QUESTION 11 - SHOULD A CAP BE SET THE SAME FOR MORTGAGES AS FOR OTHER CREDIT CONTRACTS?

IN BRIEF

1. No - causes confusion
2. Distorts the market

Varied Cap Rates Create Confusion

The Consumer Credit Act 1995 and the Regulations under the Consumer Credit Code (in Victoria) provide a structure whereby there is a differentiation of interest rate, according to whether security is taken for the loan or not. A credit contract which does not involve security has an interest rate limitation of 48%, exclusive of fees and charges. A credit contract with security has a maximum interest allowable rate of 30%.

The differentiation was introduced in recognition of the higher risk presumed to apply to the credit contract, without security.

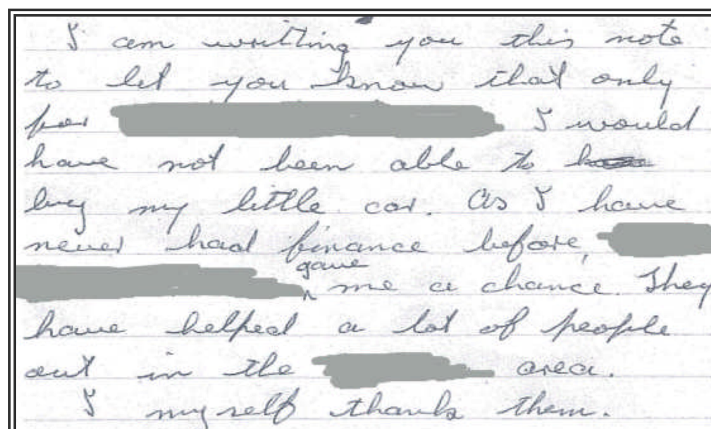
The writers have been presented with circumstances associated with loans in Victoria, where there has been an element of confusion created by Section 70 of the Code and Section 19A(2)(a) of the Act, which refers to the Act applying to “a mortgage or guarantee relating to…a credit contract”.

If Queensland was to consider a differentiation in interest rate cap regimes, such confusion should be avoided and the best way to succeed with such avoidance, would be to seek uniformity across Australia, with the regime enshrined in the Consumer Credit Code.

Distortion in the market would occur because, to avoid the limitation of the 30% cap, lenders would simply increase the fees and charges associated with the higher risk of unsecured loans. This would compensate for the lack of security. The secured loan arrangement would therefore have been cheaper for the customer.

The Other States

The Queensland, Tasmanian, Northern Territory, Western Australian and current South Australian approach, of not capping interest rates, is preferred. We do note however, that the Victorian model of separating fees and charges from interest rate calculations, while imposing an interest rate cap, is a less onerous alternative than the ill-informed NSW and ACT model.



I am writing you this note to let you know that only for [redacted] I would have not been able to buy my little car. As I have never had finance before, [redacted] gave me a chance. They have helped a lot of people out in the [redacted] area. I myself thank them.

QUESTION 12 - SHOULD A CAP INCLUDE FEES AND CHARGES?

IN BRIEF

1. No - it will abolish all lenders and/or force lending outside the Code.
2. Opens the door for the unscrupulous.
3. Denies any chance of lender business survival.

The introduction of such simply totally precludes all payday and microlenders offering short term loans, for relatively small amounts, under the Consumer Credit Code.

It is all about cost recovery. As Manning and de Jong; *"Regulating the cost of credit"*, CAV, page 41 concluded:

> *"(a) Cap of 48% all inclusive …is below cost recovery for short period loans, which it therefore prohibits".*

The Federation reiterates that any approach to regulation involving a cap:

a. wrongly assumes that a total of interest/fees and charges not exceeding 48% per annum can be economically sustained by payday lending businesses;

b. ignores the fact that borrowers are prepared to pay for time and place convenience for payday lending services;

c. overlooks the reality that many small loans are provided without any security;

d. ignores the growth of Internet and telephone payday/microlenders, operating from other states, who sell their services nationally;

e. ignores the reality that the suggested 48% cap regime, if inclusive of fees and charges, would effectively abolish legitimate, Consumer Credit Code controlled, payday lending in Queensland. This could open the way for a potential takeover of payday lending by backyard operators and an undesirable element, and would massively increase compliance enforcement costs for the Office of Fair Trading and the Police Services;

f. ignores the reality that a cap regime would generate a massive increase in the number of people turning to a charity for financial assistance. This would require a substantial increase in Government funding, if the needs of these people are going to be met by the already cash strapped charities;

g. ignores the reality that the bulk of Queenslanders requiring the nearly 80,000 payday/microloans per annum, under $5,000, do not comply with the mainstream lenders' criteria for such loans, even if they were to be available;

h. ignores the reality that a percentage of people requiring credit under $5,000, choose not to deal with mainstream lenders; and

i. ignores the fact that the figure of 48% is derived from English legislation brought in during the first half of the last century, dealing with vastly different socio-economic circumstances, as noted in the Discussion Paper. As previously indicated, this has recently been recognised with a decision, by the British Government, not to impose a cap.

It must be appreciated that many of the payday/microlenders' customers are unable to borrow from mainstream lenders because they have not established

a credit rating, or have a bad credit rating, not necessarily because they come from a lower socio-economic group, or are desperate. Further, a number of payday/microborrowers simply prefer not to deal with mainstream lenders.

Two Other Examples

A consideration of the following two examples demonstrates again the uneconomic nature of a 48% all-inclusive cap, if such were imposed. The reality is, notwithstanding the view of the NSW Office of Fair Trading, for loans under $5,000, over several months, there is no business model that will allow a lender to survive under an all inclusive 48% cap:

Example 1: The $200 loan, over 2 weeks.

With no fees and charges possible, such a loan generates $3.68 interest (200 x 0.1315% x 14 days). 0.1315% is derived by dividing 48% by 365 days, as required under the Consumer Credit Code. This does not even cover the cost of employing staff to interview the customer, undertake credit checks, process and, thereafter, administer the loan.

In this context, we are concerned that advocates of an interest rate cap continue to ignore the stark realities of commercially viable payday lending, because they attempt little or no enquiry of the industry.

Example 2: Without a cap imposed:

Amount requested: $1,165 Term requested: 3 months

Payment method requested: Weekly, by Direct Debit

Existing client: Yes ($50 rebate on $100 application fee)

Loan Summary:

Loan amount	$1,165.00		
Fees and Charges (included at cost):			
Initial costs -			
Application fee	$50.00	($50 rebate has been applied)	
Documentation fee	$66.00	(includes $6.00 GST)	
Sub-total	$116.00		
Ongoing costs -			
Account keeping	$58.50	($19.50 monthly)	
Direct Debit charges	$65.00	($5 per transaction)	
Sub-total	$123.50		
Total cost of processing, granting and maintaining service	$239.50		**$239.50**
Interest (29.95% daily, reducing)	$46.48		**$46.48**
Total Payments (12 x $112.00 + 1 x $106.98)			**$1,450.98**

Comparison Rate: 193.94%

Example 2: **WITH** <u>inclusive cap imposed</u>

The effect of the 48% inclusive cap, on this transaction is:

Loan amount:		$1,165.00
48% (daily reducing), total return	**$ 76.44**	

Total		$1,241.44

Imposing a 48% Cap

The consequences of a 48% cap on this transaction will make it uneconomic for any legitimate lender to offer such a product for a total return of $76.44, given the cost of providing such a loan (excluding the interest component), is $239.50.

Un-serviced Need for Credit

The Federation notes that the Council of Social Services is aware that, if payday and microlending are effectively prohibited and mainstream lenders cannot be obliged to provide affordable credit, there would be a potential immense detriment to consumers, because there would be a remaining, significant, un-serviced need for credit. As this submission considers elsewhere, there are fundamental reasons why the Council of Social Services' concerns are valid.

First, payday and microlending in Queensland now involves a total lending in excess of $60 million per annum. Secondly, as previously mentioned, obliging mainstream lenders to re-enter the payday and microlending market would require a major overhaul of Commonwealth financial services regulation. Such an overhaul would have to be achieved in the face of very strong and sophisticated opposition from very powerful and very politically astute lobbying groups, such as the Australian Bankers Association, representing 26 of the biggest banks in Australia, including the Bank of Queensland Limited and Suncorp Metway Bank Limited.

The Victorian Perspective

This conclusion is strongly supported by the extensive Victorian Consumer Credit Review undertaken in 2005. In this context, it is appropriate to quote extensively from the report following the Review. In Chapter 5, page 111, the Review states:

> *"It is recognised that applying the Code and imposing an inclusive interest rate cap would not necessarily arrest the cost of this form of credit, since default and other contingent charges are a significant part of the problem.*
>
> *All States and Territories have contributed to the development of a set of policy proposals to address harmful fringe lending practices. The Fringe Credit Providers proposals, which have been extensively reworked since they were originally floated in the second half of 2003, opted against recommending a national uniform interest rate ceiling on the basis that interest rates are outside the Uniformity Agreement.*
>
> *While the imposition of interest rate ceilings in some jurisdictions does not offend the Uniformity Agreement, it does pose compliance issues for small amount lenders operating across State and Territory borders. Of more concern is that where the nature of the interest rate cap applied is actually*

a cap on the total cost of credit – because it incorporates credit fees and charges – there is a break with the Code.

This is because the Code does not impose many restrictions on credit fees and charges, though it does contain a power to prohibit particular fees or charges. The prospect of several jurisdictions imposing a cap on the total cost of credit does pose a real problem for the maintenance of uniformity, hitherto a fundamental plank of the Code".

At page 116 (Part B), the Report noted:

"It is not prudent for Victoria to follow the New South Wales model while there is doubt and uncertainty about the effectiveness of such an approach. The research that has been commissioned into the small amount credit market (under term of reference 3 of the Review) will help shed light on the nature of this market sector, which, in turn will help the Review to determine the approach with the best prospects of success.

What is clear is that a cap on the total cost of credit will not:

- *address the unfair contract terms prevalent in small amount short term lending*
- *address the avoidance techniques used in this sector of the market*
- *be a catalyst for more affordable credit on the 'high street'*
- *help those who use small amount loan services sparingly and prudently*
- *work unless there is a matching commitment to deploy extensive compliance and enforcement resources to administer a cap.*

The provisional conclusion of the Review is that there is not enough evidence to be confident that capping the total cost of credit is the best way to address the causes of the very high cost of credit in the small amount sector, the non-conforming sector and in connection with default fees and charges in the mainstream market. However, the impact of the New South Wales strategy will be monitored closely. Should it prove to be highly effective, it would warrant reconsideration."

It is significant to note, as the Minister would be aware, this observation followed:

- an intensive 12 month period of review, embracing a relatively lengthy time for stakeholders to prepare submissions;
- some 13 public community forums conducted across Victoria;
- constant availability and contact with the Member of Parliament delegated by the, then, Minister to head the review;
- constant availability and contact with senior officers from the Department of Justice (Fair Trade);
- a substantial consumer market research program, conducted by a leading firm of independent researchers;
- visits to lending outlets by the Member of Parliament and a senior department officer; and
- the opportunity for industry to provide supplementary comment, when the Minister released an interim paper.

After this considerable amount of activity, never paralleled in Australia before with regard to any part or whole of the credit industry, the Victorian Minister

announced the following proposed changes, as an alternative to the inclusive interest rate:

- “controls on the manner in which credit card limit increases are offered
- national solutions to encourage more responsible lending practices – especially in relation to credit cards – such as the possibility of standard warnings on all credit card account statements
- developing a balanced way to address unreasonable credit fees and charges
- better protection for consumers who buy on vendor terms finance
- improving the registration system for credit providers and requiring all lenders to be members of an approved alternative dispute resolution service
- working with industry to remove unfair contract terms from credit contracts
- targeting education campaigns on credit to vulnerable groups, such as senior Victorians considering equity release products
- more protection for consumers taking out reverse mortgages, and
- more flexible powers for the Government to prosecute unscrupulous credit providers.”

Federation Has Mainstream Industry Support

The Victorian stance has been supported by other peak finance industry representative bodies.

As the Association of Building Societies and Credit Unions (Abacus) noted in their submission to the South Australian Payday Lending Review,

> *“On its own, an interest rate cap is no panacea in seeking to reduce excessive lending rates and predatory practices impacting vulnerable consumers”*.

UK Recommendation

As mentioned elsewhere in this Submission, a fully informed Victorian government rejected the all-inclusive 48% cap. Similarly, another government, making the same enquiries in 2006, also refused to introduce a cap.

In the UK the Department of Trade and Industry engaged the company Policis to undertake research into the impact of interest rate caps in other countries. Despite a substantial review period, the UK Competition Commission did not focus on the introduction of caps in the UK. This substantial research concluded that:

> *“Under uneven repayment conditions, eight sub-prime models can be cheaper than mainstream models, confirming the rationality of consumer choice”.*

Reference: Section 3.25, UK Competition Commission Report, August, 2006, www.competition-commission.org.au.

Further, the Department’s research indicated:

> *“i) the risk that introducing a cap would cause lenders to move out of the market, making it harder for people to obtain credit; and*
>
> *ii) the increased risk that people unable to obtain credit from legitimate lenders would turn to illegal lenders in their place.”*

The UK Government has published research into the way that interest rate controls have worked in some other countries. This research found that they might restrict the availability of short-term, low-value credit to higher-risk consumers. The government has therefore decided not to include provision for an interest rate cap in the current shake-up of consumer credit law.

The Approach for Queensland

It is useful to note that the UK Competition Commission, in its major review of the comparable UK market, utilised many public forums. The same approach was adopted in Victoria, along with numerous other opportunities for contact with those involved with the review. With this in mind, the Federation was very pleased to learn of the Minister's member of staff, Mr Cameron Crowther's email to a distinguished member of the Federation, Mr Chris Watt on December 4th, 2006. On the Minister's behalf, Mr Crowther indicated that there would be:

> *"…plenty of opportunity for the industry to be heard and to provide a business case against change. The Discussion Paper provides one such opportunity, but there will be others as the policy review moves forward".*

The Federation looks forward to these other opportunities.

The 48% Interest Rate Cap, Inclusive of all Fees and Charges

The adoption of such a cap will completely close the payday and microlending industry, which operates under the Consumer Credit Code.

That means that the role of the Office of Fair Trading, in regard to payday and microlending, will be significantly diminished, if not completely obliterated. An indirect result of such a policy should, therefore, be the opportunity to downsize the Office.

Closure of the industry means a substantial number of borrowers will be left without Consumer Credit Code protected borrowing opportunity. These people are the very stakeholders that the Minister has publicly pledged to protect.

Before any consideration of the impact on the lenders, it might be useful to reflect on the circumstances of the current borrowers, who will be denied Office of Fair Trading protection.

A Legal Opinion

In Gadens lawyers' emailed "news", dated December 2006, Mr John Denovan contributed an article entitled "Managing the cost of consumer credit in Queensland". In that article, Mr Denovan provided a practical example which was as follows:

- *"Bill receives a bill to register his car. In order to pay this bill he obtained a loan of $100 from a fringe credit provider. The loan was repaid by a single payment of $120 at the end of the week. This equated to an interest rate of 1,040% per annum (20% per week).*
- *If the fringe credit provider which provided Bill's loan was subject to an interest rate cap of 48% per annum which included other fees and charges, the maximum amount that the fringe credit provider could have charged Bill for the loan would have been under $1. This equates to a return of less than 1%."*

Mr Denovan, a distinguished solicitor with a substantial reputation in consumer credit law, went on to make the following observations:

"If payday loans are prohibited, consumers may suffer an impeded ability to overcome financial difficulties, an increased likelihood of default on loan repayments, and further exclusion from the mainstream market.

Imposing a cap on interest and credit fees and charges might result in excluding some legitimate products from the market and propel consumers away from lenders who attempt to comply with the law and further into the fringe".

Impact on Department of Housing

If the Minister's decision is to impose an inclusive cap, thereby discouraging participation in the market and certainly discouraging any thought of new entries, to increase competition, the indirect impact of such a decision must not be overlooked.

One such impact is the increased pressure on the Queensland Department of Housing and its bond loans. We already have a situation where a potential borrower faces substantial processes and the criteria, in regard to income, is very tight. The latter fundamentally favours people who are dependent on welfare. Another problem is that you have to pay off a bond loan, before you can take another one. There is no facility to roll a bond loan over, even in an emergency situation.

The Federation understands that it takes approximately two weeks between applying for a bond loan with the Department of Housing and the real estate agent getting paid. This provides substantial difficulties for people who have a fortnight or less notice to move and when there is any tightness in the rental market. Because of these circumstances, a number of people come to payday and microlenders to borrow for their bonds. The Federation Customer Survey indicates that approximately 3.6% of Queensland payday and micro-borrowers borrow to finance a bond.

Without the opportunity for payday and microlenders to assist and still remain financially viable, these people will have no option but to seek a more flexible approach from the Department of Housing and the Department of Housing will have no moral option, except to expand its services as a lender.

Support for Federation Views

The Federation is aware that the Association of Building Societies and Credit Unions (Abacus) shares similar concerns with regard to the imposition of an all-inclusive cap. This organisation, representing 146 credit unions and 9 mutual building societies entertains the following views:

1. The use of an interest rate cap has the potential to impact on a wider range of consumer credit products, to the detriment of consumers and the market more generally;
2. Such a cap is not an effective regulatory response to the emergence of payday lenders;
3. On its own, this cap is no panacea in seeking to reduce excessive lending rates and predatory practices;
4. Interest rate ceilings in some jurisdictions, although not technically offending the uniformity agreement, pose compliance challenges for lenders that operate across state and territory borders.