CONSUMER ACTION LAW CENTRE

PAYDAY LENDING REPORT – DRAFT LITERATURE REVIEW*

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Introduction

Interest rate caps have a long history. Arguments for the restriction of credit and debt arrangements are as old as the Greek philosophers, and the Jewish and Indian scripture writers. As times have changed and values have changed, and as the credit market has become more complex, arguments in relation to the restriction of credit have moved from the philosophical and religious to the economic.

All modern Western societies have gone through cycles of credit market regulation and deregulation, at various times imposing interest rate caps, and at other times allowing a *carte-blanche* free market with no caps. At the same time, Western societies and their governments have been organised around enlightenment principles of reason. A study of the role of interest rate caps in regulating the payday lending industry shows that the application of reason can produce rather divergent results. Nonetheless, reason appears to be the best tool available to us and we hope that by using it in this report we will add to the body of knowledge on interest rate caps and payday lending and assist the Victorian Government in its policy making decisions on this issue.

Executive Summary

- The Victorian Government faces a choice about whether to amend the law to make clear that the 48% interest rate cap is a comprehensive interest rate cap (ie. all fees and charges relating to the loan are included in the calculation to determine the 48% cap).

- The desirability of interest caps in general, and the role and effect of interest rate caps in relation to payday lending in particular, is fiercely disputed and elicits a divergence of opinion. Both the data, and the significance of the raw data, are disputed. Likewise, while there is unsurprisingly a different attitude to interest rate caps from individuals professing different perspectives (eg. free market libertarians and social justice advocates) there is also conflict within intellectual schools of thought (for instance, many academics supporting a free market neoclassical economics approach have opposed the imposition of an interest rate caps while others have supported it).

  Financial self-interest (through funding from the payday lending industry and other compromising links) compounds the problem. We not only have to evaluate conflicting arguments but have to establish whether an argument is genuine or, instead, only a case of 'the money speaking'. In this study we discovered a number of hidden financial links by some writers on the subject and this made us wonder

* This draft literature review has been undertaken with funding from the Consumer Credit Fund, approved by the Victorian Minister for Consumer Affairs.

whether other writers may have had undisclosed and hidden links with the payday lending industry or other stakeholders.

- It is clear that imposing a comprehensive 48% cap on payday lending in Victoria would result in the withdrawal of most payday lenders from Victoria. It is not economical for most payday lenders to lend at or below 48% per annum (although there are some attempts to do this).

- Payday lending in Victoria is a fringe industry and it is of insignificant size in comparison with the credit industry generally. The imposition of an effective comprehensive 48% interest rate cap would have a profound impact on the payday lending industry as it would lead to the withdrawal of most payday lenders. However, the imposition of such a cap would have no discernable impact on the credit industry generally as only the interest rate on fringe products such as payday loans approach or exceed 48%.[1]

- For a society committed to the twin objectives of a free market economy and the alleviation of poverty through the provision of welfare, the imposition of a comprehensive interest rate caps is economically optimal. This is because, *inter alia*, in a welfare state reckless borrowing (and lending) at very high interest rates subverts society's commitment to social welfare and externalises the cost of credit onto the welfare providing state.[2]

- Often payday borrowers cannot afford the debt burden they are taking on when they borrow from payday lenders. Even using the payday lending industry's figures, a very large percentage[3] of payday loans are lent to consumers whose income level is so low that they are below the Henderson poverty line. Payday lending is *prima facie* unethical where it involves lending to individuals who are demonstrably incapable of servicing the loan without hardship (which, frequently, it does).

- Payday lending is a supply side issue as well as a demand side issue. The supply of finance through payday lenders contributes to the inappropriate satisfaction of demand from marginalised consumers. Many payday borrowers would not borrow if the payday loan supply was withdrawn (although some will substitute by borrowing from another source, such as credit card cash advances). This is because, *inter alia*, many payday borrowers do not have access to other forms of credit, or if they do have access to credit cards, credit limits will be maxed out.

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[1] Griffith University's Centre for Credit and Consumer Law estimated the average APR for a payday loan to be 805.17%, see Griffith University Centre for Credit and Consumer Law, *Submission to Office of Fair Trading, Queensland: Managing the cost of consumer credit in Queensland, Discussion Paper, 21 December 2006*, page 7.

[2] Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995).

[3] 24% of borrowers earn $15,000 or less. See Cash Converters, *Submission to Minister for Fair Trading Hon Kerry Shine MP: Regarding Consumer Credit (Queensland(Amendment Bill 2008 and Consumer Credit (Queensland) Regulation 2008*, February 2008, part 5.1.

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- The substitution hypothesis is not current. The reduction of one form of credit will not result in a substantially identical increase in another form of credit.

  While credit card debt does appear to cause great financial hardship for many consumers, arguments that withdrawal of payday loans will lead to an equivalent increase in credit card debt are not sustainable. The evidence indicates, rather, that many potential payday borrowers will not borrow from a commercial financer if a payday loan is not available (reasons that explain why many payday borrowers cannot substitute to credit cards include the fact that their incomes are so low, and there credit history so impaired, that lenders would decline their credit card applications).

- All the available data points to the *de facto* revolving nature of payday loans. The US data indicates that payday borrowing is chronic – most borrowers take out more than 7 payday loans every year. The data from the US also indicates that the profitability of the industry is disproportionately reliant on repeat borrowers. Australian data from 2002 also shows a large minority of payday borrowers take out 10 or more payday loans per year.[4]

- In light of all the data and conflicting opinions, the imposition of a comprehensive interest rate cap in Victoria is desirable and appropriate.

Overview of the Industry

The payday lending industry is a small but growing industry that operates on the fringe of the larger consumer credit industry. Data from the US shows rapid growth in the payday lending industry (at least while it is unrestrained by interest rate caps) and it has been suggested that the US has more payday shop-fronts than do Starbucks and McDonald's combined.[5] While there is less Australian data, most observations point to a growth in the payday lending industry.[6]

The growth of the modern payday lending industry has been recent. Until the early 1990s the payday lending industry did not exist,[7] and the industry is thought to have evolved from the cheque cashing industry in the US.[8] Other writers believe payday lending has a much older history with an earlier version of payday loans provided by the 'loansharks' that emerged in

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[4] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund), page 65.

[5] Ben-Ishai, *Stephanie, Regulating Payday Lenders in Canada: Drawing on American Lessons*, CLPE Research Paper 16/2008, page i.

[6] Roger Ouk, *The Ramifications of Regulating Payday Lending in Victoria*, undated, page 3; Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund), page 34.

[7] De Young, Robert and Phillips, Ronnie J, S*trategic Pricing of Payday Loans: Evidence from Colorado 2000-2005*, Prepared for Submission to Federal Reserve System Community Affairs Research Conference 29-30 March 2007, Draft dated 14 July 2006, page 5.

[8] Morgan, Donald P, *Defining and Detecting Predatory Lending*, Federal Reserve Bank of New York Staff Reports, Report No. 273, January 2007, page 5.

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the US after the Civil War.[9] In Australia, it has been suggested that the first payday lender began operating in December 1998 in Queensland.[10]

Arguments against interest rate caps

Introduction

A major decision the Victorian Government is faced with is whether to amend the law to make clear that the 48% interest rate cap in force in Victoria is a comprehensive interest rate cap that includes all fees and charges.

Opponents of price capping present a number of arguments to support their position. Amongst other things, opponents of capping: deny that payday lending leads to a debt spiral causing long-term harm to borrowers; view price caps as a blunt tool that reduces competition; believe that capping will destroy the payday lending industry which will push borrowers into even worse credit arrangements.

It is worth noting that while many arguments against capping are objective and flow from a genuine (usually neoclassical/libertarian) perspective, some of those presenting arguments against capping are tainted by inappropriate associations and financial incentives. For instance, *The Case for Deregulating Interest Rates on Consumer Credit*[11] was produced by the Credit Research Center at the University of Purdue in the US. The directors of this centre at the time the above report was published included representatives from Visa, Chase Manhattan Bank (organisations that it is reasonable to assume do not support regulation of interest rates), the Old Republic International Corporation (a major bank underwriter), and the Beneficial Management Corporation (a large and secretive sub-prime lender that has been subject to legal proceedings for misleading consumers and has been subject to criminal prosecution).[12]

Not surprisingly, this report calls from a total removal of interest rate caps. More surprising is that this report views the exponential increase in credit card debt in the US as evidence of the desirability of removing caps.[13] Where we have been able to, we have investigated and revealed the financial incentives of the authors of various reports.

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[9] Peterson, Christopher L, *Taming the Sharks: Towards a Cure for the High Cost Credit Market*, University of Akron Press, 2004, page 10. (The author notes that the term "loanshark" was not attributed to illegal mafia lending until the 1930s.)

[10] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund), page 34.

[11] Staten, Michael E. & Johnson, Robert W., *The Case for Deregulating Interest Rates on Consumer Credit*, 1995, Monograph 31, Credit Research Center, Krannert Graduate School of Management, Purdue University.

[12] http://www.altlaw.org/v1/cases/539044 ; and http://books.google.com.au/books?id=ASw5CgBaPoUC&pg=PP416&lpg=PP416&dq=%22+beneficial+management+corporation%22+%22.com%22&source=web&ots=XFtUQ-gkoG&sig=02tWYZzDJFAXZ8yOZps5Unq03AI&hl=en

[13] Staten, Michael E. & Johnson, Robert W., *The Case for Deregulating Interest Rates on Consumer Credit*, 1995, Monograph 31, Credit Research Center, Krannert Graduate School of Management, Purdue University, pages 19-20.

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It would be unfair to suggest that only opponents of interest rate caps may be subject to bias. Supporters of such cap may also be subject to bias – however, in the case of cap supporters such bias is likely to flow from dogmatic thinking rather than a financial conflict of interest.

Price caps are a blunt tool and reduce competition (neoclassical argument against capping)

In both the classical economics era, and the modern neoclassical era, arguments against the imposition of interest rate caps have been made.

Many modern arguments against price capping are based on a neoclassical economic perspective (the notion that free markets produce competition and optimal use of resources and that, moreover, these markets are sustainable and self correcting independent of regulation).

While the soundness of neoclassical economics, and its capacity to benefit the economic wellbeing of nations, does appear proven by history, it is this last notion, that markets work without correction, that now more than ever appears to be becoming discredited. Countries that have adopted neoclassical economic approaches with too great abandon and too little caution (such as the United States) may be learning that no economic approach should be unquestionably accepted and implemented in its entirety. What is right most of the time (eg. that lending regulations such as price caps cause more harm than good) is not right all of the time in all circumstances. The United States has hopefully learned this lesson as a result of its financial crisis of 2007-2008.

One of the earliest rational voices against interest rate caps was that of British utilitarian Jeremy Bentham.[14] More recently, opposition to interest rate caps has been expressed by neoclassical economists.[15]

Researchers have argued that interest rate caps are a blunt tool and have questioned the relationship between high interest rates and over-indebtedness. It has been said that an interest rate cap "does not address all the causes of over-indebtedness".[16] It seems rather uncontroversial to suggest that high interest rates are not the *only* cause of indebtedness. However, as a matter of common sense *debt* is the cause of over-indebtedness and the two factors that are going to influence the extent of debt are the amount borrowed and the interest and fees on the amount borrowed.

Moreover, blunt or not, interest rate caps are the most effective means of drawing a line above which the state believes loans are to risky and inappropriate to be offered.[17] Of

[14] *Defence of Usury* 1787.

[15] Including Nobel Laureate Milton Friedman.

[16] Manning and de Jong argue that deregulation lead to an increase in fringe money lending. See Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 23.

[17] Manning and de Jong argue that deregulation lead to an increase in fringe money lending. See Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, 23.

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course, interest rate caps only work if they comprehensively include all fees and charges, as, for instance, does the New South Wales cap of 48%.[18]

As well as the accusation of bluntness, interest rate caps have been labeled 'indirect' because "the obvious method of tackling spiraling debt is improved loan assessment…".[19] This last assertion appears to miss the point. The problem with the payday lending industry is that there is virtually no assessment of capacity to repay – this is one of the reasons the risk to the lender, and hence interest rate, is so high. In fact, all that is required for loan approval is payslip or proof of welfare payment and bank statements and ID.[20] It is initially surprising that fringe lenders lend to very low income earners (because on the face of it, the risk of default appears too great). However, recent research has shown that lenders can profit from loans carrying very high interest rates even if it is clear that such a loan will eventually cause the borrower to default.[21] This is Because the interest in fees and charges the borrower pays in the debt "sweatbox" before bankruptcy are sufficient for the lender to make a profit.[22]

A number of purported negative economic effects of interest rate caps on competition have also been described. Most obviously, by setting a centrally fixed and inflexible rate, capping damages allocative efficiency.[23] One example of how interest rate caps can distort a market involves caps applied to hire-purchase agreements and credit cards. In the late 1960s and early 1970s many US States had comprehensive interest rate caps. In those states with a 12% cap, the cost of purchasing a motor vehicle was higher than those states that did not impose cap.[24] Arguably, car sellers recouped some of the profit they lost from losing the capacity to provide high interest car finance by increasing the sale price of their cars. In fairness, the increase in prices was minimal and could not be shown to be causally related to

[18] *Consumer Credit (New South Wales) Special Provisions Regulation 2007*, sections 6 and 7.

[19] Manning and de Jong argue that deregulation lead to an increase in fringe money lending. See Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 10.

[20] A staff member of Consumer Action Law Centre established this by anonymously telephoning the Richmond, Northcote and Melbourne, Victoria, branches of Australian payday lender and pawnbroker Cash Converters on 19 May 2008 asking for a payday loan. (It is somewhat surprising that Cash Converters was willing to lend to a person whose only source of income was the disability support pension as they would have had no legal right to enforce repayments against welfare payments). It is estimated that two fifths of payday borrowers receive Centrelink welfare benefits: See RMIT, Myers, Paul, McKeown, Warren & Shelly, Marita, *Literature Review of Credit and Debt in Australia: Families at Risk Deciding on Personal Debt*, RMIT University, 23 May 2005, page 19.

[21] Mann, Ronald, 'Bankruptcy Reform and the "Sweatbox" of Credit Card Debt', *University of Illinois Law Review*, No. 1 2007, pages 375-404. (This article relates chiefly to credit card debt, and its conclusions may be of less relevance to payday lending).

[22] Mann, Ronald, 'Bankruptcy Reform and the "Sweatbox" of Credit Card Debt', *University of Illinois Law Review*, No. 1 2007, pages 375-404.

[23] Goodwin-Groen, Ruth P & Kelly-Louw, Professor Michelle, *The National Credit Act and Its Regulations in the Context of Access to Finance in South Africa*, prepared for FinMark Trust, November 2006, page 25.

[24] Wheatley, John & Gordon, Guy, 'Regulating the Price of Consumer Credit', *Journal of Marketing*, Vol. 35 No. 4, October 1971.

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the presence of a cap. However, this example does show that imposing any sort of price control can have unintended consequences that can be detrimental.

Indeed, very few people would support price control in well functioning markets. However, the fear of market distortion is unfounded in relation to the regulation payday lending. Payday lending is, in the scheme of things, a drop in the ocean of consumer credit and imposing an interest rate cap would have no noticeable effect on competition in the consumer credit market generally. What effect such a cap would have is a profound effect on the payday lending market. In fact, even vehement proponents of removing caps admit that "[r]ate ceilings appear to have no impact on the price of credit for low risk borrowers which is determined by competition."[25] Empirical evidence has even suggested that the cost of loans for low-risk borrowers even reduces when high risk borrowers are excluded from the market,[26] although no theoretical framework as whether there is a causal relationship (and how it works) has, to our knowledge, been developed to explain this and we think it unlikely that the imposition of a cap has any noticeable impact.

Those opposed to caps have suggested that the consumer credit market operates in largely the same way as any other market for goods and services.[27] That is, price should be determined by supply and demand and anything that subverts this (such as an interest rate cap) will result in suboptimal use of resources. The argument that the consumer credit market is the same as any other market is hard to accept.[28] Consumer credit is unique because of the nature of the product, and consumer credit contracts in Australia are treated differently from other contracts for a number of reasons (including the fact that such contracts create future obligations to repay that can cause the financial ruin of individuals and families and a resultant burden on the state). Arguments for giving consumer credit special treatment are often social – eg. the impact on individuals, families and communities – but, as we shall discuss later, there is a sound economic argument for imposing interest rate caps.

While one can argue against caps using a neoclassical analysis, one can also challenge the *rational actor* premise of the neoclassical model by looking at the various cognitive deficiencies identified by behavioral economics.[29]

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[25] Policis, *The effect of interest rate controls in other countries*, report to the Department of Trade and Industry (UK), August 2004, page 22.

[26] Staten, Michael E. & Johnson, Robert W., *The Case for Deregulating Interest Rates on Consumer Credit*, 1995, Monograph 31, Credit Research Center, Krannert Graduate School of Management, Purdue University, page 17.

[27] Staten, Michael E. & Johnson, Robert W., *The Case for Deregulating Interest Rates on Consumer Credit*, 1995, Monograph 31, Credit Research Center, Krannert Graduate School of Management, Purdue University, page 12.

[28] As US Congressman Charles Vanik put it to Economist Milton Friedman: "[M]oney . . . differs from anything else—this is not wheat. This is not bread." See Hetzel, Robert L, 'The Contributions of Milton Friedman to Economics", *Economic Quarterly*, Vol. 93 No. 1 (Winter 2007), page 23.

[29] Although one researcher who examined the empirical proof for a strict neoclassical analysis and for a behavioral analysis concluded that neoclassical models were empirically proven while behavioral models were

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Imposing an interest rate cap will destroy the payday lending industry and harm consumers

Another problem that has been identified is that when a comprehensive interest rate cap is set at a rate below the level necessary for lenders to make a profit, lenders (such as payday lenders) will withdraw from the market (as ocurred in New South Wales).[30] It is likely that an effective comprehensive 48% cap cause the withdrawal of most of the payday lending industry in Victoria.

Some argue that this would be detrimental to the welfare of consumers. A series of papers have suggested that payday lending is in fact welfare enhancing, or at least better than the alternatives. Two staff members of the Federal Reserve Bank of New York argued that the removal of payday lending harms the welfare of consumers.[31] The authors identify an increase in personal bankruptcies, complaints about lenders, and 'bounced' cheques in two US states that banned payday lending.[32] We discuss this article, and others, in detail below. An alternative view, taken by Tobacman and Skiba, is that payday borrowers underestimate the risk of default, that many borrowers default, and that when they do default the cost to the borrower is very substantial.[33]

It has been argued that where capacity to repay is uneven (as might be expected of low-income borrowers) "sub prime models are often cheaper than mainstream alternatives".[34] This argument posits that despite their exceptionally high interest rates, payday loans suit consumers as they involve small one-off borrowing with a clear repayment amount. Many would find this argument superficially unappealing. However, the idea is that if payday borrowers cannot take out small payday loans with very high interest, they will be forced to take out much larger personal loans[35] or credit cards, using which they will quickly increase the quantity of debt they owe. Thus, while dollar-for-dollar payday loans are much more expensive, they are easier to control, and their use prevents the borrower taking on a much larger debt burden that would be more financially detrimental. Thus, there is a stronger argument beneath the apparently silly argument that the product (payday loans) with overwhelmingly the highest interest rate is actually the 'cheapest' option for low income

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not. See Wright, Joshua D., 'Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective, *NYU Journal of Law and Liberty*, Vol. 2 No. 3 (2007).

[30] Manning and de Jong argue that deregulation lead to an increase in fringe money lending. See Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 19.

[31] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare After Payday Credit Bans*, Staff Report No. 309, Federal Reserve Bank of New York, November 2007 (revised February 2008).

[32] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare After Payday Credit Bans*, Staff Report No. 309, Federal Reserve Bank of New York, November 2007 (revised February 2008).

[33] Skiba, Paige Marta and Tobacman, Jeremy, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default*, 19 November 2007.

[34] Policis, *The effect of interest rate controls in other countries*, report to the Department of Trade and Industry (UK), August 2004, page 28.

[35] Policis, *The effect of interest rate controls in other countries*, report to the Department of Trade and Industry (UK), August 2004, page 26.

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consumers. Even debt-skeptical academics like Professor Ronald Mann (who is certainly no apologist for the credit industry) have accepted this argument hook-line-and-sinker, fearing that the removal of payday lending will lead to a "shift"[36] to credit card borrowing which would be far more harmful.[37]

Much of the argument about the relative welfare enhancing/reducing effect of payday lending will depend on the extent to which payday borrowers can and will substitute payday borrowing for other forms of borrowing if payday lending is withdrawn – the arguments that payday lending is welfare enhancing depends on the assumption that there will be a complete or almost complete substitution of payday borrowing for other borrowing. As is discussed later, the premise of complete substitution is false – borrowers do not completely obtain alternative finance when payday lending is withdrawn. Arguments for the welfare enhancing effect of payday loans also assume that payday borrower does not default on their repayments – in fact, borrowers often default and then face bank fees in addition to payday lender fees.[38] Another problem with this argument, as we discuss in detail below, is that the assumption that there will be a very high level of migration to credit cards if payday lending is withdrawn is false.

If payday lending is withdrawn, borrowers lose all access to credit

Another argument against imposing a comprehensive cap is that this will result in the withdrawal of payday lending and that low-income consumers will have nowhere to borrow. That is, they will be completely financially excluded from the credit market. It is obvious that this argument contradicts the preceding one because total exclusion demonstrates that there is not a migration to other credit facilities. It appears logical that interest rate caps "affect the availability of dedicated sub prime models and create credit exclusion for those who cannot access the credit mainstream."[39] Thus, contrary to the argument that low income consumers might be squeezed into more dangerous credit card debt, the withdrawal of payday lending will exclude low income consumers from the credit market.

While individual consumers in financial hardship may very well desire the opportunity to obtain credit no matter how bad the terms, as a matter of policy it is not at all clear that the withdrawal of loans with exorbitantly high interest rates is a bad thing. Likewise, while clearly payday loan borrowers have limited credit options (which may often explain why they are seeking a payday loan in the first place), it is not clear that such borrowers have no options at all – for example, borrowers may have the option of borrowing from family.

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[36] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4(April 2007), page 859.

[37] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4(April 2007), page 860.

[38] Skiba, Paige Marta & Tobacman, Jeremy, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default*, Job Market Paper, 19 November 2007, page 19.

[39] Policis, *The effect of interest rate controls in other countries*, report to the UK Department of Trade and Industry, August 2004, , page 37.

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It is arguable that potential borrowers whose circumstances are so poor that they can only access fringe payday credit do not have capacity to repay a loan without hardship. If this is so, exclusion from credit that cannot be repaid without hardship may not be a bad outcome. While the data on the income levels of payday borrowers varies depending on source, all the data indicates that a substantial percentage of payday borrowers have very low incomes. Based on the figures of Australian payday lender Cash Converters (who would have an interest in overstating the financial soundness of their borrowers) 33% of payday borrowers earn $20,000 or less, 24% $15,000 or less and 8% less than $8,000.[40] How the 8% of borrowers who earn less than $8,000 have capacity to repay even $135 ($100 minimum advance plus Cash Converters interest of $35) over a two week period without hardship is unclear. Dean Wilson found that 43% of borrowers earned less than $20,852 per annum,[41] and given this figure is from a 2002 report and Cash Converters' figure is from a 2008 submission, there is a degree of conformity between these figures.

Given the above figures, it is not surprising that, according to Wilson's report, 38% of payday borrowers are below the Henderson Poverty Line.[42]

The fact that so many consumers who utilise payday borrowers are near to, or below, the poverty line calls into the extent to which such consumers should be given access to credit (and whether any lender who provides such credit is acting responsibly). While withdrawal of payday lenders may "exclude" some consumers from the consumer credit market, it appears more likely than not that this is in fact desirable. Payday lending appears to cater to individuals whose financial situations mean that they are in no capacity to take out loans with exorbitant interest. They do not have a capacity to service debt without hardship. That said, the data suggests that some payday borrowers are in a stronger financial situation and these borrowers will be able to borrow from more mainstream credit providers who, most of the time, lend responsibly based on proven capacity to repay.

For those borrowers whose financial situation is so poor that they cannot obtain mainstream finance, one option is take out a Centrelink loan. It has been suggested by opponents of interest rate caps that it is a negative for society if potential borrowers switch to Centrelink loans – for instance it has been identified that this may place an extra financial burden on the state.[43] This argument amounts to saying exorbitantly high cost loans to low income earners are better than affordable loans to low income earners provided by the state, and it is on its face an unpleasant argument. In any event, while imposing an interest rate cap will lead to an increased uptake of more affordable loans, it will also lead to reduced use of credit by low

[40] Cash Converters, *Submission to Minister for Fair Trading Hon Kerry Shine MP: Regarding Consumer Credit (Queensland(Amendment Bill 2008 and Consumer Credit (Queensland) Regulation 2008*, February 2008, part 5.1.

[41] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund), page 57.

[42] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund), page 57.

[43] Ellison, Anna & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, upcoming 2008, page 14. (Note that this report is largely a rhetorical exercise in support of payday lending).

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income households.[44] Another point of relevance, which we discuss below, is the way that the cost of high interest payday loans are externalised onto the state and other creditors.

If payday lending is withdrawn, borrowers will turn to illegal lenders

One concern is that if payday lending is withdrawn, borrowers will turn to illegal lenders. There is evidence of this occurring in the US.[45] Such lenders will presumably lend on even higher interest rates[46] (although this is questionable)[47] and will have unorthodox enforcement methods, ie. standover tactics[48] such as the physical violence to persons or property. It is reasonable to assume some borrowers will switch to illegal lending. It is also reasonable to assume that the illegal lending market will be much smaller than the legal market was.[49]

The risk of borrowers switching to illegal lenders, while undesirable, may not be a sufficient justification for the continued non-enforcement of an effective comprehensive interest rate cap. Many areas of commerce are restricted, and there are all sorts of black markets.[50] The existence of a black market is not an irrefutable argument for legalisation. To be credible, the argument requires evidence of the magnitude of likely illegal lending and must show that this magnitude is unacceptable. This evidence has not been produced. In fact it has been suggested that in Victoria in the 1970s “social welfare agencies did not report that there was any major resort to illegal loans” despite the fact that there was a lack of legally available high-interest short-term cash loans.[51] Clearly, in any regulated market there is a need for regulators to take all legal means to shut-down black market operators.

Payday loans are small, so even though they have high interest this is insignificant

It has been suggested that although interest charges on payday loans are very high, the small amounts that are borrowed means that the debt burden on borrowers is minimal. It has been argued that in those countries with comprehensive interest rate caps, high risk (ie. low

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[44] Policis, *The effect of interest rate controls in other countries*, report to the UK Department of Trade and Industry, August 2004, page 10.

[45] Stegman, Michael A. & Faris, Robert, ‘Payday Lending: A Business Model that Encourages Chronic Borrowing’, *Economic Development Quarterly*, Vol. 17 No. 1 (February 2003), page 29.

[46] Although the rate referred to in the Stegman & Faris article was 20% over two weeks, a rate that seems remarkably similar to standard US payday lending rates (and lower than the 35% rate charged by Australian payday lender Cash Converters). See Stegman, Michael A. & Faris, Robert, ‘Payday Lending: A Business Model that Encourages Chronic Borrowing’, *Economic Development Quarterly*, Vol. 17 No. 1, February 2003, page 29.

[47] Stegman, Michael A. & Faris, Robert, ‘Payday Lending: A Business Model that Encourages Chronic Borrowing’, *Economic Development Quarterly*, Vol. 17 No. 1, February 2003, page 29.

[48] Manning and de Jong argue that deregulation lead to an increase in fringe money lending. See Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 10.

[49] Manning and de Jong argue that deregulation lead to an increase in fringe money lending. See Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, Abstract, page 1.

[50] Eg. untaxed cigarettes and the already existing practice of engaging in unlicensed lending in Australia.

[51] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 12.

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income) borrowers use credit products designed for lower risk (ie. higher income) borrowers. Thus, low income borrowers use credit cards and personal loans – and through these facilities they are offered far larger advances than they need.[52] The result is that many low-income borrowers find themselves with far larger debt balances outstanding and find it more difficult to pay down this debt.[53] It is the capacity for credit card debt to increase exponentially that leads Ronald Mann to view credit cards, as opposed to payday loans, as a more dangerous form of borrowing.[54]

There are a number of shortcomings in these arguments. For example, many payday loan borrowers would qualify for neither a credit card nor personal loan (which explains why the substitution hypothesis is incorrect). The low incomes and (often) impaired credit ratings of payday borrowers means that they will not pass a mainstream credit providers credit checks. Thus many payday loan borrowers will not shift to more harmful debt if payday loans are withdrawn, but will rather forego borrowing and not take on a debt obligation at all.

Also, the amount of dollar amount of payday loans is not as small as industry suggests. For example, Cash Converters offers payday loans up to $1000 in value.[55] And research we have recently conducted indicates that 40% of payday loans are for $500 or more (and 14% for $1000 or more). When one considers that payday borrowers can borrow $1000 or more per loan, and take out several loans per year from the same lender or a different lender,[56] it becomes clear that it is often not the case that payday loans are for small dollar amounts, and for this reason it is not reasonable to conclude that the debt burden from these exorbitantly priced loans is relatively low. This is especially the case whether or not the loans are rolled over.[57]

Critique of influential arguments against interest rate caps

Introduction

In recent years a number of influential research papers that oppose interest rate caps have been written. Many of the most influential of these papers are independent (in the sense of not funded by industry) and they have had a profound impact in shifting the discourse, so that many academics relying on these reports as primary sources conclude that capping is inadvisable. For instance, noted credit-skeptic Ronald Mann has opposed the imposition of

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[52] Policis, *The effect of interest rate controls in other countries*, report to the UK Department of Trade and Industry, August 2004, page 26.

[53] Policis, *The effect of interest rate controls in other countries*, report to the UK Department of Trade and Industry, August 2004, page 26.

[54] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4 (April 2007),, page 859.

[55] http://www.cashconverters.com.au/personalfinance.html

[56] Payday borrowers usually take out 7 or more loans per year *from the same lender*, based on US data. See Office of the Commissioner of Banks (North Carolina), *Report to the General Assembly on Payday Lending*, 22 February 2001, page 6.

[57] Whether or not payday loans are rolled-over is a key point of disagreement in the debate. See later in this research report the section *Payday Lending, Debt Loads and Debt Spirals*.

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interest rate caps for payday lending in his journal article *Just Until Payday*,[58] an article apparently based on the conclusions in Morgan & Strain's paper *Payday Holiday*.[59] Despite Professor Mann's impressive research background in credit card debt, his conclusions appear to be primarily based on the argument in Morgan and Strain's paper that if payday lending is withdrawn rates of credit card debt and bankruptcy will increase. Likewise the *Regulating the cost of credit*[60] report has been influential in the Victorian debate about whether or not to introduce a comprehensive cap.

The purpose of this section is to critique some of the influential research papers to determine if the extent to which they have been relied on is justifiable, and to determine if the analysis and conclusions made in them are accurate in light of all available information. This critique is necessary as some of the key anti interest rate cap research papers have accepted the arguments and evidence in favour of payday lending uncritically while largely ignoring the evidence and arguments against payday lending (a bias which, no doubt, many pro interest rate cap papers exhibit in the reverse).

A fair supporter of caps would have to admit that a comprehensive cap at 48% in Victoria would largely lead to the end of the payday lending industry as we know it – however, many would argue that this is an excellent outcome. The debate then turns on whether the law should be rigorously applied to payday lenders by the application of a comprehensive interest rate cap (with the result that they withdraw their services) or whether payday lenders should be allowed to 'fly under the radar' and continue business.

The Payday Holiday report

The *Payday Holiday*[61] report was a personal paper written by two staff members of the Federal Reserve Bank of New York. The authors of the paper are reputable and presumably independent, although their ebullience that payday lending can be "…beneficial, even lifesaving…" shows a higher than usual level of emotional engagement.

The authors look at three factors that they believe evidence household welfare, and conclude that users of payday loans are worse off once payday lending bans come into effect.[62] The basis for their conclusions is the substitution hypothesis – that borrowers who had used payday loans will substitute to another form of credit if payday loans are withdrawn.[63]

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[58] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4(April 2007).

[59] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare After Payday Credit Bans*, Staff Report No. 309, Federal Reserve Bank of New York, November 2007 (revised February 2008).

[60] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006.

[61] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008).

[62] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 26.

[63] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 26.

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One factor the authors looked at was bounced cheques – they noted that the number of bounced cheques in Georgia rose after a payday lending ban was introduced.[64] The authors causally linked this increase to the payday lending ban (even though they did not find a significant increase in the number of bounced cheques in North Carolina, which had also banned payday lending).[65] While in Australia most households don't have cheque accounts (and therefore payday lenders don't secure loans by postdated cheque), payday lenders arrange for customers to authorise direct debits and customers incur bank fees when direct debit withdrawals fail due to insufficient funds. Thus, the question of whether withdrawal of payday loans leads to greater bank default fees (to an extent exceeding the cost of payday loans) is relevant to Australia.

As stated, North Carolina did not show a significant increase in bounced cheques after its payday lending ban. This undermines the argument that banning payday loans causes a measurable increase in bank defaults.

Also, payday loans can only act to avert a bank default fee where the amounts borrowed are used to repay an existing obligation (that will otherwise cause the borrower's bank account to overdraw). Where, for instance, payday loans are used to pay for a new obligation, they will not have this effect at all. Surely, at least some payday loans are used pay for new obligations rather than to avoid a bank overdraft – and yet this possibility is not considered in the report. In fact, empirical research in North Carolina shows that only 10% of consumers with a cash flow shortfall after the payday lending ban resorted to overdrafts.[66]

Even if it were established that payday lending is cheaper than bank default fees that will be incurred if payday lending is banned (which we think it is not), this would not necessarily justify permitting payday lenders to avoid the interest rate cap. An alternative argument is that it would justify incremental reform of both payday lending and bank fees. If payday loans with exorbitant interest *and* excessive bank fees are contrary to the public interest, they should both be reformed – and if the opportunity arises to reform one before the other, then such reform should take place. The alternative approach is to freeze the law in a static loop.

Another factor the *Payday Holiday* paper looks at is complaints against lenders and their debt collectors.[67] The authors note that the number of complaints against lenders rose in Georgia after a payday lending ban was introduced,[68] and this evidence is used to show that

[64] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 3.

[65] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 21.

[66] University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007, page 19.

[67] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 3.

[68] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 3.

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household welfare reduces after payday lending bans.[69] There are a number of problems with this conclusion – for example, complaints in North Carolina, another state that had banned payday lending, “were about average.”[70] That is, the authors focus on Georgia (which supports their hypothesis) and discount North Carolina (that does not support their hypothesis). While the empirical evidence produced does not consistently support the authors’ conclusions, even if the data showed consistently higher complaints in states that had banned payday lending, this would not show that the ban *caused* more complaints. As important as it is to low income vulnerable consumers, payday lending is not a substantial proportion of the lending market. Therefore, it is disingenuous to suggest that a change (such as withdrawal of service) in an insubstantial sector of the market is the cause of higher complaints. A more rigorous approach would be to look to see if there are differences in a more substantial sector of the market. The authors of *Payday Holiday* did not explore any other possible causes for the trends they observe.

The third factor that the authors consider is the bankruptcy rate. They find that Chapter 7 bankruptcies increase and Chapter 13 bankruptcies reduce after the imposition of payday lending bans in a jurisdiction.[71] The authors simultaneously argue that the increase in Chapter 7 bankruptcies is due to the payday lending ban and deny that such a link is at play (in the opposite direction) in relation to reduction in Chapter 13 bankruptcies.[72] The tendency to dismiss disproving data, demonstrated by the authors a number of times, evidences an approach by the authors of making the facts fit the hypothesis. In any event, United States bankruptcy law is sufficiently different from Australian bankruptcy law to mean that US observations will not necessarily apply in an Australian context.

In summary, the conclusions of the authors that banning payday lending leads to two key outcomes – namely increased bankruptcy and greater overall cost to consumers due to bank default fees exceeding payday loan interest – are not sound. Likewise, their attribution of payday bans as the cause of increases in consumer complaints against lenders (and their debt collectors) is unlikely. Accordingly, their conclusion that banning payday loans reduces household welfare is not likely to be not correct.

Ian Manning and Alice de Jong’s report

In March 2006 Consumer Affairs Victoria commissioned a report by Ian Manning and Alice de Jong, (economics and law academics respectively). This report quickly rejected the imposition of comprehensive cap and its two “policy alternatives” were (i) a cap on interest

[69] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 3.

[70] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 17.

[71] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), page 5.

[72] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report No. 309, November 2007 (Revised February 2008), pages 5-6.

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only (no cap on fees) and (ii) a structured cap justified on a cost-plus basis.[73] The authors rightly identify option (i) as being of cosmetic value only[74] (as the exorbitant interest rates of payday loans are incorporated into fees that are not capped).

The reasons given to oppose a comprehensive cap include that "many high-interest loans can be and are repaid",[75] although the authors do not consider the issue of hardship and whether it is a problem if borrows have a capacity to repay under hardship. Manning and De Jong discount the relationship between payday lending and low income indebtedness, stating that "…the obvious method of tackling spiralling debt is improved loan assessment…".[76] In our view, this comment, while quite valid in relation to mainstream lenders, shows a regrettable lack of understanding of the dynamics of the fringe lending market. Fringe lending models can profit by the interest payments made before inevitable default so long as the interest is high enough, and repayments continue for long enough[77] (this is applies to payday loans where it is rolled over and where it is secured by direct debit, which is typical). For businesses operating under this model, the fact that the loan will probably or inevitably push the borrower into a debt spiral is of no concern.

Importantly, Manning and de Jong argue that capping is a blunt and indirect tool,[78] that "[t]he correlation between high interest rates and debt spirals is fairly loose",[79] and that "the correlation between credit prices and unrepayable debt is poor".[80] This last assertion is somewhat inconsistent with common sense, and also inconsistent with earlier comments by the same authors that "[t]he higher the rate of interest, the more likely the borrower will not be able to repay".[81] Internal inconsistencies of this nature do undermine the report and leave one in doubt as to how the authors could simultaneously make contrary assertions and why they chose one assertion over the other.

The authors focus on a cost-based analysis of payday lending, which appears relatively rigorous. However, one is left wondering as to the source of the data of the assertion that the

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[73] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, pages 33-34.

[74] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, pages page 34.

[75] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 23.

[76] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 10.

[77] Mann, Ronald, 'Bankruptcy Reform and the "Sweatbox" of Credit Card Debt', *University of Illinois Law Review*, No. 1 2007, pages 375-404.

[78] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 23.

[79] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 33.

[80] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 23.

[81] Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 14.

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"minimum clerical time in establishing a payday loan is 45 minutes."[82] The "45 minute" figure has been presented by the payday lending figures for some time, and may have been unquestioningly incorporated into the Manning and de Jong report. In fact, during our recent inquiries[83] we were told by a major national payday lender that the total time for loan processing was 20-30 minutes for a new customer (processing times are quicker for repeat customers).[84]

In an area, such as payday lending, with such vested financial interests, it is appropriate to treat data, representations and arguments with a degree of robustness (and even suspicion). Manning & de Jong at times fail to do this.

Their choice of language, "borrower recruitment"[85] (to describe advertising) could be interpreted as indicative of an industry-centred mindset. More importantly the rejection of the debt trap hypothesis based on the notion that "the obvious method of tackling spiraling debt is improved loan assessment…"[86] shows a degree of what might be described as *naivete*. The *raison-d'etre* of the payday lending industry is that the typical payday borrower does not have the capacity to convince a mainstream lender of their capacity to repay, and, as discussed earlier, very substantial percentages of payday borrowers are below the poverty line when they take-out their loans. Other than calling for improved loan assessment, the authors do not provide any suggestions about how this improved assessment will be achieved. Certainly, they do not suggest imposing regulation on how payday lenders assess capacity to repay.

In summary, the Manning and de Jong paper provides a solid outline of how a cost-plus pricing model could be applied to payday lending. However, the report fails to consider a comprehensive interest rate cap as a policy alternative, and the authors lack robustness and depth in their analysis of the impact of payday lending on borrowers and appear inappropriately accepting of industry assertions.

The Department of Trade and Industry Report

The United Kingdom Department of Trade and Industry (**DTI**) commissioned research organisation Policis to prepare a report into the effects of interest rate caps.[87] The report

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82 Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 19.

83 A staff member of the Consumer Action Law Centre anonymously telephoned the Richmond, Northcote and Melbourne, Victoria, branches of Australian payday lender and pawnbroker Cash Converters on 19 May 2008 asking for a payday loan.

84 A staff member of the Consumer Action Law Centre anonymously telephoned the Richmond, Northcote and Melbourne, Victoria, branches of Australian payday lender and pawnbroker Cash Converters on 19 May 2008 asking for a payday loan.

85 Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 26.

86 Manning, Ian & de Jong, Alice, *Regulating the Cost of Credit*, Consumer Affairs Victoria Research Paper No. 6 March 2006, page 23.

87 Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004.

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strongly opposes interest rate caps.[88] While the report is apparently independent, we have recently learned that two senior staff members of Policis, Anna Ellison and Robert Forster, prepared a research paper for Australian payday lender Cash Converters.[89] In our view, this later preparation of a report for an Australian payday lender casts some doubts as to the independence of the earlier report. Policis' DTI report focuses on evidence in a market operating without interest rate caps, and it largely ignores evidence that suggests interest rate caps are appropriate.

The report reiterates many of the conclusions of the *Payday Holiday* paper (eg. that payday loans are 'cheaper' than the alternatives).[90] The report also suggests that in countries with interest rate ceilings, low-income borrowers are pushed into alternative, less appropriate, credit such as credit cards and personal loans.[91] This conclusion is based on the substitution hypothesis which, as we shall see later, does not accurately describe the likely behavior of borrowers after the withdrawal of payday lending. In fact, even the authors of the DTI report implicitly recognise that banning payday loans will not lead to complete substitution to other lending when the state that: "Lower levels of recorded credit use among low-income households in the markets with ceilings that we studied appear to be a function of constrained credit options…".[92] It seems that withdrawal of payday loans will lead to a reduction in borrowing, and this outcome is arguably appropriate.

The authors argue that interest rate caps will create exclusion from the credit markets.[93] While in one sense this is undesirable and will strain low income households who desire credit, in another sense it is desirable. As will be discussed later, there is an argument that where low income earners are provided with expensive high risk loans, this externalises the cost of those loans onto the state (which must provide a social welfare program). While the effects of bankruptcy are obviously felt by unsecured creditors (although payday lenders are somewhat protected by holding direct debit authorities), the consequences of financial collapse often fall on the social welfare schemes of the state. Where an interest rate cap stops inappropriate debt being incurred, the financial stress caused by the inability to service

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[88] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004.

[89] This report, *The impact of interest rate ceilings: The evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia*, was undated and the identity of its author was not revealed. After investigation, an email inquiry to Policis was answered by report author Anna Ellison who confirmed that the report was prepared by Policis in 2008 (see email from Anna Ellison to Consumer Action Law Centre, 21 May 2008). Although Policis would not reveal for whom the report was commissioned, an email from 18 May 2008 from Glenn Donaldson of Cash Converters revealed that the report had been commissioned by Cash Converters.

[90] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 28.

[91] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 26.

[92] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 10.

[93] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 37.

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debt without hardship reduces, and the state is not so frequently called on to pick up the pieces of individuals and families that have taken on excessive debt.

The report also notes that as a result of competitive developments the "price in the sector, and of Payday loans in particular, have declined steadily over the last five year period."[94] It is not clear whether the authors are here referring to the US or the UK. In any event, they do not provide evidence to support the assertion. In an Australian context, there is certainly no evidence of measurable reduction in the cost of payday loans. In fact, circumstantial evidence points to a lack of competition.[95]

In summary, the Policis report is substantially derivative of the *Payday Holiday* paper. While the report raises interesting points about the effect of rate caps in removing the supply of high-risk credit, its energetic promotion of arguments against interest rate caps being imposed in any circumstance and its a lack of balanced consideration of arguments for interest rate caps, does undermine the report.

The Ellison & Forster reports

The Policis research organisation has more recently been involved in research into the use, and impacts, of fringe credit in Australia. Their two upcoming reports *Impact of interest rate ceilings*[96] and *The dynamics of low income credit use*[97] written by Anna Ellison and Robert Forster clearly draw heavily on their report to United Kingdom DTI discussed above. These two reports did not reveal that Policis prepared the reports, and did not disclose the date of the reports or who funded the reports. This may be because of the draft nature of these reports. After considerable investigation was it revealed that the first report was prepared by research organisation Policis on behalf of payday lender Cash converters.[98] Given this, the reports lack independence and therefore credibility. In particular, the *Impact of interest rate ceilings* report was commissioned by an industry participant that has a direct pecuniary interest in interest rate caps in its industry. Given that *The dynamics of low income credit use* was produced at the same time as the *Impact of interest rate ceilings* report, by the same

[94] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 20.

[95] That circumstantial evidence being the (apparently deliberate) lack of price advertising by fringe lenders in Australia. See Howell, Nicola & Wilson, Therese, 'Access to Consumer Credit: The Problem of Financial Exclusion in Australia and the Current Regulatory Framework', *Macquarie Law Journal*, Volume 5 (2005), page 136.

[96] Ellison, Ann & Forster, Robert, *Impact of interest rate ceilings: the evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia*, Policis, forthcoming, 2008.

[97] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008.

[98] The report, *The impact of interest rate ceilings: The evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia*, was undated and the identity of its author was not revealed. After investigation, an email inquiry to Policis was answered by report author Anna Ellison who confirmed that the report was prepared by Policis in 2008 (see email from Anna Ellison to Consumer Action Law Centre, 21 May 2008). Although Policis would not reveal for whom the report was commissioned, an email from 18 May 2008 from Glenn Donaldson of Cash Converters revealed that the report had been commissioned by Cash Converters.

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British research organisation (Policis), and given that it concentrated on the same Australian-focused topic, it is reasonable to conclude that this report was also commissioned by the payday lending industry.

Both these reports argue against the imposition of interest rate caps. A number of the arguments presented in these reports are critiqued below. It must be noted that there is a lack of information about the source of the data used in the reports, and the raw numbers are often absent (with attractive bar graphs in their place). We do not know how the data was collected, from whom and how it was recorded. For this reason, we do not believe the data used is rigorous and appropriate to rely on, and any arguments we make based on the data must be considered in this light. We also have concern about the legitimacy of the reports given the volume of arguments presented against interest rate caps and the lack of consideration of arguments in support of an interest rate cap.

In the reports, it is argued that those unable to access commercial credit are more likely to seek social credit from the state, such as a Centrelink loan.[99] While hard data is not provided to support this assertion, it is not unreasonable to assume that in the absence of payday loans there will be a greater uptake of Centrelink loans. It is hard to suggest this can only be a bad thing – the very purpose of the Centrelink loans program is to provide affordable credit to low income individuals. And while the provision of more loans will cost the state money – it is probable that this amount will be less than the amounts the state will have to spend supporting low income individuals who face financial ruin due to default of unserviceable debt and resulting need for welfare support.

The Ellison & Forster note that a "[s]ignificant minority of payday loans users have sufficient adverse history to fail mainstream credit checks."[100] This supports our argument, made later, that the substitution hypothesis is incorrect and many payday borrowers will not migrate to more risky forms of credit. While Ellison & Forster maintain that payday borrowers are "better able to manage mainstream debt"[101] this suggestion appears to be derivative of the *Payday Holiday* arguments which we have critiqued above. Ellison & Forster also suggested that the evidence does not support a debt spiral effect.[102] We discuss the debt spiral in detail in a later section.

The authors note that 44% of payday borrowers have incomes below $35,000 per annum.[103] This differs from Cash Converters figures that showed 49% of its borrowers earned $34,000

[99] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 14.

[100] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 25.

[101] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 27.

[102] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 27.

[103] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 29.

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or less.[104] It would be surprising if Cash Converters would underestimate the income of its borrowers (because to do so would demonstrate irresponsible lending). Thus, while the disparity between the Cash Converters and Ellison & Forster figures are far from insubstantial, both figures support the conclusion that payday loans are often made to individuals who are in very financially precarious circumstances.

Interestingly, Ellison & Forster note the characteristics of vulnerability of typical payday borrowers: 4 in 10 borrowers are single parents, while 6 in 10 live in households where no individual is in full time employment.[105]

Ellison & Forster note that the debt service ratio as proportion of income is "a little higher for low income payday users than for cash advance users".[106] That is, low income payday users pay more of their income[107] to service debt than do low income credit card users who use their cards to obtain cash. This statistic seemingly undermines the whole argument that payday borrowing is better than credit card borrowing – and yet this logical progression is not recognised by Forster & Ellison.

At times, Ellison & Forster are so enthusiastic in their support of payday lending that they use divergent, even contradictory, arguments to substantiate their conclusions. For example, they note at one point that credit card cash advances (together with payday loans) are "key to keeping on top of bills and managing cash flow".[108] At another point in the same paper they conclude that credit cards are not useful cash flow management tools after all, and that they "have been a major factor in creating financial exclusion".[109] This latter conclusion also appears to sit uncomfortably with the argument that effective interest rate caps lead to the withdrawal of payday loans which creates financial exclusion.

To round out their numerous conclusions, Ellison & Forster note that interest rate caps "may be acting as a constraint on wider prosperity and growth".[110] This conclusion is unlikely –

[104] Cash Converters, *Submission to Minister for Fair Trading Hon Kerry Shine MP: Regarding Consumer Credit (Queensland(Amendment Bill 2008 and Consumer Credit (Queensland) Regulation 2008*, February 2008, part 5.1.

[105] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 29.

[106] Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 32.

[107] According to Ellison & Forster, more than 20% of their income of less than $35,000. See Ellison, Ann & Forster, Robert, *The dynamics of low income credit use: A research study of low income households in Australia*, Policis, forthcoming, 2008, page 32.

[108] Ellison, Ann & Forster, Robert, *Impact of interest rate ceilings: the evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia*, Policis, forthcoming, 2008, page 24.

[109] Ellison, Ann & Forster, Robert, *Impact of interest rate ceilings: the evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia*, Policis, forthcoming, 2008, page 32.

[110] Ellison, Ann & Forster, Robert, *Impact of interest rate ceilings: the evidence from international experience and the implications for regulation and consumer protection in the credit market in Australia*, Policis, forthcoming, 2008, page 84.

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very high interest rate fringe lending is an insubstantial proportion of the Australian credit market and whether exorbitantly priced payday loans are offered, or not, is not likely to have a measurable impact on the credit market and the economy generally.

In summary, the Ellison & Forster papers put forward a very heavy splattering of anti-interest-rate-cap arguments. Had they been more selective in their use of arguments, and perhaps included a real analysis of all the arguments, their reports would carry more credibility than the do.

Payday lending and the externalisation problem

While it is true that the majority of neoclassical scholars who comment on the subject oppose interest rate caps in all circumstances, there have been cogent arguments in favour of caps. Professor Eric Posner applied neoclassical economics to the question and concluded that a cap on interest rates is economically efficient because the absence of a cap undermines the state's twin commitment to a free market and minimum standard of welfare.[111] Professor Posner's article provides detailed mathematical models in support of his position.

Because of the existence of a welfare system, there is a perverse incentive for borrowers to take credit excessive credit risks.[112] Although the payday loan industry was in its infancy at the time Posner's article was written, payday loans are an archetypical example of high risk credit.

Thus, if a state is committed to both a free market and to "preventing citizens from falling below a minimum welfare level"[113] the imposition of an interest cap can be justified. This is because allowing extremely high risk borrowing in a welfare state leads to two outcomes. Firstly, borrowers will borrow recklessly and opportunistically knowing that the welfare system will support them if things go wrong.[114] Secondly, the cost of repaying debt may force people below the minimum welfare standard that the state is trying to ensure all citizens enjoy.[115]

[111] Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995).

[112] Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), page 285.

[113] Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), page 285.

[114] Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), page 286.

[115] Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), page 286.

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Thus, the payday lending industry externalises the cost of dealing with the financial aftermath of payday borrowing onto the welfare state.[116] (The payday lending industry can cause other externalities). This is because of the direct debit authority the borrower issues when taking out a payday loan. In Australia payday lenders hold a direct debit authority of the borrower that they exercise on payday. Therefore, payday lenders will be paid before other unsecured creditors (ie. on payday). Where payday borrowers default, it will be the payday lender (holding a direct debit authority) who is most likely to be paid, followed by other unsecured creditors. Thus, the cost of payday borrowing can be externalised onto other creditors.

At the same time, the payday lending industry undermines the state's commitment to maintaining a minimum and universal standard of welfare. This problem can be compared with the moral hazard problem that besets the insurance industry.[117]

Thus, to avoid these problems, the imposition of an interest rate cap is suggested as a "self-enforcing" response that discourages lenders from providing high risk loans by making it impossible for lenders to enforce such loans. Following this reasoning, interest rate restrictions are a useful tool for stopping the issuing of very high risk loans.[118] Professor Posner admits that imposing interest rate caps is not a solution to the problems of "inveterate risk takers, spendthrifts, gamblers, and others drawn toward extreme behavior"[119] but notes that interest rate caps would work at the margin, for instance for "ordinary people tempted to use credit to splurge on a fancy stereo."[120]

Therefore, Posner concludes, anyone who supports both a free market economy and the alleviation of poverty through state sponsored welfare should also support interest rate caps.[121] It is an interesting argument, and one that has been overlooked for too long in the Australian debate.

The problems with the substitution hypothesis

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116 There are also other, less easily quantifiable consequences, over overindebtedness including marital breakdown and health problems. See Ramsay, Professor Ian, *Access to Credit in the Alternative Consumer Credit Market*, paper prepared for Office of Consumer Affairs, Industry Canada, and Ministry of the Attorney General, British Columbia, 1 February 2000, page 19.

117 Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), page 294.

118 Glasser, Edward L & Sheinkman, Jose, 'Neither a Borrower Nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws', *Journal of Law and Economics*, Vol. 41 No. 1 (April 1988), page 12.

119 Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), pages 293-294.

120 Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), pages 293-294.

121 Posner, Eric A, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, Vol. 24 No. 2 (June 1995), page 318.

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One of the key arguments against interest rate caps is that they will cause the withdrawal of payday lending which will, in turn, cause consumers to turn to other, more harmful, sources of credit. The typical candidates for "more harmful credit" are (i) credit cards, (ii) illegal loans and (iii) bank overdrafts (with associated fees).

Of course the argument is *partly* valid. The withdrawal of payday loans will cause some consumers to incur bank default fees, it will cause some consumers to switch to credit cards which they will max out, and it will lead some consumers to take illegal loans with loansharks. This is not in doubt.

What is in doubt (and what is important) is the *extent* to which substitution will occur,[122] the cost of substitution, and whether this cost outweighs the cost of payday loans. Some of these costs are concrete and quantifiable. The 'cost' of something like using a illegal loanshark is less quantifiable.

But, contrary to arguments that have been put forward,[123] the withdrawal of one source of credit will not lead to an equivalent increase in another source of credit. Even opponents of interest rate caps admit that where an interest rate cap is introduced financial exclusion from commercial credit occurs.[124] It is contradictory to suggest that the withdrawal of payday loans causes financial exclusion *and* substitution to other forms of credit. The former assertion is correct, interest rate caps do exclude borrowers from the credit market because they reduce supply of credit.[125]

In the case of credit cards, the concern is that if payday loans are withdrawn there will be a switch to the use of credit card cash advances. This is said to be a problem because while payday loans are for a fixed amount, credit card finance is unfixed (up to a maximum) and is an intrinsically revolving form of credit. Credit card debt is therefore more of a threat to financial integrity than payday loan debt.[126] The fear of payday borrowers substituting payday loans for credit cards is the main reason why Professor Ronald Mann opposes interest rate caps.[127] Professor Mann's conclusions that the withdrawal of payday loans will lead to a shift to "products that are more harmful"[128] appears to derive from the *Payday*

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[122] "Some substitution does not mean complete substitution." See Littwin, Angela K., *Comparing Credit Cards: An Empirical Analysis of Borrowing Preferences Among Low-Income Consumers*, Harvard Law School Faculty Scholarship Series, 2007, page 63. The author of this report considers credit card finance worse for low income earners than the alternatives of pawn shops ,rent-to-own stores and catalog credit.

[123] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4 (April 2007), page 859.

[124] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 37.

[125] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 10.

[126] It is worth noting that Professor Ronald Mann has spent the lion's share of his recent career studying the relationship between credit card debt and financial distress, particularly bankruptcy. See Mann, Professor Ronald, *Charging ahead: the growth and regulation of payment card markets*, Cambridge University Press, 2006.

[127] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4 (April 2007).

[128] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4 (April 2007), page 859.

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Holiday[129] conclusions. The evidence does not support the supposition that there would be a *carte-blanche* shift to credit card (and other credit facility) use if payday loans were withdrawn. One of the main reasons why many payday borrowers will not substitute to credit cards if payday loans are withdrawn is because of defaults on their credit reports. While we have been unable to find adequate data detailing the *extent* of negative credit reports amongst Australian payday borrowers, it is reasonable to infer that a very significant percentage of payday borrowers would have defaults that would prevent them passing a credit check. Given that 49% of these borrowers earn $34,000 or less,[130] that 16% earn $15,000 or less,[131] and that 8% earn less than $8,000[132] it is clear that many payday borrowers would be denied a credit card based on insufficient income. Thus, while there will be some substitution to credit cards, it will be much less than 1 for 1.

There will also clearly not be complete substitution to illegal lending if the legal payday lending market withdraws. There will likely be an increase in illegal lending (for instance, existing payday lenders may continue their businesses for some time in breach of the law[133]). In light of this, there will be a need for enforcement agencies to recognise and respond vigorously to this likely risk.

But there will not be 1 for 1 substitution to illegal loans sources. Clearly when conduct is illegal its incidence reduces – for example, cartel conduct is less prevalent in those jurisdictions where it is illegal (particularly in the United States, where it is a crime[134]). Thus, where an effective interest rate caps causes legal payday lenders to withdraw, there will not be an equivalent in illegal payday lending. The effectiveness of US states such as North Carolina, and New York, in effectively eliminating large scale illegal payday lending demonstrates that effective enforcement can reduce illegal lending to a very small level. The successful curtailment of loan-sharking in the US in the 20th Century[135] through a variety of initiatives shows that illegal lending can be largely (if never completely) stamped out.

[129] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare After Payday Credit Bans*, Staff Report No. 309, Federal Reserve Bank of New York, November 2007 (revised February 2008).

[130] Cash Converters, *Submission to Minister for Fair Trading Hon Kerry Shine MP: Regarding Consumer Credit (Queensland(Amendment Bill 2008 and Consumer Credit (Queensland) Regulation 2008*, February 2008, part 5.1.

[131] Cash Converters, *Submission to Minister for Fair Trading Hon Kerry Shine MP: Regarding Consumer Credit (Queensland(Amendment Bill 2008 and Consumer Credit (Queensland) Regulation 2008*, February 2008, part 5.1.

[132] Cash Converters, *Submission to Minister for Fair Trading Hon Kerry Shine MP: Regarding Consumer Credit (Queensland(Amendment Bill 2008 and Consumer Credit (Queensland) Regulation 2008*, February 2008, part 5.1.

[133] This is exactly what happened when the US State of North Carolina banned payday lending, before tough regulatory action put an end to it. See Cooper, Ray, North Carolina Attorney General, *Payday lending on the way out in NC*, media release, 1 March 2006.

[134] -insert research from my article on cartel conduct -

[135] Van Deerlin, Abaigeal, *Modern-Day Loansharking and State Attorneys General: How AGs Shaped the Development of the Payday Lending Industry*, paper for State Attorneys General Seminar, Columbia University, 9 January 2005, page 3.

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Likewise, the withdrawal of payday lending will not lead to an increase in bank defaults that cost the same as, or more than, the cost of payday loan interest. For the cost of bank defaults to exceed the cost of payday loans, it would have to be shown that the majority of payday loans are taken out to pay for existing obligations (that will shortly be drawn down on an account with insufficient funds). We think this notion unlikely, and there is certainly no evidence for it. Rather, the US data shows that only in only approximately 10% of cases are bank overdrafts used as an alternative to payday credit.[136] While we do not deny that in some instances payday loans are used to avoid bank overdraft and default fees, the evidence does not support the notion that this is the primary use of payday loans or that the costs of these fees exceed the costs of payday credit.

From the above analysis, it is evident that the substitution hypothesis is not correct: a large percentage of payday borrowers will not, when payday loans are withdrawn, switch to other sources of credit such as credit cards, illegal loans and bank overdrafts. Rather, they will make do without credit (no doubt at some personal stress) and avoid a larger debt burden that will put them under even greater stress in the future.

Payday lending, debt spirals and debt loads

Payday lending causes a debt trap – that is, it causes consumers to take on debt loads that their income is insufficient to pay off. It also leads to debt spirals – that is, revolving and increasing debt. And, as is the case for low income consumers generally, payday borrowers have very high debt service loads relative to all other segments of the community.[137]

On the issue of repeat borrowing, the US data is clear. The payday lending market in its current form relies on repeat borrowing, and many payday borrowers become caught in a debt trap. The US Federal Deposit Insurance Corporation (**FIDC**) studied the frequency with which payday borrowers take out payday loans. They find that more than a quarter of the customers of mature payday stores obtain more than 12 payday advances per annum,[138] and that more than half of a payday loan store's customers take out seven or more loans per year.[139] Not surprisingly they also find that "high-frequency borrowers account for a disproportionate share of a payday store's loans and profits."[140] Data from North Carolina, that shows 52.86% of payday borrowers take out 7 or more payday loans per annum from

[136] University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007, page 19.

[137] Stegman, Michael A, 'Payday Lending', *Journal of Economic Perspectives*, Vol. 21 No. 1 (Winter 2007), page 173.

[138] Flannery, Mark & Samolyk, Katherin, *Payday Lending: Do the Costs Justify the Price?,* Federal Deposit Insurance Corporation, Working Paper No. 2005-09, June 2005, page 2.

[139] Flannery, Mark & Samolyk, Katherin, *Payday Lending: Do the Costs Justify the Price?,* Federal Deposit Insurance Corporation, Working Paper No. 2005-09, June 2005, page 5.

[140] Flannery, Mark & Samolyk, Katherin, *Payday Lending: Do the Costs Justify the Price?,* Federal Deposit Insurance Corporation, Working Paper No. 2005-09, June 2005, page 2.

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the same lender,[141] supports the FIDC's data. Data from the Centre for Responsible Lending shows a slightly higher numbers of repeat payday loans.[142] (It is noteworthy that the US data refers only to the number of payday loans taken out from the one payday store – some borrowers will take out payday loans from more than one store, which would push the number of payday loans taken out per annum even higher[143]).

The FDIC find that the profit margin is higher for repeat borrowers (because, *inter alia*, repeat borrowers are a lower credit risk) and that "it is not hard to imagine that inducing a store's existing customers to borrow again would be the most effective way of increasing loan volume."[144] They also find that the US payday loan industry would shrink if there were fewer high-frequency borrowers.[145]

In Australia, a report by Dean Wilson[146] finds that in Victoria the average number of repeat loans taken out by consumers is 6 per annum.[147] If a payday loan is rolled-over 6 times, the repayments would clearly be greater than the principal originally borrowed.[148] Wilson also finds that 15% of his sample take out 10 or more loans per annum.[149]

It is very hard to see how the 10% per cent of consumers who take out 10 or more payday loans per year (Wilson's data) or the 25% of consumers who take out 13 or more payday loans per year (the FDIC's data) are not in a debt trap. These consumers are revolving significant debt on a monthly basis and incurring the highest interest rates in the country with annual rates of 400% to 800% and up. Depending on the size of the payday loans, and early information suggests that in Australia the average payday loans sizes are sizeable and growing, this debt will quickly become unserviceable. That is, debt will spiral out of control (with compounding leading to ever increasing debt).

For those borrowers who rollover the debt monthly, their debt level clearly has become unserviceable. Rational consumers pay of high interest debt first (ie. payday loans). [150] Thus

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[141] Office of the Commissioner of Banks (North Carolina), *Report to the General Assembly on Payday Lending*, 22 February 2001, page 6.

[142] King, Uriah et al, *Financial Quicksand*, Center for Responsible Lending, 30 November 2006, page 7.

[143] For instance, Cash Converters charge a $35 fee per $100 borrowed – other lenders charge marginally less than this (ie. approximately $25 or more).

[144] Flannery, Mark & Samolyk, Katherin, *Payday Lending: Do the Costs Justify the Price?,* Federal Deposit Insurance Corporation, Working Paper No. 2005-09, June 2005, page 19.

[145] Flannery, Mark & Samolyk, Katherin, *Payday Lending: Do the Costs Justify the Price?,* Federal Deposit Insurance Corporation, Working Paper No. 2005-09, June 2005, page 21.

[146] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund).

[147] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund), page 65.

[148] At cash converters $35 per $100 rate, six rollovers results in interest payments of $210 per $100.

[149] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund), page 65.

[150] Helwigge, Diane, ' Exposing the Loansharks in Sheep's Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense, *Notre Dame University Law Review*, Vol. 80 (2004), page 1578.

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it is reasonable to conclude that payday borrowers who rollover payday loans are usually failing to service any other, cheaper, debts they owe – and once again, this indicates conditions conducive to a debt spiral.

Because of the high interest rates attaching to payday loans, the cost of the loan can very rapidly exceed the value of the credit advanced.[151] This is not an uncommon outcome. Considering the income levels of many payday borrowers, it is unfeasible for many borrowers to pay back their loan. The financial circumstances of these borrowers are so dire that mainstream lenders would not advance credit to them. Payday lenders on the other hand, do offer credit.

For example, when we approached them incognito in the guise of a Disability Support Pension recipient, Cash Converters offered to provide a payday loan where the only income disclosed was social security.[152] While it is seemingly irrational to lend where there is no capacity to repay, fringe lenders can profit even where default is likely.[153] In many cases, payday lenders obtain a direct debit authority that they can exercise on pension day or payday. This, in effect, provides security to the payday loan over other obligations. In the common circumstance where a borrower cannot afford to repay the entirety of the principal, if a borrower rolls the loan 10 times in a year the lender has made a profit of many times the principal (and would presumably not be too concerned if the borrower then defaults).

Unjust and undesirable social consequences can flow from the debt burdens of low income payday borrowers, and one academic has said that fringe lending "can also be seen as a form of cultural exploitation, resulting in redistribution from the poor and from minorities to creditors' investors."[154]

While there is data that suggests that payday lending causes an increase in bankruptcy,[155] there is conflicting data,[156] and the relationship between payday lending and bankruptcy has been subjected to far less study than the relationship between credit card debt and bankruptcy. In any event, bankruptcy is not the only evidence of financial hardship and debt spiral – and it may be that payday borrowing contributes to bankruptcy where revolving payday loan debt is serviced (because the lender withdraws amounts on payday) at the price of the neglecting of other debts (which grow and trigger bankruptcy.

[151] Helwigge, Diane, ' Exposing the Loansharks in Sheep's Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense, *Notre Dame University Law Review*, Vol. 80 (2004), page 1574.

[152] Telephone calls by Neil Ashton of Consumer Action Law Centre on 19 May 2008 to the Richmond, Northcote and Melbourne Victoria branches of Cash Converters.

[153] Mann, Ronald, 'Bankruptcy Reform and the "Sweatbox" of Credit Card Debt', *University of Illinois Law Review*, No. 1 2007, pages 375-404.

[154] Braucher, Jean & Rogers, *Theories of Overindebtedness: Interaction of Structure and Culture*, Discussion Paper No. 06-04, June 2006, page 10.

[155] Skiba, Paige Marta & Tobacman, Jeremy, Do Payday Loans Cause Bankruptcy?, University of Oxford, November 13 2007, page 20.

[156] Morgan, Donald P & Strain, Michael R, *Payday Holiday: How Households Fare After Payday Credit Bans*, Staff Report No. 309, Federal Reserve Bank of New York, November 2007 (revised February 2008).

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While we would not argue that payday lending is the only credit facility leading to a debt spiral,[157] the data does seem to show that a significant percentage of payday borrowers are in a debt trap, and that, too frequently, payday lending causes a debt spiral.

Other problems with payday lending

Uncertainty as to effectiveness of competition in the payday lending market

There is evidence that price competition is not effective in the payday lending market.

For example, there is little advertising of price by Australian fringe lenders and no sources providing price comparisons,[158] and it has been noted in the US that "competition does not appear to affect fees charged [on payday loans] in the way one normally thinks that competition will affect loan market interest rates."[159] One reason for this is the idiosyncratic fact that a payday loan for 2 weeks incurs the same fees as a payday loan for a month. It has been noted that competition only lead to price cuts where incumbents fear customer defection.[160] One reason incumbent payday lenders may not fear defection is the tendency for borrowers to borrow only from stores very close to their home or work.

Whether or not the payday lending industry has effective price competition is hotly debated. Arguing that it has, writers have suggested that competition in the payday lending sector in the United States has led to a steady decline in the cost of payday borrowing over a period of five years.[161] Faced with this conflicting data, and a lack of Australian evidence, it is hard to conclude definitively whether there is effective price competition in the payday lending market in Australia. Our preliminary view, based on the very small size of the Australian market, and the continued financial viability of large payday lenders whose prices for loans have not declined,[162] we do not think there is a strong level of price competition in payday lending in Australia.

As has been argued above, even a competitive payday lending industry would be economically undesirable due to its tendency to externalize the consequences of risky borrowing onto society. Thus while examining whether the payday lending market is price competitive is of academic interest, it is in our view not the central issue.

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[157] After all, it is a fringe product used only by a small minority of the population.

[158] Howell, Nicola & Wilson, Therese, 'Access to Consumer Credit: The Problem of Financial Exclusion in Australia and the Current Regulatory Framework', *Macquarie Law Journal*, Volume 5 (2005), page 136.

[159] Flannery, Mark & Samolyk, Katherin, *Payday Lending: Do the Costs Justify the Price?,* Federal Deposit Insurance Corporation, Working Paper No. 2005-09, June 2005, page 10.

[160] Staten, Michael E. & Johnson, Robert W., *The Case for Deregulating Interest Rates on Consumer Credit*, Monograph 31, Credit Research Center, Krannert Graduate School of Management, Purdue University, 1995, page 14. (The authors of this report view the solution as better disclosure, a conclusion we disagree with).

[161] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 20.

[162] Eg. Cash Converters.

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Payday lending is a supply side issue as well as a demand side issue

To state that there is a demand for payday loans is to state the obvious. It has been noted that low income earners have "an irreducible need for credit."[163] This statement needs to be critiqued. Clearly, it is arguable that there is an irreducible demand for credit by low income earners (which along with many other structural factors may be a reason for the poverty of some low income families). However, it is not accurate to conflate demand with need. Presumably, low income earners in France and Germany who are denied very expensive credit due to interest rate caps do not perish for lack of credit.

While there may be an irreducible demand for credit among low interest earners, to focus solely on demand may provide an incomplete picture. Even opponents of interest rate caps accept that they work in reducing supply (eg. the Policis report to the UK DTI noted that countries with interest rate caps have lower levels of credit use because this constrains supply).[164] Thus, it is helpful to consider the supply side.

The reality is that the market for credit, and its attendant benefits and detriments, is a complex interrelationship of supply as well as demand. The role of supply in contributing to demand is controversial and has been considered since the time of French economist Jean Baptiste Say.[165]

Regardless of the technical role of supply in relation to demand (a controversial, and larger, issue outside the scope of the present research), it is reasonable to conclude that supply on occasions satisfies an inappropriate demand and that any view of the payday lending industry from the demand side only will be distorted.

It is fair to start from the assumption that there is no reason to restrict the supply of goods that satisfy socially harmless demands. To argue, however, that wherever there is demand there ought to be supply, regardless of the social harm, is not helpful. Such arguments have, perhaps not explicitly, been put forward in relation to payday lending and they need to be disputed.

Payday borrowers are often vulnerable and have below average levels of education – as one former payday lender employee put it: "They will sign at whatever rate you give them…".[166]

Disclosure is not sufficient

It has been suggested that many of the problems associated with payday lending can be remedied by use of disclosure documents. One solution to the lack of competition in payday

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[163]Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 10.

[164] Policis, report to UK Department of Trade and Industry, *The effect of interest rate controls in other countries*, August 2004, page 10.

[165] Who wrote influentially on the role of supply in 1803. See Anderson, William L, *Say's Law: Were (Are) the Critics Right?*, undated, North Greenville College.

[166] Willis, Lauren E, 'Decisionmaking and the Limits of Disclosure: the Problem of Predtory Lending', *Maryland Law Review*, Volume 65 No. 3 (2006), page 710.

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lending markets proposed by opponents of interest rate caps is improved disclosure.[167] Likewise, simplification of disclosure has also been proposed.[168] It is doubtful that this will work. Payday borrowers are not sophisticated borrowers who calmly weigh the costs and benefits of a loan as, for example, a homeloan borrower might. Disclosure does not solve the information problem payday borrowers face. Payday borrowers are typically economically disadvantaged and their relative lack of education and participation in mainstream society means they are not as adept at rationally finding information as other consumers.

Cognitive weaknesses of consumers can and are exploited by predatory lenders. This calls "into question the theoretical validity of the economic model of disclosure remedies in the consumer finance market."[169] Typical payday borrowers are poor and vulnerable. They will be subject to a number of cognitive biases that will undermine the effectiveness of disclosure, including hyperbolic discounting (discounting the difficulty of repaying debt in the future). Disclosure is a good choice in responding to market failure[170] because, while it is an intervention, it is less disruptive to the market than other interventions. However, in a small number markets disclosure will be an inadequate response. Payday lending is one of these markets.

Disclosure will not stop the inappropriate advancing of extremely expensive credit to financially unsound consumers. It will not prevent consumers paying interest at the rate of 400-800% and up, and it will not prevent consumers repeatedly taking out payday loans and thereby paying annual interest many times greater than the principal originally borrowed. Disclosure will not stop payday lenders lending to very low income consumers whose income puts them below the poverty line. Disclosure will not prevent the consequences of payday borrowing being externalised onto the state and other creditors. Disclosure is unlikely to solve the problems with payday lending identified in this paper.

Alternatives to payday lending

It is highly probably that most payday lenders will withdraw operations if a comprehensive interest rate cap is introduced, and this may reduce the supply of credit. It is therefore worthwhile exploring alternative credit models.

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[167] Staten, Michael E. & Johnson, Robert W., *The Case for Deregulating Interest Rates on Consumer Credit*, 1995, Monograph 31, Credit Research Center, Krannert Graduate School of Management, Purdue University, page 14.

[168] Mann, Professor Ronald & Hawkins, Jim, 'Just Until Payday', *UCLA Law Review*, Vol. 54 No. 4, April 2007, pages 860-861.

[169] Edwards, Matthew A, 'Empirical and Behavioral Critiques of Mandatory Disclosure: Socio-Economics and the Quest for Truth in Lending', *Cornell Journal of Law and Public Policy*, Vol. 14 (2005), page 234.

[170] However, there are also real questions about the effectiveness and optimality of disclosure in the Australian financial services market.

* This draft literature review has been undertaken with funding from the Consumer Credit Fund, approved by the Victorian Minister for Consumer Affairs.

Dean Wilson describes a number of such models in his report.[171] More recently, the National Australia Bank, in partnership with Mobile Finance Pty Ltd (trading as Money Fast), launched a pilot program providing relatively small loans of $1000-$5000.[172] NAB's involvement relates to providing the payday lender with capital from which the lender will lend to consumers. Interestingly, applications will be handles by internet or telephone, and an interest rate (inclusive of fees and charges) of 28.25% was chosen as this was the amount necessary for the Mobile Finance to break even.[173] The fact that an interest rate of 28.25% for unsecured fringe lending is the break-even-point to some extent calls into question arguments from payday lenders that their very high interest rates of several hundred percent are necessary to cover the cost of doing business rather than profit taking.[174]

While many of these initiatives, like the NAB/Mobile Finance initiative, are 'pilot projects' and have questionable commercial viability on a larger scale, it would be unwise to dismiss them. The innovation that can lead to improved products often starts with small scale experimental efforts, and these efforts are to be encouraged.

What do payday borrowers think?

In the most research on payday lending, the one group that is not heard is the very group that is most affected by the nature of legal regulation of the industry – payday borrowers. We believe that the views of payday borrowers should be considered.

The University of North Carolina interviewed payday borrowers to find out their views.[175] More than twice as many payday borrowers believed that the absence of payday lending had a positive rather than negative effect on their households.[176] Most households considered themselves better off or unaffected by the closing of payday lending operators.[177]

When asked what they think of payday borrowing, borrowers noted the following: "You go in to more debt";[178] "…you are down, desperate, need money, and so you go to borrow, and

[171] Wilson, Dean, *Payday Lending in Victoria – A research report*, Consumer Law Centre Victoria, July 2002 (funded by the Victorian Consumer Credit Fund).

[172] National Australia Bank News Release, *NAB to pilot fair loans in the fringe lending sector*, 30 May 2008.

[173] National Australia Bank News Release, *NAB to pilot fair loans in the fringe lending sector*, 30 May 2008.

[174] Nonetheless, it does appear that a comprehensive 48% cap will make business unviable for most payday lenders.

[175] University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007.

[176] University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007, page 1.

[177] University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007, page 18.

[178]University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007, page 13

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you keep doing it over and over and over again.";[179] "I get happy, but then I realise I'm probably perpetuating the problem…Then reality sets in…I've put myself in another bind again."[180]

Conclusion

The above discussion has looked at evidence about payday lending and has analysed arguments based on the evidence. It has emerged that the real issue is whether a comprehensive interest rate cap including all fees and charges should be imposed in Victoria. The outcome of imposing a comprehensive cap of 48% will be the withdrawal of many, if not most, payday lenders from the market. The real issue, then, is whether the results of this withdrawal are, on balance, beneficial or detrimental.

Our analysis has revealed that a number of the arguments against interest rate caps are based on limited, ambiguous, or tainted evidence and assumptions of questionable legitimacy. For example, many authors have accepted the substitution hypothesis (that if payday loan credit is withdrawn there will be an equivalent increase in alternative credit), but our analysis shows that the hypothesis is not sound.

Our conclusion from the available evidence is that there is a strong case for the imposition of a comprehensive interest rate cap of 48%. While 48% is not, of itself, a magic number, prohibiting the provision of credit above this rate would prevent much of the high risk fringe lending that currently takes place. High risk lending to low income and credit impaired borrowers (the typical borrowers who take out payday loans) causes an externalisation problem. It undermines the twin objectives of a free market and a social welfare net that countries such as Australia pursue by externalising the consequences of loan default onto the social welfare system. It also externalises the risk of borrower default onto other unsecured creditors.

On balance, the evidence suggests that sufficient mischief results from payday lending to justify interference in its supply by way of a comprehensive interest rate cap.

[179] University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007, page 13.

[180] University of North Carolina Center for Community Capital Prepared for the North Carolina Commissioner of Banks, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*, November 2007, page 16

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