitute for commercial credit not least because low income informal lenders may suffer hardship

Informal borrowing also has other disadvantages relative to commercial credit, albeit that it is usually interest free. In large part informal borrowing is a transfer of funds from older generations to younger ones. With the exception of the young in education or at the start of their working life as discussed earlier, in most cases those on low incomes move in a social milieu in which friends, family and other members of the social network are also largely on low incomes. Effectively cash is transferred from those with less immediate need within the community to those with a more immediate need, typically by means of loans from parents to young people or to adult children with families. The older generation in low income communities may themselves be living on constrained incomes, however, so that in the same way that not being able to borrow creates hardship around financial pressure points, informal lending can

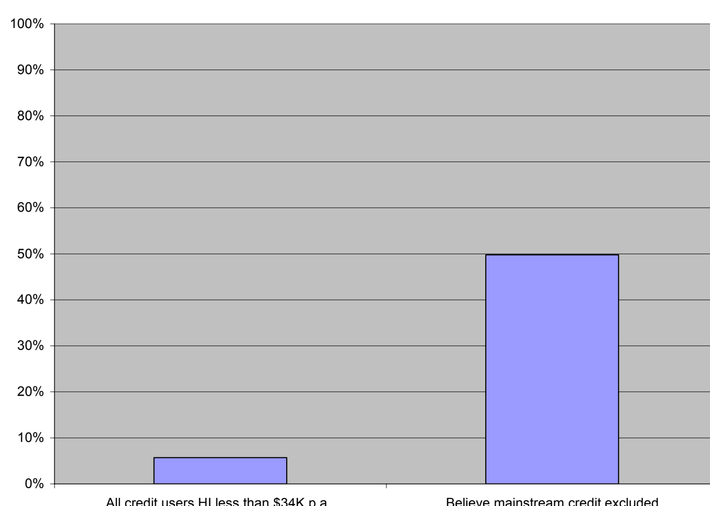
also involve some sacrifice in the form of economies made within the household budgets of informal lenders on low incomes.

Those unable to access commercial credit are much more likely to turn to the State for social credit in the form of a CentreLink loan

A further indication of the need for credit among those on low incomes can be found in the greater likelihood that those unable to borrow in the mainstream commercial market will look to the state for a loan. Almost half of those on incomes of less than $35,000 p.a. who claim it would be impossible for them to borrow in the mainstream commercial market say that their most recent loan was from CentreLink compared to only 6% of their counterparts who are credit users.

Those with no access to commercial credit are much more likely to seek state support in times of financial difficulty

Chart 9. Use of social credit, all low income credit users and those excluded from credit mainstream
% borrowing from CentreLink



The evidence suggests an irreducible need for credit among those on low incomes and that it acts as an essential lubricant of household finances

Taken together, the evidence suggests that there is a clear and irreducible need to borrow among low income households, who perhaps need credit more than the more affluent who are more likely to have savings safety nets. Credit has a key role to play for low income households as an essential lubricant of household finances and as a means of acquiring household essentials. This appears true also of high cost credit in that funds borrowed from high cost non standard sources are being used for much the same applications as those using other credit types, albeit that this type of credit is more likely to be used to bridge cash shortfalls or for unanticipated expenses. The significant minority of low income households who would find it difficult or impossible to access commercial credit are likely to suffer real hardship if access to non standard credit sources is curtailed. The likely consequence of such further credit exclusion is that they have will have even fewer means of managing financial pressure points and are thus more likely to look to the state.

4.0 Patterns of credit product use

- Trends in domestic market mirror those of global credit markets:
  - Growth of revolving card-based credit
  - Information technology-facilitated pricing of risk has resulted in extension of credit cards to higher risk low income households
  - Parallel growth of non standard market for short term small sum high cost credit
- Commercial credit in some form used by 80% of low income Australians 18 – 65 years
- Credit cards now dominant credit vehicle for all income groups
- Low income consumers using diverse mix of credit product types for variety of purposes:
  - High degree of cross-over between use of different product types and between mainstream and non standard lending
  - Revolving credit, term loans, higher value long and low value short term credit used in parallel
- Most important source of small sum credit for those on low incomes cash advances on credit cards, used primarily by those on lowest income and under greatest pressure
- High cost non standard payday lending and pawn small part of total market:
  - Payday lending used primarily by low to middle income borrowers in work
  - Majority of users have other credit options and payday used alongside other borrowing to meet 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 only source of credit
- Against background of widespread credit use, significant minority of low income households have developed adverse history or would not qualify for mainstream credit
- We estimate 800,000 low income Australians could not access new mainstream credit, 1 in 5 households with less than $20K p.a.,15% of households less than $35K p.a.
- A third of credit users with household income of less than $35,000 p.a. have been refused mainstream credit as have four in ten users of non standard lending

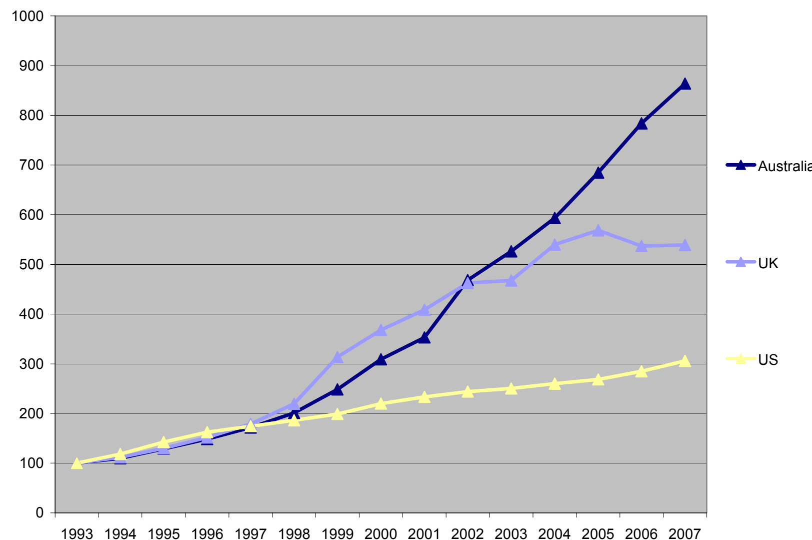
This section explores patterns of credit product use among low income households, the relative importance of different product types and the cross over between them.

The major trends in global credit markets have been the growth of revolving credit and the extension of card credit to lower income households

The major trends in global credit markets have been the growth of revolving credit, primarily in the form of credit cards, and the development of sophisticated data driven information and credit scoring technology, supported in advanced credit markets by more or less comprehensive systems of credit reference and data sharing. The latter developments have enabled lenders to make fine-tuned judgements on the degree of risk represented by different consumer groups and to price credit issued accordingly. As a result, credit has been extended further down the risk and income spectrum, to higher risk and lower income groups, with products such as credit cards, once the preserve of the relatively affluent, increasingly used by low income consumers.

Australia has seen very rapid growth in credit card borrowing in recent years

Chart 10. Growth in credit card balances in Australia, United States and UK, 1993-2007

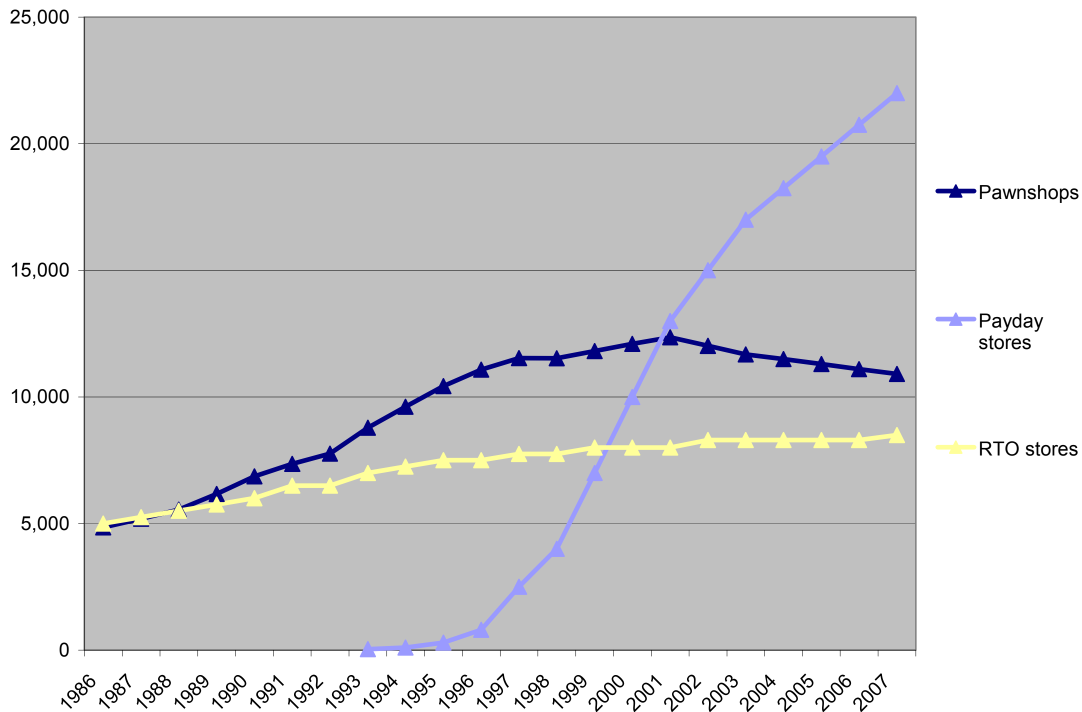


Sub prime credit markets have also developed in parallel to the mainstream – typically offering short term small sum credit at high cost

Alongside the advance of revolving credit and the increasingly fine segmentation and pricing of risk on mainstream products, there have also been developments in that part of the market often characterised as “non standard” or “sub-prime”. Here very short term and high cost small sum cash credit products, most notably in the form of “payday lending” and cheque cashing products, have developed in parallel to the mainstream market, taking share from older forms of credit used by low income households such as pawn-broking. These products tend to be used by low to middle income credit users, often alongside mainstream credit, rather than by those on very low incomes, primarily because lenders tend to advance credit only to those in work and require payment by electronic means. This type of lending has grown rapidly in a number of markets, including Australia, primarily driven by consumer demand for low value short term credit. It is a small part of overall patterns of credit use, but attracts a disproportionate degree of comment and scrutiny, both from regulators and those concerned with consumer protection. Concerns focus on the high cost of this type of credit and the bias towards low income groups within the customer base compared to other types of credit. This section seeks to explore both patterns of overall credit use among low income consumers but also how use of mainstream credit, such as credit cards and personal loans, intersects with non standard and high cost forms of lending, such as payday loans and pawn.

Payday lending has advanced rapidly in the US at expense of pawn-broking and Rent to Own stores

Chart 11. Growth of in alternative finance outlets in the US, 1986-2007



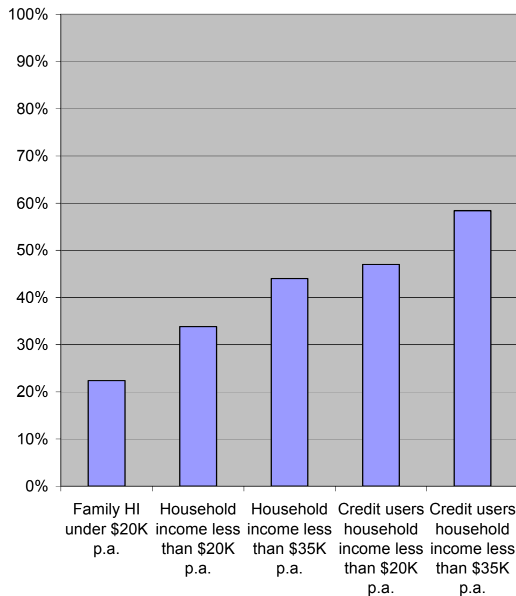
These global trends are evident in the domestic Australian market with credit cards now the dominant credit vehicle even for those on the lowest incomes

Both of the trends discussed are evident in the domestic Australian market with credit cards having become the dominant credit vehicle in all income groups, including those on the lowest incomes. For those on low incomes, credit card use is lowest among the lowest income families, at a little under a quarter (23%) of families with household incomes of less than $20,000 p.a, rising to a third among households with income of less than $20,000 p.a. overall and 44% of those with household incomes of less than $35,000. The importance of credit card use is made more explicit when viewed from the perspective of the most recent credit product used. Low income borrowers are more than three times more likely to have used a credit card as their most recent product than any other type of credit product.

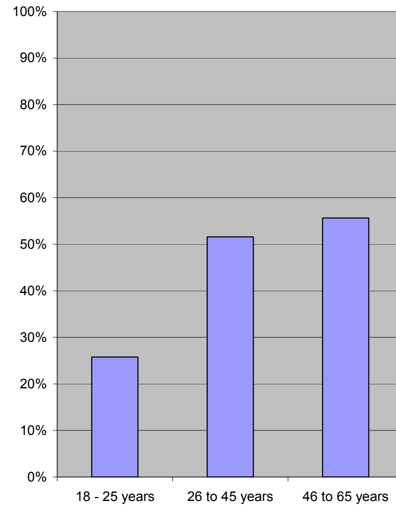
Credit cards are now the dominant credit vehicle for all low income groups

Charts 12a & 12b. Credit card use in low income households

Buy goods and services on a credit card



Ratio of purchase of goods and services to raising cash on credit cards

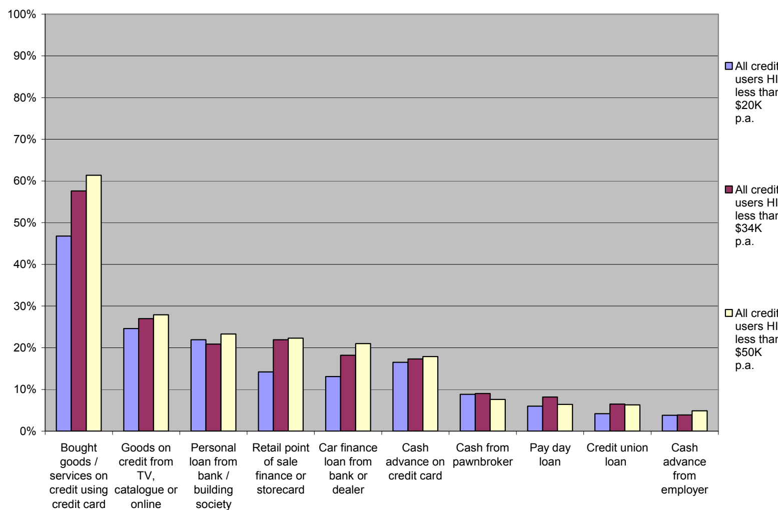


Low income borrowers use a wide range of mainstream credit products with revolving credit used alongside fixed term loans, both long and short term

Although credit use is now dominated by credit cards, low income borrowers increasingly use a wide range of credit products, fixed term loans alongside revolving credit and short term loans alongside longer term credit. Various forms of remote shopping, from the TV, catalogues and on-line are an important feature of credit use, used by a little over a quarter of credit users with incomes of less than $35,000 p.a. Retailer sourced credit negotiated at point of sale of a major retail purchase or in the form of store cards is also important, used by one in five, with a similar proportion using car finance and personal loans from banks and loan companies.

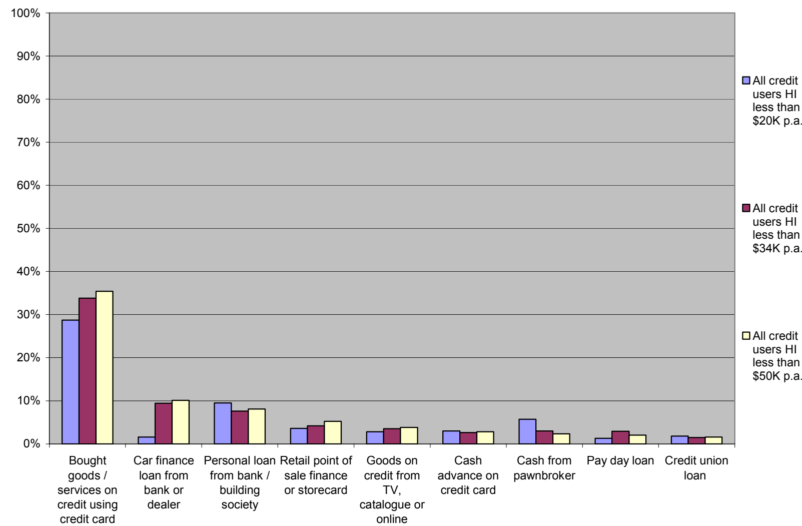
Low income borrowers using a diverse mix of credit products to meet a variety of credit needs with non standard lending a small part of the overall mix

Chart 13. Credit product use by income range



Revolving credit on credit cards used more frequently and recently than payday lending or pawn even among lowest income ranges

Chart 14. Most recent loan

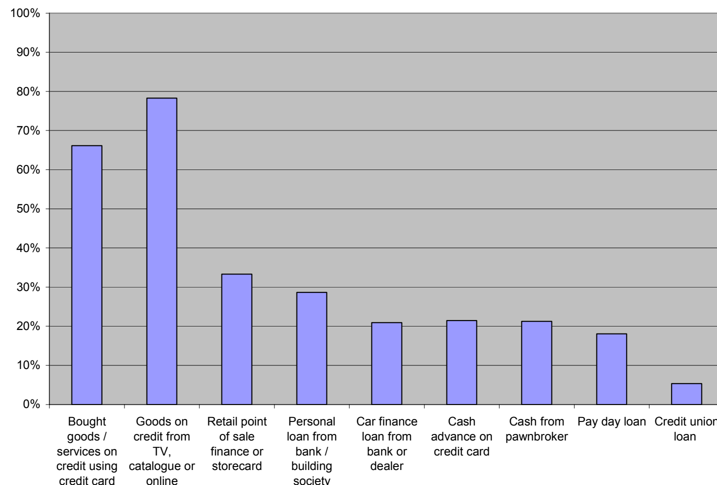


There is a significant degree of cross over in low income consumers' use of mainstream, higher cost and non standard lending

It is sometimes suggested that those using non standard lending in general and high cost payday loans in particular are doing so because they have no other credit options. Against this background, it is useful to explore further patterns of credit use among those using non mainstream credit. There would in fact appear to be a significant cross over between mainstream credit use and use of high cost credit and non standard lending vehicles. Two thirds of those using relatively high cost non standard sources of credit such as catalogues and TV shopping and store cards have bought goods and services on credit cards, a third have taken on retail finance at point of sale, almost one in three have a personal loan from a bank and one in five have a car finance loan from a bank or dealer. One in five has raised cash on a credit card. These consumers are also using non standard products alongside mainstream finance raising cash via payday lenders and pawn-brokers, also used by one in five.

Users of high cost credit from catalogues and TV shopping use mainstream and non standard lending to meet both short and long term credit needs

Chart 15. Types of credit products used, non standard lending users

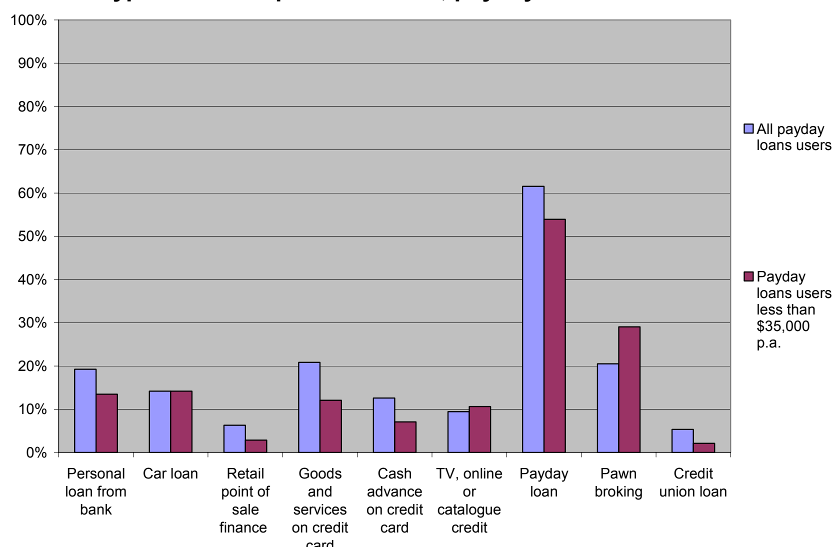


Payday borrowers, many of whom are not on a low income, use a wide range of credit products, of which credit cards are the most important

Payday loan use is sometimes assumed to be concentrated exclusively in the lowest income households. This does not appear to be the case, with more than half of payday loans users having incomes of more than $35,000 p.a. Looking at patterns of credit use among payday loans users overall, the pattern is of use of a wide mix of credit products, with these borrowers appearing to be heavier credit users than users of other types of credit. In the last twelve months one in five payday loans users have used a credit card to purchase goods and services, a similar proportion have taken out a bank personal loan and 15% have taken on a car loan. One in ten have bought goods remotely on credit via TV or the catalogue while a little over one in twenty have used point of sale credit in a retail store. These borrowers appear also to have a relatively high appetite for small sum cash. Apart from use of pay day loans, more than one in ten (13%) have raised cash from a credit card and one in five have raised cash from a pawnbroker in the last twelve months.

Payday loans users are heavy credit users borrowing in both the mainstream and non standard sectors

Chart 16. Types of credit products used, payday loans users



The most important source of small sum credit for those on low incomes is cash advances on credit cards rather than non standard lending

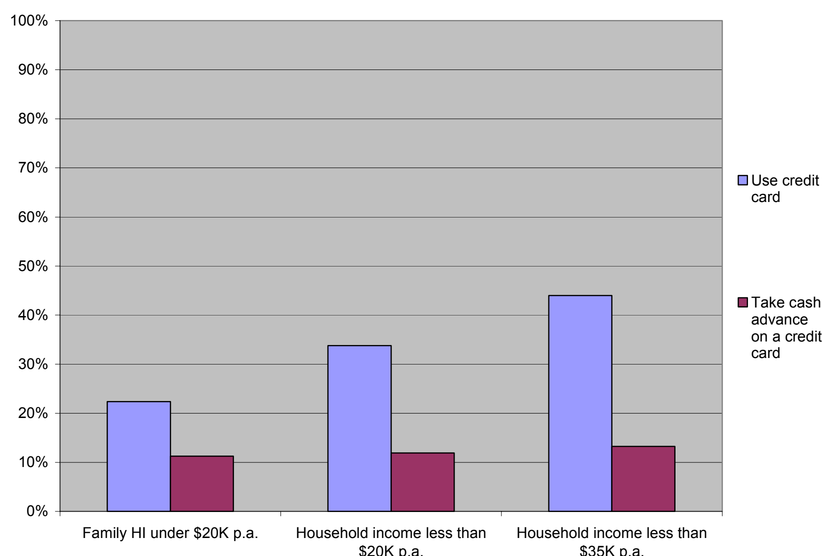
Most low income credit users and a significant proportion of those using non standard lending are clearly using mainstream products to support long term borrowing. It is important perhaps to appreciate that low income borrowers are also using mainstream credit, in the form of credit cards, to support their short term low value cash credit needs. Credit card cash advances are the most important single source of small sum cash credit, used by 17% of credit users with household incomes of less than $35,000. This is well ahead of use of non standard lending sources such as payday loans and pawn- broking. Pawn-brokers are used by close to one in ten (9%) with pay day loans being used by 6% of credit users with household income of less than $20,000 p.a. and 8% of those with household incomes of less than $35,000.

The importance of cash advances as a proportion of credit card borrowing rises as income decreases, being highest for the lowest income families

Most credit card use rests on spend on goods and services. Raising cash on credit cards, which attracts a higher rate, tends to be associated primarily with those under greater financial stress, those on the lowest incomes and on the tightest budgets. The proportion of credit card use represented by cash advances appears to rise as income falls and budgets become tighter. For low income households as a whole, the ratio of spend on goods and services to cash advances on cards is 3.3 (i.e. families with incomes of less than $35,000 p.a. are a little more than three times more likely to buy goods and services on their credit card than they are to raise a cash advance on it). For family households with incomes of less than $20,000 p.a. the ratio falls to 2.0 while among users of non standard and payday lending it falls to 1.7. By contrast, for those in the $35,000 - $50,000 range it rises to 3.7.

Cash advances are a higher proportion of credit card use for the lowest income households

Chart 17. Cash advances and spend on goods and services on credit cards

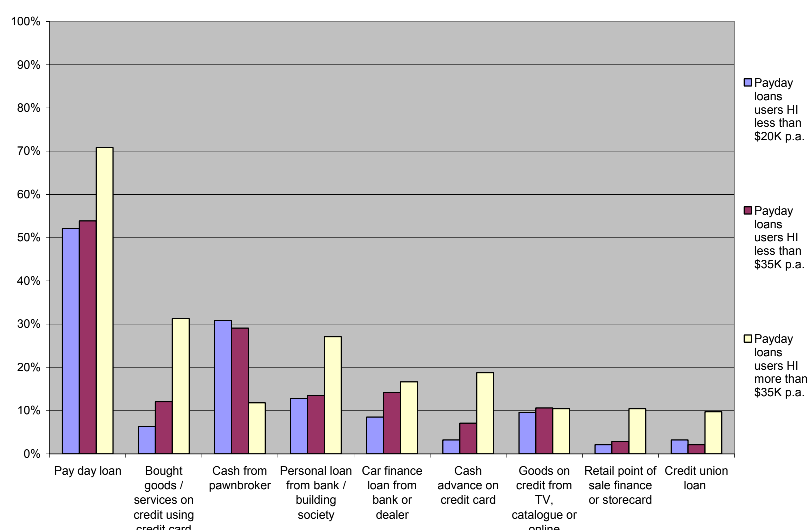


Payday users on the lowest incomes are less frequent payday borrowers and are more likely to use pawn-brokers rather than credit cards in parallel to it

Those on the lowest incomes and using non standard sources of credit such as payday loans have a different and quite distinctive pattern of credit use in comparison both to other low income credit users and to better off payday users. Payday loans users on lower incomes have a significantly lower incidence of use of a range of mainstream credit products than other low income credit users. Their use of short term credit products is also different in that they borrow less frequently in the payday market than better off pay day users, are significantly less likely to take cash advances on a credit card than either other low income credit users or better off payday borrowers and are much more likely to use pawnbrokers alongside payday lending than other low income borrowers. Payday users with incomes of less than $20,000 p.a. are almost ten times more likely to have used pawn to raise cash in the last twelve months than to obtain a cash advance on a credit card, with three in ten having used a pawn-broker. By contrast, only 3% of payday users with incomes of less than $20,000 p.a. and only 7% of those with incomes of less than $35,000 have raised cash on a credit card in the last twelve months.

For payday borrowers on the lowest incomes payday loans and pawn are the key sources of small sum cash credit

Chart 18. Payday loans users use of other credit products in lasts twelve months by income range



Differences in patterns of use of different credit vehicles to borrow small sum credit in large part a matter of access for those on the lowest incomes

The patterns of small sum credit use just described, and the differences between the lowest income groups and users of non standard lending and other low income borrowers appears in part to be a matter of access to credit and in part a matter of product fit with consumer need. Credit has become increasingly available to low income groups but many mainstream lenders would be reluctant to lend to individuals that they might judge to be an unacceptable risk, possibly because of an irregular employment history or a patchy or incomplete credit record. Equally, there are a growing number of individuals, particularly among low income groups, who have struggled to cope with their borrowing or run into financial difficulties sufficiently serious that they have acquired an adverse credit record, resulting in constraints on their access to further credit.

One in five households with income of less than $20,000 and 15% of those with less than $35,000 a year claim not to be able to access mainstream lending

A significant minority of low income households would appear to have some or substantial difficulties in accessing mainstream credit. Almost one in five (19%) of those with household incomes of less than $20,000 p.a. and 15% of those with household income of less than $35,000 believe it would be impossible for them to borrow from a mainstream lender. Close to four in ten of both groups believe it would be difficult to borrow from a mainstream lender. On the basis of those who believe it would be impossible to borrow from a mainstream lender, we estimate this to be some 800,000 Australians who would find it very difficult to access new mainstream lending.

Significant numbers of low income borrowers have experienced mainstream credit refusals

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.

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

Chart 19a. Perceived lack of access to credit mainstream
% believing could not borrow in credit mainstream currently

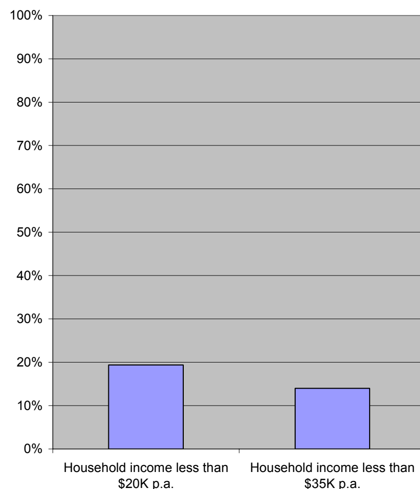
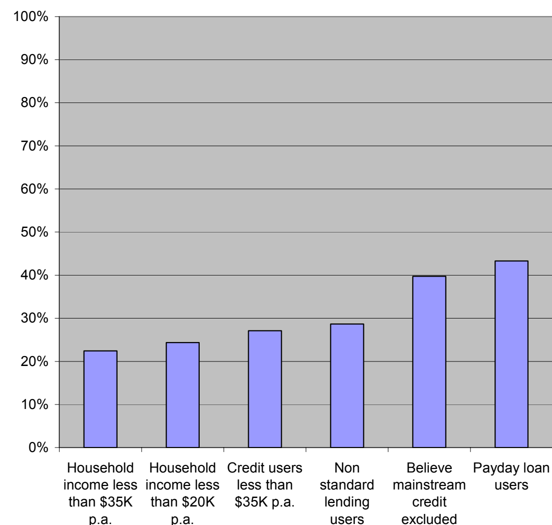


Chart 19b. Mainstream credit refusals by borrower type and by income
% experienced refusals from mainstream lender



A little over a third of those using payday lenders with household incomes of less than $35,000 a year could not borrow from other lenders

The majority of users of payday lending, both in the lowest income groups and overall, are able to borrow in the mainstream market. A significant minority of those using non standard lenders, however, are doing so because they have no other credit options. Overall, three in ten (29%) of payday users claim that they would be unable to raise new credit from another lender. This rises to 35% for borrowers with household income of less than $35,000 p.a. Among those who say that they would be unable to borrow from other lenders, four out of ten admit to having an adverse credit record.

Significant minority of payday loans users have sufficient adverse history to fail mainstream credit checks

Chart 20a Payday loans users credit history Adverse credit records and court judgements

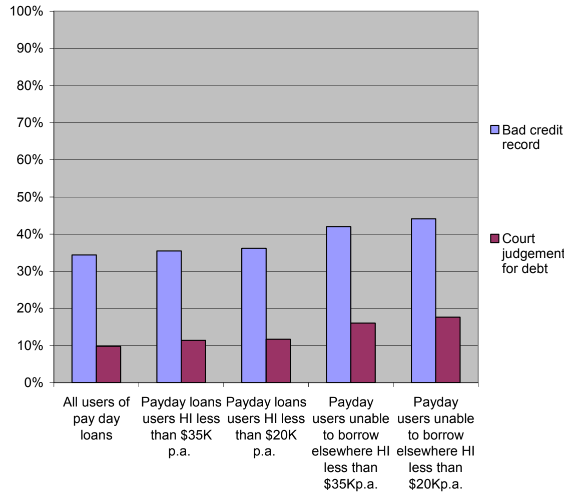
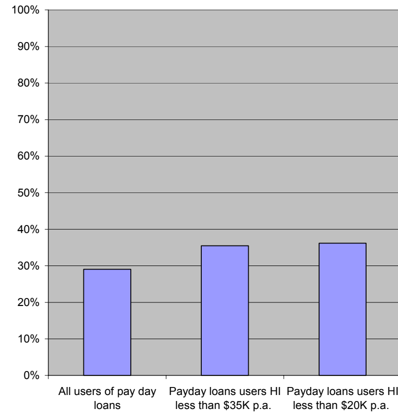


Chart 20b Payday customers access to mainstream lenders
% believing could not borrow from mainstream lender currently

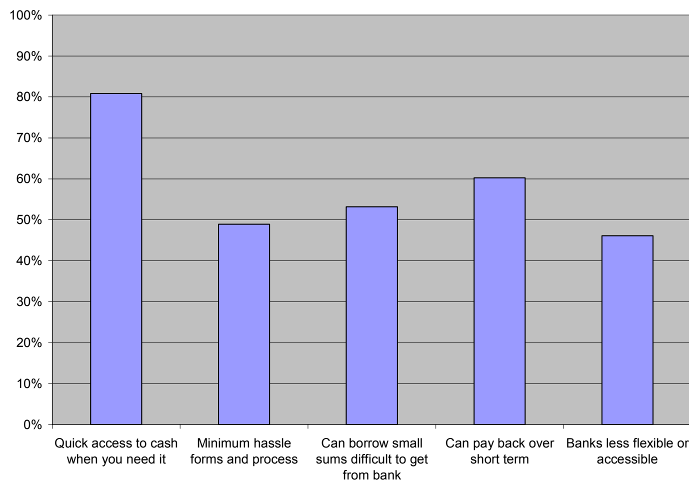


For those who have other options payday lending represents a fit with a key need in that it offers rapid access to low value credit over a very short term

Clearly access to credit is a major driver for use of non standard lending and shapes some of the use of this type of credit. Part of the explanation for those using this type of credit alongside mainstream credit vehicles and lower cost credit would appear to be a matter of the product being a fit with the clear consumer need for readily accessible low value credit. High cost lending of this type appears to meet a need for small sum short term credit which is not necessarily easily obtained from mainstream institutions. The most important features of payday lending cited by users to explain their use of this type of credit are rapid access to cash, the ability to repay over a short term, obtaining access to small scale funds which can be difficult to obtain from a bank and minimal process hurdles.

Ready access to small sum cash with minimal process hurdles the key attractions of pay day lending

Chart 21. % citing as reasons for borrowing from pay day lender



Low income households diverse range of products; credit cards dominate but a high degree of crossover between mainstream and non standard lending

Taken together, low income households appear to be using a diverse range of credit products to meet a variety of needs, with, for those using higher cost credit, a high degree of cross-over between mainstream and other credit product types. Revolving credit clearly dominates patterns of credit use even among the lowest income groups and users of non standard lending. A range of mainstream products are being used to support longer term borrowing, to manage cash-flow and spread the cost of purchases. Mainstream revolving credit is clearly also key to managing occasional small scale cash needs, with advances on credit cards being used primarily by the lowest income groups and those with the tightest budgets to manage cash shortfalls and keep on track with bills in much the same way as payday lending is used.

Hardcore of potentially credit excluded borrowers rely on payday as their only option for managing financial pressure points

Those using payday lending include those for whom the key driver in use of this kind of product appears to be less a lack of any alternative means of borrowing than the product offering a good fit with the demand for small sum instant credit borrowed over a short term, not always readily available from mainstream sources. For a significant minority of payday users, however, payday borrowing represents their only source of immediate cash credit and thus their only means of managing not only unanticipated expenses and cash emergencies but also wider applications for credit, such as spreading the cost of major purchases.

5.0 The experience of credit and debt on a low income

This section sets out to understand the experience of low income credit users and how use of different credit products and different patterns of debt service play out in terms of indebtedness, the cost of credit, impact on household finances, the extent of financial difficulties associated with credit and the outcomes of any problems that arise.

Debt and debt service

- Relatively small differences between users of different products in value of debt service, which shaped by behavioural factors rather than incomes, level of debt or product mix
- Outcomes for cash advances on credit cards and users of payday loan very similar:
  - Amount spent on debt service near identical despite using very different credit vehicles
  - Ratio of indebtedness to income much higher (3x) than other credit users at 45% in both cases
- Those taking cash advances on credit cards are more indebted than other low income credit users in both absolute terms and relative to household incomes
- Payday users indebtedness in line with levels for all low income credit users

Repayment patterns

- Tension between high level of debt and need for low outgoings resolved by partial payments and extended payment terms on credit card debt
- Widespread payment irregularity among low income credit users but more serious arrears rare
- Those taking cash advances on credit cards exhibit series of behaviours which work to increase real cost of credit on revolving credit products:
  - Pay back over longer terms than other borrowers
  - Have the highest levels of payment irregularity
  - Have the greatest exposure to penalty charges
- Payday borrowers appear better able to manage mainstream credit:
  - Payment irregularity on mainstream credit lower than other credit users
  - Miss fewer payments when do miss payments
  - Pay back credit card debt quicker than other card users

Cost of credit

- Lenders achieve price for risk, which driven by behaviour not APR:
  - There is little difference in the real cost of credit to the consumer in whether use credit cards or payday loans for small sum credit
  - Small sum credit advances on credit cards can be more expensive under uneven payment conditions

Exposure to risk of financial breakdown

- Those taking cash advances on credit cards:
  - Most exposed to risk of breakdown of all low income borrowers (high debt, no savings, ongoing obligations)
  - Significantly higher levels of insolvency than other card users
  - Significant risk of becoming trapped in maxed out credit line
- Payday borrowers:
  - Evidence does not support perceptions of debt spiral
  - Payday lending used in part to avoid bank bounce fees, penalty charges, reconnection fees and appears to have a role to play in keeping finances and credit record on track
  - Greatest financial pressures arising from historic revolving debt
  - Difficulties with credit card debt key driver of exclusion from financial mainstream

The experience of credit users and the cost of credit is increasingly driven by finely segmented risk profiling and by behaviour driven pricing structures

The research sought to understand the experiences of key groups of low income credit users, both those borrowing in the credit mainstream and those using non standard lending. The big trend in credit markets around the world is for credit pricing to become increasingly risk-based and behaviour driven. This is most typical of revolving credit, in which there is greater scope for the influence of behaviour on both the outcomes of credit use and the cost of credit to the consumer. To some extent it also occurs within fixed term products, particularly where these are offered by the banks who are able to generate behaviour driven fees not only directly from credit products offered by the bank, but also from revenues arising from other sources such as default fees on current accounts or credit related insurances.

The research set out to explore the impact of both different credit product types and behavioural dimensions of credit use

The consumer groups the research sought to examine were chosen therefore not only on the basis of the products used – selected to provide insight into the differences between the experience of mainstream and non standard borrowing and those that might arise between more or less financially included or disadvantaged borrowers – but also on the basis of the behaviour of different groups of credit users. We sought particularly to understand the experiences of those low income borrowers using credit cards, and how that varies by the approach the borrower takes in use of the card. For this reason we examine the experience of all low income borrowers and credit card users, and, within this, we compare the experience of those using the card on a “revolving” basis to those that pay back their outstanding balance every month. We also examine the experience of those using the small sum credit which previous sections have demonstrated to be an important component of the borrowing patterns of those on low incomes, and of those on the lowest incomes particularly. We compare the experience of using the most common source of small sum credit, being cash advances on credit cards, with that of using the high cost cash loans offered by the pay-day lenders. We also look at the experience of those using pawn-broking, among the most vulnerable and disadvantaged of borrowers.

Among card users with household incomes of less than $35,000, users are evenly split between those with income from full time work and those without

In order to place the experience of different credit users in context, it is helpful to first examine their profile. As indicated in previous sections, the presence of children is a useful indicator of need in that family borrowers have the greatest need for credit. Having at least one full time income in a household may be taken as indicator of relative stability and affluence while, conversely, a relatively high proportion of single parents, those in irregular work or without income from employment could be taken as a indicator of relative disadvantage. Household income will also provide a measure of affluence.

The profile of those raising cash advances on cards is more disadvantaged than other card users but less disadvantaged than that of payday users

On this basis low income credit card users overall split fairly evenly between those with at least one full time income and those either in irregular work or benefit dependent. “Revolvers” making only partial payments on their credit card debt have a

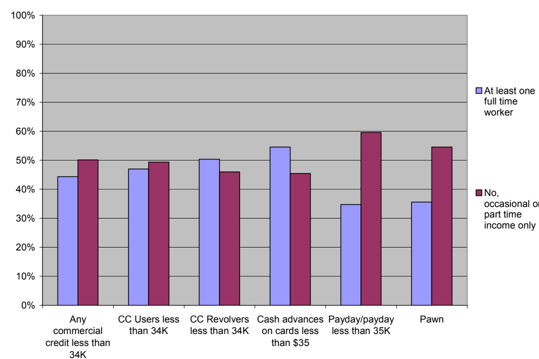
profile broadly in line with all credit users while those using their card to raise cash advances are more likely to be family households and have a higher proportion of single parents than other low income credit card users.

Only half of payday customers have incomes below $35,000 p.a. but low income payday users more disadvantaged than other low income credit users

In comparison, low income users of payday lenders are disadvantaged by comparison to other both low income credit users and those taking cash advances on credit cards. Almost four in ten low income payday users are single parents, while six out of ten live in households where there is no income from full time employment (many payday users do not live in low income households and we should make clear that the analysis in this section rests solely on that just under a half (44%) of the payday user base which is on low incomes, i.e. with household income of less than $35,000 p.a). Users of pawn-brokers are both likely to have a high need for credit and to be more disadvantaged than other low income credit users. Almost two thirds (63%) are family households with four in ten single parents and only a little over a third (36%) living in a household with income from full time employment. Clearly these differences will have an influence on patterns of credit use and on the impact of credit use on household finances.

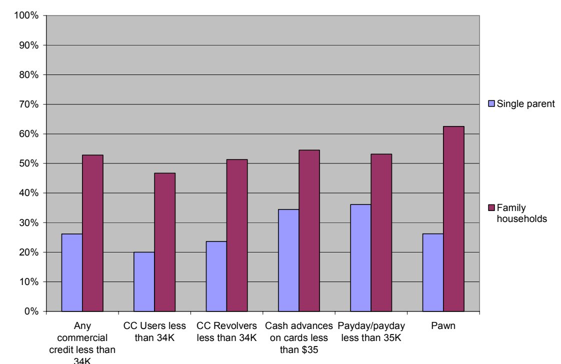
Payday users have lower incidence of full time workers than those raising cash on credit cards

Chart 22a.Credit user types by employment profile



Single parent households strongly represented among both payday users and users of card cash advances

Chart 22b. Credit user types by family profile

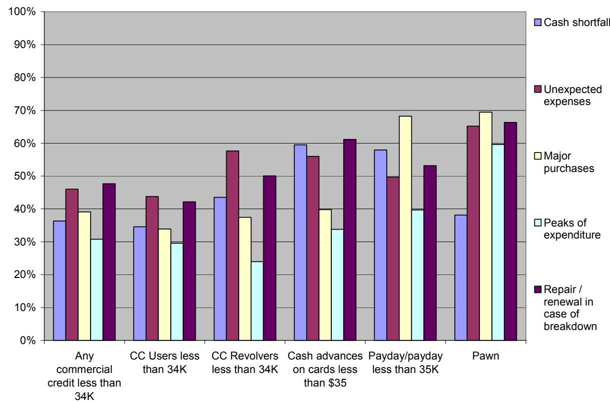


Users of payday and pawn are least well placed to manage through financial pressure points but users of cash advance on credit cards not far behind

A ready measure of the extent of need for credit within these different groups can be found in the extent to which they are able to cope with various financial pressure points without borrowing. Users of pawn and payday are least well equipped to cope with such pressure points. However those taking cash advances on credit cards are clearly not much better placed and are significantly more likely to need to borrow. small sums to keep their finances on track than other than low income credit users.

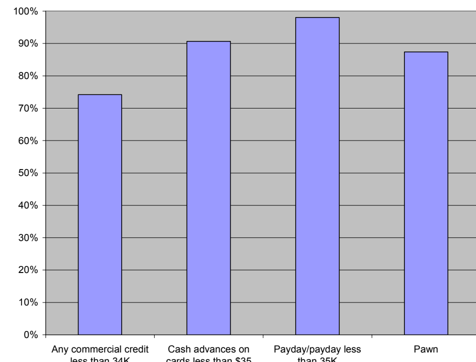
Those using payday and card cash advances both more likely than other low income credit users to face cash flow difficulties

Chart 23a. Pressure points which difficult to cope with without borrowing



Payday users likely to struggle with range of day to day pressure points without borrowing but card cash advance users similarly pressured

Chart 23b. All who will find at least one of a range of pressure points difficult to cope with without borrowing*



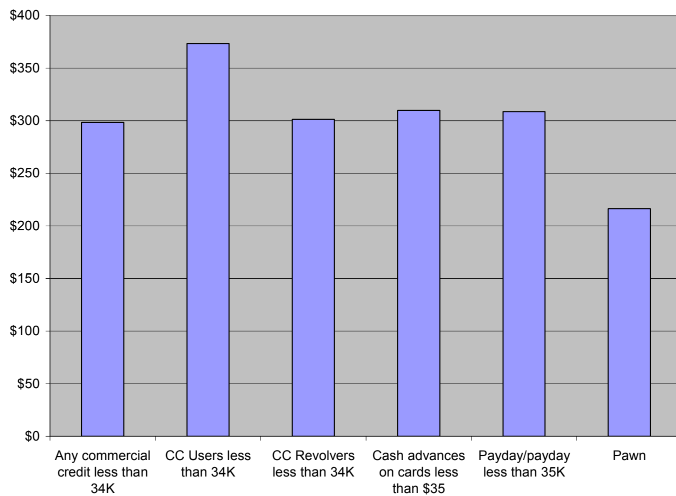
* Pressure points concerned are those described in Chart 23a

There is much less difference in outgoings on debt service than incomes or borrowings would suggest, with a strong behavioural element

We first examine the relative outgoings on debt service of the different credit user types, by which we mean the total value of debt service for all borrowings except mortgages. The impact of behaviour is immediately apparent in that despite there being large differences in income available to service debt and the value of borrowings, there is remarkably little difference in levels of outgoing. The biggest difference arises between credit card revolvers and other credit card users, with revolvers paying some 30% less each month than all credit card users. Average outgoings on debt service are a little under $300 p.m. ($298) in total for all credit users with household income of less than $35,000, rising to a little over $370 p.m. ($373) for credit card users, and falling to $300 p.m. ($301) for credit card revolvers, the lower value being primarily explained by these borrowers' inclination to keep payments down rather than minimise sums outstanding. Payments on debt service for the rather lower income and more disadvantage borrower types are remarkably similar to those for revolvers and credit users as a whole, being around $310 both for those taking cash advances on credit cards and for payday borrowers (being $310 and $309 respectively). For those using pawnshops, generally the most financially pressured, debt service was much lower than for other low income credit users, at a little over $215 ($216).

Value of debt service remarkably similar for payday users and users of card cash advances despite using very different credit vehicles

Chart 24. Monthly value of debt service on all borrowings

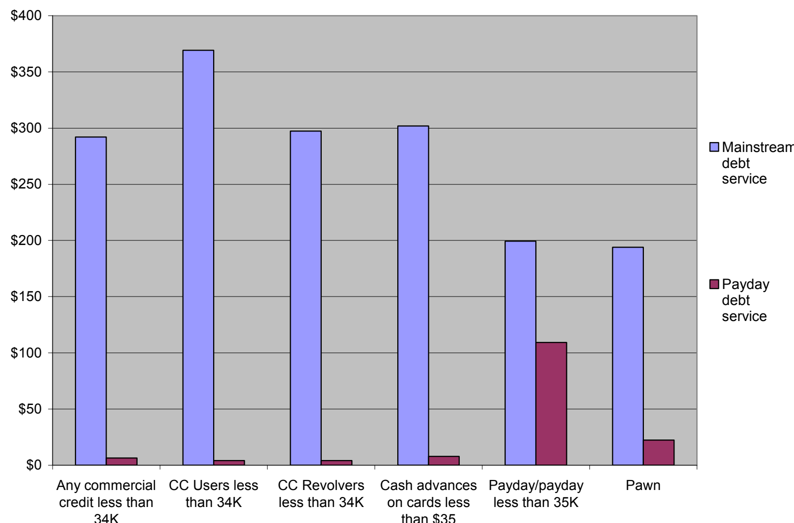


Total value of debt service for payday users and those taking cash advances on credit cards is very similar, despite using radically different credit vehicles

Debt service on short term payday borrowing represented 55% of the outgoings on debt service for payday borrowers and 12% for those using pawnshops. For no other categories of borrower did service of payday debt represent more than 3% of outgoings on debt service. The average monthly service on pay day debt for pay day users was a little under $110 and for those using pawnshops a little over $20 ($22) (It should be noted that these values are extrapolated from the annualised total of the total capital and repayment on the average number of payday loans at average payday values for households with less than $34,000 and adjusted to take account of extensions and associated charges, based again on the average for the group). Perhaps the most striking aspect of this analysis is that the amount laid out in debt service for payday users and those taking cash advances is so similar, despite the fact that both groups are taking very different approaches to their small sum cash credit needs.

Service of pay-debt represents a little over half of low income pay-day users outgoings on debt service

Chart 25. Monthly debt service on mainstream credit and short term payday lending

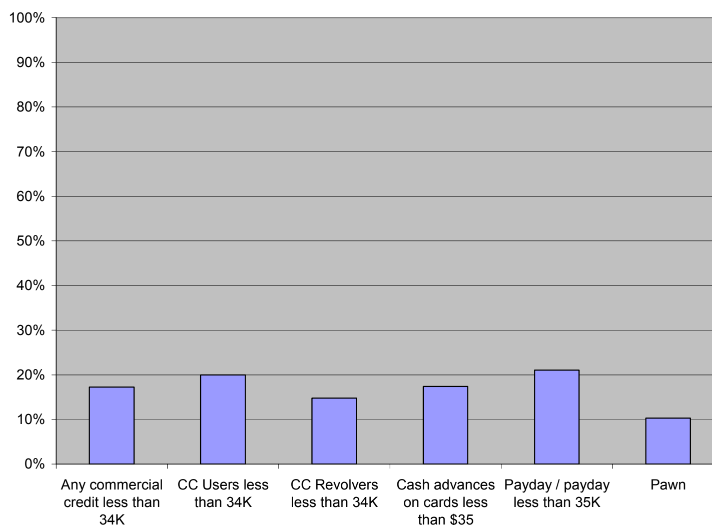


Debt service as a proportion of income is around a fifth for each of the credit user types except those using pawn-brokers

Debt service averages some 17% of income for all credit users on low incomes, rising to 20% for credit card users and falling to 15% for credit card revolvers. For payday loans users, who have lower incomes than those taking cash advances on credit cards, debt service was some 21% of household income compared to 17% for those taking cash advances. Debt service as a proportion of income was lowest for those using pawnbrokers, at 10%.

Debt service as share of income a little higher for low income payday users than for card cash advance users

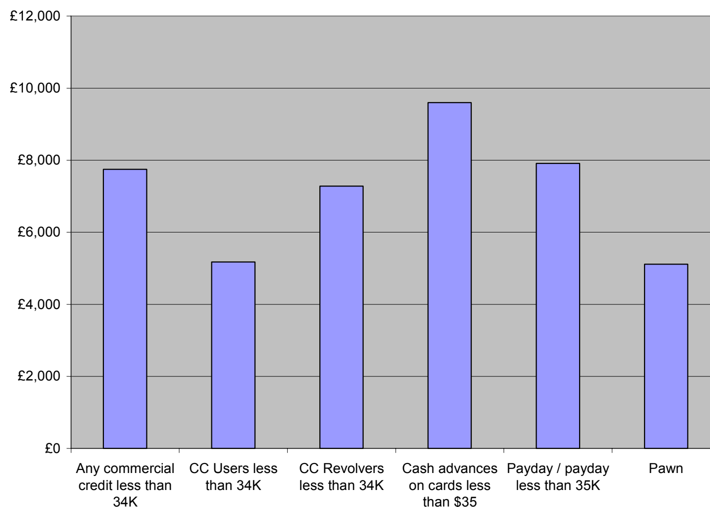
Chart 26. Debt service relative to income



Despite the similarity in absolute outgoings on debt service, those on the tightest budgets have higher net debt overall

The picture of debt service needs to be placed in the context of the value of the debt that is being serviced. Here, the picture is effectively the reverse of that on payments on debt service. The average total debt for all low income credit users, i.e. for households with less than $34,000 p.a. is $7,745. For credit card users as a whole, average total debt is $5,175, rising to a little short of $7,300 for credit card revolvers. The total value of outstanding debt is highest for the low income borrowers who are taking cash advances on credit cards, averaging $9,600, some 20% higher than for all low income credit users. It is lowest among those using Pawn, whose average debt is a little over $5,100, 30% lower than for all low income credit users, primarily because these borrowers have constrained access to credit in any case. The total debt owed by those using payday lenders, at $7,900 is broadly in line with that for all low income credit users.

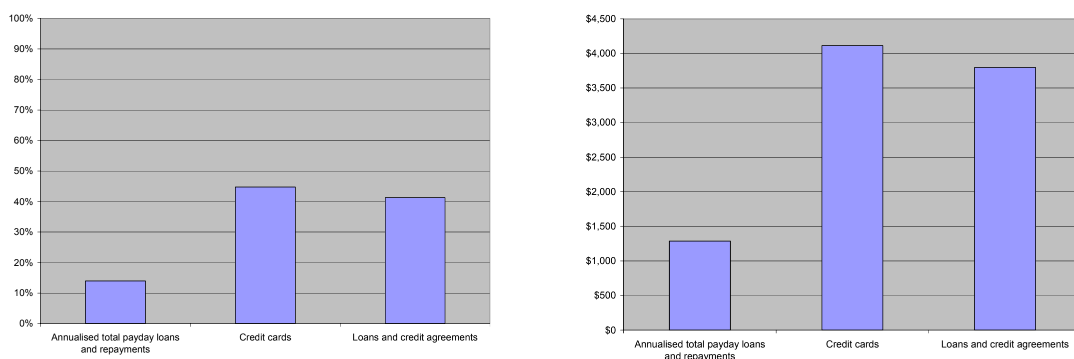
Card cash advance users have the highest level of indebtedness despite their disadvantage relative to other mainstream credit users
Chart 27. Value of total debt outstanding



For payday users, payday debt is a relative small proportion of overall indebtedness

If one takes the average of all payday borrowings and repayments over the course of a single year as a proxy for the relative importance of payday borrowing within the overall portfolio of debt being carried by payday borrowers, payday borrowing is relatively unimportant, representing some 16% of the total, with other debt split fairly evenly between credit cards (44%) and mainstream loans and credit agreements (40%).

Payday borrowing represents a small share of low income payday users overall indebtedness
Chart 28a. & 28b. Payday users indebtedness by type of debt

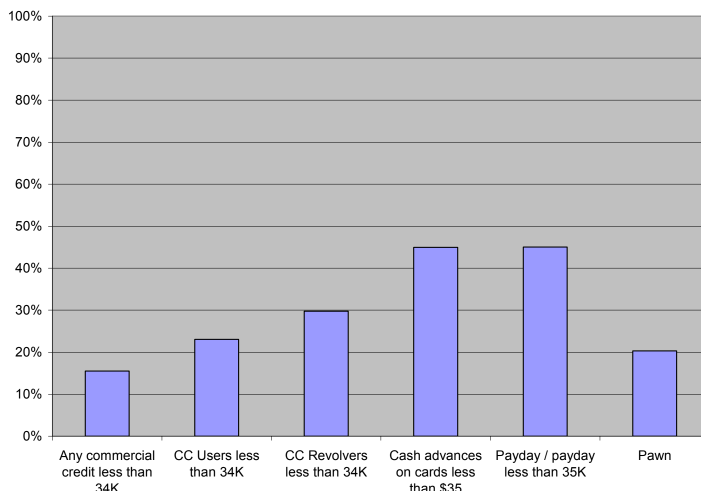


Payday users and those raising cash advances have similar levels of debt relative to their incomes, both three times that of all low income credit users

The impact of this pattern of the total value of debt is perhaps best understood in relation to the household income of the different groups. For all low income credit users, average indebtedness is some 16% of household incomes, rising to 23% for credit card users and to 30% for credit card revolvers. For those using their credit card to obtain cash advances, indebtedness as a proportion of annual household income rises sharply to 45%, nearly three times the level for all low income credit users and nearly twice the level for all credit card users (90% higher). It is notable

that those using their credit card for cash advances have very similar levels of debt relative to their income as do users of payday loans users, for whom debt is also 45% of annual income. For those using pawn-brokers, whose total indebtedness is some 30% lower than for all low income credit users, the debt relative to incomes falls to 20%, a little higher than for all credit users.

Ratio of indebtedness to income very similar for payday users and card cash advance users implying similar levels of financial pressure
Chart 29. Debt relative to household income, % of household income represented by debt

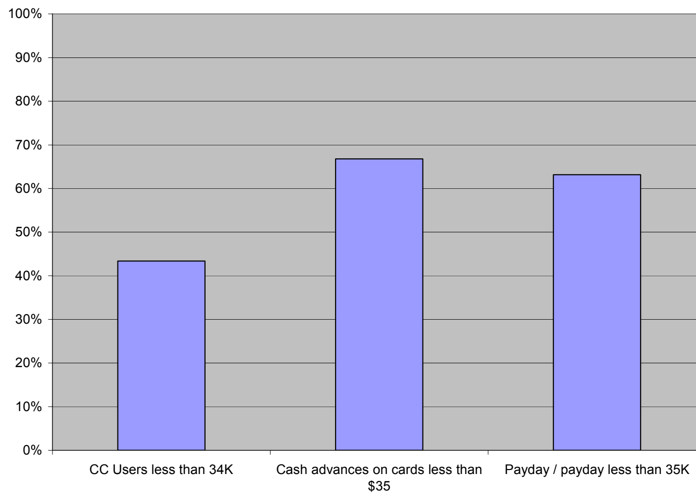


The tension between high levels of debt and relatively low outgoings on debt service is resolved by partial payments on balances and extended terms

This apparent dichotomy in which some of the households under greatest financial pressure are carrying the highest debt, both in absolute terms, and more markedly in relation to their incomes – while yet maintaining outgoings on debt service at similar levels to other credit users is resolved by examining payment behaviour. Among low income credit card holders as a whole, some 44% are “revolvers”, i.e. choosing to make only partial or minimum payments on their outstanding credit card balance at month end. Among credit card users with household of less than $34,000 p.a. and using their card for cash advances, the proportion of revolvers rises to close to seven out of ten (67%), slightly higher than among other hard pressed groups of credit users, such as those using payday lenders (63%) and those using pawn-brokers (52%).

Both payday borrowers and users of card cash advances are more likely to be credit card "revolvers" than other card users

Chart 30. Incidence of revolving on credit cards
% making partial or minimum payments on outstanding credit card balances

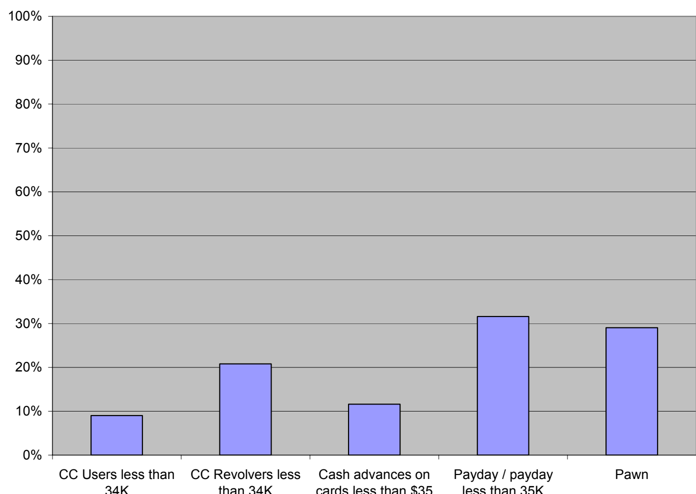


Credit card debt is made more manageable by paying down card balances only slowly over a greatly extended period

Credit card debt is made more manageable by extending the term over which debt is paid down through the medium of partial or minimum payments. Minimum payments on credit card debt, if set at typical levels of 2%, can effectively extend the term over which debt will be paid down by some years (for example on a $2,500 balance it would take 20 years to pay down the debt at minimum payments) The incidence of making minimum payments is low, however. Card users tend to prefer to pay down their debt where they can afford to. Perhaps unsurprisingly, making minimum payments is most closely associated with households who are under greatest financial pressure, those on the tightest budgets, those who have experienced an income shock (such as unemployment or the onset of sickness or disability) or who are suffering a temporary income shortfall (as a result of the late payment of benefits for example or irregular income flow arising from contract or freelance employment).

Card cash advance users have lower incidence of minimum payments as part of effort to keep credit line live

Chart 31. Minimum payments on card debt



Those raising cash advances on credit cards actively manage their payment profile to keep open their credit line and to avoid "maxing out" cards

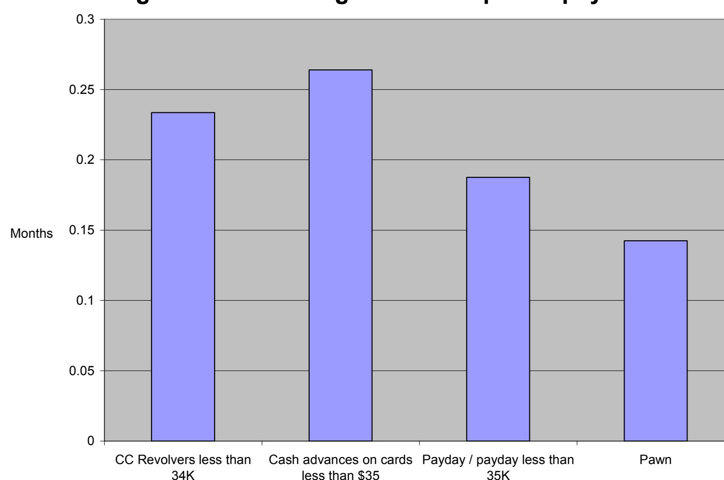
Overall, less than one in ten credit card users make only the minimum payment, rising to one in five of "revolvers". It is highest among those also using non standard lending, with close to a third of those using payday lenders making minimum payments and three in ten of those using pawn-brokers. Among those choosing to raise cash advances on credit cards as their chosen vehicle for small sum credit, the incidence of making minimum payments is relatively low, at 12%. This would indicate that although the incidence of making partial payments is very high (at seven out of ten), those raising cash advances are paying down their debt where they can afford to, in a pattern typical of those actively using a "live" credit line. This contrasts with the pattern of extended minimum payments, most typical of those who have "maxed out" their credit cards, i.e. reached the limit of a revolving credit line which they may be able to service at minimum payment levels, but which they can either not afford to pay down – typically because new credit is taken on as soon as it becomes available – or can afford to pay down only slowly over an extended term.

Payday borrowers and those using short term small sum cash credit pay back credit card debt over a shorter term than other credit card users

The pattern of making partial payments of credit card debt over an extended period is found in a significant minority of low income credit card users. Of those making minimum or partial payments, the average time over which partial payments have been being made is a little under 2 years (23.3 months). Low income card users who are raising cash advances on their credit cards and making partial payment of the debt are likely to have been making partial payments for some 10% longer than other revolvers, at 26.3 months. Those using non standard lending alongside credit cards are less likely to be paying down debt over an extended period than other low income credit users, averaging 19 months for payday loans users and 14 months for users of pawn, i.e. these borrowers are paying down their credit card balances in a 20% and 40% shorter time-scale than other low income credit card revolvers.

Payday users pay down credit card debt significantly faster than other card users

Chart 32. Length of time making minimum / partial payments on cards



Payment irregularity on mainstream credit is widespread among low income borrowers and is highest among those raising cash advances on credit cards

The other common coping mechanism for managing credit card and loan debt is to miss payments as they fall due. Irregular payment patterns – missed and late payments – are a common feature of the account management of low income credit users, not only in Australia, but internationally. 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. It would appear that missing the occasional payment on credit and loan agreements has become built into the credit behaviour of low income credit users, with the associated penalty charges having become the price of flex and of operating accounts to this pattern. A similar syndrome is evident among low income households in other credit markets also.

Despite widespread payment irregularity comparatively few credit users run into serious difficulties

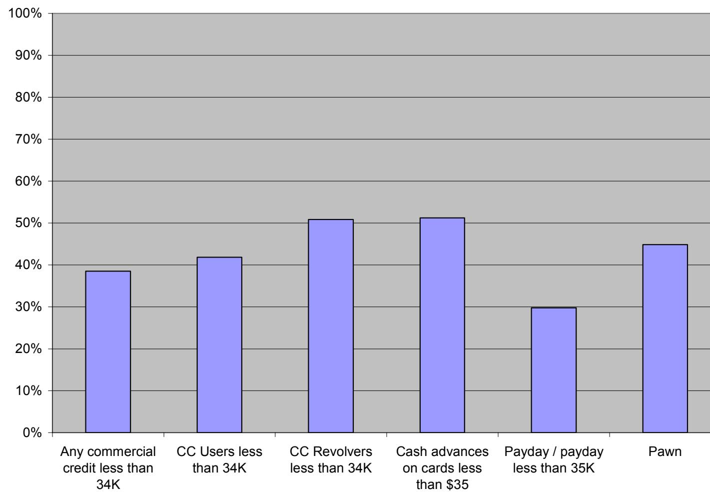
Against the background of what appears to be widespread payment irregularity, far fewer households encounter serious financial difficulties, in the sense that they had fallen more than three months behind on loans, credit agreements or mortgages, with this applying to only 9% of all credit users with household income of less than $35,000 p.a., 6% of low income credit card users and 8% of low income credit card revolvers. The overwhelming majority of borrowers and credit card users clearly can manage through tight cash flow, even if they have to miss or make a late payment from time to time.

The incidence of late and missed payments on mainstream credit is significantly lower for payday users than for other low income credit users

The incidence of late and missed payments on mainstream credit among those using non standard lending is significantly lower than among other low income credit card users, despite their greater incidence of revolving. Three in ten (29%) of Payday loans users and 44% of those using pawn have made missed or late payments on credit cards and loans agreements. Payday loans users on low incomes (i.e. those with incomes of less than $35,000 p.a.) are thus 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 than other credit card users. 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, as has been discussed earlier, both groups having very similar incidences of revolving (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.

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

Chart 33. Incidence of delinquency on loans and credit agreements

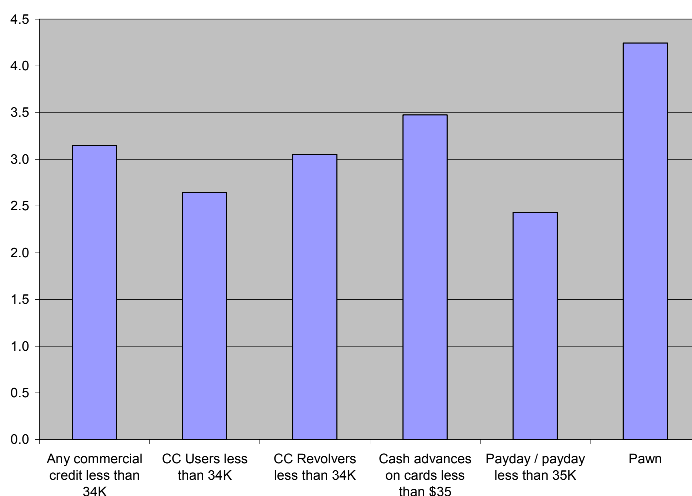


Where payday borrowers do miss payments on mainstream credit, they miss fewer payments than other low income credit users

Low income credit users with irregular payment patterns (i.e. those who miss or make late payments) miss an average of a little more than three payments a year (3.15). This falls to 2.6 for all credit card users but rises to 3.5 for low income credit card users taking cash advances on their credit card. The highest levels are found among the credit card users under greatest pressure, those using pawn to raise cash, who miss an average of 4.2 payments per year. Payment irregularity on mainstream credit and loan agreements is lower among payday loans users, at 2.4 missed or late payments a year, than among other low income credit users, indicating that users of payday lending miss 20% fewer payments than all low income credit users and 30% fewer payments than those raising cash advances on credit cards.

Payday users who do miss payments on mainstream credit miss fewer payments than other low income credit users

Chart 34. Frequency of missed / late payments on loans and credit cards p.a.



There are cost dimensions to the behaviours described, including penalty charges attached to account delinquency and bounced direct debit fees

There are cost dimensions to these patterns of behaviour, in the sense that missing or making late payments on credit card or loan agreements will tend to expose account holders to penalty charges for late payment or bounced direct debits while extending the term over which a debt or card balance is paid off will also increase the overall cost of credit. There is a relatively high exposure to penalty charges for late payments on loans and credit agreements among households with less than $35,000 p.a. household income.

A third of all low income credit users and almost half of low income credit card "revolvers" have paid credit-related penalty charges

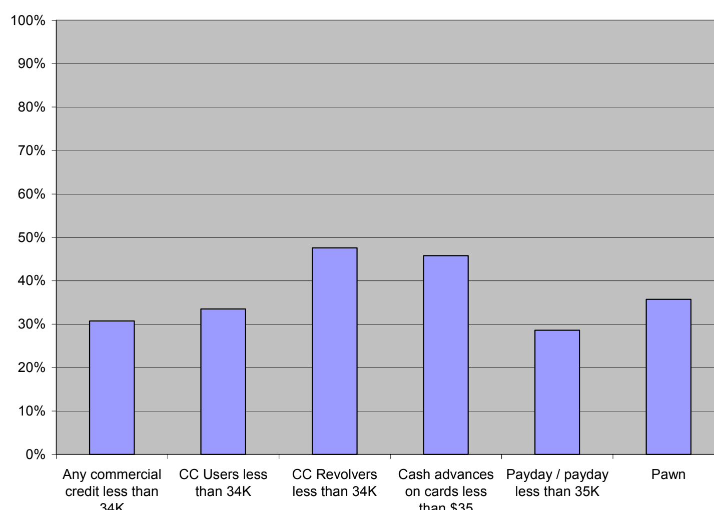
Almost a third of low income credit users (32%) have paid penalty charges on credit cards and loan agreements. This rises to almost half among credit card revolvers (48%). Among those raising cash advances on their credit card, the incidence of incurring penalty charges is similar to that for all card revolvers. This pattern of irregular payment and occasional missed or late payments on loan and credit agreements, and indeed household bills, is further reflected in the incidence of exposure to bank charges for exceeding overdrafts and for missed direct debits. Some 42% of low income credit users have paid bank charges for bounced direct debits and a further 28% have paid bank charges for use of unauthorised overdrafts.

Users of non standard lending are 40% less likely to pay penalty charges on loans and credit agreements, despite having high levels of revolving credit use

Among users of non standard lending the incidence of incurring penalty charge is significantly lower. Among users of payday lending, a little short of three in ten (29%) have paid penalty charges for late or missed payments, some 40% fewer than low income card revolvers as a whole or those taking cash advances on their credit cards. Among users of pawn, exposure to penalty charges for late payments on loans and credit agreements is a little higher than for all low income credit users, at 36%.

Payday users are less likely to pay penalty charges on credit cards, reflecting their lower incidence of delinquency on mainstream credit

Chart 35. Exposure to penalty charges on credit cards
% claiming to have paid penalty charges on credit cards

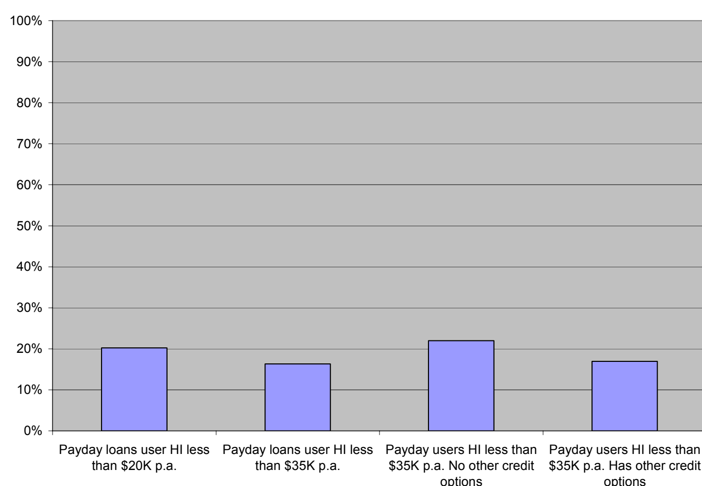


There is a lower incidence of account delinquency on high cost products, reflecting the reduced opportunity to miss payments on a short term contract

The research also set out to understand patterns of account delinquency among low income users of high cost credit and the extent to which the cost of credit on short term loans is increased by extending payment terms in the same way as appears to be the case for long term revolving credit relationships. The incidence of missed and late payments appears in fact significantly lower than for other types of credit, reflecting the fact that these loans are very short term with a limited number of contractual payments to be made in each case, with thus limited opportunity for missed payments. Some 16% of payday users with incomes of less than $35,000 p.a. had had difficulties at some point with repaying their payday loan, rising to 20% among the lowest income payday users and to 22% among those who felt they had no other credit options.

Payday borrowers have a relatively low incidence of payment problems, reflecting the short term nature of the contract

Chart 36. Incidence of payment problems on payday borrowing



The large majority of Payday loans appear to being paid back within the contract term, with multiple extensions rare

The most common mechanism for accommodating payment problems is for lenders to re-schedule payments. Practices vary between lenders on how this eventuality is charged for, with the larger lenders tending not to charge additionally where borrowers seek to re-schedule. The overwhelming majority of low income payday borrowers (93%) claimed however that they usually paid their payday loan within the contract term, with only 7% of borrowers claiming that they usually needed to re-schedule. A little more than a quarter had needed to reschedule their payments at some point, however, with two thirds of these claiming to have re-scheduled their loan only once. The average number of times that the loan had been re-scheduled, for the minority that had re-scheduled payments on their loan, was 1.7 times.

It would appear that few borrowers are being exposed to additional costs other than that implied by the headline price of the loan

Of those who re-schedule, three in ten claimed not to have been charged for doing so, and three in ten to have been charged once, 10% to have been charged twice or more for with almost three in ten not knowing whether they had been charged or not.

Payment difficulties with short term payday loans do not appear therefore to be having long term financial impacts for the borrower in the sense that delinquency appears relatively low and the incidence of re-scheduling of the loan also appears low, with relatively few of those who do run into difficulty being exposed to charges and even fewer to multiple charges.

Loans are not so much extended as taken out frequently, with the average borrower being in the market and paying back debt for 18 weeks p.a.

It appears rather that the pattern is not of loans being frequently extended but rather that payday borrowers take on a number of low value loans over the course of the year, each of which are paid back over a very short term. The average appears to be a little over four loans per year, rising to a little over five loans a year for those who do not have other credit options. Product terms and structures will vary between lenders but on the basis of one the most common products (Fee $35 per $100 loaned on 4-week basis) in the market place, this will imply that the average payday borrower with a household income of less than $35,000 will be making payments for 18 weeks of the year, borrowing an average of $238 a time, $1,061 a year and paying back on average, allowing for re-scheduling of charges based on the pattern described above, of $1,457 per year at an average of $81 p.w. for those weeks over which the loan is being repaid.

The evidence does not support the popular perception that payday lending is associated with a debt spiral, rather the reverse

While this is clearly high cost credit, borrowers and repayments of $80 p.w. may be hard to find during the third of the year in which payments are being made, the evidence is that the pain is relatively short term and that, on an annualised basis, overall outgoings on debt service are very close to those being made by their counterparts choosing to raise short term cash via cash advances on credit cards.

The evidence would not appear to support the popular perception that payday borrowers tend to become trapped in a spiral of continually extended and escalating debt. The data rather indicates that pay-day debt is paid within a clearly defined and very short term, at a cost to the borrower consistent with expectations and headline pricing and that borrowers are on average making payments to the lenders for less than a fifth of the year.

There are clear cost effects attached to different behavioural scenarios as they apply to different product and pricing structures. In order to illustrate these effects, we have taken a number of scenarios each of which is rooted in the research and based on typical behaviours and averages as applied to the different groups of credit user types. The exercise also illustrates why total cost of credit (TCC) may be more useful than APR in comparing costs of short term loans.

Scenario 1. Four week payday loan paid to contract term

We assume that the borrowers takes an average loan for those with household income of less than $35,000 and that it is paid four weeks later to term, with assumptions on the basis of the market leading lenders' pricing at time of writing.

Key conditions	
Fee per $100 borrowed	$ 35.00

Key results	
Cost of Credit	$ 35.00
Fees	$ 35.00
Cost per $100	$ 35.00
Observed APR	146.0%
Amount advanced	$100.00
Over term	1 month
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 time.

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 term is extended twice (a little more than the average number of extensions at 1.7). A significant proportion of loan extensions 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 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 research.

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

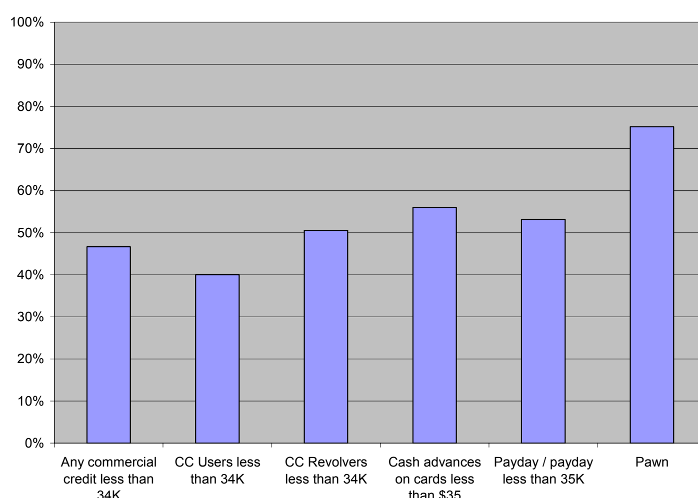
Both payday users and users of card cash advances more likely to struggle with keeping on top of bills than other low income credit users

In seeking to understand the impact of credit use on the finances and well-being of low income credit users, the research also went beyond the cost of credit to the consumer to explore the incidence of payment difficulties more widely. It revealed that a significant minority of low income credit users have experienced arrears on rent, utilities or phone bills, though few had encountered difficulties so serious as to put them three months or more behind. Almost half (47%) of low income credit users admitted to having been behind on household bills, with this falling to four in ten (40%) for credit card users as a whole and rising to a little over half (51%) for revolvers.

Payday users are slightly less likely than those raising cash on cards to be behind on bills but both groups fall behind more often than other borrowers

Perhaps unsurprisingly, given that as discussed in section 4.0 small sum credit is frequently applied to cash shortfalls, managing peaks of expenditure and keeping up with bills, those using small sum credit, in the form of cash advances on credit cards and payday loan, had a higher incidence of arrears on households bills (respectively 20% and 10% higher than all credit users though only 11% and 5% higher than other card revolvers), with payday loans users slightly less likely to be behind on bills than those using cash advances on credit cards. Those raising small sum cash via pawn shops were 60% more likely to have been behind on household bills, experienced by three quarters of this group.

Little difference between payday users and card cash advance users on payment problems on bills; payday users managing slightly better
Chart 37. Incidence of arrears on household bills
% who claiming to have had arrears on household bills



One of the drivers of use of payday loans is that the cash obtained is used to avoid penalty charges, overdraft fees and reconnection charges on utilities

The dynamic behind the broad pattern revealed by the research in which those using different credit vehicles and doing so in different ways appear to have different experiences and outcomes (in terms of overall indebtedness, incidence of payment difficulties, cost of credit to the consumer etc) is fundamentally explained by differences in the structure and nature of long versus short term credit and by

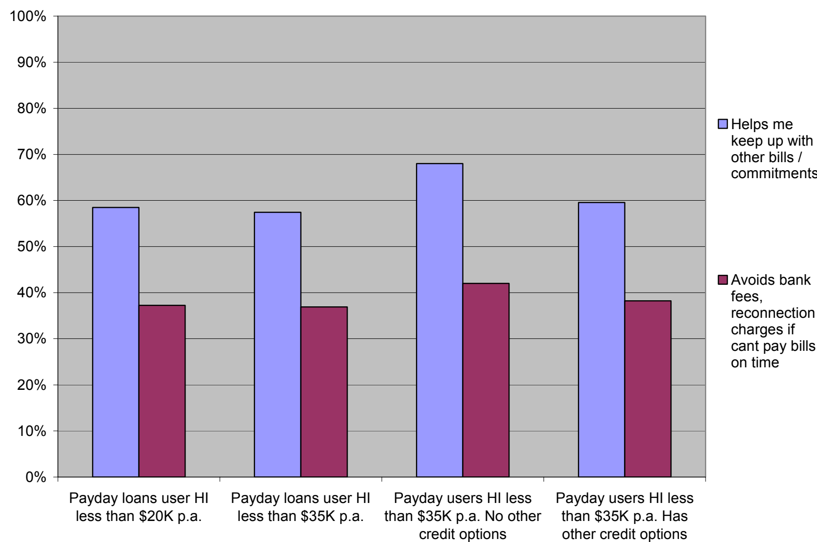
differences in approach to the pricing of credit particularly. Part of the explanation may lie also with the motivation and financial mind-set users bring to use of different types of credit. The qualitative research with low income low income credit users and users of high cost credit, undertaken to inform the framing of the quantitative research here discussed, suggested that some use of high cost cash credit such as payday lending is undertaken to maintain commitments on mortgages and bills and to avoid default charges on loan and credit agreements, reconnection fees on utilities and over-limit fees on overdrafts etc. Borrowers also used short term high cost loans to keep up payments on commitments specifically to avoid damage, or further damage, to credit records.

Payday appears to be used to avoid bank fees, card penalty fees and reconnection charges that would arise in the event of missed payments

The qualitative work also suggested that credit card users who have found themselves over-extended or servicing balances they find difficult to pay down become more measured in their use of revolving credit and become more conscious also of the advantages and disadvantages of different credit vehicles. Those who had experienced payment difficulties, whether with households bills or credit agreements were also conscious both of the cost of account delinquency and the potential impact adverse history might have on their future access to credit, an important consideration in relation to mortgage applications particularly. The quantitative research subsequently asked payday users about the reasons for their use of payday lending. Four out of ten cited the desire to avoid bank fees, penalty payments or reconnection fees as a reason they used payday lending.

Payday users appear to feel that payday borrowing helps with meeting financial commitments and avoiding default charges

Chart 38. Reasons for using payday loans
% citing as a reason for using payday loans



Six out of ten low income payday users claim to use payday loans to keep abreast of household bills and other commitments

Further credence may be given to the notion that short term high cost credit, in the form of payday lending, may have a role to play in keeping household finances on track and enabling borrowers to keep up with commitments by other evidence from

the consumer research. Almost six out of ten (58%) of payday users with households incomes of less than $35,000 p.a. claimed that they used payday loans because it helped them to keep up with mortgages, bills or other commitments, with this rising to nearly seven out of ten (68%) for those who felt that they did not have mainstream credit options.

Payday borrowers themselves are most likely to take the view that despite the high cost of credit there is a net financial benefit to the use of payday lending

Clearly, however, the high cost of payday loans needs to be met out of a finite pool of income and from the same household budgets from which some borrowers are finding it hard to meet commitments. It could be argued therefore that payday borrowers' ability to meet commitments is itself in part a function of borrowing from high cost lenders. Payday loans users were therefore asked about the impact of payday loans on their household finances, with borrowers being offered a list of potential impacts of not using payday loans, with these again framed by the qualitative consumer research. Within this list (the order of which was rotated), respondents were offered pairs of opposing statements, suggesting, for example, that without borrowing from payday lenders it would be easier to manage finances, afford essentials, keep up with commitments or avoid getting into financial difficulties paired with those suggesting the converse would be true.

Those most likely to believe that payday lending works to ameliorate and prevent financial difficulties are those with no other credit options

The evidence suggests that, on balance, users of payday lending 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 Payday borrowing makes it easier to manage their finances

Chart 39a. % believing it would be easier or more difficult to afford essentials if did not use Payday lending

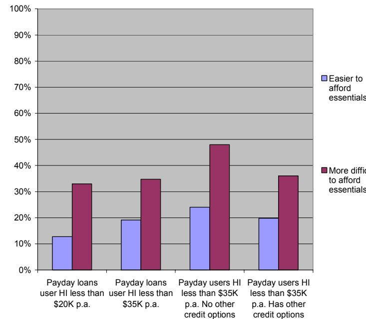


Chart 39b. % believing it would be more or less likely to get into trouble financially if did not use Payday lending

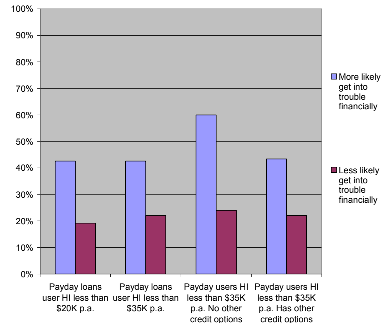
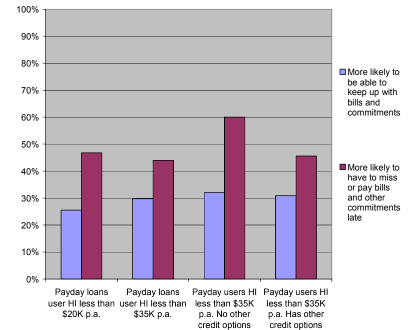


Chart 39c. % believing they would be more or less able to keep up with bills or commitments if they did not use Payday lending



One of the key concerns around credit user among low income consumers is the extent to which credit use increases the risk of financial breakdown

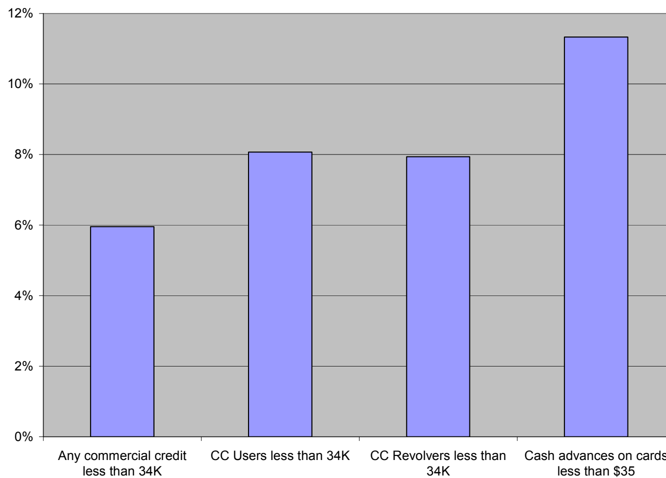
One of the key concerns around the use of credit among low income consumers is not only the price of credit and the impact that payments on debt service have on household budgets and standard of living but also how far credit use exposes individuals to the risk of financial breakdown.

Those who are most highly geared on long term or revolving debt and without savings safety nets are at greatest risk of financial breakdown

The overwhelming majority of even those most exposed within the credit mainstream (as we have seen those taking cash advances on a credit card and those making minimum payments) appear to manage without running into sufficient difficulties as to give rise to sanctions from the lender or to lead to court action. Nonetheless 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.

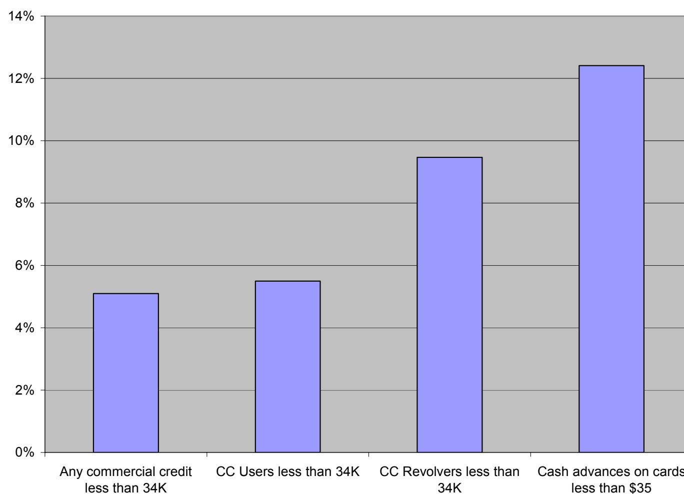
Those using card cash advances have greater exposure to risk of insolvency

Chart 40. Experience of insolvency among low income credit users
% experiencing Section 9 insolvency or bankruptcy



Cash card advance users more likely than other low income credit users to feel so pressured as to need help from debt adviser

Chart 41. Needed help from financial counsellor
% who have sought advice on debt related problems



The factor precipitating breakdown is often illness or unemployment, a risk to which the most highly geared low income borrowers are most exposed

The likelihood is that those who have encountered severe financial difficulties will tend to put the best face on their problems and ascribe their difficulties to circumstances beyond their control. Even acknowledging that possibility, the evidence suggests that serious financial problems arise primarily from factors associated with irregularity in income flows (as discussed earlier, more closely associated with the types of credit user using small sum credit, howsoever sourced) and with income shocks, arising from illness or the onset of disability, unemployment or relationship breakdown. For those who had suffered various serious financial difficulty, unemployment or reduced working hours or delays in receiving wages and benefits were a feature in 44% of cases among low income credit users as a whole and for 55% of cases involving revolving credit. Illness was also a feature for a little more than one in ten.

The nature of revolving credit as an ongoing commitment means that even a short period of instability or an income shock can quickly unravel finances

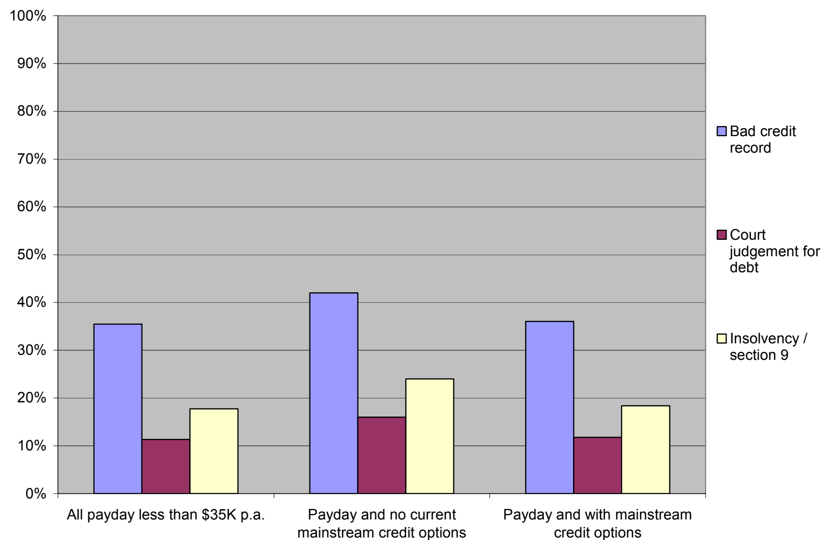
A major part of the risk for low income borrowers in using revolving credit is the ongoing nature of the commitment, sometimes over a greatly extended term in the case of those making proportionately low or minimum payments. It would appear relatively easy for the small minority of individuals who do run into serious trouble with revolving credit to acquire an adverse credit record and thus find themselves with constrained credit options. Against this background, those whose debt is highest relative to their income and whose obligations are furthest extended into the future are those most at risk of catastrophic financial breakdown in the event of even a fairly temporary reversal of fortunes. As earlier discussed the group most at risk, on the basis of these characteristics, is those taking cash advances on credit cards. Some may be able to manage through a period of difficulty by reducing payments to the minimum. Others may already be holding down payments on debt service as low as can be achieved. Some may emerge with some adverse history but avoid financial breakdown. Others will manage without moving into outright delinquency, but only at the price of increasing their exposure while at the same time using up the safety net that this represented, making future finances less secure.

Those acquiring an adverse credit record can quickly find themselves shut out of the credit mainstream with no options but high cost short term loans

As was discussed in earlier chapters, those who find themselves shut out of the mainstream market are likely to turn to high cost non standard lending sources, with around four in ten payday users and 86% of pawn users having no mainstream credit options. Indeed a significant minority of users of payday lenders and pawnshops appear to have a background of serious financial difficulty, most frequently with credit cards, with these difficulties being a key factor in their current exclusion. More than a third of low income payday users (35%) claim to have a poor credit record as do 8% of pawn users. More than one in ten (11%) have had a court judgement for debt, while 7% have made a section 9 arrangement with creditors and 11% have been bankrupt. Some 15% of those using pawnshops have experienced insolvency in some form. Among those who claim to have no cash credit options other than payday lending, this rises to 44%, 16% and 24% for a poor credit record, court judgment for non payment of debt and some form of insolvency respectively.

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

Chart 42. Payday users background adverse history

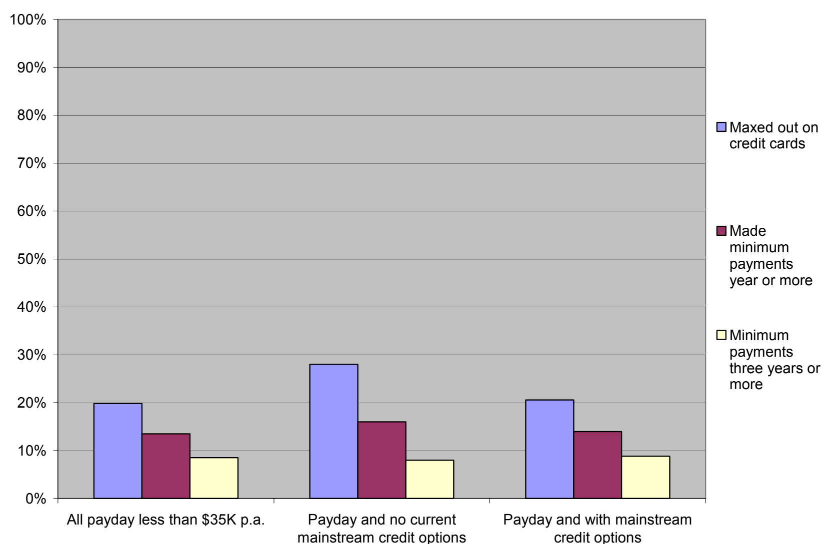


A key component of the financial pressures experienced by Payday users arises from historic borrowing, particularly on "maxed out" credit cards

Difficulties with mainstream credit and loans and a hangover of mainstream debt appear to be a significant feature of the broad picture of financial pressure for payday users, most particularly from use of mainstream revolving credit cards. More payday users appear, however, to have managed through financial difficulties without straying into delinquency or outright default than appear to have fallen significantly behind on payments. The syndrome of having borrowed to the limit of a credit card appears to be a significant feature, with almost three in ten of payday users on low incomes claiming to have no credit options and one in five of those using payday lending but having other credit option saying that they are "maxed out" out on credit cards, with 16% claiming to have been making a minimum payments on credit cards for more than a year with a further 8% claiming to have been making minimum payments on credit cards for more than three years. One in ten pay day users with household incomes of less than $35,000 a year claims to be three or more payments behind on a mainstream loan or credit agreement.

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

Chart 43. Payday uses credit card experience
% with various credit problems



Low income borrowers appear to have a need for a mix of different credit products, offering both short and longer term solutions

Taken together, the patterns here described suggest that the structure and nature of different credit vehicles have a profound impact not only on the cost of credit to the consumer but also on the potential impact of credit on the broader finances and well being of low income credit users. Low income consumers would appear to have a real need for a mix of credit product types, with varying product structures and pricing and for long and short term credit options.

Revolving credit offers low income consumers significant advantages but the most vulnerable users are exposed to significant risk and costs

Revolving credit has become so popular because in many ways it represents a good fit with both demand and supply side needs. Consumers are able to leverage their incomes to the maximum extent while also enjoying significant flexibility. From the perspective of the lender, the price for risk is fine-tuned by consumer behaviour. Profitability is enhanced by behaviours that allow the highest risk consumers to exhibit a limited – and revenue enhancing – degree of delinquency while simultaneously moderating the risk of default through extending the term of repayment, and thus the cost of credit to the consumer. The popularity and growth of revolving credit is testament to this equation working for both parties most of the time. The downside for those on low incomes – and particularly the most over-stretched borrowers – is that credit users on tight budgets are at significant risk of becoming trapped in a vicious and extended cycle of barely manageable debt and are also exposed to the possibility of financial breakdown in the event of any reversal in fortunes.

Short term credit, howsoever sourced, is high cost but appears to have a key role to play in the effective management of low income households' finances

Short term cash credit is indubitably high cost, howsoever sourced, and the differences between credit vehicles in the total cost of credit to the consumer may be smaller than is sometimes supposed. Rapid growth of products specifically designed to meet the need for short term credit, such as payday lending, may in part have resulted from the consumer experience of revolving credit. The majority of those who use payday lending are making an active choice over other credit options, even among low income households. It would appear that payday borrowing has a role to play in managing household finances, with in some cases the high cost of this type of borrowing seen as a substitution for alternative charges and costs – such as overdraft or reconnection fees – which could even work out more expensive than the cost of the credit concerned. For those without other credit options, payday and other forms of small sum cash credit would appear to be an important component of these households' financial management and their ability to keep finances on track.

The evidence does not support the view that high cost credit creates a debt spiral or that it is associated with higher detriment than other credit types

The evidence does not appear to support the popular perception that short term high cost loans are associated with either a debt spiral or more significant consumer detriment than other types of credit used by those on low incomes. Indeed, the reverse would appear to be the case. For those able to manage it effectively, and who do not suffer a significant downturn in income or circumstances, revolving credit has many advantages, for low income consumers as much as other borrowers. For the most vulnerable credit users, these types of products may be less appropriate to needs, exposing borrowers to significant risks to their financial well-being and potentially – for those with uneven payment records or unable to pay down balances other than very slowly – even more expensive than short term credit from high APR providers.

6.0 Conclusions and implications for policy makers

- Credit appears to be playing a positive role in the financial management of low income households with access to small sum credit a key part of consumer needs
- There is no evidence of a debt spiral associated with high cost credit
- The practice of taking cash advances on revolving credit cards (the leading source of small sum credit) may expose vulnerable consumers to a series of risks to their well-being and financial security
- Lenders appear to be able to achieve a price for credit commensurate with risk by alignment of product and pricing structures with behavioural drivers of enhanced cost
- APR appears to be an insufficient guide to the real cost of credit and is a particularly poor indicator for small sum credit, where TCC might be more appropriately used
- Moves which seek to control price are likely to be met by further product adaptation and may fail to achieve reduced prices while compromising price transparency
- Alternatively consumers may be diverted to less appropriate products. Were high risk borrowers currently using high cost credit to be diverted to revolving credit, the most likely scenario, the likely outcome is an increase in default and financial breakdown
- If successful, price controls may result in a restriction of supply, with those consumer groups most likely to be impacted those with the greatest need for small sum credit.
- Those who become credit excluded are likely to suffer hardship and may be at greater risk of financial difficulties
- A credit vacuum may be filled by unregulated black market lenders, potentially both higher cost and more exploitative than the existing lender set

Credit would appear to be playing a positive role in the finances of those on low incomes

The evidence suggests that most people on low incomes manage their credit use effectively and that credit is playing a positive role in facilitating the management of household finances, preventing cash flow shortfalls becoming crises and enabling the acquisition of essential items that could not otherwise be afforded on limited incomes. Low income credit users clearly exhibit a high degree of payment irregularity, the accommodation of which by the lenders and card issuers appears to inject an important element of flex into budgets, albeit at a cost. Despite this widespread account delinquency, serious financial difficulties and financial breakdown remain relatively rare.

Lenders appear to achieve a price commensurate with risk irrespective of the lending vehicle or headline APR associated with different credit product types

Different groups of low income borrowers and different behavioural approaches to the use of credit appear to imply different degrees of risk. Indeed there would appear to be something of a spectrum of more or less high risk borrowers among low income credit users, with those paying down term loans or paying down balances on credit cards each month at one end of the spectrum and those taking constant cash advances on maxed out credit cards or using payday loans at the other. Lenders appear to have achieved a price for that risk through a variety of mechanisms. Product features and pricing structures are adapted so as to work with patterns of consumer behaviour to generate a price to the consumer adjusted for the risk associated with a given set of characteristics or behavioural traits.

Total cost of credit may be a better basis on which to assess relative cost of small sum short term cash credit vehicles

The most transparent approach to product pricing and structure would appear to be that of the short term high cost lenders. Pricing on other products, notably revolving credit, would seem less transparent and predictable to the user – though possibly not to the lender – with the cost to the user ultimately determined by exposure to penalty charges and the term over which credit balances are repaid. In this respect the Total Cost of Credit (TCC) would perhaps seem a better guide to the real cost of credit for those on low incomes than the APR. The worked examples earlier presented suggest there is a spectrum of increasing cost for credit analogous to that of increasing risk earlier mentioned, regardless of the headline APR of the credit vehicle concerned.

Revolving credit clearly central to credit use of all but the most disadvantaged but may not be the most appropriate vehicle for certain types of borrowing

Low income households appear to have a variety of credit needs which they are meeting in different ways with a diverse mix of credit product types. Longer term personal loans and car loans are often used for the acquisition of very large items, with higher cost retail credit or TV shopping used to fund peaks of expenditure or spread the cost of goods which are less expensive – clothes, furniture or white goods for example – which are less expensive but which would nonetheless be hard to pay for all at once. Revolving credit now clearly has the central role to play for all except the most disadvantaged and most excluded groups, being used to facilitate the purchase of both essential and discretionary items and acting as a financial lubricant, facilitating cash flow through pressure points.

There is less difference in the cost of small sum credit vehicles than headline APRs would suggest, with consumers appearing to make rational choices

There is a clear need for small sum short term credit among those on the lowest incomes and under greatest financial pressure, without which these households will be exposed to significantly greater risk of hardship, financial difficulties and breakdown. Low income borrowers are choosing to meet this need in a variety of ways, most commonly through cash advances on mainstream credit cards rather than through high cost short term payday loans. Given the relative difference in the real cost of credit to the consumer associated with the two types of credit, those choosing either option would appear to be making a rational choice based on their assessment of their own circumstances and needs, albeit that those using high APR loans may have a better grasp at point of sale of the cost of the credit that they are taking on.

Those borrowing from high cost lenders are less exposed to a variety of risks than users of revolving credit who enjoy greater flexibility

From the perspective of the payday borrower, or at least those who have credit options, the choice of payday lending as a means of keeping finances on track and avoiding charges to which they might otherwise be exposed would seem to be a strategy validated by the evidence on the lower incidence of payment difficulties – and associated costs – among these borrowers. Alternatively, those raising cash advances on credit cards and able to manage revolving credit, may find the greater flex and the facility to defer obligations through an extended payment term more valuable and better suited to their own needs and circumstances.

The issue may not be so much about the relative cost of different approaches to small sum credit as the degree of risk to which borrowers are exposed

For policy makers, the issue may be not so much the relative cost of the two approaches to small sum credit, which as this analysis has shown may in fact be smaller than is sometimes supposed, but rather the relative risk to which different types of credit expose the borrower. By their nature long term products, and revolving credit in particular expose individuals to a greater risk of breakdown than do short term loans. On the one hand, the debt generated by revolving credit – and cash advances on revolving credit in particular – is likely to be significantly higher than that associated with other types of credit available to those on low incomes. On the other, the open ended and ongoing nature of the obligation means that individuals without savings safety nets are also exposed to a downturn in their fortunes on an ongoing basis. In those cases where the income shock arising is significant or the period of disruption to income flows is extended or permanent, there is a high risk of default and financial breakdown.

Low income borrowers taking small sum cash advances on credit cards risk a long term debt trap as well as the potential for financial breakdown

Low income borrowers using revolving credit are also all too easily exposed to a situation which they can manage without delinquency and default but which no longer has any utility for the borrower and nonetheless represents a continual drain on the borrower's finances, which it can take some years to resolve. Maxed out credit cards being paid down on minimum payments exemplify this situation. Unsurprisingly perhaps, this pattern is one of those is most closely associated with borrowers most likely to default.

High cost debt creates short term pain rather than long term risk and appears to put finances on a more stable footing than for other high risk credit users

By contrast, high cost short term loans may require some sacrifice and create considerable financial pressure for the duration of the loan term, but the evidence suggests that the utility of what is obtained with the loan is immediate (whether an urgent repair or relief from being unable to meet a commitment) and that such borrowing creates little risk of financial breakdown, indeed quite the reverse. There would appear to be little evidence that short term high cost loans are creating a vicious cycle of consumer detriment or contributing to a debt spiral.

High cost credit appears to play a greater role in the effective management of household finances for consumers with the most constrained credit options

Clearly some consumers are making an active choice of one form of small sum credit over another while others are using both mainstream and non standard lending in parallel. The majority of users of high cost credit do appear to have a variety of options. Others do not have that choice, either because their circumstances render them too high risk to be attractive to mainstream lenders or, more commonly, because, having acquired adverse credit history, the credit mainstream is no longer open to them. For these consumers, often the most disadvantaged, short term non standard lending appears to play a particularly important role in the effective management of household finances and prevention of hardship, albeit that that credit comes at high cost.

There are significant social risks associated with various aspects of credit market regulation

Clearly in seeking to improve consumer protection and limit consumer detriment for those on low incomes, there is the potential for a range of unintended and undesirable effects. There are significant social risks associated with regulation of credit markets. Regulatory moves will tend to have an impact outside the credit markets, impacting consumer social welfare, standards of living and quality of life more widely.

Moves which restrict credit supply may create a credit vacuum most likely to be filled by unlicensed operators lending at higher cost than incumbents

Policy makers seeking to protect consumer interests will need to strike a delicate balance. Efforts to control the price of credit will likely result in some restriction of supply as lenders withdraw from serving borrower types representing a risk for which they judge a commensurate price can no longer be achieved. The most obvious group of borrowers likely to be impacted by such a scenario are those currently solely reliant on the high cost lenders. These borrowers, among the most disadvantaged, are also those with the greatest need for credit and may suffer considerable hardship as a result. The resulting credit vacuum will likely be challenging and resource, time and cost intensive to fill with any sort of social lending alternative. The more likely scenario is that is filled with unlicensed and unregulated lenders likely not only to lend at significantly higher prices than the incumbent lenders but also to exhibit a series of behaviours likely to be damaging to, and exploitative of, vulnerable low income consumers.

If those who can access the mainstream are diverted to low APR revolving credit, consumer detriment and financial breakdown are likely to increase

For those who do have alternative credit options, any move to restrict the supply of high cost credit will likely cause a diversion from high cost products to low APR credit vehicles, primarily revolving credit, a transition which is unlikely to reduce the real cost of credit for low income high risk borrowers. The evidence of this research is that if those currently using payday lending were to be diverted to greater use of credit cards for small sum cash credit, the likelihood is that the incidence of delinquency and ultimately default would increase significantly on credit card borrowing, overall indebtedness would rise and that more low income credit users would become trapped at the top of a credit card limit that they are barely able to service, thus increasing their exposure to the risk of financial breakdown.

Efforts to enhance consumer protection unlikely to be moved forward by moves that create exclusion

Efforts to address poverty, social exclusion and over-indebtedness are unlikely to be moved forward by regulatory initiatives which create credit exclusion or work to divert vulnerable borrowers to products that expose them to the likelihood of greater indebtedness. The better way forward may be an emphasis on enhanced consumer protection through more effective regulatory enforcement of best practice and the elimination of unfair and exploitative practice, accompanied by a greater focus on both price transparency and the terms and conditions attached to credit contracts.