consumer action law centre

28 October 2011

By email: corporations.joint@aph.gov.au

Mr Bernie Ripoll MP
Chair
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Mr Ripoll

Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011

We write to provide further comments in relation to the inquiry considering the above bill. We particularly to respond to lenders' claims that an increase in the cap on costs allowed for small amount credit contracts should be recommended by the committee. As outlined below, we believe any increase will undermine the intent of the bill.

As you know, the bill imposes a cap on the cost of small amount credit contacts of less than $2,000 and 2 years duration. The cap is an establishment fee of 10 per cent of the amount borrowed, and an ongoing interest rate of 2 per cent per month.

Typically, short term loans in Australia are about $200-$500 paid back over a period of two to four weeks. For a one month loan, the proposed cap would be the equivalent of an annual percentage rate of 144%. This is 3 times the return to lenders compared to the current legislative position in Queensland, NSW and the ACT, which all cap the costs imposed by all borrowings at 48 per cent per annum.

Lenders have argued that the establishment fee in the proposed cap should be increased. We want to emphasise that, if this argument is accepted, the bill will not achieve its policy goal of impacting small amount loans in Australia so that they are not unaffordable for borrowers and do not lead to debt traps.

If the establishment fee is increased to 20 per cent of the amount borrowed (keeping the monthly rate the same), this will be equivalent to an annual percentage rate of 264% for a one month loan. If it is increased to 25 per cent, this will be the equivalent to an annual percentage rate of 324% on a one month loan. If the establishment fee is increased to 30 per cent, this will be the equivalent to an annual percentage rate of 384%.

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Lenders argue that an annual percentage rate is not a reasonable representation of the cost of a short-term loan. However, given that the majority of borrowers are repeat borrowers—some of them borrowing many times over the period of a year—an annual percentage rate is an appropriate measure of the cost for these loans.

Leaving annual percentage rates aside, a 20 per cent, 25 per cent, or 30 per cent establishment fee would allow a lender to obtain a return of $66, $81, or $96 on a one month loan of $300. A fortnightly repayment on such a loan would be between 22.5% and 24% of a single pensioner's fortnightly income. A product that takes such a large proportion of a low-income earner's regular income is designed to require them to come back to obtain another loan.

That the design of much small amount lending is to produce repeat borrowing was made clear in the speech by Minister Shorten when introducing the bill into parliament:

> *Take the example of [someone being] caught short one week—they have to replace the tyres on their car or fix up the engine—and they take out a loan of $300, filling in a direct-debit form with the paperwork for the day their next payment will hit their account. Typical fees—not exaggerated fees—on that loan will be around $105 (35 per cent as a fee). So, if you borrow $300, you have to pay interest of $105 to establish the loan. So on their next payday $405 comes out of their account, leaving them short for that week as well. So this time they take out another loan—$350, and a higher rate again—and so the spiral of debt commences.*

The example provided by Minister Shorten is not uncommon. In most cases, the high cost, short-term loans are required because individuals have insufficient cash to meet their essential, daily needs (such as utilities, car expenses, food and rent). They are already in financial difficulty. The loan is repaid via direct debit from their bank account at the same time their wages or benefits are credited into the account. Having such a significant amount deducted from their next pay usually leads a borrower to needing another loan within a short period of time to supplement their reduced income.

Thus short term lending leads to repeat borrowing—the borrower is continually "caught short", obtains another loan, and so on. The product itself is designed to encourage repeat borrowing and dependency. It is exactly the same features which make this product so dangerous that makes it so profitable.

Consumer advocates have long called for a 48% inclusive interest rate cap to address this issue—however, this does not mean that we believe that cost is the only problem. Nevertheless, cost is a key factor causing harm to consumers and high establishment fees such as 20 per cent of the amount borrowed provide an incentive for lenders to provide short term loans which encourage repeat borrowing, rather than one longer term loan. The proposed cap on establishment fees of 10 per cent of the amount borrowed plus an ongoing interest rate of 2 per cent per month would encourage more affordable small amount loans, for example, so that they can be paid off over a longer term. We strongly believe, however, that this goal would not be realised should the cost cap be increased any further at all.

We note that, in addition to imposing a cost on the cost of credit, the bill seeks to ban repeat borrowing and multiple borrowing of short-term loans, to address the risk of a debt spiral. Currently, however, the bill only bans refinancing short-term loans with a new loan. As described above, borrowers generally do not refinance short-term loans but pay it back in full (via direct debit) before

obtaining another loan. To limit destructive repeat borrowing, the bill needs to be strengthened to include a prohibition on any subsequent loan during the borrower's pay period (14 days or one month).

We would be happy to discuss these matters with you further.

Yours sincerely

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