THE CLASH BETWEEN IDEALISM AND REALITY

A SUBMISSION

to the

SENATE ECONOMICS LEGISLATION COMMITTEE INQUIRY

into the

Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011:

formerly the Exposure Draft entitled the National Consumer Credit Protection Amendment (Enhancements) Bill 2011

from the

FINANCIERS' ASSOCIATION OF AUSTRALIA / INDUSTRY / SMILES TURNER DELEGATION

Consultants:

Phillip Smiles LL.B., B.Ec., M.B.A., Dip.Ed.
Lyn Turner M.A., Dip.Drama
Smiles Turner
Ph: (02) 9975 4244
Fax: (02) 9975 6877
Email: info@smilesturner.com.au

© *Smiles Turner, November 2011*

"You certainly, in a modern economy can't regulate interest rates. That's economics discarded for the last 30 years."

- Prime Minister Julia Gillard, 4 November 2010, Today Show, TCN Channel 9

© *Smiles Turner, November 2011*

INDEX

Content	Page
Executive Summary	4
About this Submission	11
Section 1 - Market Characteristics and Supply Realities	14
If the Bill Proceeds to Enactment Unchanged	14
Section 2 - The Delegation's Simple Alternative	24
Section 3 - A Detailed Analysis of the Current Bill	30
Section 32A	49
Section 4 - Explanatory Memorandum and RIS Deficient	57
Concerns in Regard to the Explanatory Memorandum	57
An Analysis of the Regulation Impact Statement	65
A Major Government Study Ignored by Treasury	76
An Analysis of the Minister's Second Reading Speech	77
Section 5 - Non-Commercial Alternatives Grossly Inadequate	81
Decisions Demanding Alternatives, Without Timely Research	81
Not-for-profit, Non-commercial Credit Opportunities	82
Other Possible Alternatives	89
Section 6 - Business Realities	97
Business Cost of Loans for the Lender	99
Bad Debt Realities	110
Section 7 - Consumer Advocates Misguided	123
Consumer Advocates and APRs	123
Use of Direct Debits	123
Security for Loans	128
Repeat Loans (Rollovers) - the Reality	134
Section 8 - Consumer Protection Continues	141
A Consumer Profile	141
Centrelink Benefit Recipients and Borrowing	150
Consumer Complaints	151
Section 9 - Small Amount, Short Term Lending - A Social Need	161
The Social Need for Short Term Loan Availability	161
Section 10 - Facing the Realities	165
Idealism Compromised in the Face of Reality	165
The CALC Supplementary Submission	184
Other Consumer Advocates' Submissions and Evidence	187
Total Number of Consumer Advocate Clients	191

© *Smiles Turner, November 2011*

The Research on Which the Consumer Advocates Rely	191
Site Inspections Overlooked	192
COAG Review	193
Criminal Elements	193
International Studies	194
Alternatives and the 'Not-for-profit' Sector Senate Inquiry	195
Review and Control Process	195
ASIC Now in Play	197
An Import Invitation	198
Conclusion	198
Appendices	200
Appendix 1 - Smiles Turner Research	
Appendix 2 - Income Generation under the 10%, 2% and 48% 2-tier regime	
Appendix 3 - 90 Day Potential Consumer Assessment Form	
Appendix 4 - Break Even Lenders' Figures	
Appendix 5 - Economic Modelling Methodology	
Appendix 6 - About Our Consumer	

Please Note: Appendices 3 and 5 have been provided to the Committee as confidential documents.

© Smiles Turner, November 2011

EXECUTIVE SUMMARY

Putting the Inquiry in Context

This Submission is fundamentally a consumer and industry analysis. When considering the current Bill the statistics must be recognised, whether to support consumers, consumer advocates (not the same thing as consumers), or the lenders. Advocacy of the lenders' position takes a minor role in comparison to presenting the facts, which clearly indicate that the current Bill's objectives will not and cannot be satisfied without a major multi-billion dollar government investment in the alternative, non-commercial, not-for-profit credit providers.

No choice for consumers

Smiles Turner research, supported by the recent RMIT University research and the Consumer Action Law Centre Victoria (CALC) 2008 research, indicates that around 80% of borrowing is for purposes that, in our society, would be regarded as non-discretionary. This figure makes the opportunity to borrow small amount, short term loans a critical issue for most consumers. This in circumstances where less than 30% of borrowers have any alternative source of funds, as illustrated in repeated Smiles Turner and other research.

No economic modelling

Treasury has admitted that there as been no economic modelling carried out in regard to the 10%, 2% and 48% 2-tier regime included in the current Bill.

Treasury has no evidence

There is no evidence or financial analysis available to Treasury, from any credible source, to support the premise that small amount, short term lenders can break even lending at 48% inclusive of all fees and charges, under at least $3,000.

Regulation Impact Study (RIS) and Explanatory Memorandum substantially flawed

Both documents rely on flawed research, do not include any reference to contemporary research, include conclusions that appear to have no evidentiary support, ignore lenders' unavoidable business costs and reveal there has been no consideration of the capacity of the nominated alternatives to handle the borrowers redirected from the commercial sector.

RIS minus critical industry facts

This RIS recommendation was conceived in September/October 2010, prior to Treasury receiving major research results, calculation charts and economic modelling from the Financiers' Association of Australia (FAA)/Industry/Smiles Turner Delegation (the Delegation) via a series of Discussion Papers, industry and consumer consultation meetings and Delegation/Treasury meetings this year.

Treasury RIS recommendation ignored

Despite other issues associated with the RIS, Treasury did nominate a relatively realistic $30 fee for every $100 lent. This is a far cry from the current Bill's $12 per $100 (for the first month - 10%, 2%) included in the current Bill without any explanation for the change of direction, either in the Explanatory Memorandum, or from the Minister.

The socio-economic disaster

This socio-economic disaster will occur because:

- all commercial lenders lending under $3,000 and most lending from $3,000 to $5,000 will exit the industry sector;
- those lenders will no longer be available to lend their current total loan book of $1.2 billion annually;

© *Smiles Turner, November 2011*

- at least 70% of the 750,000 individuals currently borrowing at least one loan annually (total over 1.5 million) will have to turn to the non-commercial, Government and bank subsidised lenders;
- based on Smiles Turner research, a significant proportion of the 30% of intending borrowers (225,000) will attempt to access their untried alternate source of credit. A large proportion of these people will be rejected and will have their optimism completely dashed, when they are forced to join tens of thousands of other rejected borrowers travelling to join the queues at the non-commercial credit provider's premises; and
- the non-commercial, not-for-profit lenders will face the challenges of:
  - a 100 fold increase in loan applications, as they currently do not satisfy even 1% of the total existing market;
  - reducing their application time from the present 4-6 weeks in most cases, to between 2 hours (payday loans) and 24 hours (microloans);
  - 86% of these applications not satisfying the non-commercial, not-for-profit lending criteria and having to turn these people away;
  - having less than half the number of lending offices (according to bank media releases and one quarter according to ACOSS) currently operated by the commercial lenders, with many of the not-for-profit offices currently only operating part time, with volunteer staff;
  - recruiting and training 2,500 full-time equivalent people, to replace the commercial lenders' current highly trained and experienced staff;
  - handling the growing avalanche of enquiries commencing 1 July 2012 and substantially increasing until 1st January 2013, when virtually none of the commercial lenders will be lending in the sector;
  - lifting their total loans from the less than $20 million advanced annually in recent years, for less than 25,000 loans, to over $1 billion for at least 525,000 people applying for loans approximately twice each year; and
  - the establishment of major internet lending facilities to replace the 58 internet lenders (known to the Delegation), with close to 300 sites feeding leads into them.

The economics of industry destruction under the current Bill

The issues contributing to industry destruction, such as:

- the fixed costs faced by the lenders that cannot be reduced, because of relative market power, the Veda Advantage/Dunn & Bradstreet duopoly, ASIC's expensive compliance requirements, bank fees, and State and Commonwealth awards; plus
- the currently included 48% cap extending the number of successful loans needed to make up for one bad loan from 8.3, to as many as 71, depending on the length and size of the loan - a practical and mathematical impossibility in the sector's lending environment. This guarantees business failure; and
- the total inability of payday lenders to break even, from 1 January 2013, under the 10%, 2% regime included in the current Bill; and
- the total inability to break even of microlenders who lend amounts all under $3,000, secured or unsecured, under the 48% inclusive interest rate cap regime included in the current Bill; and
- the challenges facing lenders who lend above and below $3,000, not being able to lend enough to replace the under $3,000 loans, abolished under the current Bill, that previously contributed to paying fixed costs.

All the above means certain abolition of the industry sector.

1930-40's price controls

The current Bill plus the proposed Section 32A(2), discussed in this Submission, constitute the most specific and precise attempt at price control in Australia since the Second World War. The unintended consequences of massive credit exclusion have been ignored.

© *Smiles Turner, November 2011*

The last time such price control was attempted by an Australian government was in the late 1940's, with the attempt to nationalise the banks. As the Committee will recall, the result of this attempt was the formation of the Australian Bankers' Association, the destruction of a formerly highly regarded ALP Government, and the opportunity for a Liberal Prime Minister to enjoy a record 16 years as Australia's Prime Minister.

10%, 2% surprise package

The 10%, 2% and 48%, 2-tier model was never canvassed with stakeholders prior to the presentation of the Exposure Draft to Parliament, despite the modelling, statistical charts and multiple industry polling results provided to Treasury by the Delegation and others.

Notwithstanding the 10%, 2% and 48% model never being presented, information based on other models clearly demonstrates that a 10%, 2% and 48%, 2-tier model would not allow any lender with loans under $3,000, and most lenders who have loan books including loans between $3,000 and $5,000, to break even.

Creating more debt

The few lenders left after 1 January 2013 will be forced to encourage their consumers to borrow larger amounts, over longer terms. None of the commercial lenders will be lending the current 91.4% (by amount and term) small amount, short term loans in Australia. This means borrowers will be strongly encouraged to borrow towards $5,000, for at least 3 years, even if all they need is a loan of $250 for 2 weeks.

48% inclusive cap - a fantasy

The 48% championed by the consumer advocates and included in the current Bill is not what was originally introduced in the UK in 1927 and has never had any empirical research support. In 1927 it was 48% flat, to reflect the anti-Semitic usury concerns of its backbench proposer, in 2011 it is 48% reducible. Since being abolished in 1974 and following major investigations, the UK has rejected its reintroduction three times. Using the rejected historic British calculation - the 48% flat rate would be an approximately 72% reducible cap.

Forced lender exit commences next July 1

Regardless of the impact of the 2-tier cap model in the current Bill, if the other alleged consumer protection provisions concerning the prohibition of rollovers and repeat borrowing commence on the 1st July 2012, as proposed, at least 28% of small amount, short term payday lenders will be forced to exit the industry sector on that date. These provisions impact most on the payday lender segment of the small amount, short term market, which is the type of lender providing 90% of the current loans.

ASIC still to report

The ASIC review of small amount, short term lenders commenced in late November 2010 and, with the subsequent collection of thousands of contracts, has yet to conclude and report.

No research on not-for-profit sector capabilities

Despite promises of a forthcoming discussion paper on the alternatives to the commercial lender, there has never been an examination by Treasury, or by consumer advocates, of the inadequacy of the current non-commercial sector lenders to accommodate the demand that would be created by the current Bill. This sector is already reporting an inability to cope with existing demand, resulting in substantial numbers of people seeking help being turned away.

No consumer demand

There is no demand for this Bill from consumers. This is evidenced by an 18% compound annual growth experienced by the industry sector, over the last 3 years, and only 114 EDR complaints received (30 resolved against lenders) out of over 1 million loans, since 1 July 2010 - most not related to provisions in the current Bill.

University report - consumers want lenders

The RMIT University released a report this year that indicated significant support from consumers - who want their lenders to remain in business.

© *Smiles Turner, November 2011*

Consumer advocates say they do not want abolition

There is no demand for punitive industry legislation from the majority of consumer advocate and welfare groups. Greater protection of the *"desperate and vulnerable"* is requested, but not even the consumer advocates' campaign leader, CALC has formally stated that it wants the industry sector abolished - which is what the current Bill will effectively achieve.

86% will be rejected

At least 86% of small amount, short term loan consumers, responding to Smiles Turner research, do not satisfy the criteria of any of the non-commercial (not-for-profit) sources of funds (NILS, LILS, NAB Fast Money, etc) nominated by the Minister and the consumer advocates as the alternative to commercial borrowing.

Draconian provisions not justified by a tiny minority

Consumer advocates are concerned about consumers having multiple loans and the possibility of consequent debt traps. They have stated that the use of payday and microloans for a one-off emergency, as currently available, is acceptable. The tiny proportion of total consumer numbers that the consumer advocates and their financial counsellor and credit law colleagues see, <u>do</u> require targeted assistance - but not through a draconian Bill that applies to <u>all</u> borrowers.

These people constitute 1.15% of total borrowers of small amount, short term loans. However, no statistics appear to have been kept that clarify how many of these people actually had a financial problem caused, in whole or part, by a small amount, short term payday or microloan. The 2010 CALC report actually identifies that credit cards were the dominant financial problem. It must be noted that the average number of small amount, short term loans borrowed, per consumer, is under 2 per year.

Flawed and dated consumer advocate research interpretation

The consumer advocates who have championed the current Bill have not undertaken any research since the Commonwealth takeover, 1 July 2010, and rely on two limited research programs undertaken for CALC. The first of these programs was undertaken for the Centre in 2002 and the second was undertaken in 2008 and 2009, although not published until 2010. Both research programs were substantially inadequate and breached fundamental research protocols. Ironically, the research data referred to in these studies largely supports the Delegation's findings and concerns, but the 2010 report's conclusions do not.

Government funding dilemma

Current and promised funding will make no contribution to the existing 750,000 borrowers' ongoing demand and will not even accommodate those borrowers who constitute the 18% compound growth in consumer demand for small amount, short term loans.

160 times more Government funding needed

If the current Bill becomes law, the non-commercial alternatives will have to substantially broaden their criteria and, in the <u>first year alone</u>, Treasurer Wayne Swan will have to find at least 160 times the amount of money the Government recently promised the not-for-profit sector (in total, spread over the next 4 years). This just to fund the non-commercial sector's loan book for <u>one year</u>. That is assuming the loans lent after 1 July 2013, by principal and term, are what the consumer's will continue to demand - but from the non-commercial sector instead.

Another billion dollars required

If the current Bill becomes law and the Minister, Treasury and the consumer advocates' wishes are fulfilled for longer loans, with smaller individual repayment amounts over the new extended term of the loans, the extra loan book investment required for the longer loans will be towards <u>another</u> $1 billion.

© *Smiles Turner, November 2011*

No site inspections

The current Bill has been prepared without a single Treasury and/or Ministerial and/or consumer advocate representative visiting any of the lenders, to observe what goes on and/or talk to the ordinary borrowers as they apply for their loans.

Consumers never invited to give their side of the story

Despite Treasury coordinating industry and consumer advocate consultation meetings every several weeks and the Minister known to have had at least three meetings with lenders and a number of meetings with consumer advocates, the Delegation is unaware of any invitation being issued to a single consumer - so that the decision makers could hear from the very people they are so concerned to protect.

Amongst the consumers who have participated in Smiles Turner consumer surveys are people who would like to be heard, such as the bank manager, plumber, primary school principal and nurse, who do not want their choice determined by legislation designed for a minority of borrowers.

NSW cap a lie

Adopting the NSW model in the current Bill denies the reality - there are no small amount, short term lenders operating under the 48% inclusive cap in NSW. As a means of regulating the cost of loans for consumers in NSW it has been a total failure. Further, it is an "open secret" that the Queensland regime has been accommodated by the use of a brokerage arrangement by many lenders. Evidence was provided at the Joint Committee hearing on Monday 24th October, that 6 "accommodation" techniques - all supported by substantial legal opinion - have been employed in NSW and the ACT. In its RIS, Treasury notes 9 techniques as being employed in NSW and Queensland.

Amazing nonsense

The 2 companies that originally publicly stated they could operate lending a range of payday and microloans under the NSW cap, no longer do so. The first, Amazing Loans, went into liquidation and the second, GE Money, now lends an advertised minimum of $3,000 and with a preference for loans in excess of $5,000. 11 members of the FAA are known to have had better business judgement and permanently ceased lending in NSW, while several are known to have continued modest trading, at a loss, in hope that the Commonwealth regime would be more realistic.

Just in time for the Federal Election

If the current Bill is approved by the Committee and passed, unamended, by the Parliament, there will be a major socio-economic disaster that will commence 1 July 2012, will dramatically expand during the fourth quarter of the year as lenders exit to avoid being locked into continuing overheads post-1 January 2013, and will be fully established as an ongoing catastrophe during the first 3 months of 2013.

Incomplete Bill referred to Committee

The extraordinary circumstances of Treasury commencing a Discussion Paper process, in regard to "Section 32A(2)", which was included in the Exposure Draft, but omitted in the Bill before Parliament, means that the Committee is reviewing a Bill that is only 80% complete. The problem is the other 20%, if presented to the Parliament, will interact with major provisions in the Bill before the Committee, so that the effective interest rate cap will not be 48%, but will in fact be below 40%, to ensure compliance.

No money promised

Despite the Minister and consumer advocates' constant message that all that matters is consumers be made more aware of the non-commercial alternatives, the not-for-profit sector will require towards $3 billion, in total, for the replacement of existing commercial loans, accommodating the policy requirement of longer term lending, staff training and the essential outlet and office infrastructure, with access to at least some of that money prior to 1 July 2012. To date, nothing has been promised and there are no funding provisions included in the current Bill.

© *Smiles Turner, November 2011*

Criminals will dominate the market

If the Bill is adopted in its current form, the majority of current commercial lenders will leave the market and, if the Government does not find the $3.2 billion needed to subsidise the under resourced non-commercial, not-for-profit sector lenders, there will be a massive vacuum created. The only element left to fill that void will be the illegal lender gangs, who already have the experience.

Delegation delivers simple changes, as requested by the Minister

The Delegation recognises that the Minister wants only simple changes to the current Bill's structure and content and remains committed to protecting the *"desperate and vulnerable"*, while <u>also</u> maintaining a viable commercial industry sector.

The protection of the "*desperate and vulnerable*" will be achieved by the Delegation's model which adopts the current Bill as it is, but with the specific identification of the protected consumer group defined in accordance with gross income and those not within the definition being protected by a 48% cap plus a one only, totally transparent, market driven establishment/administration fee.

Recognition of "*desperate and vulnerable*" achieved by the Delegation

The Delegation's recommendations delivers the Minister what he wants - recognition that there is a *"desperate and vulnerable"* group of consumers but, if further protection is going to be introduced for them, it must be done in a way that objectively recognises who these people may be, so that both the lending sector and the ASIC compliance supervisors have clear guidelines with which to work.

ATO provides answer for criteria

Such an objective and essential guideline is the proposed significantly increased ATO tax free threshold - likely to be a 'net of any tax income of $18,600', up to the recent Tax Forum's suggested $21,000 - by the Bill's interest rate cap commencement date, with anyone earning a net income of that amount or less being the borrowers attracting the current Bill's 10%, 2% and 48% 2-tier provisions. This satisfies Henderson Poverty Line guidelines. The introduction of this threshold would be in the context of keeping all the current Bill's protection provisions exactly as drafted, but specifically for these lower income consumers.

Government assistance for "*desperate and vulnerable*" consumers will be required

The delayed Discussion Paper concerning the alternatives to the commercial lender will have to address how and when Government assistance will be needed to contribute to the provision of financial services for the *"desperate and vulnerable"*, as requested by the consumer advocates. These people currently make up 20% of the commercial payday borrowers. To accommodate the Minister and consumer advocates' concerns, some $600 million per annum will be required - a long way from the $3 billion required in 2012-13, if the current Bill commences unchanged.

Smaller, but viable industry maintained, as the Minister requires

The Delegation's recommendations also deliver in regard to the Minister's second requirement - recognition of the essential social and economic need to maintain a viable industry sector. Those earning a net income over the threshold to attract an interest/fee cap that embraces the broad concept of the current Bill's 48%, but adds the concept, already recognised as a conceptual platform in the Bill for the lower net income earning group, of a one (only) clearly transparent, market determined establishment fee.

100% cost transparency guaranteed by the Delegation

This 48% interest <u>plus</u> establishment fee, recommended by the Delegation for inclusion in an amended Bill, enables easy consumer assessment and competitive comparison and fosters competition, while avoiding the abolition of the industry sector that would occur under the current Bill.

© *Smiles Turner, November 2011*

Lender competition to increase

The conclusion of the last 2 years of Commonwealth regulatory uncertainty will see existing lenders seeking to expand and numerous lenders, who are currently waiting on the sidelines, entering the industry, thus providing an environment of aggressive competition that will benefit consumers.

Consumer advocates are not criticising the Delegation's model

The consumer advocates have maintained their focus with regard to achieving greater protection for the *"desperate and vulnerable"*. Throughout the submission stages and the public hearing before the Joint Committee on Corporations and Financial Services, their focus has remained 100% on payday lending to the *"desperate and vulnerable"* consumer.

Their demonstrated interest is not with the non-desperate and non-vulnerable who borrow payday loans, and not with the micro-borrower. Despite their exposure to the Delegation's model both in its submission to the Joint Committee and during the Public Hearing, while they have strongly attacked the other representative body's alternate model, they have not raised any criticism in regard to the Delegation's model.

Minister leaves it to the Committee

The Delegation's model was presented to Minister Shorten at a meeting with the Delegation and other industry representatives on 9th September 2011, without his making any negative comment. The Minister asked the Delegation to present the model to the Committees and this is the model presented in, and justified by, this Submission.

COAG agreement - review in two years' time

The terms of the 2009 National Credit Law Agreement between the Commonwealth, States and Territories requires the Commonwealth to commence a review of the operation of the National Credit Law no later than 2 years from commencement.

This provides another opportunity for the Committee to adopt the Delegation's suggested model, knowing that it will be thoroughly reviewed in 2 years' time. In contrast, if the current Bill is passed unchanged, a 2 year review period will not be soon enough to repair the massive damage it will cause.

There is an opportunity for idealism to embrace reality

The Delegation's recommended changes to the current Bill will provide the idealists with greater consumer protection for the *"desperate and vulnerable"*, the focus of their concern.

A win for idealism.

They will also ensure that the continuing majority of consumers are able to access the commercial lending of their choice, in a highly competitive environment, without imposing an intolerable burden on Government and the alternative non-commercial sector.

A win for **reality**.

The Minister -

"*It is not the government's intention to ban small amount lending. The Government believes that small amount loans, including payday loans are a legitimate source of credit for many people who are unable to access credit through mainstream lenders*".

(Minister Bill Shorten, document entitled "*Thank you for contacting me*" provided by the Minister for distribution by Parliamentary colleagues, September 2011)

© *Smiles Turner, November 2011*

About the Submission

Why such a substantial submission?

The extremely challenging circumstances faced by the small amount, short term loan industry sector, over the last 18 months, demanded a comprehensive presentation of the issues, the facts and the background to the Financiers' Association of Australia / Industry / Smiles Turner Delegation (the Delegation)'s advocacy.

Too often -

so little has been presented,

so many comments made without factual support,

so much imperfect research relied on, and

so much concluded, without economic modelling and cost analysis,

...when so much more is needed to be known by those who will determine the final shape of the Commonwealth regulatory regime.

As with all industry sectors, the small amount, short term finance sector is not to be presented as perfect. All lenders of good conscience, such as the Delegation's committee members and supporters, recognise that consumer credit protection regulation is required.

In a perfect world, that would not require recognition of commercial reality and, with a ready supply of the huge resources required to provide the ideal state, the consumer advocates' dreams on behalf of the small and important segment of the borrowing population with whom they deal, would be rightfully fully recognised.

However, as Treasurer Wayne Swan was concerned to remind attendees at the recent Tax Forum, this is not a perfect world and the Commonwealth does not have enough resources to make it so. As this submission attempts to present commercial reality on behalf of the lenders, it does so within the parameters of an imperfect world.

Consequently, this Submission offers the details of, the rationale for, and the consumer and industry factual background concerning a best possible compromise.

This compromise will cost an estimated 25% of lenders dearly.

This compromise recognises the *"desperate and vulnerable"* borrowers of concern to the consumer advocates and the Minister, but attempts to maintain a commercial lending presence for the 75% of borrowers who are not in the *"desperate and vulnerable"* group and who have no other possible commercial or non-commercial alternative.

The Delegation appreciates that this submission involves a very substantial read. However we maintain that, as the results of the Senate Economics Legislation Committee (the Committee) and others' current endeavours will substantially affect the lives of many of the 750,000 Australians now borrowing 1.5 million small amount, short term loans each year, this effort by critical decision makers - however personally or professionally inconvenient - is justified.

The Delegation invites careful consideration of this Submission and thanks the Committee for the invitation to provide it as part of the Committee's inquiry process.

The Submission's Focus

This Submission recognises the legislative focus of the Committee. The Submission is provided to assist the Senators to have a broad understanding of the business and socio-economic environment that the current Bill is intended to regulate.

The Delegation advocates a continuation of a viable commercial small amount, short term finance sector, as has been listed as one of their objectives by both the Minister and Treasury. However, this Submission also recognises and acknowledges the call for greater consumer protection of one segment of the small amount, short term loan borrowing public.

The Submission includes consideration of simple additions to the current Bill, which will satisfy the consumer advocates and also satisfy the Minister, in that these simple additions recognise

the opportunity for greater consumer protection of the *"desperate and vulnerable"*, as the Minister describes them.

These additions will allow the borrowers who are not *"desperate and vulnerable"* to continue to be covered by the vast amount of consumer protection regulation already in place. This regime will allow commercial lenders, operating with 100% transparency, to provide the loans these borrowers seek. At the same time, it will allow a dynamic new marketplace to exist which, when there is certainty in regard to the Commonwealth regulation of this lending market, will experience a substantial increase in competition.

The fundamental reality is - controlling or inhibiting the lenders, by introducing price controls, will not make the demand go away and will not stop people seeking to borrow for these "*everyday living*" purposes.

Social engineering is not achieved by manipulating the rules applying to lenders. Fundamentally, lenders do not create the demand, they simply offer to supply what is already in demand. If you are attempting to reduce demand, you must address what it is that creates it.

In addition, the Delegation remains concerned as to whether or not it is appropriate, in our democratic Australian society, for one relatively privileged small group to impose their values on another. The latter being a very numerous group who has shown no indication that they want their freedom of choice curtailed, or their self-esteem inhibited.

As the Senators and Committee staff will quickly come to appreciate, the current Bill is a drafting disaster and the socio-economic impact on up to 750,000 Australians will be both negative and profound.

If the current Bill is enacted unchanged there will be no marketplace, because all lenders who lend under $3,000, and most lenders who lend between $3,000 and $5,000, will be forced to exit the market.

There will be no new competition. Commencing 1 July 2012, the not-for-profit, non-commercial lenders will see a 100 fold increase in demand, without the necessary $3 billion+ needed to accommodate that dramatic surge. This future lending environment will be created by the current Bill, which has been presented to the Parliament without the Minister, Treasury and/or the consumer advocates having undertaken any preparatory business cost research and analysis, or having secured any increase in government funding to accommodate its extremely expensive implementation.

This Submission is an invitation to the Committee to recommend the adoption of the Delegation's simple additions, thereby avoiding the socio-economic disaster that will otherwise unfold.

The Submission's Structure

The submission is structured to accommodate the time-poor reader.

The Executive Summary (6 pages long and a maximum 10 minute read) states the Delegation's fundamental case, with very short explanations outlining the critical elements associated with the Delegation's position.

The Sections following the Executive Summary include draft legislation, an explanation for the Delegation's recommendation and, thereafter, a detailed explanation and a consideration of the environment in which the current, or any amended Bill, will operate. These Sections are offered to assist with an in-depth review and understanding of the real issues involved.

About the Delegation

The Financiers' Association of Australia (FAA) / Industry / Smiles Turner Delegation is the representative entity for the largest number of lending and broking companies involved in the small amount, short term finance sector. The Delegation consists of some 147 companies, over 180 authorised credit representatives and 2 major service providers associated with these companies.

The Delegation is supported by:

- the oldest peak industry body, with the Financiers' Association of Australia (FAA) having been formed in the early 1930s;

© *Smiles Turner, November 2011*

- four of the 7 major small amount, short term lenders in Australia;
- an extended range of small, medium and larger lenders and brokers, with business interests Australia wide;
- a well known compliance advisory and industry research consultancy; and
- Australia's major software service provider to the sector.

The various lenders and brokers undertake either, or both, payday and microlending.

Of the Delegation's committee, two are Directors of the FAA and three are also Directors of the other representative body, the National Financial Services Federation (NFSF). Internet lenders, telephone lenders and both small and large retail lenders are represented on the committee.

"***I'm not supporting the industry in the slightest, but until something more "ethical" can meet the demand, these services meet the needs of many in our community***".

Anglicare Social Inclusion Director Andrew Hall, The Sunday Times, 30 July 2011

© *Smiles Turner, November 2011*

SECTION 1

Market Characteristics and Supply Realities

The impact of the current Bill, if not amended prior to its commencement, will be profound and extremely negative. This Section commences the examination of that impact.

If the Bill Proceeds to Enactment Unchanged

If the Committee recommends the current Bill be passed unchanged, a substantial credit vacuum in the small amount, short term lending sector will emerge. It must be expected that almost all lenders who currently lend $5,000 or less, secured or unsecured, whether payday or microlenders, will leave the small amount, short term lending sector.

A lender cannot break even on either the 10% of principal, plus 2% per month, or 48% inclusive interest rate caps, across any loan book that includes a majority of loans spread under $3,000 (NAB Fast Money Pilot report 2010 and Smiles Turner industry research September 2011). The business profile section, Section 6 provides substantial statistics and research explaining why.

The 8.6% of lenders who lend a fair proportion of their loans in the $3,000 to $5,000 range, while still attempting to lend amounts under $3,000, will find their profits will shrink to levels below business sustainability, under the impact of both the cap and other provisions in the current Bill (Smiles Turner industry research March/April 2011).

The banks and other mainstream lenders moved out of the smaller personal loan market approximately 10 years ago. Now the smaller "fringe lenders" who replaced them will be moving out too (Smiles Turner industry analysis March/April 2011 and research post-the publication of the Exposure Draft Bill in September 2011 - see further details of all Smiles Turner research included in Appendix 1).

A personal staff member from the Minister's office commented to a senior lending representative, at the recent RMIT University launch of their report entitled "*Caught Short - Exploring the Role of Small Short Term Loans in the Lives of Australians*" (August 2011), that the Minister would not receive any political flak if the Bill abolished all commercial small amount, short term lending.

The staff member may be right - but only in the short term.

The Delegation has no doubt that enactment of the Bill, unchanged, would attract considerable praise from the consumer advocate campaign leaders and substantial favourable media attention for the Minister, during the week following its passing.

However...

A growing socio-economic disaster will emerge

In time, the growing socio-economic disaster created by the Act, if unchanged, as each of its 2 stages commence - 1 July 2012 and 1 January 2013 - would overturn this early praise and favourable media attention.

The exodus will not wait until 1 January 2013, when the charges and interest rate caps are proposed to commence, it will begin at least 9 months earlier, as lenders exit to avoid the July 1 regulations and/or being financially burdened with continuing business overheads, while being restricted only to collecting the ever-diminishing outstanding loans.

The socio-economic disaster will become very evident just prior to the start of the next Federal election campaign.

Unless the Government has unannounced plans for a massive increase in aid (discussed later in this Submission), that period will see the beginning of an avalanche of applicants seeking loans from an entirely over-stretched and unable to cope, non-commercial, small amount, short term sector - a sector unable to cope with current demand.

If the Minister and supporters of the current Bill are concerned about *"desperate and vulnerable"* consumers, these concerns will be multiplied many times over in late 2012 and

© *Smiles Turner, November 2011*

early 2013, as 100+ times the current number of applicants, seeking non-commercial loans, flood the non-commercial lender interview rooms.

In loan book funding alone, the No Interest Loan Scheme (NILS) and Low Interest Loan Scheme (LILS) - per year - post-2012 - will need 160 times the amount of funding, spread over 4 years, that was mentioned by the Minister in his August 25 media release. This is without allowing for the exponential growth in demand for these loans, which now exceeds 18% per annum (Smiles Turner March/April 2011 industry research).

The reasons for this growth deserve the Committee's attention.

Dynamic growth in microlending

A February 1, 2000 study by Professor Iain Ramsay, Professor of Law, Osgoode Hall Law School, Toronto, entitled "*Access to Credit in the Alternative Consumer Credit Market*", prepared for the Office of Consumer Affairs, Industry Canada and Ministry of the Attorney General, British Columbia, provided some interesting comments concerning the emergence of the industry in Canada. The Delegation believes that there are significant parallels with Australian circumstances.

At page i, Professor Ramsay identified:

"…broader socio-economic factors which are relevant to understanding the growth of the alternative financial sector. During the past twenty-five years there has been a growth in income inequality, declining savings to income ratios, and increasing debt-to-income ratios. …Significant numbers of consumers may be using credit to maintain living standards in the face of flat income. There is thus a larger group of individuals who may have problems with credit, perhaps caused by changes in circumstances such as marital breakdown or unstable employment and who may face difficulties in funding short term credit needs in the mainstream market."

And at page 3:

"…A study in the US indicated that the bottom 40% of consumers borrowed to compensate for stagnant incomes (R. Pollin, "Deeper in Debt: The Changing Financial Conditions of US Households" (1990)(Washington: Economic Policy Institute), while in the UK the Policy Studies Institute concluded that "poorer families, on the whole, use credit to ease financial difficulties, those who are better off take on credit commitments to finance a consumer lifestyle" (R. Berthoud and E. Kempson, (1992) Credit and Debt: The PSI Report (London: Policy Studies Institute) at page 64)."

At page 17 Professor Ramsay identified two possible explanations as to why consumers might seek small amount, short term loans, on "*the limited empirical evidence*" available:

"First, individuals may have no reasonable choice because they do not have access to the "mainstream" financial markets to meet their immediate needs. This lack of access may be temporary (bank account low in funds, credit cards over the limit, new entrant to credit market, fear of bounced cheque charges) or continuing. This explanation appears to be adopted in the recent report of the UK Office of Fair Trading (Vulnerable Consumers and Financial Services, The Report of the Director General's Inquiry (1999)). A second explanation is that individuals may choose to deal with these high priced services rather than with the mainstream financial system. This may be because of factors such as convenience and the ability to obtain cash or goods immediately, or a dislike of dealing with banks (J Murray Smith, "Street Youth and Banking: A Needs Assessment for Banking Services for Youth" (December 1996)(Prepared for the Pape Adolescent Resource Centre and the Healthy City Office, City of Toronto))."

Smiles Turner's 11-year experience in consulting to and researching about microlending in Australia, confirms six of the seven growth contributing factors identified by Mr Dean Wilson, in his paper "*Payday lending: Policy making for the financial fringe*", Just Policy, Vol. 33, October 2004:

- the rising use of credit cards across all levels of society;
- the deregulation of the banking industry and their refusal to continue providing services to low income consumers (this includes the refusal to provide any small, traditional loans at all);

- the stagnation or decline of the real incomes of low income earners (the Delegation would add lower middle income groups to this phenomena);
- the rising level of household debt;
- lower levels of saving; and
- an increasing number of people with a poor credit rating (we note the significant contribution to this phenomena of credit card generosity by the large banks. Also, there is almost no other opportunity for an increasing number of individuals to repair their poor credit rating, other than to be micro-borrowers).

The elements identified by Professor Ramsay and Mr Wilson, the information gathered by Smiles Turner in its research undertaken in 2006-7 to 2011 and anecdotal information provided by lenders in general, support an assessment that, over the last 11 years, there has been a substantial compound growth in demand for payday and microloans.

The Australian scene

The dynamic growth in Australia is demonstrated in the Smiles Turner 2011 Lender/Broker Survey results. Of the 38 companies established as at January 2009 (one respondent was established thereafter), when asked what percentage increase their turnover achieved between January 2010 and January 2011:

- only one company reported a decline in turnover (of -40%);
- 16 companies reported there was no increase;
- 8 companies reported increases from between 2% and 10%;
- 7 companies reported increases from 15% to 20%; and
- 7 companies reported increases above 20%.

With 22 companies reporting increases ranging from 2% to 300%, excluding the one company with the highest growth (many times higher than any other), the average was 15.73%. If the company with the highest growth was included, the average would be 18.17%.

It is interesting to note that one of the two largest lenders, the Cash Converters group, which did not participate in the above survey, in recent years enjoyed a compound growth, per annum, in excess of 15.73% according to ASX required reports. This was noted in one of the Treasury Discussion Papers. However, in the second half of the calendar year 2010, the company enjoyed a 48% increase in its lending activities.

The internet-based companies participating in the 2011 survey revealed stronger growth than the retail outlets. While 3 reported nil growth in 2010, one reported growth of 2% per month and 8 reported monthly growth rates of between 5% and 30%.

On the assumption that the average of 18.17% can reasonably be applied to the whole industry, it is highly relevant to note that, in 2010, the non-commercial lending sector (NILS, LILS, etc.) in total, was not able to service even 10% of the growth in lending of that year, let alone contributing anything to the base number of loans.

The changing character of payday borrowers

The research reported in the 2010 CALC Report and 2010 and 2011 Smiles Turner research results confirm that there is a growing new group of borrowers who also do not fit the stereotype of being *"desperate and vulnerable"*. These people do not need to be caught up in the small amount loan provisions in the current Bill.

The CALC report includes the following findings, comparing Dean Wilson's 2002 findings and the 2008 research results used in the 2010 CALC report (pages 51 to 77):

- There was a large decrease in the proportion of borrowers with low incomes, with a significant increase in borrowers with high incomes. In 2002, 95% of borrowers earned incomes of less than $41,600 but, in 2008, 51.3% earned less than $40,000.
- In 2002, 22% had TAFE, college or university qualifications - this had grown to 58% in 2008.

- A substantial decrease (down 33%) borrowed for "*basic living expenses*", but there was a significant increase (up 120%) in those who stated "*car repairs and registration*" as their reason for borrowing.
- The majority did not use payday loans frequently, with 74% of respondents borrowing only once or twice within the previous 18 months.
- Only 8% were unemployed in 2008, with 62% being professionals, managers, administrators, small business owners, salespeople, clerical workers, service workers or tradespeople.
- In 2002, 40% reported having no access to other funds. In 2008, none of the participants reported having no access to other funds and 41.5% reported having access to more than one other source.

Ironically, both these studies (2002 and 2010) were undertaken for CALC, the leading organisation amongst the anti-payday and microlending consumer advocates. They are presented as supporting the current Bill's inclusions aimed at protecting the *"desperate and vulnerable"* and neither the research, nor CALC, have put any focus on the majority of consumers who do not fall into that category.

Lending outlets

The significance of the current extensive distribution of retail lending outlets should not be overlooked. This distribution reflects demand and the importance of convenience to consumers. Most consumers do not expect to have to travel great distances for their loans, with outlet convenience consistently being one of the three major reasons given for the selection of their lender, when completing Smiles Turner consumer research questionnaires.

In the November 2010 Smiles Turner consumer survey, 19.24% of the 441 responding consumers listed convenience of location as their reason for choosing the particular lender. This was ahead of "good service" (18.3%), "long term customer loyalty" (13.54%) and "friendly staff" (10.45%).

In the 2006 national research, when 3,418 were asked about their reasons for borrowing, "convenience" came second with 22.8%. "Service" related reasons were first with 36.4%, 12.1% said "customer loyalty" and 9.9% thought the ability to be able to borrow small amounts, for short terms as required, was paramount.

Minister Shorten's electorate of Maribyrnong is a typical example of the convenient availability of lenders. Located in Melbourne's north-western suburbs, the Delegation is aware of at least 4 lenders within the electorate boundary:

- In Moonee Ponds - Cash Converters and Money 3; and
- in St Albans - Kwik Cash and Money 3.

Further, there are at least 11 lenders in adjacent suburbs who would lend to constituents living within the Maribyrnong electorate:

- In Sunshine - Cash Converters, Cash Stop, The Cash Store;
- Gladstone Park - The Cash Store;
- Footscray - Cash Loan Money Centre, The Cash Store;
- Glenroy - The Cash Store, Money 3, Cash Converters, Cash Loan Money; and
- in Coburg - Money 3.

The Delegation would expect a substantial number of the Minister's constituents would be customers of one or more of these outlets. 15 outlets exist because of consumer demand from the constituents in this electorate and the surrounding electorates. All borrowers, as mandated by the National Credit Code, must be over 18.

Non-commercial demand dynamics

The non-government, not-for-profit sector itself admits it will not be able to cope with even a proportion of the extra demand the Delegation warns will be created, if the current Bill is enacted unamended.

© *Smiles Turner, November 2011*

Substantial numbers of people are already being turned away. As Financial Counselling Australia has noted on page 15 of its submission to the Committees, the ACOSS Poverty Report, "*It's Time to Raise Newstart*", October 2011, announced the latest available statistics revealing that, in 2006, 2.2 million people - or 11% of Australians - lived in poverty. This was up from 10% in 2004 and 8% in 1994. The submission went on to note, "*...the annual Australian Community Sector Survey reported that more people are turning to community groups for help, leaving services unable to meet demand. The survey provides the most comprehensive picture of how the non-government community services sector is travelling, and this year showed a 12% increase in assistance provided by agencies. It revealed that 1 in 20 people were turned away, a 19% increase on the previous year*".

The abovementioned ACOSS Poverty Report also included other information of which the Committee should be aware, when assessing the non-commercial sector's ability to cope with <u>any</u> increase in demand due to lenders exiting the small amount, short term loan sector.

These included:

- The number of people turned away for every hundred people seeking "*financial support*" in 2009-10, was 4.5.
- The percentage increase in the services provided by agencies "*was most pronounced*" for financial support services (50%), which constitutes the second highest service growth area.
- Cost of living pressures were noted as continuing to have a significant impact on low income households, with housing stress due to rent increases, electricity price increases of 18.2%, water and sewerage by 14% and gas and other household fuels by 3.6%, over the years since 2005.

The Delegation notes that these factors all promote demand for small amount, short term credit.

The report notes that there are 175 financial support services. This figure is more conservative than some published statements concerning NILS and LILS. If it is the more accurate, then there will need to be a fourfold increase in the outlet and office numbers of these financial support services to replace current microlending outlets.

The report includes a table 3.5, referring to organisation size by annual income range. While there is no breakdown according to service function or category, it is interesting to note that 64.3% of the services included in the survey do not have an annual income as large as the average loan income experienced by the outlets and offices of the 19 lending companies that participated in the October 2011 survey. The implications for organisational stress and incapacity are examined later in this section.

To the ACOSS and Financial Counselling Australia concern must be added the evidence of Anglicare Sydney, when appearing before the Joint Committee on Corporations and Financial Services (the Joint Committee), on 24 October, 2011:

"*I think our services are extremely well accessed by people. The issue is that we cannot provide services to the number of people who need help, which leaves people out there very vulnerable... For my office alone, which is Mount Druitt, one of the poorest suburbs in Sydney, we turned away 4,000 people last year simply because we did not have the staff or the means to provide a service to them. And then that also excludes the people you talk about who may well be on a full-time income which could still be a low income...*".

Normal living expenses

The Delegation submits that, while the consumer advocates imply criticism of the small amount, short term lenders for lending around 70% of their total loans for "*normal living expenses*", all Smiles Turner research (as outlined in the "Reasons for Borrowing" chapter, in the Consumer Profile Section of this Submission) indicates that this has been a continuing pattern over the last decade.

These findings are also supported by the data included in the 2010 CALC report.

The small amount, short term payday (but not micro) lenders may not be acceptable to the consumer advocates and the Minister and the current Bill is drafted specifically to get rid of these lenders. However, the up to 70% of the annual 750,000 borrowers currently borrowing for "*normal living expenses*" do see them as the answer, and the current Bill has absolutely no

© *Smiles Turner, November 2011*

funding provisions which will assist any community, or other, organisation to offer an alternative that is acceptable to the consumer advocates and the Minister.

Idealism cannot replace reality in these circumstances.

What the current Bill ignores

Even before Treasury received industry statistics from the Delegation that demonstrated rate caps such as those included in the current Bill would not be commercially feasible, the Treasury authors of the Regulation Impact Statement (largely written following the release of the Green Paper in August 2010) recommended a $30 per $100 lent cap. This is substantially more than the totally uneconomic $10 establishment fee, plus $2 per month, per $100 lent, for small amount, short term credit contracts, or the 48% inclusive cap on all other loans included in the current Bill, that effectively means 92 cents per week, per $100 lent.

It should be noted that the 10%, 2% concept was never presented as an option at any time during the more than 18 month stakeholder consultation process. Not in the Green Paper released in August 2010, nor the 4 Treasury Discussion Papers presented since, nor was it ever suggested at any stakeholder meeting with either Treasury or the Minister, prior to the release of the Exposure Draft Bill in late August.

As has now been established, Treasury has not carried out any economic modelling regarding the 10%, 2% provision.

There are now 750,000 Australians per annum borrowing, at least once, from small amount, short term lenders each year (Smiles Turner industry research November 2010, April/March 2011, plus published and unpublished data from public company lenders).

The total value of all small amount, short term loans in 2010 was $1.2 billion (Smiles Turner industry analysis March/April 2011, including published and unpublished data from public company lenders, plus inclusion of loans provided by non-ASX listed lenders. Some of these lenders' loan books are entirely, and some are partially, comprised of small amount, short term loans).

The figure of $500 million that has been quoted by some consumer advocates, as well as Minister Shorten, was a figure researched and published in 2006/7 by Smiles Turner. It primarily related to payday loan figures.

The figure of $800 million that has been quoted recently by lender representatives, was a figure researched in 2008 by Smiles Turner and included both payday and microloans, offered by lenders whose entire loan books were comprised of these loan types at the time of the research.

The larger figure of $1.2 billion, noted above, reflects not only the inclusion of lenders who have only part of their loan books attributed to payday and microloans, but also the annual compound growth rates reported by many successful lenders, during industry research programs undertaken by Smiles Turner.

Bill unchanged - insufficient alternatives

The non-commercial alternatives to small amount, short term commercial lending are currently substantially inadequate. The Minister, Treasury and the consumer advocates have never examined the capacity of the non-commercial sector, nor have they projected any Government assistance to allow this non-commercial sector to accommodate any of the increased demand that would result from the current Bill.

All three have commented on the existence of the alternatives, with the Minister listing a number of them in an information sheet that accompanied his 25th August 2011 press release, but absolutely no quantification has been attempted. In this context it may be useful to consider:

- In 2010 the non-commercial small amount, short term lending sector provided less than $20 million in total loans, as opposed to the $1.2 billion provided by the commercial sector.
- In 2010 the non-commercial small amount, short term lending sector imposed criteria that precluded 84.6% of all commercial small amount, short term borrowers - by purpose for loans (Smiles Turner consumer research November 2010, April/May 2011, supported by similar studies in 2006 and 2007).

© *Smiles Turner, November 2011*

- The commercial sector responds to a demand which is characterised by the need for fast provision of funds, generally on the same day for payday lenders and within 1-3 days, at most, for microlenders. The non-commercial sector generally involves an interview/application process of between 4 and 6 weeks' duration.
- Non-commercial loan centres offer a total annual number of loans fewer than the larger lenders, such as Cash Stop, Cash Converters, GE Money and Money 3, offer per outlet - in an average week.
- In 2010, non-commercial loan centres (significantly expanded in number over the previous 3 years), given how few loans many actually offered, still provided less than 1% of the number of loans provided by the 834 retail commercial lending outlets and face to face services (credit assistance providers and credit providers) across Australia (Smiles Turner industry analysis March/April 2011).
- Only one non-commercial internet lending site is known to the Delegation, compared to the 59 known commercial internet lenders, with 340 websites identified by the Delegation, and 2 major lead generation companies feeding lending business into these known internet lenders.
- Commercial lenders have an estimated 2,500 trained staff (full time equivalent). Most non-commercial lending is provided by utilising well-meaning part time, often volunteer staff, many of whom have had little or no experience in the lending sector.

Impact on commercial lenders

The impact of the provisions of the current Bill will have a traumatic impact on the industry sector:

1. The 2-tier cap model included in the current Bill means that all relevant credit assistance provider (broker) activities will cease, at least from 1 January 2013.
2. As indicated earlier, 28% of the payday lenders will exit on or before 1 July 2012, with the rest on or before 1 January 2013.
3. Approximately 90% of the microlenders will exit on or before 1 January 2013.
4. Lenders facing long term rental and other fixed commitments, entered into before the current Bill was announced, and who will continue to face compliance and compulsory staff training costs introduced July 1, 2010, will face insolvency in the first half of 2013 (Smiles Turner industry research September 2011).
5. Lenders are already starting to see a staff drain, with expensively trained and experienced staff increasingly "seeing the writing on the wall" and seeking other more secure employment outside small amount, short term finance. Two Delegation supporters have reported much valued staff leaving over the late September/early October period because of this.

The Delegation has chosen to list below the limitations of the current alternatives to commercial lending. To avoid any challenge of bias, we list what Treasury and the Minister have publicly admitted and remind the Committee of the CALC, RMIT University and Smiles Turner research, all indicating the considerable number of current consumers who, in 2013, would not qualify for a loan under these organisations' current lending guidelines (at least 80%).

The Minister's "Fact Sheet"

The Minister included the following table with his media statement of 25 August 2011. This table summarises the available alternatives for a very small proportion of the current small amount, short term borrowers.

Expense	**Possible Lower cost alternatives**
Utility bills	Centrelink advance and Utility provider's hardship policies
Food	Centrelink advance
Vehicle repairs & registration	LILS and Centrelink advance

Rent	Centrepay
Mortgage payments	Lender's hardship policies
Other essentials	NILS & LILS, and Centrelink advances

In the analysis of the alternatives included in the table by the Minister, the Minister acknowledged some of the limitations on the availability of these alternatives.

(a) Centrelink advances on benefits - the need to be a Centrelink recipient to access this source of funds.

(b) NILS - for essential household items only. Must have a Centrelink concession card, the loans are up to $1,200 "*or more in special circumstances*".

(c) LILS - $800 to $3,000 loans, "*available for personal, domestic or household purposes such as fridges, cars, computers, furniture, medical expenses and house repairs*".

(d) Hardship relief with a utility provider - "*a plan to pay their bill in instalments*".

(e) Centrepay is a direct debit facility run by Centrelink.

In addition, the Minister mentioned Emergency Relief services funded by the Australian Government's Financial Management Program to "*support people to meet their immediate needs in times of crisis*".

The Minister also mentioned "*The new Household Energy and Financial Sustainability Scheme*", assisting "*by improving low income households experiencing difficulty meeting and paying for their energy... improving their energy efficiency and financial sustainability*".

Alternatives in the Treasury's RIS

Treasury's RIS included the following comments in regard to the alternative opportunities available:

(a) Centrelink - "*The amount and frequency of the advance is limited according to the type and rate of a consumer's benefit... only available if a person can afford to repay over the following 6 months... (some) limited to 3 advances over 6 months... (others) one advance per annum...*".

(b) Utility programs - "*...generally for concession card holders...*" (although a new national hardship program is anticipated by Treasury).

(c) Microfinance programs - (NILS, LILS, Step Up, AddsUp, Fast Money, etc.) - "*...generally only available to low income consumers or consumers in receipt of government benefits...*".

Smiles Turner consumer research has consistently indicated that 78% to 84% of small amount, short term loan consumers would not qualify for any of this assistance, even if the funds were available.

Please note, with published 90% rejection rates for these programs (e.g. NAB Fast Money), the Delegation asks the Committee not to accept the Treasury's unfortunate statement on page 55 of the RIS concerning the microfinance programs, "*Currently, the demand for these products is less than the available supply, so there is an existing capacity to meet an increase in requests following the introduction of the reforms*".

The Delegation submits that, with these programs now providing less than 1% of total small amount, short term loans each year, the issue is not excess capacity, but how funding to increase capacity - by nearly 100 times - can be achieved in the 2012 and 2013 Budgets - just for the necessary loan book. In addition, a further $2 billion will have to be found to cover staff, infrastructure and the provision of funding for longer loans which, as discussed elsewhere in this Submission, will need:

- to begin to be in place on 1 July 2012;
- to be substantially in place before the fourth quarter in 2012; and
- to be completely in place by 1 January 2013.

© *Smiles Turner, November 2011*

The Government's essential funding ignored

Apart from the Minister's inclusion of information concerning "*Alternatives to Payday Lending*" in the "*Fact Sheet*" mentioned above, the Delegation was pleased to note the Minister's comments, in his Second Reading speech, about the importance of alternatives.

However, in neither the Minister's media release and attachments, nor in his speech, is there any consideration of the capacity of the alternatives to handle any increase in demand. This despite:

- Section 124A and 133CA in the current Bill that demands inclusions to "*promote awareness of ...alternatives*" (RIS page 53), "*disclose the availability of other options*" (Minister Shorten's media release 25.8.10) with contact information about non-commercial alternatives mandatory on all lender and broker websites;
- the Ministers concern that "*For some people, taking out a payday loan ...creates more problems than it solves*" and the desire that they look to the "*other options such as Centrelink advances, No Interest and Low Interest Loan Schemes run by community organisations, and the availability of hardship programs with utilities and other credit providers*" (Media release);
- the Minister stating, "*The Government will also release a discussion paper with more detailed proposals to improve access to alternatives to payday loans*" (Media release - Delegation's emphasis);
- the Minister's comments during his Second Reading speech introducing the current Bill - "*We think more could be done to encourage consumers to utilise other cheaper options... Under these reforms small-amount lenders will be required to disclose the availability of these option to their customers*";
- Treasury admitting in its RIS that, in regard to the "*Specific Protection*" non-cap reforms now included in the current Bill (RIS page 50 and following), "*The impact of this reform on short term lenders and lessors will be:*
  - *A reduction in the amount of credit provided (to the extent that consumers are being encouraged to use alternative sources of finance...)*"; and
- Treasury admitting in its RIS that the introduction of a flat rate interest rate, "*...may also result in some borrowers being refused credit when this would not have been the case previously, ...where the return ...is deemed insufficient to justify the risk*" (page 46).

The Minister's funding comments

While outlining the existence of the current alternatives in the August media release "*Fact Sheet*", the only mention of existing or previously announced (but not new) Commonwealth funding, by the Minister that day, was:

- "*$335 million over three years to support a range of initiatives to build financial resilience and wellbeing for vulnerable people and those most at risk of financial and social exclusion, including those using pay day loans*" (Australian government Financial Management Program); and
- "*$30 million over four years to support low income households experiencing difficulty meeting and paying for their energy needs by improving their energy efficiency and financial sustainability*".

The Delegation is not aware of any funding specifically planned in conjunction with the current Bill.

Funding comments in Treasury's RIS (page 54 and continuing)

"*In October 2009 the Government announced targeted funding to support the Good Shepherd Youth and Family service/NAB No Interest Loans Scheme (NILS), Step Up and Adds Up programs and the Brotherhood of St Laurence ANZ Saver Plus and Progress Loans programs. This support was extended under the 2011/12 Budget, with the government committing $60.6 million to continue these and other micro finance and financial literacy initiatives, including $6.2 million over four years to support financial literacy services for indigenous people across Australia*".

Increases required and not recognised

The following table presents the above amounts annualised and indicates the multiples required from the Government for each program by itself, to satisfy the amount required to replace the commercial sector in calendar year 2013, on the important assumption that the loans in 2013 will have the same amounts and terms as those advanced in 2010.

Program	Current/announced annual amount	To satisfy 100% 2013 non-commercial loan capital demand
Financial Management Program	$111.66 million	Multiply by 10.75
Household Energy and Financial Sustainability Scheme	$7.5 million	Multiply by 160 *
NILS, LILS, Step Up, Adds Up, etc	$15.15 million	Multiply by 79.2
Total all above programs	$134.3 million	Multiply by 8.94

* Please note, due to a typographical error, prior to this submission the Delegation referred to this amount as 60.

The need to increase all these figures by 200%

Please note that the figures in the above chart are conservative and only include funding for the loan book in 2013. They do not include:

1. any allowance for the compound growth in demand of 18%;
2. expanding the current non-commercial lending outlets to replace the commercial sector;
3. recruiting, training and paying for the 2,500 full time equivalent, experienced staff currently working for the lenders;
4. any funds for infrastructure such as computer hardware and software, safes and security; and
5. any funds for advertising and marketing, but

...the Delegation assesses that these inclusions will demand another $1 billion investment by the Government in 2012-2013, in addition to the $1 billion provided for the loan book capital in 2012.

Another 100% more funding

Please note that the amounts in the table do not include any recognition of the Minister and Treasury's concern to have all loans include a longer term, so that the individual repayment amounts are significantly reduced. On the assumption that repayment amounts are halved and the contract term is doubled, which would reflect comments made to Delegation members by both the Minister and Treasury, implementation of that policy would require towards another $1 billion loan book investment by the Government.

In total, the current Bill will create a impost on the 2012 budget that will be towards $3 billion. The Delegation is unaware of any contact with the Treasurer Wayne Swan in regard to this funding. Significantly, in a speech to the recent Tax Forum, where it would have been most appropriate to mention plans for such funding, the Treasurer did not make any reference to small amount, short term lending, or plans to increase funding to the non-commercial credit providing sector.

© *Smiles Turner, November 2011*

SECTION 2

The Delegation's Simple Alternative

This Section includes the Delegation's suggestion for an alternative approach to the current Bill, which is currently the subject of a Treasury Discussion Paper. The analysis has been approached on the theoretic assumption that there will be sufficient lenders continuing to exist, to regulate, after 1 January 2013.

Respecting 80% of Consumers

The Delegation's suggested alternative model accepts the Minister's, Treasury's and the consumer advocates' concerns to move the *"desperate and vulnerable"* away from commercial lenders, to other cheaper options "*probably better suited for this class of borrowers*", as Treasury told the Senate Economics Estimates Committee on the 19th October 2011.

The model suggests the use of an independently calculated ATO tax threshold as the cut off point for those choosing and/or needing the cheaper options, leaving the current Bill's small loan provisions largely, if not entirely, in place for the perceived benefit of low income earners. This would allow those who earn a net income above the threshold, from any source, to participate in a lending market where lenders charge 48%, plus one only establishment/ administration fee that is clearly identified and encourages price competition.

The model would only require the addition of one subsection with two lines and one new section with 11 lines, to the current Bill and no other changes (satisfying the Minister's concern that the structure and content of the current Bill be largely left as is).

Many lenders are keen to stress a significant difference between the payday loan and the micro-loan. The former, with its loan amounts averaging between $285 and $325, for a term of 1 to 6 weeks, the latter with its larger amount loans, often over $1,000 and up to $4,000, and with repayments spread over numerous months, and even 2 or 3 years. The Delegation's model recognises this distinction.

The *"desperate and vulnerable"* tend to attempt to borrow smaller payday loans, not microloans and, because the consumer profiles are different, it is inappropriate to attempt to regulate both in the same manner, or larger payday loans in the same manner as smaller payday loans. This element is included in the current Bill, but in a way that embraces all payday borrowers, rather than just those who are *"desperate and vulnerable"*.

The current Bill therefore assumes all small amount, short term borrowers are *"desperate and vulnerable"*. The reality is that some 20% would more correctly be considered as being "disadvantaged by circumstances", according to both Consumer Action Law Centre (CALC)'s 2008 research and Smiles Turner's 2006, 2007 and 2010 continuing research. The Delegation would prefer to use this more respectful phrase in relation to low income borrowers, but recognises the common reference by all other stakeholders to the descriptive phrase *"desperate and vulnerable"*.

Details on the alternate model

The Delegation is aware that Minister Shorten does not want major restructuring of his current Bill. However, the Delegation notes that the Regulation Impact Statement identified the "*objectives of the government*" to include:

- "*to assist consumers to have a greater degree of social and financial inclusion...*".

The model proposed by the Delegation achieves this objective. The non-"*desperate*" and non-"*vulnerable*" will have the opportunity to borrow under a 48% cap and establishment/ administration fee model, with targeted Government assistance and some help from the industry sector. This in contrast to the regime the current Bill would establish, which would make it financially impossible for lenders to provide loans to most of this group and/or other borrowers.

Commercial lending to a segment of the market at a loss, is only possible if there is an opportunity for cross-subsidisation as part of a longer term marketing strategy. This would be

© *Smiles Turner, November 2011*

to build consumer loyalty with those borrowers who are expecting to enjoy improved financial circumstances and/or those who will refer other more profitable lending business.

The *"desperate and vulnerable"* will have the opportunity to borrow under the regulatory circumstances provided by the existing Bill, or enjoy the achievement of the second objective, which is:

- "*to mitigate the particular risks associated with short term credit...*".

This will be achieved by the promotion of the availability of the alternatives, by the lenders, via the mandatory website inclusions in the current Bill. As the RIS explains, more borrowers need to be made aware of these alternatives and the Minister's August media release announced extra funding, over the next four years, to assist at least some of these organisations. This will require a proactive admission that Government funding must occur.

To these objectives must be added the Minister's concern to promote "*access to credit and the growth and long term sustainability of financial services businesses*", as he stated in his conclusion to his Second Reading Speech when introducing the current Bill into the House. This could be achieved under the Delegation's proposed alternative, while it will definitely not occur under the current Bill.

At a meeting called by Minister Shorten in September and attended by a broad cross-section of the small amount, short term lending sector, the Delegation's proposal was advanced by Delegation representatives, which was supported at the meeting by all sector personnel attending. This proposal satisfies the Minister's concern to avoid a substantial re-structuring of the Bill. While prepared to be critical in regard to other matters in the earlier part of the meeting, the Minister listened to the proposal without raising critical comment.

The proposal satisfies the key concerns, in regard to the cost to low income borrowers, included at Clause 5.7 in the Explanatory Memorandum:

1. "*The lower the income, the greater the reduction in income that will result from having to meet repayments under a credit contract. (Noting that a significant percentage of borrowers who use these products will have low incomes*)".
2. To "*leave opportunity for the borrower to receive sufficient income to either repay the debt or avoid the immediate need for additional credit...*".
3. To avoid the downside of debtors entering "*into a contract irrespective of the costs being charged*".

Because the bulk of the, then, Draft and now current Bill's content was designed to further protect the *"desperate and vulnerable"*, it is important that:

- some attempt must be made to identify the *"desperate and vulnerable"*, rather than wrongly assume all small amount, short term borrowers belonged to such a category;
- there should be recognition that many who could be included in such a category were those receiving lower incomes, generally entirely from the lower Centrelink benefits, or lowly paid employment;
- a neutral, third-party calculated income figure should be sought as an identifier, rather than one set by the Minister or the lending sector;
- there should be an acceptance that such an identification does not mean those above the identifier will automatically be granted a loan, as they (and the *"desperate and vulnerable"* will still continue to have the protection of the National Consumer Protection Act 2009's mandatory responsible lending regime, with all loans granted having to be "*not unsuitable*", according to regulatory criteria.

At the meeting with the Minister it was suggested that a particular Centrelink benefit might be considered, but this has presented some difficulties associated with the different categories of benefit. Similarly, there are a number of concerns in regard to how the Henderson Poverty Index is calculated for different groups of people. Both the benefits and the Index introduce the possible need for multiple threshold measurements.

As mentioned previously, the recent Tax Forum offered a one-figure solution, with the proposal to increase the minimum taxable income threshold to $21,000 per annum. While it is appreciated that the Treasurer expressed approval in regard to the concept of moving the threshold from the current $6,500 to $18,300, the Delegation is aware that he will be under

© *Smiles Turner, November 2011*

considerable pressure to take the amount to $21,000 and there is another 15 months, 1 Federal budget and a possible mini-budget between now and the 1st January 2013.

The Delegation recommends

The Delegation therefore suggests to the Committee that, in regard to amending the current Bill:

1. the Minister's concern for the *"desperate and vulnerable"* borrower be recognised, with the current Bill, in its entirety, being applied only to those people; and
2. that the threshold test to identify the *"desperate and vulnerable"* borrower be the current (at the time) ATO minimum taxable income amount. This having the advantage of putting it above the Henderson Poverty Index single worker and the single non-worker poverty lines. This recognises the Consumer Action Legal Centre's 2010 "*Pay Day Loans - Helping Hand or Quicksand*" report, which expressed particular concern for the 23.4% of its consumer research respondents who earned below $20,000 per annum, and acknowledges the concerns of Marston and Shevallar in their 2010 Pilot Study, "*The Experience of Using Fringe Lending in Queensland*", where they expressed concern for borrowers who were below "*usually accepted measures of poverty*". In comparison, this is $160 per week in excess of the Newstart allowance for a single person with no dependents and is $20 per week less than is paid, in NSW, under the Workers' Compensation Act 1987;
3. Those borrowers earning above the ATO-set minimum taxable income threshold, to be advantaged by a simple pricing structure of 48% daily reducible interest rate (calculated as proposed in the Bill), plus a competitive market determined and very transparent establishment/administration fee.

   The latter to be one fee only, repayable in equal amounts over the term of the loan, easily compared as between competing lenders and to be subject to all the "*unjust*" and "*unconscionable*" provisions currently available in the National Credit Code and the ASIC Act.

Such a model will encourage price competition, regulated by the concepts of fairness and conscionable for the non-*"desperate and vulnerable"* borrowers, already included in the National Consumer Credit Code and the ASIC Act, and will provide the essential compromise between idealism and reality.

Maximum percentage of disposable income criteria

The Delegation is aware of a number of lenders who, as part of their internal responsible lending controls, impose a maximum percentage to a consumer's disposable income that can be consumed repaying one of their company's loans.

Smiles Turner industry research results in 2006 and 2010 revealed between 51% and 56% of lender respondents favoured such a mandated standard. 83% of these indicated that they already had such a benchmark in place, as a self-imposed assessment and responsible lending criteria.

The Delegation recognises that, where some lenders impose such a benchmark and others do not, there can be a competitive advantages to the latter. Where one lender refuses, another without the benchmark may accept the loan application. Consumers who may borrow a smaller and more conservative amount from the lender with the benchmark are lured away by the lender who allows larger loans.

In an effort to explore this concept further and as a contribution to the consumer advocates' aims and objectives, 2 Delegation members raised the concept at a Treasury Industry and Consumer Consultation meeting earlier this year.

Consumer advocates attending the Treasury meeting unanimously condemned the approach. They expressed concerns that:

1. assessing such a benchmark could be arbitrary;
2. such a benchmark may suit one consumer but not another, e.g. a loan over a short period that extends a consumer may be acceptable for an emergency, but a loan of similar financial repayment demand that extends over a long period could not be tolerated;

© *Smiles Turner, November 2011*

3. it could lead to credit exclusion, based on the subjective assessment of the lender involving a 'one test fits all'.

As a result, the Delegation abandoned any consideration of this concept. That is why, following careful research and consideration of third party policy decision and application, the Delegation moved to adopting a minimum taxable income threshold as their suggested model, eliminating most of the consumer advocate objections regarding a maximum discretionary income threshold.

Drafting changes needed

To illustrate the relative simplicity of the changes necessary to the current Bill in order to achieve the introduction of the Delegation's proposal and the Minister and consumer advocates' primary objectives, there are only two basic amendments that need to be made after the inclusion, if any, of "*small amount credit contract*" in the existing Sections, as deemed necessary by Parliamentary Counsel, to direct their applicability.

The first - the addition of subsection 5(1)(g), on page 46 of the current Bill:

"*The debtor/s is/are a recipient of a tax free income no greater than the ATO tax threshold amount, as calculated at the time of entering the contract*".

The second - a section similar to Section 31A (say 31AA), on page 55 of the current Bill, being restrictions on fees and charges for non-small amount credit contracts:

"*(1) A non-small amount credit contract must not impose, or provide for fees and charges, if the fees or charges are not of the following kind:*

> *(a) A fee or charge (a permitted establishment/administration fee) that reflects the credit provider's reasonable costs of determining the application for credit, initial administrative costs and consequent administrative costs of providing the credit under the contract;*
>
> *(b) A fee or charge that is payable in the event of a default in payment under the contract;*
>
> *(c) A government fee, charge or duty payable in relation to the contract;*
>
> *(d) An annual interest rate".*

(2) The amount of a permitted annual interest rate shall not exceed 48%".

Delegation model left uncriticised by consumer advocates

It may be useful for the Committee to note that the Delegation's suggested model and modifications to the current Bill have not received any criticism from the consumer advocates. This notwithstanding:

- the Delegation's clear presentation of the modified model recommended, in the Delegation's submission to the Joint Committee on Corporations and Financial Services;
- leading consumer advocate representatives Ms Catriona Lowe, Co-Chief Executive Officer, Consumer Action Law Centre, and Ms Catherine Uhr, Senior Solicitor and Consumer Advocate, Consumer Protection Unit, Legal Aid Queensland, representing National Legal Aid (all 8 state and territory Legal Aid services) both attending as witnesses before the Joint Committee on 24 October 2011;
- the consumer advocates appearances coming after the Delegation's appearance before that Committee, allowing them to hear the Delegation's evidence as they sat in the public gallery while it was being given;
- their later appearances providing an opportunity to negatively comment on the Delegation's evidence and submission, both during their introductory speeches and as part of their responses to the many questions asked by the Committee;
- the Consumer Action Law Centre providing a supplementary submission to the Joint Committee on 28 October 2011, highly critical of another lender representative organisation's recommended model, without any criticism of the Delegation's suggestions. This despite the substantial attention the Joint Committee paid to the issues raised by the Delegation throughout its hearing day; and

© *Smiles Turner, November 2011*

- the Consumer Action Law Centre choosing to provide the same submission to the Senate Economics Committee, without amendment or addition.

The Delegation surmises that this is largely because the Delegation's model clearly recognises that there is a group of low income *"desperate and vulnerable"* people, who are currently borrowing from a variety of sources. Also, that these people should be protected by a regulatory regime that reduces their ability to take out currently available commercial higher interest loans, as the consumer advocates' demand, while providing the non-commercial sector with clear lending guidelines.

Such recognition supporting the fees and interest cap, lower cost loan regime and the low income borrower protective structure that the Minister has included in the current Bill. This to be provided by either or both those commercial lenders who are prepared to cross-subsidise these loans for business or charitable purposes, and the non-commercial sector's alternatives in which both the Minister and the consumer advocates have great faith.

The Delegation also surmises that the consumer advocates accept the current Bill has been structured to offer further protection for their *"desperate and vulnerable"* clients who take out payday loans, and that those people who are <u>not</u> *"desperate and vulnerable"* and who choose to take out commercial small amount, short term loans never constitute part of their client group and should not be included under the ambit of the Bill.

This is an appropriate recognition of the fact that the latter two elements of the total small amount, short term loan borrowing population are not seeking consumer advocate and associated organisation assistance because, for the great majority, their incomes and lifestyles allow them to manage their finances and make borrowing choices that do not lead to the circumstances of concern to the consumer advocates. It is only the group of low income earners who suffer harm that is of concern to the consumer advocates and who are within the parameters of the consumer advocates' professional experience.

Statistical evidence of 'harm' - who are we protecting?

In protecting the 10% of borrowers identified by CALC researchers as *"desperate and vulnerable"* (the Delegation identifies 20%), the current Bill harms the 90% who are <u>not</u> *"desperate and vulnerable"* (Delegation's 80%). The latter group simply do not need to be included. These are people capable of managing their own finances.

An analysis of the statistics provided by consumer advocates and their associates, in an effort to justify support for the current Bill, has not been a demanding task for the Delegation - there are so few statistics and most of those that are provided are not necessarily accurate. If the representations of the consumer advocates are to be accepted, there should be damming evidence of major harm affecting most borrowers.

There is not.

There is evidence that a small proportion of borrowers facing financial hardship have payday or microloans. In the "*case studies*" presented by the consumer advocates this year, approximately 50% allude to the kind of harm that is addressed by the current Bill. However, there is little evidence provided isolating payday or microloans as the only, or major, cause of the financial hardship.

For example, the RMIT University Interim Report considers respondents and their exposure to payday loans, but makes no attempt to identify the impact of the other debt generators beyond a fairly basic listing of the "*types of debt mentioned by respondents*" in its Table 2. The CALC Report, dated 2010, is also of little assistance, with no detailed segregation provided.

The Committee is left only with anecdotal evidence, claiming that some thousands of these people are facing financial hardship primarily because of their payday or microloans. This provides opportunity for exaggeration and advocacy - not measured and objective consideration of the problem.

As indicated above, accurate statistics from the consumer advocates are scarce - they are generally poorly collected and, even if taken at their worst interpretation, clearly demonstrate that the majority of borrowers - far in excess of 90% - are managing their payday and microloans without getting into long term difficulties.

Smiles Turner research identifies the difficulty in that most borrowers repay in accordance with the contract, only 3-4% turn into bad debts. It is from these bad debtors that the consumer

© *Smiles Turner, November 2011*

advocates' services attract most of their payday and micro-clients. None of the clients of consumer advisory services appear to be seeing them while continuing to pay off their loan.

That makes the current Bill inappropriate, with its major and draconian impact on the entire payday and microlending sector, legislation that will potentially deprive up to 750,000 people of the opportunity to borrow, a Bill that is specifically designed for people who get into financial trouble, a Bill designed to address the perceived needs of some part of the 3% identified by Smiles Turner that constitute less than 1.5% of all lenders.

3% alone would be 22,500 borrowers, but the consumer advocate statistics do not even come close to demonstrating that 22,500 borrowers approach financial counsellors each year with payday or microloan issues as the predominant reason for the appointment.

The Smiles Turner 2011 research indicated that 8.7% of respondents had, some time in the past, been to see a financial counsellor. Unfortunately, with such people continuing to borrow, the research did not explore whether or not this reflected financial counselling not working, or financial counsellors actually recommending that these people approach the lenders. If it is the former, it provides a problem for consumer advocates who present that financial counselling will be a major solution and alternative.

The Delegation has sought to assess the number of borrowers needing to seek assistance because of their payday or microloans, against the statistics of 750,000 individual borrowers and at least 1.5 million loans in 2010. The task has also been approached with a concern that the consumer advocates appear focused on payday loans, presenting their support for the current Bill without consideration of the fact that the current Bill also regulates microloans.

Later in this Submission we summarise the statistics offered by the consumer advocates which, in support of the current Bill, they have listed for the Committee's consideration as evidence of actual harm.

In doing so, the Delegation does not deny that there are *"desperate and vulnerable"* people who deserve further consumer protection. However, the Delegation is concerned to highlight the fact that, while the consumer advocates present their message implying most payday consumers are suffering significant harm, the numbers that the consumer advocates actually see, or research, do not justify such a broad claim.

RMIT University

"*The current debate about the impact of payday lending on the lives of many borrowers needs to be reframed from a market to a welfare issue*".

"*A 48% per cent cap, of course, will be unprofitable for a sector which deals with high risk lending practices...*".

(RMIT University Interim Report - "*Caught $hort... Exploring the role of small, short-term loans in the lives of Australians*", August/September 2011, page 4, under the subheading "*Findings*" and page 23 under the subheading "*Discussion*").

SECTION 3
A Detailed Analysis of the Current Bill

The following concerns are presented without reference to the Delegation's alternate model for interest rate and fee caps, discussed previously in this Submission and detailed in Section 4. The Delegation's suggestions for change are largely to improve the functionality of the regulatory regime being imposed, and/or to recognise the realities of the lending environment.

Changes on grounds of hardship - Section 72

"(1) If a debtor considers that he or she is or will be unable to meet his or her obligations under a credit contract, the debtor may give the credit provider notice (a hardship notice), orally or in writing, of the debtor's inability to meet the obligations."

The Delegation's concerns are:

1. The unnecessary multiplicity of notices being introduced by the new Section, plus the notice required under the continuing Section 73.
2. The new Section 72 requires the credit provider to issue two notices in the process included in this section and a third in the continuing Section 73. It is recommended that the Committee seek a way of avoiding the need for 3 notices, when 1 or 2 may fulfil the objectives of both Sections.
3. The Delegation is not convinced there is a formal need to communicate a willingness to negotiate. Either an oral or a written notice from the debtor, under Section 72(1), will generally be responded to immediately by the credit provider and having to pause to issue a notice, just to state that they intend to negotiate, is an unnecessary delay and an expensive inconvenience.
4. The Delegation is not convinced that a credit provider needs to give a notice to the debtor indicating that they are prepared to negotiate and, thereafter, give a second notice contradicting the first.
5. The Delegation is not convinced that it is necessary to have yet another separate notice detailing the changes agreed to following the negotiation, as is currently prescribed in the continuing Section 73.
6. The Delegation is concerned about the opportunity for confusion, whereby the new Section 72 provides for 21 days, but the old Section 73 provides for 30 days.
7. The new Section 72 requires:
   - A written or verbal notice of hardship from the debtor to the creditor. This is an understandable provision. Obviously the credit provider has got to be put on notice by the debtor.
   - Within 21 days - a notice from the credit provider to the debtor, to inform them the creditor agrees to negotiate. This is totally unnecessary and could be a cause for unnecessary delay. The former concern because, by implication or statement, the content can be merged with another notice.

     The delegation's view is that, if the credit provider is prepared to negotiate, the only notice that should be issued is the final notice outlining the agreement reached in the negotiation, as is required under the continuing Section 73, or a notice indicating that negotiations have broken down and the opportunities now available to the debtor are the same as those offered to a debtor when a credit provider refuses to negotiate.

     Both these notices should be issued within 21 days of the debtor's notice in regard to hardship.
   - In the alternative to the notice in (b) - a notice indicating that the credit provider is not prepared to negotiate. This notice should simply be available within the 21 days if it reflects the credit provider's decision, following receipt of the notice from the debtor. This notice containing the information as prescribed in the new Section 72(2)(b).

© *Smiles Turner, November 2011*

- The 30 days stipulated in continuing section 30, should be changed to 21 days to save confusion and guarantee a faster finalisation of the process for the debtor.

The Delegation Requests:

That the debtor provide written or verbal notice. Then, within 21 days, the credit provider gives notice as per the new Section 72(2)(b);

OR

the credit provider gives notice as per the old Section 73.

- The offence is one of strict liability. This, plus criminal penalties, would create most unfair circumstances where a procedural mistake was made, with a confirmation notice overlooked, yet negotiation successfully takes place and the mutual agreement that arose is implemented.

The Delegation Requests:

That this circumstance should attract only a lesser, relatively minor civil penalty, under the situation where agreement is reached and one of the negotiating parties reneges, or where the credit provider simply ignores the hardship application (provided there is more than the debtor's word that a verbal request has been made).

89A - Effect of hardship notices on enforcement

Section 89A - providing that, before or after issuing a default notice, if the consumer makes a hardship application or a request for negotiation of a postponement of enforcement proceedings, the credit provider cannot move immediately to, or continue, enforcement. This introduces inequitable disadvantages for the lender, particularly if this occurs by the hardship application being provided over 16 days after receiving the default.

The effect of the late hardship application notice is to automatically extend the 30 day period after the provision of a default notice to a debtor, before the credit provider can commence recovery action. Industry experience shows that the longer the credit provider has to take before they can commence recovery action, the less likely they will receive any of their money owing.

It is noted with concern that this possible extension of time occurs because the credit provider cannot start enforcement proceedings within 14 days after receiving this application or request.

Presumably the 14 days are to ensure consideration of the hardship application or postponement request. Obviously, the consumer could use this at the end of the default period to gain up to an extra 14 days. This will depend on just when, during the 30 days, the hardship application or postponement of enforcement request is considered.

The Delegation Requests:

That the debtor only be allowed to provide their hardship application, or postponement request, during the first 16 days after receiving their default notice from the credit provider. This then allows 14 days for the credit provider to consider the notice, prior to the expiration of the existing time before recovery action can commence and avoids unfair manipulation of the hardship and postponement procedures by the debtor.

There is also no recognition of the circumstances where a default notice has been issued and the parties have already agreed to a change in the contractual obligations, recognising hardship.

Then the consumer comes back for a second go, seeking a postponement by providing either a postponement or a hardship notice to the credit provider, claiming new grounds justifying the application.

This opportunity for cumulative exploitation by the dishonest consumer, supported by possibly unprincipled legal advisers, is of concern.

The Delegation Requests:

To accommodate the circumstance of a second hardship notice, after agreement following receipt of the first, a similar provision to Section 89A(1)(c)(ii) should be provided for that second circumstance.

© *Smiles Turner, November 2011*

Section 160B - Words Banned for Brokers - "Independent", "Impartial", or "Unbiased"

Although the Delegation believes this is probably reasonable, the provision focuses on Credit Assistance Providers (brokers) and gives no attention to the words used by unscrupulous credit providers who achieve an advertising advantage over their more principled and compliant competitors. The next provision addresses some part, but not all, of this concern.

In addition, the Delegation is concerned that unscrupulous lenders exploit emotive and highly suggestive words to the disadvantage of their more honourable competitors. These words were discussed following their inclusion in a November 2010 Treasury Discussion Paper, and the Delegation believes they should be considered by the Senate Committee.

The Delegation Requests:

(a) that these words be banned for credit providers as well;

(b) that, in addition, the following words be banned from use by both credit assistance providers and credit providers, as the majority of lenders indicated when responding to a Smiles Turner survey last year:

What terms do you think should be banned from credit advertisements?			
You are pre-qualified	18%	No application refused	20.5%
You are pre-approved *	37.6%	You will walk out with the money	18%
Any mention of pensioners	0.5%	Bad credit OK	7.3%
Cheapest, fastest	2.9%	No credit checks	27.8%
Cheaper than competitors	6.3%	Easy credit	1.05%
Interest free	2%	Bankrupts OK	0.5%
Defaults OK	0.5%	100% approval rate	0.5%

* Note: this phrase does not refer to preliminary approval.

Section 94(1)(2)(3) and (4) - Postponement requests

These new Sections and the content of the associated relevant Sections, introduce most of the same issues discussed above in regard to the new Section 72 and Section 89A.

The Delegation Requests:

That, for the same reasons discussed above in regard to Sections 72 and 89A, these Subsections and the continuing associated Subsections be amended in common.

Section 180A - Orders to remedy unfair or dishonest conduct by credit service providers

It is noted that there is wide ranging flexibility for the court to make orders against the person who provided a "*credit service*" and who is determined to have been unfair or dishonest.

The Delegation regards this provision as one of concern.

We note that this provision means any person in the provision of credit chain - the Referrer, Authorised Credit Representative, Credit Assistance Provider (broker), or Credit Provider can be the person who provides the "*conduct*" complained about.

The Delegation Requests:

The reference to a "*credit service*" in Section 180A(1)(a) be clarified to exclude a Referrer. The individual who may be a referrer should be specifically excluded, because that person does not have the responsibility to collect information. In fact they are prohibited from collecting such information under the National Consumer Credit Protection Act 2009 and associated Regulations.

© *Smiles Turner, November 2011*

The Delegation questions the reliability of establishing point (b)(i) - engaging in conduct that was connected with the provision of the service. However, point (c) appears to be a catch-all that makes point (b) superfluous.

The delegation is concerned with the inclusion of the line at the conclusion of Section 189A(3), "*This does not limit the matters to which the court may have regard*", given the very broad but descriptive inclusions in subsection (4). This imports an unnecessarily wide discretion, in that it introduces uncertainty into a Section which has very serious ramifications for any defendant. Such a level of seriousness deserves certainty as to the elements of a possible offence.

The Delegation Requests:

The removal of the line, "*This does not limit the matters to which a court may have regard*".

What the Courts will have to determine

The Delegation notes that, in determining whether or not the conduct is "*unfair*" or "*dishonest*", the courts can consider the following circumstances:

(a) Whether or not the consumer was at a "*special disadvantage*" in dealing with the credit provider.

Delegation Comment: There is no assistance, in regard to this terminology, in any of several recognised reputable sources of legal definition, including law dictionaries published by The Law Book Company of Australia, Collins, Oxford University Press and LexisNexis Butterworths.

(b) Whether or not the consumer was a "*member of a class, whose members were more likely than people who were not members of the class, to be at such a disadvantage*".

Delegation Comment: This presumes that the person engaged in the credit activity can clearly identify such "class" membership and that the Privacy Principles do not inhibit enquiry.

(c) "*The plaintiff was unable, or considered himself or herself unable to make... a credit contract with a credit provider other than the credit provider to which the conduct related...*".

Delegation Comment: "*Considered himself or herself unable to*" introduces major subjectivity and power for the plaintiff to allege, in circumstances where such a consideration is unlikely to emerge for exploration during the application and establishing suitability/unsuitability process.

(d) "*the conduct involved a technique that... should not have in good conscience have been used; or... manipulated the plaintiff".*

Delegation Comment: Techniques that manipulate are the common skill of every sales person and credit is a product that is for sale. This provides the challenge of determining when an action constitutes an acceptable action associated with selling, and when it assumes a manifestation appropriate for consideration in this context? Again, the above listed comprehensive legal dictionaries do not provide any assistance with the concept of "*good conscience*".

(e) The credit provider "*could determine or significantly influence the terms of the contract...".*

Delegation Comment: Every credit provider offering a standard contract is caught in this net, as is every credit provider who has a consumer who is not particularly assertive, or could not be bothered negotiating.

(f) "*the terms of the transaction ...were less favourable to the consumer than the terms of a comparable transaction*".

Delegation Comment: What constitutes a "*comparable transaction*"? Given many stakeholders identifying themselves as concerned for the consumer, are concerned about levels of competition, why should credit providers be constrained to having to adopt identical business models, just to give them a defence to any allegation associated with, or utilising, this subclause?

© *Smiles Turner, November 2011*

Further, this provision does not make it clear whether the "*comparable transaction*" must be one that the particular consumer could have entered into if they had known about its availability.

The Delegation is particularly concerned with the practical application associated with the above six provisions. There is substantial opportunity to introduce an adverse arbitrary decision that is both manifestly unfair to credit providers, and exploits consumer dishonesty against the credit provider.

Subsection (4) provides an absolute field day for the Legal Aid and Consumer Credit Legal Centres to blackmail credit providers into giving them what they want for their clients, in order to avoid legal and court costs greater than the outstanding debt.

For practical purposes, there must be an opportunity to include some provision in regard to this issue, providing greater certainty for credit providers in regard to credit contracts. The Delegation asks that there be some curtailment of the breadth of advantage implied in the current provisions. The current Bill's provisions encourage the dishonest consumer, and their often unprincipled legal advisers, to be unethical in their allegations against the lender.

In addition, the Delegation is also troubled with the concept of "*class*", which implies separation from the majority and opens opportunities for highly subjective assessment, including adverse characterisation of the individual.

The Delegation Requests:

That this area be considered one of the rare occasions when attempting to be prescriptive and detailed raises serious concerns, rather than constructively and equitably assisting justice. As a consequence, that Subclauses (3) and (4) be removed.

What this will mean in practice

Given the taxpayer funded consumer advocates have nothing to lose, the legislative provisions effectively reverse the standard of proof, with the allegation against the credit provider having to be disproved by the credit provider.

The consumer only has to assert that they now think the conduct was unfair (let alone dishonest), that one or more of the four criteria existed and applied, and that one or more significantly affected the consumer.

The Delegation believes further consideration of the following would be beneficial:

1. The opportunity for the court to declare void the offending part of the contract that emerges from the dishonesty or unfairness. The current range of court order options do not specifically include this and this may be a far more equitable solution than those currently contemplated. It is also consistent with other provisions in the National Credit Code.
2. We are not convinced that there has been adequate recognition of the possibility that, although there may have been unfair or dishonest conduct, in fact the contract entered into may not have been disadvantageous to the consumer.
3. There is no consideration of the consumer's potential or actual awareness of the unfairness or dishonesty at the time the conduct was occurring, and that the consumer had the opportunity to mitigate their disadvantage at that time and subsequently.

SCHEDULE 3 - Small Amount Credit Contracts

Sections 124A and 133CA - website content requirements

The Delegation is pleased to note the response to its previous submission to Treasury suggesting this website content, providing information as to alternative sources of credit and assistance for consumers in regard to credit. This statement to be provided by Government, to ensure content is as the Minister approves.

The Delegation is concerned to note that the provision is simply expressed as "*the licensee must ensure that the website complies with the requirements prescribed by the regulations*".

The content of this statement is now expected to be completely provided by the Government. However, it should include copy, print size and layout. Without such, clarity of Government requirement and dependence on lender/broker research for inclusions, will be a challenge.

© *Smiles Turner, November 2011*

The Delegation Requests:

That the Regulations should include copy, print size and layout detail, or preferably a template.

We regard the penalties of adverse conduct of "*$5,500*", in regard to providing access to website inclusion, as a fairly tough incentive. The provision of prescribing the offence as criminal is extremely excessive. Further, the civil penalty of "*$220,000*", presumably to be levied against a company for not complying, is simply draconian and unjust.

The Delegation Requests:

That the current Bill be amended in regard to these penalties to reflect a fairer, more equitable measure of penalty as, given the nature of the offence/s involved, the current penalties are inequitable.

The identification of a website as being the applicable place to post the proposed statement and as being one where a consumer can "*make an enquiry about*" (a loan), is of considerable concern to the Delegation. When does someone browsing become an enquiry? Is the mere logging on to a website the making of an enquiry? Does there have to be some consumer/viewer action beyond clicking on to the home page?

The Delegation Requests:

Some attempt at a definition of "*make an enquiry*" be included in the Bill that reflects contemporary standards of "browsing", as opposed to "*deliberate and conscious enquiry indicating a manifest interest in doing business as opposed to curiosity*".

The Delegation notes that "*It is intended that the disclosures will be generic and prescribed... and will have the same content for all licensees*".

That poses a problem. As the provision is applicable to licensees all over Australia, there will need to be generic and functional contact opportunities established, such as 1800 numbers. Further, it will be unwise to assume that all potential consumers will be internet connected and savvy.

As Smiles Turner consumer research conducted in 2006, 2007, 2010 and 2011 has consistently demonstrated, consumers are locality and convenience driven. Out of area contact details will have limited impact.

The Delegation asserts that this is a matter for clarification or definition in the Bill.

Sections 124B and 133CB - prohibition where another small loan exists

As the Committee would appreciate, under this provision it is an offence both to suggest/offer or to assist the consumer to apply/enter into the forbidden contract.

There are two issues of immediate concern to the delegation:

1. the loan does not need to actually happen; and
2. suggestion is enough.

Individually and together, these concepts provide great opportunity for the consumer and their legal advisers to allege an offence, in circumstances where the existence of either is hard to both prove and/or disprove. Given the behaviour of certain consumer legal advisers, who use accusation and allegation as a weapon to effectively blackmail the credit provider into refraining from seeking repayments from their clients - as a trade-off for avoiding legal costs incurred defending themselves against a debtor who has no legal costs to pay - it would be more equitable if the provisions were removed from the Bill

In addition the prescribed penalties, both of 2,000 penalty points, make the continued inclusion of the "*attempted offences*" an absolute magnet for the blackmailing activities outlined above, as they significantly enhance the potency of a conviction in circumstances where the alleged possible consumer has easy opportunity to claim an event or series of events - no matter how fictitious.

The Delegation Requests:

(a) That Section 124B(1) be amended to specify that the prescribed offence requires the element of the credit contract actually having been entered into.

© *Smiles Turner, November 2011*

(b) That Section 133CB(1) be amended by the removal of the words "*or offer to enter into*".

The Delegation welcomes the inclusion of the requirement for a "*reasonable belief*", which has been added following recommendations made in response to the Draft Bill.

The Delegation has since taken legal advice, which has determined that "*reckless*" or "*recklessness*" is a form of mens rea that amounts to less than intention, but more than negligence. Such occurring when the offender is aware of the risk of a particular consequence arising from their actions, but nonetheless decides to continue with that action and take the risk, where it is unreasonable to do so [*R v G* (2004) 1 AC 1034].

Australian courts have also considered recklessness as heedless or careless conduct, where the offender can foresee some probable or possible harmful conduct but, nevertheless, decides to continue with those actions with an indifference to, or a disregard of, the consequences [*R v Nuri* (1990) VR 641]. The High Court has determined that recklessness is something less than intent, but more than mere negligence, as was discussed at the Consultation Group meeting [*R v Crabb* (1985) 156 CLR 464].

The concept of "*reasonable belief*" may imply a similar duty to that of making "*reasonable enquiries*" under Section 117 and similar provisions of the National Consumer Credit Protection Act 2009. This imports the concept of reasonableness being in accordance with community standards [*Bankstown Foundry Pty Ltd v Braistina* (1986) 160 CLR 301] and where the lender could fairly anticipate something as possible [*Minister administering the Environmental Planning and Assessment Act v San Sebastian Pt Ltd* (1983) 2 NSW R 268].

There may be uncertainty as to whether the above provides a universally accepted definition or explanation.

The Delegation Requests:

That the Senate Committee consider the opportunity of including the above explanation in any report to the Parliament, in order to test whether or not the Minister had such explanation or definition in mind when accepting the Parliamentary Draftspersons' inclusion of the words "*reasonable belief*". Statutory interpretation in the future may well be advanced if there is an opportunity for litigating parties to refer to Parliamentary comment for guidance.

The Delegation is aware of a view that the provision concerning "*reasonable belief*" introduces an evidentiary nightmare. Arguably, provided a credit provider does not know, and has not been reckless, then another loan is legal under this provision. However, a number of questions then arise:

(a) if the lender does not find out about the other loan, when does this conflict with the "*reasonable enquiries*" associated with the assessment process?

(b) What happens if the consumer lies?

(c) What happens if the lender discovers the first loan <u>after</u> the lender and consumer have entered into the second loan contract?

(d) Does the provision actually create two offences - "*recklessness*" and "*lack of reasonable belief*"?

The Delegation regards it as a possibility that a lender could commit both this offence and an offence under the NCCP Act, on the grounds of advancing a loan which was "*not suitable*" as a result of the same actions, and face two fines of $220,000. We do not believe such an opportunity is equitable and an aggregated fine may well be disproportional to the offence/s.

The Delegation Requests:

That the possibility of facing prosecution for dual offences arising from the one set of circumstances be explored in this context, and clarification be included in the Bill that prosecution would take place for one only offence, or that the combined penalty would not exceed 2,000 penalty points.

The Delegation requests that the Committee seek clarification and the avoidance of double jeopardy in this regard.

© *Smiles Turner, November 2011*

Sections 124C and 133CD - no increase in credit limits

This provision introduces a Government policy clash. The Government policy associated with the responsible lending provisions in the NCCP Act demands that the lender assess the suitability of the consumer for a loan every 90 days, or at a shorter interval if a loan larger than the one associated with the initial successful 90 day assessment is being applied for. The Delegation asks, what is the difference with a consumer applying for an increase in their credit limit, with a 90 day assessment being undertaken at the time of this particular application?

The issue is whether or not the loan is "*not suitable*", not how the consumer came to apply for extra finance.

The Delegation Requests:

That Sections 124C and 133CD be removed, because the Government policy objectives encouraging their inclusion have already been satisfied.

Section 133CC - Rollover and refinancing avoidance

It is noted that this Section applies to both rollovers and re-financing, notwithstanding its failure to use the industry acknowledged term "rollover".

Again, the provision inherently contradicts an existing Government policy associated with responsible lending (NCCP Act). It must be remembered that the consumer has already been rigorously assessed as to suitability for a loan of a certain size.

If the application for the rollover or refinancing is made during the 90 days after the loan was advanced, and involves the consumer in an indebtedness that is no greater than that approved at the commencement of the loan, or there is an opportunity to undertake a fresh and successful 90 day assessment as to suitability, why should the parties be prohibited from re-establishing the level of debt at no more than the original loan, or higher if approved?

There is no issue of debt traps if the borrower has been appropriately assessed under the provisions of the NCCP Act.

This Section is a clear indication of the dominance of consumer advocates' influence, with their passion for change based on poor, or non-existent research and a complete failure to recognise that their thinking was moulded prior to the Commonwealth takeover on the 1st July 2010.

The provision not only introduces a prohibition on the lender rolling over, or refinancing, existing loans advanced by that lender prior to the rollover or refinancing application, but makes it an offence to offer the same services when the prior loan was entered into with another lender. The Delegation has major concerns with regard to the creation of the current credit provider's responsibility for the previous activities of a third party lender and the consumer.

It is noted that, arguably, the provision has been drafted as an impossible absolute, with no element of mens rea and/or knowledge and/or recklessness recognised. The Delegation would argue that this is unrealistic.

This section also prohibits the borrower refinancing in order to consolidate their indebtedness, which is a method of managing finances often suggested and/or facilitated by financial counsellors. It is noted that banning debt consolidation provides a significant issue for 12% of the consumer respondents who wanted such, listed in the August 2011 RMIT University report "*Caught $hort - Exploring the Role of Small Short Term Loans in the Lives of Australians*".

Further considerations

The Delegation offers the following comments for the Committee's consideration:

1. No company has a business model where they deliberately lend knowing they are not going to be repaid.
2. There has been no substantial research showing that rollovers have been a problem since 1 July 2010. To justify their concerns, for the most part the consumer advocates continue to use a small number of pre-1 July consumer stories.

© *Smiles Turner, November 2011*

3. This overrides responsible lending and fails to recognise changes in circumstances. It also fails to recognise that every consumer's circumstances are different and that a number of consumers will simply use multiple lenders.
4. The rationale for adopting a prohibition of rollovers cannot include a premise that a rollover is evidence that a consumer cannot afford their existing loan. Rollovers frequently emerge because the consumer, having already repaid most of the original principal, is faced with a spending opportunity that requires money now - not borrowing sometime later after an existing loan has been completely repaid. There is also the issue of debt consolidation, where it makes economic sense for a series of debts to be amalgamated.
5. As indicated above, prohibition of rollovers also introduces the possibility of encouraging consumers to borrow more than they actually need, at a particular time, in case a later circumstance occurs. Such would encourage irresponsible borrowing behaviour. In addition, a refusal to accept a rollover application may simply encourage that consumer to go to a competitor. In such circumstances, there is an enhanced chance that the consumer will default on the first loan.
6. The introduction of rollover regulation of any kind implies that the Government's responsible lending and assessment policies have already proven inadequate. It is far too early to imply such.

There are consumers in the marketplace who embrace the concept of a rollover as part of their financial management strategy. To that end, it may be useful to note that 30.7% of the consumers participating in the Consumer Snapshot 2010 study, had sought a rollover in that year.

The Delegation Requests

That Section 133CC be removed from the Bill.

SCHEDULE FOUR - Caps on Costs

Section 31A(1) - Permitted establishment fee of 10%

This is similar to the Victorian provision concerning fees and charges, in that it demands that the fee be calculated with reference to "*reasonable costs of determining the application*".

This provision means that there can be no legal possibility of cross-subsidisation towards income, in addition to the 2% monthly fee, as discussed later in this submission.

We note the concept of "*reasonableness*" is not imposed on calculating the second component of the "*permitted establishment fee*" - the "*initial administrative costs of providing the credit*".

With the fee not changing, except in accordance with the size of the loan, if the microlending sector could survive, "*the permitted establishment fee*" would encourage larger amount and shorter term loans. For example -

1. a one month loan of $200 would attract fees of $24, a one week loan of $200 would attract fees of $24 (the same amount);
2. two $250 loans, for 4 months, would attract $90 in total, a $500 loan for 2 months and another $500 loan for 2 months, would attract $140;
3. a six month $1,000 loan would attract a gross fee of $220. Six one month loans of $1,000 would attract a gross fee of $720.

The Delegation is intrigued at the justification for this 10% being offered in the media and the Parliament by the Minister, and also by others in the media. They are ignoring the detail of the current Bill that demands that it be "*reasonable"* and reflect actual costs. All are assuming that it is 10%, regardless. That is an indication of the flawed construction that haunts the current Bill.

As the Delegation has repeatedly presented during the consultation process, the reality is that most of the lenders' "*reasonable costs of determining the application*" and "*the initial administrative costs*" are fairly common. This regardless of the size or length of the loan.

The demanding application and assessment process to determine "*unsuitability*" (read 'suitability'), the 7 year record keeping requirement that must be provided for in the initial administration of the loan, the highly encouraged credit reference agency checks, and the ever

© *Smiles Turner, November 2011*

increasing Austrac "know your customer" regulatory requirements, all impose costs associated with staff time, documentation, compliance standards and external party payments that are very similar, regardless of whether the loan applied for is $300, $3,000, $30,000, or $3 million, or is for 2 weeks, 2 months, 2 years or 20 years.

There is no incentive to reduce prices for consumers, given the manner in which the economically unrealistic 10%, one-off fee, was proposed.

1. The wording outlining the structure of the 10% "*permitted establishment fee*" states that it is only for reasonable application costs, plus initial administrative costs. This means that, if those costs are less than 10%, then the lesser amount should be charged.
2. As indicated above, the current Bill thereby does not provide any opportunity for contribution, from the 10% amount, to costs other than those specified, or for profit, i.e. no cross-subsidisation is recognised.
3. While the current Bill implies an optimistic view that consumers would be charged less if "*reasonable*" costs in this area did not come to 10%, the Bill thereby does not provide any incentive for the lender to seek to cut costs in the area of assessment and initial administration.

Covering costs

A very detailed analysis of lender costs is included later in this Submission. The brief consideration below is to assist the Committee's analysis of the current Bill's provisions, in a commercial context.

The following chart indicates the battle lenders will have to cover costs, if the current Bill becomes law unchanged. It cannot be emphasised enough that a model embracing a 10%, 2% fee regime simply cannot work, financially, for <u>any lender</u>.

Amount	Term	Maximum gross income unsecured, establishment fee plus per month %
$100	1, 2, 3 or 4 weeks	$10 plus $2 = $12
$200	1, 2, 3 or 4 weeks	$20 plus $4 = $24
$200	5, 6, 7 or 8 weeks	$20 plus $8 = $28
$270	1, 2, 3 or 4 weeks	$27 plus $5.40 = $32.40
$325	1, 2, 3 or 4 weeks	$32.50 plus $6.50 = $39
$325	5, 6, 7 or 8 weeks	$32.50 plus $6.50 = $45.50
$500	1, 2, 3 or 4 weeks	$50 plus $10 = $60
$500	5, 6, 7 or 8 weeks	$50 plus $20 = $70
$1,000	12 weeks	$100 plus $60 = $160
$1,000	24 weeks	$100 plus $120 = $220
$1,500	12 weeks	$150 plus $90 = $240
$1,500	24 weeks	$150 plus $180 = $330
$1,500	36 weeks	$150 plus $270 = $420
$2,000	12 weeks	$200 plus $120 = $320
$2,000	24 weeks	$200 plus $240 = $440
$2,000	36 weeks	$200 plus $360 = $560
$2,000	52 weeks	$200 plus $480 = $680

Notwithstanding issues of terminology considered above, the maximum amount of 10% also indicates that this is the amount the Minister wrongly assesses as the maximum necessary to cover the costs of assessment and initial administration for small amount, short term credit provisions [Section 31A(1)(a)], including:

(a) credit checks with outside suppliers;

(b) contribution to legal and compliance professional advice costs;

(c) payment of software service providers to create the file;

(d) contribution to insurance and superannuation costs;

(e) cost of staff time to process applications and establish the loan file;

(f) the cost of all the contract and associated compliance documentation development and printing and the like.

The 10% is more easily supported for the larger loans, that attract larger dollar fee amounts. Smiles Turner industry research in November 2010 and April/May 2011, revealed that the assessment requirements incurred at least 45 to 90 minutes of staff time, being paid an average of $18.50 per hour (junior) to $23 per hour (relatively senior) to $35 per hour (senior). Allowance must be made for even a minor contribution to on-costs often involving a credit check, which Smiles Turner September 2011 industry research indicated averaged $7, and the establishment of the loan attracting compliance costs averaging $11 per contract for payday lenders, and a range of greater amounts for microlenders up to $160 per loan.

That means any contract that does not create an opportunity to attract a permitted establishment fee of at least $31.50 to $35 (with no allowance for general business overheads and advertising), will not be advanced. With just the above costs considered, the impact of this provision if the Bill is left unchanged means that at least all loans under $300 and generally under $500 (particularly if a senior staff member is involved and there is any inclusion of the Responsible Manager's time, in their role as supervisor) will be effectively abolished because of the above costs alone (Smiles Turner industry research April/May and September 2011).

Note: The fees and charges referred to are those "*under the contract*", which are "*permitted credit fees and charges*".

The Commonwealth's National Consumer Credit Protection Act 2009 and associated Regulations 2010 and 2011, do not allow any differentiation in the processes demanded of lenders. Only ASIC, in its Regulatory Guidelines, concedes the possibility of less rigorous assessment for smaller loans and smaller lenders. However, ASIC does not give any concession on the fundamental processes, or the amount of contract and associated documentation involved.

While taking the loan length out of the calculation in the current Bill is realistic - to publicly assume or imply that these costs vary, as a percentage of the amount of the loan, demonstrates one or more of the following:

(a) a fundamental lack of business knowledge and general business costs;

(b) a fundamental lack of knowledge of the lending process that the Commonwealth has already imposed on the microlending sector;

(c) an attempt to provide some income for lenders under an inappropriate and inaccurate heading;

(d) an underhand attempt to gain acceptance from the microlending sector, while fooling the general public;

(e) a deliberate attempt to deceive the consumer advocates with the detail, knowing their poor numeracy levels; and/or

(f) a deliberate attempt to deceive the borrowers across Australia.

The Delegation Requests:

That the terminology "*being a fee contributing to the payment for determining the application and undertaking administration of the loan*" be substituted for the terminology "*reasonable costs of determining the application*" and "*the initial administrative costs*".

Section 31A(3) - 2% "permitted monthly fee"

The Delegation is aware that enquiries made of the Minister's office, and comment by senior Treasury officials at the Consultation Group meeting on 26th August 2011, together with the

© *Smiles Turner, November 2011*

Delegation's independent research since, have revealed that this concept, together with the 10% considered above, is not known to exist in any other jurisdiction around the world.

The nearest is the regime in South Africa, with its complex mix of maximum amounts and years and permitted fees being based, in part, on a multiple of the official bank rate. This south African model is nothing like the Australian model being suggested.

It was indicated to the Delegation, by the Minister's office, that caps currently applying in US jurisdictions were considered and that Canadian and European models were not. The Delegation has undertaken extensive research into these US provisions and the results of such impositions.

The Delegation has not been able to identify any support from the US for the current Australian proposals, nor from Canadian, European or UK jurisdictions. Only one US state has a tiered model, cost structures are vastly different and there are continuing independent reports of failure and unintended consequences, including significant increases in bounced cheques, bankruptcies and contracting with interstate and international (out of jurisdiction) lenders.

The Delegation notes that, given the small income that can be earned under the current Bill provisions, it would be expected that these amounts would, at least in part, be incorporated in most contracts as the early payout fee.

Implementation difficulties

The Delegation notes that the 2% "*is payable on a monthly basis starting on the day the contract is entered into*". That means it is payable in advance. A literal reading of this provision would indicate that the 2% must be paid all in one sum, on that first day of each month of the loan. The lenders' contracts will have to reflect this, with no apportionment over the 2 or more repayments contracted for each month.

This will provide major challenges for loan management software design and implementation. In addition, the amount of extra entries in the contract documentation, to explain a different amount of payment for one only repayment each month, offers a further field of confusion for the consumer.

The Delegation concludes this comment on the 10%, 2% model with this observation - as reported in the Sydney Morning Herald on 24th May 2011 by Chris Zappone, under the headline "*Retailers' Mark ups Under Threat from Online*" - the Australian Bureau of Statistics reports average product mark ups to be anywhere from a low of 40% to a high of 142%. The average mark up applied to all goods, wholesale or retail, was 65% (flat).

The mark up on an average $325 payday loan for 4 weeks, under the current Bill, is $40.50 or 12.46%. On a $500 loan for 3 months it is $80 or 16%. On a $2,000 loan for 12 months it is $680 or 34%. On a rarely lent $2,000 loan for 24 months, the maximum permissible under the current Bill as a small amount loan, is $1,160 and 58%.

A major contrast between the payday model and the retail model to which the Sydney Morning Herald was referring is that the retailer gets their money, in one lump and with certainty when they hand the purchased good over. The money lender hands over their money and then gets paid periodically, in relatively small amounts, over extended periods and there is no certainty that they will receive their money back.

There has been no comment from the consumer advocates about these comparative figures.

Distortions of the current Bill

The Delegation is aware that Treasury attempted to carefully select the 10%, 2%, to minimise distortions in the interface between the small amount credit contract and those coming under the 48% inclusive cap (motivation - mathematics, rather than business reality).

The ideal is to have one price point, where it is obviously appropriate for the lender to move from one cap to another. Given the current Bill's inclusion of the $2,000, 2 year criteria, Treasury would hope that intersection between amount and time would assist. Unfortunately, this attempt was not successful, as the contents of the chart at Appendix 2, kindly facilitated by Min-It Software, has revealed.

© *Smiles Turner, November 2011*

Section 32A - The 48% inclusive cap

The Delegation has always recognised that the political challenges associated with the Commonwealth Government completely abandoning the 48% cap concept would require a Ministerial, Parliamentary and now Committee preparedness to stand up to the nonsense generally pedalled by the consumer advocates.

In addition, the Ministerial, Parliamentary and Committee preparedness requires ignoring those who argue that, just because NSW, Queensland, Victoria and the ACT have a cap, however unwise and unsuccessful, then the Commonwealth must have one. This despite Victoria attempting to recognise commercial reality and Tasmania, South Australia, Western Australia and the Northern Territory never adopting a cap, although the first three jurisdictions have considered it.

The following chart indicates the battle lenders will have to cover costs under the current Bill's 48% provisions. Again, substantial detail is provided in regard to costs and why the relatively small amounts listed in the third column ensure insolvency for almost all lenders who attempt to operate under the 48% cap, following its intended commencement on 1 January 2013.

Amount	Term	Maximum gross income secured (48%)
$100	1, 2, 3 or 4 weeks	4 weeks = $2.26
$200	1, 2, 3 or 4 weeks	4 weeks = $4.54
$200	5, 6, 7 or 8 weeks	8 weeks = $15.72
$270	1, 2, 3 or 4 weeks	4 weeks = $6.13
$325	1, 2, 3 or 4 weeks	4 weeks = $7.38
$325	5, 6, 7 or 8 weeks	8 weeks = $13.35
$500	1, 2, 3 or 4 weeks	4 weeks = $11.35
$500	5, 6, 7 or 8 weeks	8 weeks = $20.55
$1,000	12 weeks	12 weeks = $59.79
$1,000	24 weeks	24 weeks = $117.06
$1,500	12 weeks	12 weeks = $89.69
$1,500	24 weeks	24 weeks = $175.61
$1,500	36 weeks	36 weeks = $264.48
$2,000	12 weeks	12 weeks = $119.56
$2,000	24 weeks	24 weeks = $234.13
$2,000	36 weeks	36 weeks = $352.62
$2,000	52 weeks	52 weeks = $516.51

The choice of the NSW model (48% inclusive of all fees and charges)

The Delegation notes that the current Bill has attempted to embrace the most rigorous cap of all - that applying in NSW. This despite the fact that the NSW Minister, who reintroduced the NSW legislation earlier this year, subsequently told ABC Radio listeners that he thought lenders earned 7 or 8 times what they actually do, under the NSW cap. The answer to the question as to how much the lenders earned on $100 lent for 1 week at 48%, should have been "a maximum of 92 cents". The answer he gave was "$7 to $8".

It is important for the Committee to understand that the cap in NSW was progressively introduced under the political tenure of several Ministers of Fair Trading, only one of whom ever met with an industry delegation and, then, only after his legislation had passed through the Legislative Assembly.

© *Smiles Turner, November 2011*

NSW can also boast ministerial Chiefs of Staff who thought 48% meant $48 income, per $100 lent, per month and a ministerial Policy Adviser who admitted, a week after her Minister's legislation had been passed by the Parliament, that she had not read any industry submission.

In addition, for many years the NSW Office of Fair Trading had a senior policy adviser who was committed to anti-business measures, never visited a lender, nor endorsed a research program, before embarking on encouraging new anti-small amount, short term sector legislation.

Again we have another government proposal to introduce a 48% cap that has never been researched by its consumer advocate supporters and was simply the result of an anti-Semitic UK parliamentarian assessing that 50% was usury, as he sat in the backbench of the House of Commons in 1927. However, as mentioned previously in this Submission, he advocated a flat rate 48%, not a nominal daily reducing rate 48%.

It may be useful for the Committee to note the following jurisdictions that have rejected the imposition of a cap, all following extensive research, debate and consideration, over the last 20 years:

- The UK, where it was abolished in 1974, with the decision re-endorsed a further three times following substantial reviews, including in 2006.
- Victoria introduced a cap in 1941, but has consistently refused to include fees and charges ever since.
- Victoria also removed a 48% cap on pawn broking in 1996, following a campaign involving the Victorian Police and welfare groups, including the Salvation Army, who were concerned about the emergence of illegal pawn broking and associated corruption.
- Taiwan rejected a cap in 2006.
- In 2007, New Zealand rejected a cap following substantial investigation.
- South Africa rejected an inclusive 48% cap in 2005 and now has a tiered cap which cannot be compared to the NSW model that the current Bill endorses.
- In Australia, on at least two occasions over the last decade, the current NSW all-inclusive cap has been considered, but has not been introduced, by every other State and Territory jurisdiction, with the exception of the ACT.
- Korea rejected a cap in 2009 after a major review; and
- Ireland has also rejected a cap.

In addition, the Delegation recommends consideration of the following major national and international studies which, over the last decade, have recommend against an interest rate cap, particularly one involving an all-inclusive 48%.

Philippines	Asian Development Bank 2006-7
UK	The UK Department of Trade and Industry, 2004-2006
UK	UK Competition Commission, April 2006
UK	UK Department of Industrial Relations, 2008
Washington DC	Consultative Group to Support the Poor (CGAP) 2007
New York	Federal Reserve Bank of New York Staff Report No. 309, Donald P. Morgan and Michael R. Strain, November 2007 (Revised February 2008)
New Zealand	NZ Ministry of Consumer Affairs, August 2007
Victoria	MISC Australia Consumer Credit Report, 2006, for the Victorian Department of Justice, Consumer Affairs
Queensland Office of Fair Trading Inquiry	Pay Day Lending in South East Queensland - A Report to the Minister of Fair Trading, Queensland, 1999-2000
Queensland	Queensland University of Technology Report, March 2011
South Australia	Parliamentary Economics and Finance Committee Report, 2007

© *Smiles Turner, November 2011*

In this context, the Committee may be interested in the following:

- "*A cap ignores the industry realities of different lenders being subject to a wide range of costs and income variables, including size and rental of business premises, total capital invested, volume of business transacted and the relative viability of various business locations*."
- "*Review of the Regulation of Pawnbrokers in Victoria*", May 2001, page 11.
- Pilot Partners, Chartered Accountants' 2007 audit of 3 branches of a major lending company, with diverse demographics, when referring to a 48% cap stated, "*Our review indicates that at all levels of the industry the (proposed) change in legislation will result in the loan providers incurring substantial losses from running their current book of debtors*".
- 48% including absolutely all interest, fees and charges (and therefore a loss generator) is contrary to the statement by Ms Karen Cox, Consumer Credit Law Centre, who said at a "Round Table" in Melbourne on 1st April 2008, that the consumer advocates "*were happy to allow lenders to make a profit*".
- The Abstract at the start of the Federal Reserve Bank of New York Staff Report, no. 309, written by Donald P. Morgan and Michael R. Strain in November 2007 and revised in February 2008, stated, "*Payday loans are widely condemned as a "predatory debt trap." We test that claim by researching how households in Georgia and North Carolina have fared since those states banned payday loans in May 2004 and December 2005. Compared with households in states where payday lending is permitted, households in Georgia have bounced more checks, complained more to the Federal Trade Commission about lenders and debt collectors, and filed for Chapter 7 bankruptcy protection at a higher rate. North Carolina households have fared about the same. This negative correlation - reduced payday credit supply, increased credit problems - contradicts the debt trap critiques of payday lending, but is consistent with the hypothesis that payday credit is preferable to substitutes such as the bounced-check "protection" sold by credit unions and banks or loans from pawnshops".*
- From the UK Office of Fair Trading, "Review of High Cost Credit", Final Report 2010, page 10, "*There are a number of different high cost credit products available at different prices with different costs based on the product characteristics and target consumers. Imposing price controls would be difficult in these markets, as detailed investigations of the pricing and profits of suppliers would be needed at a product-by-product level*".

The Delegation notes that, despite providing Treasury with some of this information, it was obviously totally rejected and there has been no Government investigation implemented.

Unfortunately, most of the larger loans between $3,000 and $5,000 will also be effectively abolished, when you add all the general business and specific lending costs not included in the above. These costs are analysed in depth later in this Submission.

Section 32B - Calculation of annual cost rate

The Delegation is aware that the methodology used by NSW has been adopted. A number of attempts have been made by the Delegation to question the nature and application of such a formula, because it is <u>fundamentally flawed</u>.

This is provided for in Section 32B(1) and (2) and is calculated "*as a nominal rate per annum, together with the compounding frequency, using the* (provided) *formula...*".

This is the very flawed formula that Haydn Cooper, from Min-It Software, has attempted to draw to Treasury and the states' attention over the last 20 months. It is the formula championed by NSW in Section 7 of that State's Credit (Commonwealth Powers) Act 2010. The ACT, Queensland and Victoria all have identical formulae in their Commonwealth Powers' legislation. Further:

- The "*credit cost amount*" for the 48% loans includes most of the characteristics one or other of the States have included.
- The Bill also refers to an "*annual cost rate*", which is the amount calculated by this section (Section 20).

However, at the Consultation Group meeting on 26th August, a senior Treasury official indicated that the Delegation's concerns had been considered by Treasury experts and, while

© *Smiles Turner, November 2011*

there may be some issues, it was a formula the industry was familiar with and, consequently, it was being adopted.

Notwithstanding the fundamental adoption, the Delegation notes one difference between the NSW and the Commonwealth formulae - the Commonwealth formula imports uncertainty by providing an opportunity to recognise Section 32B(3)(c), which allows for amounts to be included in the cost amount, prescribed by regulation.

After 11 years of State and Territory regulatory uncertainty, it is unfortunate that there are elements of the Commonwealth regime which continue to provided such.

Inherent challenges

The employment of this formula may provide the following problems:

(a) R1 implies repayments of equal value. If that is the case, it must be remembered that there are frequent occasions when the last payment under a contract is different to the preceding repayments.

(b) J, in providing for circumstances where the contract does not have a constant repayment interval by allowing the credit provider to select an interval, runs the risk of generating a value outside the prescribed tolerance amount in Section 32B(5).

We note the possibility of "*distortion*" is acknowledged in the "*Commentary - Caps on Credit Contracts*" paper, issued by Treasury some weeks ago.

Impracticality of the legislative provisions

The Delegation notes that the cap provisions are described as being "*an annual cost rate*" rather than "*an annual interest rate*", which is used in the NSW and Queensland legislation.

The annual cost rate formula is <u>different</u> from the Comparison Rate, in that the definition of C_j is defined as being:

"*the credit cost amount (if any) for the credit contract that is payable by the debtor at time **j** in addition to the repayments* R_j",

Whereas, under the Comparison Rate formula, it is

"*the fee or charge (if any) payable by the debtor at time **j** in addition to the repayments* R_j*, being a credit fee or charge (other than a government fee, charge or duty) that is ascertainable when the comparison rate is disclosed (whether or not the credit fee or charge is payable if the credit is not provided*".

Whilst the definitions of ***j*** and ***t*** are worded slightly differently, they have the same meaning.

The effect of this would likely mean that all existing calculators would have to be modified, or reassembled to cope with the change, as no existing software will be able to calculate it. It may even mean having to use two calculators, one to calculate the actual repayment using a nominal interest rate and another to ensure it remains within the annual cost rate. It is not possible to use a nominal rate, as occurs now, on any lender's ability to legitimately comply with the NSW capping regime. For many credit providers, given the complexity that it entails, it may mean changing systems.

The formula in the current Bill creates distortion where there are irregular payment amounts and dates and suggests redefining ***j*** to be a multiple of days. Whilst this is achievable for those that can calculate it (it cannot be calculated using Microsoft Excel®), being based on the Comparison rate formula, it would encompass the same inherent distortions that one produces.

The definition of "*credit cost amount*" is a new term, defined in Section 32B(3) and this is the sum of the following amounts if they are ascertainable:

(a) "*the amount of credit fees and charges payable in relation to the contract;*

(b) *the amount of a fee or charge payable by the debtor (whether or not payable under the contract) to:*

   i. *any person (whether or not associated with the credit provider) for an introduction to the credit provider; or*

ii. *any person (whether or not associated with the credit provider) for any service if the person has been introduced to the debtor by the credit provider; or*

iii. *the credit provider for any service relating to the provision of credit, other than a service referred to in subparagraph (ii);*

(c) *any other amount prescribed by the regulations*".

Although similar to the redefinition of credit fees and charges in the NSW Credit legislation, it differs from it in two respects:

1. the formula now excludes all government fees and charges, making it closer to the Comparison Rate formula; and
2. the wording further extends the NSW provision of the definition of credit fees and charges, to include all fees and charges payable by the debtor to anyone for an introduction to the credit provider, or for any service if the person has been introduced to the debtor by the credit provider, even if they are not associated with the credit provider (a more detailed analysis, provided by Haydn Cooper, is included in the Appendices).

Unintended consequences

The Delegation has identified four unintended consequences that will emerge:

1. Any default fees or charges would have to be regarded as principal and therefore any actual expenses incurred in the exercise of the defaults would be totally unrecoverable by the credit provider.
2. The recovery of costs expended by the credit provider prior to the contract being executed, such as a REVS or security interest certificate, will also be cause for concern. Most contracts contain a provision for the credit provider to recover, from the borrower, any fees or charges they may expend prior to execution. If the debtor does not actually take up the credit, for whatever reason, A_j will always be "0.00" and, as the requirement is not to exceed 48% at any time, where there is no credit being provided this would make it impossible for any lender to recover such costs. Even if the borrower were to pre-pay such costs, the wording would mean the credit provider breaches Section 32A(2) if any amount pre-paid is not refunded in full.
3. As "*government fees and charges*" are not defined, there is confusion as to whether a fee payable to a third party for a government certificate, in connection with the credit contract, is included or excluded. Typical examples here are REVS or V-Check certificates, but it will also encompass security interests under PPSR. This is because that third party will also have made some element of profit for supplying the certificate - yet the credit provider is not permitted to make any profit for supplying exactly the same certificate.
4. The formula also provides the ability to be further modified under Regulation. Again, we have the introduction of regulatory uncertainty.

The Delegation Requests:

That a more appropriate formula be adopted, but that such adoption should await Treasury's recommendations concerning a provision to guarantee that at no time will the cost of a loan exceed 48% throughout the term of the loan (should such a provision be recommended, major recalculations of any existing formula known to the Delegation will have to be attempted in order to provide lenders with a formula that allows them to be compliant).

Section 32A(4)(a) - Exemptions

The Delegation notes that, if the credit provider is an ADI, it is exempt from the 48% cap regime. This unequal treatment offers the potential to distort the market and is plainly an opportunity to provide a major competitive advantage to ADIs.

During 20 months of consultation, no explanation has ever been offered as to why ADIs should be treated differently.

The Delegation Requests:

That the exemption for ADIs be removed.

© *Smiles Turner, November 2011*

Section 204(1) - The first amount of credit

The Delegation notes that a new addition to Section 204(1), being the definitions section of the Code, is included in the current Bill. It is "*the first amount of credit*", minus permitted establishment fee, minus permitted monthly fee, minus any prohibited credit amount, minus anything else that may be included in the regulations from time to time.

The first payment of 2% at the signing of the contract, in accordance with the provision "*payable on a monthly basis starting on the day the contract is entered into*", is highly likely going to be included in the borrowed amount. The 10% establishment/initial administration fee is highly likely to be included in the contract credit amount. As the Senate Committee would also appreciate, this is due to the consumer applying for a loan because he is short of money and it is likely that he will need the lender to cover these two fees on the first day of the loan.

It is accepted that this 2% for the first month will be paid back periodically thereafter, along with a contribution to repaying the principal, from the consumer's own resources.

Free loan portion for consumers

The problem with deducting the first 2% payment and the 10% payment from the amount advanced, and then calculating the fees to be paid as a reward to the lender for the credit provision, is that the methodology provides an inbuilt subsidy to the consumer. While he has to repay that money as it is part of the loan principal, he pays nothing for it. It is a free loan.

That means the lender cannot calculate a gross income of 10% plus 2% per month, on the money advanced. The meagre total involved must be reduced by that amount attributable to the money provided, to cover the 10% and the first 2% fees.

In addition, when the lender approaches calculating his net profit, he must deduct the cost to provide the portion of the loan that is available for free to the consumer. This will be some part of his business costs appropriately apportioned, plus the 10% and 2% per month of that portion of the credit provided that cannot attract those fees, being his opportunity cost. That money has been tied up giving a free loan to the first consumer to cover costs, and is not then available to lend to a second consumer, who would be paying the 10% and 2% on that money (or a similarly adjusted down amount).

If the borrower provides his own 10% and first 2% fees, on the signing of the contract, then the calculation is simple.

The Delegation expects some software programming challenges and some complexity in explaining all this in the contract documentation.

As the definition in Schedule 4, Topic 20 is written - if the consumer borrows an amount and this does not include an amount for an establishment fee and to cover the monthly fee and/or the first 2% monthly fee - it still has to be deducted - even if paid separately by the consumer, without any of the amount borrowed being used to pay any part of the fee/s.

The Delegation Requests:

That, due to the complexities introduced by the concept of "*the first amount of credit*" and the unintended consequence of the commercial disadvantage to credit providers, the concept of "*the first amount of credit*" be abandoned.

SCHEDULE 5 - Consumer Leases

- Section 175H - being the requirement of an End of Lease Statement.

The Delegation Requests:

That the regulations foreshadowed in Section 175H(1), as an option, should also provide for the lessee to extend the lease, rather than just a requirement to return the goods.

If the goods are to be returned, in addition to the prescription of a return date, the Regulations should also require the statement to include a time and place for the return of the goods.

- Section 179A(2) - in regard to the provision in subsection (2)(b), to the effect that the lessee has no right to own the goods if the lease is terminated - the Senate Committee is asked to note that legal advice received by the Delegation supports the proposition that a contractual

option allowing the lessee to make an offer for the goods, is essentially granting a right - but not an obligation - to purchase.

However, it is recognised that this option adds some value to the lease. There is an argument, supported by a number of the Delegation's legal advisers, that the inclusion of the option demands that the lease be treated as if the option was granted from the start.

In the alternative, the Delegation recognises that an option is the equivalent of an unascertainable fee and should not colour the nature of the lease until it is exercised.

On this basis, the Delegation has come to the opinion that a contract containing such an option should not invalidate the lease, as it is clear the intent is to allow return or purchase.

The Delegation Requests:

That relevant Sections should be included to provide that, only where the choice is to purchase should the arrangement become subject to Section 9 of the Code.

- Section 179M(1) - requiring the lessee to provide details of the location under a lease, within 7 days of the request being received.

  The Delegation is concerned with the challenges of getting Courts to enforce such a provision.

The Delegation Requests:

That Section 179M(1) be drafted to allow for a Contempt of Court order to be granted, if the previous Disclosure Order is disobeyed by the lessee.

It appears that any enforcement action must be taken by ASIC, given there is no obvious ability for the lessor to take the lessee to Court. In light of the previous reluctance by the States to enforce a similar provision under the former Consumer Credit Codes, it might be useful if the section was also amended to allow the lessor to take the lessee to Court.

- Division 9 - concerning increasing the credit provider's responsibility in linked credit circumstances.

  The Delegation interprets this provision to mean any supplier's misrepresentations, in linked leases and tied consumer leases, are to be treated as if they were either the supplier or the lessor's statement and the lessee can chase the lessor, rather than the supplier, when the goods do not match their description.

  The Delegation's concern is that this provision is inequitable. It is unrealistic to expect a credit provider to have the opportunity for sufficient management and control over a retailer, or control over the quality of manufacture of the product that retailer is selling.

The Delegation Requests:

That this inequity be addressed.

The Delegation supports the general thrust of the new legislation, which equates loans with leases. However, Credit Providers that provide both loans and leases face a significant test of establishing suitability/unsuitability, particularly as most lease applications are made at the point of sale.

If a retailer is encouraged to concentrate on one method of finance over another (lease over loan, or reverse) via a bonus or commission structure, the credit provider has no real way of establishing whether or not the loan or lease requested is more suitable than the other for the consumer's needs.

The Delegation suggests that a clear conflict of interest arises that leaves the credit provider at risk to claims - after the event - that the contract/lease was not suitable. This may emerge as an important issue, as a result of the new regulatory provisions concerning tied leases.

It is the Delegations' view that there needs to be a high degree of certainty established and, with a salesperson in a unique and influential position when dealing with the consumer, we do not believe this is possible unless the point of sale company and staff are also made accountable under the NCCP Act.

© *Smiles Turner, November 2011*

The Delegation Requests:

That point of sale personnel and their employer be made accountable, under the NCCP Act, for their involvement in assessing unsuitability/suitability.

Section 151 - Obligations to assess unsuitability (promising eligibility without assessment)

The Delegation notes this Section provides that you cannot promise eligibility for a loan or a lease without the need for an “unsuitability” assessment. While this is understandable, given the focus on assessment in the NCCP Act, the Delegation suggests splitting this section into a credit contract and a lease component and inclusion of this lease provision in Schedule 5, so that all provisions concerning consumer leases are in the one area of the Bill.

Section 32A

Incomplete reference to Committees - a flawed process

The Delegation considers it extraordinary that the Consumer Credit and Corporations Amendment (Enhancements) Bill 2011 has been referred to both the Parliamentary Joint Committee on Corporations and Financial Services and the Senate Economics Legislation Committee while it is incomplete.

A very significant Section 32A(2), included in the Exposure Draft of the Bill, has been omitted from the Bill before the Parliament and the Committees. If this Section is introduced in any form similar to that in the Draft, it will be highly regulatory in itself. It will also have major implications in regard to the provisions included in the rest of the Bill now being considered by both Committees. These implications concern the 48% tier of the 2-tier interest rate/fees and charges cap. The Treasury has now released a Discussion Paper concerning this omitted Section.

The Delegation submits that the 2 Committees’ deliberations, in regard to the 48% cap, will be materially deficient without any consideration of their interface with the likely Section 32A(2).

The Delegation is most distressed that the Minister made no reference to this section in his second reading speech on the 21st September, nor when he referred the Bill to both Committees on the 22nd. Further, Treasury chose to email the Discussion Paper to stakeholders at 3.12 pm on the 14th October, the day submissions to the Parliamentary Joint Committee on Corporations and Financial Services were due and one week before the Senate Economics Legislation Committee submissions were due, with Treasury requiring responses to the Discussion Paper by 29th October.

To assist in communicating the Delegation’s concerns to the Committee, the following is a reproduction of the introduction and options included in that Discussion Paper, interspersed with Delegation comment as indicated. As discussed, the proposed section could have a major impact on the current 48% provision, effectively reducing that cap to some amount under 40%.

“Discussion Paper: Maximum Annual Cost Rate

Introduction

The Exposure Draft of the National Consumer Credit Protection Amendment (Enhancements) Bill 2011 included a prohibition in relation to a person being a credit provider under a credit contract where the annual cost rate exceeds 48% at any time. The provision was in subsection 32A(2):

32A Credit provider must not enter into a credit contract if the annual cost rate exceeds 48%

(1) A credit provider must not enter into a credit contract (other than a small amount credit contract) if the annual cost rate of the contract exceeds 48%.

Criminal penalty: 50 penalty units.

(2) A person must not be a credit provider under a credit contract (other than a small amount credit contract) if the annual cost rate of the contract exceeds 48% at any time.

Criminal penalty: 50 penalty units.”

© Smiles Turner, November 2011

Delegation Comment:

The phrase "*at any time*" is the critical element. As with the 10%, 2% small contract cap in the current Bill, this concept is not known to have been introduced into any other jurisdiction.

To achieve the objective, it is understood that 2 formulae are involved. The first associated with the comparison rate, as recognised in NSW and Queensland, which anticipates that the loan will run to maturity. The second is the annual cost rate, where maturity occurs on any given day and not necessarily the maturity date of the contract. The annual cost rate formula is a new concept.

"*The purpose of subsection 32A(2) was to address potential techniques for avoiding the annual cost rate, including:*

- *the imposition, under the credit contract, of relatively high contingent fees that were in practice usually payable (particularly a deferred establishment fee);*
- *varying the interest rate or increasing fees and charges to exceed the 48% cap once the credit contract has been entered into; and*
- *the use of continuing credit contracts where costs were imposed in a way that differed from the assumptions specified in relation to this class of contracts"*.

Delegation Comment:

All of these concerns could have been addressed simply by prohibiting the alleged avoidance technique already well known to ASIC, given the 12 months in which they have been reviewing the payday lending sector and the many thousands of credit contracts they have collected from lenders all over the nation.

The Section also assumes that the consumer can be located to accept the repayment. This is not always the case, with a number of borrowers who are highly mobile, who misrepresent their position, borrow from small amount, short term lenders and "do a runner" somewhere during the term.

Lenders on accrual accounting will face difficulties when they attempt to write back the expense. The calculated excess is probably to be deemed a non-collectable. Again, the lender could have to give back money, even though they have never been paid the amount.

It must be remembered that the suggested provisions have a powerful ally. If you charge a fee, even of $5, the interest on that runs the whole term of the loan. This is also relevant with the above discussed loan term extensions, with every extension increasing the total interest paid.

The calculation issue is that you are no longer calculating on an outstanding balance, but recalculating all that has passed from day 1.

"Subsection 32A(2) was not included in the Bill when it was introduced into the House of Representatives. It was considered that further consultation was desirable to consider whether the prohibition introduced practical difficulties where the annual cost rate was imposed over the life of the contract.

While the same formula was used to calculate the annual cost rate for subsections 32A(1) and (2), subsection 32A(2) would in practice operate differently from subsection 32A(1):

- *Subsection 32A(1) only included non-contingent fees that were known to be payable at the time the contract was entered into.*
- *Subsection 32A(2) includes contingent fees that became payable under the contract (for example, fees for providing statements or deferred establishment fees where the liability arises after the contract was entered into)".*

Delegation Comment:

It might be more appropriate to say that 2 formulae are now needed to calculate the amounts required.

The second dot point introduces the following challenges:

(a) There has to be very precise definition provided associated with cost items;

© *Smiles Turner, November 2011*

(b) It should be expected that, for the first time, the fees of debt consolidation companies will have to be included in the cost of credit;

(c) The concept essentially requires that the lender has to calculate backwards, because the non ascertainable fees and charges that emerge during the contract term are not capable of being anticipated and included in the contract commencement calculations.

(d) The concern is only to reduce the amounts a consumer might actually pay.

(e) There is no recognition of the fact that many of the contingent fees and charges, involving legitimate cost recovery by the lender, are caused by the actions of the consumer.

"*The primary concern was whether subsection 32A(2) would, in practice, require credit providers to check whether or not they exceeded the annual cost rate each time they charged a contingent fee or varied the interest rate.*

Having considered the matter further Treasury's view is that:

- *The formula used to calculate the annual cost rate averages the cost of the term of the contract, and therefore the impact of a new fee or charge will not usually be significant in itself*".

Delegation Comment:

This overlooks the point that the second formula demands recognition of the new fee or charge and calculation including the amount - no matter how little or how much. There is the need for a mandatory calculation and, once calculated, even if the impact is "*not ...significant in itself*", some payment, even if it is just a few cents, will have to be made to the consumer or there will be a compliance breach.

- "*The formula allows a credit provider to determine the maximum amount they can charge before the contract is entered into, and therefore to ascertain a relative buffer of additional costs that they can charge*".

Delegation Comment:

The opportunity to "*ascertain a relative buffer*" is pure guess work. The central issue is that the fees and charges involved are non-ascertainable. They will arise if a certain event happens in the future and will not if that event does not occur.

If the lender guesses too big a buffer, the lender loses income because they have charged less than they might have.

If the lender guesses too small a buffer, the lender has to pay money to the consumer, even if the fee that caused the excess is one created because the consumer defaulted on one or more payments.

In other words, the regime appear to create an opportunity for people who do not acknowledge their contractual obligations to actually receive money from the lender, from payments they agreed to make at the commencement of the loan if they defaulted. Remembering always that a default costs the lender in terms of uncollected income, administration time chasing up and the opportunity to derive income from on-lending to another consumer, who would contribute to their profits.

This provision makes an absolute mockery of the 48% cap provision included in the current Bill. It effectively reduces this maximum allowable interest rate to something less and something unknown.

The 2 Parliamentary Committees have been asked to review a Bill that provides for a maximum 48% cap. If the proposed Section 32A(2) is reintroduced, the maximum will **NEVER** be 48% and the Bill will be fundamentally altered in its impact on the few small amount, short term lenders that may be left after 1 January 2013.

- "*The impact of an individual fee or charge will be significant where the fee is relatively large compared to the amount of credit being provided (particularly therefore where the credit provider is arranging a credit contract for a relatively small amount)*".

© *Smiles Turner, November 2011*

Delegation Comment:

This is true, but it should not be overlooked that some fees, such as default letter fees, are constant no matter what size the loan is, because they reflect the actual costs of preparing and sending a letter that are quarantined from the amount of the actual loan.

Under the proposed Section, in the case of a common $25 default letter (remembering most solicitors charge $60 for a simple rote letter), the impact will be much greater if the loan is for $200, than for one that is for $800, but the costs to the lender to generate this letter, passed on to the consumers, are the same.

"Option 1 – retain existing provision

The existing provision could be retained. The effect of this would be that the annual cost rate could not be exceeded, capping the amount of contingent fees that could be charged, irrespective of the type of those fees".

Delegation Comment:

Treasury appears to assume that the issue is the large one payment that takes the calculation over the 48%. However, the same effect can be achieved with a run of very little fees and charges, such as with a serial defaulter.

This means the frequent defaulter, who repeatedly chooses to breach their loan contract terms by not making a due repayment, will enjoy a capped cost advantage whereby each default will cost them less per default than for the good consumer, who misses just one payment during the term of the loan and has to pay the full default fee on that incident. Such occurring because the one default may not have led to the annual cost rate being exceeded.

The current Bill's 200% of principal, as the maximum indebtedness allowed, presumes that the lender can recover the 100% above the principal. With this Section 32A(2), collection of all of that amount is highly unlikely. This unless the lender extended the loan out every time a fee or charge was incurred by the borrower.

Such forced extensions deserve criticism:

(a) The consumer never feels they will complete their loan obligations;

(b) The other provisions of the current Bill will mean that the extension periods will prolong the time before the consumer can get another loan.

(c) Extensions create a bad credit history, which will discourage lenders from giving the consumer another loan after the conclusion of the extended first loan.

(d) The consumer will face a prolonged period of being unable to effectively apply for an increase in their credit limit.

The delegation has noted elsewhere that the proposed section 32A(2) excludes the use of brokers as an avoidance technique. The use of brokers, as a general business policy, is also discouraged. Under what is proposed, a lender could pay a broker on behalf of the consumer, then have the consumer pay out early and find that they (the lender) are refunding part of the brokerage fee to the consumer (which they never kept in the first place).

Again, there is no recognition of actual cost recovery by the lender - as opposed to any profit.

The major problem with this option is that - at present, all credit laws allow a lender to recover costs incurred by way of a credit fee or charge and these are recognised under the comparison rate formula. In addition, under section 32 of the National Credit Code, the lender is not allowed to make any profit on a fee or charge paid entirely to a third party, yet that same lender may be obliged to repay some of that fee to the borrower.

However, if the annual cost rate formula is applied, some costs that are excluded from the comparison rate formula will be included. These costs could push the rate over the 48% limit and the lender would have to repay the borrower. This even though the lender may never have collected the fee or charge and/or this fee or charge was collected by the lender but, in both cases, a third party was paid the full amount of that fee or charge. The result is that the lender will pay out, when they have never received the contributing fee or charge in question and their profits will be reduced by that amount.

It would appear that this annual cost rate is what the states have formally called their annual percentage rate.

© *Smiles Turner, November 2011*

This burden is in addition to the employment of the traditional comparison rate formula, which was designed to cope with long term mortgages. That means there may be significant distortions when using it for very short term loans, or for loans paid out very quickly.

The adoption of the NSW-style comparison rate contradicts Treasury promises and Ministerial promises to the Delegation and others, that a NSW-style cap would not be adopted.

The definition of "*credit cost amount*", under the Section 32A(2) regime, significantly includes the following:

(b) "*the amount of a fee or charge payable by the debtor (whether or not payable under the contract) to:*

i. *any person (whether or not associated with the credit provider) for an introduction to the credit provider (this excludes brokerage arrangements as an avoidance technique); or*

ii. *any person (whether or not associated with the credit provider) for any service if the person has been introduced to the debtor by the credit provider (this excludes income splitting); or*

iii. *the credit provider for any service relating to the provision of credit, other than a service referred to in paragraph (ii)*".

The practical problem with these provisions is that, if the lender does not physically pay the person described, it is probable that such amounts will not be recorded in the lenders' loan management system. That means software designers will have to create new fields in which to record amounts only for interest rate calculation purposes.

In addition this definition of "*credit cost amount*" includes "*(c) any other amount prescribed by regulation*". That means there is no certainty and the possibility of lenders facing the expensive undoing of initial development, or the inconvenience of modification as new regulation content comes on stream.

"*It would not be necessary for most credit providers to check whether they exceeded the annual cost rate every time they charged a contingent fee or increased the annual percentage rate, as for most credit providers the total amount payable would be substantially below the annual cost rate*".

Delegation Comment:

This statement mixes in ADIs, who are exempt, and other longer term, larger lenders, with small amount, short term lenders. The latter have to charge the permitted maximum 48% to survive, if at all.

This statement totally goes against all the modelling, statistics, research results and other information provided by the Delegation and other sector representatives, that demonstrate most lenders will not even be able to break even at 48%. It assumes that lenders in this category will suddenly be able to afford to lend at rates even lower than 48%.

The Delegation clearly and objectively explained to Treasury why a cap of less than $30, per $100 lent, will not allow most lenders to break even...

...so the current Bill includes a cap which generates $12 per $100 lent, for 1 month or less, and $14 per $100 lent for 1 to 2 months.

The Delegation clearly and objectively explained to Treasury why a 48% inclusive interest rate cap does not generate break even income for most small amount, short term lenders...

...so the current Bill includes a 48% cap and the proposed additional Section reduces that even further.

It is very hard not to feel extremely frustrated in such circumstances.

"*This approach:*

- *would be simple to apply, as it would not require credit providers to operate two different formulas;*".

Delegation Comment:

The simplicity referred to is that of credit providers charging so little, that they do not run the risk of having to apply the 2 formulas.

© *Smiles Turner, November 2011*

In this assertion, there is no recognition of the costs of lending involved. A lender can keep their interest rate low to come under the radar, but will that allow them to break even, let alone make a profit? Treasury and the Minister would not know, because Treasury has admitted that it has not done any economic modelling to assist their recommendations to the Minister.

Both have totally ignored the Delegation's modelling provided to assist them in their deliberations and to reach anything other than these totally fanciful conclusions that Section 32A(2) and the 48% inclusive cap can actually leave a viable commercial lending sector in existence.

- "*would address current avoidance techniques; and...*".

Delegation Comment:

It probably would, but why drag down a whole financial sector when it is simpler to ban the obviously known avoidance techniques and not generate the mass of unintended consequences that are apparent with any version of the section 32A(2) included in the Discussion Paper?

In the alternative, why not introduce a simple and realistic interest rate cap regime, such as that recommended by the Delegation, which satisfies the concerns of the consumer advocates and the Minister, for the *"desperate and vulnerable"*. This leaves the non-desperate and non-vulnerable borrowers to use their pent up market influence on lenders who do not have to adopt "avoidance techniques", because there is an opportunity to make a reasonable profit, under a very simple regulatory regime that offers the consumer a very transparent and very easily understood one-figure declaration of competitive prices.

- "*would create the risk that some credit providers who charge significant contingent fees could exceed the annual cost rate*".

Delegation Comment:

To honestly reflect the truth, this statement should be re-written - "*would create the risk that some credit providers who charge very little interest and significant contingent fees, could exceed the annual cost rate, as would any lender who charged the maximum interest rate allowed under the Bill and even very small contingent fees*".

This statement ignores the obvious reality - the proposed Section 32A(2) is designed to:

(a) attempt to force lenders NOT to adopt the maximum allowable interest rate under the Bill; and/or

(b) force small amount, short term lenders (microlenders) out of the sector who might have stayed under a 48% cap regime, but cannot, with the need to adopt even lower interest rates.

Not even the most financially and business illiterate consumer advocate has asked for a maximum interest rate lower than 48%.

"Option 2 – retain existing provision but apply a modified version of the formula

The existing provision could be retained, but the formula could apply in a modified way, by distinguishing between fees that relate to the cost of credit and those that relate to costs incurred by the credit provider for services. The prohibition in respect of the annual cost rate could not be exceeded would only apply in respect of fees that relate to the cost of credit. For example, under this approach, deferred establishment or early termination fees would be included in the annual cost rate, but charges for providing statements of account would not.

This approach:

- *would depend on whether the distinction between fees and charges that relate to the cost of credit and all other fees and charges can be determined or defined with precision (with the risk that it may encourage artificial changes in fees, so that fees could be charged that are not covered by the definition developed to describe fees that relate to the cost of credit);*"

Delegation Comment:

The definition of credit fees and charges appears to exclude unascertainable or contingent default fees and charges, such as dishonour letters, default notice fees and missed payment fees, but the annual credit rate will include these and enforcement charges.

In addition, recovery of both initial credit fee costs and contingent costs could depend on the actual pay out date chosen by the borrower who wants to pay out before the conclusion of their contract.

This is a further disincentive for lenders to continue in the industry, after the commencement of the Bill, inclusive of Section 32A(2).

There is a software development challenge associated with these provisions. Microsoft Excel, or similar spreadsheet software, will not do the calculations. This will require up to 18 months to development programs. Development may not be complete for many on 1 January 2013, let alone 1 July 2012.

Delegation member and IT expert, Haydn Cooper, questions whether any value of 'n', as included in the formula, can ever be applied except on a perfectly run contract. Any number of dishonours, significant or otherwise, will distort the results. Therefore, at least for microlenders, the annual cost rate will need to be calculated daily, taking into account every single entry on the ledger of each loan. This would impose additional processing requirements on servers in regard to end of day processing. For large multi-transaction businesses, this may mean ledgers cannot be accessed in real time, due to system overload.

- "*would address current avoidance techniques; and*
- *would address the risk that some credit providers who charge significant contingent fees that do not relate to the cost of credit could exceed the annual cost rate inadvertently*".

Delegation Comment:

This is a more acceptable approach but:

(a) as noted, we still have the challenge of clearly defining what charges qualify for exemption - the service charges;

(b) there is still lender cost recovery, or non-recovery, involved;

(c) again, why go to this convoluted and complex trouble, when all the proposed section needs to do is prohibit "*avoidance techniques*", which have been clearly identified; and

(d) again, why not adopt a simple Delegation recommended regulatory model, where such artificial "*avoidance techniques*" are unnecessary.

"Option 3 – change the obligation so that it is an obligation not to have charged more than 48% by the time the contract is discharged.

The operation of the provision would be changed, so that it would only be an offence if the annual cost rate was exceeded when the contract was discharged - so that the credit provider would either have to reduce the final payment by the debtor or refund the difference.

This approach would still need to address the issue raised in Options 1 and 2, as to whether the definition of fees and charges for the purpose of calculating the annual cost rate included all fees and charges or only those that relate to the cost of credit.

This approach:

- *would only require credit providers to determine whether the total amount charged exceeds the annual cost rate at the end of the contract;*".

Delegation Comment:

Under this proposal, the managing of cash flows by lenders would be a nightmare. The lender would have to quarantine a proportion of income for every loan, to have available to refund at the end of the loan.

In addition, it still means that the frequent defaulter would enjoy an advantage over the one-off defaulter.

Lenders would still be obliged to shoulder calculation expenses at the beginning and at the end of the loan.

Again, lenders costs, incurred due to the administration associated with the extra charges involved during the term of the loan, may not be recovered because the cap does not provide any recognition of these.

© *Smiles Turner, November 2011*

There is also the practical issue, in that many borrowers ring their lender to enquire what the payout figure is during the term of the loan. Under the National Credit Code lenders have to be able to accommodate such enquiries. That means, while the option only requires the 2 calculations from the software system, the Code and consumers demand a continuing ability of the software to calculate the payout figures.

- "*would address current avoidance techniques; and*
- *would create the risk of avoidance through contracts providing that the contract is not discharged even where the debtor has made all payments due under the contract*".

Delegation Comment:

This concern overlooks the fact that, while the principal and interest may have been repaid, there is an overhang of default fees and charges or similar. In part, the lender wants these to pay for the cost of their administration and, in part, because they have a profit element.

"Option 4 – application of the provision to continuing credit contracts

The application of the annual cost rate to continuing credit contracts creates different issues. The ongoing nature of these contracts and the uncertainty as to how consumers will use the credit provided or the timing and amount of repayments makes its application more complex.

Views are sought on whether the formula could still apply to determine the annual cost rate on the basis of the fees and interest charged under the contract, including whether a distinction can be made between fees and charges that relate to the cost of credit and all other fees and charges".

Delegation Comment:

Any attempt to introduce any adoption of the above regimes faces at least the following problems:

(a) Having to wait the full 12 months before attempting any recalculation;

(b) Clearly understanding the draw down fee mechanism;

(c) Again, clearly defining what fees and charges are exempt from the calculation; and

(d) again, recognising that there is a cost recovery element in every fee and charge.

Again, the "*avoidance technique*" of obvious concern is very well known. Why attract all the complexities of 2 formulae and unintended consequences, when a simple prohibition is all that needs to be included in the Bill?

Again, the major circumstance encouraging the employment of the "*avoidance technique*" exists only because state regimes have failed to adopt a simple regulatory methodology that is realistic, as opposed to what the consumer advocates want.

These are the same consumer advocates who have never had to borrow a small amount, short term loan in their life; who have never visited a relevant lending outlet; and who have never commissioned a contemporary and professionally conducted research program - while adopting a 48% cap philosophy that, as previously mentioned in this submission, has its origin with an anti-Semitic British backbencher in 1927 picking the figure of 48% (flat, not reducible) out of the air.

The Delegation would understand if there was a prohibition of the "*avoidance technique*" in question, but only if a realistic and simple regulatory regime was introduced that actually permitted the Minister's objective of having a viable small amount, short term lending sector continue to exist.

© *Smiles Turner, November 2011*

SECTION 4

Explanatory Memorandum and RIS Deficient

This Section reviews the associated support documentation relevant to the current Bill. This documentation is the Explanatory Memorandum and the Regulation Impact Statement, neither of which satisfies or provides relevant justification for the current Bill.

Concerns in Regard to the Explanatory Memorandum

While the attempt at a comprehensive explanation in regard to all the many facets in the current Bill is appreciated, there are a number of misconceptions expressed in the Explanatory Memorandum, which could misinform the Committee.

Those of most concern to the Delegation are the following:

- In the introduction concerning "*Main points*" under "*Enhancements to the NCCP Act*" there is the statement, "*There will be limited financial impact on persons engaging in credit activities as the changes largely target misconduct*".

  Unfortunately, this is <u>totally</u> inaccurate. There are a number of changes which will have a dramatic impact, financially, on many lenders who have not previously been regarded as engaging in "*misconduct*". The complete ban on rollovers and refinancing, the abolition of second loans and the interest rate caps will financially decimate the lending sector - including both credit assistance providers (brokers) and credit providers (lenders).

  As indicated earlier, Smiles Turner industry research, undertaken following the publication of the Draft Bill in September this year and supported by industry research earlier in April/May, indicates that the impact of the non-cap provisions <u>alone</u> will be significant. 28% of lenders could exit the sector due just to these non-cap provisions.

- In the same section of the document, under "*Small amount credit contracts*", there is the mention of "*the prohibition on multiple borrowing and refinancing (including rollovers)*" which "*will address the risk of debtors entering into a debt spiral...*".

  This is far too simplistic and, if there are any credit providers left, overlooks the likely outcome of larger loans being promoted to exploit the different rules applying to loans over $2,000 and over 2 years, while ignoring the underlying problem of the consumer being generally unable to manage their finances.

- There follows the statement that, "*improving disclosure about the availability of alternatives will help consumers to make better and more informed financial decisions and to seek out lower cost alternatives to relatively higher cost short-term credit contracts*".

  Given that the non-commercial lending sector does not have the resources to lend to even 1% of total demand, such a statement is very misleading. Over 99% of all consumers who relied on its veracity would be very disappointed when they attempted to acquire their "*lower cost alternatives*" (Smiles Turner industry analysis March/April 2011).

  In addition, the statement implies that there are widely distributed non-commercial lending offices across Australia, just as there are commercial lending premises.

  That is simply not true, as non-commercial offices constitute not even 25% of the number of commercial retail lending outlets. This is a very important issue, because sourcing of commercial loans is often determined on the proximity of the lending outlet. People do not travel great distances to borrow payday loans and most of the smaller microloans (Smiles Turner consumer research 2003, 2005, 2007, 2010).

- Under "*Caps on costs*", the Explanatory Memorandum offers, "*specifying the maximum amount that can be charged will reduce the cost to the consumer, and particularly assist low-income consumers...*".

  This is an extremely deceptive statement, when there will be few commercial lenders remaining to offer commercial loans to these, or any, consumers.

- This deception is not resolved when the Explanatory Memorandum goes on to state, "*the introduction of the cap may have significant impact on the revenue generated by individual credit providers, although this will vary depending on their business models*".

  To accurately present the outcome, the phrase should have been written, "*the introduction of the cap will have significant impact on the revenue generated by all credit providers who are payday lenders or microlenders, offering amounts under $3,000, for periods of less than 2 years, even if they are able to remain in the sector. This will not vary depending on their business models because, at best, the impact of the caps will be to pay for their compliance costs, credit reference agency costs and loan staff costs, leaving nothing for their other variable costs, nothing for their fixed costs and nothing for any contribution to profit*".

- Clause 4.23 notes "*alternative and cheaper sources of credit*", assuming that these are available to many, if not all, small amount, short term consumers. There is no indication of any quantitative research having being carried out as to the availability of such sources, to justify this very flawed assumption.

- Clauses 4.25, 4.26 and 4.35 - explain the need for credit providers to make enquiries, with these enquiries leading to the reasonable belief that the consumer does not already have a credit contract at the time of the relevant application with the responsible credit provider.

  However, no allowance is made in these explanations for the frequently lying consumer, who may make successful enquiry difficult in an effort to hide the existence of the earlier loan. This continues to illustrate a bias in the approach to the current Bill that assumes the consumer is incapable of doing anything wrong and places the onus entirely on the credit provider.

  The definition of "*vulnerability*" in the Explanatory Memorandum includes 2 criteria - low incomes and no access to mainstream credit. This supporting a different treatment for those consumers who do not necessarily face both challenges, being:

  (a) those who enjoy a relatively higher income compared to the sector's borrowers in general; and

  (b) those increasing numbers of borrowers, as identified in Veda Advantage Reports this year, that do have access to mainstream lenders, but choose small amount, short term lenders for their microloans.

  These 2-sub categories of consumers are "suitable" to receive loans capped with the 48% interest rate, plus a "fair" or "conscionable" establishment/administration fee.

- Clause 5.6 of the Explanatory Memorandum provides that "*The* (current) *Enhancement Bill introduces a Cap on credit contracts to address specific risks of financial detriment or harm to consumers, through the use of relatively high cost credit*".

  Clause 5.7 follows, to present, "*The risk to a consumer of this financial detriment increases according to the following factors (including):*

  (a) *the borrower's income - the lower the income the greater the reduction in income that will result from having to meet repayments under a credit contract...*

  (b) *the term of the credit contract - the shorter the term the less income the borrower can expect to receive from other sources while they need to repay it, so that there is less opportunity to receive sufficient income to either repay the debt or avoid an immediate need for additional credit...*".

  This analysis supports assistance for the consumer who has suffered circumstances of misfortune and become "*desperate*" or "*vulnerable*" and is receiving only a limited income, while requiring a payday type loan. It also recognises that other consumers do not fall into this category and do not need such protection.

  The legislative challenge is to provide an environment which recognises the concerns of the apparently politically influential consumer advocates. They want to achieve a reduction in payday loans, by discouraging commercial lenders from providing loans to the approximately 20% of borrowers who are *"desperate and vulnerable"*. At the same time, the lenders and the other 80% of consumers want an opportunity to lend or access loans.

© *Smiles Turner, November 2011*

- Clause 5.9 provides that, "*The tiered approach to the cap on costs reflects the need to allow credit providers to receive a greater return for small amount credit contracts, given the relatively higher establishment costs they may incur*". If the authors of the Explanatory Memorandum had considered the industry research provided to Treasury, or undertaken their own research, they would have discovered that this comment means absolutely nothing.

  Relatively higher establishment costs are experienced, but the 10%, 2% model does not allow cost recovery for the payday loans of the size and term demanded by the consumer, in accordance with the costs of lending discussed elsewhere in this submission.

Treasury's position

The cap/fee model included in the current Bill, by its first element involving 10% of principal establishment fee, 2% of principal per month fee, is **NOT** what Treasury recommended in its RIS.

The Delegation notes that this 2% fee is in lieu of interest. It does not meet the test set out in Section 28 of the National Credit Code as to how interest must be calculated. Consequently, it imparts a completely new regime on the lenders in regard to their calculations. There may also be definitional problems in the attempt to continue with an APR regime.

Its second element of 48% was recommended by Treasury. However, this is despite the Treasury's RIS including major reservations as to practicality, loan availability and compliance and despite Treasury never undertaking any economic modelling to explore whether such a cap was economically feasible for lenders.

Further, this recommendation was made in spite of the Delegation's submitted economic modelling, which clearly demonstrated that it was not economically feasible.

The Delegation wishes to emphasise that the relevant Treasury officers with whom the Delegation Committee Members have dealt, from the commencement of contact late last year and throughout this year, have been unfailingly courteous, professional and dedicated to their tasks. The difficulties of being a member of a Treasury team advising Ministers are known and appreciated.

The following is presented to the Committee without any intention to criticise any member of the Treasury team, but to advise the Committee that they cannot assume the current Bill has the enthusiastic backing of Treasury in regard to the critical interest/fee cap structure included.

What Treasury assessed

Supporting the Delegation's concerns, Treasury made the following comments in its RIS regarding a 48% ("flat rate") cap, on page 44 and following:

"*...a flat rate cap is inflexible ...it can have the following consequences... The cap can be set too low, and therefore risk putting out of business large parts of the market (as has been argued in relation to the current cap in New south Wales, of 48%)*".

"*This issue was identified by the 1973 UK Inquiry into Consumer Credit Reform, with the government stating that "It would not be realistic to try to set a rate which could be reasonably applied to every type of transaction*"."

"*The impact of a flat rate cap on consumers and providers will vary depending on the level at which the cap is set up:... If it is too low, it may restrict the availability of short term credit by limiting charges to such an extent that short term lending businesses becomes unprofitable. The consequences of this could be either greater exclusion from the credit market of certain sections of the Australian population, or the emergence of an unregulated market in short term credit*".

"*...on the assumption that a flat rate cap is set at the same level ...to the existing cap in New south Wales ...this reform is likely to have the following consequences for lenders:*

- *Some lenders will exit the market...*
- *Some lenders will continue to operate but seek to recover a similar level of costs to those they currently receive by adopting a range of methods to avoid the comprehensive cap...*

- *These avoidance techniques create a range of new problems for the consumers; including lack of transparency in disclosures, and a continuing risk of financial harm, so that the regulation may be ineffective in achieving its desired outcomes...*
- *A small number of lenders may continue to operate by complying with the cap...*
- *It may also result in some borrowers being refused credit when this would not have been the case previously....*"

Observations concerning consequences were also included under the subheading "*Recommended Options*", on page 59 and following:

"*Given that the combination of these options* (a suggested $30 per $100 borrowed cap for loans under $2,000 and up to 12 or 24 months and a 48% cap for the rest) *is likely to result in a decrease in the number of lenders the following analysis of the impact on competition is provided...*

- *The number of lenders could be expected to decrease, although this would primarily be those who find most difficulty in complying with the cap on costs... because they currently charge significantly higher levels of costs and are unable... to adapt...*
- *The overall volume of short term contracts could be expected to decrease...*
- *Lenders will have little scope to compete on price...*".

As discussed elsewhere in this submission, the RIS did not include any consideration of lenders costs, there were no results of economic modelling and it included only one table (Table 12 on page 48 - see below) which purportedly offered a comparison of Treasury's Option 1.2 and Options 1.3 and contained the only amount per $100 in the paper (there was no mention of 10%, 2% as included in the current Bill). This led the lenders to believe this was the recommended rate.

Lenders were not alone in that view, in their submission CALC expressed a similar understanding on page 7 of their submission to the Joint Committee on Corporations and Financial Services, "*...the RIS suggested a return of "approximately $20-30 per $100 is required to generate a reasonable return" on loans under around $300...*".

Treasury actually provided the income calculations for the 2-tier model that Treasury recommended in the RIS.

Loan amount and term	Flat rate cap (48% per annum)	Tiered cap - $30 per $100
$300 for 1 month	$4.81	$90
$300 for 3 months	$14.43	$90
$1,000 for 1 month	$21.13	$300
$1,000 for 3 months	$63.30	$300

The Delegation is at a loss to understand how the current Bill includes a 48% cap for all secured loans, regardless of size or term, given the second column in the above table.

The Delegation regards it as most unfortunate that Treasury chose not to include consideration of any fixed and variable business costs, which were presented in numerous lender submissions to the Green Paper that preceded the writing of the RIS. Nor did Treasury make any attempt to compare these with the above gross income calculations, given the 48% cap has now been included in the current Bill to apply to all secured loans.

The $30 per $100 was included with the comment "*(assuming that a rate of $30 per $100 advanced is allowed)*". It is emphasised that no other amount per $100 borrowed was even mentioned.

Similarly it is most unfortunate that, while the figure of $30 per $100 borrowed appears to have been chosen at the time of writing the RIS (continuing as the amount chosen, without any amendment or further explanation, for the next 11 months - with Treasury releasing their June dated RIS in September), the subsequent 10%, 2% model included in the current Bill provides a different set of figures for the third column in the table - $36, $48, $120 and $160.

These being only 40%, 53.3%, 40% and 53.3% of what Treasury appeared to recommend for inclusion in the 2-tier model, was recommended in the RIS.

© *Smiles Turner, November 2011*

Treasury chose to leave the $30 figure without comment until their evidence before the Joint Committee on Corporations and Financial Services on 24 October 2011.

While the Delegation accepts that there may be some adjustments between any recommendation from a Department and the Minister's decision, in regard to inclusions in proposed legislation, we find it difficult to understand a 50% reduction in the recommended rate, with absolutely no evidence to support the feasibility of that reduced rate.

Evidence before the Senate Estimates Committee

Sections of the transcripts of evidence presented to the Senate Economics Estimates Committee, on 19 October 2011, are included below, with limited comment by the Delegation because the evidence says it all:

Question: *Have you done any economic modelling to assess the (interest rate cap) figures.*

Treasury: *They're based on analysis, but I wouldn't have said they were based on economic modelling.*

Question: *What sort of analysis.*

Treasury: *The process of developing the model took some time and evolved through a series of consultations.*

Question: *How did you come up with the numbers.*

Treasury: *...there was a group consisting of a range of stakeholders... There were a number of proposals put forward through discussion papers and comments received. The proposal that was settled on was identified as the best option for addressing the problems associated with payday lending...*

Delegation comment:

While the 48% element was offered by way of discussion paper and consideration at consultation meetings, the 10%, 2% fee was never presented and the package included in the current Bill was never presented for stakeholder consideration, until the release of the Exposure Draft on 25 August 2011. Unfortunately, some stakeholders have presented the current Bill as a certainty after that date, rather than recognising Exposure Draft consultation and the reference to the two parliamentary Committees.

Despite the Delegation and other stakeholders scrambling to submit a researched response in the one week allowed following its release, all responses from industry concerning the cap model were ignored and, in regard to the cap, the Exposure Draft content has simply been repeated in the current Bill. The implication in the words "*settled on*" is that agreement was reached. The Committee should entirely reject any such implication.

Question: *So you made a judgement but it is not based on any economic modelling, that is effectively it.*

Treasury: *Yes, that is right. It was consultation with people. "What's a fair thing?" That is all.*

Delegation comment:

The Delegation emphasises - the model Incorporated in the Bill was not presented for consultation until the publication of the Exposure Draft. The substantial written and verbal representations to Treasury, that have been made by the Delegation over the last 11 months, including the response to the Exposure Draft, do not support any assessment of "*a fair thing*". We do not think the abolition of all commercially provided loans under $3,000 and most between $3,000 and $5,000, plus the consequent socio-economic disaster, qualifies as "*a fair thing*" either for the lenders or the consumers.

Treasury: *ASIC has conducted a review of responsible lending. It has looked particularly at payday lending as a sort of industry-sector-specific review. I am not sure whether it has completed it yet, but certainly there is no public report.*

Question: *...as I best understand it, the government wants to now pursue further change without actually having the benefit of the review of the changes that have only recently been made.*

© *Smiles Turner, November 2011*

Treasury: *But I think government sees that, in terms of credit, payday lending is a particular issue that needs to be addressed. Yes, the responsible lending concept applies across the board, but this is a particular problem that needs to be addressed.*

Delegation comment:

Apart from the admission there has been no review of the major reforms introduced on 1 July 2010 and following, the answer fails to acknowledge that the current Bill, with all its commercial and socio-economic disadvantages, applies equally to microlending and that all ADIs are exempt (banks and other mainstream and second stream lenders). This admission is also made in the absence of the final report concerning the ASIC review of payday lending, which commenced in late November 2010. The Delegation expects this report to be firm, but we are confident ASIC will report that the lenders have been substantially compliant and have enthusiastically embraced their responsible lending duties.

Treasury: *...The predominant use of payday lending is by people either on low incomes or, often, on Centrelink payments. ...It is seen... as important that those people ...that the risk of financial exclusion being exacerbated through payday loans is addressed. One way of doing that is through the cap on costs, which seeks to ensure that, to the extent that they make use of this type of lending, it is done in a more responsible and cheaper way, but it is supplemented by a range of other options designed to both address the risk of debt spiral and also encourage grater use of alternatives...*

There are alternatives out there. For example, approximately 20 per cent of borrowers consistently, across a range of research reports, use payday lending to meet electricity or utility bills. We see that as economically inefficient... it is clearly preferable in those cases that they are able to come to some arrangement with their utility provider, possibly paying by instalment but not necessarily being charged interest or additional costs. ...There are also a range of government supported microfinance and community organisations that offer no-interest or low-interest loans. We are looking at other measure to disclose those alternatives, which in general are probably better suited for this class of borrowers....

Delegation comment:

The Delegation has concerns in regard to a number of elements associated with Treasury's concluding statement.

1. We do not believe that it is a valid solution to financial exclusion to impose a fee and interest cap model that forces the commercial lender to cease lending to such people. In fact the result of the current Bill, in total, is that it will create more financial exclusion, by including in its exclusionary provisions not only the payday borrowers, but most of the microloan borrowers, including those who are not *"desperate and vulnerable"*.
2. The comment concerning "*the cap on costs*" is recognised as an attempt to force lending to be undertaken in a "*cheaper way*", but Treasury has failed to inform the Committee that the Bill's cap model demands that commercial lenders trade at a loss and become pseudo-charitable institutions, in order to fulfil this objective.
3. It could be argued that Treasury's failure to recognise the commercial reality results in their encouragement for lending companies to trade in breach of Section 588G of the Corporations Act 2001, by trading while insolvent and exposing their directors to civil penalties under Section 1317G of that Act.
4. The "*range of other options*" to address the debt spiral embraces a number of flaws, discussed elsewhere in this submission, which the Treasury witnesses did not bring to the Joint Committee's attention.
5. The often repeated panacea of encouraging "*greater use of alternatives*" is again presented without any consideration of the capacity of the "*alternatives*" to cope with this "*greater use*" and also in the absence of any evidence of Treasury liaising with these organisations.
6. The Delegation is unaware of any utility representatives participating in any part of the consultation process. This omission leaves a void in Treasury's knowledge, which is not reflected in the above statement that assumes the utilities can also become pseudo-charities, by "*not necessarily*" charging interest or additional costs when consumers seek to pay by extended instalments.

© *Smiles Turner, November 2011*

7. Given that over 80,000 Australian households per year are now being disconnected from their gas and/or electricity supply, any assumption that utility companies can offer assistance to everyone in financial trouble is naive at best.
8. The Treasury spokesperson appeared to assume that all the Government has to do is provide more effective ways "*to disclose those alternatives*" and a substantial contribution to solving the perceived problems will be achieved. The Delegation is unaware of any representation from the various alternative organisations attended the Treasury consultation meetings that were also attended by the Delegation, and no information concerning the resources and capacities of these organisations has ever been included in the several discussion papers issued by Treasury.
9. In this context, it might be useful for the Committee to be aware that an Anglicare Sydney witness, attending before the Joint Committee on Corporations and Financial Services admitted that, in a recent 12 month period, 4,000 clients were turned away from one of several Sydney offices.

Evidence before the Joint Committee on Corporations and Financial Services

Below are extracts from contemporaneous notes taken at the Public Hearing before the Joint Committee on Corporations and Financial Services on 24 October 2011, which demonstrate Treasury's current position. We provide limited comment, because the evidence says it all.

Treasury: *I think the Minister has said his objective is to continue to have a viable industry, whilst addressing the concerns for consumer protection in this space.*

Treasury: *We have looked to address some of those practices around avoidance for the 48% cap and applied those lessons to the small-amount cap as well...*

Question: *You believe that the formula as it is intended in New South Wales is reasonable, allows people the opportunity to make a commercial return and therefore should not endanger the viability of the industry...?*

Treasury: *Yes.*

Delegation comment:

This is not what the lenders have repeatedly told Treasury and is in conflict with the only economic modelling Treasury has had to refer to, which was provided by the Delegation. It is also not enthusiastically supported by sections of the RIS included elsewhere in this Submission.

Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA): *...we are very strong supporters of providing alternatives to payday lending.*

Treasury: *...there are people who need small and affordable sums of credit... The approach we took there was the 10 and two model... Where you are looking for someone with a small amount of money, there are going to be fixed costs upfront, but you also do not want to distort the way in which the lending operates so that there is an incentive to provide other short term loans... by allowing a return over time.*

Delegation comment:

This answer ignores the fact that, under the current Bill, all secured loans can only be lent under the 48% cap, no matter what the amount of the loan.

FaHCSIA: *We have not done any specific modelling to work out exactly what the impact would be... It depends which way it goes and how much it effects the supply side.*

FaHCSIA: *...(Concerning the Commonwealth Financial Counselling service) ...we do not go down to the level of asking the question of whether the problem was caused by a payday loan... It is not quite as clear as "It is because of payday lending".*

Treasury: *The $30 per $100 is not a figure that Treasury has publicly endorsed and is a slight misdescription of some information that was in the RIS... It was used by way of example. It was an example of the sort of thing we could put in place. We were looking at the model rather than a specific number.*

© *Smiles Turner, November 2011*

Delegation comment:

We do not agree with this assessment and address this issue in the analysis of the Regulation Impact Statement included in this submission.

Question: *...you are confident that the economies of what is being proposed makes it viable for people to remain in the industry to provide the products.*

Treasury: *Yes, that is consistent... Under this model, it (48%) only applies to loans over $2,000 for a term of two years or more. We think that probably resolves the issue and that it can be viable at that level.*

Question: *The sense that I got was that people were basically saying that for loans under $3,000 the circumstances were that the industry would walk. You are saying that is not the Treasury's view in the circumstances.*

Treasury: *That is correct.*

Treasury: (The Treasury witness) *...was saying that the formula, the 48 per cent cap, works well in the New South Wales model. But what we have done in the Bill is place some further provisions and address the avoidance concerns that were identified in New South Wales.*

Delegation comment:

During an earlier period this year, Treasury made it clear to industry sector representatives that they would not be recommending the NSW model. The Delegation is unaware of any information presented to Treasury, since that time, which would justify such a change of direction.

Addressing the avoidance techniques in the Bill has been very successfully achieved. In addition, throughout the entire current Bill, the Minister is given extraordinary powers to make law by Regulation, thus providing a flexibility for fast action to include practices not foreseen during the drafting of the Bill under its provisions. The Committee should consider the issue on the basis that, in any event, there will be no opportunity for avoidance under the legislation - there will be no lenders left to attempt to employ such for at least 90% of the current loans.

Treasury: *The existing demand for credit does not necessarily have to be met.*

Delegation comment:

It is unfortunate that Treasury has never taken an opportunity to actually visit a retail lender's business and talk to consumers as they came in the door to seek a loan. As with the consumer advocates, this assessment recognises that the *"desperate and vulnerable"* will not be able to borrow under the provisions included in the current Bill.

Treasury: *If loans were cheaper then you would have less problems with repeat borrowing, and if people make greater use of alternatives or if there is a greater ability to access -*

Delegation comment:

This comment fails to address the fact that the proportion of the total repayment amount that constitutes fees and interest, is significantly less than the proportion that is actually repayment of the loan principal, as discussed in detail elsewhere in this Submission. Again the expected substantial reliance on non-commercial alternatives from January 2013, without any consideration of their capacity to satisfy this reliance, as admitted immediately below.

FaHCSIA: *On the alternative side, I do not know what the level of displacement etc. is going to be, but I suspect that there would need to be some work done on developing alternatives further... Our Community Development Financial Institution pilot is a case in point... This is due to be evaluated in March next year. I guess we will have a better idea then as to the type of issue you are getting at as to what level of interest rate is actually going to give you a viable business...*

Question: *How could you possibly reduce the demand just by making it cheaper.*

Treasury: *Reducing the cost reduces the potential disadvantage suffered by people entering into these loans. The fact that there is demand at quite high prices suggests that this is a product that is quite price inelastic, so reducing the price is not necessarily going to lead to a massive increase in demand, I would argue.*

© *Smiles Turner, November 2011*

Delegation comment:

"S*uggests*", "*is not necessarily*" do not engender confidence that the Bill has been developed on known facts.

Question: *You are pretty confident that in fact there is a bit of commercial bluff and counterbluff going on here and there will still be products in the field...*

Treasury: *...the government's objective with reforms and with the caps as outlined in the Bill was to balance the social costs and improve the outcomes for vulnerable consumers while maintaining a viable industry.*

Question: *You are confident it will maintain as a viable industry.*

Treasury: *I am saying that was the government's objective in setting that cap.*

Delegation comment:

The Delegation encourages a careful consideration of the responses to the two questions immediately above.

An Analysis of the Regulation Impact Statement

"The Regulation of Small amount, short term Finance": Regulation Impact Statement, June 2011 (released September)

As these studies are traditionally provided to assist in the development of appropriate government policy and legislation, the Delegation considers that it is important for the Committee to be aware of the few strengths - and many weaknesses - of this RIS, that are offered to support the current Bill. There is much, but not all, that the Committee should ignore or reject in the RIS.

Although dated June 2011, this study was obviously substantially completed shortly after the August 2010 Green Paper. While there are two token mentions of 2011 literature, as previously mentioned there is no consideration or inclusion of the mass of statistical and qualitative information provided by industry stakeholders, including the Delegation, in response to the 4 Treasury Discussion Papers issued from November 2010.

This assessment of a very dated RIS is confirmed by the detail provided under the subheading "*Consultation*" on page 57 of the RIS.

None of the information provided at 6 face to face and telephone conference meetings between senior Treasury officials and industry representatives, including two that were exclusively with the Delegation committee, has been included. Nor has any information provided during other industry representative organisation contact with Treasury this year.

It is noted that the RIS anticipated continuing consultation with stakeholders concerning "*the level at which the cap will be set*" and "*the detail of the other changes*", "*Given the specialised nature of this reform*" (page 61).

However, it is a matter of grave concern and extremely unfortunate that the existence of the RIS was kept secret for such a long and very relevant period, with a dubious release on the Department of Finance and Deregulation's Office of Best Practice Regulation website on 9th September, 2011. It is noted that, although Treasury prepared this RIS, there is no apparent mention of it on the Treasury website, it is the only RIS relevant to the Exposure Draft released on the 5th August 2011 and the current Bill, and that the Office of Best Practice Regulation assessed it as "*adequate*".

As a foundation for Government policy and the Bill, it must be regarded as substantially inadequate.

Significantly, portions of this RIS appear to have been included piecemeal in Treasury Discussion Papers from November 2010 onward, with stakeholders spending substantial time and money on preparing submissions in response. Even worse, stakeholders were continually scrambling to meet impossible deadlines demanded by Treasury, some as short as one week. Those portions have been reinserted into the RIS without **ANY** inclusions from the mass of information stakeholders provided in their submissions.

Critics would regard this as evidence of a very demanding consultation process over 12 months, commencing with the Green Paper, that has all the appearances of a total sham.

© *Smiles Turner, November 2011*

Either the real story is a ministerial rejection of Treasury recommendations, in recognition of a handful of well-connected consumer advocates' representations, or a simply oversight of the commercial realities.

Completed in secrecy, released in September, with a bogus date of June on the cover, this RIS is less than satisfactory and much of it should be ignored by the Committee for its lack of intellectual rigour and recognition of so called research, which embraced totally inadequate research methodologies. On many occasions, the conclusions cited in the RIS are **NOT** supported by the research studies to which they refer.

Issues of contention

There are many areas of the RIS which are fundamentally flawed and should not be accepted as appropriate to contribute to a foundation for new government policy and legislation to offer the Parliament. We consider a sample of these below.

Research results referred to in the RIS

There are major limitations with all the studies to which it refers.

1. "*In the recent Marston and Shevallar pilot study... the authors stated that "the overwhelming majority of the borrowers we spoke with were living below widely accepted measures of poverty. A quarter of the borrowers we spoke with were routinely accessing emergency relief for food vouchers* (their page 6). *Of the 44 borrowers interviewed, only six had full-time employment* (their page 5)". (citing G Marston and L Shevallar - "*The Experience of Using Fringe Lenders in Queensland: A Pilot Study*", July 2010).

   As noted on page 11 of the RIS - "*44 borrowers surveyed in total (28 surveyed in-depth). Borrowers self selected by responding to a request contained in a postcard that was available at loan centres, financial counsellors and offices of legal aid*".

   This is a pilot study with an incredibly unrepresentative sample and, with these severe limitations, cannot be used for the formulation of government policy.

2. The 2010 Consumer Action Legal Centre Report (CALC) (Z. Gillian "*Payday Loans, Helping Hand or Quicksand*") - "*28.1% of respondents were in part time or casual employment and 21.9% unemployed. For those consumers who were employed, 72.8% had income levels below the average wage, 23.4% had incomes of less than $20,000*" (their page 53).

   The limited and biased population from which the sample was taken has to be considered, together with the problems of conducting research on-line, including excluding those without access to computers or the internet. The research was also done in 2008 and 2009 and the CALC report continually mixes the results of qualitative and quantitative research, undertaken in those years, to reach its conclusions and to project them onto the circumstances post-1 July 2010.

3. The UK-based international research organisation, Policis, reports that half of the payday customers it surveyed ("*The Dynamics of Low Income Credit Use*") had "*household incomes of below $35,000*" (their page 29).

   The research report is undated, but is at least a year before 1 July 2010.

4. "*Smiles Turner research for the NFSF was noted with its 2006 finding that 50.1% of applicants received social security payments (including where this was their only income)*", page 10, Green paper response. Had the RIS been prepared after September/October 2010, it would have been able to refer to more contemporary research undertaken in November 2010, April/May 2011 and August 2011 by Smiles Turner. There appears to have been no attempt to clarify those respondents to the Smiles Turner study who had other sources of income.

   It is to be noted that Treasury was provided with much of the results of the Smiles Turner November and April/May research, during the first half of this year - well before the RIS was released.

5. 2010 Cash Converters' data shows that 46.15% of consumers of loans of less than $1,000 and one month duration ("cash advances"), received government benefits (although they may also be in receipt of other income) "*...43.93% for ...a loan over $1,000 with a duration of 6-12 months*" ("personal loan") "*...75.69% of customers* (for the cash advances) *have an*

© *Smiles Turner, November 2011*

income of under $36,000 and just under half (43.59%) *had an income of under $24,000*" (their pages 6 and 7).

In the RIS, the phrase "*just under half*" was used, rather than the actual 43.59% and then, at page 15, the RIS summarised by saying "*Approximately 40 to 49% of short term customers have an annual income of less than $24,000*". The problem with this statement is that only the Cash Converters study was cited with a $24,000 measurement criteria.

The 3 other studies used to come to this "rubbery" conclusion were a dated 2002 Dean Wilson study, using just 72 consumers approached outside lending outlets, which was quoted for its $20,862 and $31,304 per annum income criteria; a 2009 CALC study with 448 borrowers on-line, but mentioned in the RIS only for incomes under $20,000 (with an unspecified figure for average wage), and a Policis report that measured incomes under $35,000.

The RIS then asserts, also on page 15, that "*Between 50 to 74% of short term customers have an annual income of less than $36,000*". Again, only the Cash Converters' data provides that benchmark and the figure is not 50 to 74%, it is 75.69%.

Given the fact that there is much diversity in the approach to marketing and the lending products offered in the small amount, short term sector, it would be totally inappropriate to assume that the Cash Converters' figures can be applied across the sector.

None of the research projects used the Henderson Poverty Line criteria (working single person under $401 per week, $20,852 per annum; or non-working single person, disposable income of under $325 per week, $16,900 per annum). However, the RIS concluded with the imprecise statement, "*The research also demonstrated that a substantial number of short term borrowers, possible up to 25%, have incomes that are so low that they fall beneath the Henderson Poverty Line*".

6. "*…significant levels of repeat borrowing*", page 6. The delegation is particularly concerned at the lack of intellectual rigour employed in regard to this very important issue (pages 20-22).

   It is noted that the reference to the discredited 2010 CALC report, page 72, which concludes with financial counsellors providing "*qualitative data*" - note, **NOT** quantitative data - indicating "*…that borrowers using short term loans experience great difficulty in avoiding repeat use*". This implication concerning 100% repeat borrowing is nonsense and emerges because the entire borrowing population in this CALC assessment were apparently seeing financial counsellors at the time they participated in the research program.

   As Smiles Turner research indicates, the figure is considerably less than 100%:

   (a) The proportion of the borrowing population that actually saw a financial counsellor is considerably less than 10%, as shown in Smiles Turner surveys (8.7%).

   (b) The 2011 survey revealed 23.61% of the respondents had 1 or more rollovers.

   The inaccuracy of the CALC report occurs because of the fundamentally faulty research methodology employed in that study - mixing qualitative with quantitative research results.

7. Another fundamental flaw is that all studies quoted in the RIS were undertaken **BEFORE** the introduction of responsible lending under the Commonwealth regime, commencing 1 July 2010.

   After simply quoting dated studies, with their statistics concerning the percentage of borrowers that rollover or repeat borrow, the RIS then included a most unfortunate paragraph that is **NOT** substantiated in any way by any of the studies quoted anywhere in the RIS and, even if it had some truth in the past, has been severely curtailed by the post-1 July 2010 responsible lending and licence condition regime -

   "*The greater the extent of repeat borrowing (including consecutive loans) the greater the probability the borrower will be left with a significant shortfall in income, depending on the terms of the loan, to meet other recurring essential costs, such as food, utilities and transport costs. The inability to stagger payments according to necessity may add to, or not resolve, the borrower's financial situation with consequent pressure on the consumer to borrow again to meet these costs, and, as noted above, to have an ongoing reduction in income as their budget now incurs the costs associated with short term lending on a continuing basis*".

© *Smiles Turner, November 2011*

None of this is actually considered in the material included in the section from which these grand deductions are supposed to acquire support.

8. The section then concludes with consideration of some circumstances in the USA states of Florida and Oklahoma and comment on, presumably, general US research. This is included as if the conditions in the US were identical to those found in Australia. They are not. In particular, terms are much shorter in the USA, business costs are dramatically lower, wages and social service benefits are much less and post-dated cheques are used as security (which is prohibited in Australia by the National Credit Code).

   Such a comparison is useless as a contribution to the formation of government policy and the development of legislation in Australia.

9. The high cost of the loans "*...resulting in financial harm through an inability to accumulate savings or personal wealth...*" (page 6).

   In Smiles Turner's comprehensive industry and consumer research and analysis experience, many consumers are not prepared to financially discipline themselves to ever accumulate savings or personal wealth. Upper middle class assumptions and attempts at imposing a socio-economic culture, relevant for that class, on those of a different socio-economic class, should be ignored.

   The literature written by comfortable middle class academics sometimes includes expressions of concern as to the fact that the small amount, short term loan consumers should be "saving", or building up their assets.

   This concern of relatively well paid academics and consumer advocates may not have much relevance to the 24.6% of the 465 consumers surveyed just before Christmas, in 2006, who borrowed to buy Christmas presents, or the 3.96% who borrowed to pay for a holiday, or the 0.23% who borrowed for a birthday.

   Included in the expressions of disapproval of payday lending, this concern appears based on an ideological commitment to the attitude and acquisition of wealth and fails to recognise that other people may have differing values and needs.

   To the borrowers surveyed - buying furniture, registering their car, buying a particular birthday gift, organising a child's birthday party, with enough money for the cake - represented an asset within the meaning of their lifestyle choices. Psychologically it was productive, because it satisfied a perceived desire or need to purchase at the time of borrowing and goes beyond the limited view that only tangible assets, with some finite economic value, are of worth.

10. "*Consumers tend not to identify different short term lenders and consciously choose between them...*" page 18.

    This is not supported by Smiles Turner research undertaken in 2006, 2007 and 2010, where a substantial proportion of consumers were found to be aware of at least 1 or more other lenders (discussed in detail in the Consumer Profile section of this Submission). At least 30% of respondents had borrowed from another lender in the past and the Delegation notes that the CALC 2010 report indicated that 41.5% of the respondents to its research had access to other forms of credit.

11. "*Consumers are generally not price sensitive...* (with consumers) *accepting the credit irrespective of the terms on which it is offered*" Page 18.

    This is not supported by Smiles Turner research in the above years, where more than 88.5% of consumers made enquiry as to cost, prior to entering into the contract and regarded price as a significant factor (see Consumer Profile Section).

12. The size and nature of the Australian market, included at page 22, is very dated. The Delegation is pleased to note the inclusion of the Smiles Turner researched 2007 figure, of $500 million worth of loans per annum. This was taken from the response to the 2010 Green Paper prepared for Cash Stop, a major highly reputable lender. However, the current amount of loans at $1.2 billion is considerably larger than an industry figure of $800 million quoted by other representatives.

    A comprehensive investigation conducted by Smiles Turner earlier this year (2011), including industry research, analysis of public company lender published figures and telephone contact with lesser know lenders who only have part of their loan book devoted

© *Smiles Turner, November 2011*

to microloans revealed that, in the year 2010, $1.2 billion was lent to three quarters of a million different Australians.

Should the Bill proceed unchanged, this is the amount of loan funds the government will have to provide to the charities, NILS and LILS, etc., to avoid a social calamity.

13. The Delegation notes the RIS mentions "*at least 567 branches of short term providers in Australia ...an indicative minimum only*", page 29. It might be useful to reflect on the fact that there are actually some 834 lending and broking outlets, including major internet and telephone delivery providers.

    That is the branch and office network currently delivering commercial small amount, short term loans across Australia, which the Government will have to replace if the current Bill proceeds without amendment and with the results the Minister hopes to achieve.

Other matters of concern

1. "*A review of internet-only short term loan providers undertaken by CALC in 2010 identified more than 20. However, according to the CALC survey of 448 consumers in 2008, only a small percentage of borrowing was done purely online*" (page 23, quoting the CALC report at pages 11 and 90).

   The Senate Committee should be aware that there are some 340 websites now active, including those controlled by major overseas lead generating companies feeding leads to major lenders, and at least 59 companies offer internet lending. In addition, Smiles Turner research indicates that the growth rate for internet lending is at least twice that of retail bricks and mortar lending.

   If the final version of the Bill does not recognise this phenomena, notwithstanding any other deficiency, then within 5 years 40% of the lending turnover will not be appropriately regulated and it will be impossible to apply the regulatory demands to this sector. If the other deficiencies in the Bill are also passed unamended, this growth in internet credit providers should not be overlooked as a foundation for off-shore lending in the future.

   After consultation with international internet lending companies and a former senior technical officer with Telstra, the Delegation is not as confident as the senior ASIC representative, at a recent Treasury Industry and Consumer Consultation Group meeting, who expressed considerable confidence that ASIC could control 'out of jurisdiction' internet lending services.

2. Prices charged by short term lenders are considered on pages 25 to 27 of the RIS. This analysis focuses on the APRs, with the traditional and simplistic assessment that, as these are large, then the charges of microlenders are inappropriate.

   No attempt is made to consider the faulty reasoning employed by the Griffith University study on which it heavily relies. Such reasoning including issues overlooked and an inappropriate approach to calculation. In addition, the Griffith University study was carried out in 2008, well before the costs incurred by lenders as a result of the Commonwealth regime. The prices used are therefore irrelevant to consider in formulating appropriate government policy and legislation in late 2011.

   No substantial and necessary attempt was made to consider the relatively small dollar amounts of actual income involved, because the payday loans involved were small and short term.

   Significantly, no attempt appears to have been made to substantially research the costs of being able to lend. An assessment of costs and their relative level for consumers is impossible without a consideration of actual costs of providing the loan and actual profits enjoyed across the microlending sector.

   While we are aware that one microlending sector peak body was reluctant to provide cost information to Treasury, substantial cost information on this issue was provided to Treasury by the Delegation and more would have been provided if the preparation of the RIS had not been kept secret.

3. Default cost are considered on page 27. The RIS states that "*It is likely that the level of default varies significantly because of the difference in charges levied by the lenders... It would not be surprising if some lenders experienced default rates of 30% or more*".

© *Smiles Turner, November 2011*

The problem with such a statement, where comment on the majority does not follow, is the opportunity for the term “some” to be perceived as “many”.

There is no research at all mentioned to support these claims. Further, the implication of a significant number is not supported by substantial Smiles Turner research results over the last 11 years, none of which showed a single established lender with default rates anywhere near this level and most lenders with default rates well under half that.

The Delegation was recently provided with anecdotal (only) evidence of one lender with a default rate approaching 50% - this is an extremely high figure by industry standards and no other lender is known by the Delegation to be experiencing anywhere near similar rates.

In addition, the quoted Cash Converters’ default rate of 3.46% can be extrapolated with confidence, across much of the industry. However, care must be taken with terminology. In this instance default rate means bad debts. This actually being close to the common bad debt ratio of approximately 4%. It should be noted that default rates are largely dependent on the employment of criteria in the selection process. This criteria has been substantially prescribed under the Commonwealth regime and the opportunity for high default rates has very much diminished since 1 July 2010.

The RIS’ nonsense of assuming default rates could be very high indicates a continuing presumption that lenders will continue to lend, even though it is highly unlikely they will be repaid, or their continuing lending practices will generate a high proportion of loans that will not be repaid.

The Delegation encourages the Senate Committee to consider how much effort is required to recover, when one loan goes bad. At present, a minimum of 8 loans is required simply to put the lender back in the same financial position enjoyed before the failed loan. As discussed elsewhere in this submission, under the Bill’s proposed caps, the multiples of successful loans required extends far beyond 8, to over 70.

4. On page 32 the RIS considers the “*Problem Identification*” associated with microlending.

The RIS commences this section with the following, “*Short term lending and consumer leases are both products that have a significant risk of financial harm …where it is not regulated or capped …limiting the financial impact of this form of finance can improve the capacity of the borrower to stabilise or improve their position*”.

The Delegation notes that the current Bill achieves a solution to these identified problems - if its aims are achieved it will ensure almost no small amount, short term loans are provided.

It is not comforting to note that the RIS identifies the solution and makes no mention of any supply limitations. At page 33 -

“*There are currently a range of alternatives to high cost short term loans, such as Centrelink products, …utility hardship programs, and non-commercial microfinance products …there are also a range of services available, principally financial counsellors, who can assist borrowers to better understand and address underlying problems*”.

While the Delegation considers these alternatives in greater detail later in the Submission, it may be useful to again note the table attached to Minister Shorten’s media release dated 25 August 2010.

We remind the Committee that this table was not accompanied by any quantitative information indicating the capacity of the included alternatives to accommodate any increase in demand following the commencement of the current Bill.

While it might be expected that consumers in financial stress would be aware of or seek out these alternatives, this is not necessarily the case, as Smiles Turner research revealed in an Australia-wide survey undertaken in 2007. Consumers of microlending demonstrated that they were relatively unaware of the existence of No Interest and Low Interest loan schemes when asked:

Do you know of any no-interest or low-interest loan schemes run by a charity?	**Yes: 6.4%**	**No: 93.6%**
Have you ever borrowed from a no-interest, or low-interest loan scheme run by a charity?	**Yes: 3.6%**	**No: 96.4%**

© *Smiles Turner, November 2011*

The 2008 CALC survey also found there was minimal consumer knowledge of these options. "*Navigating the range of services available to identify appropriate options can prove a formidable task for disadvantaged consumers, and a lack of information can impact on people's capacity to make informed decisions and actively participate in the life of the community*", Page 33. Similar low levels of knowledge were revealed by the Smiles Turner 2010 and 2011 research.

The current Bill, with its imposition of internet site advertising for the alternative loan sources, will assist here - but only if there are lenders and brokers still in business to operate their websites. Without these, the Government will face a continuing marketing challenge, with the Smiles Turner industry analysis, March/April 2011, providing an indicative advertising budget of $21 million.

What follows in the RIS is a consideration of borrowing impacts on a person earning $24,000 per annum. Unfortunately, the assumptions implicit in the above are not tested.

5. On pages 38 and 39 the RIS attempts to demolish the positive impact of the responsible lending obligations. The Statement attempts the following observations:

   (a) Some consumers will be offered longer loans, with lower repayments than might be the case, to make the loan affordable and not "*unsuitable*", as is required under responsible lending. However, the RIS comments, "*However, this would apply on an individual basis and does not provide comprehensive response in the same way that an upfront limitation on costs would*".

   We note the implication is that, because some borrowers could not afford a standard loan, then a draconian cost control must be introduced so that all borrowers, no matter what their financial circumstances, can pay less per scheduled repayment.

   The RIS makes no attempt to consider whether or not the lenders can afford to lend under the suggested upfront limitation included in the current Bill.

   (b) Despite the introduction of responsible lending "*there do not appear to have been any significant changes in practices in this area*".

   The Delegation notes that there has been no evidence provided to support this assertion and no consideration of ASIC being more proactive, to satisfy this concern. Further, the statement was written before ASIC commenced its investigations in late November and is included without ASIC having completed its investigation into small amount, short term lenders, which has been ongoing since November/December 2010.

   (c) "*...the responsible lending obligations require each contract to be considered in isolation... It is not possible to consider the cumulative effects of a series of contracts with the same lender*".

   The delegation is intrigued with this assessment. The responsible lending obligations demand attention to all financial circumstances and that means the cumulative financial impact most certainly is considered by lenders (see the sample 90 Day Assessment form in Appendix 3). The assessment may be for one loan, but any known previous or continuing loan is recognised in that assessment. The judgement as to whether or not the loan is "*not unsuitable*" is made in the light of all the consumer's financial circumstances. These will obviously be impacted on by previous loans taken out, and continuing.

   (d) In practice, establishing expenses can be difficult for consumers. The Delegation wonders why the authors of the RIS did not bother to visit any lending outlets to see what goes on, and how effectively lenders can establish such amounts - and do so for three quarters of a million individuals each year (based on 2010 calendar year figures).

6. The hypocrisy of use of the term "financial exclusion" is shown at page 39, where the RIS attempts to blame the microlenders for financial exclusion, determined on the number of people who do not have a credit card, or who have one, but cannot raise $3,000 on it. Ironically, the RIS has been prepared to support the current Bill, which will create financial exclusion for up to 750,000 Australians.

   It is noted that the RIS then considers the non-financial impact of financial exclusion, but overlooks the fact that many lenders lend to the people who have been excluded by the banks, thereby reducing the incidence of such non-financial impacts.

© *Smiles Turner, November 2011*

7. The tiered cap options - at page 47 and following, the RIS considers the tiered cap option. On page 48 the RIS states -

   "*The rate at which the cap would be set would be determined as follows:*

   - *For short-term loans - taking into account the lowest amounts commonly charged by short term lenders in Australia (enabling the cap to be set at a level that results in consumers paying a controlled price for credit, while still allowing some lenders to achieve a return on this type of lending that allows for a profit)*
   - *For all other regulated forms of credit - the annual percentage rate would be set taking into account the experience of the cap in the States and Territories where it currently operates*".

   As commented on earlier in this Submission, the RIS then establishes a reasonably realistic $30, per $100 lent, as the rate for short-term loans. Unfortunately, this realism was ignored in the current Bill and substituted with a 10% one off fee and 2% per month.

   It is useful to compare what the RIS recommended, with what the current Bill stipulates. Taking Table 12 in the RIS and including the amounts that would be generated by the provisions in the Bill as a fourth column, the comparisons are stark.

Amount and term	48% p.a.	Option $30 per $100	Under the current Bill
$300, 1 month	$ 4.81	$ 90	$ 36
$300, 3 months	$ 14.43	$ 90	$ 46
$1,000, 1 month	$ 21.13	$ 300	$ 120
$1,000, 3 months	$ 63.39	$ 300	$ 160

   The above demonstrates why:

   (a) Under the Bill, why would you lend $300 for 3 months, to gross $48, when you could lend $300 for 1 month, 3 times, and gross $108.

   (b) Under the Bill, why would you lend $1,000 for 3 months to gross $160, when you could lend $1,000 for 1 month, 3 times, and gross $360?

   (c) Under the current Bill, secured loans will disappear for small amounts. Why would you lend a secured $1,000 loan for 1 month to make $21.13, when you can lend unsecured and gross $120?

   While there are obvious advantages for the consumer in having an unsecured loan, the disadvantages are reduced opportunity to impose discipline on the consumer, and lenders no longer being prepared to risk lending unsecured to a whole range of people. Putting aside any other issue, this will generate major exclusion from credit.

8. <u>No Support for 10%, 2% Cap</u> - The Delegation notes that the RIS assumes lenders should make a profit, as mentioned at the conclusion of dot point 1. In addition, the RIS claims that it takes into account "*the lowest amounts currently charged by short term lenders in Australia*".

   With this in mind, the RIS then sets the figure at $30 per $100 lent. So how can the figure of 10%, plus 2%, i.e. 12% for a 1 month loan, as provided in the current Bill, be considered appropriate?

   The answer is - only if substantial research indicates that the lenders are currently all charging at least near 3 times more than the amount that would generate a reasonable profit for their loans. No evidence of such Government sponsored or academic research has ever been provided and Smiles Turner research on industry costs clearly indicates that this proposition is unsound.

9. The Delegation notes that the second dot point, referring to a general interest rate cap, indicates that such a cap must be set "*taking into account the experience of the cap in the States and Territories where it currently operates*".

   Unfortunately "*the experience*" is not explored in the RIS which, nevertheless, proceeds to strongly encourage the adoption of this option. This is a very serious omission.

© *Smiles Turner, November 2011*

10. Without any research or factual comment, the RIS proceeds to erroneously note that the option will have the following different consequences for lenders -

    - "*Some lenders will be able to continue to operate...*
    - *Some but not all lenders would have lower revenue per contract.*
    - *Lenders would be under pressure to reduce operating costs.*
    - *Some lenders would exit the market... it is more likely to be those lenders who are reluctant to comply with the cap because they want to keep charging costs that are uncompetitive.*
    - *Some of these lenders would continue to operate but seek to recover a similar level of costs by adopting a range of methods to avoid the comprehensive cap (again requiring specific anti-avoidance measures).*
    - *Again, it is unlikely that there would be any increase in loan sharks... it is expected a larger number of lenders would remain in the market*".

    On the basis of Smiles Turner qualitative research and industry analysis, these are fundamentally unsound and totally untested assumptions (by the RIS writers).

    It is unfortunate that the developers of the current Bill have accepted the above and have proceeded on the assumption that the current NSW cap is appropriate.

    This, and a similar inclusion on page 56, has encouraged one of the Minister's influential staff to continually claim that "*all the lenders have to do is reduce their operating costs*". Clearly, this staff member has never run a business.

    Unfortunately:

    - the lenders are generally small players compared to the mainstream financial institutions that have deals on the cost of using credit reference agencies;
    - no one is talking about reducing the relevant staff awards;
    - the Government keeps piling on compliance costs;
    - the media is not interested in doing many special deals for advertising that it can sell to industries not facing unrealistic price control; and
    - no landlord feels compelled to reduce rents to support the Minister's ambitions.

11. The last 2 dot points in the RIS are the only comments of factual substance. Except in Victoria, every jurisdiction with an existing cap has seen substantial avoidance measures introduced by most lenders and the rest leaving the microlending sector altogether. The RIS even notes that several "*methods*" have been adopted in NSW and explains a total of 9 having been adopted in both Queensland and NSW.

    As Policis' international research has indicated, strongly supported by numerous academic studies, listed elsewhere in this submission, every overseas jurisdiction that has attempted an effective ban on microlending, either intentional or as an indirect effect, has seen a rise in loan sharks and other untended consequences. In Europe it is illegal lending, in the US it is illegal and uncontrollable cross-border contracts, plus major increases in bouncing cheques and bankruptcies.

12. Other "reforms" - Beginning at page 51, the RIS considers the concepts of:

    (a) restricting consumers to one loan at a time;

    (b) restricting rollovers; and

    (c) restricting loan extensions or refinancing.

    Thereby:

    (d) restricting repeat borrowing;

    (e) encouraging longer term loans;

    (f) making lenders and brokers address "*specific high risk practices*"; and

    (g) minimising the risk of debt spiral -

© *Smiles Turner, November 2011*

with the overall aim being "*either a decrease in the amount of credit provided or a decline in the rate of growth of these products...*".

None of these measures include any associated reference to research. All have been adopted in the current Bill on that basis. Substantial Smiles Turner research results in these areas have been provided to Treasury at numerous different stages this year.

13. Concerning encouraging consumers to seek alternative sources, or seek financial counselling - the alternative sources of loans are listed from page 53 of the RIS. Unfortunately, the only listing of capacity and resources is included on page 55, when it is noted that the Government will provide $60.6 million over 4 years for the Good Shepherd Youth and Family Service/NAB schemes and the Brotherhood of St Laurence/ANZ Bank schemes.

    If the Minister achieves his objectives of total adherence to the Bill, as currently drafted, Treasurer Wayne Swan and his Government will have to find in excess of 160 times this amount, each year, to replace the commercial microlending sector.

    It is noted that, on page 55, the RIS successfully advocates the introduction of a mandatory "*high impact statement*", including reference to the alternatives, facilitated by lender and broker websites. If the Bill achieves its apparent objectives, this will be academic as there will be very few lender or broker websites.

Issues of support

Notwithstanding our overall concerns, there are a few areas of consideration and conclusion that are consistent with Smiles Turner research and industry analysis.

1. "*Most common use... to meet living expenses... negligible use of short term loans for discretionary purposes*", Page 6.

   The delegation is pleased to note that, on page 17, the RIS lists 5 studies in support, including the Smiles Turner research, which is the most comprehensive and definitive. This "*...found that the top uses for credit were for basic expenses ands bills (29.8%), personal (32.9%), car expenses (8.1%) and groceries (5.6%)*". A similar South Australian study undertaken by Smiles Turner in 2007, involving 535 South Australian consumers, had similar findings:

   - bills (25.3%);
   - groceries and food (22%);
   - shopping (undefined) (16.1%);
   - living costs (11.2%);
   - car repairs/maintenance (10%).

   It is interesting to note that the 2006 Smiles Turner Customer Survey revealed a considerable proportion of the borrowing could not be categorised as emergency circumstances - not an issue of people being driven to do desperate things, e.g. 24.8% - Christmas, 3.96% - holiday expenditure, 3.29% - white goods, 0.23% - for a birthday.

   In 2010 week to week expenditure, including emergencies, appeared to be 27.97% of the reasons for borrowing - a long way short of 100%.

2. "*Borrowers largely have no access to other forms of credit...*" (page 6).

   We are pleased to note that, on page 16, the RIS considers 4 studies in support, including the definitive and most comprehensive Smiles Turner research, involving 3,418 consumers across Australia. In the surveys, "*consumers reported that they had no access to other forms of credit - 71.6% (Qld), 72.1% (SA), 76.7% (NSW); 81.6% (WA)*", Page 16.

3. Admission that NSW cap does not work. The frank statement to be found on page 47 summarises all the submissions on the topic in which Smiles Turner have been involved for the last 11 years.

   "*In summary (assuming the flat rate cap was based on the New South Wales model), this option can be expected to have the following costs and benefits:*

© *Smiles Turner, November 2011*

- *It is unlikely to provide significant benefits for consumers, and can be expected to have a limited impact on costs (because of the development of avoidance techniques); and*
- *It will have a relatively low impact on providers, although it could be expected that some short-term lenders would cease operating in those jurisdictions that do not currently have a cap (Northern territory, South Australia, Tasmania and Western Australia)*".

If subsequent effective anti-avoidance measures are introduced, the Committee can be assured avoidance techniques will be replaced by the criminal element's approach, the current providers will move on and be replaced by the bikie gangs and the Lebanese/Australian and Vietnamese/Australian gangs, as discussed in the section on Criminal Elements.

ASIC compliance officers will have little to do, because the new breed of lender will be very hard to find and, if found, very, very mobile and there will be no Australian Credit Licenses in the microlending sector to police.

4. On page 60, the RIS concludes with the statement, "*In summary, these options are all intended to have significant and direct impact on short term lending practices... A benefit to low income borrowers ...is necessarily a cost to lenders*".

   Throughout the RIS its writers optimistically assume that at least "*some*" reluctant lenders will remain in the market. This optimism is presented without research and is contradicted by the results of Smiles Turner research in April/March and September 2011.

The foundations on which the contents of the Bill are built also assume that lenders will remain in the market. Unfortunately, while the RIS attempted to identify realistic caps for the smaller loans, no such attempt has been made within the current Bill. That means the foundations on which the Bill is constructed are unstable and the Minister's plans will collapse into a major socioeconomic disaster if the Bill is not suitably amended, before approval by the Parliament.

The RIS options and cap comments

The attitudes expressed in a number of areas associated with the discussion on the options are important to consider, given the lack of foundation associated with applying the current Bill's model across the whole microlending sector.

1. At page 45 - "*The cap can be set too low, and therefore risk putting out of business large parts of the market*".

   The current cap will put **all** lenders out of business.

2. At page 45 - quoting the 1973 UK Inquiry into Consumer Credit Reform, "*...with the Government stating that, "It would not be realistic to try to set a rate which could reasonably be applied to every type of transaction. Whether a rate is excessive essentially depends on such circumstances as the size and duration of the loan, whether it is secured or unsecured, the credit worthiness of the borrower*".

   The Delegation is pleased to note that this statement supports the Delegation's recommended alternative, discussed earlier. It is interesting to note the omission of a number of later UK reports that recommended against any kind of cap, regardless of size.

3. At page 45 - discussing the impact of a cap - "*If it is too low, it may restrict the availability of short term credit by limiting charges to such an extent that short term lending businesses become unprofitable. The consequences of this could be greater exclusion from the credit market of certain sections of the Australian population, or the emergence of an unregulated market in short term credit*".

   As discussed elsewhere in this submission, with three quarters of a million people looking for a lender, following the introduction of the cap provisions in the current Bill, the Delegation expects major exclusion and a major illegal market to emerge.

4. At page 45 - the introduction of a NSW cap - "*Some lenders will exit the market*", "*Some lenders will continue to operate ...by adopting a range of methods to avoid the comprehensive cap*", "*A small number of lenders may continue to operate by complying with the cap ...through economies of scale...(and) a market presence...*".

© *Smiles Turner, November 2011*

The paragraphs following this, which clearly recognise that avoidance could be expected, are realistic. Those that present that lenders will continue to lend under the (10%, 2% and 48% inclusive) caps proposed in the Bill are not realistic, particularly for those lenders lending under $3,000 and for most lending between $3,000 and $5,000.

5. At page 46 - "*It may also result in some borrowers being refused credit when this would not have been the case previously, where the return that can be earned from contracts with these borrowers is deemed insufficient to justify the risk. It is considered that this would be a relatively small number of borrowers...*".

   As this submission has previously discussed, the assessment of "*relatively small numbers*" is extremely unrealistic when applied to the clearly apparent result of the two caps in the current Bill. It will be an avalanche, unless avoidance is successfully implemented.

A Major Government Study Ignored by Treasury

The Victorian perspective

It is most unfortunate Treasury apparently failed to closely consider the one major government study ever undertaken in Australia, that considered the payday and microloans from a very comprehensive consumer perspective following substantial research and stakeholder contact.

The extensive Victorian Consumer Credit Review, undertaken in 2005, concluded with a review that should be considered closely by the Committee and all decision makers involved with the current Bill. 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:

(a) address the unfair contract terms prevalent in small amount, short term lending

(b) address the avoidance techniques used in this sector of the market

(c) be a catalyst for more affordable credit on the 'high street'

(d) help those who use small amount loan services sparingly and prudently

(e) 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

© Smiles Turner, November 2011

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."

These observations 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 Trading);
- 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 or since, 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*".

An Analysis of the Minister's Second Reading Speech

The Delegation appreciates the courtesy shown by the Minister in his invitation for the Delegation and others to meet with him on 9th September, 2011, and his obvious commitment to a consultation and review process - as evidenced by his referral of the current Bill to two Parliamentary Committees.

In this context, the Delegation does not believe it is appropriate or helpful, during the period associated with the Committee's enquiry, to engage in adverse public comment directed at the Minister or the Government and the Delegation does not support those who have adopted and continue to adopt such a strategy.

However, there are issues associated with the Minister's Second Reading Speech (21 September 2011) that, in the interests of the Committee fully appreciating the Delegation's position, demand mention and critical consideration in this Submission.

The following are extracts from the Minister's speech, followed by the Delegation's comments. Please note that many of these responses cover topics given greater attention later in this Submission.

"*Today I introduce the Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011... It also underlines how this Gillard Labor government is unquestionably both pro-business and a consumer champion*".

Delegation Comment: While we are sure the Minister means well, the current Bill is far from "*pro-business*", when actual lending costs are recognised.

"*This bill maintains our commitment to ensuring that the balance of fairness is not lost, particularly for the most vulnerable of consumers*".

Delegation Comment: The average consumer is hardly well served when a credit vacuum is being created to accommodate a minority of "*vulnerable*" consumers.

"***Payday lending***

...it is estimated that at least $500 million is lent annually in short-term, small amount loans. At one end it can include small loans in which a person borrows $300 which must be repaid plus interest a week or two later, on the borrower's next payday. It also covers larger loans up to $2,000".

Delegation Comment: The Minister indicates considerable confusion between very small amount, short term payday lending and microlending, which includes loans for $2,000. In excess of $500 million is lent on just payday loans and, as indicated elsewhere in this Submission, the relevant small amount, short term credit annual loan book is **$1.2 billion**.

"*The vast majority of these loans are sought by low-paid workers or people on Centrelink benefits. It is estimated that nearly half of payday borrowers have incomes of less than $24,000 a year, and up to two-thirds earn less than $36,000. We do not believe it is acceptable that these consumers are left to pay exorbitant rates of interest because they have a very urgent need for a small amount of money*".

Delegation Comment: These are figures taken from relatively poor - and now very dated - 2008 research undertaken for the Consumer Action Legal Centre in Victoria. The contemporary proportions for all small amount, short term borrowers, across the sector, are closer to 20% of borrowers with incomes of $20,000 to $24,000 or less. The small sample selected for the 2008 study appears to have been biased towards lower income earners.

"*Australians who use payday loans are usually unable to access other cheaper forms of credit*".

Delegation Comment: Veda Advantage reports a significant growth in borrowers from the payday and microlending sector who could just as easily have accessed bank credit. However, the majority of payday and micro-borrowers are turned away by the banks, who are not interested in advancing personal loans for generally under $4,000.

"*Borrowing money at very high interest leaves the underlying financial difficulties unresolved. When the direct debit payment comes out automatically at the next payday, it can leave the borrower with no cash for the next week's basics, so they have to go and get another loan, trapping them again in a cycle of debt*".

Delegation Comment: This is a consumer advocate myth. Under the NCCP Act, responsible lending does not permit this. It should be noted that unwise discretionary spending by the consumer, particularly on cigarettes and alcohol, can be a major contributor to the problem.

"*A significant number of borrowers take out multiple loans and there is evidence that some lenders' existing business models actually rely on this occurring. They need people to keep coming back again and again, borrowing more and more, and paying larger and larger fees*".

Delegation Comment: Again, this practice must satisfy responsible lending criteria. Abuse of this mandatory consideration can attract fines of $220,000 for an individual and $1.1 million for a company.

"*Take the example of a person on a fortnightly Centrelink benefit. They are 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*".

© Smiles Turner, November 2011

Delegation Comment: This appears to be The Cash Store's model, probably imported by the Canadian company's owners and is not adopted by the majority of Australian lenders.

"*There is a case to argue that in payday lending there is a significant example of market failure: the price of borrowing money is simply too high. Borrowers who are desperate for cash will pay whatever it costs to get them their loan quickly, whatever the consequences might be the next week*".

Delegation Comment: If the price is too high, two of the major reasons are the National Credit Code regulation that makes it too expensive to advertise interest rates, because you have to then buy extra space to display a useless comparison rate chart, and the second is the continuing regulatory uncertainty that is scaring off new entrants into the lending market.

The Smiles Turner 2010 industry survey revealed that 35.9% of lenders would like to be able to advertise their interest rate, fees and charges and would do so if they didn't have to buy the extra space necessary for the comparative rate table. In this context it should be noted that 25.6% of the respondents to the November 2010 lender survey, were currently advertising their interest rates and 20.5% were advertising their fees and charges.

It is also important to note that, unlike companies such as The Cash Store, Delegation supporters do not insist on one only repayment, as the Minister has suggested applies universally. Delegation supporters require at least two or more periodic payment amounts.

"*In America, some states have adopted caps of between 16 per cent and 35 per cent. In Canada, rates are capped as low as 17 per cent in some provinces. Interest rate caps apply in 14 European Union nations: France, Germany, Italy, the Netherlands, Poland, Portugal, Slovakia, Spain, Slovenia, Greece, Ireland, Malta, Belgium and Estonia*".

Delegation Comment: The Delegation is particularly concerned at the attempts to compare USA caps and lender profitability with Australian lending and prosed cap levels. This ignores the majority of USA jurisdictions that have rejected their adoption, the methods of avoidance being used in the jurisdictions that have adopted the caps, the much cheaper costs experienced by North American lenders and various government controlled lending interventions in a number of European countries that are not duplicated in Australia. The USA lenders enjoy a situation which is the reverse of that suffered by Australian lenders.

The quoted USA rates do not provide a useful comparison with that which is proposed for Australia. As in Canada, the USA rates are flat ad valorem rates and not daily reducible interest rates, as demanded by the National Credit Code. For example, the 35% flat rate applying in some provinces of Canada is actually approximately 65% reducible. This also ignores the other jurisdictions that have refused a cap (discussed in greater detail elsewhere in this submission).

As considered by Greg Elliehausen, Board of Governors, Federal Research Washington DC and Direct of Research and Statistics, George Washington University School of Business and author of the two papers, "*Consumer Use of High Cost Credit Products*" and "*Memograph 41, Analysis of high Cost Credit*", July 2009 - an Australian lender charging 35% is subject to 66% of that being costs and 33% being profit. In the USA, the lender earning 35% is subject to 33% of that being costs and 67% of that being profit.

"*This cap delivers real outcomes for consumers. It ensures that borrowers who are in need of a small amount loan will not face relatively high costs, and will reduce the risk of an ongoing cycle of dependency through the continued use of this form of credit*".

Delegation Comment: True - not for the reasons the Minister has given - but because there simply will be almost no commercial loans offered in the sector after 1 January 2013, when the current Bill's caps are scheduled for commencement.

"*The bill addresses the risk of a debt spiral by introducing prohibitions on refinancing small amount contracts, and on lenders and brokers providing or arranging multiple loans. It may be convenient or simple for a consumer to take out one loan to meet the repayments under a second loan. However, in the long term they are only going backwards financially until they reach a point where they can no longer repay their debts and seek help*".

Delegation Comment: The second element is largely unacceptable under responsible lending criteria while the first element, with its blanket prohibitions, contradicts the whole premise of mandatory responsible lending and the 90 day credit assessment regime.

© *Smiles Turner, November 2011*

"*Also, we think more could be done to encourage consumers to utilise other cheaper options. There are currently cheaper alternatives to small-amount loans, such as Centrelink advances, utility hardship programs from the large utility companies, and no-interest and low-interest microfinance schemes. Under these reforms small-amount lenders will be required to disclose the availability of these options to their customers*".

Delegation Comment: The sector has accepted this disclosure responsibility but, again, it is emphasised that the Minister's words imply an unlimited supply of these alternatives - which simply is not the case.

"*Let me be clear, the Gillard government strongly believes that short-term loans do have a role in the Australian economy and should be a part of everyday life, but we are also focussed on protecting vulnerable consumers, not terminating the payday lending industry. We do believe it is time that the interests of consumers are improved*".

Delegation Comment: If the Bill works as the Minister intends, with the effective abolition of most lenders, none of the above will be achieved.

"*Whilst early negotiations with payday lenders perhaps have not seen much movement from payday lenders, I do remain optimistic that, in the process of consultation and negotiation of this bill, sensible heads and pragmatic business operators amongst the payday lenders will recognise that change is inevitable and the status quo can no longer remain. I look forward to that process*".

Delegation Comment: The Delegation and its supporters have deliberately not participated in any media campaigns attempting to fight for change, or no caps. Instead, the Delegation has offered a realistic change for the Minister and the Committee to consider, but the Committee and the Minister will have to accept that pragmatic business operators do not enthusiastically embrace the current Bill that will see their substantial investment, their staff's employment, their own employment, their businesses and, in some cases, their homes effectively destroyed within 14 months.

Pragmatic political leadership, committed to protecting the majority of consumers, cannot endorse or continue to endorse a Bill which will provide credit exclusion for up to 750,000 Australians.

"...a majority of Members State authorities underscored that in their view interest rate restrictions are not justified. They argued that interest rate restrictions can give way to black economy as regulation and the ceiling can be circumvented. Also, it was stressed that the interest rate ceiling is an intervention that limits the access to credit and narrows the room for manoeuvre in credit risk management".

European Commission, Directorate General Internal Market and Services, Financial Institutions, retail financial services and consumer policy report, "*Summary of Responses to the Public Consultation on the Study on Interest Rate Restrictions in the EU*", Brussels, 15 June 2011.

Responses from government authorities included: Czech Republic, Denmark, Germany, Estonia, Greece, Spain, France, Malta, Austria, Poland, Portugal, Romania, Finland, Sweden, United Kingdom

© *Smiles Turner, November 2011*

SECTION 5

Non-Commercial Alternatives Grossly Inadequate

This Section explores the fundamental deficiency that lies like a great shadow across the current Bill and has nothing to do with the commercial lenders. This deficiency, which has still to be addressed by the Minister and has never been addressed by the consumer advocates, is the inadequacy of the championed non-commercial alternatives to commercial small amount, short term lending.

Decisions Demanding Alternatives, Without Timely Research

As the Delegation has stressed throughout this Submission, the Delegation is deeply concerned that, if the intentions of the current Bill are achieved, payday and most microlending will be effectively abolished in Australia as of 1 January 2013.

The Delegation was particularly concerned with the Minister's statement in his media release of 25th August 2011, when announcing the release of the Exposure Draft -

"*The government will also release a discussion paper with more detailed proposals to improve access to alternatives to payday loans*".

It was noted with amazement that the timetable for this discussion was stated as being "*in the next 3 months*". Without this discussion, the current Bill should not proceed.

Six days after the Minister's press release, Ms Carolyn Bond from the Consumer Action Legal Centre commented, on TV's Today Tonight, "*The cap will reduce the amount people will have to pay*". No quantitative support was offered for this statement.

The challenge for both the Minister and Ms Bond is that, if the current Bill proceeds unchanged, there will be an urgent need for access to alternatives and, without the identification of adequate resources for such there will be no loans available to repay. This in circumstances where, effectively, there will be no commercial lenders in this sector.

The Delegation considers that this discussion should have been an integral part of the consultation process associated with all the reforms over the last 18 months, and particularly those included in the August Exposure Draft. The issue of alternatives should also have been a major inclusion in the Regulatory Impact Statement.

Instead it was ignored.

It appears this absolutely critical Discussion Paper will now be released, along with the associated consultation process, after the Bill has been considered by two Parliamentary Committees and possibly even after the vote in the Parliament.

The Delegation has warned Treasury a number of times throughout the consultation process that adherence to an unrealistic regulatory regime, in regard to interest, fees and charges caps, would drive many or all lenders from the sector. As discussed in this Submission, under the proposals included in the current Bill - without any doubt - this will happen.

These draconian proposals lose their efficacy if the Minister does not already know what all the alternatives are - and their willingness and capacity to satisfy the demand.

While the Delegation is aware of one Treasury official's comment to a lender, that "*they*" have got the issue of lenders closing "*covered*" - unless the Australia Post People's Bank is coming on stream, as discussed below, the Delegation is unable to identify any other feasible solution.

The planned Discussion Paper has come too late. Its delay has left the consumer advocates free to irresponsibly argue for the measures in the current Bill that will destroy the commercial microlending sector. They have been free to generate their sensationalist media coverage without any accountability for factual information. They have been free to chant their 48% cap mantra, without any responsibility for the adverse outcome.

They will be challenged in their attempt to respond to the proposed Discussion Paper concerning the availability of alternatives but, unfortunately, their public exposure will also have come too late.

© *Smiles Turner, November 2011*

During her speech at the Melbourne launch of the July 2010 University of Queensland study "*The Experience of Using Fringe Lenders in Queensland: A Pilot Study*", co-author, Dr Lynda Shevallar (with Dr Gregory Marston), Social Policy Unit, School of Social Work and Human Resources, spoke of her experience where she had been forced to put aside her middle class, financially relatively comfortable preconceptions and look at the reality.

Drs Shevallar and Marston noted in their study, at page 79, "*Policy reforms aimed at limiting the costs of those loans and access to these products may be well intentioned, but they can also have unintended consequences, particularly if fairer credit alternatives are not made available and more permanent preventative measures put in place*".

Friends and relatives

It is useful to note that, in the 2007 Smiles Turner national consumer survey, the respondents revealed that 17.9% had been refused a loan by a family member or friend, and 60.2% were uncomfortable asking a family member or friend for a loan. Of possible future relevance, the 2010 consumer research revealed that 17.85% of the respondents optimistically intended to approach a friend or family member for a loan, if their current lender was closed down under Government legislation.

In 2011, when asked what they would do if their lenders were shut down, consumers indicated that they would turn to family (7.7%) and friends (1.5%). Applying the refusal rate revealed in 2007, this total would be reduced by 2% and those rejected people (15,000) would join all the others seeking help from the non-commercial lending sector. The Delegation notes that 15,000 is approximately the total number of non-commercial sector loans claimed to have been provided annually.

Not-for-profit, Non-commercial Credit Opportunities

Unfortunately, while charitable and community organisations make a commendable contribution, there are significant limitations in regard to the credit opportunities they offer. Therefore, they cannot provide a comprehensive alternative to the commercial microlenders. These limitations include:

- Until now, funding of no more than $20 million per annum, with the addition of $16 million, spread over the next four years, as consumers were reminded by the Minister in August;
- Loan numbers less than 20,000 per annum;
- Currently, the non-commercial organisations involved do not have the people power necessary for long term and substantially increased involvement;
- The organisations involved do not have the expensive number of outlets required, across Australia. While recent statements included in bank media releases would encourage the reader to believe there may be numbers around 280, the most recent ACOSS report lists 175 such financial service outlets;
- A considerable number of the non-commercial credit providers' activities have been of a pilot nature, or have only recently emerged from that pilot status;
- 94% of applicants are refused a loan;
- Terms are longer than most microloans - up to 18 months;
- Limited generally to Centrelink benefit recipients and the unemployed;
- Long delays, up to 6 weeks until being interviewed;
- Generally for white goods and emergencies, not discretionary or day to day purchases.

Smiles Turner research has consistently revealed that the percentage of commercial loan borrowers applying for a loan for a purpose that falls within the NILS' criteria, has ranged from 2.4% (2007) to 16% (2011).

Given that the commercial sector lends approximately 1.5 million loans a year, it is useful to note inclusions from media releases and other publicity publications presented by the ANZ and NAB and various non-commercial organisations involved in partnership with these banks, in recent years.

© *Smiles Turner, November 2011*

"**Saver Plus**"

In 2004, in partnership with the Brotherhood of St Laurence, the ANZ Bank piloted this matched savings program. Participants are provided with financial education and personal financial coaching. They also receive a dollar for dollar saving incentive up to $500.

In 2005, the program extended beyond one state, with an allocation of $3 million from the ANZ Bank, over three years, commencing 2006. The objective was to help 5,400 families in 3 states.

At the time, it was calculated that the $3 million would not have been sufficient to fund an average fortnight's payday and microlending in Victoria, or NSW, or Queensland, the states where the Saver Plus scheme was established. It is interesting to note that the $3 million contribution was for 5 different credit areas, only one of which was payday loans.

In regard to the ANZ's Saver Plus product, details concerning their results can be found on the ANZ website (Ref: www.anz.com/about-us/corporate-responsibility). The 2009 results gave some indication of the non-commercial sector's size, relative to the commercial sector. While the Saver Plus initiative involves a matched savings and financial literacy program, the number of participants involved tell an interesting story.

At its commencement in 2004, 248 people were involved, with an ANZ investment, including the matching amount, of $810,000. In 2009, the numbers had grown to 1,192, with $3 million invested. The average for those 6 years was 837 people, with a combined investment of $890,000. At the time, a Western Australian-based franchise group, with a relative handful of outlets in three states, was easily lending that amount in under two months.

In the 2009 publication, the conclusion reads, "*We will work with our community partners and the Australian Government to reach a further 7,600 people with our Saver Plus program over two years*". In a media release dated 16th October 2009, the ANZ announced that the Saver Plus program was then being delivered from 20 locations across Australia. The anticipated 7,600 people, over the two years "*by 2011*", was to be achieved by making it available "*from more than 50 sites*".

The 2010 results listed 3,320 participants, with the ANZ investment constituting $1,624,000, delivered from 60 community sites, to an average of 55 people per site.

These figures have to be compared with one of the larger retail lenders with some 46 outlets, operating in three states, who lends in excess of 10,000 loans a month.

In a speech to the Commonwealth Parliament's House of Representatives on 23 May 2011, Ms Maria Vamvakinou, the Member for Calwell (Victoria), indicated that the ANZ Saver Plus scheme had assisted 253 families in her electorate since its establishment in her Melbourne suburban area in 2007. There are at least three payday and microlending outlets in her electorate, with at least one of them lending that number of loans in an average week.

"**StepUp**"

The NAB/Good Shepherd StepUp Loan Scheme started in 2004 and offered unsecured loans from $800 to $3,000. It was only available in South Australia, Victoria and NSW, with the loan purpose limited to household goods. It was a financial failure, requiring a mid-way injection of further funds.

From October 2004 to May 2006, the scheme averaged only 6.14 loans per pilot location, had handled 522 enquiries (an average of 74 enquiries for loans, per outlet) and, by May 2006, there were 42 active loans.

In contrast, the Smiles Turner November 2006 Loan Information Survey indicated that, at the time, there was an average of 204.8 active loans, per small amount, short term commercial lender outlet and this was excluding the two largest companies.

The rejection rate for the StepUp Scheme was 91.7% and there were fewer than 300 loans ever issued at that time. It is interesting to note that, on required purpose criteria alone, more than 90% of commercial borrowers would not qualify for a StepUp Loan.

In contrast, the Smiles Turner surveys indicate the commercial lenders' average rejection rate as being as high as 53%.

© *Smiles Turner, November 2011*

On the Rosemount Good Shepherd website, the loan purposes for which the NAB StepUp program applies are listed under the heading "*What are the loans for?*", as being:

"*Loans are available for items such as fridges, washing machines, computers, furniture, medical expenses, house repairs, airfares for refugee family reunion, second-hand cars, car repairs & vocational education.*

Loans are not for cash, holidays, bills or debt consolidation, and a credit check is required".

The ASIC Money Smart website adds the purposes, "*buy health items such as wheelchairs or asthma pumps… pay for car repairs (although these loans are only available to people who live in areas where there is little or no public transport)...*".

It should be noted that the Good Shepherd website states the loans are specifically for "*Individuals or families holding a current Centrelink Health Care Card or Pension Card or Family Tax Benefit Part A*", with the applicant/s having to "*have lived at their current address for more than three months*" and the ASIC website adds the criteria that "*You must also show that you can and are willing to repay the loan within 12 or 18 months*".

In a media release from the NAB, dated Friday 20th February 2009, there was celebration that the NAB StepUp loans program in NSW "*has delivered over 180 not-for-profit loans worth up to $3,000 since the program launched in NSW in October 2004. This comes as NAB has announced a national milestone of 1,200 loans valued at more than $3.2 million since 2004...".*

Public statements by the CEO and Chairman of Cash Converters indicate that most Cash Converters stores each equal or better that number of loans in just one month.

It is understood that this NAB small loans program lent 699 loans in the preceding two years, with 4 new loans advanced in June 2010. In October 2010, 81 new loans were issued. The average number of loans for the two year period was 29 loans per month.

The Delegation notes that, with is no deduction for administration, the average national StepUp loan is $2,667 per person. This is considerably more than the $275-$325 average payday loan and is likely to suit fewer than 8.6% of small amount, short term borrowers (2010 Smiles Turner industry research).

"NILS"

The May 2009 NAB publication, "*Growing the NILS® footprint: A summary of NAB's commitment to the No Interest Loan Scheme*", has the following inclusions:

"*Good Shepherd Youth & Family Service coordinates an expanding national NILS network, rolling out the program to over 280 other community agencies across Australia. These programs... provide approximately 5,500 small loans per annum. The total value of lending in 2008 was $4 million*". The Delegation note that the loans averaged $727.27.

The publication goes on to state, "*NILS loan features... Amount $800-2,000 (depends on individual program capacity)... loan defaults 3-5% ...loan term 1-1.5 years".*

Under the subheading "*NILS customer profile*", the top 5 loan purposes listed were, "*Fridges and freezers: 30%, washing machines: 21%, household appliances: 12%, beds: 8%, computers: 6%*". Income type was listed as "*Newstart: 20%, disability: 26%, age: 6%, parenting pay (single): 32%, parenting (partnered): 5%, other govt: 10%*".

Although claiming to have rolled out the programme to "*over 280*" other community agencies, the same report, for the three year period completed in 2008, states "*$10 million of loan capital across the nation (was allocated) to 142 groups*".

The Delegation notes that, averaging the amounts, each of the 142 groups were provided with $23,474 to cover 38.7 loans per year. Most Delegation supporters are advancing in excess of that number each week.

The Delegation notes that the NAB target for 2010 was "*140 schemes*" and "*9,000 loans*".

That target appears optimistic, given it would have involved a minimum loan book of $7.2 million in that year alone. This amount would have been a minimum of 218% more than the NAB had previously allocated, annually, up to 2008 and the Delegation was unable to discover any announcements of such a substantial increase in funding.

© *Smiles Turner, November 2011*

The NAB 2010 Annual Review reported that, from May 2008 to September 2010, micro-enterprise loans, plus StepUp loans, plus NILS loans provided 15,445 loans. Between January and September 2010, for those 9 months alone, the commercial lenders had already lent in excess of 1 million loans.

"Progress Loans"

The ANZ/Community Development Finance Program, involving $3 million funding, started in 2005. The target was 200 loans of between $500 and $3,000 for essential household goods (at the time, Smiles Turner research indicated that only 1.68% of microlenders' credit was for essential household goods).

On the 31st May 2006, AAP released a news item entitled "*Poor to access credit under new program*". Referring to the Brotherhood of St Laurence and the ANZ partnership, the news item noted that, "*under a pilot version of the program, 20 people have so far taken out loans this year*". This is the same number of loans that were being advanced in less than one week, in most of the commercial retail lending outlets at the time. In fact, at about the same time, an Adelaide lender with a small number of outlets was lending 576 loans a week.

The ANZ "*Progress Loans Update*", dated July 2007, reported on the commencement of the Progress Loans Scheme. Eligibility criteria stipulates the loans are for Healthcare Card and Pension Card holders who have "*Demonstrated money management ability through paid utility and other personal bills and no unpaid credit defaults above $300 within last five years*".

This appears to preclude many who would be classified as *"desperate and vulnerable"*.

The purpose is described as "*household items and services, education and self development, medical and dental care*".

"*The most common loan purpose was the purchase of whitegoods like washing machines and refrigerators (27%) followed by household furniture (19%) and motor vehicles (27%)*".

In the March/April 2011, 10.4% of consumers borrowed for such purposes.

The results of the May 2006 to May 2007 Pilot Scheme reported the number of loans drawn as 140, from a total of 225 applications, with the average loan size being $1,549. A total of $216,800 was lent.

During that period, a Smiles Turner survey of 100 lending outlets in Queensland, including small and medium lenders, revealed that these lenders had an average of 15,500 loans on their books and, in total, had lent $30 million over the preceding 12 months (note, this amount did not include the big lenders such as the City Finance franchise group and Cash Converters).

"AddsUp"

The ASIC Money Smart website also lists the AddsUp program, which is described as "*A matched savings plan open to people who have successfully repaid their NILS or StepUp loan. Once you have saved $300, the bank will put in a dollar for every dollar you save, up to a level of $500*".

This worthwhile program does not apply to the majority of people who have a relatively urgent perceived need to borrow and no discretionary funds at their disposal. A savings plan is not much assistance to a person who urgently requires the money.

It also limits the participation to NILS and StepUp borrowers, who must be Centrelink benefit etc. recipients.

NAB "Fast Money" Program

Now 4 years old, the NAB Fast Money Program was last reported as averaging 31 loans per month. This is equal to or higher than just 4 of the 19 lenders surveyed in September 2011 and constitutes less than 20% of the average loan volume in that survey.

The Delegation understands it continues to reject between 92 and 96% of all applicants and, as is mentioned elsewhere in this Submission, does not believe any lender can break even on an inclusive 48% cap.

© *Smiles Turner, November 2011*

"<u>Utility Bills</u>"

As the Money Smart website explains, "*If you're having trouble paying a water, phone, gas or electricity bill, contact your utility provider. Most companies have hardship officers who can help you work out a plan to pay the bill in instalments*".

No evidence from the utilities concerning their hardship programs appears to have been collected by the consumer advocates, or provided by the companies themselves, to either Parliamentary Committee.

The Delegation regards this as significant, given the assumption by the consumer advocates that these companies can turn into charitable loan companies, by extending their repayment arrangements to all who apply claiming inability to pay. This assumption presumes that the shareholders will approve, when they bought their shares in a utility - not a charitable institution.

It may be of interest to note that Smiles Turner consumer research in 2010 indicated that a maximum of 12.6% of respondents were aware of this opportunity. In addition, up to 4.5% of respondents have received such assistance.

The April 2011 consumer survey, involving 1,305 respondents, revealed that 24.5% of respondents had availed themselves of assistance by a utility. Such a relatively large proportion may indicate an already substantial awareness of such assistance by consumers.

These substantial numbers must encourage Committee examination of the capacity of the utility companies to financially accommodate any more demand for delayed payment. In addition, it must be noted that this apparent increase in demand for utility assistance did not stop the exponential growth in demand for payday and microlending.

"<u>Centrelink Advance</u>"

The Money Smart website states, "*If you're eligible for Centrelink payments, you may be able to get an advance payment. The amount available varies depending on the type of payment you receive. For some payments it is between $250 and $500. For other payments, such as pensions, it is between 1 and 3 week's worth of payment. You'll have to pay this money back to Centrelink over 6 months,... you won't have to pay interest or fees*".

The Delegation is particularly aware that most of the above alternatives are not available to people who are not Centrelink beneficiaries.

The assistance offered may suit a portion of the *"desperate and vulnerable"*, but it appears those potential borrowers who do not fall into this category cannot expect to obtain credit through one of these sources - that includes the great majority of commercial small amount, short term lenders' customers.

The Delegation recognises that there may be a social justice issue involved, with the variety of non-commercial assistance available for a minority of Centrelink recipients. The issue may well be society's recognition that Centrelink Benefits need to be increased, not provided ad hoc and relatively easily exploited by a minority of Centrelink recipients.

<u>Housing assistance</u>

The system whereby private tenants receive cash assistance from the Commonwealth and public tenants receive rebated rent assistance from the states, has not been mentioned by the Minister, or the consumer advocates.

A number of states fix the rent paid by public tenants at approximately 20% of their income, while the Commonwealth schemes tend to be based on levels of private rent.

This source of assistance will be relevant if the current Bill commences unamended because, as revealed in Smiles Turner's 2006-7 customer surveys and in 2010, up to 6.6% of all borrowings are applied to rent or financing rental bonds.

In 2011, 2.2% of respondents to the March/April survey indicated that they had borrowed for rent, a bond, or some associated housing assistance.

© *Smiles Turner, November 2011*

A case study

Applying the 10%, 2% and 48% 2-tier regime to the historic pilot study referred to in the paper, "*To their credit - evaluating an experiment with personal loans for people on low incomes*", Rosanna Scutella and Genevieve Sheehan, Brotherhood of St Laurence, May 2006, provides some useful insights into the challenges the non-commercial sector will have post-1 January 2013, if the current Bill proceeds unamended. The authors considered the performance of this pilot scheme carried out by the Brotherhood.

On pp 26-30, Scutella and Sheehan detailed generally applicable reasons why these types of programs can never be regarded as the comprehensive replacement for commercial microlending. The Delegation comments included below apply the provisions in the current Bill, by taking an average of the pilot's loans of $1,200 for a term of 1 year. The figures also demonstrate why the commercial small amount, short term lenders will largely cease to exist:

"The average rate of arrears over the pilot was 4%".

Delegation comment: The Delegation provides the following table, to illustrate four possible scenarios associated with one of the loans included in that 4%. Also included are the figures for a successfully completed loan.

Payment History	0 repaid	25% at 3 months	50% at 6 months	75% at 9 months	100% repaid in 12 months
Principal repaid	$0	$300	$600	$900	$1,200
Day 1 - 10%, 2%	$144	$144	$144	$144	$144
Total 2% per month (month 2 on)	$0	$48	$144	$192	$288
Total fees received	$144	$192	$288	$336	$432
Principal repaid + total fees	$144	$492	$888	$1,236	$1,632
Balance total receipts - $1,200 principal	-$1,056	-$708	-$312	$36	$452
Balance incl. $801 average cost	-$1,853	-$1,509	-$1,113	-$765	-$369

This chart demonstrates that the actual costs per loan experienced by the Pilot Scheme (average $801) could never be recovered under the current Bill's provisions, because there is no opportunity to adjust your price to reflect the actual cost of your loans.

To simply allow sufficient gross income to cover this cost, plus those identified above (not all costs that a commercial lender faces are included), plus allow a contribution for the 4% default rate, the 10% establishment fee would have to be increased to 44.75%.

It must be remembered that there were significant subsidies applied in the Pilot Scheme that are not available to the commercial lender.

It is useful to note that applying the most identifiable costs associated with the September 2011 lenders, including commercial-in-confidence information, results in a loss of $370 per loan. In an effort to calculate an indicative value constituting "break even" for this program, to replace the 10% establishment fee, the Delegation has very conservatively used the program costs noted below. This is assuming it to be the total cost, to allow simplicity of calculation. That means the conclusions reached by the Delegation are purely indicative and, if full financial details were available, somewhat higher cost amounts could emerge.

In regard to the 2% per month, at least an extra $516 has been assessed as real costs. To break even, with this extra cost impost, would demand the 2% be increased to 5.58%.

Conducting this project in a commercial environment, with access to greater economies of scale, a loan book of at least 10 times that of the pilot scheme and lending capital measured in millions, not a few hundred thousand, may generate a break even cost structure where the 10% would have to be increased to between 21 and 25%, while maintaining the 2% per month. None of the September lender respondents would accept such a business environment.

© *Smiles Turner, November 2011*

Over a two and a half year pilot, 212 applications were received and 170 loans were provided.

The program cost $136,284, which equals an average $801.67 per loan.

"The salary expenses of this type of program are increased because many people on low incomes are inexperienced in dealing with the banking sector, or have financial or other literacy problems. They therefore have difficulty with paperwork and processes and require a higher level of support than banks may otherwise provide. In fact, there was an average of seven contacts per customer, either by phone or meeting in person (which added considerably to staffing costs)."

Delegation comment: On the basis of the results of the September 2011 survey, if a commercial lender had been involved, a contribution to one staff member's wages and on-costs of $16,354, would have to be factored in.

All of this despite the fact that the program had additional assistance, in that *"Many professionals assisted on a pro-bono or voluntary basis. In addition, free space was provided in newsletters and local newspapers and brochures were displayed at a variety of organisations for no cost, so marketing costs were reduced. The Brotherhood's retail division did not charge rent, giving the program the flexibility to experiment across a range of geographic locations. Because of the generosity of people and organisations, it is difficult to determine the true investment made into developing this model."*

Delegation comment: On the basis of the September 2011 research, an additional $30,306 for marketing and $41,062 for rent would have to be included.

In addition, the Brotherhood of St Laurence reported a loss, *"...At the end of the two and a half year pilot, the program had not yet achieved cost recovery, requiring a subsidy of over $100,000. For it to become financially sustainable, the volume of loans (and therefore interest income) will need to increase substantially and the process made more efficient."*

We note that the $100,000 could have funded the Principal for 83 loans. The challenge is - why provide a further opportunity to lose another $30,750?

Consumers avoid charities and government handouts

The Smiles Turner national survey 2006-7 involved 3,034 consumers across Australia. The percentage of those, in three of the relevant states, who indicated they would turn to Government or charity if the small amount, short term lenders were closed down were - 0.7% in SA, 1.5% in NSW and 3.9% in Queensland.

This reluctance is supported by Commonwealth Government statistics. In the Department of Prime Minister and Cabinet, "*Family Economic Wellbeing study, Families in Australia*", 2008, at Table 5.1 - the proportion of population reporting cash flow problems over the past year (2006), revealed families were:

- unable to pay utilities - 10.9%;
- unable to make minimum payment on credit cards - 4.5%;
- went without meals - 2%;
- pawned or sold something - 2%; but
- only 2.2% sought assistance from charities.

Consumer awareness of the proposed alternatives

The Delegation has reflected on the possible challenges in regard to counteracting a low consumer awareness of these various schemes. The following table, taken from Smiles Turner 2007 National research, reflects the consumers' recognition:

Customer Response	NSW %	SA %	Qld %	WA %
Knew of a no-interest or low-interest loan scheme	12.6	6.4	12.0	12.6
Has borrowed from a no-interest or low-interest loan scheme (including Centrelink)	10.5	3.6	9.0	12.3

This awareness was canvassed in the March/April 2011 consumer survey (1,305 respondents), when consumers were asked if they had ever tried to get a loan from one of the following schemes, with the proportion of the total sample who had attempted to do so segregated into the following:

NILS	3.5%	StepUp	0.7%	Progress	1.1%	NAB Money	4.1%
LILS	0.5%	AddsUp	0.6%	Saver Plus	1.0%		

Other Possible Alternatives

In the absence of adequate planned major funding for non-commercial lenders, after the possibly unchanged Bill commences as law, the Delegation believes that it is appropriate for the Committee to consider a range of other alternatives.

An Australian Grameen Bank

This concept may have earned founder Professor Muhammad Yunas considerable world fame, but the model has some flaws in it which might discourage serious adoption by the Australian Government. The record now shows:

- 10% of all loans are overdue, with 19.5% of all loans one year overdue.
- The bank is converting many overdue loans into "flexible" loans.
- The bank has provided 15% as a provision against loan losses, when the Consultative Group to Assist the Poor (CGAP) recommends 50%.
- The 1,170 branches throughout Bangladesh are expensive to run. Accounting standards are unconventional, e.g. while a profit of $200,000 was being declared in 2000, employing appropriate accounting standards indicates that it actually lost $7.5 million in that year.

A more successful attempt at such a bank can be found in the UK. Fair Finance, established in 2005 and now financed in some considerable part by two mainstream banks, has proved a modest success. However, its loan book is understood to be less than £4 million and its loans are generally for 10 months or more and for amounts of £500.

Expanding credit unions

The opportunity to expand credit unions should not be overlooked. As the Minister would have noted during his time with the AWU, the AWU's Credit Union, in North Hobart, could provide a model.

Treasurer, Wayne Swan advocated these as an alternative to the banks on 22 November 2010, on radio 2UE and ABC Radio 774. We can presume that, as the high fees charged by banks was a concern at that time, a similar preference could be expected from the Treasurer in circumstances of allegations of high charges by non-mainstream lenders.

Unfortunately, expansion of the credit union movement will involve an appropriate lead period for planning and the establishment of a branch infrastructure to at least equal the current outlet and branch numbers of the microlending sector.

There is one other fundamental problem the Minister will have to address, if this is the commercial lending option favoured - and that is most of the small amount, short term loans advanced by the commercial microlenders are not, traditionally, what credit unions provide to their members.

The Delegation considers that it is appropriate to note the challenges faced by the seriously declining British Credit Union movement, as reported in a recent Association of British Credit Unions Ltd report.

The Joseph Roundtree Foundation looked at the UK Home Credit Market and concluded that, if the credit unions were to provide the service, they would have to charge huge APRs to break even.

© *Smiles Turner, November 2011*

Mainstream bank involvement

Since the 1970s the mainstream banks have progressively disengaged from microlending and now the majority do not lend under $4-5,000.

The Minister telephoned all the senior people in the Australian banks during August and all the banks rejected any relevant involvement in providing microloans, outside their subsidised support of the charities offering their limited number and range of loans.

This response should not have surprised the Minister. It certainly promotes the issue of banks withdrawing from the market as a significant one.

In 2001, the Chief Executive of the Commonwealth Bank, Mr David Murray, appeared on ABC TV News, where he threatened to *"dump poor customers if the Commonwealth Bank is forced to offer low fee accounts".*

Unfortunately, this has often been the general attitude of the banking industry. The costs of:

- assessing a potential borrower's ability to repay;
- administration of the loan;
- money holding;
- staff;
- interview time;
- repayment collection; and
- higher default rates;

make the small, short term lending industry a risky, unprofitable and insecure arrangement. This is a discouragement to the banking industry, who are reluctant to lend under $5,000.

While some loans are available for $2,000 and $3,000, only two of the mainstream lending institutions surveyed are prepared to lend down to $1,000. Even this figure of $1,000 is three times the size of an average micro-loan. It is this very reluctance that has created the payday/microlending market, who are willing to take the risks involved.

A 2001 UK study noted: "*On the grounds that they are non-profitable and too risky to be regarded as serious customers, most mainstream credit providers make access to their services difficult, and often impossible, for people on low incomes*".

Ref: Jones; "*Access to credit on a low income: a study into how people on low incomes in Liverpool access and use consumer credit, the co-operative bank*", 2001, p. 4. www.creditunionresearch.com/uploads/access_to_credit.pdf

The following table highlights the current polices of many of the mainstream sources of finance, in regard to small loans:

Bank	Minimum secured	Minimum unsecured
Adelaide Bank	$2,000	$2,000
ANZ	$5,000	$5,000
Bank of Queensland	$3,000	$3,000
BankWest	$5,000	$5,000
Bendigo Bank	$2,000	$2,000
Citibank	$4,000	$4,000
Commonwealth Bank	$10,000	$5,000
Members Equity	$5,000	$5,000
NAB	$5,000	$5,000
St George Bank	$3,000	$3,000
Suncorp	$5,000	$5,000
Westpac	$4,000	$4,000
Newcastle Permanent	$1,000	$1,000

© *Smiles Turner, November 2011*

AMP Credit Union	$1,000	$1,000
Bankstown City Credit Union	$10,000	$10,000
Community Alliance Credit Union	$10,000	$2,000
IMB	$2,000	$2,000
Sydney Credit Union	$5,000	$5,000
Wagga Mutual	$10,000	$5,000
Community First Credit Union	$5,000	$5,000
Family First Credit Union	$2,000	$2,000

In addition to the banks' policy, there are other factors at work in the relationship between potential borrowers and the highly technologically run banks. As Scutella and Sheehan, stated in their May 2006 report for the Brotherhood of St Laurence, at page (iv):

"Computerised systems for analysing credit-worthiness would have automatically declined most of the pilots' loan applicants".

Establish a Government Bond structure (securitisation)

This to effectively provide a guarantee to the banks, or other mainstream lenders, who would then be encouraged to lend small amount, short term loans. As ADIs, they would be exempt from the current Bill and would not have to face the caps that forced the payday and microlenders from the sector.

Expecting big business to step in

The Delegation is reminded that big business is now international. The opportunity to lend in Australia will always be compared to lending opportunities overseas. This is evidenced by the comments of Cash Converters' Chairman Peter Cumins, in an interview with the ABC's Ticky Fullerton, on Lateline Business, on 31.8.11.

"Fullerton: *Do you - you still, though, believe that these sorts of cutbacks* (the draft legislation) *will cripple your business?*"

"Cumins: *It won't cripple our business because I want to make the point clear that being an international business, one option for us is to redirect our capital into a market which is business friendly*".

"Fullerton: *I think you've suggested that one place you might focus your business on is the UK, where they don't have such draconian legislation from your point of view...*"

If international companies already in the microlending sector are considering pulling out, no one should expect any interest from other big companies to actually enter the market after the final version of the legislation has been announced - if it hasn't been substantially amended.

Providing a people's bank via Australia Post

The Delegation recognises this is a Government issue that has been fermenting for a number of years. It is little more than the Government returning to a government-owned Commonwealth Bank approach. The concept is not foreign to Australian Labor Governments, nor to many middle aged and older Australians. Into the melting pot of this concept goes the following ingredients:

1. Important people who have been exposed to the same tuition on finance and business modelling as Minister Shorten, at the University of Melbourne Masters of Business Administration Program. The Delegation recognises that there may be a commonality of thinking between Australia Post CEO Ahmed Fahour and Minister Bill Shorten on the concept of a "people's bank", using an Australia Post branch network. Both received their MBAs from Melbourne.
2. Mr Fahour expressed an interest in people's banking when still an executive with the NAB, in April 2008. At the Government Summit in April 2008, Mr Fahour presented a micro-finance, low interest proposal, involving a Bank/Federal Government approach, at the Strengthening Communities' Group. The concept was to provide small business loans of

© *Smiles Turner, November 2011*

$5,000 to $25,000 and personal loans of $500 to $5,000, for emergency purchases of household white goods etc. We note that Minister Shorten presented a paper on national disability insurance at the same conference.

In a Sydney Morning Herald interview at the time, Mr Fahour noted that the plan was to help disadvantaged people break out of the welfare cycle. "*At least a third of Australians do not have access to proper credit from commercial banks, and they end up either not having the advantage of credit, or having to go to payday lenders or loan sharks*".

The Herald reported, "*He said the foundation would get the capital for lending from banks and other big corporations. Banks taking part in the scheme would also provide the expertise and infrastructure to administer the loans, while the federal government would meet the foundation's running cost*.

It will be recalled that Mr Fahour has already had senior banking experience and experience assisting the Government, with his involvement in government attempts to assist the commercial property sector when that sector faced an economic crises in 2009-10.

The challenge of physically establishing outlets is partially overcome with the recruitment of Australia Post, headed by Mr Fahour, with his impeccable banking credentials and 4,433 outlets already established, branded and with locations generally well known in the community.

However, there are expensive peripheral costs, including:

- staff recruitment and training,
- development and implementation of new computer systems,
- renovation and enlargement of current Australia Post outlets, and/or
- the purchase of new, larger sites,
- inclusion of safes within the structure, and
- the inherent need for increased security.

It would not be unreasonable to assume a total Government investment, in the first year, of well over $1 billion for this infrastructure, on top of the $1.2 billion to fund the loan book.

We are unable to identify any easier opportunity for the Government. The apparently successful New Zealand Kiwi Bank, a division of New Zealand Post, demonstrates the viability of such a model. Established 9 years ago, this institution has competed successfully with the major New Zealand banks, all owned by Australian banks, and now has approaching 1 million customers.

Expanding Centrelink advances

The Delegation has been unable to source information concerning the exact amount of advances Centrelink has granted to its clients. The figures that exist appear to include administrative and other costs.

However, Smiles Turner 2011 research revealed that 48.73% borrowers could be presumed to be aware of this Centrelink opportunity as, for part or whole of their income, they were Centrelink benefit recipients. Lenders in the March/April 2011 survey calculated that 28.2% of their consumers saw a Centrelink advance as an alternate to a payday loan, with 22.2% "*seeing it as a right*". Notwithstanding these larger figures, in 2010 only 1% of respondents nominated Centrelink as their alternative, if their commercial lender was closed down.

The Delegation notes the introduction of an expansion of these advances, with the 2009/10 Centrelink policy that has effectively increased the opportunities for Centrelink benefit recipients to take out 'no interest rate loans'. This means Centrelink has attempted to enter the microlending industry as a potentially major player.

Recently announced details indicate that benefit recipients could be repaying amounts up to $77.40 per fortnight and that there will be repeated opportunities, over a 12 month period, to receive advance payments. Up to 12 categories of social security recipients will be offered the advance payment opportunity. Potential recipients are asked to consider 15 categories of regular expenses, including loan repayments.

© *Smiles Turner, November 2011*

However, following the massive expansion of such assistance being required when the current Bill, if unchanged, becomes law, the Committee should be aware of a number of challenges associated with such non-commercial provision of credit:

- There is no clarity of involvement by Centrelink personnel in undertaking a rigorous assessment of suitability, as has been imposed on microlenders;
- Centrelink does not know of the clients' pre-existing loans with the commercial lenders;
- Centrelink simply pays less, or nothing at all, at pension time;
- with less, or no, money coming into the client's bank account, the commercial lender's direct debit arrangement with that bank account could still be attempted in regard to a pre-existing loan - leading to the client defaulting on the loan. This means a default charge against the Centrelink client and a breach of their pre-existing contract with the commercial lender; and
- a critical mass of indebtedness may emerge as Centrelink clients are left with no money to live on after spending their advances. This will preclude commercial lenders advancing funds to those clients, as it will Centrelink, because the mandatory assessment procedures will demand their being assessed as "unsuitable".

Last resort financing

In circumstances where the banks have refused the relevant involvement in microloans sought by the Minister, and if Australia Post is not able or willing to fund a "people's bank", the Delegation can only identify the following accessible sources for funding of a lending facility to replace the commercial lenders who will not be able to stay in the finance industry if this draft legislation becomes law, without change:

- The taxpayer;
- A new Banking levy/tax;
- Increased banking licence fees;
- Increased Australian Credit Licence fees (for those few who remain in the sector).

We note that this year's Federal Budget did not contain any provision recognising any of the above options.

As indicated elsewhere in this submission, if the Government is to replace commercial lenders it will not only require the availability of $1.2 billion in loan capital in 2013 and every year thereafter (without allowing for any growth in loan demand), but also require the acquisition and/or preparation of retail sites, installation of a major national software system and staff training in the period leading up to 1 January 2013.

Leaving almost all of it to next year's Federal Budget and allowing just 6 months to be ready to replace the commercial small amount, short term lending sector with a fully functional alternative, could be considered optimistic in the extreme.

Two MPs' solutions

Ms Maria Vamvakinou MP, in her previously mentioned speech to the Parliament, was highly critical of the small amount, short term lenders. The Delegation respects every MP's right to make their own assessment. However, with an adverse assessment comes the responsibility of clearly presenting the researched and realistic alternatives to the commercial provision of the supply of credit.

Failure to do this risks the cruel danger of raising people's hopes. To be in a position to help decide on the content of legislation that is passed by the Parliament, without such research and realism, may lead to a victory of idealism over reality.

The Delegation carefully considered Ms Vamvakinou's speech and listed below are her suggestions to address the realities identified in this Submission:

"*...it is very important that we as a parliament ensure that there are more efficient and responsive regulatory mechanisms in place to address the shortfalls and loopholes which have allowed the practice of what is commonly and quite rightly known as "dodgy lending" to flourish in the broader Australian community*".

© *Smiles Turner, November 2011*

"*I launched the "Your shopping rights" fact sheet, which is about helping people make informed savings and financial decisions without running the risk of falling victim to the sales pitch and the spin which often lead them to accumulating more debt than they can afford*".

In fairness, her Opposition parliamentary colleague, Mr Bertt Van Manen, Member for Fordee (Queensland) may not have been any more helpful on the day:

"*If we can bring the poor and marginalised in our society into the mainstream banking system... If we can reduce these costs and complexities for the mainstream banking system, and building societies, maybe that will provide them with the option and the avenue to help the lower end of the community to obtain finance without having to deal with these so-called payday lenders*".

Commencement date - very bad timing

The first business day after the scheduled commencement of the interest and fee cap provisions is likely to be Wednesday, 2 January 2013. That day will start, what is traditionally, a very busy period for lenders, because people seek loans after exhausting their ready cash over the Christmas and New Year break. There are normally delays in payment of wages and the like over the holiday break and many people lose the opportunity for part-time or casual employment over a holiday period. There are also people who are paid in advance and spend too quickly over the holiday season.

The Delegation's best estimate is that, during the 4 days from that Wednesday to the following Saturday, 43,270 people will seek a small amount, short term loan from the payday and microlenders the current Bill will have largely shut down. Similar numbers will be knocking on the closed outlet's doors, telephone systems and websites the following week. The choice of 1 January could not have been a worse one in the borrowing cycle.

The Delegation asks the Committee to consider the following comments made by the different MP's who spoke after Ms Vamvakinou.

Mr Van Manen concluded: "*It is not through rushed or ill-considered legislation …that we are going to solve these issues …take advice from the industry …on how to deal with these very important issues…*".

Mr Bernie Ripoll, Member for Oxley (Queensland), "*…I am very much concerned about a confusion in this debate between a properly regulated operator in a market - people operating within the law and providing a legal product - and those who are basically loan sharks. There is a huge difference...*".

"*It is easy enough to get confused and populist in this debate about annualised figures of 400, 500 and 600 percent but it tells us very little of the need or the type of credit that it actually represents …but annualising does not paint an accurate or even responsible picture of the actual cost compared with any other type of traditional loan...*".

"*Studies have shown that consumers generally have high-cost short-term loans in order to meet basic needs... But that is exactly the point. That is exactly where a payday loan can actually be of great advantage, because if there in no other means of credit to actually pay those essential bills, what happens?*"

Mr Billson (Member for Dunkley Victoria), "*…payday loan facilities …is certainly an area of finance that does need a close examination …this is a very legitimate area of financial service …it is a product well suited to particular people's circumstances*".

"*With transparency and a clear understanding given to people considering this line of finance I think you will see a strengthening of the credibility of payday lending...*".

The consumer advocates' solutions

Given the strong consumer advocate support for all provisions in the current Bill, the Delegation thought it appropriate to review the submissions and Joint Committee evidence provided by a selection of the leading consumer advocate organisations to consider their solutions.

The Delegation has constantly mentioned its continuing distress at the lack of substantial contemporary research presented to support the consumer advocates' concerns.

© *Smiles Turner, November 2011*

There has been no attempt to remedy this concern with the inclusion of appropriate research results, of any kind, to support the following statements.

The Good Shepherd Youth and Family Service - Joint Committee submission dated 14 October 2011.

"*Good Shepherd Youth & Family Service believes that primary, secondary and tertiary supports are necessary to enable financial inclusion. For this reason we believe that options like pawn broking and "pay day" lending have a role to play for people excluded from the normative or mainstream financial services. However this role should be limited to a tertiary service. Regulation is needed in the tertiary sector to ensure that the most vulnerable consumers using financial services in this sector are not exploited when they have exhausted all other options. This protective regulation approach presumes other public policy approaches including:*

- *ensuring income adequacy including social security,*
- *public education approaches to financial competency and*
- *strategies to encourage inclusion of consumers by providers in the normative financial services sector*".

The list was somewhat extended in Good Shepherd's quote in CALC's September 2 document, "*Broad support for proposed payday lending reforms*", as follows:

"*We believe the right protection needs to be in place as well as a suite of programs including microfinance, emergency relief services and financial counselling*".

Anglicare Sydney - Joint Committee submission October 2011.

"*Increased promotion... of Work Development Orders for the payment of fines...*".

"*...borrowers are made aware of appropriate support services including financial counselling, financial literacy courses, and as a last resort, emergency relief funding*".

"*Microfinance programs and support services need to be supported with appropriate funding to ensure they are available to vulnerable people in the longer term...*".

"*Increased options for low income consumers in the "mainstream" credit market... The government should encourage mainstream credit providers (including banks) to enter the low income consumer credit market, potentially through the introduction of grants or tax incentives...".*

"The Federal Government assist in the development of collaborative programs between credit unions and community groups for consumers who are not eligible to access microfinance products. Such an initiative may increase the customer base of credit unions and give them a competitive edge over banks in the low-income market...".

Choice Magazine

As quoted in the CALC September 2 publication:

"*...welcomes the promotion of alternatives to high cost short term lending ...encourage the government to ask the banks*".

Consumer Credit Legal Centre NSW - Ms Karen Cox

"*We don't have a panacea for inadequate income... but allowing the meagre resources of some of our most vulnerable... to pay off high cost loans is not the answer*".

Consumer Action Law Centre Victoria - Ms Catriona Lowe, Co-Chief Executive Officer

"*We say that the government is right in its intent to cause adjustment in the very short term lending... a reduction in the numbers of the low amount, high cost, short term loans that are currently available...*".

"*We think that there will be a reliance on the other hardship mechanisms that are available to consumers... So we would expect to see people getting in touch with their utility providers or their bank. We would expect to see that there will be, ...an expansion of the availability of NILS and LILS. We also hope to see useful reform in the Centrelink area that will bring in more flexibility...*".

"*We would certainly very strongly welcome any recommendations from this Committee around those additional reforms in the Centrepay area*".

© *Smiles Turner, November 2011*

"*We do not consider that people need expensive credit, what they need is an adequate income to be able to afford the cost of living*".

"*(concerning NILS)...my understanding is that there is scope for increasing. They have a lot of capital that has not yet been placed in these programs and there is scope to increase them and it is about having the workforce and the means to do that*".

This idealism is no answer for 750,000 people each year, when dealing with the realities of a small amount, short term loan sector, involving $1.2 billion in loan book funding.

© *Smiles Turner, November 2011*

SECTION 6
Business Realities

The Delegation is concerned that the fees and interest rate 2-tier cap model, included in the current Bill - particularly the concept of 48% - has been presented to the general public as being commercially feasible. This is a most unfortunate circumstance, given that it implies that consumers can expect substantially cheaper small amount, short term credit and that such will actually be available in the numbers demanded.

Neither is possible under the current Bill.

To put this Section in context, the Delegation provides the following summary of the number of lenders involved in the different range of payday and microloans, according to amount of principal and the term of the loans offered. This analysis has been undertaken using the results of the 2010 and 2011 Smiles Turner industry surveys. Please note that the results reflect company policy and no attempt has been made to extrapolate according to the number of lending outlets or offices operated by each of the responding companies. The Delegation's concern was to present an indicative analysis of industry sector policy.

Amount of loan principal	% of companies offering such
$500 or under	14%
$501 - $1,000	40%
$1,001 - $1,500	20%
$1,501 - $2,000	17%
$2,001 and above	8%

The difference between 48% flat and 48% reducible, as proposed in the current Bill

The current Bill will abolish all commercial lending for the 10%, 2% segment of the small amount, short term loan sector, because all lenders report that they will suffer substantial loses under this segment of the regime.

Consequently, the consideration must be with the second element of the 2 tier offered under the current Bill. However, lenders' financial circumstances all indicate that only loans of higher value and longer terms can be accommodated under the 48% cap.

Given that there is a tendency for people to assume that 48% means that, for $100 lent, for 1 year, the consumer will repay a total of $148, it is important to stress the difference between a flat rate and a reducible rate from the outset.

The 48% interest, applicable daily percentage rate, calculated on the outstanding daily balance as the Bill prescribes, actually provides a gross income that can be under 20% of the amount the same loan would achieve under a 48% flat rate.

That means, if you lend $100 for a flat rate of 48% for 1 year, you will receive $148 back. A 48% reducible for the same loan, if paid weekly, returns a total interest amount of $26.91. If repaid fortnightly, the return drops to $26.33.

This equates to an average weekly return of just under 51 cents.

Interestingly, the impact of the daily reducible, i.e. interest charged on an ever decreasing amount of principal still outstanding, as the loan term progresses and the consumer pays their series of repayments, is illustrated by the basic fact that, if you lend $100 under a 48% reducible interest rate for 1 week, you receive 92 cents. As the Committee would be aware, given the above, that does not mean simply multiplying that amount for (say) a loan of 1 year, by 52.

It is useful to note that a 48% daily reducing interest rate, for a 12 month period, is approximately 26% flat. Further, Min-It Software, a major loan management software supplier to the small amount, short term industry sector, with hundreds of lending clients has calculated

© *Smiles Turner, November 2011*

that, for lenders to remain viable, they need 120% (calculated purely as a straight interest rate). It is noted that 120%, calculated on a daily reducing basis approximates 68.9% as a simple flat rate.

Minister's media release and retail mark up

The Minister's 25 August 2010 media release included a loan example of $500 for 4 weeks, at 600%. The Delegation is concerned to put such a loan in its competitive environment.

The Delegation notes the following:

- $500 borrowed unsecured, by an absolute stranger, for 4 weeks, at 600% interest, means - 3 weekly repayments of $155.69 and a final week payment of $155.57 - total interest in dollar terms - $122.64. Retail mark up - 24.53%.
- $500 borrowed unsecured, by an absolute stranger, for 4 weeks, at 48% interest, means - 3 weekly repayments of $127.86 and a final week payment of $127.77 - total interest in dollar terms - $11.35. Retail mark up - 2.27%.
- $325 - the average payday loan - borrowed for 4 weeks at 48% means - 3 weekly repayments of $83.12 and a final week repayment of $83.07 - total interest in dollar terms - $7.38. retail mark up 2.27%.

Recently published figures by the Australian Bureau of Statistics indicated that the average retail mark up in Australia was 65%. Retail traders indicate that the low mark ups for the financial products listed above would only be tolerated in the clothing market, if there was a crisis sale to move dead stock.

Why payday and microlending can be more expensive than mainstream lending

Financial journalist, Jane Searle, in her article "*Cash in Demand*", BRW, August 23-29, 2007, provided the following Summary:

"*Fixed Cost of Providing Loans*

- *The fixed labour and operating costs associated with providing a small loan are the same as those for providing a large loan.*
- *With a larger loan principal, the lender can recover costs and earn a profit by charging a lower Annual Percentage Rate over a longer period of time. Short-term loans must however charge higher rates of interest over short payback periods in order to cover the cost of the given loan and be profitable.*
- *Smaller loans cost more per dollar borrowed than larger loans even when the efficiencies of an online-only organisation are considered....*

The Inherent Risk Associated With Providing Unsecured Loans

- *The fringe lending industry is riskier than most other financial venture and entrepreneurs must recover their investments and earn a positive return*".

Comparing microlenders with mainstream lenders

The following table lists the return on capital earned by the 21 respondent lenders prepared to provide this information to the Smiles Turner 2006 Industry Analysis.

Number of microlenders	Ratio %	Mainstream lender *	Ratio %
3	Negative	Bank of Queensland	15.80
1	5.13	National Australia Bank	17.70
1	6.80	St George Bank	20.39
1	9.10	Suncorp Metway	21.00
1	9.62	Westpac Bank	21.00
1	10.82	Coles Myer Ltd	21.90

© *Smiles Turner, November 2011*

2	12.00	Woolworths Ltd	33.81 (down from 50.93 in 2005)
1	12.50		
1	19.10		
1	19.13		
2	20.00		
1	22.00		
1	25.66		
1	28.00		
2	30.00		
1	35.00		
Average	**18.15**	**Average**	**19.06**

* All banking/company information gathered from 2006 Annual Reports.

As the above table indicates, on average, the microlending sector does not earn as much on its lending capital as the major banks cited. Eleven (52.4%) of the 21 microlenders earned less than the Bank of Queensland, 15 of the 21 (71.4%) earned less than both St George and Suncorp Metway and only 6 of the 21 (28.6%) earned more than the three banks listed.

Business Cost of Loans for the Lender

In April 2011 information was sought to allow the calculation of average variable and fixed costs per lender, in relation to (as a proportion of) their average loans.

The results presented are indicative because, without an intrusive level of audit that may not have been acceptable to the respondents and would have been beyond Smiles Turner's resources, there can be no assumption that each lender's costs have been calculated exactly in the same manner.

Predominant range - 21.25 to 33% - retail, phone and internet lenders.

High - 64.9% - retail only.

Meaningful low 17.25% - internet only.

The 4 highest lenders, in terms of their costs, averaged 57.54% of loan principal.

Based only on the data provided, the Delegation concludes that 33-37% should be taken as a break even benchmark.

There appeared to be 3 categories of business model demonstrated by the cost figures provided. Because of the differing principals and terms, these were so different that treating them as one sample appeared problematic. As with the above, the figures presented below should be treated as broadly indicative.

The categories were:

- **Category One**: Fixed costs of $15 to $55; 13 companies, with an average of $29.69.

  These companies had variable costs with an average of $12.80. Consequently, their average total costs was $42.49.

  These companies tended to be short term lenders, with loan terms of weeks and only hundreds of dollars principal.

- **Category Two**: Fixed costs of $100 to $200; 9 companies, with an average $195.

  Variable cost for these companies averaged $74. Their average total cost was $269.

  These lenders presented loans of $1,500 to $3,000, mid-range terms, i.e. up to 18 months.

- **Category three**: Fixed costs - above $201, 8 companies, average $482.87.

  These companies had variable costs, with an average of $138. Their average total cost was $620.87.

  This category lends medium to longer term loans than the industry in general. They are usually in excess of 18 months, with amounts generally of $2,000 or more.

The above analysis provides a useful comparison to information provided by the 19 respondents to the November 2010 lender survey. Again, the figures can only be regarded as indicative, as there was no opportunity to undertake an independent and standard audit of each company's costs.

Principal	Term	Average cost
$250	14 days	$56.16
$250	28 days	$82.50
$250	62 days	$95.85
$1,000	12 weeks	$292.59
$1,000	24 weeks	$391.40
$1,000	36 weeks	$441.60
$1,000	52 weeks	$600.28

Cost of regulatory compliance

Regulatory compliance costs reported in the 2011 surveys were as follows:

All lenders have faced increased costs since before 1 July 2010.

- Category One lenders, who tend to refer to themselves as payday lenders: range $5 to $18 per loan. Average $11.
- Category Two and Three lenders, referred to as microlenders: $10 to $160. Average $60.70.
- For microlenders, 46.9% reported costs of $100 or more per loan. However, this may reflect generally lower loan volumes.

It may be useful to note that, in order to satisfy ASIC compliance requirements, the delegates' lending businesses provide consumers with a minimum of 15 pages of documentation and utilise a 12 page, 90 Day Assessment Form (Appendix 3) - even for a $250 loan, for 2 weeks.

The cumulative costs of those regulations already imposed by the Commonwealth, together with any ceilings imposed in regard to income, must be recognised in order to allow a continuation of a viable industry.

The comprehensive costs of ASIC expected staff education and training has yet to hit the sector's profit and loss statements. In November 2010, based on approximate figures, lenders participating in the industry survey provided the following indicative assessment:

Average per lender, 2010	$5,800
% needed to cover ASIC compliance	7.75%
% of gross income 2009-10	4.9%
Interest rate needed to cover compliance	9.92%

Of the companies offering to provide senior management training, one is currently offering an inadequate internet product for $495 and others are pricing more ASIC-compliant courses, involving seminar and tutorial attendance, from $2,200 up to $4,700. This does not include the big city legal firms, whose fees are substantially higher than those quoted - for basically the same product.

Other costs to come

The sector is only just starting to become aware of extra costs that will be associated with positive or comprehensive credit reporting, despite its continually postponed starting date, and has recently been advised that Austrac will be charging for the mandatory filing of reports.

The Delegation awaits the impact of the current Bill, before any assessment can be made with regard to the cost of the introduction of the anti-avoidance legislation.

© *Smiles Turner, November 2011*

Rejection of loan applications creates cost

The 32 companies involved in the 2007 survey reject from 10% to 90% of applicants and the average for the companies, as opposed to the number of outlets/offices, is 46.55%.

70.77% of all outlets reject 50% or more applicants, in 2010 the range was 36.46% to 42.43% and, in the September 2011 study the average rejection rate was 53%.

As discussed in greater detail elsewhere, the rejections attract costs including the share of advertising expenditure to “get them in the door”, the wages for interviewing staff (to assess the applications) and the Veda Advantage credit checks.

In 2010, the percentage of the total number of loan applications rejected, per lending outlet or Internet/telephone lending office, was found to be:

Retail lenders

% rejected	No. Outlets
90%	2
85%	9
80%	3
70%	30
65%	2
50%	5
42%	1
34.81%	1
32.28%	1
30.2%	1
30%	1
29%	1
24%	1
20%	4
18%	1
16.82%	1
12.3%	1

Internet / telephone lenders

% rejected	No. lending offices
75	1
50	2
45	1
30	1
25	1
20	1
10	1

These rejection rates occur in a labour intensive environment, where there is a significant investment in staff time either at the counter, on the computer, or on the telephone with consumers. A representative from Anglicare appearing before the Joint Committee indicated that his organisation experienced a 45 minute staff cost to assess the application. Smiles Turner’s industry analysis reveals that the time involved varies from 30 minutes to 90 minutes. Even dealing with repeat customers takes a company average of 30 minutes to process each application.

© *Smiles Turner, November 2011*

The costs of the time that has been allocated to rejected potential customers, has to be recovered from the successful loans. It is interesting to note each successful loan, during its term and at its conclusion, absorbs an average 30 minutes extra of a staff member's time.

Business realities and 10%

The 10% provision is fundamentally impractical for application to all businesses because, as defined in the current Bill, it must be considered the gross income source for:

the cost and initial administration of all the successful loan applications;

- arguably, at least some of the advertising and marketing costs, which can be directly attributable to getting the consumer to actually make the enquiry and proceed to a successful application;
- all costs associated with the assessment of potential consumers, and initial administration costs associated with the majority of applicants who are assessed as "*unsuitable*", under the strict responsible lending guidelines included in the National Consumer Protection Act 2009 (i.e. are deemed not suitable to be granted a loan);
- the Veda Advantage and Dunn & Bradstreet credit checks for both successful and unsuccessful applicants. Respondents to the September 2011 survey reported a range of charges from $4.50 through to $11.19, but Smiles Turner's industry analysis in February/March discovered some lenders were paying as much as $15.70 per credit check. Veda's published price list provides a minimum of $5.34 - tier 7, max $16.23 - tier 1.

Even just the limited number of costs listed above provide a cost per loan of $106.90.

Given the above costs, it may be useful to consider what 10% means over the range of most popular payday loans. It must be remembered that there is no apportionment, so the 10% is calculated as a proportion of the principal, as a once only contribution to gross income.

The following table indicates the gross income to be derived under the current Bill - not net profit - which can be attributed to the immediately above listed costs.

Table - 10% income generation

Amount borrowed	Length of loan	10% income
$275	2 weeks	$27.50
$275	4 weeks	$27.50
$300	2 weeks	$30.00
$300	4 weeks	$30.00
$325	2 weeks	$32.50
$325	4 weeks	$32.50
$350	2 weeks	$35.00
$350	4 weeks	$35.00
$500	2 weeks	$50.00
$500	4 weeks	$50.00
$500	6 weeks	$50.00
$500	8 weeks	$50.00
$750	4 weeks	$75.00
$750	6 weeks	$75.00
$750	8 weeks	$75.00
$750	12 weeks	$75.00
$1,000	2 weeks	$100.00
$1,000	12 weeks	$100.00
$1,000	6 months	$100.00

We emphasise that the amounts listed above, reflecting the current most popular and the average small amount loans, are what is available under the rationale included in the current

© *Smiles Turner, November 2011*

Bill and provided in media and Parliamentary speeches by the Minister. These amounts are to cover all the expenses listed above and provide some net profit to the lender, on an unsecured loan to an absolute stranger who has walked in from the street, or telephoned, or emailed with anonymity.

Even if all other things were considered neutral in their impact, as opposed to negative in the reality, no lender will continue to lend the current average payday loans of $275 and $325 (Cash Converters' published figures and Smiles Turner 2010-2011 research).

While a considerable number of payday lenders provide loans greater than $500, this rarely comprises a dominating section of their loan book. These lenders are included in the samples taken to find the above averages (Smiles Turner research November 2010, March/April and September 2011).

The Bill effectively abolishes payday lending in Australia. The non-cap content of the current Bill, relating to the small amount contract, could almost be dropped because, under these provisions, payday loan providers will not make a profit and will exit the market.

The Delegation Requests:

That, in order to more accurately portray the impact of the current Bill if it proceeds unamended, at least a subtitle be added - "*The Abolition of Pay Day Lending Bill.*"

Business Realities and 2%

Given that all costs other than those listed above, to be covered by the 10%, must be covered by the 2% per month as defined in the current Bill, the Delegation commences with the following table indicating what 2% per month income actually means in dollar terms.

Table - 2% income generation

Amount borrowed	Length of loan	2% income
$275	2 weeks	$5.50
$275	4 weeks	$5.50
$300	2 weeks	$6.00
$300	4 weeks	$6.00
$325	2 weeks	$6.50
$325	4 weeks	$6.50
$350	2 weeks	$7.00
$350	4 weeks	$7.00
$500	2 weeks	$10.00
$500	4 weeks	$10.00
$500	6 weeks	$20.00
$500	8 weeks	$20.00
$750	4 weeks	$15.00
$750	6 weeks	$30.00
$750	8 weeks	$30.00
$750	12 weeks	$45.00
$1,000	2 weeks	$20.00
$1,000	12 weeks	$60.00
$1,000	6 months	$120.00

A consideration of the difficulties with the current Bill's 2% per month regime invites a careful analysis of the costs faced by payday and microlenders, as revealed in the Smiles Turner

© *Smiles Turner, November 2011*

November 2010, March/April 2011 and September 2011 surveys. The following cost information comes from those surveys.

- All wages, e.g. $18.60 - $25 per hour for non-managerial, junior loans officers - applicable to the 30 minutes they will spend on loan management, on average, after the assessment and possibly "initial administration" costs;
- all rent, utility, building/contents insurance, cleaning, bank fees, workers' compensation insurance, wages on-costs, associated with the conduct of the business outside the times of application and initial administration. The September 2011 survey established that the average retail rent was $42,000 per annum. On the 2% per month allowed, for the payday industry average loan of $325, the lender would have to lend 6,461.5 loans to break even on just this cost alone;
- all wholesale finance costs (currently between 7.5% and 18%, average 12.75% flat - i.e. 15.56% to 36.4% daily reducing - with most lenders paying under 12% flat - Smiles Turner industry research, September 2011). Earlier in 2010, the March/April research provided an average of 12.84% for 37 respondents. 67.92% of the total respondents funded their loan book with wholesale funds;
- compliance costs ($11 for smaller loans, to $160 for larger loans), including legal costs to develop new documentation, ASIC Corporations Law annual report filing fees, Regular Austrac report fees, EDR membership, PI insurance and the like, staff and responsible manager training, over and above that part covered by the 10%;
- all bad debts and collection costs (associated with the 3% of non-performing loans, costing lenders anything from $100 to $2,000 per loan). This in the context of the September survey figure, which indicated the cost of bad debts constitutes 10.57% of the average lender's gross income;
- substantial software, hardware and internet data management costs.

This does not take into account any consideration of profit.

The following table combines the 10% and 2% generated incomes, to demonstrate how little this first tier offers, as prescribed in the current Bill.

Table - 10% + 2% income generation

Amount borrowed	Length of loan	10% + 2% income
$275	2 weeks	$33.00
$275	4 weeks	$33.00
$300	2 weeks	$36.00
$300	4 weeks	$36.00
$325	2 weeks	$39.00
$325	4 weeks	$39.00
$350	2 weeks	$42.00
$350	4 weeks	$42.00
$500	2 weeks	$60.00
$500	4 weeks	$60.00
$500	6 weeks	$70.00
$500	8 weeks	$70.00
$750	4 weeks	$90.00
$750	6 weeks	$105.00
$750	8 weeks	$105.00
$750	12 weeks	$120.00
$1,000	2 weeks	$120.00
$1,000	12 weeks	$160.00
$1,000	6 months	$220.00

© *Smiles Turner, November 2011*

Crunching the numbers (1)

An indicative calculation reveals that, to cover the average annual total business costs revealed in the September 2012 survey - $664,000 - the lenders will need to lend 17,026 average payday loans ($325, for 1 month, grossing $39 in fees and flat rate interest, with full repayment during the year), just to break even.

That number, net of any consideration of additional variable costs that may be involved with the extra loans required to break even, is:

- Approximately 3 times the number of payday loans currently being lent, per outlet, by the biggest lender in Australia.
- Approximately 5 times the number advanced, per store, by one of the largest second tier lenders.
- Has to be adjusted upward to recognise the 30% extra variable costs attracted by the extra loans, over the number that created the fixed plus variable costs that added up to the $664,000 result in the September research (see analysis of variable and fixed costs discussed earlier in this Section). We have not attempted any calculation of the adjustment required, as the data collected does not make this a simple calculation.
- Very much above any lending volumes undertaken by any of the other respondents in the September 2011 survey (albeit some of their volume is micro, not payday loans).
- A further example of why, under the current Bill, the average consumer will not be able to borrow the average amount they require, from 1 January 2013.

Business realities and the 48% cap

Remembering that all secured loans only attract the 48% inclusive interest rate income and all loans over $2,000 and 2 years attract the 48%, it is useful to note the gross income derived, as illustrated in the following table.

It must also be remembered that there are no additional fees over various terms, as is prescribed under the current Bill.

Note: the amounts are not cumulative. Each amount refers to total interest, for the particular principal, for the number of weeks at the head of the column.

Colour Code:	Typical Industry Terms	Unlikely Term offered	"Payday" term	"Micro-loan" term

Principal Amount	Term (in weeks)						
	2	4	8	12	26	40	52
100	1.37	2.26	4.11	5.96	12.57	19.43	25.63
150	2.06	3.40	6.14	8.95	18.95	29.32	38.39
200	2.75	4.54	8.22	11.95	25.30	39.11	51.18
250	3.43	5.67	10.28	14.95	31.63	48.96	63.97
300	4.12	6.81	12.33	17.94	38.03	58.79	76.83
350	4.81	7.94	14.39	20.92	44.32	68.79	89.64
400	5.50	9.08	16.43	23.92	50.66	78.43	102.42
450	6.18	10.20	18.50	26.90	57.00	88.27	115.23
500	6.87	11.35	20.55	29.90	63.41	98.15	128.03
550	7.56	12.48	22.62	32.89	69.70	107.91	140.83
600	8.24	13.62	24.66	35.90	76.03	117.80	153.63
650	8.93	14.74	26.74	38.88	82.34	127.57	166.42
700	9.62	15.89	28.79	41.86	88.73	137.42	179.22
750	10.30	17.02	30.86	44.83	95.13	147.24	192.03
800	10.99	18.15	32.90	47.83	101.45	157.10	204.86

© *Smiles Turner, November 2011*

1000	13.75	22.70	41.14	59.81	126.82	196.43	256.06
1500	20.62	34.06	61.70	89.76	190.27	294.75	384.12
2000	27.49	45.40	82.25	119.64	253.65	393.09	512.16
2500	34.36	56.75	102.83	149.56	317.13	491.41	640.15
3000	41.24	68.10	123.40	179.48	380.59	589.72	768.21

These income figures are provided to assist in assessing the economic unreality of a 48% cap, when the break even calculations of lenders are compared with the Delegation's selection of a diverse group of lenders to participate in a 'break even' and 'reasonable profits' analysis in May 2011. The lenders' assessment figures are included in the table in Appendix 4.

It should be noted that the Discussion Paper put out by Treasury in April 2011, clearly indicated that both the 48% interest rate cap and APR's were unrealistic.

The brutality of an all inclusive 48% cap on the industry

The following scenarios, calculated on the basis of the spreadsheet and econometric modelling in Appendix 5, which was provided to Treasury in April 2011, demonstrate the devastating effect of a 48% all inclusive NSW-style, no opportunities to accommodate or avoid, cap on the Australian microlending sector.

(a) Under 62 day loans -

All 19 lenders surveyed in September 2011 reported that they would not break even.

(b) Loans 40 to 52 weeks -

Only 2 of the 19 lenders have a loan book of $3.9 million or more, needed to achieve this break even.

(c) Loans of short, through to longer term, mix -

Only 6 of the 19 lenders would break even, requiring a loan book of $2.5 million.

(d) You need every loan to be $3,200, for 26 weeks, to break even -

Only 1 lender of the 19 could break even in these circumstances.

(e) Loan books of at least $1 million are required to achieve useful economies of scale. Unfortunately, this must be compared with "the typical" lender, who invests $350,000 to $500,000, with up to 3 staff, including the principal -

Only 7 of the 19 lenders can achieve these economies of scale.

(f) Typical franchisee lenders, with loan books of approximately $500,000, will not break even and will discover that they are dipping into personal or others' funds just to pay their franchise fee, as well as cover their other costs -

11 of the 19 lenders are in this position.

As can be seen from the above, the impact on lender numbers is substantial. When you take the different factors as a matrix, there is only a slim possibility that one of the lenders could continue and that lender has assessed that, if the bill proceeds unamended, he will exit the small amount, short term loan sector.

That particular lender reviewed his company's default and bad debt history (reasonable by industry standards) and determined that the slim profits possible post-1 January 2013 did not justify the risk of incurring the defaults and bad debts that could be reasonably expected.

There appears to be five levels of loan book investment:

- 12 lenders (with at least 4 doing business loans as well) who have loan books in excess of $3.5 million;
- 21 lenders who have loan books in excess of $2.5 million;
- 32 lenders who have loan books in excess of $1.5 million;
- 250 lenders with loans books of $500,000; and

- approximately 350 lenders with loan books of less than $500,000 - particularly in regional areas and/or working essentially part-time.

On the above 48% income and Delegation modelling, the imposition of the 48% all inclusive, 'no way round it' cap, as envisaged in the current Bill, will leave only approximately 20 full time lenders in the industry sector, lending large amount, long term loans.

Such an imposition would mean that all other lenders would have to move to lending minimum principal amounts of $2,500, for 12 months, or $1,200+ for terms of 3 years - expecting to break even and earn a marginal profit, but not necessarily making enough to justify staying in business full time.

This result could make a major contribution to forcing people who should only ever be assessed as suitable for a small loan, into a lending environment which contributes a higher risk to the lender but, more significantly, contributes a greater risk of further debt spiral challenges to the consumer. Smiles Turner industry analyses over the last 11 years have determined that, for every 3 months you extend the term of a loan, you double both the default and bad debt ratios. The current Bill exacerbates this problem by demanding larger loan principals.

The November 2010 Smiles Turner Industry survey involved 19 companies, including 7 with multi-company outlets and franchise systems, 206 retail outlets and offices, 6 internet/telephone outlets or offices and 12 mobile lending services. To emphasise their collective national significance, these companies, assisted by relevant brokers (credit assistance providers) or authorised credit representatives, marketed their small amount, short term financial products as follows:

Qld	NSW	Vic	SA	Tas	WA	NT	ACT
85	43	34	7	3	25	2	1

To these figures must be added the internet and telephone lenders, who cross all borders.

At the time of the survey, Treasury had just released a Discussion Paper which put the 48% cap at the forefront of the industry sector's collective minds. Details of the explanations offered by Treasury were included in an industry newsletter published by Smiles Turner, which accompanied the request for participation sent to the lenders. In regard to the issue of interest rate caps, the national response was as follows:

Question	YES	NO
Have you ever been provided with research results concerning why the figure of 48% has been used by government in Australia?	16.1%	83.9%
If your company has to operate in the micro-finance market (your existing market), lending at 48% inclusive of all interest, fee and charges, including brokerage and absolutely no other way - could the company break even or make a profit?	Nil	100%
If your company had to operate lending at an interest rate of 48% plus fees and charges that largely relate to actual costs (the Victorian model), could your company break even or make a profit?	99%	1%

Crunching the numbers (2)

The Delegation accepts that there are some basic assumptions involved with the following analysis. These include accepting that the average total annual business cost revealed by the September survey can be applied across all lenders, that there is tax neutrality and that the choice of loan size reflects a high enough proportion of the microloans issued to be an approximate average size (it certainly is a most popular size). Should the Committee have any doubts, please take 50% off our conclusions - the devastation of the current industry sector is still revealed.

Taking the average annual cost of running the lending business, as determined by the September 2011 survey - $664,000, and assuming the average loan is for $2,000 for 2 years and is secured, so there is no debate that they have to fall with the 48% cap.

© *Smiles Turner, November 2011*

Assuming further that the loans are all paid off in 24 monthly instalments, the total interest income will be approximately $1,095.82. That means the microlender will have to lend 1,212 loans to break even on the average cost discovered by the research,

When you factor in variable costs for the extra loans required, over and above those that are currently contributing variable costs to the $664,000, the loan numbers required to break even are even greater.

Earlier research-based analysis in this Submission revealed 2 categories of cost relationship that might apply here. One calculation indicated that total costs per loan were $269 and that variable costs were $74, i.e. the proportion of variable costs to total costs was approximately 27.5%. On that basis the 2 year variable costs of the extra loans, calculated against the total costs discovered in the September 2012 survey (remembering that these are 2 year loans and the annual amount has to be doubled), is $365,200. This requires a further 333 loans, so the loans needed to break even will be 1,545.

The second calculation revealed variable costs of $138 and total costs of $620, giving a percentage of 22.3%. If this is the more applicable figure, total costs would increase by $296,000, requiring an extra 296 loans for a total of 1,508.

The problem is that many smaller microlenders are managing a loan book of 200 to 250 active microloans at any one period, generally 36 to 40 weeks in duration, and issuing 120 to 150 new loans a year. A second problem is, although a very challenging exercise to quantify because there are so many variables, lenders should expect substantial increases in the amount needed to fund the loan book to achieve this break even - at least 2 to 4 times their current investment.

As a hypothetical example of the income/cost impact and what break even will mean from 1 January, 2013, the Delegation provides a further analysis.

On the limited information available to the Delegation, the largest lender in Australia appears to have lent approximately 620 microloans, per outlet, in 2010. Almost all of these were for 12 months or less and they averaged just over $1,000. Assuming repayment monthly at 48%, because they are secured, the gross 48% interest income would be $264.33 for each loan paid fortnightly. Assuming that these loans contributed to total cost in the same proportion as the total amounts lent (43% of total), the amount of average business cost would be $285,520 and 1,080 loans would be required to break even. That means a 174% increase in the number of loans.

19 companies respond

The responses of the 19 companies in September 2011 indicated an adverse situation for consumers, commencing 1 January 2013.

Questions re. 48% reducible inclusive of all fees and charges	Yes	No	N/A
Can you break even lending $2,001 to $2,500 for 6 months?	0	17	2
Can you break even lending $2,001 to $2,500 for 1 year?	0	17	2
Can you break even lending $2,001 to $2,500 for 18 months?	1	14	4
Can you break even lending $2,501 to $3,000 for 6 months?	0	16	3
Can you break even lending $2,501 to $3,000 for 1 year?	0	15	4
Can you break even lending $2,501 to $3,000 for 18 months?	1	15	3
Can you break even lending $2,501 to $3,000 for 2 years?	2	13	4
Can you break even lending $3,001 to $3,500 for 6 months?	1	15	3
Can you break even lending $3,001 to $3,500 for 1 year?	1	14	4
Can you break even lending $3,001 to $3,500 for 18 months?	2	13	4
Can you break even lending $3,001 to $3,500 for 2 years?	2	14	3

It is important to note that these answers were given assessing an individual loan. The un-winnable challenge is where the loan book encompasses a wide variety of loans, by amount

© *Smiles Turner, November 2011*

and term. Fundamentally, none of the lenders who said yes to any of the above lends enough in that category to cover their losses on their other loans, or to make enough profit to contribute to the total fixed costs if they continue lending the loss creating loans.

Fixed costs contributions

The Delegation is concerned that the Committee not overlook a fundamental issue of cost recovery which will bedevil those lenders who lend some of their loans in the $3,000 to $5,000 range (which can generate some profit in the post-1 January 2013 environment) and other loans that are not within this range, but are currently making a contribution to fixed costs.

Most people assume that a lender would automatically stop lending unprofitable loans. Most lenders can be expected to do exactly this.

However, there is a relationship between the loss on a loan and its contribution to fixed costs. In business an important element is economies of scale. For a lender the fixed costs, regardless of how many loans are advanced, such as outlet rental, the salary or wages of a staff member who has to be in attendance every hour the outlet is open, the cost of the security guard service both in the day and overnight, etc. are all cost elements that do not vary, whether or not 1 loan or 100 loans are lent.

Obviously, the more loans you can lend, the more you spread these fixed costs so, on average, they become smaller for each loan. Sometimes, while the loan may lose a small amount, nevertheless its contribution to fixed costs make it worthwhile to continue lending such a loan. The more profitable loans cross-subsidise the loss creating loans, because it is literally cheaper to cross-subsidise for the small loss, than it is for the profitable loans to carry 100% of the fixed costs load.

A frequently observed example of this principle is the women's clothing shops that have their sales, with very large reductions on the original retail price. They are at least moving slow stock and making a contribution to their overheads, which is not available if they leave the stock in the storeroom.

Presenting a simplistic (indicative only) example -

No. of loans - profitable - 100, unprofitable post-1.1.13 - 100.

Contribution to fixed costs of unprofitable loans - $20.

Profit on profitable loans - $20.

Loss on unprofitable loans - $10.

Total profit on profitable loans - $2,000.

Total contribution to fixed costs, unprofitable loans - $2,000.

Total losses on unprofitable loans - $1,000.

Therefore, the total profit for the company is $2,000, minus $1,000 = $1,000 and the consumers have 200 loans to borrow.

However, if the unprofitable loans are dropped, the problem is as follows:

Total profit - $2,000.

Total fixed costs, previously paid by the unprofitable loans, that now has to be paid out of profits, $2,000.

Final profit - $0.

Now, the number of loans available to the consumer - only 100.

We will assume that the lender is at least paid a wage and is included in the overheads at this stage and that the lender decides to remain in the industry, in the hope that things will improve.

However, if the lender is like Cash Converters with 90% of their group's loans in the unprofitable 10%, 2% range and they are dropped post-1 January 2013, the following occurs:

Total profitable loans being offered - 20.

Total profit - $400.

© *Smiles Turner, November 2011*

Contribution to fixed costs of the profitable loans, to replace the contribution of the 180 loans (x $20) that are no longer offered - $3,600.

Loss - $3,200.

Result - almost instantly - total loans available to the consumer - NIL.

The above explains why every one of the above lenders will exit the market on or before 1 January 2013, under the current Bill.

The Delegation surmises that there will be:

(a) a reduction somewhere in the vicinity of 96.7% of lender numbers, offering the same mix of loans currently offered;

(b) only amateur lenders wanting to lose money, offering loans measured in $100s;

(c) definitely no one lending for under 62 days;

(d) definitely no one lending under the 10%, 2% regime;

(e) many of the estimated 55.4% of current part time lenders discontinuing their lending, because the returns on their money, after advertising, defaults and bad debts, will be negative;

(f) a loss of 1,800 full time positions and approaching 2,000 part time positions (the Delegation assesses approximately 2,500 equivalent full time);

(g) a loss of expertise and knowledge within the Australian finance industry, not readily replicated by the surviving mainstream lenders.

This assessment is also supported by the analysis included in the NAB Fast Money 2010 Pilot Report and the 2006 report concerning the Brotherhood of St Laurence pilot scheme, discussed earlier.

Bad Debt Realities

If the current Bill is passed unchanged, there is another reason why lenders will move away from offering small amount loans. That is the extended number of loans that would have to be advanced to recover the losses from one defaulting loan that has become a bad debt.

Put simply - if you lend $200 for a month, with a gross income (not profit) of (say) $100, one bad debt where the borrower pays nothing back puts the lender in a position of losing his $200 capital (we will not worry about his costs for this example). With a (say) $100 gross income per $200 loan, the lender then has to lend 2 more such loans to regain his capital.

Under the current Bill, the lender loses his $200, but the maximum gross income from such a loan is $24. With a $24 gross income, the lender has to lend 8.33 further consecutively successful loans to recover.

When you add the cost of defaults and further bad debts associated with these 8.33 new loans, plus all the assessment and initial administrative costs, plus the later administrative costs and all the other variable costs of lending listed above - the number of loans the lender has to lend, to recover his lost $200, is much, much greater than 8.33.

Factoring these costs in, for a typical $300 payday loan, repaid over a 4 week term, using a 10%, 2% cap, it would take 83 fully repaid loans simply to recover that capital loss and a further 10 loans to recover the capital, plus the original lost income.

Using the same parameters for any loan amount:

- repaid over 8 weeks, the figures are 71 and 81 respectively;
- repaid over 26 weeks, the figures are 45 and 55 respectively;
- repaid over 40 weeks, the figures are 35 and 45 respectively;
- repaid over 52 weeks, the figures are 29 and 39 respectively;
- repaid over 78 weeks, the figures are 21 and 31 respectively; and
- repaid over 104 weeks, the figures are 17 and 27 respectively.

© *Smiles Turner, November 2011*

This factor alone makes the risk of lending under the current Bill prohibitive. This is another indication of why the attempt to impose a 10%, 2% regime is unrealistic. Without exception, the more loans and longer the time you need to lend successfully, to cover the one original loan that went bad, the greater the possibility that another of these loans will also go bad.

It is unfortunate that the RIS did not seriously address lender costs, particularly in relation to failed loans.

Defaults and direct debits - another cost

The very high employment of direct debits to collect repayments has been the subject of strong criticism from the consumer advocates. However, research statistics on the extent of defaults are absolute proof that direct debit arrangements do not guarantee repayment, because the defaults occur with direct debit failure due to insufficient funds being in the relevant bank account.

The following table shows the response to questions in the Smiles Turner 2010 Lender Survey:

<table>
<tr><th colspan="5">What percentage of your unsecured loan borrowers default?</th></tr>
<tr><td>Lenders</td><td>9.3% said↓</td><td>83.4% said↓</td><td>6.8% said↓</td><td>0.5%↓</td></tr>
<tr><td>Consumers</td><td>0-5%</td><td>6-10%</td><td>11-15%</td><td>Unanswered</td></tr>
<tr><td>What is the average amount that they leave owing to you?</td><td colspan="4">Range, all $150 - $3,500, average $733.
Strictly small amount, short term loans, average $333.</td></tr>
<tr><td rowspan="3">If you offer secured loans, what percentage of your secured loan borrowers default?</td><td colspan="4">30.2% offered secured loans.</td></tr>
<tr><td colspan="2">Default rate 0-5%:</td><td colspan="2">95% outlets</td></tr>
<tr><td colspan="2">Default rate 6-10%:</td><td colspan="2">5% outlets</td></tr>
<tr><td colspan="3">What is the average amount these secured loan borrowers leave owing to you after collection action, including repossession, if any?</td><td colspan="2">Range is $150-$4,000.
Average $2,165</td></tr>
</table>

The table above, listing the amounts left owing, adds significance to the default rate statistics which in some considerable part, by dollar value, become bad debts. The latter being entirely at the expense of the lender.

It must be remembered that, if they default, the consumer is sent a Form 11, a Form 12, a default notice, has had (and continues to have for another 30 days) the opportunity to access hardship applications, IDR and EDR and will possibly have received telephone or email contact. All this costs the lender time and money.

The consumer advocates fail to acknowledge that the great majority of micro-borrowers never face a debt spiral caused by their micro-borrowing. This is supported by the proportionately low numbers of consumers involved in serious default and bad debt in regard to their microloans.

These figures are supported by other studies:

- The issues of bad debts, defaults and collection costs were explored with the 19 lenders who participated in the September 2011 industry study. It is important to note that default and collection costs constituted 4.25% of total costs and bad debts generated 10.11% of total costs. While it is acknowledged that some portion of the default and collection costs are retrieved when there is a successful prosecution, it is appropriate to note that none of the lenders participating in the survey had taken any consumer to court in the preceding 12 months. Therefore, the participating lenders had 14.36% of their total business costs at risk of little or no collection.
- Early in 2011, a major franchise lender calculated that, with all its loans, 11% suffered at least 1 default in payment and the bad debt ratio was averaging 4%.
- At the same time, a lender with a number of company stores was seeing 18% defaults, most repairing and ending with a 6-8% bad debt ratio.

© *Smiles Turner, November 2011*

- The September 2011 results are supported by the 39 lenders with 84 lending outlets, responding to the April 2011 survey, reported between 0-10% of their loans were never repaid, with an average of 4.3%.
- The Smiles Turner 2006-7 research revealed that the average default rate was 3.8%.
- In May 2007 a study of defaults faced by 100 Min-It Software clients revealed that defaults, by number, averaged 10.62% and by loan value 10.99%.
- The September 2011 research revealed that this currently constitutes 10.57% of total business costs.
- In June 2010, the NAB Small Loans program reported 3.7% as being arrears defaults.
- The 2010 Smiles Turner Lender Survey results indicated that 83.4% of lenders have default rates between 6 and 10%.
- The Brotherhood of St Laurence pilot scheme, discussed elsewhere in this Submission, reported 4%.
- One major internet lender, with a relatively conservative policy concerning application acceptance, suffers a 4.9% bad debt rate. This is a particularly low figure for an internet lender, given that some internet lenders are reporting 30% default rates.
- Included on the current NAB website, in regard to the subsidised Good Shepherd NILS scheme, the site reports the scheme suffering a default rate of 4.75% which, despite there being no interest or fees charged, is comparable to many current conservatively run lenders' rates.

The difference between the NAB and commercial results reflect, in particular, the NAB's Small Loans program having access to Centrepay (Centrelink automatic payment, prior to benefits distribution), which is not available to the general commercial sector.

It is important to note that the 2011 lender research discovered the following average default and repair picture:

- 1 default - 65.5% did not experienced any problems repaying thereafter, with 1.2% making hardship applications.
- 2nd default - 69.6% had no problems thereafter, with hardship applications at 1.6%.
- 3rd default - 47.9% had no problems thereafter and hardship applications were made 4.7% of the time.

The average success rate in regard to these hardship applications was 93.4% and none of the lenders believed their consumers were unable to pay, from their regular income, just because of the default charges.

In regard to the default charges, 66.6% of lenders reported that they did not make any profit on these. The average fees that were reported were considerably lower than most solicitors charge and on a par, or lower, than most mainstream financial institutions charge.

- Letters - $12.26
- Dishonour/missed payment fee - $29.29
- Account management fees - $48.20
- Direct debit fees - $13.66
- Field visits - $60.00
- Other fees, variously named, averaged $15.00.

(Please note, a default never attracts all these fees. They constitute a menu of actions and in no way constitute the totality).

In regard to default costs to the borrower, it is important to bear in mind the following:

(a) Default fees applying to a loan where there is (say) 2 repayments scheduled under the contract, as opposed to loans where there are 20 repayments scheduled, have a greater impact. Obviously, the percentage of total rescheduled payments being missed, plus the default fees and the consequent percentage impact on total loan costs, is much greater with the shorter term loans.

© *Smiles Turner, November 2011*

(b) Default rates trend upward when you have Easter, Anzac Day and Christmas, involving unusually long periods where the banks have been shut, or delays to a return to a regular income cycle for the borrower. Earlier this year there was a surge in defaults when the NAB and Commonwealth Banks' major computer systems collapsed, leading to extensive failures to process direct debits on time. Substantial efforts were made by lenders to correct the negative impact on consumers, but that action came with a time lag.

(c) The proportion of part time, or under employed borrowers appears to be increasing. The 2 or 3 level economy and the impact of the floods in Queensland have both been significant.

(d) There has been a tendency for rent, electricity prices, petrol and food costs to rise, while wages and Centrelink benefits have lagged behind.

(e) The value of unsuccessfully collected bad debts is on the increase. This is particularly because, under Australian privacy laws, tracing people once they have changed residences and/or employment can be very difficult. Skip trace now results in a success rate of no more than 5%, in an environment where there is increasing consumer mobility in general, plus the opportunities for work in the high development areas of Western Australia, parts of Queensland and the Northern Territory, encourages people to move interstate. It much be remembered that, officially, electoral rolls cannot be used for debt collection. This phenomena is particularly affecting payday lenders. One of Australia's major debt collectors, Pushka, has reported a 7% success rate with payday loans and an average of 48% for all other credit business (Australian Financial Review, 15.6.11, page 50).

(f) An additional incentive for a higher bad debt rate is the Australian taxation year bias of encouraging write-offs in one year, with collection occurring in a second or later year.

(g) Finally, mechanisms such as Veda's Bad Debt Watch, have the capacity to collect over the next five years, but the reality is - any collections are primarily bigger and longer microloans, not payday loans.

Sundry Business Details

The following deserve attention when considering the provisions in the current Bill.

Money 3 losses

- At the Joint Committee on Corporations and Financial Services' public hearing, Mr Rob Bryant, Managing Director of Money 3 explained that, under the current Bill, his company's profit would fall from $2.5 million positive to $1 million negative. He also indicated that his current 15,000 loans per annum, provided from the Money 3 outlet in Collingwood, Victoria, would be reduced to less than a third, as the company moves to lend different products and stops lending small amount, short term loans.

ATO loses money

- Mr Bryant's small listed company Money 3, with some 9 stores in Victoria, calculated and publicly announced at the Joint Committee hearing that, under the provisions of the current Bill their taxation payments per annum will fall by $1.4 million. It is to be noted that this company is a 4 or 5 tier participant in the small amount, short term lending sector.

Examples of costs and associated matters faced by current lenders include:

- One successful internet payday and microlender conducts marketing campaigns, with average costs per new consumer of $650.
- One internet lender's average payday loan is $320. They charge an average of $112 and their average cost is $70.8.

Future costs:

- Elsewhere in this Submission, the Delegation mentions Veda Advantage and Dunn & Bradstreet costs. In addition, there are bank fees, such as expedited EFT payments and the likely future registration of secured interests fees associated with the Personal Properties Securities Register and foreshadowed Austrac filing fees. All of these are third party fees which are included in the current Bill's 48%, providing another reduction in net income for the lender.

© *Smiles Turner, November 2011*

- It takes an average of 6 to 8 months for a new small lender to gain the necessary experience and, in the meantime, at least 50 loans will have caused loss, with many new lenders losing towards $90,000 of their original capital during those months.

ASIC loses money

According to ASIC publication 11/147MR, Australian Credit Licensees currently number 1,089 lenders lending under $3,000 and 2,147 lending short term. Given the information included in this Submission, ASIC can expect a massive reduction in the aggregated numbers of 3,813.

In addition, it is unknown how many of the 3,964 licensed Credit Assistance Providers (brokers) will be affected. The delegation is aware of a possible 80 who specialise in securing small amount, short term loans, who will definitely have no need to renew their licenses for 2013.

Size of loans will drive lenders from the market

Concerning the size of their loans, the companies responding to the May 2011 lender survey indicated:

Size of loans	Lenders involved
$500 or under	5 lenders, 2 of whom regard themselves as payday lenders
$501 to $1,000	14 lenders, 1 of whom classified its lending model as payday
$1,001 to $1,500	7 lenders, 2 of whom classified themselves as payday, either in whole or part
$1,501 to $2,000	6 lenders, 3 of whom classified themselves as payday, either in whole or part
$2,001 and above	3 lenders

That means, on the analysis of costs and mandated maximum income discussed above, the 32 lenders lending up to $2,000 (91%) will definitely be forced out of business by the current Bill if it proceeds unamended, and the 3 lenders lending above $2,001 will need to have their loan books very much concentrated in the $4,000 to $5,000 range.

On this survey result, the current Bill's barrier of 2 years and $2,000, if applied simplistically to the above, means that only a possible 8.6% of the current 328 lenders will operate under the inclusive 48% in 2013.

However, as discussed elsewhere in this Submission, the Delegation is aware of only 50 with loan book capital large enough to exclusively lend in this sub-segment of the market, e.g. in September 2011, respondents to the Smiles Turner survey indicated that they had an average of 627 customers on their books at the time.

If the loan book had to be funded to provide loans at $5,000 on day 1, these customers would require a total of $8.135 million. This is 6.33 times their average loan book. Very few of these companies could possibly raise the capital or successfully offer collateral, in order to obtain wholesale finance to achieve this funding.

The Delegation would expect some diminution if you allowed for these customers borrowing over a 12 months period, with the opportunity for the lender to again lend amounts being repaid over the various loan terms. However, any consideration of such a calculation must be made in the light of a study of 40 lenders in 2006, who were clients of Min-It Software. On page 17 in Min-It Software's submission to the Queensland Government's December 2006 Inquiry entitled "Managing the cost of credit in Queensland", it was revealed that the total investment of these companies was $15,200,000 and their total loan book, for the year, was $15,320,000.

That study revealed that the companies' investment constituted 99.22% of their loan book value. Unfortunately, no statistics were provided on what proportion of the total investment was allocated to administration costs. However, the comparison may be a useful indicative one, given that the lenders have all been operating for between 1 and 4 years, so that the costs of establishment would have largely been attributed to the years before 2006.

© *Smiles Turner, November 2011*

Lender costs realities - wages

A comparison of the following wage costs, with the 48% gross income table included earlier indicates that all combinations of loans involving up to $1,500, for up to 40 weeks, are uneconomic on just wages alone. Further, that many of the loans above that amount and up to a year, are seriously impacted when you deduct wages from the gross income amounts and the balance is then compared with other costs.

As will be observed, in most circumstances, the gross income generated does not even cover staff costs.

Staff Member	Average rate per hour (net of on-costs)	Average rate per hour including on-costs	Labour costs per loan
Junior Clerk	$18.60	$21.39	$32.09
Loans Officer	$22.38	$25.74	$38.61
Outlet Manager	$25.75	$29.61	$44.42
Approvals Officer	$31.50	$36.23	$54.35
Underwriting Manager	$47.00	$54.05	$81.06
Senior Manager/Owner	$44.50		apportioned
Compliance Manager	$67.00		apportioned
Director	$75.00		apportioned

(Smiles Turner May 2011 Supplementary Lender Research)

Note, the range of wages paid within the small amount, short term finance sector were relatively common, e.g. loans officers range - $22.20 - $24.55, outlet manager $23.00 - $28.50, approvals officer $28.00 - $35.00). The September 2011 research indicated a minimum of 15% on-costs should be recognised.

The right hand column of the above chart recognises the post-1 July, 2010 Commonwealth expectations of comprehensive consumer assessment, the 1 October implementation of Credit Guides, the substantial documentation to be presented to the consumer and explained, plus loan administration time, lenders find it necessary to allocate at least 1½ hours of staff time to the process for each consumer and the management of their loan during the term.

Post-Exposure Draft research

Following the release of the Exposure Draft, Smiles Turner invited Delegation supporters to participate in a research program focused on the provisions of the Bill.

The September 2011 research revealed each of the 19 companies had an average loan book of $1,606,000, there was a total of 330.5 full time equivalent staff employed and 11 of the companies offer loans above and below $2,000. The remaining 8 companies do not provide any loans over $2,000.

As noted earlier, all companies indicated that, if the current Bill was passed unamended, they would leave the industry. If such were to occur, the larger companies indicated an investment loss averaging $1,918,000. The medium sized companies estimated an average of $660,000 and the smaller companies averaged a $280,000 loss.

All companies indicated that they could not break even lending at 10%, 2%. On a $500 loan the minimum break even figure provided, for a 1 month loan, was a minimum of $25 per $100 lent, plus the 2%. This is consistent with the Delegation's analysis of the Brotherhood of St Laurence's pilot program, included elsewhere in this Submission.

While two of the companies provide loans of $3,000 and $3,200, their economics of survival were inhibited because these amounts are generally lent for 1 year.

Everything else aside, the fundamental problem for these companies is the assessment of the contribution their under $2,000, under 2 year loans make to their total costs. There were 5 companies that did not provide any loans over the $2,000-2 year barrier and so their future uneconomic 10%, 2% loans will theoretically have to cover 100% of their costs.

© *Smiles Turner, November 2011*

The three companies whose potential 10%, 2% loans contributed least to business costs are still in a situation where 69.8%, 75% and 75.6% of their total costs are derived from their shorter and smaller loans.

What the research shows is that, even where you have existing companies lending in the $3,000 to $5,000 range, the key to their future survival, if the Bill is passed unamended, will lie in how little of the under $2,000, under 2 year contracts contribute to their total business costs. It is the Delegation's assessment that the contributions to the total cost of all companies surveyed which will be foregone, from their 10%, 2% loans, means that they cannot survive post-1 January 2013.

It is relevant to note that, for all companies known to the Delegation, including the biggest lending companies, the proportion of payday (10%, 2%) loans constitutes approximately 90% of their total loans. By loan number, loan book size and contribution to company profit, the payday sector is the critical sector.

For the volume lenders, this proportionality simply reflects consumer preference, which is why the average payday loan is $325. The Delegation notes that the average for Cash Converters is approximately $275.

The position of the microlending companies who generally lend $2,000 or more should not be overlooked. The problems these companies will face will include a lack of encouragement to lend unsecured loans, because there will be no incentive when the mandated interest rate is exactly the same for secured as it is for unsecured loans. Further, many lenders in this segment of the market are lending predominantly in the $2,000 to $3,000 area which, at best, will only be marginal. That means facing the challenge of at least doubling their investment in their loan books, to lend far more at over $5,000, to ensure profitability.

Simply put, 1,000 loans at $325 requires lending capital of $325,000. 1,000 at even $5,000 requires lending capital of $5 million - an entirely different level of business risk and commitment. In this context it should be noted that, currently, the larger banks are perceiving this level of lending as competitive, or establishing a foothold from which to launch other products that definitely compete with the banks and it is now almost impossible for short term lenders to borrow any extra wholesale funds from the banks.

Current Bill in conflict with National Consumer Credit Protection Act

Forcing the market to accommodate the current Bill, by demanding the cessation of 90% of the current loans and demanding that the consumer accept loans at least 9 times larger than they need, and for terms 36 times longer than they want - via the imposed price mechanism - is a major conflict with the statutory provisions of the NCCP Act, which demands that, in assessing "*not unsuitable*", the lender give consideration to the consumer's "*objectives*" and "*preferences*".

Minister versus Industry - defining "reasonable"

The September respondents were asked "*Do you agree with the Minister's office that a Cash Converters loan of average $325... for two months - generating the proposed revenue of $48.50 - is reasonable?*".

The 19 respondents indicated that they would require an average of $97.36 more. This is 3 times the Minister's assessment. This calculation was from respondents with an average profit of 18.07% of gross revenue, before interest and taxation.

The profit figure of 18.07% is significant in this consideration. The lenders who have made the contradictory evaluation have an average profit that business accountants and business analysts regard as "tight".

Contact with a number of accounting and business broker experts revealed that they do not encourage clients to view any amount under 20% as generally acceptable and, when assessing a business for purchase or corporate takeover, unless there are other outstanding attractive features, most business brokers and cost accountants will not enthusiastically recommend the takeover of such a business.

© *Smiles Turner, November 2011*

More on the September 2011 study

Relevant cost information derived from the September 2011 business study is useful to compare with the tables indicating gross revenue included in this section:

Cost Category	Average $ Amount
Advertising	$71,000
Bad debts	$70,000
Rent	$42,000
Employee - all categories - plus employee on-costs (average)	$80,000 each

Although there was considerable variation in the number of employees and the rents paid for premises, the average total business cost was $664,000 and the amount actually lent, averaged in excess of $2 million, with each business having an average of 1,548 consumers listed on their books.

The adverting and marketing cost to attract each successful applicant averaged $46 per customer. The 11 companies that relied on wholesale funds for their loan book, paid between 7.5% and 30% for their wholesale money, with an average of 13.64%.

The average rental figures indicate at least 3 of the businesses declaring negligible rents, which reflect home-based internet lending, or substantial cross-subsidisation from a pawn broking or similar business.

In addition, because they deal with cash and armed robberies have occurred, most retail lending outlets have invested substantially in premises, staff and operational security facilities, some as much as $63,000 just for one outlet.

Using the simplistic assessment of lending $2,000 for 2 years and recovering your costs in the first year, the gross profit at 48% for the 2 years is $960. that is $9.23 for each week, on the assumption that all repayments are repaid on time and in full.

Taking a conservative “High Street” shop rental at $80,000 (which is consistent with the rents of the average lenders who participated in the September 2012 survey who have “High Street” locations); plus one junior staff member on a salary of $37,440; and with absolutely no other costs and no contribution to any profit or company taxation, you need to have advanced 244.66 loans of $2,000 for 2 years, consuming $489,333 of capital, if lent at the start of year 1, to break even.

The problem is - these 2 costs represent only 17.69% of the average annual business costs faced by the survey respondents, and the loans are not all made at the one time at the start of the year.

The Delegation is unaware of any offer by the consumer advocates to assist, by offering to “donate” a half a million dollars to cover the other costs not included in the above sample, when their preferred new regime commences on 1 January 2013.

The comprehensive analysis of these businesses’ financial information, taking into account commercial in confidence information that has not been included in this Submission indicates that, if the current Bill is passed unchanged and all these businesses attempted to continue in business after 1 January 2013, on average each would lose a minimum of $142,000 per year.

Job losses

The details indicating failure to cover costs, listed above, will contribute to the loss of towards 2,500 full time equivalent positions and affect some 3,500 people, with payday, microlenders and brokers across Australia exiting the sector.

The Delegation concedes that a small proportion will hold on to employment with the lenders remaining offering the above $3,000, mainly $4,000 to $5,000 loans. However, loans of this amount are less than 2% of current total loans advanced and the necessary funds to finance the much larger loan books that will be required, will mean only a tiny number of current employers will remain in the industry sector.

© *Smiles Turner, November 2011*

During the September 2011 research period, 5 companies indicated they would try to operate in other segments of the finance industry, if the current Bill commences unaltered. The 5 tended to be smaller companies and it can be expected that over 240 of the 260 fulltime equivalent employees, currently working for these companies, will lose their jobs.

14 companies planned to leave the finance industry altogether and one of the Delegation's bigger lenders has already reported key staff resigning to seek employment security before the avalanche of retrenchments. One of the first casualties is one of the Delegation's smaller supporters, who has had to quit the sector, with his investors terminating their long term commitment due to the uncertainty.

Break even - NAB / Fast Money

The NAB/Fast Money "*Do You Want to Hurt Me*" report on the pilot scheme heavily subsidised by the NAB, released in 2010, illustrates a selection of these challenges.

As mentioned previously, the report indicated that, with a 48% inclusive cap, you could not break even (for secured loans under the current Bill), unless you lent at least $1,700 for at least a year and lent a minimum of 3,000 loans, with a loan book of $5 million.

As discussed earlier, a loan book of this size is far beyond the resources of the majority of current lenders and the banks are refusing to increase their wholesale lending in this area.

The Delegation contends that this program's actual costs were very conservatively calculated and the figure of $1,700 is far too low. There are a number of cost components that have been overlooked. These include:

1. that business operating costs were far from fully factored in, including rents and leasing being ignored;
2. that the pilot study was limited to an internet lending model;
3. that no wages or salaries appeared to have been included or, if they have, recognition of the full amount of time involved has been seriously underestimated; and
4. that 90% of applicants were rejected, but the costs associated with attracting and rejecting this 90% were not factored in.

It is useful to note that lending $1,700 for 12 months, with monthly repayments, generates a gross income at 48% (reducible daily balance and all inclusive) of $439.41. Without factoring in the many costs, on the NAB/Fast Money analysis this would constitute break even but, in reality, would be very much below break even.

The failure to include all costs and the subsidies provided by the NAB for this pilot project, highlight a regulatory dilemma. Setting the boundary between tiers to avoid economically impractical or arbitrary regulation, with the resultant loss of entrepreneurial talent and less choice for the consumer, demands comprehensive recognition of varying business costs - all legitimate, but determined by business models including, but not limited to, whether or not:

1. the lender is an Internet, or "bricks and mortar" lender;
2. the cost of wholesale funds paid by the lender;
3. the turnover in loan numbers;
4. the turnover, as measured by the loan book - the loaned dollar amounts;
5. staffing policies (McDonalds - or providing jobs for adults);
6. a franchise, or series of company-owned outlets is involved; and
7. what marketing activities are employed for three different categories of lender - the small, medium and large.

Unless there is a stated intention to set a fixed price, with fixed common conditions - which is the situation with the current Bill - then a number of boundaries will have to be set to recognise the opportunity for the different type of lenders to earn a sustainable return. Without this sustainable return, the Minister's promises of a continuing opportunity for lenders to survive economically and, by implication, for the majority of current borrowers to have someone from whom to borrow, will have been broken.

© *Smiles Turner, November 2011*

Break even - Cash Converters

In 2010 Cash Converters lent approximately 84,000 bigger and longer loans (for that company), largely via its Saffrock subsidiary. These loans had the following characteristics:

(a) they were the loans offered in the 'above payday lending' amounts and for 'terms of several months and more' category;

(b) the average principal of these loans was approximately $1,070.

On the NAB analysis, these loans would no longer be offered and would encourage the following range of business behaviours to be adopted by companies such as Cash Converters:

- to encourage consumers to go into greater debt and borrow larger amounts; and
- to encourage consumers to borrow for longer terms.

Cash Converters lent $90,000,000 in this category of loans in 2010. To maintain their profitability and ASX share price, "*the money has got to go somewhere*", to generate similar revenue levels. It is no wonder that company Chairman, Peter Cumins, has publicly commented on moving off shore because of the current Bill. However, that will not help the approximate 146 franchisees and their staff and their combined customer numbers, which are in the vicinity of 400,000.

Break even - Money 3

For 2008-9 Money 3, the other publicly listed microlending company, announced a net profit after company tax and interest of $1,033,926. This was on gross revenue of $9,013,813.

That means the company's net profit was 11.47% of revenue. However, this figure has to be considered in the context of the paid up capital of the company being reported as $22,516,008. That means the net return on capital, after company tax and interest, was 4.59%.

These percentages were earned in an environment where most, if not all, that company's loans were lent to Victorians who are legally able to be charged 48% interest, plus fees and charges.

In assessing a variety of public statements, the company's annual reports and using a comparative analysis with Saffrock, the Delegation estimates that Money 3 lent 12,000 loans in that year, with an average loan principal of somewhere around $1,205.

An indicative assessment is that approximately one third of the company's income was generated by fees and charges. That means, with no ability to add fees and charges on top of the 48% interest rate, the net profit would have been 7.639% and the net return on capital would have been in the vicinity of 3.057%.

The Managing Director of Money 3, Mr Rob Bryant, has confirmed that, if the current Bill proceeds and a NSW-style 48% inclusive cap becomes law, Money 3 will withdraw from this market segment. Mr Bryant has noted that the opportunity to earn the above amounts and more, without the attendant risk, would clearly be available elsewhere and he has also indicated that a substantial number of the company's lending outlets will close.

Even with this one company withdrawing, the impact on the current Victorian providers of subsidised loans, such as LILS and NILS, would be devastating. This sector's total annual loan offerings do not equal even one third of Money 3's annual loan volume.

Modest profit - 20%

It is useful to note that a loan of $2,900 for 1 year, repaid weekly at 48%, generates $749.80 gross income. If repaid monthly, the gross income is $818.07. On the NAB's suggested "modest" profit of 20%, the net income enjoyed by the lender would be either $149.96 (5.17% of the loan amount if repaid weekly), or $163.61 (5.64% of the loan amount if repaid monthly).

If the loan was to be extended to 18 months - paid weekly, it would generate a gross income of $1,156.50 ($231.30 modest profit, being 7.98% return on the principal) and, if paid monthly, $1,230.23 ($246.05 modest profit, being 8.48% return on the principal).

If the loan was to be extended to 2 years - paid weekly it would generate a gross income of $1,589.11 ($317.82 modest profit, being 10.96% return on the principal) and, if paid monthly, $1,672.34 ($334.47 modest profit, being 11.53% return on the principal).

© *Smiles Turner, November 2011*

These calculations indicate that even loans as large as $2,900 could not be included in the 48% cap regime with any confidence that lenders would continue to lend.

This is particularly the case if the amount is lent for 18 months or less. It is evident that loans of this amount only start to provide almost comparatively attractive returns on capital when the term is for 2 years or longer.

Minimum loan book - $5 million

In its 2010 pilot scheme report, the NAB calculated that, to remain viable under a 48% cap regime, a lending company would need a $5 million loan book and to be lending loans at an average principal of $2,900.

Concerning the $5 million loan book - the Delegation's experts estimate that fewer than 50 lenders included in ASIC's 3,890 "*other personal loans*" sources in Australia, would have loan books of this amount or more.

Contact with industry leaders and a small selection of lenders in this "*other personal loans*" sector indicates that, while up to 85 brokers might be registered with a lender, some reported the number of brokers they were aware of who were continually referring deals to the lenders (each) was 5 to 6 and, at the other end of the spectrum, the range provided was 10 to 15.

For purposes of providing the broadest indication, the Delegation is assuming 10 brokers per lender. This is without taking into consideration the distinct possibility that some brokers are referring deals to more than one lender amongst the 50.

On the basis of that assessment, 50 lenders and their (maximum) 500 brokers, may survive the introduction of a 48% all inclusive cap on their mid-tier sector.

If these estimates (both the NAB's and the Delegations') are anywhere near correct, if the current Bill's NSW-style cap is introduced, approximately 3,340 lenders and brokers (of ASIC's total of 3,890) in this non-short term sector, would not be able to continue lending or facilitating loans.

In addition, based on Smiles Turner's general knowledge of the industry, a possible 200 lenders and some brokers out of ASIC's 1,089 licensees categorised as "*microloans (less than $3,000)*", would be joining the exit queue. The economic, social and personal dislocation and distress that would be created by this exodus, is beyond description.

Wages and salaries

The 2008-9 annual return for Money 3 indicated that 67% of revenue went on staff salaries and wages. According to the substantial database maintained by Min-It Software over the last 7 years, involving many hundreds of lenders, this is at a higher level for the industry sector's bricks and mortar lenders. It is also relatively consistent with that experienced by some Smiles Turner clients who have larger wages and salaries expenditure, although a number of Smiles Turner clients have lower, and much lower, ratios.

Given that Money 3 is a public company, subject to substantial scrutiny in that capacity, with several bricks and mortar outlets in relatively profitable areas of Victoria, we use their audited published figures as a benchmark. Their wages and salary costs mean the lenders who might face a 48% inclusive cap would be left with 15.84% of gross income to cover all other business expenses.

In these circumstances, even one unavoidable expense that is critical to continuing market participation has a significant impact. The Smiles Turner lender research in April-May 2011 revealed that compliance costs for lenders, at the lower cost payday grouping, averaged $11 per loan. Money 3 would incur this amount at least.

Adjusting the 2008-9 Money 3 figures for this impost, occurring only post-July 1, 2010, net profit for Money 3 would have been $901,926. This would have constituted 10.00% of gross revenue and a return on capital of 4.00%.

If we consider loans of similar amounts to Cash Converters and Money 3, plus larger loans for 18 month terms (78 weeks), fortnightly repayment, at 48% inclusive - and apply the NAB modest profit and Money 3 actual profit figures to the income generated - under the proposed Option we again see little reason for companies continuing to lend in this segment of the possible 48% sector. This is illustrated in the following table.

© *Smiles Turner, November 2011*

Amount	Gross income - 48%	Net profit NAB Modest 20% = X% - being p.a. return on principal	Net profit Money 3 10% - $11 = X% being p.a. return on principal
$1,000	$405.13	$81.02 = 5.35%	$29.51 = 1.95%
$1,100	$445.77	$89.15 = 5.35%	$33.57 = 2.01%
$1,200	$486.29	$97.26 = 5.35%	$37.62 = 2.06%
$1,500	$608.01	$121.60 = 5.35%	$49.80 = 2.19%
$2,500	$1,013.65	$202.72 = 5.35	$90.36 = 2.39%

GE - out of business

To further illustrate the dynamic and negative impact of the 48% inclusive regime, the Delegation provides this analysis of GE Money and assumes that it lends a range of loans, rather than from its current minimum of $3,000, up to its preference of $5,000 loans. Please note that some of the following is approximate, but the conclusions are powerful and indicative.

The company's website and print promotional material indicate that "*rates vary - we factor in the risk*". However, anecdotal information provided to Smiles Turner, by a keen analyst of GE Money's business model, indicates that most consumers can expect to pay up to 36% interest.

On a $1,000 loan with a term of 12 months, paid fortnightly, this equates to $195.29. To this amount has to be added an establishment fee of $250, plus $10 per month "*loan service fee*", plus $1.50 per payment "*payment handling fee*" - total $604.29. This equates to approximately 103.5% p.a. interest.

With the introduction of a 48% inclusive cap, GE Money's income would be reduced to 56.32% of its current gross earnings, being a fall from $604.29 to $263.97.

It is reasonable to assume that GE is a very well run company. As such, it could face wages and salary costs of as low as 34% ($89.75), which is the lowest proportion known to be achieved by a Smiles Turner client. It could also face $11 for compliance costs and about 8% for the cost of wholesale funds sourced in Australia ($80.00). On these costs alone (total $180.75), the company would be left with just $83.22 (8.32% of the loan principal), to cover contribution to leases on its bricks and mortar premises, its substantial advertising, computer equipment purchase or hire, contribution to professional services such as legal and accounting, company registration and report and audit fees, stationery, etc.

To this must be added a contribution to bad debt, slow payer and non-performing loans, IDR and EDR costs, and contribution to shareholders' dividends after company tax. We would expect GE Money to withdraw from providing loans under at least $3,000.

GE Money has already made the decision to move towards $5,000 loans. If others can access the necessary increase in loan book capital, they will have to follow this lead or exit the industry, if the current Bill remains unchanged.

The cost of wholesale funds

One major group of competing lenders are paying an average of 10.9% for wholesale funds. The impact on gross income, fortnightly repayments, is as follows:

Amount lent	12 months interest	Minus cost of funds	18 months interest	Minus cost of funds
$2,500	$660.73	($272.50) $388.23	$1,013.65	(411.75) $601.90
$1,500	$396.34	($163.50) $232.84	$608.01	($245.25) $362.76
$3,200	$845.81	($348.80) $497.01	$1297.57	(523.20) $774.37

As this table indicates, it is only when loans are towards $3,000, over 12 months, that gross income may encourage a lender to continue lending under a 48% cap. If loans for $1,000 to nearly $3,000 were included in the proposed options 48% inclusive cap, on the calculations

© *Smiles Turner, November 2011*

included in the above table, again it could be expected that loans in that range would cease to be offered and there would be a major distortion in the smaller loans market.

However, it should be noted that, on the $3,200 loan for 12 months listed above, after deducting Money 3's (bricks and mortar lender) 67% for wages and salaries ($566.69) and the $11 for compliance costs, the balance to cover all other costs and provide a profit is down to $268.12, or 8.38% return on principal. Even at this size of loan we cannot predict whether or not lenders would enthusiastically continue in the market.

Unfortunately, this does not assist those consumers that require loans of lesser amounts, but above the approximately $1,000 that could be the logical cut off amount for the short-term category.

Note: all 48% inclusive interest rate calculations are made on the Min-It Software interest rate calculator, based on the date of calculation (23.7.11), with loans commencing 1 July, with the first payment due one week, a fortnight or a month later, according to the example being considered.

Any boundary setting, involving only two tiers, will face the challenge of creating a no-loan gap, where the relative profitability of the micro-loan and the more profitable longer term loan, will ensure that lenders do not offer loans for the mid-term.

The statement by a leading consumer advocate some time ago, that lenders would "*just have to adjust their business model*" to accommodate a 48% inclusive cap, is critically at odds with the lender cost realities that are considered above. Her statement indicated her expectation that "adjustment" would still leave loans available from the commercial lenders. What she failed to realise was that the cost realities of her un-researched, idealistic campaign will lead to an adjustment that will close down the small amount, short term commercial lenders altogether.

© *Smiles Turner, November 2011*