

CONTENTS

EXECUTIVE SUMMARY	i
Background	i
Size of the Market	i
Lending Practices	i
The Cost of Pay Day Loans	ii
Types of Consumers Obtaining Pay Day Loans	ii
Problems with Pay Day Lending Requiring Regulation	iii
Regulatory Options and Recommendations	iii
CHAPTER 1. INTRODUCTION	1
1.1 Review	1
1.2 What is “Pay day lending”?	1
1.3 Present Regulation of Pay Day Lending	1
1.4 Reasons for the Working Party	1
1.5 National Response	2
1.6 Terms of Reference	2
1.7 Working Party	3
1.8 Submissions to the Working Party	3
1.9 Role of Working Party	4
1.10 Comment on Policy Development	4
CHAPTER 2. TERM OF REFERENCE 1	5
The Size of the Pay Day Lending Market	
2.1 The Market Presently	5
2.2 Expectations of the Market	5
2.3 Conclusion on the Size of the Market	6
CHAPTER 3. TERM OF REFERENCE 2	7
The Lending Practices Within Pay Day Lending Market	
3.1 Consumer Submissions	7
Pre Contractual Disclosure and Conduct	7
Terms and Conditions of the Contract	7
Enforcement Practices	8
3.2 Pay Day Lender’s Submissions	9
Pre contract	9
Sign up	9
Terms of the Loan	10
Defaults	10
CHAPTER 4. TERM OF REFERENCE 3	12
Establish the Cost of Pay Day Lending	
4.1 The Relevance of Annual Percentage Rates to Pay Day Loans	12
4.2 Working Party Discussion	13
4.3 Converting	13
Table 1 – Example Effective Interest Rates	14
4.4 Conclusion on Cost of Pay Day Loans	14

CHAPTER 5.	TERM OF REFERENCE 4	15
	Types of Consumers Obtaining Pay Day Loans	
5.1	The Types of Consumer Borrowing Money from Pay Day Lenders	15
CHAPTER 6.	TERM OF REFERENCE 5	16
	Develop Options and Make Recommendations...	
6.1	Identification of the "Mischief" with Pay Day Lending	16
6.2	"Truth in Lending" Mischief	16
6.3	"Unconscionability and Over-Commitment" Mischief	17
	Example 2	18
6.4	Regulatory Options	20
6.5	Option 1 – Status Quo – No Regulation	20
6.6	Option 2 – Voluntary Industry Code of Conduct	20
6.7	Option 3 – Regulation by the Code	21
	Truth in Lending (table)	22
	Unconscionability and Over-Commitment (table)	22
	Interest Rate Disclosure	23
	Security for Pay Day Loans	24
	Submissions from Stakeholders	25
6.8	Option 4 – Licensing	27
6.9	Option 5 – Cap Effective Interest Rates	29
6.10	Option 6 – Prohibition	30
6.11	Recommendations	31

Executive Summary

Background

Pay day lending is the practice of a lender advancing to a consumer a relatively small amount of money until their next pay day in exchange for a fee.

Presently there is no specific regulation of pay day lending as the Consumer Credit Code does not apply to loans of less than 62 days duration. Pay day loans are typically for less than 62 days.

In March 2000, the Queensland Minister for Fair Trading, Judy Spence MLA, established an independent working party to investigate the pay day lending industry and to make recommendations for the regulation of the industry.

The working party was comprised of a cross section of interested stakeholders, including mainstream credit providers, financial counsellors, consumer groups, lawyers, academic and Government officials.

The Terms of Reference for the working party were to investigate and/or identify:

1. The extent of the pay day lending market;
2. The lending practices within the pay day lending market;
3. The real cost of pay day loans by reference to an annual percentage rate;
4. The types of consumer borrowing money from pay day lenders; and
5. Options, and to make recommendations for the regulation of pay day lending in Queensland.

Submissions were received from both consumer groups and pay day lenders in relation to the Terms of Reference.

Size of the Market

The working party found the pay day lending market to be new and small having only commenced in Australia in the past 18 months to 2 years.

There are only 3 major operators in the industry with a combined total of just over 80 outlets in all States of Australia except Tasmania.

The pay day lending market is expected to grow rapidly in the next 5 to 10 years. Predictions are there will be up to 10 times the current number of outlets in as little as 5 years. In the United States, pay day lending has expanded rapidly to the point where there are estimated to be up to 8,000 pay day outlets across the country.

Lending Practices

The lending practices of pay day lenders were found to be similar across the 3 main operators. Most pay day lenders lend for any purpose to anyone who has a regular source of income, including welfare payments, and a bank account. All lenders promote the main feature of the service as being the ease and speed with which cash can be obtained.

All lend cash in exchange for a fixed fee rather than charging an interest rate. The fee is usually in the range of \$20 to \$25 per \$100 advanced. The period of time over which pay day loans are offered vary between 7 and 62 days. The average amount of a pay day loan is about \$250.

The most common method of repayment is via a direct debit authority by the customer, which is usually utilised on the customer's next pay day. Some require security for the loan, including bills of sale over motor vehicles.

Some lenders are willing to "roll over" the loans, or in other words, allow the customer to increase the amount of the loan in exchange for an additional fee. This can lead consumers into the "debt trap".

One lender repossesses secured goods and imposes additional default fees. Overall, the default rate is relatively low, in the range of 2% to 3%.

The cost of Pay Day Loans

The relevance of an annual percentage rate to pay day loans is questioned by pay day lenders. They argue that they only charge a fixed fee, not interest and as the life of the loan is only a few weeks, an annual rate is irrelevant.

On the other hand, interest is a widely understood method of referring to the cost of lending. Annual interest rates are widely used and understood in the community.

The working party, noting the limitations of referring to an annual percentage rate in relation to pay day loans, believes quoting an annual percentage rate for pay day loans does offer to consumers valuable information for comparison and comprehension purposes. For example, pay day loans can be up to 70 times more expensive than a credit card, which is not immediately apparent.

The effective annual percentage rates charged by pay day lenders was found to range between 235% to over 1,300%, depending upon the amount of the fee and the length of the time over which the advance is repayable.

Types of Consumers Obtaining Pay Day Loans

The lack of reliable data on the socio-economic backgrounds of pay day borrowers makes a definitive answer on this issue difficult to obtain.

However, the 2 main categories the product would appeal to most are:

1. Those in need of urgent cash, such as those people with urgent or unexpected household bills or gambling; and

2. Those who are unable to access mainstream credit. This might be due to poor credit rating, unemployment or pension or age restrictions.

A reasonable proportion of pay day borrowers would appear to be vulnerable.

Problems with Pay Day Lending Requiring Regulation

The problems with pay day lending that require some form of regulation were found to fall into 2 main categories, the lack of any truth in lending and concerns about over-commitment and unconscionability.

The specific issues about the lack of truth in lending include:

1. Lack of adequate (if any) disclosure of relevant terms of the contract, including the fees payable;
2. The lack of disclosure of interest rates to allow comparisons to be made; and
3. The lack of compulsion on the lender to provide copies of the contract to the borrower.

The specific issues in relation to over-commitment and unconscionability are:

1. The real potential for borrowers to become over-committed to the extent that they are incapable of paying for both the loan and the necessities of life;
2. The relatively high fees charged for a pay day loan which might be considered to be unjust and unconscionable;
3. The ability of borrowers to "roll over" the pay day loan so borrowers become caught in the "debt trap";
4. Pay day lenders requiring security for small loans over short periods of time and, in particular, requiring high valued security (eg cars worth thousands of dollars) to secure low value loans (worth hundreds of dollars);
5. Repossession tactics that would be illegal if regulated by the Consumer Credit Code such as repossessing items without notice and very soon after a default; and
6. The potential for lenders to charge borrowers excessive repossession fees after goods are repossessed.

Regulatory Options and Recommendations

The working party has considered a number of regulatory responses, ranging from the status quo to full prohibition.

The working party has recommended that at this stage pay day lending should be regulated by the Consumer Credit Code, the law that governs all other forms of consumer lending in Australia.

All other forms of consumer lending are regulated. There is a real potential for consumer exploitation with pay day loans. In this context, the continued unregulated status of pay day lending is unjustified.

In addition, it is recommended that:

1. Pay day lenders should be required to disclose to consumers an effective annual percentage rate for the pay day loan;
2. Regulators should send a clear message to the industry that requiring security for short term, small value, high interest rate loans such as pay day loans is considered to be unjust and unconscionable and will be challenged; and
3. Ensuring pay day lenders are regulated is preferable to banning pay day lenders altogether and forcing borrowers unable to access mainstream credit to pursue even more detrimental avenues of credit. To maintain uniform legislation across the States and Territories, New South Wales and Victoria should review their 48% ceilings on interest rates.

CHAPTER 1. INTRODUCTION

1.1 Review

On 22 March 2000, the Minister for Fair Trading, Judy Spence MLA, announced the establishment of a working party to report on the so-called "pay day lending" market in Queensland.

1.2 What is "Pay day lending"?

"Pay day lending" is the practice of a lender advancing money to a customer until their next pay day in exchange for a fee. The advance is therefore for a relatively short period of time, typically 1 or 2 weeks.

This type of loan is variously referred to as "pay day loan", "pay day advance" and the more generic term "micro lending".

The term "pay day loan" as used by the working party is intended to be a broad term covering all short term lending for personal, domestic or household purposes of up to 2 months duration.

1.3 Present Regulation of Pay Day Lending

Presently, there is no specific regulation of pay day lending in Queensland.

Pay day loans are not regulated by the Consumer Credit Code ("the Code"), the law which governs all other forms of consumer lending in Queensland. Section 7(1) of the Code specifically excludes loans of 62 days or less from the operation of the Code. As pay day loans are typically for a period of less than 62 days, they are not subject to the Code.

1.4 Reasons for the Working Party

The Explanatory Notes for the *Consumer Credit (Queensland) Act 1994*, to which the Code is an appendix, states:

"The objectives of the (Code) are to provide laws which apply equally to all forms of consumer lending and to all credit providers, and which are uniform in all jurisdictions in Australia.

The legislation is based on the principle of truth-in-lending which will allow borrowers to make informed choices when purchasing credit."

Therefore, the main objectives of the Code are:

1. Equal application to all forms of consumer lending and to all credit providers;
2. Uniformity in all jurisdictions; and
3. Truth-in-lending.

The absence of regulation of pay day loans is therefore in direct contradiction to objectives 1 and 3 above.

Consequently, the Minister for Fair Trading has established this Working Party to investigate the pay day lending market in Queensland and to develop options for the regulation of the market.

1.5 National Response

The Code is national uniform legislation administered by the States and Territories. Any amendment to the Code requires a 2/3 approval of State and Territory Ministers for Consumer Affairs.

The Queensland Minister for Fair Trading is able to raise any proposed amendments to the Code with other State and Territory Ministers through the Ministerial Council on Consumer Affairs (MCCA).

Therefore, while the Queensland Minister for Fair Trading has established the working party, if amendment to the Code is ultimately recommended, this can be achieved through MCCA.

1.6 Terms of Reference

The specific terms of reference for the Working Party are to:

1. Investigate the size of the pay day lending market;
2. Investigate the lending practices within the pay day lending market;
3. Establish the real cost of pay day loans by reference to an annual percentage rate;
4. Identify the types of consumer borrowing money from pay day lenders; and
5. Develop options and make recommendations for the regulation of pay day lending in Queensland.

The working party also recognises the practice of exchanging or cashing cheques is closely related to pay day loans and is usually offered by the same lenders. However, since cashing cheques does not involve the provision of credit, the practice of cheque exchanging or cashing is beyond the scope of the working party.

The working party also notes some pay day lenders also offer pawnbroking services. Pawnbroking is subject to separate regulation¹ and is also outside the scope of the working party.

¹ *Pawnbrokers Act* 1984. Most other States and Territories also have similar legislation regulating pawnbroking.

1.7 Working Party

The working party was established to review, objectively and independently, the pay day lending industry and to make recommendations to the Minister on regulating the industry. The working party members were selected to represent a number of interested stakeholders including mainstream credit providers, financial counsellors, the legal profession, academia and the Office of Fair Trading as the regulator.

Each member of the working party brings experience in consumer credit to the working party from various backgrounds.

The working party was comprised of the following people:

- Keith Booker, Head of Operations, Bank of Queensland;
- John Cushion, Senior Investigator, Office of Fair Trading;
- Randal Dennings, Partner, Clayton Utz Lawyers;
- Peter Guttormsen, General Counsel, SuncorpMetway;
- Kate Keating, Manager, Financial Counselling Service (Queensland) Inc.;
- Geoff Kennedy, Senior Legal Officer, Office of Fair Trading (Chair); and
- Justin Malbon, Senior Lecturer, Law School, Griffith University.

1.8 Submissions to the Working Party

The working party held 4 meetings from April to July 2000.

During the second meeting, the working party received submissions from consumer groups through the Consumer Protection Unit of Legal Aid Queensland ("Legal Aid"). Legal Aid provided submissions to the working party on the following issues:

- The need to regulate the pay day lending industry;
- Problems or potential problems in the pay day lending industry from a consumer's point of view;
- Case studies on "real life" examples of consumers' dealings with pay day lenders; and
- Options for the regulation of the industry.

Legal Aid provided comment and analysis on behalf of consumer groups in other States and Territories, including Queensland Consumer's Association, Consumer Credit Legal Services New South Wales, Victoria and Western Australia, Financial Counsellor's Association Qld, Consumer Law Centre Victoria and Fitzroy Legal Service.

During the third meeting, the working party received submissions from representatives of the pay day lending industry, including:

1. Australian Money Exchange (AMX);
2. Cash Converters; and

3. ChequExchange.

Those organisations made submissions on each of the Terms of Reference, and in particular:

- Size of the market;
- Lending practices; and
- Options for regulating the industry.

Details of those submissions are outlined in the discussion that follows on each of the specific terms of reference.

1.9 Role of Working Party

The role of the working party is primarily to develop regulatory options and to make a recommendation on the most effective option.

However, it is not the role of the working party to draft any amending legislation. This is the role of the Office of Parliamentary Counsel in consultation with the Office of Fair Trading.

Further, it is not the role of the working party to decide or pass judgment on the legality or otherwise of the conduct of pay day lenders.

1.10 Comment on Policy Development

The working party decided at an early stage to identify the mischief with pay day lending. In other words, what are the problems, both real and potential, associated with pay day lending that require or justify regulation.

The working party agreed it was futile to make recommendations on the most effective regulatory option without first fully understanding what the mischief with pay day lending is.

The focus of Terms of Reference 1 to 4 is essentially establishing what the real and potential problems are.

CHAPTER 2. TERM OF REFERENCE 1

The Size of the Pay Day Lending Market

2.1 The Market Presently

The pay day lending industry is very much in its infancy. The first pay day lender started operating in Australia in December 1998. Most commenced operating in 1999. Pay day loans have only been a feature in Australia for 12 to 18 months.

As at the end of May 2000, the 3 organisations that made submissions to the Working Party have a combined total of 82 outlets offering pay day loans.

The outlets of the pay day lenders are currently located in Queensland, New South Wales, Victoria, South Australia and Western Australia. Queensland has the most number of outlets, followed by New South Wales, Western Australia and Victoria. One operator also has at least one outlet in New Zealand and plans to have outlets in a number of countries.

The 3 organisations that made submissions to the Working Party are the main providers of pay day loans in Australia. There may be a number of other smaller providers of pay day loans operating.

The number of pay day loans currently being entered into is, noting the commercially sensitive nature of the information, in the order of hundreds each month by most of the lenders. The total market for pay day loans is presently in the order of a few thousand pay day loans per month at the most.

As the typical pay day loan is for a few hundred dollars, the total turn over for the pay day loan market would be in the order of approximately \$200,000 to \$500,000 per month. It should be noted these figures are estimates only as no reliable industry figures are available.

2.2 Expectations of the Market

All pay day lenders plan to have outlets in each State and Territory in the short to medium term.

Pay day lenders expect rapid growth of pay day lending in the next 5 years.

Predictions are there will be up to 5 times the number of outlets offering pay day loans in 12 months time than there are currently. In 5 years time, it is predicted there will be up to 10 times the number of outlets than presently.

Two of the pay day lenders have franchised their operations and are currently selling franchises throughout the country. Those franchises offer a range of products and services, but pay day loans are a significant part of those businesses.

It is noted the pay day lending industry in the U.S. is far more advanced. According to the National Cash Checkers Association (NaCCA), it is estimated pay day loans (or

"deferred deposit services" as NaCCA refers to them as) are being offered at somewhere between 6,000 and 8,000 different sites across the United States².

2.3 Conclusion on the Size of the Market

The conclusions to be drawn on the size of the market in Australia are:

1. The market is very young and small;
2. There are presently few operators; and
3. The size of the market and number of outlets offering pay day loans are expected to increase significantly in the next 5 to 10 years.

² "Freedom of Choice for Consumers: The Truth About Deferred Deposit Services – A Reasoned Response to the CFA's Misrepresentations", National Check Cashers Association Inc., May 1999, <http://www.nacca.org/ddresponse.html>.

CHAPTER 3. TERM OF REFERENCE 2

The Lending Practices Within the Pay Day Lending Market

3.1 Consumer Submissions

Consumer groups, through Legal Aid, have made a number of comments on the practices of pay day lenders they have observed. Legal Aid has also provided comments on potential problems that may develop in the market and other issues that may justify regulation of the market.

The submission by Legal Aid concentrated on 3 broad areas of pay day lending:

1. Pre contract disclosure and conduct;
2. The terms and conditions of the contract; and
3. Enforcement.

Pre Contractual Disclosure and Conduct

Legal Aid make the following comments in relation to the pre-contract issues:

- (i) Typically, there is an insufficient assessment made of the borrower's ability to repay the loan;
- (ii) Borrowers are not advised of the cost of credit as an annual percentage rate making it extremely difficult for borrowers to compare the cost of pay day lending with other lenders and to fully comprehend the cost of pay day lending;
- (iii) There is no obligation to provide a copy of the loan contract or mortgage; and
- (iv) Pay day lenders target their advertising at consumers who are already overcommitted and will be unable to repay without substantial hardship.

Terms and Conditions of the Contract

- (i) The fees and charges imposed are excessive. When converted to an annual percentage rate, the rates imposed by pay day lenders typically range between 500% and 1,000% per annum;
- (ii) There is no obligation on pay day lenders to provide an accounting for payments made by the borrower and no provision for a refund of fees in the event of early repayment;
- (iii) Mortgages or security may be taken over goods worth thousands of dollars (such as motor vehicles) to secure a loan worth a few hundred;
- (iv) Borrowers cannot challenge unreasonable or unconscionable fees and charges, in contrast with section 70 of the Code;

- (v) Borrowers have no legal right to seek a variation of the contract in the event of hardship, such as unemployment.

Enforcement Practices

- (i) Demands and threats made by pay day lenders sometimes have no legal basis and are unconscionable. For example, threatening to list a Credit Advantage default after being in default for only a few days or purporting to impose additional fees where there is no contractual basis for doing so.

- (ii) Pay day lenders obtaining a direct debit authority from the borrower may result in problems. For example:

- Financial institutions honoring the direct debit when there are insufficient funds in the account meaning additional fees and charges are imposed on the borrower;
- The fact most people are unaware they can cancel the direct debit authority without the knowledge or consent of the lender; and
- The direct debit gives the pay day lender first priority on the borrower's wages, possibly at the expense of the necessities of life such as housing and food.

- (iii) The issue of a pay day lender obtaining a cheque from a borrower and agreeing to keep it until their next pay day has some potential problems, including:

- The pay day lender may threaten criminal prosecution against a borrower for fraud for passing bad cheques even though at the time of writing the cheque both the borrower and the pay day lender were aware there was no money in the bank account;
- Threat of criminal proceedings gives pay day lenders an advantage no other creditor enjoys;
- If a cheque is presented twice without success, a default can be listed automatically with Credit Advantage, whereas in most cases a borrower must be in default for at least 60 days; and
- When a cheque is presented and dishonored, the borrower is imposed with additional fees and charges by their bank.

- (iv) A pay day lender may take enforcement action as soon as there is a default. There is no provision for negotiation or deferring enforcement action to allow the borrower time to remedy the default, in contrast with section 80 of the Code;

- (v) There are no restrictions on the entry to private property to repossess goods, in contrast with sections 91- 93 of the Code;

- (vi) The absences of any regulation of repossession of secured goods are of concern. For example:

- There is no requirement to give prior notice, in contrast with section 80 of the Code;
- The pay day lender may impose additional fees that are unregulated, in contrast with section 99 of the Code;
- Borrowers may simply pay any additional fees to get the mortgaged goods back even the pay day lender has no contractual right to those fees; and
- There is no statutory obligation on the lender to provide written notices to the borrower in relation to the sale of repossessed goods, or obtain the best reasonable price for the goods nor account for the proceeds of the sale to the borrower, in contrast with sections 94 to 98 of the Code.

3.2 Pay Day Lender's Submissions

The pay day lenders that made submissions to the working party were invited to outline their lending practices, which was done.

A summary of the submissions made by pay day lenders is as follows.

Pre contract

- All pay day lenders use some form of promotion, including advertisements, flyers, radio, television and word of mouth.
- Most pay day lenders provide to prospective customers a "quote" or a copy of the terms of the contract including the cost prior to entering into the contract.
- Pay day lenders do not usually inquire as to the purpose of the loan.
- Pay day lenders lend money for most purposes, except illegal activity. One lender does not lend to people who are obviously desperate to satisfy an addiction to gambling, alcohol or drugs.
- One pay day lender through its advertising has specifically targeted gamblers as potential customers.

Sign up

- All lenders perform some inquiries to determine the borrower's capacity to repay the loan.
- All lenders check details provided by the customer in relation to employment, address and banking details. Credit history checks with Credit Advantage are not done very often.
- All lenders use a system for determining how much they will lend to a particular customer, which is usually a percentage of the customer's disposable income.
- All lenders require customers to demonstrate a reliable source of income. Most will lend to anyone demonstrating a regular income, including Government welfare payments (such as pensions and unemployment benefits).

- Most lenders use computer systems which generate the contract documentation and some have centrally linked computers that provide recommendations on the amount of money that should be advanced to the customer.
- Most lenders prominently disclose the fees payable by the customer. One lender does not currently disclose the fees charged in the contract documentation, although this will be done in the future.
- Most lenders do not as a matter of course provide the customer with a copy of the contract. Most only provide a repayment schedule which indicates the date for payment and the amount of the repayment, which includes any fees.

Terms of the Loan

- The average amount advanced by pay day lenders is estimated to be \$250.
- The period over which the loan or advance is repayable varies, with typical periods being 7, 14, 21, 28 and 30 days. The maximum period over which the loan or advance is repayable varies between lenders and ranges from 36 days to 62 days.
- Pay day lenders do not charge interest. The return to the lender is all encompassed in a fee, which is usually calculated as a percentage of the amount advanced. For example, the fee might be 20% of the amount advanced, so if a customer obtains an advance of \$100, the customer will be required to repay \$120.
- Some lenders also charge a one off or annual membership fee.
- Early repayment of the loan is usually allowed, but rarely seen in practice. There is generally no form of discount offered for early repayment. The fee is fixed.
- The most common repayment method is by direct debit from a bank account. Other forms of repayment, including cash and bank cheque, are also available.
- No lender agrees to hold a cheque signed by the customer and present it on the customer's next pay day. (This is a practice of some US pay day lenders that does not appear to be used in Australia).
- Only one lender requires security for pay day loans in some circumstances, usually a bill of sale or mortgage over a motor vehicle.
- No lender requires guarantees from third parties.
- The policies of the lenders in relation to "rolling over" loans varies.
- One lender is willing to extend the life of the loan beyond the original time frame in exchange for a further fee.
- The other lenders do not extend the loan beyond the original time frame but in some circumstances will allow the borrower more time to repay the original amount plus the original fee. These lenders do not impose further fees for extending the life of the loan.
- Most lenders do not provide statements of account as a matter of practice, but they are available on request.

Defaults

- For those customers who do not repay on time, all lenders write to the customer seeking to make alternative repayment arrangements. Telephone calls are also made to the customer, usually soon after the default, by most lenders.
- All lenders indicated they would take legal action against a defaulting borrower in the appropriate circumstances.
- Most lenders also list defaulters with Credit Advantage.
- Only one lender repossesses secured goods.
- One lender also imposes additional default fees.
- On the whole, pay day lenders reported relatively low levels of defaults, typically in the 2% to 3% range.

CHAPTER 4. TERM OF REFERENCE 3

Establish the Cost of Pay Day Lending

4.1 The relevance of annual percentage rates to pay day loans

From the outset, the working party notes the relevance of converting the cost of pay day loans to an annual percentage rate is a hotly debated topic, particularly in the United States³.

On the one hand, pay day lenders argue converting the fee charged by a pay day lender to an annual percentage rate is an academic exercise at best. It is argued an interest rate or annual percentage rate is not used as a method of calculating the return for the pay day lender. Perhaps more importantly, as the loans are of such a short duration, an annual rate is irrelevant.

The US National Check Cashers Association argues this as follows⁴:

*"Using an APR (annual percentage rate) analysis for deferred deposit services (pay day loans) is comparable to a pedestrian in New York City hailing a cab and asking about the fare to San Francisco. There is a **theoretical** fare, just as there is a theoretical APR for a deferred deposit service advance, but nobody enters into a transaction with the intent to pay or receive anything like that amount."*

(The Australian equivalent would be asking about the cab fare from Sydney to Perth).

On the other hand, it is noted that an annual percentage rate is the norm for comparing the cost of lending. Members of the public generally understand that the cost of borrowing money is represented by an annual interest rate.

Further, recent research on consumer behaviour in the consumer credit market indicates that a vast majority of people compare interest rates between lenders in deciding which lender to borrow from and a majority of consumers find it relatively easy to compare interest rates⁵. As a generality, more people found it easy to compare interest rates than fees and charges⁶.

Consumer groups point out consumers are unaware of the true cost of pay day loans when compared to other types of loans and, based upon admittedly limited

³ The working party notes the debate in the USA on this issue. See the contrasting views on this issue between the Consumers' Federation of America and the National Cash Checkers Association (NaCCA) in the articles "The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry", Jean Ann Cox, Director of Consumer Protection, Consumer Federation of America, November 1998, <http://www.stateandlocal.org/loanshar.html> and the NaCCA response "Freedom of Choice for Consumers: The Truth About Deferred Deposit Services - A Reasoned Response to the CFA's Misrepresentations", National Check Cashers Association Inc., May 1999, <http://www.nacca.org/ddresponse.html>.

⁴ Ibid, page 11.

⁵ See "Taking Credit - A Survey of Consumer Behaviour in the Australian Consumer Credit Market", Malbon, J, Law School, Griffith University, September 1999, and in particular 9.2.3, pages 58 to 60.

⁶ Ibid.

anecdotal evidence, consumers are generally shocked and surprised when informed of the effective annual interest rate of a pay day loan.

4.2 Working Party Discussion

The working party notes that credit cards are the perhaps the closest comparable and most analogous product to pay day loans offered by mainstream lenders. Once a consumer has a credit card, the card also offers the consumer the opportunity to access short-term cash at the consumer's convenience, which is the main feature pay day lenders promote about their product.

Lenders use interest and interest rates as the primary means of calculating the return to the lender on credit cards, even though very few, if any, consumers intend to and actually have an amount outstanding on their credit card for a year or more.

Taking this analogy one step further, comparing a pay day loan to a credit card on a daily cost is instructive.

Take a simple \$100 pay day loan repayable in 14 days plus a \$20 fee. The daily cost to the consumer for the loan is \$1.43 per day. The cost to a consumer for \$100 outstanding on a credit card at 16.5% per annum interest is 4.5 cents per day.

The pay day loan is 32 times more expensive than the credit card. If the pay day loan was repayable in 7 days, the daily cost would be \$2.86, which is 64 times more expensive than the credit card. This would not be immediately apparent to a consumer, nor is it simple to calculate.

Therefore, while the working party notes an annual percentage rate has limitations in relation to pay day loans, the working party believes converting the fee charged for pay day loans to an annual percentage rate does give consumers valuable information for comparison and comprehension purposes. An annual percentage rate is a readily available and most commonly understood way of referring to the cost of credit.

4.3 Converting

Converting the fees charged to an annual percentage rate will depend upon the fees charged and the length of time over which the principal and the fee are repayable. Because the amounts are repayable over a variety of time periods depending upon the date the borrower is paid and when they take out the loan, it is impossible to calculate a typical or "standard" annual percentage rate to indicate the cost of pay day loans in interest rate terms.

The fees charged by pay day lenders vary. Obviously, the fee structure adopted by each industry participant is commercially sensitive.

Some examples of the fees charged include a flat fee of \$20 per \$100 advanced. Another example was \$25 per \$100 advanced. Therefore, the fees are typically 20% to 25% of the amount borrowed.

The length of the loans also varies. The advances are repayable in as short a period of time as 1 week, while the maximum length of time to repay is typically 1 month.

The following table shows the effective annual percentage rate of a number of different hypothetical pay day loans with different fees and repayment periods.

Table 1 – Example Effective Interest Rates⁷

Fee per \$100 advanced	Repayable in 1 week (7 days)	Repayable in 2 weeks (14 days)	Repayable in 1 month (31 days)
\$20	1,043.60%	521.80%	235.60%
\$25	1,304.50%	652.25%	294.50%

The interest rates calculated in Table 1 are simple interest rates. The simple interest rate is the correct calculation as the amount payable as a fee is not capitalised. In other words, if the loan is rolled over, the fee payable for the first period is not included in the amount of the principal for the second period. This is illustrated by a simple example.

Example 1

Assume X obtains a \$100 advance on his pay from a pay day lender on 1 May. The \$100 advance plus a fee of \$20 is repayable in 2 weeks time on the 14th of May.

On 14 May, X requires a further \$100 advance on his next pay in 2 weeks time on 28 May. The fee for the second advance of \$100 is also \$20.

On 14 May, X will have to pay the \$20 fee to the pay day lender for the first advance. As the loan is "rolled over", X will have to repay the \$100 plus a further fee of \$20 on 28 May.

This is a simple interest calculation. If it were a compound interest calculation, the \$20 fee on the first advance would be included in the amount of the second advance, making the second advance \$120. The fee for the second fortnight would then be \$24 rather than \$20.

4.4 Conclusion on Cost of Pay Day Loans

In conclusion on the cost of pay day loans:

1. Rather than charging interest, pay day lenders impose a flat fee on customers for pay day loans;
2. The fee is usually a percentage of the amount advanced;
3. Those fees vary across the industry, but are typically in the range of 20% to 25% of the amount advanced; and

⁷ The calculations assume 52.18 weeks per year and 26.09 fortnights per year as specified in regulation 12 of the *Consumer Credit Regulation 1995* (Qld) which relates to calculating the comparison rate.

4. The cost of pay day loans in annual percentage rate terms varies between about 235% and 1,300% depending on the fee charged and the length of time over which the fee and the amount advanced is repayable.

CHAPTER 5. TERM OF REFERENCE 4

Types of Consumers Obtaining Pay Day Loans

5.1 The types of consumer borrowing money from pay day lenders

This is a difficult issue to answer definitively.

Pay day lenders were generally unable to provide reliable data on the socio-economic or other backgrounds of their customers, presumably for a number of reasons including the infancy of the market and lenders not seeking or maintaining detailed information on their customers. Consumer groups were also unable to shed any light on this Term of Reference.

Pay day lenders did, however, provide a number of general comments about their "typical" customer, including:

1. In need of short term or emergency cash;
2. Has a regular source of income;
3. Come from all walks of life and socio-economic groups;
4. Does not have the time, or is not interested in the complexity of having to go to a bank for a loan; and
5. Not eligible for mainstream credit (e.g. banks, building societies etc).

From the advertising and the nature of the product, it is objectively apparent that pay day loans would be attractive to 2 broad categories of consumers:

1. Those consumers who have an urgent need for cash for some reason; and
2. Those who are unable to access mainstream credit and are attracted to the ease with which a loan can be obtained. This might be for a number of reasons, including poor credit rating, unemployment or age restrictions.

These 2 groups would not be mutually exclusive and the two are likely to have at least some overlap. It is however safe to assume that a reasonably large proportion of people accessing pay day loans are vulnerable consumers⁸.

However, beyond these generalisations and in the absence of any real data, it is difficult to draw any further conclusions about the types of consumers accessing pay day loans.

⁸ See for example, observations from Canada on this issue in "Access to Credit in the Alternative Consumer Credit Market" by Iain Ramsay, Professor of Law, Osgoode Hall Law School, Toronto, February 2000, pages 17 to 18, accessible from <http://www.strategis.ic.gc.ca/>.

CHAPTER 6. TERM OF REFERENCE 5

Develop options and make recommendations for the regulation of pay day lending in Queensland

6.1 Identification of the "Mischief" with Pay Day Lending

As stated at the outset, the working party believes there must be a firm understanding of the "mischief" with pay day lending prior to any consideration of the regulatory options.

The working party has considered the submissions made by both consumer groups and pay day lenders in arriving at a final "mischief list". This list contains the real and potential problems associated with pay day lending which, in the opinion of the working party, require regulation.

The "mischief" with pay day lending as identified by the working party can be separated into 2 broad categories, Truth in Lending and Unconscionability and Over-Commitment.

6.2 "Truth in Lending" Mischief

The working party believes the lack of specific regulation of pay day lending is in direct contradiction to the main objective of the consumer credit laws, namely truth in lending.

Truth in lending is essentially ensuring a lender fully and frankly discloses to customers the terms and conditions of the loan, including such things as the interest rate, the fees and charges payable, the term of the loan, the repayments and whether security has been taken out.

The way the Code achieves this (principally through the provisions of Part 2) is by compelling lenders to:

1. Provide loan contracts in writing;
2. Prominently disclose the relevant terms of the loan before the consumer enters the contract and in the contract itself; and
3. Provide the borrower with a copy of the loan contract.

The working party notes that presently pay day lenders are not required to do any of these things. There is nothing to prevent a pay day lender from avoiding some or all of those requirements.

In fact, the working party heard of this occurring in practice. Most pay day lenders reported they do not provide the borrower with a copy of the contract unless requested and, more worryingly, one pay day lender does not currently disclose the fees charged in the contract documentation.

Further, the working party believes the reluctance of most pay day lenders to convert the fees charged to an annual percentage rate is at least in part motivated

by a desire to avoid having to fully and frankly disclose to consumers the cost of pay day loans. The working party believes this is due to the potential to deter some borrowers upon discovering the effective annual interest rate and how expensive pay day loans are in comparison with other forms of credit, especially credit cards.

Therefore, the specific issues that, in the working party's view, require regulatory intervention to ensure truth in lending in pay day loans are:

1. Lack of adequate (or any) disclosure of relevant terms of the contract, including the fees payable;
2. The lack of disclosure of interest rates to allow comparisons to be made;
3. The lack of compulsion on the lender to provide copies of the contract to the borrower; and
4. The absence or inadequacy of pre-contractual disclosure to borrowers.

6.3 "Unconscionability and Over-Commitment" Mischief

Another major pillar of the Code is the ability of borrowers and regulators to challenge unjust and unconscionable conduct by credit providers.

Specifically, borrowers have the power to challenge unjust and unconscionable conduct through sections 70 and 72 of the Code and regulators in Australia have the ability to control such conduct through provisions in the various administration Acts⁹.

Pay day lender's avoidance of these provisions is a major frustration of another of the main objectives of the Code.

In particular, the working party is concerned by the very real possibility of borrowers becoming over-committed such that they are incapable of paying both the necessities of life and the loan.

Government policy on this issue, and expressed in section 70(2)(l) of the Code in particular, is that lenders cannot simply close their eyes to the financial position of a potential borrower and lend money irrespective of the ability of the debtor to repay the loan. In other words, lenders must be responsible in their lending practices.

The working party sees no reason why this principle should not apply to pay day lenders. Pay day lenders point out that it does not make commercial sense to lend money to people who will be unable to repay. If commercial interests call for responsible lending, then there should be no resistance to legislating for lenders to act responsibly.

This problem is only exacerbated by the ability of borrowers to "roll over" the pay day loan and increase the amount of the loan in exchange for an additional fee. For

⁹ For example, Part 6 of the *Consumer Credit (Queensland) Act 1994*, which provides the Government Consumer Agency with power to ask a credit provider to enter into a conduct deed and the ability to apply to a court for orders restraining unjust conduct or orders prohibiting someone from acting as a credit provider.

example, one consumer who sought advice from the Office of Fair Trading during the course of the working party's deliberations highlighted this problem.

Example 2

The consumer and the consumer's spouse originally borrowed \$50 in July 1999 from a pay day lender to be repaid in 2 weeks time. This was rolled over virtually every fortnight with the consumers paying just the fee and obtaining a further loan each fortnight.

By the time the consumers sought advice from the Office of Fair Trading in May 2000, the consumers owed \$980 to the pay day lender which attracted a fee of \$196 per fortnight. The consumers were having difficulty repaying the fee each fortnight, let alone the principal.

The loan was outstanding for 10 months and at the end, the consumers were paying an effective annual percentage rate of 487% for the funds.

This highlights the very real potential for borrowers to become over-committed and caught in the debt trap where they make existing loan repayments by borrowing more and more money. This is an example of someone becoming caught in the debt trap by incurring more debt to pay off existing debt.

Similarly, the working party believes there should be a mechanism for an independent umpire to determine whether the fees charged by pay day lenders are unconscionable. Pay day lenders argue market forces should be left to determine the price. The working party agrees in principle, but is of the view that there needs to be some mechanism for reviewing exploitative prices. This is particularly relevant to the pay day lending market where a reasonably large proportion of customers are likely to be vulnerable.

Additionally, the working party sees the practice of pay day lenders requiring security for pay day loans and repossessing secured goods as being real problem areas. Generally, the working party sees no justification for a pay day lender requiring security for relatively small loans over a short period of time such as one month or less.

The working party believes requiring security for such a small loan over such a short period of time is, to use the terminology of section 70 of the Code in relation to determining whether a term of a contract is unjust:

*" ... not reasonably necessary for the protection of the legitimate interests of a party to the contract (the lender) ..."*¹⁰

The working party sees the practice of requiring security particularly unnecessary given most pay day lenders organise a direct debit from the customer's bank account on the customer's next pay day. The practical effect of the pay day lender obtaining a direct debit authority from the customer's bank account when the pay day lender knows the date of the customer's next pay day is the pay day lender having first access to the customer's pay.

¹⁰ Section 70(2)(e) of the Code.

This, in the working party's view, provides the pay day lender with, in practical terms if not legal terms, a first charge on the customer's pay. It also gives the customer the impression the pay day lender has right to be paid first.

Furthermore, the practice of "over-securitising", in which a lender requires a mortgage over goods worth thousands of dollars (such as a motor vehicle) to secure a loan worth significantly less (such as a few hundred dollars), is seen by the working party as a major problem. The working party considers that it is generally unnecessary and unreasonable for a lender to take security over a motor vehicle to secure a pay day loan.

Similarly, repossession practices in an unregulated environment have long been an area attracting intervention by Government with good reason to outlaw sharp practice, such as:

1. Repossessing secured goods as soon as there has been a default and without any notice;
2. After repossession, demanding additional fees for the return of the secured goods, often with no legal basis for charging repossession fees; and
3. Repossessing goods even though there is very little money outstanding, such as when the borrower defaults on one of the last few repayments¹¹.

These practices are addressed by the Code but are potentially available to pay day lenders in the current unregulated environment.

In conclusion, the particular issues of concern for the working party in relation to the potential for unconscionability and over-commitment with pay day loans are as follows:

1. The real potential for borrowers to become over-committed to the extent that they are incapable of paying for both the loan and the necessities of life;
2. The relatively high fees charged for a pay day loan which might be considered to be unjust and unconscionable;
3. The ability of borrower's to "roll over" the pay day loan so borrowers become caught in the "debt trap";
4. Pay day lenders requiring security for small loans over short periods of time and, in particular, requiring high valued security (e.g. cars worth thousands of dollars) to secure low value loans (worth hundreds of dollars);
5. repossession tactics that would be illegal if regulated by the Code (eg repossession items without notice and very soon after a default); and
6. The potential for lenders to charge borrowers excessive repossession fees after goods are repossessed.

¹¹ For example, Governments have been attempting to outlaw these practices for at least 50 years, with one of the earlier attempts being the *Hire Purchase Acts* of the States and Territories in the early 1950's.

The working party notes that virtually identical issues have been identified recently in Canada as the main problems with pay day lending¹².

¹² See “Access to Credit in the Alternative Consumer Credit Market”, Ibid.

6.4 Regulatory Options

The working party, as part of its deliberations considered a number of different models for regulation of the pay day lending market. These models, from least to most interventionist, are:

1. Status quo – no regulation;
2. Voluntary industry Code of Conduct;
3. Regulation of pay day lending by the Code;
4. Licensing pay day lenders;
5. Legislate a cap on effective interest rates that may be charged; and
6. Outright prohibition of pay day lending.

The working party analysed each of these regulatory options by considering how effectively each dealt with the “mischiefs” identified above. That analysis follows. Pay day lenders and consumer groups were invited to comment on the various regulatory options, and those comments are included.

6.5 Option 1 – Status Quo – No Regulation

It was unanimously agreed by the working party that the continuation of a complete lack of regulation of pay day lending is an untenable position, for a number of reasons:

1. It is illogical and inconsistent with the policy objectives of the Code to regulate some sectors of the consumer lending market and not others;
2. Further, it is most illogical for a consumer protection law such as the Code to not regulate the sector of the market which in all likelihood contains the most vulnerable consumers; and
3. Most importantly, the real and potential problems with pay day lending as identified by the working party are not addressed in any way.

Therefore, it was agreed to dismiss this option.

6.6 Option 2 – Voluntary Industry Code of Conduct

The working party sees the advantages of a Code of Conduct in some circumstances. The advantages include, for example:

1. A Code of Conduct places responsibility on market participants to administer, rather than Government and therefore tax payers;
2. Compliance with the Code is dependent upon “peer” pressure and fear of ostracism from industry bodies which can potentially be just as damaging as an adverse court finding for breaches of the law; and

3. If organisations are serious about being a good corporate citizen, then compliance with the Code is taken as seriously as compliance with any legislation.

One pay day lender saw this as being an attractive option and pointed out its endeavours to establish an industry body which currently has 2 members, however the industry body included neither of the other 2 main industry participants.

This highlights the principal problem the working party has with a voluntary Code of Conduct for pay day lenders - the infancy of the industry. The working party believes for an industry Code of Conduct to be effective, there must be a strong industry body.

In the pay day lending industry, there is no industry association. Further, the working party saw little, if any, degree of co-operation between the market participants. There was no sense of "peer" pressure among the participants to conform to any standards. Each market participant seemed to be interested only in ensuring the growth and strength of its own organisation, as is normal in fledgling industries, with little consideration of its fellow market participants.

In addition, the working party has received no details of any draft industry Codes of Conduct or any serious attempts at establishing such a Code of Conduct.

Finally, legislative provisions often supplement industry Codes of Conduct. At present, there are no such legislative provisions for pay day lending.

For these reasons, the working party has serious doubts about the effectiveness of an industry Code of Conduct and consequently cannot recommend regulation by such a Code of Conduct.

6.7 Option 3 – Regulation by the Code

The working party did not limit its consideration of regulation by the Code just in its present form, but also considered whether there were additional issues that should be addressed.

The working party sees regulation of pay day lending by the Code as the most logical, effective and workable regulatory response for a number of reasons.

Fundamentally, the policy of the Code is to apply uniformly to all consumer credit and to all credit providers. A pay day loan is clearly a form of consumer lending. Consequently, there is, in the working party's view, no valid reason why pay day lending should be exempt from the Code. In fact, it is clear to the working party that some pay day lenders are taking advantage of an unintended loop hole in section 7 of the Code to avoid any form of regulation.

Secondly, and as the following table shows, regulation of pay day lending by the Code in its present form addresses most of the "mischiefs" identified by the working party previously.

The following table shows in summary form those "mischiefs" and the relevant sections of the Code and a brief comment on how effectively each problem is addressed.

Truth in Lending

Mischief	Relevant Code Sections	Comment
Lack of adequate (or any) disclosure of relevant terms of the contract, including the fees payable.	15	Section 15 requires disclosure of the relevant terms and conditions of contract.
The lack of disclosure of interest rates to allow comparisons to be made.	15(C) and 143	Section 143 requires disclosure of an annual percentage rate in advertising and before a debtor enters the contract and section 15(C) requires disclosure of the annual percentage rate in the contract.
No compulsion on the lender to provide copies of the contract to the borrower.	12, 18, 39	Section 12 requires the contract to be in writing and sections 18 and 39 compel a lender to provide a copy of the contract and any mortgage to the borrower.
The absence or inadequacy of pre-contractual disclosure to borrowers.	14	Section 14 requires pre-contractual disclosure, including the financial table.

Unconscionability and Over-Commitment

Mischief	Relevant Code Sections	Comment
Potential for borrowers to become over-committed so they are incapable of paying both the loan and necessities of life.	70(2)(l), 70 generally and Part 6 of the <i>Consumer Credit Queensland Act 1994</i>	The over-commitment provision, subsection 70(2)(l), and section 70 generally would require lenders to be more responsible or risk Court action by the borrower or Government.
The relatively high fees charged.	70 and 72	Nothing in the Code limits or caps the fees or interest that may be charged. However, sections 70 and 72 allow the Court to review unconscionable contracts, including excessive fees, charges and interest rates.
Rolling over the loan so borrowers become caught in the "debt trap".	70	Again, section 70, particularly the over-commitment provision 70(2)(l), would impose on the lender a duty to act more responsibly in lending and "rolling over" the loan.
Lenders requiring security	45 and 70	Section 45 provides that the mortgage

for pay day loans, including high valued security to secure low value loans.		is void to the extent that it secures an amount greater than the amount of the liability and reasonable enforcement expenses. Section 70(2) paragraphs (e), (j), (m) and (n) are particularly relevant to security for pay day loans.
Repossession tactics that would be illegal if regulated by the Code (e.g. repossessing items without notice and very soon after a default).	80, 81, 83	Section 80 would cover most of this problem, that is requiring 30 days written notice before enforcement action. Section 83 prevents repossession of goods in some circumstances.
Charging unreasonable repossession fees that could be challenged under the Code.	96, 97, 98, 99	These sections regulate the sale of repossessed goods, including accounting to the debtor and limit to reasonable enforcement expenses.

The working party believes regulation by the Code addresses most of the problems and potential problems associated with pay day lending.

However, there are two issues that should receive special note as they may require something in addition to regulation by the Code in its present form, namely:

1. Requiring lenders to disclose an interest rate; and
2. Lenders requiring security for pay day loans and in particular "over-securitising".

Interest Rate Disclosure

The working party believes pay day lenders should be required to disclose to borrowers an effective annual percentage rate for the pay day loan. This should be done in any advertising that refers in any way to the cost of a pay day loan, in pre-contractual disclosure and in the contract itself, as credit providers are currently required to do with an interest rate.

As discussed previously, pay day lenders charge an all encompassing "fee" which is typically calculated as a percentage of the amount advanced. It might be argued that even if pay day lending is regulated by the Code, pay day lenders would satisfy the disclosure requirements by simply stating the "fee" of, for example, \$20 for a \$100 pay day advance.

This disclosure, it might be argued, satisfies section 15(G) of the Code which requires a statement of the credit fees and charges and no disclosure under section 15(C), which requires a statement of the annual percentage rate, is required.

In support of this argument, section 25 defines "annual percentage rate" under a credit contract as a rate specified in the contract as an annual percentage rate. Therefore, the argument could go, if the contract does not state an annual percentage rate (because it imposes an all encompassing "fee" only) then section 15(C) need not be complied with. In other words, it could be argued that pay day lenders do not need to disclose an annual percentage rate at all.

The working party believes this argument is doomed to fail. Firstly, the working party sees the practice of pay day lenders charging a "fee" calculated as a percentage of the amount of the loan as charging interest. The all encompassing "fee", or whatever it is called, is in the working party's view charging interest if it is expressed as a percentage of the amount of the loan. That is, the "fee" of \$20 per \$100 advanced is an interest rate.

Consequently, section 143 of the Code requires the lender to state, in advertising and before the debtor enters into a credit contract, either an annual percentage rate or a comparison rate. The working party notes the amendment to section 143 of the Code which will come into force on 28 October 2000 to provide that the interest rate must be expressed as a nominal percentage rate per annum, rather than an "annual percentage rate"¹³.

Further, section 15(C) requires the credit provider to state the annual percentage rate. Stating and charging a rate other than an annual percentage rate is a breach of section 15(C).

Having said that, the working party believes it will be useful for Government Consumer Agencies to publish a guideline clarifying this issue. The guideline could state if a credit provider imposes a "fee" or "charge" or however it is described and it is calculated as a percentage of the amount of credit, then regulators view this as being an interest rate. Therefore, the rate must be stated as an annual rate pursuant to sections 143 and 15(C).

The working party notes New South Wales and Victoria both have 48% ceilings on interest rates¹⁴. The New South Wales provisions are to the effect that the credit provider is precluded from recovering interest above 48%. The Victorian provisions are to the effect that the whole contract is unenforceable if the interest rate exceeds 48%¹⁵. Obviously, these ceilings will have a profound effect on pay day lenders operating in those States if pay day lending is regulated by the Code.

The working party notes the overriding objective of the Code is uniformity. The working party believes that in order to maintain uniformity, New South Wales and Victoria should review those ceilings. If pay day lending becomes regulated by the Code, the maintenance of those ceilings will spell the death to the pay day lending market in Victoria and New South Wales.

As discussed later, the working party believes it is preferable to allow the industry to operate in a regulated way rather than to kill the industry altogether and force consumers into the jaws of loan sharks¹⁶.

Security for Pay Day Loans

¹³ See section 55 of the *Consumer Credit (Queensland) Amendment Act 1998*.

¹⁴ See Section 11 of the *Consumer Credit (NSW) Act 1995* and Regulation 7 of the *Consumer Credit (New South Wales) Special Provisions Regulations 1996* and Section 39 of the *Consumer Credit (Victoria) Act 1995*.

¹⁵ See Duggan and Lanyon, *Consumer Credit Law*, Butterworths, Sydney, 1999 at page 365.

¹⁶ See the discussion at 6.10 below.

The working party sees no justification for requiring security for small loans such as the typical pay day loan for a number of reasons including:

1. As discussed previously, where the pay day lender arranges a direct debit authority from a bank account, this effectively provides the lender with a first charge over the borrower's income. The working party notes section 46, which specifically prohibits a credit provider from taking a mortgage over a borrower's remuneration or employment benefits;
2. The fees charged by pay day lenders adequately provide a return to the pay day lender and recognise the risk associated with the loan. The working party sees pay day lenders charging effective rates of interest in the range of 250% to over 1,000% as being more than adequate rates of return having regard to the risk associated with the transaction; and
3. Requiring security for a short term loan of a relatively small amount when the effective interest rate is in the range of 250% to 1000% is, in the working party's view, unjustified. Requiring security in those circumstances is unjust as defined in section 70 of the Code¹⁷. Specifically, paragraphs (m) and (n) of subsection 70(2) are relevant.

The working party considered recommending amendment to the Code to prohibit any form of security over pay day loans. However, this has a number of problems, including the difficulty defining pay day lending and imposing separate obligations on different categories of lenders is contrary to the main policy of the Code, that is, providing one set of rules that apply across all lenders and products.

Ultimately, the working party believes section 70 contains sufficient consumer protection to address this issue.

However, the working party recommends that regulators issue a guideline to the effect of requiring security for a short term, small value, high interest rate loan is, in the regulators view, prima facie evidence of the transaction being:

1. Unjust as defined in section 70, particularly paragraphs 70(2) (e), (j), (m) and (n); and
2. Unconscionable within the meaning of sections 21 and 23 of the *Consumer Credit (Queensland) Act 1994* and the equivalent State and Territory Acts.

The guideline could go on to say it is incumbent upon pay day lenders to show that the security is necessary having regard to the criteria listed in section 70.

Submissions from Stakeholders

Consumer groups submitted that pay day lending should be regulated by the Code. In addition, consumer groups would like to see one or more of the following:

- (i) Require pay day lenders to convert the fees charged to an annual percentage rate;

¹⁷ "Unjust" is defined in section 70 of the Code as including unconscionable, harsh or oppressive.

- (ii) Prohibit fees and charges beyond a certain percentage of the amount lent (perhaps through section 29 of the Code and the Regulations);
- (iii) Prohibit pay day lenders from pressing criminal charges, or threatening to press criminal charges, for passing valueless cheques. This arises where the customer provides a cheque to the pay day lender to hold until the customers next pay day; and/or
- (iv) A licensing scheme for pay day lenders in which all pay day lenders and relevant employees would need to be licensed. This could be supplemented by an enforceable Code of Conduct or legislative amendment (such as regulating pay day lending under the Code). Breaches of the Code of Conduct or the Code could lead to a loss of license.

Item (i) above has been dealt with. Items (ii) and (iv) are discussed elsewhere in this report.

In relation to a pay day lender threatening to press criminal charges against a borrower for passing a valueless cheque, the working party saw no evidence of this occurring in Australia. This seems to be an issue in the United States that has not surfaced yet in Australia. No pay day lender accepts a cheque written by a customer and agrees to hold the cheque until the customer's next pay day. Therefore, the working party sees no need to address this issue at present.

All pay day lenders expressed some concern about any possible regulation of pay day loans by the Code, including:

1. Add to the cost of running the business, mainly through increased compliance costs;
2. The added paperwork may make pay day lending uneconomic;
3. Passing on extra costs to the consumer may not be possible at this low end of the market; and
4. It may also mean that lenders would be unwilling to lend to people with bad credit ratings, meaning some customers who need the service would no longer qualify.

The main positive comment made about regulation by the Code by pay day lenders was that it may keep unscrupulous lenders out of the market. Most lenders advise they would probably increase the fees charged to compensate for any increased compliance costs as a result of regulation by the Code.

The working party notes the potential for regulation by the Code, in fact regulation of any kind, to increase compliance costs and ultimately prices charged in the market place. However, the working party also notes that to a certain extent, the cost of compliance with the Code is dependent upon how complicated the product is.

If the loan product is highly sophisticated involving different interest rates and fees and charges depending upon certain events, then Code complaint disclosure can be difficult and costly.

However, a pay day loan is, relatively speaking, a very simple loan product. It involves one advance, one repayment, and a flat rate of interest. The disclosure in order to comply with the Code is quite straightforward. The most difficult part will potentially be the calculation of the effective annual interest rate, which is relatively straightforward mathematically.

On balance, the working party believes that any added cost imposed on pay day loan borrowers as a result of regulation by the Code is more than outweighed by the benefits obtained by that customer, and in particular, the consumer protection provisions contained in the Code.

Accordingly, the working party recommends regulation of pay day lenders by the Code at this stage. The working party believes the effectiveness of regulation by the Code should be monitored and if it proves to be insufficient, then other options, particularly licensing, should be considered more closely.

Additionally, the working party recommends:

1. Regulators of the Code issue a guideline stating if a credit provider charges a "fee" or "charge" or however it is described and it is calculated as a percentage of amount of credit, then regulators view this as being an interest rate. Therefore, the rate must be stated as an annual rate pursuant to sections 143 and 15(C).
2. Regulators issue a guideline to the effect of requiring security for a short term, small value, high interest rate loan is, in the regulators view, prima facie evidence of the transaction being:
 - (a) Unjust as defined in section 70, particularly paragraphs 70(2) (e), (j), (m) and (n); and
 - (b) Unconscionable within the meaning of sections 21 and 23 of the *Consumer Credit (Queensland) Act 1994* and the equivalent State and Territory Acts.

It will then be incumbent on pay day lenders to show that the security is necessary having regard to the criteria listed in section 70.

3. In order to maintain uniformity, New South Wales and Victoria should review the 48% ceilings on interest rates in those States and the effect this will have on the pay day lending market.

6.8 Option 4 – Licensing

The working party considered the option of licensing pay day lenders. The main features of the licensing model considered by the working party are as follows:

1. Every pay day lending organisation would need a license to operate;

2. Every employee of pay day lending organisation who has contact with customers would also need a license;
3. Licenses would be renewable annually;
4. In support of annual renewals, pay day lending organisations would be required to lodge returns including financial information, volume of business, names and details of company directors and the names and details of licensed employees; and
5. Pay day lending companies and employees can lose their license if they, for example, are convicted of a criminal offence, breach legislation such as the Consumer Credit Code or Fair Trading Act, become insolvent or bankrupt etc.

The advantages of a licensing scheme include the following:

1. Obtaining a license can be made dependent upon minimum competency standards and knowledge so licensees at least have some level of competency;
2. This flows into consumer confidence knowing traders have minimum competency standards, providing consumers with the ability to perform searches to discover who they are dealing with and whether the trader has been granted a license to operate;
3. From a regulatory perspective, Government knows who the market participants are;
4. The fear of losing its license acts as a strong incentive for traders to comply with the law; and
5. Licensing may discourage unscrupulous traders from entering the market.

However, the working party notes the down-side of a licensing scheme for pay day lenders, including:

1. Licensing presents a significant and costly barrier to entry into the market, which favours existing traders over new participants in the market;
2. As a consequence of this and the cost of obtaining and renewing licenses, licensing is difficult to justify on competition policy grounds;
3. Licensing alone does not directly address any of the identified "mischiefs" with pay day lending and a licensing scheme would need to be supplemented by other regulation, such as the Code; and
4. Requiring minimum standards does not necessarily eliminate exploitative behaviour.

Pay day lenders generally advise they were not completely averse to a licensing scheme and all advised they would comply if introduced. One pay day lender

endorses a licensing scheme and most lenders point out that although it would increase costs, licensing is a way of controlling unscrupulous operators.

Consumer groups indicated some support for a licensing scheme, but acknowledge the need for additional regulation through the Code.

The working party notes that Government is able to obtain orders of the Court preventing credit providers from operating if they, for example, are convicted of an offence against a consumer credit law, engage in dishonest, unfair or unjust conduct or have a contract re-opened under sections 70 and 72 of the Code¹⁸.

This ability to prevent an operator from trading is known as "negative licensing", as opposed to positive licensing of the type discussed in this model. Negative licensing should provide traders with the same incentives to behave as positive licensing as the effect of both is the same, that is the trader is banned from trading.

After considering the advantages and disadvantages, the working party is of the view that regulation by the Code as outlined in 6.8 above is sufficient at this stage.

Licensing pay day lenders would, in order to be effective in dealing with the problems in the pay day lending market, need to supplement regulation by the Code. In those circumstances, the working party believes that the costs of licensing on top of regulation by the Code will outweigh the advantages, and does not recommend licensing pay day lenders.

6.9 Option 5 – Cap Effective Interest Rates

This option was considered by the working party as being either a stand-alone option or an additional option to regulation by the Code.

The attraction of capping effective annual interest rates at say 48% is the complete removal of any concerns about usury or exploitation of vulnerable consumers by pay day lenders.

However, as pay day lenders correctly point out, a cap of say 48% does not take into account the amount of time and effort (and therefore expense) involved in providing the finance from the lender's perspective.

For example, the application for a \$200 loan for 1 month would take approximately 45 minutes to process. If effective interest rates were capped at 48%, the lender would receive \$8 interest, meaning the loan would not be economically viable from the lender's perspective.

If the cap were set at a higher level in recognition of this fact, what level is appropriate - 100%, 200% or perhaps 500%? All of these rates are potentially unconscionable in different circumstances. For example, a \$100,000 home loan over 25 years at 100% p.a. is clearly unconscionable when comparable lenders are charging less than 10% p.a. But a 100% p.a. interest rate on a \$100 loan over 2 weeks will yield the lender \$3.85, which is probably not worth the effort.

¹⁸ See section 23 of the *Consumer Credit (Queensland) Act 1995*.

Furthermore, there is the potential for a legislated cap receiving some legitimacy it would not otherwise have. In the previous example of the home loan at 100% p.a., if the legislation set a cap at 100%, the borrower might have difficulty challenging the rate as being unconscionable when legislation prescribes 100% as the maximum rate.

In short, there are numerous practical difficulties associated with legislating a cap on effective interest rates. Consequently, the working party believes it is preferable to leave interest rates to the market to determine backed by the ability of the borrower and the regulator to challenge the rate as being unjust and unconscionable.

Furthermore, the capping of interest rates (assuming pay day loans were still viable) does not overcome the other real and potential problems identified by the working party.

Understandably, industry does not support the capping of interest rates and consumer groups recognise capping rates would mean pay day lending would no longer be viable.

As discussed previously, both New South Wales and Victoria have 48% ceilings on interest rates. If New South Wales and Victoria do not review those ceilings and regulation by the Code is adopted, then pay day lending will no longer be a viable option in New South Wales and Victoria for the reasons outlined above.

The working party cannot recommend capping effective interest rates as a regulatory response.

6.10 Option 6 – Prohibition

Neither consumer groups nor, for obvious reasons, industry favour this option.

Prohibiting pay day lending has apparently been adopted in some States of the USA¹⁹ and for this reason it was considered as one of the options, particularly if the working party considered the problems presented by the industry were such that no other regulatory option properly dealt with them. However, this did not prove to be the case.

In addition, there are a number of other compelling reasons why pay day lending should not be prohibited.

Pay day loans offer a service that is in demand in the market place. Some people obviously want the convenience of being able to obtain a short term loan without the time and paperwork involved in getting a loan from a bank and are prepared to pay for that convenience. Those consumers should, subject to some safeguards, be free to obtain a pay day loan if they so choose.

Some people are unable to obtain a loan from a bank or mainstream lender. The working party recognises that the lender of last resort market, if done correctly and in accordance with the law, is a legitimate market. Mainstream lenders seem to

¹⁹ According to Consumers Federation of America research, 19 American States do not permit pay day loans due to small loan interest rate caps and by specific prohibitions against pay day lending by cheque cashers. "The Growth of Legal Loan Sharking", *Ibid*, p. 5.

have moved away from lending to consumers in the lower socio-economic groups and there is no valid reason why those sectors should be excluded from obtaining credit altogether.

Further, there would be competition policy implications for an outright ban and the policy would be difficult to defend.

Finally, if pay day lending was prohibited, where would people who cannot get mainstream finance go for a loan? The working party is conscious of not inadvertently encouraging loan sharks to fill any void created²⁰.

Consequently, the working party cannot recommend the outright prohibition of pay day lending.

6.11 Recommendations

The working party's specific recommendations are as follows:

1. Amend section 7 of the Consumer Credit Code so that pay day loans are regulated by the Consumer Credit Code. This should be done in such a way as to avoid unintentionally catching other short-term products offered by mainstream lenders, such as bridging finance.

This can be achieved by consulting with industry on what short term products are available and how they can be defined so to avoid being caught by the Code.

The effectiveness of regulation by the Code should be monitored and if it proves to be insufficient, then other options, particularly licensing, should be considered more closely.

2. Regulators of the Code issue a guideline stating if a credit provider charges a "fee" or "charge" or however it is described and it is calculated as a percentage of the amount of credit, then regulators view this as being an interest rate. Therefore, the rate must be stated as an annual rate pursuant to sections 143 and 15(C).
3. Regulators issue a guideline to the effect of requiring security for a short term, small value, high interest rate loan is, in the regulators view, prima facie evidence of the transaction being:
 - (a) Unjust as defined in section 70, particularly paragraphs 70(2) (e), (j), (m) and (n); and
 - (b) Unconscionable within the meaning of sections 21 and 23 of the *Consumer Credit (Queensland) Act 1994* and the equivalent State and Territory Acts.

It will then be incumbent on pay day lenders to show that the security is necessary having regard to the criteria listed in section 70.

²⁰ For example, the loan sharks of the type reported in "'Fringe' Credit Provider - A Report and Issues Paper", Office of Fair Trading Queensland, May 1999.

4. In order to maintain uniformity, New South Wales and Victoria should review the 48% ceilings on interest rates in those States and the effect this will have on the pay day lending market.