FINLAYSONS

Our ref MRB:390901/16:JJP/SXM

September 12, 2011

APPENDIX A

The General Manager
Retail Investor Division
The Treasury

Attention: Mr Christian Mikula

Dear Sirs & Mesdames

81 Flinders Street, Adelaide
South Australia 5000

Telephone +61 8 8235 7400
Facsimile +61 8 8232 2944

info@finlaysons.com.au
finlaysons.com.au

GPO Box 1244, Adelaide
South Australia 5001

DX152 Adelaide

Submission on the Exposure Draft – National Consumer Credit Protection Amendment (Enhancements) Bill 2011 (*ED*)
Super Nexus Pty Ltd (*Nexus*)
Cash Converters International Ltd (*CCI*)
Cash Converters Franchisees (*Franchisees*)

We act for Nexus, which operates a number of Franchisees in South Australia.

Nexus welcomes the opportunity to comment on the ED, which contains proposals for changes to the regulation of short term, small amount (payday) lending.

Nexus supports the regulation of the micro-finance industry as a specific market segment.

Nexus has real concerns, however, for customers, business owners and their employees if regulatory changes result in the loss of payday lending as a viable credit option.

The measures in the ED include:

- Australia's first national cap on costs;
- a prohibition on refinancing small amount contracts; and
- requirements for short term lenders to disclose the availability of alternatives to short term lending.

Nexus supports the policy objective of consumer inclusion and protection, and believes the dual objective can be met while maintaining a viable micro-finance industry.

However, Nexus strongly objects to the proposed prohibition that prevents lenders charging establishment fees that exceed 10% or monthly fees that exceed 2%, and to the blunt approach of prohibiting refinancing of small amount contracts as a treatment to prevent debt spiral.

In order to comment sensibly and effectively on the measures in the ED, this Submission sets out the following:

1. Background information regarding Nexus and the Franchisees.
2. Our understanding of the objectives of, and the philosophy underlying, the Government's payday lending reform proposals.
3. The general characteristics of the micro-finance market.
4. The reasons behind the high costs for lenders of providing micro-finance.
5. The characteristics of the "*Cash Advance*" lending product offered by Nexus and the manner in which it operates in the micro-finance market.
6. A workable alternative that meets the policy objective.
7. General comments on the ED.
8. Specific comments on the ED.

KEY POINTS

In considering reforms for micro-finance and payday lending, it is important to remove emotion and conjecture, and focus on verifiable facts. Those facts are simple and incontrovertible:

- the blunt introduction of a fixed 10% cap on establishment fees and 2% cap on monthly fees will make it impossible for legitimate lenders to make commercially viable payday loans;
- the introduction of those caps would be tantamount to outlawing payday lending by making it economically unviable;
- legitimate lenders will cease offering payday loans;
- loans will instead likely be offered only by unscrupulous, unethical operators;
- consumers will need to rely on charitable and government schemes that are under-funded, overstretched and only available to a minority of customers due to strict eligibility criteria; and
- consumers will thus be denied access to an important source of funds.

Nexus submits it is possible to introduce price controls to protect consumers at a level which supports a viable credit industry and that the Government should therefore withdraw the proposed national cap on costs.

With respect, the cap is an ill-considered proposal that will likely cause more harm than good to those the Government clearly wishes to protect.

Nexus acknowledges refinancing payday loans is misused by some lenders and can contribute to consumer debt spiral. However, the issue is debt spiral and not refinancing *per se*.

The Cash Advance product represents the largest payday offering in the market; it accommodates refinancing and ***does not*** contribute to debt spiral.

Nexus submits the Government should consider measures which avoid consumer debt spiral, without imposing an outright prohibition on refinancing.

Financial exclusion may well result from the prohibition on refinancing outlined in the ED; and Nexus believes effective regulation can maintain access to credit when most needed, while avoiding debt spiral.

Nexus has no objection to the proposed requirement that short term lenders must disclose the availability of alternatives to short term lending.

I. Nexus & the Franchisees

Nexus

9. The 5 principals of Nexus have operated Cash Converter franchised outlets since 1989.

10. Over this period the principals have established and operate 8 franchised stores in the greater Adelaide metropolitan area.

Franchisees

11. The Franchisees operate as Cash Converters stores offering pawn broking, unsecured micro-loans and trading in second-hand goods.

12. There are currently over 130 Cash Converter stores in Australia, the majority of which are franchised.

Cash Advances

13. A Cash Advance is an unsecured, low value, short-term loan to deal with unexpected costs.

14. The Cash Advances offered by the Franchisees have the following features:

    14.1 The Franchisee makes the Cash Advance to the customer pursuant to a signed Cash Advance Agreement.

    14.2 Cash Advances generally vary in value from $50 to $1,000.

    14.3 80% of Cash Advances offered by Nexus are for values of between $120 and $600, averaging approximately $320.

    14.4 Under the Cash Advance Agreement, the customer agrees to repay the loan by instalments over approximately 30 days.

    14.5 Customers generally make repayments via direct debits to their bank accounts that are aligned with the customer's pay cycle.

    > For example, a customer paid weekly will generally repay via 4 weekly direct debits, whereas a customer paid fortnightly will generally repay via 2 fortnightly direct debits.

    14.6 Customers may, however, repay cash over the counter at any point (i.e. partially or fully repay the Cash Advance), without any additional cost.

II. Objective and Philosophy of the National Credit Reforms

15. The June 2011 Regulation of Short Term, Small Amount Finance Regulatory Impact Statement (***RIS***) indicates the objective of the reforms is to "*assist consumers to have a greater degree of social and financial inclusion*".[1]

16. The RIS indicates the Government is concerned, in particular, by the risk of consumers falling into a "debt spiral", by repeatedly borrowing using short-term lending facilities, merely to meet the escalating cost of their debt.[2]

17. Nexus agrees it is desirable to clean up the regulation of the Australian micro-finance market, but submits the impact of imposing significant restrictions on lenders, who already operate on small dollar margins, needs to be carefully considered.

---

1 RIS, p 40.

2 RIS, p 32.

III. General Characteristic of Micro-finance Market

18. Payday loans are designed for consumers with low or unpredictable income, or with impaired credit history, who often have insufficient savings to meet unexpected bills or optional living expenses.

19. Low-income earners and those with impaired credit histories are not well-served by mainstream credit providers, since banks do not generally lend less than $2,000. Further, traditional bank products are a poor fit with the characteristics and behaviours of a typical payday loan customer. The Cash Advance product matches the needs of a market segment unsuited to traditional bank products.

20. Franchisees and other micro-credit providers therefore play an important role in smoothing income and expense fluctuations for their customers, and providing funds to a segment of the consumer finance market that traditional lenders largely ignore.

21. Mainstream credit providers (such as banks) have moved away from servicing the needs of low income customers, and typically do not lend small amounts repayable over a fixed short term because the processing, administration and reputation costs involved are too high.[3]

22. For example, the National Australia Bank launched a program in Australia to provide small loans of between $1,000 to $5,000 over short periods, on a break-even basis. However, with an internal loan administration cost of $321, the NAB has indicated the program is not a commercial venture but an extension of NAB's not-for-profit micro-finance programs.[4]

23. Accordingly, there are extremely limited sources of finance available to low-income citizens.

---

3 Australian Ministerial Council on Consumer Affairs, *Fringe Credit Providers, Decision-Making Regulatory Impact Statement and Final Public Benefit Test (2006)*, p 12.

4 National Australia Bank, *Fringe lending pilot brings transparency in tough times* (Press Release, 2 March 2009).

24. Independent research has identified that consumers value the sense of independence, privacy and self-esteem associated with access to payday loans, in circumstances in which they would otherwise have been denied access to credit.[5]

25. The Cash Advance product was designed to meet the needs of consumers in the micro-finance market.

26. The product is clear in its term and repayment amount. There is no interest or other time-based fees.

27. Nexus believes it is possible to provide a "fair" product to the market provided the regulatory provisions recognize it is a fundamentally different market segment to that serviced by traditional lenders.

---

5 D Wilson, *Payday Lending in Victoria – A Research Report* (July 2002), pp 9 and 79-81. That research indicates borrowers consider payday loans have the following benefits compared with other sources of credit:

- the payment schedule is easy to understand and manage;
- funds are easily and quickly obtainable;
- impaired credit history does not disqualify a customer;
- a small (manageable) sum is advanced compared to the minimum (unmanageable) amounts banks will lend;
- the term of a payday loan is short and well defined compared to bank loans and credit cards;
- payday loans are commercial, rather than charitable, transactions;
- independence and privacy can be maintained without straining personal relationships; and
- borrowers do not need to have property to qualify for a payday loan, i.e. the loans are always unsecured.

IV. Providing Micro-finance is Expensive

28. Appropriately regulated and understood, payday lending provides an important service for consumers.

29. In order to explain the true costs of providing payday loans, and explain why fees appear to be comparatively high, it is necessary to look at the facts and to disregard emotion and conjecture.[6]

30. The fixed labour and operating costs associated with providing a small loan are the same as those for providing a larger loan.

31. With a larger loan and thus a larger loan principal, the lender can recover its costs and make a commercially reasonable profit by charging an interest rate over a longer period of time.

32. However, short-term payday loans must charge a fee or higher rates of interest over short payback periods in order to recover the costs of the loan and provide a reasonable return.

33. There is also inherent risk associated with providing unsecured short-term loans. Payday loans are generally made on an unsecured basis and often to customers who have damaged credit histories.

V. Characteristics of "Cash Advance" Payday Lending Product

34. The Cash Advance product offered by Nexus to customers in South Australia carries a fee of 35% of the amount advanced.

35. <u>This is the ***only*** fee payable if a customer complies with the Cash Advance agreement.</u>

36. There is <u>***no***</u> interest or time-based fee.

37. There is <u>***no***</u> fee associated with rescheduling repayments.

38. Bank-styled loans impose significant additional financial costs where payments are made later than contracted.

39. Nexus customers are mostly well-intentioned (more than 90% will pay) but poorly-organised (they often pay late).

---

[6] Cash Doctors, *Uncovering Payday Lending Myths* <http://www.cashdoctors.com.au/about-us/uncovering-payday-lending-myths> at 10 November 2009. This specifically refers to Donald P Morgan, *Defining and Detecting Predatory Lending* (2007) 273 Federal Reserve Bank of New York Staff Reports.

40. Accordingly, approximately 40% of payments by customers are not made as originally scheduled, and more than 50% of customers fail to pay as contracted. After credit assistance, bad debt is usually 5-6%.

41. Because more than 50% of customers fail to pay as contracted, the total cost of an interest-based loan product is practically unascertainable by the customer at the time they enter into the transaction. <u>Nexus believes this is an important issue inadequately understood by regulators and consumer advocates.</u>

42. By charging a fixed fee, the Cash Advance product delivers <u>simplicity</u>, <u>clarity</u> and <u>certainty</u> to the customer and matches the needs of a market segment unsuited to traditional lending products.

43. The RIS has suggested certain payday lenders profit by deliberately lending more than borrowers can afford to repay.[7]

44. However, there are strong disincentives for Nexus and Franchisees to lend more than a customer can reasonably repay given:

    44.1 the Cash Advance product has no interest or time-based fees (so Nexus bears the cost and risk associated with late payment);

    44.2 the loan is unsecured (and Nexus does not instigate formal recovery action against its customers); and

    44.3 there is no reschedule fee for customers who need to defer repayments.

45. Product lending limits and a "one-loan-at-a-time" policy avoid customer debt spiral. This meets the policy objectives of the RIS without prohibiting roll-overs or imposing a cost of credit limit, which are uncommercial for lenders.

VI. Framework for Workable Alternative

46. Recent submissions have focussed on failings of the ED but have not offered a workable alternative that meets the dual policy objectives of inclusion and protection of consumers.

47. Both Treasury and the NFSF submission of 5 September 2011 have touched on the South African regulatory regime.

---

7 RIS, p 37.

48. A business associated with Nexus operates in South Africa and has practical experience dealing with the *National Credit Act* 2005 (Sth Africa) (***NCA***).

49. Regulators in South Africa recognize the importance of microfinance in providing a large number of consumers with access to credit, and have sought to deliver a viable and vibrant micro-finance industry in that country whilst protecting consumers.

50. The NCA subjects lenders to responsible lending obligations, and imposes caps on fees and interest.

51. Caps have been set at realistic rates which equate to a total cost of credit of approximately 30-40% for payday loans, while also providing for larger value, longer term loans.

52. As a result of the introduction of the NCA, unscrupulous lenders have exited the market and been replaced with viable, compliant lenders who can maintain credit availability to consumers and make a reasonable commercial return.

53. Nexus submits that South African regulators have achieved equivalent policy objectives (i.e. consumer inclusion and protection), and their regulatory solution is worthy of closer consideration by Treasury.

54. Associates of Nexus have worked closely with the National Credit Regulator in South Africa and are willing share further information if that would be of assistance.

VII. General Comments on ED

55. The *National Consumer Credit Protection Act* has achieved the consumer protection objectives via:

    55.1 internal and external dispute resolution arrangements;

    55.2 responsible lending obligations; and

    55.3 strict disclosure obligations.

56. Nexus submits the proposed ED fails to deliver on the dual policy objectives by restricting access to credit. With respect, Nexus believes the ED has missed the mark.

Cost caps

57. Nexus is strongly opposed to the introduction of cost caps in the form proposed.

58. As noted above, whilst the rates charged by a micro-finance lender may at first sight appear high, lenders in this market segment incur significant fixed costs and higher default rates.

59. The introduction of the proposed cost caps would therefore be tantamount to outlawing payday lending by making it economically unviable.

60. We understand Treasury and the Minister have already received information regarding the cost of providing payday loans. Rather than duplicate that information, Nexus wishes to share its actual experience.

61. FY2011 was Nexus's most successful year to date and its profit was 10% of revenue.

62. Nexus is willing to provide Treasury with actual information regarding the financial performance of its business and the contribution of the Cash Advance product.

63. This information will demonstrate the profitability of the Cash Advance product is extremely sensitive to price changes, and that it would take only a small reduction from the present 35% fee to destroy Cash Advance's viability for Nexus.

64. Nexus's present ***gross*** revenue on an average Cash Advance is approximately $106, and its costs are about $94, leaving a profit of about $12.

65. It is worth noting NAB's report on the small loans pilot program, referred to above, disclosed the cost to NAB of making each loan is $321.[8]

66. Compared with the NAB trial, Nexus is a very efficient provider of small value, short term loans, but Nexus needs to preserve its revenue for the product to remain viable.

67. The NAB report also notes: "*it is not possible to make a profit and legally operate within the 48% per annum [APR] cap for loans of $1,700 or smaller, for a portfolio of 3,000 loans or less, for loan terms of one year or less.*"[9]

---

8 National Australia Bank, *Do you really want to hurt me? Exploring the costs of fringe lending – a report on the NAB Small Loans Pilot* (2010), p 12.

9 National Australia Bank, *Do you really want to hurt me? Exploring the costs of fringe lending – a report on the NAB Small Loans Pilot* (2010), p 13.

68. Indeed, the 10% establishment fee and 2% monthly fee equates to an even lower APR of 34%.

69. Applying those caps to the average Cash Advance of $320 would result in a loss to Nexus of $55.60 per loan:

Amount Borrowed	$320.00
Loan Period	1 month
Establishment Fee	$32.00 (10%)
Monthly Fee (1 month)	$6.40 (2%)
Gross Revenue	$38.40
Cost of Loan	$94.00
Loss per Loan	**$55.60**

70. <u>In these circumstances, it would not be rational for Nexus to continue making Cash Advances.</u>

Refinancing

71. Nexus supports measures which address consumer debt spiral. However, Nexus is opposed to a blanket prohibition on refinancing.

72. Refinancing can maintain consumer access to short term, small value credit which, in some circumstances, may be the only form of credit available to meet the consumer's immediate needs.

> For example, a customer who has $50 remaining on a $200 Cash Advance may wish to refinance to access the additional $150 of available credit to meet immediate needs.
>
> A prohibition on refinancing would leave this customer with only $50 of borrowings, and no access to credit.

73. A prohibition on refinancing, as illustrated by the above example, would deny the consumer access to credit and clearly fail to meet the policy objective of consumer inclusion.

74. The consumer protection policy objective in question seeks to prevent unintended increases to debt levels (debt spiral).

75. Refinancing does not need to result in debt spiral and the Cash Advance product offered by Nexus and Franchisees accommodates refinancing, whilst providing protection against debt spiral.

VIII. Specific Comments

Caps on Credit Contracts

In the limited time available, we have been unable to prepare comprehensive submissions on all aspects of the ED.

However, we set out below a number of comments on the questions posed in the Treasury's Commentary – Caps on Consumer Contracts, which we hope will be helpful.

1.	**Stakeholders are asked to address the issue of what transitional period is necessary before the provisions come into effect.**

76. The adoption of the measures proposed by the ED would:

    76.1 deny many borrowers access to micro-credit;

    76.2 adversely displace a significant number of employees in their current employment;

    76.3 force ethical and legitimate payday lenders out of the market;

    76.4 stimulate activities which do not comply with the NCCPA; and

    76.5 increase the burden on Government and charities.

77. We submit that further consultation and time is therefore needed to assess the appropriateness of the measures, in light of the likely adverse consequences on industry participants and consumers.

2.	**Stakeholders are asked to consider whether any of the other disclosure requirements in Section 17 of the Code are no longer relevant for small amount credit contracts.**

78. We have not had time to address this question.

3. Stakeholders are asked to address the rate at which the permitted fees can be charged under draft Section 31A.

79. ***Nexus strongly believes the imposition of the proposed cap on establishment fees and monthly fees is unreasonable and inappropriate in relation to payday lending***.

80. As discussed above, the rates and fees charged on payday loans must take into account the costs of providing unsecured, higher-risk loans in a time frame appropriate to meet customer needs and provide a reasonable return for the lender.

81. The purpose of introducing the caps was to limit the fees on payday loans to a monthly fee plus an establishment fee that: "*reflect(s) the credit provider's reasonable costs of determining the application for credit and the initial administrative cost of providing credit under the contract*."

82. This purpose provides for only a subset of the costs involved in providing and administering an unsecured short term, low value loan; and makes inadequate provision for the costs of managing a loan, inadequate provision for bad debts incurred, and inadequate provision for a reasonable commercial return to the lender.

83. The establishment fee and monthly caps proposed by the ED are arbitrary and appear to have been set without reference to the cost to lenders of providing short-term finance.

84. This is supported by page 7 of the RIS, which notes: "*approximately $20 to $30 per $100 is required to generate a reasonable return on providing loans up to a certain limit (under $300)*"; and "*the shorter the loan term the higher the repayments will need to be to generate a return*".

85. The proposed 10% establishment fee cap and 2% monthly fee cap allow lenders to charge a maximum fee of $12 per $100 lent on a one-month loan.

86. <u>The resultant $38 fee (12% of an average $320 Cash Advance) is clearly insufficient to cover the $94 cost to Nexus of providing the loan.</u>

87. The imposition of the caps will be tantamount to outlawing payday lending and will force most, if not all, payday lenders from the market.

88. Far from achieving the Government's objective "*to assist consumers to have a greater degree of social and financial inclusion*", the measures will result in financial exclusion for the majority of these consumers.

89. While some consumers may turn to government bodies or charities for assistance, the limited funds of those entities, their strict eligibility criteria for assistance, and the slow turn-around time, means the needs of those consumers will go unsatisfied.

4. Stakeholders are asked to address the effect of Subsection 32A(2), so that the annual cost rate applies throughout the life of the contract, and is not restricted to when the credit provider enters into the credit contract.

90. We have not had sufficient time to address this question.

5. Stakeholders are asked to address the level of the cap on the total amount of default charges.

91. Nexus supports the proposed 200% cap and, subject to a realistic approach to total cost of credit, supports a ceiling lower than 200%.

92. In the absence of a realistic approach to total cost of credit, a 200% cap on default charges may become a tool to claw back losses on short term, low value loans. Nexus believes this will create a confusing product which does not meet customer needs.

6. Stakeholders are asked to consider whether there should be a penalty on persons who provide credit assistance by arranging or suggesting a credit contract that is in breach of either of the caps, and, if so, whether consumers should have access to a specific remedy against them (for example, loss of any brokerage fees where charged to the consumer).

93. Nexus is not in a position to answer this question, as it believes lenders will cease offering Cash Advances (or similar short term, low value loans) if the caps are implemented.

7.	**Stakeholders are asked to address the definition small amount credit contract, including whether continuing credit contracts should only be subject to the 48% cap.**

94. See the comments above in relation to Question 6.

8.	**Stakeholders are asked to consider whether there should be an exemption for bridging finance and, if so, the adequacy of the working definition and whether or not there should still be some regulation of costs (for example, a cap on interest charges only but not fees and charges).**

95. As noted by the National Financial Services Federation in its Submission of 5 September 2011 (on the National Credit Reforms Issues Paper on Short-term Lending), consumers seek loans of varying amounts with a wide range of repayment terms.

96. The rates charged by providers of short-term finance will depend, among other things, on the type, size, security and term of the loan offered.

97. There appears to be no basis for excluding bridging finance from the operation of the 48% cap, where providers of other short term finance (such as Cash Advances) are subject to an effective 34% cap.

9.	**Stakeholders are asked to consider whether there should be an exemption for credit provided by Authorised Deposit-taking Institutions, and, if so, whether the exemption should apply in all cases or only to particular classes of contracts.**

98. There is no reasonable justification for providing an exemption for ADIs.

10.	**Stakeholders are asked to consider whether there should be a similar exemption for temporary credit facilities, and, if so, the circumstances in which it should apply.**

99. See the comments above in relation to questions 8 and 9.

Small Amount Credit Contracts

We set out below our responses to the questions posed in the Treasury's Commentary – Small Amount Credit Contracts, adopting the numbering used therein.

1.	**What would be an appropriate period of time to allow before the provisions come into effect?**

100. A sensible solution could be deployed in 12 months.

2.	**Are there any particular transitional issues raised by the reforms that need to be specifically addressed?**

101. See comments at question 1 above.

* * * * *

If the Treasury believes it would be useful to meet with our client to discuss in greater detail any of the issues raised above, or if we can be of any further assistance, please do not hesitate to let us know.

Yours faithfully

M St J R Butler
Partner