

Towards a 'cost of credit' cap in the UK:

Lessons from Australia¹

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Key Findings

The UK government has recently announced that the FCA (Financial Conduct Authority) must introduce some limitation on the cost of credit by January 2015. It has cited Australia as an example of a country where such a cap works well. However, Australia only implemented its interest rate cap in July 2013 and there has been no systematic evaluation of its impact. This paper provides a brief overview of the cap in Australia combined with evidence from in-depth interviews with stakeholders, carried out between November 2013 and January 2014, about the impact of the new regime. The key findings are:

- The interest rate regime in Australia is complex as it is a tiered system and there is no requirement on lenders to inform borrowers of the APR on loans. This can make it difficult for consumers to compare the cost of different loans;
- The maximum interest rate allowed is 48% per annum, but lenders are also entitled to charge an 'establishment fee' which means that loans of around 300% APR are permissible;
- The cap has been met with mixed reactions from Australian stakeholders and it is unclear what impact it has had on consumers as there has been no systematic evaluation or review of its impact;
- The cap appears to have resulted in increased avoidance activity and further regulations have already been drafted to tackle this issue;
- There appears to have been a drop in the number of lenders in this part of the credit market though this may be due to a combination of the cap and more onerous obligations on lenders to check affordability (eg the requirement to check the bank account transactions of borrowers for the previous 90 days); and
- Care should be taken when drawing lessons from Australia given the lack of systematic evaluation of the cap and also the major differences between Australia and the UK in terms of: the responsible lending obligations; the potential penalties for breach of lender obligations; and differences in supply and demand for credit.³

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³ See Gardner (2014) *The Challenges of Regulating High-Cost Short-Term Credit: A Comparison of UK and Australian Approaches*, Birmingham: CHASM

Introduction

High-cost short-term credit (HCSTC) (defined by the Financial Conduct Authority (FCA) as loans of less than 12 months at an interest rate of over 100% APR) has received considerable media attention recently.⁴ In November 2013, the United Kingdom Government announced that the FCA will be legally required to implement a cap on the total cost of credit by early 2015. This came as a major surprise to many stakeholders in the field. Since that time, there have been a number of references, from government and non-government sources, to the system in Australia, not least its national interest rate cap, indicating that this could be a potential model for the FCA to follow⁵. Unfortunately there has been no systematic investigation of this important issue. This paper therefore aims to fill this gap, by discussing what the UK can learn from Australia's new national cap on the cost of credit. A broader comparison of the two regimes can be found in Gardner (2014).

Australia's cost of credit cap

In July 2013, Australia implemented a national cap on the total amount of interest that can be charged by lenders. The new tiered cap introduced three different consumer credit definitions. Figure 1 provides information on these different forms of credit. Two key points are worth making here: loans with a length of 15 days or less are effectively banned under the new legislation; and the APR can equate to (at least) 290% for small account credit contracts (SACCs).

Lessons from Australia

As yet there has been no systematic evaluation of the impact of the cap. Between November 2013 and January 2014, we carried out in-depth interviews with relevant stakeholders in Australia in order to provide some information about the early workings of the cap. These interviews included lenders, trade associations, consumer lawyers, consumer advocates, debt advisors and researchers. The interview process highlighted the mixed reactions to the tiered interest rate cap system. Whilst this type of research has limitations, until a detailed review of the interest rate regime is conducted, interviews are a highly useful way of gaining an insight into the market and the impact of these reforms, particularly on low income borrowers.

One feature of the new regime worth highlighting is that there is no requirement for lenders to disclose the APR or any other kind of comparison rate to borrowers (as there is in the UK). This is partly in response to the argument that APRs are not a useful mechanism for providing information on short term loans. While it is true that there are limitations with APRs, some other kind of price comparison would be helpful, such as the total cost of credit or pounds per hundred pounds lent.

⁴ Interestingly, the definition from the FCA specifically excludes 'home credit loan agreements' even if the APR is over 100%.

⁵ <http://www.bbc.co.uk/news/uk-politics-25083701>

Figure 1 Australia's tiered credit cap system from July 2013

	STCC short-term credit contracts	SACC small amount credit contracts	MACC medium amount credit contracts	Other Loans
<i>Nature of loan</i>	Under AUD\$2,000 with a length of 15 days or less	Under AUD\$2,000 with a length of 16 days to 1 year	AUD\$2,001 to \$5,000 for a period of 16 days to 2 years	All other loans
<i>Maximum interest rate</i>	0%	48% per annum (4% per month)	48% per annum (4% per month)	48% per annum (4% per month)
<i>Maximum establishment fee</i>	\$0	20% of credit amount	\$400	\$0
<i>Example Loan</i>	Lending has been effectively banned	\$1,000 over one month = \$1,240 repaid, made up of a \$200 establishment fee (being 20% of \$1,000) and \$40 interest (being 4% of \$1,000)	\$3,000 over three months = \$3,760 repaid, made up of a \$400 establishment fee (a set \$400) and \$360 interest (being 3 x 4% of \$3,000)	\$6,000 over six months = \$7,440 repaid, made up of no establishment fee and \$1,440 interest (being 6 x 4% of \$6,000)
<i>APR Equivalent of example loan</i>		290%	100%	48%

Some interviewees, mainly from the debt advisor and researcher categories, believed that the cap is an effective way to price credit appropriately. There has however been criticism of the level of interest from both sides of the debate; with some consumer advocates/lawyers commenting it is still set too high and is therefore unaffordable for low-income borrowers, and some lenders/trade associations arguing it is too low for the time-consuming administrative burden for small amount lending, particularly in light of the new prescriptive responsible lending requirements. For example lenders are expected to check the last 90 days of bank statements of potential borrowers to ensure that loans are affordable. Trade associations report a significant decrease in the number of lenders providing this sort of credit though whether this is due to the cap itself or the responsible lending requirements (or a combination of the two) is unclear. This reduction in the availability of short-term loans is considered, by some, to be a desirable outcome and, in fact, is the aim of the legislation. It does however raise the potential issue of increased financial exclusion for consumers who cannot access mainstream credit – or a growth in illegal lending. The legal

reforms have not been linked with an increased focus on the provision of alternative financial products, such as additional funding for CDFIs.⁶

The new legal regime in Australia has also resulted in increased avoidance activity, as businesses attempt to find ways to lend above the statutory threshold. The government therefore has had to devote additional time and resources to stop lenders circumventing the cap. Avoidance activity is an unfortunate, but almost inevitable, consequence of a stricter legal framework and something that the UK should be prepared to tackle when it introduces its new cap.

Some commentators, including debt advisors and consumer lawyers, have stated that the tiered nature of the regime is too complicated, making it difficult for borrowers to understand whether their loan is legally compliant.

When drawing lessons from Australia about the cap on the cost of credit it is important to bear in mind that Australia's regulation of this sector is rather different in many other important respects, including potential criminal prosecution for breaches of obligation⁷. Australia also has a wide range of government and not-for-profit services that provide access to short-term loans or small grants. For example, Centrelink (the Australian social security provider) has a range of crisis payments and special benefits. People can also receive a lump sum advance of their benefits, which is then repaid by slightly reducing future benefit payments. In addition to this, Good Shepherd Microfinance has teamed up with the National Australia Bank to provide low income consumers in Australia with access to no- or low-interest loans. The program has provided loans to over 125,000 people who had previously been excluded from mainstream credit. This represents over 0.55% of the Australian population, which is a remarkable feat.⁸

Conclusion

Australia provides a useful case study for the UK's approach to responsible lending and the regulation of high-interest, short-term loans. Despite the strong similarities in the two countries' legal regimes, the Australian approach to consumer credit and, in particular, the responsible lending obligations vary drastically from that of the UK. This paper has outlined what the UK can learn from Australia's treatment of these very important issues. It is clear that the Australian system has a lot to offer the UK, but it is important to be aware of the potential detrimental aspects of the regime and the impact of the different legal and social frameworks in which the laws are situated.

⁶ There will however be an independent review of the reforms in 2015 and the need for alternative products may be raised at this stage.

⁷ See Gardner (2014) *The Challenges of Regulating High-Cost Short-Term Credit: A Comparison of UK and Australian Approaches*, Birmingham: CHASM

⁸ For more detail on financial exclusion in Australia, see The Centre for Social Impact for National Australia Bank, *Measuring Financial Exclusion In Australia* (June 2013).