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The Challenges of Regulating High-Cost Short-Term Credit: A Comparison of UK and Australian Approaches[1]

by Jodi Gardner, Research Fellow

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Key Findings

This paper provides a comparison of the Australian and the United Kingdom (UK) approaches to regulating the provision of high-cost, short-term credit. This is particularly timely as Australia implemented a tiered interest rate cap in July 2013, and the UK government has recently announced there will be some limitation on the cost of credit in early 2015. The research for this paper was conducted through an analysis of legal regimes of the two countries and a literature review of the existing research on the topic. The Australian reforms were only implemented in July 2013, and therefore this information has been complemented with qualitative empirical research in the form of in-depth interviews with stakeholders about the impact of the new regimes. The key findings of this paper are:

- the responsible lending obligations in the UK are comparatively limited when compared with the prescriptive and detailed Australian system and this is likely to be related to the timing of the different regimes;
- the potential penalties for breach of lender obligations in the UK are relatively 'light touch' when compared with the comprehensive and potentially serious penalties in Australia;
- the exact meaning 'unfair relationship' in UK law remains unclear, as does its relationship to responsible lending – further clarification from the courts is urgently required;
- the interest rate regime in Australia is more complicated than it may appear. It is not a flat 48% cap and, due to the 'establishment fee' lenders are entitled to charge, loans of 300% APR are allowed;
- due to the recent implementation of the regime, the cap has been met with mixed reactions from Australian stakeholders and it unclear the impact it has had on consumers;
- the Australian cap has resulted in increased avoidance activity and further regulations have already been drafted to tackle this issue; and
- finally, whilst there is a lot the UK can learn from Australia's experiences, the legal and social framework of the two countries are very different and this will significantly influence the impact that an interest rate cap has on consumers.

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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.[2] 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 strong surprise to many stakeholders in the industry. Since that time, there have been a number of references, from government and non-government sources, to the legal regime for HCSTC and responsible lending in Australia, including its tiered interest rate cap, indicating that this could be a potential model for the FCA to follow. Whilst there are many potential benefits to the Australian system, the regulatory regime has not been without its problems. In addition, the legal and social framework in Australia is markedly different from that in the UK, and this has had a significant impact on the experiences of low income consumers. Therefore, prior to any comparisons being drawn, it is important to fully understand and appreciate the differences between the two countries and the influence this could have to the practical implementation of any new laws. Unfortunately there seems to be a lack of academic investigation of this important issue. This paper therefore aims to fill this gap, by analysing the consumer credit regimes in both countries, and then discussing what the UK can learn from Australia's regulatory treatment of HCSTC.

Part 1 – High-Cost Short-Term Credit and Responsible Lending in the United Kingdom

The first part of this paper will discuss the regulation of HCSTC and responsible lending obligations in the UK, as well as an analysis of the unfair relationship test and how it applies to this type of financial product.

Regulation of High-Cost Short-Term Credit

The UK has a split regulatory regime. The consumer credit regime applies to all lending that does not involve a first charge over the borrower's property.[3] This is regulated by the *Consumer Credit Act* 1974 (the Act), as amended by the *Consumer Credit Act* 2006, and is currently overseen by the Office of Fair Trading. This will change on 1 April 2014, when the jurisdiction will be transferred to the newly established regulator, the FCA. The second regime is related to first mortgages over borrowers' property. It is regulated by the *Financial Services and Markets Act* 2000 and since 1 April 2013 has been overseen the FCA since that time.[4] Under the Act, it is an offence to enter into a consumer credit agreement without a

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

[3] It does however apply to a second or subsequent charge over borrower's property.

[4] Formerly known as the Financial Services Authority.

licence.[5] To obtain a licence, the creditor must make an application and satisfy the regulator that they are a 'fit person' to carry on a consumer credit business.[6] Lenders are also required to follow legislative restrictions on advertising of products and contractual disclosure of lending agreements.

Limitations on the Cost of Credit

In light of the explosion of payday lending there have been increased calls for a restriction on the total cost of credit, meaning the imposition of a statutory limit on the interest, fees and charges that lenders can charge. A number of jurisdictions have interest rate caps including Japan, Germany, Greece, France, Ireland, Malta and, as will be discussed below, Australia. The debate on whether the UK would benefit from some form of a cap has recently received increasing levels of media and academic interest. The Personal Finance Research Centre at Bristol University released a report in 2013 highlighting the lack of empirical evidence about the impact of a potential cap in the UK. The FCA has also commented that, due to the lack of credit alternatives for low income consumers, a restriction on the total cost of credit could exacerbate the financial difficulties of some borrowers. Despite these issues, the government recently announced that there will be a future cap on the total cost of credit. An amendment to the *Financial Services (Banking Reform) Act* 2013, requires the FCA to restrict the charges applicable to HCSTC by 2 January 2015. After the results of the research by Bristol University and the FCA, this move took a large number of stakeholders by surprise, and appears to be a highly politicised reaction to the public backlash against the high interest rates being charged by many lenders. Further information on potential options for the cap, as well as consultation opportunities, will be released shortly by the FCA.

Responsible Lending Obligations

There are no explicit references to responsible lending in the 1974 CCA. The requirement to lend responsibly is included in the fitness test for licensees; therefore the OFT requires creditors engage in responsible lending in order to obtain and continue a consumer credit licence.[7] There are also indications of responsible lending requirements in the duty to explain the nature and consequences of credit[8] and the duty to make a creditworthiness assessment.[9] In 2011 the OFT produced 'Guidance on Irresponsible Lending', when it became evident that despite the legal obligation to do so, many lenders were not lending

5 Consumer Credit Act 1974, s 21(1) and definition of 'consumer credit business' in s 189. The only exceptions to this are public authorities (s 21(2)) and 'A body corporate empowered by a public general Act naming it to carry on a business' (s 21(3)).

6 *Consumer Credit Act* 1974, s.25(1).

7 See references to the requirement to lend responsibly in The Office of Fair Trading, *Consumer Credit Licensing: General guidance for licensees and applicants on fitness and requirements*, pp. 4, 6, 8, 9 and 30.

8 *Consumer Credit Act* 1974, s.55A.

9 *Consumer Credit Act* 1974, s.55B.

responsibly and further guidance was required. Lenders are required to comply with these guidelines as part of determining fitness for their consumer credit licence.[10] This appears to have had little, if any, impact on the actions of lenders – the 2013 OFT Review on Payday Lending Compliance recently highlighted that there is still an unacceptably high level of non-compliance in the industry.

Whilst there are references to lending responsibly, the legislation does not include a proactive duty of responsible lending and it is merely a subset of the fitness to hold a consumer credit licence test. The duty of the lender to explain the nature and consequences of the credit under section 55A(1) of the CCA 1974 appears to merely provide an obligation on the lender to provide the borrower with a sufficient explanation of the credit contract so that the borrower can determine whether the agreement is suitable for their needs and financial situation. This seems to place the obligation on the consumer to determine whether the *borrowing* is responsible. This inference is supported by the fact that there are no references in the Irresponsible Lending Guidance to the lender enquiring about the borrower's intended use, requirements or objectives of the credit contract. It is however a breach of the Guidance to promote the sale of a credit product which is *clearly unsuitable* for the specific borrower and their financial situation and/or intended use (if this information is known by the lender). As the obligation only applies when the information is known by the lender (and there is no obligation on the lender to inquire about this information), it is unclear if and how this provision would be enforced by the regulator. In addition, the reference to 'clearly unsuitable' provides a high threshold test for determining a breach of the obligation.

Lenders also have an obligation to take 'reasonable steps' to ensure that a borrower can meet repayments under the credit agreement in a sustainable manner (i.e. credit can be repaid without undue difficulty, over the life of the specific credit agreement and without the borrower having to release any assets). The specific requirements of 'reasonable steps' are however proportionate to, and dependent upon, a number of different factors including the type of credit product, the amount of credit provided, the borrower's financial situation, existing and future financial commitments, and the borrower's credit history. The OFT does not provide concrete obligations about what steps must be taken in this regard, indicating that it is left to the discretion of the lender to determine what is reasonable in the specific circumstances of the loan.

<u>Penalty Regime and the Unfair Relationship Test</u>

In addition to the limitations of the UK responsible lending obligations discussed above, there are also inadequate potential sanctions in place if breaches of the obligations occur. In

[10] The Office of Fair Trading, *Guidance on Irresponsible Lending* (2011). The result of this is that there are now three areas of consumer credit law that require lenders to act responsibly, the duty to explain the nature and consequences of credit (s.55A), the duty to make a creditworthiness assessment (s.55B) and the requirements of responsible lending linked to the consumer credit licence.

general, the potential sanctions currently available to the OFT are fining the lender, the revocation or suspension of a credit licence, or the provision of additional obligations on a licence holder.[11] There is however an opportunity for consumers to take action against lenders under the wide wording of the relatively new 'unfair relationship test'[12], which allows the court to look at the general relationship between the lender and borrower including 'any other thing done (or not done) by, or on behalf of, the creditor'. Whilst there is no specific reference to responsible lending obligations in the legislation, it was explicitly stated by the relevant Minister that the duty to lend responsibly was included in the unfair relationship test.

Unfortunately, there has been minimal judicial consideration of the protection afforded by the unfair relationship test. It is therefore unclear how the courts will approach the interpretation of the test and its connection with responsible lending obligations. The Court of Appeal has recently analysed the unfair relationship test in *Harrison v Black Horse Limited*.[13] This case did not refer to responsible lending obligations and, in fact, stated that the wording of the legislative provision 'offers no guidance in respect of the factors which either may or must be regarded as rendering the relationship unfair'.[14] The cases referring to the test have also largely related to procedural issues,[15] including the right to amend pleadings to introduce a claim of an unfair relationship,[16] and an application to appeal against forfeiture out of time on the grounds that the credit was obtained through an unfair relationship.[17]

There have been a handful of cases considering the scope of the test. An unfair relationship was not found in *Shaw v Nine Regions*[18] in the context of a £3,000 loan at 119.16% APR for 36 months, which created total repayments of £13,724.88. This was on the basis that the borrower, despite having bad financial judgment, was considered a 'sophisticated, articulate and intelligent man'.[19] In contrast, an unfair relationship was held to exist in *Morrison v Betterplace Ltd (t/a Log Book Loans)*.[20] In this case two loans of £1,500 were entered into, one at 343.4% APR with Mr Morrison and the second one approximately 2 ½ years later at 485.25% APR, but this time with Mrs Morrison. Both were repayable over 58 weeks. The judge held that the second loan was out of the ordinary as Mrs Morrison was essentially

11 There is however the potential for enforcement action under Part 8 of the Enterprise Act 2002, but it has to be shown that the collective interests of consumers have been harmed.

12 See s.140A *Consumer Credit Act* 1974 (UK), as implemented by the *Consumer Credit Act* 2006 (UK).

13 *Harrison v Black Horse Ltd* [2011] EWCA Civ 1128, [2012] Lloyd's Rep IR 521.

14 Lord Justice Tomlinson in ibid [38].

15 The Queen's Bench has considered the unfair relationship test in the context of a credit card agreement and held that a breach of Consumer Credit Act 1974, s 78(1) (duty to give information to debtor under running-account credit agreement) does not on its own give rise to an unfair relationship: *Carey v HSBC Bank plc* [2009] EWHC 3417 (QB).

16 *Barnes v Black Horse Ltd* [2011] EWHC 1416 (QB).

17 *Barons Finance Ltd v Makanju* [2013] EWHC 153 (QB).

18 *Robert Shaw v Nine Regions* [2009] EWHC 3514 (QB).

19 *Robert Shaw v Nine Regions* [2009] EWHC 3514 (QB) [29].

20 *Morrison v Betterplace Ltd (t/a Log Book Loans)* 1 September 2009, (County Court at Lowestoft).

taking over responsibilities of the first loan, but at a significantly higher rate. His Honour therefore varied the rate of the second loan to that of the first. He also held that sending multiple default letters each month at a cost of £12 per lender was unfair and limited this to one letter per month. Despite the finding, the judge did not directly consider whether 485.25% APR was unfair and did not make a finding on this point.

An unfair relationship was also held to exist in *Patel v Patel*, where a number of loans totalling £56,450 between two friends had snowballed after 30 years into over £6 million owed, despite the borrower making repayments totalling £72,336. The unfair relationship was found for a variety of reasons, including the personal relationship between the two parties, a lack of any written terms of the loans, the borrower not being provided with a copy of the agreements, repayment sums only being made on request of the creditor, and a lack of account information being provided to the borrower.[21] Despite the disturbing practices in both cases, there was no consideration by the court of whether the lender actions breached responsible lending obligations. The exact meaning of 'unfair relationship' therefore remains unclear, as does its relationship to responsible lending; further clarification from the courts is urgently required.

Part 2 – High-Cost Short-Term Credit and Responsible Lending in Australia

The second part of the paper will focus on Australia's legal system and will discuss the regulation of HCSTC, including the development of the current consumer protection system, as well as the responsible lending obligations and potential penalties when lenders' breach their legal obligations.

<u>Regulation of High-Cost Short-Term Credit</u>

Due to the follow on effects of colonialism, the Australian legal system very closely aligns with the British system. It is also a common law system and a number of areas of law, including contract and tort, are largely in line with that of the UK. As will be discussed in more detail below, Australia however has a more regulated and prescriptive approach to responsible lending and consumer credit. Australia is divided into eight different states and territories which, until relatively recently, shared jurisdiction of both general consumer protection and consumer credit with the Federal Government. This meant that there were a number of differing legal regimes which created confusion for both businesses and consumers, as well as enforcement difficulties for regulators. Both of these areas were recently amended to a unified national system. In 2011, the Australian Consumer Law was enacted which provided for a unified general consumer protection regime across all Australian jurisdictions.[22]

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21 *Patel v Patel* [2009] EWHC 3264 (QB).

22 Located in Schedule 2 of the *Competition and Consumer Act* 2010 (Cth).

In Australia, the *National Consumer Credit Protection Act* 2009 (Cth) (NCCPA) and the National Credit Code (NCC) regulates the provision of consumer credit. In 2013, the *Consumer Credit Legislation Amendment (Enhancements) Act* 2012 (Cth) (CCLAEA) was enacted, providing for a national interest rate cap and additional protections for borrowers of HCSTC. Similar to the UK, in Australia all lenders must be licenced before entering into credit agreements.[23] There are also legal requirements for contractual disclosure, the form of credit agreements and advertising of credit products.

Limitations on the Cost of Credit

Australia has recently implemented a nationalised cap on the total amount of interest that can be charged by lenders. Prior to 1 July 2013, there was a state-based system with varying approaches to interest rate limitations. New South Wales, the Australian Capital Territory and Queensland had a 48% interest rate cap inclusive of all fees and charges. Victoria had a 48% cap for unsecured loans and a 30% cap for secured loans, but both excluded fees and charges. Finally, Northern Territory, South Australia, Tasmania and Western Australia did not have any limitation on the cost of credit.

On 1 July 2013, the CCLAEA came into force which provided for a national interest rate cap through differential price regulation.[24] This Act made significant amendments to the NCCPA and the NCC. The CCLAEA also introduced three different consumer credit definitions – small amount credit contracts (SACCs), medium amount credit contracts (MACCs) and short-term credit contracts (STCCs).

A STCC is a loan for under AUD$2,000 with a length of 15 days or less. No interest can be charged on these types of loans, meaning that they have effectively been banned under the new legislation. SACCs are unsecured loans of AUD$2,000 or less with a length of 16 days to 1 year. The lender is only entitled to charge an establishment fee of 20% of the adjusted credit amount and interest of 4% per month (48% per annum). No other fees, charges or interest are permitted on the loan. MACCs are loans for AUD$2,001 to $5,000 for a period of 16 days to 2 years. The lender is entitled to charge interest of 4% per month (48% per annum) and an establishment fee of up to AUD$400. In addition, the total default fees must equate to no more than two times the adjusted credit amount, meaning that consumers will only ever be required to repay twice the amount they have borrowed. The 'establishment fee' for SACCs and MACCs are once-off fees designed to allow lenders to recoup the administrative costs associated with these types of short-term financial products. All loans which are not STCCs, SACCs or MACCs have an interest rate of 48% with no additional fees or charges permitted. Any interest, fees or charges above the stated amounts are prohibited and cannot be recovered by the lender.

23 See *National Consumer Credit Protection Act* 2009 (Cth), s.35.
24 This is discussed in further detail below.

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

	STCC	**SACC**	**MACC**	**Other Loans**
Maximum interest rate	0%	48% per annum (4% per month)	48% per annum (4% per month)	48% per annum (4% per month)
Maximum establishment fee	$0	20% of credit amount	$400	$0
Example Loan and APR Equivalent	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 5% of $1,000) * This equates to an APR of approximately 290%	$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) * This equates to an APR of approximately 100%	$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) * This equates to an APR of 48%

The new regime appears to have accepted the argument that APRs are not a useful mechanism for providing information on short term loans as there is no requirement for the lender to disclose the APR or a comparison rate to borrowers. Unfortunately, it does mean that there is no longer a uniform mechanism that allows consumers to compare prices across a number of different loans.

As yet there has been no quantitative empirical research conducted on the impact of the cap; it is therefore difficult to make firm conclusions on the impact it has had on consumer welfare in Australia. Qualitative empirical research, conducted through in-depth interviews with relevant stakeholders, including lenders, trade associations, consumer lawyers, consumer advocates, debt advisors and researchers, has however 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.

Some interviewees, mainly from the debt advisor and researcher categories, believe that the cap is an effective way to price credit appropriately, ensuring that businesses can still make an adequate profit from HCSTC without exploiting vulnerable consumers desperate for access to funds or creating financial exclusion of these borrowers. There has however been criticism of the level of interest from both sides of the debate; with some consumer advocates/consumer 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. There is evidence to support this assertion, with the trade association reporting a significant decrease in the number of lenders providing this sort of credit operating in the market after the implementation of the cap. Other commentators, including debt advisors and consumer lawyers, have stated that the regime is too complicated, making it difficult for borrowers to understand whether their loan is legally compliant.

Unsurprisingly, the prescriptive nature of the new legal regime has resulted in increased avoidance activity. There is strong anecdotal evidence that many lenders are operating without a licence and providing loans above the statutory threshold. Businesses are also using existing legal exemptions more broadly than they were intended. These avoidance activities have resulted in the Australian government drafting regulations, namely the *National Consumer Credit Protection Amendment (Small Amount Credit Contracts) Regulation* 2014 (Cth), to prevent businesses from circumventing the new laws. It also appears that the industry was unsure about the boundaries between SACCs and MACCs, and the draft regulations seek to provide additional clarification on these definitions.

<u>Responsible Lending Obligations</u>

Unlike the UK, Australia has a unified regulatory system. The NCCPA applies to all forms of consumer credit, secured or unsecured. The legislation is overseen and enforced by the Australian Securities and Investment Commission (ASIC). The approach to responsible lending in Australia is sharply different to that of the UK. For example, the responsible lending obligations have an entire chapter of the NCCPA making up over 70 pages of text, as well as a Regulatory Guide produced by the ASIC which was updated in February 2013.[25]

The core obligation of lenders is to ensure that the credit contract is 'not unsuitable' for the borrower. Even if a preliminary assessment on the credit contract is made, the lender must still make an assessment of suitability for the credit. There are two aspects when determining whether the credit is ‘not unsuitable’ - the 'affordability' of the loan[26] and

25 See the Australian Securities and Investment Commission, Regulatory Guide 209.

26 A detailed list of what is potentially relevant for determining ‘affordability’ is set out in the Regulatory Guide 209 and include the amount of money borrowers have after their living expenses, the source, reliability and consistency of the income, any existing financial obligations, any special features of the borrower which are likely to result in significantly higher expenses, whether the consumer is likely to

whether the product meets the consumer's requirements and objectives.[27] The lender has an obligation to take 'reasonable steps to verify information' provided by the consumer about their financial position to ensure that the credit is 'not unsuitable'. The Explanatory Memorandum for the NCCPA states that at a minimum, the lender is required to 'understand the purpose for which the credit is sought and determine if the type, length, rate, terms, special conditions, charges and other aspects of the proposed contract meet this purpose'. Unfortunately there are no detailed prescriptive measures provided on what is needed to take these 'reasonable steps' and the Regulatory Guide merely provides examples of the types of information that lenders may want to use for verification. This will create difficulties for the regulator when determining whether a lender has breached its obligations in this regard. Similar to the system in place in the UK, the Australian Guide also states that the process a lender will have to take when determining what are 'reasonable steps' is scalable, i.e. it varies depending on the types of credit products offered by the lender.

The CCLAEA does however add to the NCCPA and provide for additional prescriptive responsible lending requirements in relation to small amount credit contracts (SACCs). The borrower will be presumed to be unsuitable for additional loans (a) they are currently in default under a SACC or (b) have had two or more SACCs in the past 90 days. When assessing loan suitability for a SACC, if the borrower has an account in an authorised deposit-taking institution, the lender must obtain and consider statements from their account over the past 90 days before approving a loan.

The CCLAEA also provides further general responsible lending requirements that apply to all loans. If 50% or more of the borrower's income is from Centrelink benefits or pension, the SACC repayments can be a maximum of 20% of the borrower's income. All lenders must display a sign on their physical premises, on any websites and provide verbal warns (where appropriate) highlighting that borrowing small amounts of credit is expensive and may not solve the borrower's money problems. If the loan is paid back under a direct debit agreement, the lender cannot attempt to debit the borrower's account until the borrower is advised that the debit has been unsuccessful or the lender makes reasonable attempts to contact the debtor. This is an attempt to stop the 'drip feeding' of money out of borrowers' accounts and ensure that there is sufficient money to pay priority debts.

have to see their assets to pay the repayment and any expressed willingness from the borrower to make reasonable changes to their lifestyle to ensure repayments can be made.

[27] A detailed list of what should be considered when determining whether the credit product meets the consumer's requirements and objectives is set out in the Regulatory Guide 209 including the nature of the credit and the consumer's state objectives, the interest rate, fees and charges applying to the contract, the complexity of the contract and whether the consumer will need to finance a large final payment under the contract. The ASIC Guide however explicitly states that the contract is not unsuitable merely because another product would be more suitable for the consumer, highlighting that the product does not have to be the most suitable loan available for the consumer.

Penalty Regime

Australia has strengthened its consumer credit and responsible lending regime significantly by implementing a wide range of different penalties for breaches of lending obligations. The penalties can be quite severe and for the most serious of offences, such as equity stripping and predatory lending, include criminal penalties of up to $11,000 for natural persons, $55,000 for body corporates, two years imprisonment or both. Alternatively for less harmful offences, such as failure to undertake reasonable inquiries or failure to assess an unsuitable contract as unsuitable, the ASIC may pursue financial penalties of up to $220,000 for natural persons and $1,100,000 for body corporates. Instead of a civil penalty, the regulator may choose to impose an administrative sanction of suspending, cancelling or amending a licence. Borrowers also have the power to directly initiate proceedings against lenders if they have suffered loss or damage as a result of a lender breaching an obligation under the NCCPA. If this occurs, the Court has access to a broad range of remedies under these types of matters, including declaring a contract void, refusing to enforce any or all terms of a contract, ordering compensation and injunctive relief.

Part 3 – Experiences from Australia: What Can We Learn?

Whilst the two countries in question have a number of strong similarities, it is important to recognise and understand the pertinent differences before considering what the United Kingdom can learn from Australia's relatively new approach to consumer credit and the protection of vulnerable borrowers.

Social Framework and Equality in Australia

It is naïve to believe that legal and regulatory systems can be transplanted from one country to another without a detailed understanding of the cultural and societal differences and how this may impact the implementation of the laws. For example, the average annual wages are remarkably similar, USD $44,983 for Australia and $44,743 for the United Kingdom, but this only tells part of the story. A range of other economic and non-economic indicators must also be considered. One of the most important aspects of this issue is the level of inequality that exists in the two countries, which is strongly linked to the treatment and circumstances of low-income consumers in society – the people most likely to be impacted by changes to the HCSTC regime. Inequality is rising almost universally in OECD countries.[28] There is, however, less inequality in Australia than the United Kingdom. Using the most commonly accepted tool of measuring in equality, the Gini-coefficient, in Australia the level of inequality has risen from 0.309 in the mid 1990's, to 0.315 in the mid-2000's. It then skyrocketed for the next few years and in the late 2000's was at 0.336. A similar pattern was noted in the United Kingdom, where the levels increased from 0.336 in the mid

[28] For more detail, see discussion in OECD, *An Overview of Growing Income Inequalities in OECD Countries: Main Findings*, 2011.

1990's to 0.345 in the late 2000's.[29] These findings are supported by the Inequality-Adjusted Human Development Index (IHDI), published by the United Nation Development Programme's Human Development Reports. The 2013 Report states that Australia is the second lowest level of inequality (behind Norway), compared to the United Kingdom which is in nineteenth place.

The Economist Intelligence Unit's *Worldwide Cost of Living 2013* Report highlights that Australia is quickly becoming one of the most expensive places to live, with two Australian cities (Sydney and Melbourne) now in the top five most expensive destinations. The OECD *Better Life Index* however considers the overall standard of living in the OECD countries by looking at 11 different lifestyle indicators including income, education, community, health, environment and employment. The most recent report highlights that Australia has a better general standard of living than the United Kingdom, and the higher cost of living is compensated by other factors, including housing, education, health and life satisfaction.

In summary, whilst inequality is increasing in both countries and the economic and social situation for low-income consumers is continuing to worsen, it appears that Australian low-income borrowers are in a slightly better situation than their United Kingdom counterparts. This important consideration must be taken into account when analysing what we can learn from the regulatory regime currently in place in Australia.

<u>Comparison of the Responsible Lending Obligations</u>

The difference in the timing of the responsible lending regimes of the two jurisdictions makes a considerable impact on the regulatory approach. The United Kingdom's responsible lending obligations were implemented the 2006 CCA. Whilst this means that they are relatively new in relation to the general consumer credit requirements, the legal obligations and requirements related to responsible lending were implemented *before* the global financial crisis, where the impact of irresponsible lending became evident. One consequence of this timing is that, as discussed above, the obligations in the UK are brief and minimal.

In contrast, Australia's responsible lending obligations were created in the height of the global financial crisis when the levels of irresponsible lending and the impact that this type of behaviour had on the stability of general financial system had become evident. In fact, the subprime crisis and the impact of irresponsible lending was directly referred to in the Australian 2008 Green Paper on Financial Services and Credit Reform. The Australian responsible lending obligations for small amount credit contracts were further developed by the recent CCLAEA and additional, more prescriptive, requirements were included.

It is therefore important for the FCA to rethink the responsible lending obligations in the UK in light of the financial crisis and what that taught us about the harm of an overly relaxed

[29] These measures are the Gini coefficient after taxes and transfers (as opposed to being based solely on income levels).

approach to lending. Unfortunately it does not appear like this will happen. The recent FCA proposals in this regard involve largely transposing the current irresponsible lending guidance into the new FCA regime. Parts of the guidance will become binding rules, including the requirement for firms to lend only where the credit is affordable and to only refinance a loan at the consumer's request and where the firm reasonably believes it is in the consumer's best interests, but mostly will remain as mere guidance.

<u>Lessons from Australia – A More Prescriptive Approach</u>

The UK will be moving to a unified credit regulatory regime under the newly established FCA from 1 April 2014. It is unclear exactly what the system will look like, however the FCA have been given wider enforcement powers and increased resources. It is however very clear that increased focus should be given to the responsible lending provisions and a more prescriptive approach taken to the regulatory regime. The Office of Fair Trading's recent payday lending compliance review highlighted that there is an environment of non-compliance in the industry, part of which arises from a perceived belief that the OFT Guidance is not mandatory. A detailed and prescriptive responsible lending regime, such as that implemented in the CCLAEA in relation to small amount credit contracts, coupled with enhanced remedies for breaches and increased resources for enforcement, would go a significant way towards ensuring a more compliant lending industry.

Other aspects of the Australian regime that are likely to be beneficial for the UK industry include the specific obligation on the lender to determine the objective and purpose of the loan and ensure that the product meets the consumer's requirements and objectives. This ensures a balance between responsible *lending* and responsible *borrowing*, something that appears to be lacking in the current UK system. The Australian approach to penalties also provides a number of benefits, as it provides the regulator with a larger range of sanctions for breaches of obligations. The limited consequences for breaching responsible lending obligations in the current UK system creates insufficient consequences to act as a deterrent for unscrupulous lenders.

There are however some aspects of the Australian system which are open to questioning, of which the FCA and UK government should be aware. Firstly, despite the criticisms of the use of APRs, removing the requirement to inform borrowers of APRs does reduce consumer empowerment as there is no longer an established mechanism for price comparison. If the UK follows suit and remove the legal requirement to advertise APRs, it should be replaced with another form of price comparison, such as the total cost of credit or pounds per hundred pounds lent. It is also widely accepted that new Australian regime, including the interest rate caps and the enhanced responsible lending requirements, will reduce the cost of small amount loans as well as the availability of short-term loans. Due to the potentially dangerous nature of the lending product, this is generally considered a desirable outcome and, in fact, is the aim of the legislation. It does however raise the potential issue of increased financial exclusion for vulnerable consumers who cannot access mainstream credit. Unfortunately, the legal reforms have not been linked with an increased focus on the provision of alternative financial products, such as additional funding for CDFIs.[30]

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 the interest rate limitations are implemented next year.

Conclusion

Australia provides a highly enlightening 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. A summary of those differences is included below in Appendix 1. Despite these differences, the Australian system of tiered interest rate caps has been referenced by the UK government as a potential model for the FCA to consider. In light of the shocking levels of interest being charged to some of the most vulnerable consumers, an interest rate cap can seem like a very attractive proposal. Any drastic limitation on the cost of credit will however reduce the supply of the product, especially to people on low incomes or with impaired credit histories. It is therefore very important that there is an adequate social security framework available to ensure that a cap on the cost of credit does not exacerbate pre-existing financial difficulties. This paper has outlined the HCSTC and responsible lending regimes in the two countries, highlighting 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 framework in which the laws are situated.

Jodi Gardner
CHASM
University of Birmingham
Edgbaston
Birmingham
B15 2TT
j.gardner.1@bham.ac.uk
k.rowlingson@bham.ac.uk

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

Appendix 1: Summary of UK and Australian guidance/rules on (responsible) lending in 2013/14

UK	Australia
1974 Consumer Credit Act 2006 Consumer Credit Act	2009 National Consumer Credit Protection Act 2012 Consumer Credit Legislation Amendment (Enhancements) Act (CCLAEA)
HCSTC (High-cost short-term credit) – less than 12 months with an APR over 100%	STCCs (Short-term Credit Contracts) – less than 15 days, under AUD$2,000 SACCs (Small Amount Credit Contracts) – 16 days- 1 year, under AUD$2,000 MACCs (Medium Amount Credit Contracts) – 16 days- 2 years, under AUD$2,001-5,000
Fitness test for licencees Duty to explain the nature and consequences of credit Duty to make a creditworthiness assessment General 'unfair relationship test' but this appears to focus more on procedure than 'irresponsible lending' OFT guidance on 'irresponsible lending' includes obligation to take 'reasonable steps' to ensure loan is affordable and not 'clearly unsuitable'	70 pages of responsible lending obligations Lender must make an assessment of suitability for the credit not just affordability but also whether product meets the consumer's requirements and objectives, including understanding reason for borrowing Lenders obliged to take reasonable steps to verify information provided Lenders must obtain past 90 days bank statements for SACCs if borrower has such an account
No prescriptive rules on 'creditworthiness' or affordable or suitable	Borrower is presumed unsuitable for additional loans if they are: currently in default on a SACC; or have had two or more SACCs in the past 90 days
No rules on the amount that can be lent	If 50% or more of the borrower's income is from benefits, the SACC repayments can be a maximum of 20% of borrower's income
No current cap on the cost of credit but one to be implemented in 2015	No interest can be charged on STCCs therefore effectively banned SACCs – establishment fee of 20% of loan amount, interest of 4% per month, default fees

	totally not more than two times the adjusted credit amount MACCs – establishment fee of up to AUSD$400, interest of 4% per month, default fees totally not more than two times the adjusted credit amount Other loans – interest of 4% per month, with no additional charges or fees
Penalties for breaching fitness test include a fine, revocation or suspension of license, or provision of additional obligations on licencee	Failure to undertake reasonable inquiries or assess suitability carries financial penalties of up to AUSD$220,000 for natural persons and AUSD$1,100,000 for body corporates. Licences can be suspended, cancelled or amended. There are also potential for criminal sanctions against individual lenders for the most serious breaches of obligations