

WEST HEIDELBERG COMMUNITY LEGAL SERVICE

21 Alamein St West Heidelberg 3081
Phone 9450 2002 Fax 9458 1067
ABN 48 964 511 645 (Reg No A0013686G)

BACKGROUND PAPER PAYDAY LENDING

By Pat Stobaus

La Trobe Law Student on Clinical Legal Education Placement
at the West Heidelberg Legal Community under the supervision of Dr Liz Curran
Lecturer in Law, La Trobe Law/ West Heidelberg Community Legal Service

INTRODUCTION

A payday loan is a small amount, high interest loan over a short period¹, so named because the apparent intention of the loan is to help borrowers make ends meet between their paydays. These types of loans are of particular appeal to low income earners who often view them as a 'quick fix' for their financial woes². However in many cases the loans often have the effect of worsening their financial situation³. These types of loans are relatively new to Victoria, with the first lending opening in 1998. The government response to provide protection to consumers has been to introduce measures to cap interest and enforce disclosure⁴. This paper will seek to analyse the practice of payday lenders and assess the impact on borrowers and well as evaluate the consumer protection measures that are in place in Victoria.

PAY DAY LENDING IN PRACTICE

To obtain a loan, most lenders require that the borrower first pay a nominal fee of around \$20 to become a member of the company⁵. Upon becoming a member, the lender is given a card that resembles a credit card, designed to make the borrower's dealings with the borrower easier and more efficient and possibly to better facilitate future loans. As a member, the borrower is then able to obtain a loan, usually between \$250 and \$500⁶, to be repaid over a period of around thirty days with the borrower usually to pay in weekly instalments. The interest that can be charged on a loan in Victoria is capped at 48%, but this does not apply to the fees that a lender is able to charge⁷. Subsequently lenders are unrestricted in the fees that they can charge, so a lender can circumvent the cap on interest by charging exorbitant fees whilst still charging interest below the

¹ Wilson, Dean. Payday Lending in Victoria: A Research Report, Consumer Law Centre Victoria 2002

² Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

³ ibid

⁴ Wilson, 2002

⁵ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

⁶ Wilson, 2002

⁷ Interview with consumer law expert, Denis Nelthorpe. Friday 23 May 2008.

cap⁸ (in some instances no interest at all). In fact lenders may charge fees based on a percentage of the loan amount or on the period of the loan that for all intents and purposes appears to be a form of interest, but does not attract the application of the cap because of small variances that allow the charges to be classified as 'fees'⁹.

In order to make the repayments, lenders often require a borrower to consent to the repayments being taken straight out of their account via direct debit¹⁰. In addition to the actual 'fees' for the loan there are also several types of administrative fees that can be incurred by the borrower, even including a fee for paying before the due date, with at least one case of a lender charging a 10% 'early payment fee'¹¹. If a borrower fails to repay the loan on time a lender often provides the 'option' to roll over the loan¹², that is to extend the loan for a longer period at a significant additional cost¹³. A common effect of this is that borrowers could find themselves paying more in fees and interest than the actual principle of the of the loan amount¹⁴.

ISSUES

Operators in the payday lending market claim that they provide a service to borrowers that is not available in the mainstream credit market¹⁵. It is argued that other finance providers such as banks are not prepared to offer loans to the type of high risk borrowers that payday lenders attract¹⁶ and that therefore customers of these lenders appreciate and value the service that they provide¹⁷.

There is a market based argument that as long as sufficient information is provided a consumer can, of their own free will, make choices about what commercial arrangements they enter into based upon their own prerogative¹⁸. The assumption being that, all things being equal, the consumer will not choose to enter into an agreement that is detrimental or unfair to them¹⁹. The argument taken by payday lenders is along this line, saying that they simply provide the service and if potential borrowers choose to take up their product it is because they view the cost and terms of the loan as reasonable, otherwise they would exercise their power of choice and not take up the loan²⁰. The flaw in this argument is that there is disparity of power, that the borrowers do not in fact have a choice, no matter how onerous the terms of the loan may be the borrower is

⁸ Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test, March 2006. Available: www.creditcode.gov.au/downloads/FRINGE_RI.pdf

⁹ *ibid*

¹⁰ What is Payday Lending? Office of consumer and Business Affairs, South Australia. Fact Sheet. Available: www.ocba.sa.gov.au/consumeradvice/matters/paydaylending/whatispaydaylending

¹¹ *ibid*

¹² Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test, March 2006

¹³ *ibid*

¹⁴ *ibid*

¹⁵ Cash Converters Submission - 'Review of Australia's Consumer Policy Framework', Productivity Commission Inquiry. February 6 2008

¹⁶ *ibid*

¹⁷ *ibid*

¹⁸ Coombes, T, Reimers, D. *Contemporary Australian Macroeconomics – An Analytical Approach*. Longman. Melbourne 1998.

¹⁹ *ibid*

²⁰ Smyles, P, Turner, L. *Comment on Proposed Consumer Credit Code Amendment Bill 2007*. National Financial Services Federation. September 2007

desperate and has no other finance options and therefore takes up the loan irrespective of the cost. Payday lenders offer up their product as a take it or leave it scenario, knowing that with the desperation involved, the borrower will inevitably have to take on the loan²¹. In many cases a borrower may be aware of the ultimate cost of the loan but be living literally week to week and therefore have to still take on the loan as their only source of income to get them through the next few days²².

Taking on a payday loan in desperation can have significant adverse effects for the borrower, the fees incurred can be particularly troublesome²³, often equating to effective annual interest rates of over several hundred percent, and may prove to exacerbate the problem, sending the borrower into greater debt²⁴. Indeed if the loan is of any assistance at all it will probably only be so in the very short term. Despite this, it appears that payday lenders view low income earners that struggle to make ends meet on a regular income as their key demographic of potential customers²⁵, this combined with the short term superficial appeal of payday loans to battlers, has led to many people continuing to take up payday loans, meaning that those least able to deal with the associated costs are the ones that wear them²⁶.

²¹ Interview with consumer law expert, Denis Nelthorpe. Friday 23 May 2008.

²² Wilson, 2002

²³ Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test, March 2006

²⁴ *ibid*

²⁵ Wilson, 2002

²⁶ Wilson, 2002

TARGETTING AND APPEAL OF PAYDAY LENDING TO LOW INCOME EARNERS

By its very nature payday lending proves most attractive to low income earners, offering quick and easy credit with little or no attention given to the borrower's background by way of credit checks. In contrast the mainstream lenders have more stringent probity requirements and would therefore take much longer to approve finance and depending on the security that can be offered and a check of past credit history may not approve finance at all²⁷. Furthermore, other institutions are unlikely to provide the type of loan offered by payday lenders, that is short term and low amount loans to be used for purposes such as paying off existing debt²⁸. Low income earners are also more likely to require extra finance to make ends meet and fund everyday living expenses than those with a larger income²⁹. The extreme costs associated with payday loans essentially mean that any prudent person would not choose to take out such a loan unless they were incredibly desperate and it was their last resort³⁰. For example, a person earning a middle class income would not resort to a payday loan for a one off payment such as a few hundred dollars for vehicle repairs, they would instead dip in to their savings or use a standard credit card. However, a welfare recipient in the same situation will probably not have savings or be able to obtain a credit card. Therefore, the only option open to them if they want to get their vehicle back on the road is to turn to a payday lender. This contradicts the argument put by payday lenders that they provide a valuable finance option to borrowers generally³¹; there is only one demographic to whom payday loans appeal, those on very low incomes and for them the loan is not so much an option but a last resort which they turn to in desperation. A desperation that the lenders are no doubt aware of, and arguably actively exploit.

It is evident that payday lenders are aware that their products appeal to low income earners in looking at their promotional activities and the locations of their outlets. Payday lenders are much more prevalent in low income areas, particularly in places in the northern and western suburbs of Melbourne³². In West Heidelberg, an area with significant stocks of public housing, lenders are known to undertake letter box drops of pamphlets, in the opinion of a financial counsellor in the area, with a specific targeting of public housing estates³³.

It is patently clear from payday lender's advertisements that they not only do knowingly lend to people receiving Centrelink benefits³⁴, but actively promote the fact that they do. A common promotional line used in advertisements in newspapers³⁵ and flyers distributed to letterboxes³⁶ is

²⁷ Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test, March 2006

²⁸ *ibid*

²⁹ *ibid*

³⁰ Wilson, 2002

³¹ Cash Converters Submission - 'Review of Australia's Consumer Policy Framework', Productivity Commission Inquiry. February 6 2008

³² Wilson, 2002

³³ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

³⁴ *ibid*

³⁵ Herald Sun Finance and Loans Advertisement section, Saturday 24 May 2008

³⁶ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

one along the lines of “finance provided to pensioners” or “pensioners welcome”³⁷. Another commonly advertised characteristic is that credit checks are not necessary to obtain finance³⁸. Such activities could be taken to demonstrate that there is deliberate targeting of people who would not be able to obtain finance from other sources.

There also appears to be a direct appeal to the vulnerabilities of lower income earners. The use of membership cards that resemble credit cards and outlets set up very much in the style of major bank branches are designed to induce a belief from the borrower that they are dealing with a professional and reputable organisation, possibly causing the borrower to feel the same way as they would if they were dealing with a mainstream credit provider. This can lead the borrower to have a greater sense of independence, in that they are able to obtain credit from a legitimate source. Payday lenders have also been known to offer borrowers the chance to build up a credit rating of their own, giving the false sense that if they continue to borrow from the payday lender they will one day have a sufficiently strong credit rating³⁹ to be able to deal with other financial institutions and obtain access to services such as credit cards.

USE AS ON GOING SOURCE OF CREDIT RATHER THAN FOR ONE OFF PAYMENTS

For public perception reasons, for purposes of the application of the Uniform Consumer Credit Code and to avoid having their effective interest rates being described as annual, payday lenders claim that their clients obtain loans for “one off” purposes. However, often the reality is that borrowers use the loans as an ongoing source of finance finding that they have come to rely on them as a necessary supplement to their income or of more concern⁴⁰, that they have taken out a loan originally and have not been able to cover the full cost so have subsequently had to take up the roll-over or refinance option⁴¹. Taking out a loan and being overwhelmed by the repayments and fees can send a borrower in to a so called debt spiral⁴², from which they may find it extremely difficult to recover, often having to resort to making a claim of bankruptcy⁴³. Although payday lenders may say that the loans are not meant to be used in such a way and are really meant for one-off expenses⁴⁴, the reality is that borrowers do use the loans to regularly pay off other debt such as rent and energy bills and find that they have no choice but to roll-over existing loans⁴⁵. The ongoing use of payday loans deals a significant blow to lender’s claims that it is

³⁷ *ibid*

³⁸ *ibid*

³⁹ Wilson, 2002

⁴⁰ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

⁴¹ *ibid*

⁴² Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test, March 2006

⁴³ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

⁴⁴ Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test, March 2006

⁴⁵ *ibid*

misleading to equate their fees to an effective annual interest rate⁴⁶, in fact their have been examples of loans being rolled continually for up to twelve months⁴⁷, in which case it would be impossible to argue that the rates are not annual.

Furthermore the provision of a membership card and number as well as examples of incentive programs such as a lender offering a 50% discount on fees upon taking up their sixth loan⁴⁸, show that it is very much the intention of the lender that customers make ongoing use of the loan facilities.

RESPONSE FROM GOVERNMENT

Governments have not taken a desirable view of payday lending. The predominate response has been through the Uniform Consumer Credit Code, particularly ensuring that payday lending comes within the jurisdiction of the code⁴⁹.

In Victoria, a cap was introduced to limit the interest that could be charged to 48%, it is important to note though, that this cap does not extend to other fees and charges⁵⁰. The UCCC's main aim is to ensure truth in lending⁵¹, requiring disclosure of all fees, charges and terms. Disclosure is trumpeted as a substantial form of consumer protection by federal and all state and territory governments^{52,53}.

Victoria has recently fallen behind in comparison to the consumer protection provided by other states, particularly Queensland where the 48% cap has been extended to include fees and charges⁵⁴.

ADEQUACY OF MEASURES

The notion that, of itself, disclosure is an adequate protective measure appears to be somewhat naïve as it operates on the assumption that consumers have choice and does not take into account the stark reality that the very people sought to be protected have little to no market power. In fact disclosure is described by one expert, consumer lawyer Denis Nelthorpe, as being a middle class protective measure that is almost irrelevant in payday lending cases⁵⁵. Nelthorpe's view is that "*disclosure is not a form of consumer protection for someone that cannot afford to turn the heater on or put food on the table*"⁵⁶. This view is supported by Wilson, who his 2002 review of payday lending says that disclosure of high interest and fees is unlikely to make any

⁴⁶ Morely, G. *Calculating Annual Percentage Rates and Comparison Rates*. December 2007

⁴⁷ Wilson, 2002

⁴⁸ Wilson, 2002

⁴⁹ *ibid*

⁵⁰ Interview with consumer law expert, Denis Nelthorpe. Friday 23 May 2008

⁵¹ Wilson, T. The inadequacy of the current regulatory response to payday lending (2004) 32 ABLR 193

⁵² Press Release – *Action needed on Payday Lending*. Joe Hockey MP, Minister for Financial Services and Regulation. 3 April 2001

⁵³ Press Release – *Days Are Numbered for Payday Lending 'Rogues'*. Hon. Jennifer Rannkie MP, Minister for Consumer Affairs, South Australia. 21 October 2007

⁵⁴ Interview with consumer law expert, Denis Nelthorpe. Friday 23 May 2008

⁵⁵ *ibid*

⁵⁶ *ibid*

difference to a person's decision to take out a loan⁵⁷. There is an example of an actual disclosure agreement showing that the fees and interest on a loan are equivalent to an effective annual interest rate of 740%⁵⁸, yet the borrower has continued with the loan, undeterred by this. In consideration of these views, it is apparent that whilst disclosure plays a part, to afford greater protection to borrowers, a more 'hard headed' approach needs to be taken, perhaps in the form of a stricter application of the 48% cap.

The cap of 48% on interest rates that currently operates in Victoria, is viewed as ineffective by Nelthorpe who takes the position that based on the way that fees are imposed in the industry a cap that does not include fees is, in reality, hardly a cap at all⁵⁹. The cap does not preclude lenders from imposing fees that have very similar characteristics to interest, in effect allowing lenders to charge rates on loans that equate to several hundred percent, far in excess of the 48% cap⁶⁰. The argument from lenders that the fees/interest charged are necessary to counter the risk involved has been dealt a significant blow in a very recent Queensland case where the judge has ruled that "the rate of 204% charged on a payday loan far exceeds what may reasonably be required to reflect the degree of risk presented by the lender's situation"⁶¹. The overall judicial perspective from this case appears to be that there is a strong argument that any rate charged above 48% could be considered unjust⁶². The view taken in this case should give considerable weight to the argument that the 48% cap on interest in Victoria should be extended to include fees and charges⁶³.

FURTHER MEASURES THAT CAN BE TAKEN

Regulation: The Victorian Government should follow the lead of Queensland, New South Wales and the ACT and the guidance given by the Queensland Court of Appeal that charges on loans exceeding 48% are unjust and therefore should be capped at this rate⁶⁴.

Alternative sources: There should be further investigation of alternative sources of income that can be provided to low income earners. This could involve greater flexibility from Centrelink in their distribution of payments to recipients⁶⁵. An expansion of the currently operating, but small scale low interest loan schemes that now operate such as the partnership between the Brotherhood of St Laurence and the Bendigo Bank. Given the recent evidence of increased

⁵⁷ Wilson, 2002

⁵⁸ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

⁵⁹ Interview with consumer law expert, Denis Nelthorpe. Friday 23 May 2008

⁶⁰ Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test, March 2006

⁶¹ *Cash Solutions (Australia) Pty Ltd v Turner & Anor* [2008] QCA

⁶² *ibid*

⁶⁴ Interview with consumer law expert, Denis Nelthorpe. Friday 23 May 2008

⁶⁵ *ibid*

interest of the major banks in corporate social responsibility, particularly from the NAB⁶⁶, governments could actively assist and encourage mainstream lenders to enter the small loans market.

Increase in financial counselling resources and promotion: It has become apparent that many people turn to payday loans in desperation without being aware of other options⁶⁷. It is often the case that had people been aware of the financial counselling service offered they would not have needed to resort to a payday loan⁶⁸. There are measures that could be taken in relation to several forms of debt, for example; those struggling to pay utility bills may be eligible for a hardship or relief plan, the Department of Human Services provides several options for those in rental arrears with public housing and the UCCC may provide for more affordable payment options for other debts such as car loans/finance⁶⁹.

BIBLIOGRAPHY

Legislation

Uniform Consumer Credit Code

- Consumer Credit (Queensland) Amendment Act 2001 (Qld)

Cases

Cash Solutions (Australia) Pty Ltd v Turner & Anor [2008] QCA

Other sources

-Wilson, Dean. *Payday Lending in Victoria: A Research Report*, Consumer Law Centre Victoria 2002

-Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

-Interview with consumer law expert, Denis Nelthorpe. Friday 23 May 2008

-*Fringe Credit Providers: Decision Making Regulatory Impact Statement and Final Public Benefit Test*, March 2006. Available: www.creditcode.gov.au/downloads/FRINGE_RI.pdf

- *What is Payday Lending?* Office of Consumer and Business Affairs, South Australia. Fact Sheet. Available:

www.ocba.sa.gov.au/consumeradvice/matters/paydaylending/whatispaydaylending

- Cash Converters Submission - 'Review of Australia's Consumer Policy Framework', Productivity Commission Inquiry. February 6 2008

- Coombes, T, Reimers, D. *Contemporary Australian Macroeconomics – An Analytical Approach*. Longman. Melbourne 1998.

- Smyles, P, Turner, L. *Comment on Proposed Consumer Credit Code Amendment Bill 2007*. National Financial Services Federation. September 2007

- Morely, G. *Calculating Annual Percentage Rates and Comparison Rates*. December 2007

- Wilson, T. *The inadequacy of the current regulatory response to payday lending* (2004) 32 ABLR 193

- Press Release – *Action needed on Payday Lending*. Hon. Joe Hockey MP, Minister for Financial Services and Regulation. 3 April 2001

- Press Release – *Days Are Numbered for Payday Lending 'Rogues'*. Hon. Jennifer Rannkie MP, Minister for Consumer Affairs, South Australia. 21 October 2007

- Nelthorpe, D. *Financial Counsellors and the Legal System*. Consumer Credit Legal Service. Future of Paralegal Professionals Conference, Canberra, 19-20 February 1990

⁶⁶ See NAB CEO Ahmed Fahour's support of micro-lending programs at the 20/20 Summit in Canberra, April 2008.

⁶⁷ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

⁶⁸ Interview with Financial Counsellor, Banyule Community Health Service. Friday 23 May, 2008

⁶⁹ *ibid*