Consumer Affairs Victoria

Regulating the cost of credit

Research Paper No. 6 March 2006

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Paper for Consumer Affairs Victoria

Victoria
The Place To Be

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Published by Consumer Affairs Victoria,
452 Flinders Street, Melbourne, Victoria, 3000.

Authorised by the Victorian Government,
452 Flinders Street, Melbourne, Victoria, 3000.

Consumer Affairs Victoria is a division of the Department of Justice.

Printed by Impact Digital, 32 Syme Street, Brunswick, 3056.

Preface

In July 2005, the Minister for Consumer Affairs in Victoria, the Hon Marsha Thomson MLC, initiated a major review of Credit, led by James Merlino MP with assistance from Consumer Affairs Victoria.

To assist this Review, the National Institute for Economic and Industry Research was commissioned to prepare this Discussion Paper on *Regulating the Cost of Credit*. The views expressed by the paper's authors, Dr Ian Manning and Ms Alice de Jonge, are their own and not necessarily shared by Consumer Affairs Victoria or Mr Merlino.

The Review is especially concerned to ensure vulnerable and disadvantage consumers have access to 'safe' and affordable credit and that effective controls exist to prevent predatory finance practices.

There are a range of market and regulatory measures in place now to deal with these matters. The Paper examines the rationale, background and operation of a number of these measures including the use of interest rate caps. Whether interest rate caps continue to be relevant in today's more competitive environment is a matter for the Review to consider.

Consumer Affairs Victoria welcomes feedback on the Discussion Paper, especially while the Consumer Credit Review is taking place. Feedback can be forwarded via creditreview@justice.vic.gov.au or to the Consumer Credit Review, GPO Box 123A, Melbourne, VIC 3000.

DR DAVID COUSINS
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Abstract

Abstract: Government controls over the price of credit have a long history, beginning in Biblical times.
In British history, borrowing and lending were first de-regulated in 1854, then were gradually re-regulated culminating a century later in a period of very tight policy control over the volume, direction and price of credit. This was followed in the late 20th Century by a second de-regulation, one aspect of which was a revival of high-cost fringe moneylending. The current policy preference in Australia is to rely on competition to ensure that fair terms are available to borrowers, but in addition Victoria retains its historic interest rate caps. NSW has reacted to the recent rise of pay-day lending by moving to include fees in the calculation of the capped interest rate for short-term consumer lending. Cost analysis suggests that a structured cap would be more appropriate.

"Why governments limit the price of credit" 1

Ever since the invention of money, there has been an intimate and often contested relationship between government and the financial sector. Governments issue the money on which the financial system is based and enact the forms of contract from which it is built. It is inevitable that the financial sector depends heavily on government, not just for the law and order that is necessary for all kinds of production and trade, but for very legitimacy of the stuff in which it deals and for the enforcement of the contracts that it writes. Equally inevitably, there will be disagreement between institutions in the financial sector and governments over the expectations of governments concerning financial sector behaviour, and over the types of contracts that should be enforced.

A second peculiarity of the finance sector also implies a close but potentially conflictual relationship with government. Despite the common use of the word 'product' to describe the various contracts the finance sector has on offer, the sector does not actually produce anything directly useful. It does not produce food, clothing or houses, or even services like haircuts. In other words, it does not contribute directly to the standard of living. Rather, it administers an important part of the web of contracts on which business relationships are founded, and having thus assisted with the flow of production, helps to determine who is entitled to what. Like government, the finance sector is essential to the working of a modern economy. Governments depend on the sector for the detailed administration of financial obligations and entitlements without which capitalist production cannot take place, but do not always agree with the patterns of production and allocations of wealth that result.

These characteristics – money, contract law and essentially administrative, allocative rather than directly productive functions – bind government and the financial sector in a close but mutually watchful relationship. A fundamental judgement underlying this paper is that the finance sector is in no position to declare itself autonomous, and that governments are entitled to exact a behavioural quid pro quo as the price of the foundations which they provide for the sector.

1.1 Finance and justice

Since it is party to all economic transactions save those conducted by barter, the finance sector inevitably comes under scrutiny whenever the justice of economic affairs is discussed. Where the sector is not directly party to a transaction, but merely facilitates it by providing the medium of exchange, the relevant scrutiny concerns the adequacy of the sector's transactions services. The sector is not directly implicated in discussions of the just price that can be charged for food or clothing, or of the just wage that should be paid for labour, but can come under criticism for shortcomings in servicing these transactions, for example excessive bank fees. These discussions can become quite lively, because, taken as a whole, the inter-bank payments system is a monopoly within which there are significant opportunities for profiteering, provided tacit agreement can be maintained between the member banks.

The finance sector comes under rather more intense scrutiny when it is itself party to transactions – when it borrows and lends (Wilson 2004). On the borrowing side, there has been a troubling history of defaults, particularly among fringe financial institutions, but sometimes extending into the mainstream, and governments have stepped in to protect depositors from fraud and over-optimism. On the lending side, bad practices have included making loans to mates and denying them to non-mates even when proper risk assessment favours the latter. Market power has also been used to exact excessive interest rates and, in particularly bad cases, to force people into debt-slavery ('I owe my soul to the company store'). Malpractice in loan allocation tends to be revealed when the loans go bad, but the exercise of market power strengthens rather than weakens financial intermediary balance sheets, and is not so regularly exposed. It has not proved hard to establish the theoretical possibility that financial intermediaries may misuse market power, but has proved much harder to identify actual cases of malpractice. There has also been disagreement over how market power should be controlled. Should households be expected to recognise shonky deals and steer clear of them, or should the scope for such deals be limited by regulation? Can competition between financial intermediaries be relied on to ensure their good behaviour?

Malpractice is also difficult to separate from risk management. Bias towards mates is hard to separate from the many other factors that enter into judgements of creditworthiness, and exercise of market power is hard to separate from reasonable cost-recovery from high-risk loans.

Aside from malpractice, more general questions of social responsibility arise at the level of loan allocation policy (Manning 1995). In the daily business of making loans, a great deal has to be left to the good judgement of the lender, but much still depends on general loan policy. The options can be sketched in terms of the more general debate as to whether corporations should maximise shareholder value, versus 'triple bottom line' behaviour. According to the former approach, a financier should invest to maximise his profits, allocating funds so that his loans are repaid with maximum returns. The latter approach makes a distinction between financial rates of return and social rates of return. Sometimes the social rate of return is less than the financial – for example, a casino may be highly profitable, but at uncounted cost in broken homes and white-collar crimes. By contrast, investment in infrastructure frequently generates high social returns in terms of jobs created even though the actual investment is not particularly profitable. Judgements differ on the extent to which financial and social rates of return diverge – at one extreme stand those who can discern no divergence, and at the other those for whom divergence is endemic and justifies rigorous government control of the finance sector. Stretton (2005) has recently argued that the financial deregulation of the 1980s was a moral and economic failure, and proposed a return to government direction of lending into areas with high social returns, such as housing. An alternative recent approach, pioneered by Robert Shiller, argues that the finance sector is unable to allocate funds to maximum social benefit due to lack of appropriate financial instruments (Shiller 2004). If the sector was rewarded for undertaking investments with high social benefit, and punished if its investments caused social loss, it would develop appropriate risk pricing and management. Shiller's approach is salutary in that it reminds us that the finance sector has both strengths and weaknesses, and that reform should build on the strengths.

And what are the strengths of the sector? Shiller would instance its ability to manage large volumes of transactions accurately and quickly, and its ability to manage the risks inherent in borrowing and lending, saving and investing. The sector's obvious weakness is that it contributes to booms and busts – one may instance its collective misallocation of loans to the paper entrepreneurs of the 1980s, and more recently its over-allocation of funds to the urban property markets. It also misallocates funds when social rates of return diverge from financial rates. These two problems are inter-related – speculation, whether in shares or land, has a low social rate of return, and there is an obvious case for financial innovation to render the sector less prone to speculative misallocation of funds. This will require careful distinctions between the management of inevitable commercial risks and the creation of excess risk by the sector.

However, the concern of this paper is not at this grand level, but rather with the millions of small consumer credit accounts. This paper accordingly concentrates on one small aspect of the contested relationship between finance and government, the question of whether government should cap interest and fees charged for consumer credit. It thus tackles an area where argument has been going on for centuries. With the passage of so many centuries, the arguments both for and against have been thoroughly rehearsed. A historical account of the arguments is valuable, since it puts current debates into perspective.

1.2 From the invention of private property to the first deregulation of credit

The notion of property, with its distinction between mine and thine, is fundamental to borrowing and lending. Some, but far from all, demands for restrictions on credit practices can be traced back to uneasiness with the institution of private property, particularly the disruption of community caused by the intrusion of property rights. At its narrowest, there is a strong tradition that married couples should hold their property in common, and therefore should not be able to lend to one another. The moral community whose members should hold property in common has sometimes been enlarged to the family, or to the village. Enlarge the village to the nation, and we obtain the nineteenth-century left-wing slogan 'all property is theft'. Lest this sound like thunder from the past, one has only to notice that native title in Australia and the Pacific island nations is communal rather than individual, and that there is heated current debate as to whether it should be replaced by individual title, the better to enable Aboriginal people to seek debt finance for their enterprises. (The fundamental role in capitalism of debt secured on property is discussed in de Soto 2001.)

Despite the questions raised by native title, it may be assumed that, in settler Australia, private property is an accepted and foundational institution derived from long cultural tradition – though the tradition does not wholly justify current highly individualistic interpretations of property rights. The advantages of private property in terms of the care people lavish on it, and the self-expression they achieve through it, are such that the major religious traditions accept it as a principle of social organisation, and also accept the potential for borrowing and lending that comes with it. However, the ancient texts are concerned about the disruption of community that can result from borrowing and lending, and in Leviticus 2535-37 and Deuteronomy 2318-19 there are prohibitions on the charging of interest, at least on loans made within the Jewish community.

Christianity

The Christian New Testament has extensive commentary on property, which emphasises the secondary importance of possessions compared to things of the Spirit, their nature as a gift, and their owners' status as stewards rather than proprietors. Despite passages highly critical of wealth accumulation, there is no explicit prohibition against lending at interest. Early Christian prohibitions of usury relied on the passages in Leviticus and Deuteronomy. The economist Alfred Marshall gave the following typically 19th Century explanation of these prohibitions. 'In primitive communities there were but few openings for the employment of fresh capital in enterprise… Those who borrowed were generally the poor and the weak, people whose needs were urgent and whose powers of bargaining were very small. Those who lent were as a rule either people who spared freely of their superfluity to help their distressed neighbours, or else professional moneylenders. To these last the poor man had resort in his need; and they frequently made a cruel use of their power, entangling him in meshes from which he could not escape without great suffering, and perhaps the loss of the personal freedom of himself or his children. Not only uneducated people, but the sages of early times, the fathers of the mediaeval church, and the English rulers in India in our own time, have been inclined to say, that money-lenders "traffic in other people's misfortunes, seeking gain through their adversity: under the pretence of compassion they dig a pit for the oppressed". (Marshall here quotes St John Chrysostom) (Marshall 1949 p485). Based on this type of analysis medieval Christians prohibited the taking of usury, but somewhat inconsistently permitted rent for the use of assets other than money, such as land.

Marshall's view is that interest became respectable once it was realised that capital was a factor or production worthy of reward. An alternative historic interpretation is that the needs of kings to borrow for war, and of merchants to borrow to finance trade, caused the lifting of the prohibition. In 1545 English law caught up with practice and lending at interest was legalised, subject to a cap of 10 per cent. This legal maximum was gradually reduced to 5 per cent. Here were the first caps on interest rates, introduced as part of a redefinition of 'usury' from interest per se to interest at excessive rates. (Chan J gives a history of the relevant English law in Bumiputra Merchant Bankers Berhad vs Meng Kuang Properties Berhad, High Court of Malaysia, 1990.) Though they rarely state this premise, advocates of caps still sometimes imply that moral distinction can be made between acceptable and excessive, or usurious, interest rates. We will encounter this type of argument several times in the following pages.

Islam

The Western tradition has gradually come to tolerate interest-bearing loans, but to this day the Muslim tradition is known for its prohibition on the taking of interest. It is rather less well known for its approval of profit. Combined with this approval, the Muslim prohibition on the taking of interest can be interpreted as an insistence, on moral grounds, that lenders should share risks with borrowers. Joint ventures are welcome. Buying followed by selling at a capital gain is fine. Fees for financial services are acceptable. Not surprisingly, despite the prohibition of interest, modern Western merchant bankers can easily make themselves at home in the world of Islamic banking. However, regulations designed for standard Western banking may be inappropriate for the Islamic alternative. (de Jonge 1996)

The 16th, 17th and 18th Centuries

Had the Venetians been Muslim rather than Christian, Shakespeare would have been deprived of the plot of his play The Merchant of Venice. The plot turns on an ethically hard case, that of a merchant who can only pay his fixed-interest debts when his trading fleet returns to port. In 17th and 18th Century Britain many a merchant was cast into the debtors' prison for no better reason than that his ships were wrecked. In the Muslim world merchants did not bear this risk, because their financiers were required to share the loss. In Europe fixed interest-bearing debts continued to be legal, but – perhaps partly as a result of Shakespeare's advocacy – their impact was gradually alleviated by two financial innovations: insurance and bankruptcy. The former spread the risk of loss from the merchant to the insurers, and the latter required the financier to accept losses which the merchant had no hope of repaying. What had been true in practice – a lender who financed a wrecked voyage would not be repaid – now became true in law, and at least to this small degree Western law came to incorporate the principle of risk-sharing. From 1842 nobody in Britain could be sent to prison for debt, and bankruptcy became an option for non-traders as well as traders. The state undertook to enforce contracts, if necessary by compulsory transfer of property, but would not enforce the deprivation of liberty. This reform, begun in the 17th Century, was completed by the same group of parliamentarians who legislated for the abolition of slavery. At the time, the relationship between debt and slavery was highlighted by the position of the Russian serfs, whose condition was objectively that of slaves, but who were technically debtors.

The institution of bankruptcy put the onus on lenders to assess and bear the risk that borrowers might go bankrupt. The question of how far the state should go in assisting debt recovery is still live, with South Africa currently moving to limit debt recovery in cases of reckless lending (Credit Law Review 2003). At the opposite extreme, lenders in the USA are campaigning to make it harder for debtors to declare bankruptcy. On a more modest scale, in the Australian states permissible debt collection practices are continuously under review. Whether state refusal to enforce repayments that threaten deprivation of liberty can be substituted for caps on the cost of credit is also a live question.

The Merchant of Venice not only concerns the morality of exacting repayment from a merchant whose ships have been lost at sea. The reason why the merchant was in debt was not that he needed cash to finance trade, but that he had made an interest-free loan to a friend who needed cash to court a rich widow. If the courtship succeeded, the loan would be repaid, but if it failed it would not. A prudent assessment would be that there is large risk in such a loan, and the lender should quietly refuse. The merchant, of course, was a generous man, and lent. Even so, the play raises the question as to the moral status of loans according to purpose. Against a background where all borrowing and lending was treated with suspicion, it was easier to justify a loan to a merchant who had the prospect of profit than a loan to finance a courtship. Given that the doyen of late 19th Century English economists justified interest as a claim on profits, it is not surprising that earlier moralists were uneasy about loans to finance consumption.

Against the political background of Europe in the 16th and 17th Centuries, moralists were also occupied with the case of loans for war finance. Wars are a negative-sum game, yet kings were often desperately anxious to finance them. Here was an opportunity for financiers to make high-risk loans, and for persuading kings to guarantee the financiers' requirements even if it meant impoverishing their nation. The tax burdens that resulted from wars financed by borrowing lay behind the moral condemnation of government borrowing – a condemnation with strong echoes in present-day financial sector insistence on balanced government budgets. Once again, the distant past echoes into the present.

In the late 18th Century the movement for free trade addressed the interest rate cap of 5 per cent, arguing that it should be abolished in the name of liberty. The classic defence of 'the liberty of making one's own terms in money-bargains' remains Jeremy Bentham's Defence of Usury, written in 1787. Bentham addresses a series of arguments then current for interest rate caps.

1. To the argument that usury is bad by definition he replies that it is impossible to define a usurious rate, for who is to say that an interest rate agreed between gentlemen is too high, or for that matter too low?
2. He counters the argument that the interest rate cap curbed prodigality by asking whether anybody is in a position to prevent a spendthrift from getting rid of his assets. And who will grant loans to a person they know will not be able to repay, whatever the rate of interest? An interest rate cap, therefore, has no role in the discouragement of prodigality.
3. To the argument that the interest rate cap benefits the indigent borrower he replies that either the cap is high enough to cover the risk of lending to an indigent person, in which case it has no effect, or is too low to cover the risk, in which case the indigent person is denied the loan. By preventing the making of loans that might be helpful, the cap is accordingly against the interests of indigent persons.
4. He argues that regulating markets to protect lenders from risky lending is not necessary, since lenders should be able to assess the risks for themselves and bargain a rate of return accordingly.
5. Finally, he argues that it is unnecessary to regulate markets to protect simple people from deceit, because people are not idiots.

All of these arguments are still current, particularly the third and fifth and the underlying assumption that competition between lenders would give borrowers access to funds at reasonable rates. Even in the 19th Century there was much debate. The tide of utilitarianism rose slowly, and a lengthy campaign was necessary before the financial deregulation of 1854, which abolished the British interest rate cap. However, one act of deregulation cannot quell an argument that has been going on for millennia. Over the following century the tide gradually turned towards re-regulation, culminating with detailed requirements imposed on the financial sector (particularly the banks) during and immediately after the Second World War. We now trace the gradual lead-up to this second phase of regulation.

1.3 The re-regulation of credit after 1854

The financial deregulation of 1854 was a triumph for free-market economics. In the following decades the trend was towards re-regulation – gradually at first, then with considerable force as the war economy of 1939-45 was converted to an economy managed for full employment. We consider first the 19th Century intellectual background, then the increase in concern over fringe lending, and finally the rise of Keynesian economics.

Intellectual uncertainties

Though the interest rate deregulation of 1854 settled the practical question of whether interest rates were to be market-determined for the greater part of a century, it did not settle the more academic question of the legitimacy of interest. The late 19th Century was the heyday of the labour theory of value. This theory extended the work of David Ricardo, who had concentrated on the rent of land. His argument had had two simple steps.

- Land is scarce, and hence must be rationed. Landowners therefore receive rents.
- However, the landowners did not produce the land and do not have to take any positive action to ensure that it continues to provide its services. Therefore they do not deserve their rents.

Marx extended these propositions by assigning the value of all production to labour. Payments to capitalists, however much they might reflect scarcity of capital, were accordingly undeserved. The Austrian school of economists, Bohm Bawerk prominent among them and Hayek their successor, defended capitalist practice by developing the theory that interest was a reward for waiting for the superior productivity of roundabout methods of production; in short, a reward for saving. Marshall was at pains to distinguish the undeserved rent of land from the deserved quasi-rent of the capitalist (Marshall 1949 p353). In Australia, the theory of the undeserved rent of land was influential in the introduction of the progressive land tax, but the legitimacy of interest was never seriously challenged.

Marshall's justification of the legitimacy of interest applied only to savings that were productively invested. Like so much else in liberal economics, the coherence of this theory depended on demand and supply. The supply side rested with households, which would increase their savings if suitably rewarded with interest payments. The demand side rested with business, which would increase its investment in productive capital if borrowing costs were low enough. To quote Marshall again: 'Thus then interest, being the price paid for the use of capital in any market, tends towards an equilibrium level such that the aggregate demand for capital in that market, at that rate of interest, is equal to the aggregate stock forthcoming at that rate.' (p443)

But what if social returns diverge from financial returns? A classic case here was the railway investments of the colony of Victoria. The colonial railways were barely profitable financially, but opened up the land for farming, so making possible an increase in colonial incomes that amply compensated for the poor financial returns of the railways themselves. Cases like this continue to appear, and the World Bank, AusAID and other development financiers regularly assess them when distributing soft loans and grants. They provide loans at less than commercial interest rates to projects assessed as having social rates of return in excess of their expected financial returns.

In the 19th Century, as now, one of the major complaints against the financial system was that of small businesspeople short of working capital. By the end of the Century all the Australian colonies had founded government banks with the aim of filling two gaps in the commercial market: providing an outlet for the small savings of the working class, and providing loans to small business, particularly farmers (Butlin 1961 Ch 12). In the 20th Century these savings banks extended their loans to the support of home ownership. In both cases the state banks provided loans at lower interest rates than the commercial banks. Here was a case of governments pursuing social policies by directing flows of finance, rather than leaving the business of lending to the market. Effectively, people borrowing for approved purposes had access to capped loans, though loans in general were not capped.

It should be noted that interest rate caps for approved purposes must be complemented by regulations which ensure that funds are made available, and not transferred to uncapped lending, where profits are presumably greater. The government savings banks of the first half of the 20th Century did this by tapping a distinctive source of funds – small household savings. These banks minimised borrowing costs by offering pass-book accounts with limited transactions services (no cheques) and low interest returns. An alternative method of ensuring that funds are provided for preferential, capped lending is simple command and control. Japan, Taiwan and South Korea are well-known for their application of this technique to industry finance, but it was also used in post-war Australia.

With the encouragement of borrowing to finance home purchase, it became normal for Australian households to be in debt during the home-buying phase of the life course. This provided a precedent for mass consumer borrowing. Home purchase was not a business investment of the kind envisaged by Alfred Marshall when he justified borrowing to finance investment, but it had similarities. A house is an asset that can be used to secure a loan, and home ownership saves on rent and has tax advantages and therefore yields a cash flow that can be used to service the loan – all this, in addition to advantages like security of tenure and freedom from landlord requirements. No wonder home purchase was a popular justification for borrowing. Even so, the switch to home-buying financed by mortgage breached a psychological barrier. It was no longer necessary for consumers to save up before they bought.

The control of fringe lending

Even further removed from the world of commercial banking than the small businesses and aspiring home owners served by the government savings banks was the experience of the poor. Marshall, quoted above, implies that, by the beginning of the 20th Century, economic growth had lifted the poor of England out of the clutches of the moneylenders, but in this he was unduly optimistic. Social welfare agencies reported quite the reverse, raising the question as to the responsibilities of the state in circumstances not contemplated by Bentham. What should be done when neither borrowers nor lenders were gentlemen? Bankruptcy was an expensive procedure involving state administration of the bankrupt estate, not suited to the relief of poor debtors with negligible assets. A new generation of social reformers argued that the government should control moneylenders who were exploiting the poor.

In Victoria, the control of moneylending began with provisions allowing the courts to re-open loan contracts that they considered harsh and unconscionable. The Money Lenders Act of 1906 was modelled on the English Money Lenders Act of 1900. The Victorian Act excluded lending by banks and pawnbrokers, the former because they had become a Federal matter under the Constitution, and the latter because their potential connection with criminal second-hand markets was thought to require separate legislation.

Introducing the Bill that became the 1906 Act, the Victorian Attorney General recalled that the British legal tradition had included Usury Acts in the past, but that attempts to cap interest rates had been abandoned. This had allowed moneylenders to exploit ignorant and desperate borrowers, and there was need to provide such borrowers with means of redress. However, the circumstances of borrowing differed so widely for different loans that no single rate cap was considered appropriate. Like Britain, Victoria put its faith in the willingness of borrowers to request review of their loans in the courts, and the ability of the courts to recognise and disallow harsh or unconscionable contracts. Under the 1906 Act relief was only available where money had been lent at 12 per cent and above, thus indicating the lower bound of unconscionability (the prime rate at the time was around 4 or 5 per cent). By amendment during the debate on the Bill, the 12 per cent was to be calculated including all fees that were part of the contract, defined as payments apart from the repayment of principal.

In England, the 1900 Act was found to be ineffective, partly because the courts had difficulty in recognising harsh or unconscionable loans. In 1927 the English Money Lenders Act was revised to include specific mention of 48 per cent per annum as a rate above which the onus of proof would fall on the moneylender to show that the rate was not harsh or unconscionable. Below 48 per cent the onus of proof would fall on the borrower. In the House of Commons debate there was some discussion of how the 48 per cent should be calculated, and it would appear that fees were excluded, but the Act prohibited the charging of fees for preliminary expenses. Both the proponents and opponents of the Bill professed to have the interests of the poor at heart. Opponents predicted that the cap at 48 per cent would drive out of business the 'decent moneylender' of small amounts over short periods, and argued that moneylenders' mark-ups were not excessive compared with those charged in other forms of small trading business. The withdrawal of decent moneylenders from the small-amount, short-term market would force poor borrowers into the hands of illegal moneylenders, who used standover tactics rather than legal processes for the recovery of debts. In contrast, the proponents of the Bill were on the side of the angels. Money lending interest rates above 48 per cent was branded as an iniquitous imposition on the downtrodden of the slums, practised by men whose faces were those of the devil incarnate. The last speaker in the debate made the intriguing comment that 'the evils of money lending reflect the extremes of wealth and poverty in our midst'.

Despite its propensity to follow developments in Britain, Victoria did not update its Money Lenders Act till 1938. The provision that the courts could re-open contracts with harsh and unconscionable interest rates remained, with a general indication that such rates should be calculated including all payments in excess of principal, including fees. However, this was not very precisely expressed. The legislators discussed the merits of the English specification of 48 per cent, but did not include it in the Act. Instead, they provided that maximum interest rates could be set by regulation, their apparent intention being that there would be a schedule of maximum rates appropriate for different classes of loan. Critics of the Bill who argued that this would not work were proved right – it apparently proved impossible to draft appropriate regulations, so the English cap of 48 per cent was inserted into the Victorian Money Lenders Act by amendment in 1941. There it has stayed ever since.

The rise of Keynesian economics

Meanwhile, market determination of interest rates came under popular attack. In Victoria, the reputation of the finance sector, to say nothing of the self-confidence of the sector itself, was undermined by the depression of the 1890s, and a further, global undermining occurred as a result of the depression of the 1930s. Bad behaviour by the banks was held responsible, and large sections of the public sought vengeance.

An academic justification for re-regulation of the financial system, and in particular the banks, was provided by the development of Keynesian macroeconomics. The exact content of the Keynesian revolution is still debated, but one element was a sharp break with Marshall's theory of interest (Keynes 1936, chapter on liquidity preference). Instead of envisaging the rate of interest as determined by equilibrium between the supply of savings and the demand for new capital, Keynes incorporated into his system an interest rate determined by the supply and demand for money as against other financial assets. In this he was merely formalising established Bank of England practice – the Bank already influenced market rates by its dealings in the money market. The difference was that the rate of interest was no longer conceptualised as an essential return to Thrift, but as a macroeconomic control variable to be manipulated in the interests of full employment.

The adoption of Keynesian macroeconomic management after the Second World War involved the Commonwealth capping both the borrowing and lending rates of interest charged by the trading and savings banks. Fees were not capped, but by 1990s standards remained low, perhaps because of the conservative culture of the banks but also because the proliferation of fees had to wait for the invention of electronic account-keeping. Lending rates were capped so stringently that very little lending took place below the caps. Borrowing rates were capped so as to allow the banks a conventional profit margin. All of this was done in the interests of macroeconomic control, and was unrelated to the older legal tradition that disallowed harsh and unconscionable contracts.

In 1950 the overdraft rate was capped at 4.5 per cent with the actual average rate around 4.25 per cent. Real interest rates were negative, due to the burst of inflation associated with the Korean War, but they became positive as inflation fell during the 1950s. Both the borrowing and the lending rates gradually drifted upwards, as did the maximum rate for housing loans from savings banks, reaching 8.25 per cent in 1970, with actual average rates slightly below. With the Consumer Price Index at around 4 per cent, real lending rates were positive (Norton, Garmston and Brodie 1982).

Nominal interest rates lagged the breakout in inflation in the 1970s, and for most of the decade real rates were negative. Even in 1980 the capped lending rate of 10.5 per cent was barely positive given the inflation rate that year. Understandably, there was a gradual increase in bank loans exempt from the cap. Because of these exemptions, the actual average loan rate was above the cap for many years during the 1970s. There was an even more rapid increase in uncapped loans through non-bank financial intermediaries, the chief of which were bank-owned. The home mortgage lending rates charged by the non-bank finance companies in the 1950s were not much above the savings banks, but by the 1960s were diverging by 4 percentage points or so – i.e. around 9 per cent compared with 5 per cent. In 1980 they averaged 13.4 per cent compared with regulated caps of 10.5 per cent, and an inflation rate of 10.2 per cent.

The consistently higher returns on non-bank financial assets resulted in the non-bank sector growing faster than the banks. In the two decades to 1973 bank assets contracted in real terms, and non-bank assets grew. This did not seriously affect the profitability of the banks as corporate entities – after all, they owned many of the non-banks. However, bank loans at capped rates were rationed with increasing severity. The banks required top-notch collateral and conservative valuation ratios. Even then, loans were often restricted to people with a record of prior saving with the bank. As a result, housing finance came to depend on a mixture of first and second mortgages (the first with the bank, the second with its non-bank subsidiary) and other consumer finance became largely the province of non-bank finance companies, operating under state rather than Commonwealth regulation. The states did not regard themselves as macroeconomic managers, and made no attempt to extend Commonwealth monetary policy to the financial intermediaries under their control.

Given two decades of co-existence between a tightly regulated sector and an essentially unregulated sector, one may ask why the transfer of assets to the unregulated sector was not faster, and why the divergence of interest rates was fairly moderate. Part of the answer would be that the banking sector has the privilege of credit creation, and this advantage remains even when its regulator insists on reining in the growth of credit in the interests of monetary policy. Again, the regulator allowed interest rates to creep upwards. Allowing for risk and for other benefits to depositors (chiefly liquidity and ready transfer), the competitiveness gap between the banks and the non-banks was not as wide as their relative interest rates would indicate.

On the borrowing side, the non-banks gradually widened their range of consumer loans from financing home purchase through mortgages to hire purchase of vehicles and other consumer durables that could, in theory, be repossessed, to straight personal loans without collateral other than the consumer's word and income-earning prospects. This reflected a gradual relaxation in social judgement from Marshall's defence of borrowing restricted to the finance of productive investment to something more akin to Bentham's defence of the prodigal borrower. The social sanctions against debt diminished as it became less fashionable to judge the decisions of others.

Fringe lending during the post-war period

Despite the growth of the non-bank financial intermediaries, pawnbrokers and traditional moneylenders fell on hard times during the 1950s, and many ceased business. The reasons include the following.

- Banks were discouraged from lending to moneylenders, who accordingly had difficulty in raising finance for their operations.
- Demand for high-risk loans fell due to the general prosperity and high level of employment.
- In Victoria if not in other states the cap on interest rates discouraged moneylending.
- Moneylending and borrowing from moneylenders were both stigmatised in most sectors of society.

An indicator of the unimportance of cash moneylending was the social welfare agencies' lack of concern about cash loans. In evidence to the Henderson Poverty Inquiry of 1973-5 they disregarded moneylenders, but argued for stricter regulation of retailer lending. One or two notorious retailers specialised in lending small sums to high-risk borrowers, tied to the purchase of the retailer's goods. Despite the lack of availability of short-term high-risk cash loans, the social welfare agencies did not report that there was any major resort to illegal loans, apart from transactions associated with illegal gambling.

1.4 The second deregulation and its aftermath

The deregulation of interest rates during the 1980s was part of the government response to stagflation. Much has been written about why the Australian and other English-speaking governments responded in this way, and the reasons will doubtless be re-evaluated by historians for centuries yet. However, it is important to note that the deregulation of the 1980s was contested to a degree that the deregulation of 1854 was not, and that many of the control instruments erected during the era of re-regulation are still with us, even though some of them are dormant like the Commonwealth legislation allowing for quantitative controls of non-bank credit.

The retreat from Keynesian economics

During the 1960s the Commonwealth viewed the gradual contraction of the banks vis a vis the non-bank intermediaries with concern for the effectiveness of its monetary policies. The view that the management of aggregate demand required further control of the non-bank financial intermediaries gained ground, and resulted in the Financial Corporations Act (Cth) of 1974, which obliged financial corporations registered under state or territory legislation to supply information on their operations to the Reserve Bank and to the Commonwealth statistician. The Act also provided that, in respect of financial corporations with total assets exceeding five million dollars, the Reserve Bank could promulgate regulations on asset ratios, the volume and direction of lending, and maximum interest rates. As it turned out, these powers have not been used.

The breakout of stagflation in the mid-1970s began a remarkable reversal of policy (Hughes 1980). The Australian stagflation had both domestic and overseas causes. The major domestic cause was a breakout in wage inflation, due to a breakdown in union restraint. The imported cause was the OPEC inflation. Theoretically the imported inflation could have been denied entry by raising the exchange rate, but in the post-war period exchange rates had been as far as possible fixed, to encourage trade and investment. Maintenance of this fixed exchange rate while export prices increased rapidly meant that bank assets increased faster than non-bank financial assets for the first time since the beginning of bank interest rate controls.

The Commonwealth's first, monetarist, reaction to the inflation was to tighten monetary policy. However, it also began the decontrol of bank interest rates and allowed the issue of the country's first credit cards, which bore borrowing rates well above the controlled rates for other bank loans. Full control of the money supply implied the extension of controls to non-bank intermediaries, but no attempt was made to use the power to regulate awarded to the Reserve Bank in 1974. In 1984, the waning of monetarism and the revival of neoclassical economic theory led to full decontrol of bank interest rates. Financial innovation made it difficult to define, let alone control, monetary aggregates, and the Reserve Bank withdrew its monetary targets a few years later. In effect, the banks and non-banks were put on an equal footing by de-regulating the banks, rather than by extending regulation as provided in the 1974 legislation. These changes had the expected effect of allowing the banks to fold their non-bank subsidiaries back into themselves. They also permitted the banks and some building societies to engage in a disastrous adventure in the financing of speculative entrepreneurs, leading to financial breakdown and a recession in the early 1990s. The Commonwealth's considered reaction to this came in 1998, when prudential controls under the Banking Act were extended to all deposit-taking institutions.

The neoclassical economics that came to provide the basis of Commonwealth policy is agnostic as to the purposes of national economic life, but adamant on the importance of competition as a means of reconciling the pursuits of individuals. The Commonwealth's Keynesian appetite for direct credit controls was therefore replaced by a priority for the promotion of competition. Since 1998 the Reserve Bank has had a responsibility to promote competition in the payments system, while since 2003 the Australian Securities and Investments Commission has implemented the approach throughout the financial sector (Lanyon 2004). A principle of competition is to welcome new entrants to the market. In principle, therefore, moneylenders were once again welcome. They were now seen as adding to the range of competitive financial services – a far cry from their pariah status in the post-war period.

Recent macroeconomic policy

The deregulation of bank interest rates and the lifting of all quantitative controls over bank balance sheets did not mean a complete return to the financial conditions of the early 20th Century. Australia still has a Reserve Bank, and that Bank still intervenes to influence market interest rates in the interests of macroeconomic policy. From the early 1990s macroeconomic policy gave further impetus to the revival of moneylending.

To speed recovery from the recession the Commonwealth Treasury and the Reserve Bank encouraged a growth in consumer indebtedness in tandem with a policy of reducing government indebtedness (Brain 1999 Ch 9). Technically speaking, they have pursued a permissive monetary policy. So long as the inflation rate was satisfactorily low, the financial sector was allowed to increase its outstanding loans. The hope was that the flow of funds which governments had released by their abstention from borrowing would be absorbed by private business anxious to invest in Australia's future (in the phrases of the time, governments could not pick winners and should not crowd out the private sector), but the reality was that banks found it more profitable to increase their loans to households, particularly for house purchase but also for general consumption. The easy availability of loans for the purchase of dwellings resulted in a boom in house prices, or more accurately in suburban land prices, since increases in productivity in construction meant that the cost of the dwellings themselves did not increase. This in turn brought capital gains to suburban households, who became all the more willing to borrow. As a result of the capital gains, the aggregate balance sheet of the Australian household sector does not appear to be seriously loaded with debt, but the debt-service ratio (interest and loan repayments in relation to income) is now at historically unprecedented levels (Manning 2004).

It has been said that Australian macroeconomic performance during the decade from 1993 was brilliant (Argy 2003 Ch 2). GDP has grown despite a drought that depressed rural production and external circumstances that were not always favourable – one may instance the Asian financial meltdown. However, other commentators fear the consequences of the land boom, especially the increase in both household and overseas indebtedness.

The revival of fringe moneylending

The debt boom reversed the factors that led to the post-war withering of moneylending. On the supply side, with the abandonment of quantitative controls over the finance sector, finance is again available for fringe moneylending, pawnbroking and the like. On the demand side, several factors have been important. As a direct consequence of the increase in consumer indebtedness, there has been an increase in the number of would-be borrowers whose bad credit records require them to borrow from fringe lenders or not at all. High indebtedness also increases the chances that a household will resort to a fringe lender for additional credit, having exhausted its credit-worthiness at the bank. Various psychological factors are also likely to contribute. It may not be far from the truth to argue that debt is fashionable. It is widely advertised. The Commonwealth government seems to approve of it. A decade of capital gains has made households feel that it is safe to be in debt – even that it is desirable to be in debt to harvest tax-winnings from negative gearing. They may also reason that, if the worst comes to the worst, the accumulating National Superannuation lump sum provides a backstop that can be used to repay debt, even if it means retiring on the age pension.

More speculatively, it has been claimed that the increase in demand for fringe credit reflects a decrease in employment security (Wilson 2002). This claim is supported by the increase in the proportion of the population with casual jobs and/or jobs with variable hours. However, it is not so strongly supported by evidence of increased inequality in the earnings distribution or of reduced typical job tenure. What is certain, however, is that with the increase in average indebtedness, household vulnerability to fluctuations in income is now much more widespread than it was when consumer credit regulation was last reviewed a decade ago, and similarly households have become more vulnerable to increases in interest rates. Australia is in uncharted territory: consumer indebtedness has never before been as high in relation to income.

1.5 History and the future

Taking the sweep of Western history from the Middle Ages to the present, there has been an increase in the respectability of borrowing. In Shakespeare's time it was frowned on, though the upper classes might indulge. In the 19th Century borrowing for business purposes became thoroughly respectable, but economics gave no justification for borrowing for consumption. Such borrowing was the last resort of the desperate poor, and the academic defenders of capitalism preferred to believe that there weren't any such people. By contrast, consumer borrowing has now become so respectable that it formed the centrepiece of Commonwealth macroeconomic strategy in the recovery from the 1990 recession. The resulting high level of household indebtedness, coupled with an individualistic refusal to judge the motive for borrowing, has underpinned the revival of fringe moneylending.

We do not know how long this revival will continue. A business-as-usual projection in which household debt continues to accumulate, and with it resort to fringe moneylenders, is difficult to believe, since it would exhaust even the current elastic tests of creditworthiness. At the opposite extreme, there are those who predict financial disaster. Victoria still has the monuments if not the memory of the land boom of the 1880s and the depression that followed it. More recently, Japan has experienced little economic growth since the conclusion of its land boom fifteen years ago. Were the current high level of household indebtedness to precipitate a financial crisis such as happened in Victoria in 1890 or in Japan in 1990, widespread default would result in major restructuring of the financial system. The fate of the fringe moneylenders in such a restructuring is hard to predict.

More optimistically, a 'soft landing' scenario is currently popular, in which resources released by a revival in household saving are switched to the construction of infrastructure and the rectification of environmental damage. In this scenario household debt remains high but under control, and fringe lenders prosper.

In addition to the gradually increasing respectability of borrowing to finance consumption, the historic record also makes clear the difficulty of reconciling individualism and freedom. At its most stringent, respect for creditor's rights can result in individual borrowers becoming debt-slaves. Since the 19th Century there have been safeguards against this, the chief being bankruptcy, but there are many other arrangements for the management of over-indebtedness so that it does not become debt-slavery, such as requirements that lenders should make minimum inquiries as to the credit-worthiness of the borrower before the state will enforce the contract. Interest rate caps may have a place in this context. The higher the rate, the more likely the borrower will not be able to pay, therefore prohibiting loans at high rates helps to prohibit loans with a high probability of causing over-indebtedness. However, as Bentham pointed out, this is a blunt instrument. Many loans at high interest rates are indeed repaid and are, prima facie at least, to the mutual benefit of both borrower and lender; again, loans at low interest rates sometimes become onerous, usually due to unexpected changes in the borrower's household circumstances. Caps on interest and fees cannot substitute for bankruptcy and allied provisions.

A second strand of argument that was important when caps were reinstituted following the deregulation of 1854 concerned the relative bargaining power of lender and borrower. Bentham was at his weakest at this point. It is not enough just to assert that borrowers can't be idiots. During the second deregulation of the 1980s governments were concerned to equalise bargaining power by promoting competition between lenders. They licensed additional banks and insisted on uniform description of loan 'products' to facilitate comparison. However, there is always a risk in competition between financiers, which is that they will seek market share or short-term profit at the expense of asset quality. Faced with failing banks, regulators have usually taken the anti-competitive route of amalgamating the sick bank with another stronger one. The result is that Australia has four major banks, and competition in banking is oligopolistic rather than perfect (for comparison with South Africa, see Task Group 2004). The same might be said for fringe moneylending, where competition tends to be limited at the neighbourhood level – though telephone and internet-based operators are having some effect.

The mere presence of oligopoly is hardly a sufficient argument for price controls – after all, a high proportion of Australian consumer purchases are from oligopolists, starting with the two great retail chains. However, the welfare agencies point to the existence of two types of borrower who may require the protection of interest rate caps. One is the eternal optimist who seriously underestimates risks – in Bentham's terms, the profligate. The other is the truly desperate modern-day equivalent of the 19th Century and depression-era indebted poor. Ramsay disputes this dichotomy, arguing that all consumers have their moments of qualified rationality; their impulses and moments of over-optimism (Ramsay 2004). A cap can have the effect of denying credit to the over-optimist, and may reduce the need for resort to stronger remedies such as bankruptcy. Financial optimists merge into people who borrow out of desperation. In their case, whatever temporary relief borrowing may offer, it is no solution for poverty unless the proceeds are invested in income generation. A cap that effectively denies loans to the desperate consumer borrower may assist in driving home this fact. (One might add that welfare agencies administering low-interest or no-interest loans restrict their lending to occasions where income is likely to increase as a result, either directly through investment in small business, or indirectly, as where a refrigerator reduces time spent in food preparation and so releases time for paid work.)

Where the concern is potential profiteering by lenders, there is a strong argument for caps set to reflect lending costs. To date there has been little effort to do this, but South Africa is contemplating a cap which differentiates between loan establishment costs (incurred at the commencement of the loan), loan administration costs (incurred periodically through the life of the loan) and costs related to loan amount (the cost of funds and the risk premium) (Credit Law Review 2003).

The question of the relationship between interest rates and loan purpose is little discussed at present, but shows signs of revival (Stretton 2005). In strong contrast to policy two generations ago, is not currently fashionable for governments to favour one loan purpose over another. However, there are still glimmers of purpose-related controls, for example limitations on access to credit card debt in gambling venues. Should current levels of consumer indebtedness be judged excessive, the pendulum may again swing, and caps be seen as part of credit-direction policy aimed at encouraging household savings. Thus there may be a cap deliberately set to deny credit for risky consumer borrowing – complemented by encouragement of high-risk venture capital for business, and perhaps by lower caps and reserved flows of funds for such worthy items as home purchase.

1.6 Conclusion

Our review of the arguments for and against the regulation of credit may be summarised as follows.

Usury and the market

At one extreme lies the old religious command that lending for consumption purposes should be prohibited; at the other the libertarian view that whatever contracts are entered into between gentlemen should be legal and enforced. A milder version of complete prohibition allows lending provided rates are not usurious – but this view of itself cannot serve to define a particular rate which is the limit of acceptability. A milder version of the voluntary agreement argument is that enforcement should be restricted to agreements that meet standards of procedural fairness and do not threaten debt-slavery, but that beyond this point controls infringe liberty.

Cost-recovery and competition

Controls on the cost of credit have been advocated to ensure that profitability is limited to acceptable levels, and in particular that lenders do not exploit borrowers. This argument reflects a view that competition is inadequate to control costs and profits in consumer lending, particularly in lending to marginal borrowers who lack collateral and whose credit-worthiness cannot be quickly assessed from a checklist. Counter arguments have been mounted from two points of view. One is to assert that competition is effective so that there is no need for controls. Alternatively, it may be admitted that competition is weak, but argued that it can be fostered to the point where controls are not necessary. An allied argument is that controls are counter-productive, increasing the costs of borrowing by marginal borrowers by limiting competition or imposing extra costs on lenders.

Credit denial

A purpose of controls can be to prevent lending which is likely, because of the high rates charged, to push the borrower into a downwards debt spiral. Against this, it is claimed that bankruptcy is available to arrest such spirals, and that it is unfair to deny credit. A second form of credit denial is related to the purpose of borrowing – for example, low caps may be imposed on consumer borrowing to discourage lenders from making consumer loans – and is likely to be integrated into economic development policy. The counter argument is that governments should not deprive citizens of the liberty of borrowing by judging purpose.

“Mechanisms used in Australia to regulate the cost of credit” 2

The mechanisms currently used in Australia to regulate the cost of credit include fostering competition, regulating the circumstances under which loans can be recovered so that excessively costly loans are not recoverable, and direct caps.

We have already noted that fostering competition between lenders is not always easy, since it can result in the relaxation of prudential standards. Secondly, financial ‘products’ can often be varied to avoid regulation. It is not always easy to assist consumers to compare branded, differentiated loan contracts, nor to ensure that consumers have the mobility between providers that is required if high-cost lenders are to lose custom and so be forced to lower their prices.

It has not been hard to legislate against loan recovery when the borrower has no reasonable prospect of being able to repay: bankruptcy looks after this. Should it be desired, it may not be impossible to legislate to make loans non-recoverable when the lender has failed to carry out obligatory steps in the assessment of credit-worthiness – the South African ‘reckless lending’ proposal is a step in this direction. However, it is difficult to frame enforceable regulations to make loans non-recoverable on the ground of excessive interest charges. This is the history of the ‘unconscionability’ provision – courts can determine if the procedures leading up to the grant of a loan were defective, but in the absence of specific numbers (a cap) they have not been able to determine whether or not a given interest rate is unconscionable. This indeterminacy lay behind the institution of specific interest rate caps in the UK, Victoria and NSW.

2.1 Interest rate caps – the NSW experience

The Victorian cap has been in place since 1941 at the levels of 30 per cent for secured and 48 per cent for unsecured lending. The meaning of ‘interest’ has varied, at some stages including, and currently excluding, fees. The coverage has also varied, with large loans originally excluded, and with short-term (less than 62-day) loans previously excluded. A legislated cap of 48 per cent applies in the A.C.T. These caps rank as additional state-specific provisions that supplement the Uniform Consumer Credit Code, which does not contain caps.

In recent years, public debate over interest rate caps has been most lively in NSW – not unexpectedly, since the land boom has resulted in greater household indebtedness in Sydney than in the other major cities.

We have already described the history of legislation regulating moneylenders in Victoria, where the cap of 48 per cent has been imposed since 1941. In the same year NSW enacted its Moneylenders and Infant Loans Act, which provided that the courts could re-open credit contracts that were harsh or unconscionable, particularly if they considered the interest rate or the amounts charged for expenses, etc., to be excessive. Unlike Victoria, NSW did not impose a cap.

The Moneylenders Act and other Acts passed during the post-war period dealing with hire-purchase were superseded in 1981 by a new Credit Act, which was further updated in 1984. Consultation with Victoria raised the question of an interest rate cap, one suggestion being that moneylenders who lent at more than 50 per cent should be deregistered. The proponents of a cap were only partially successful, for the 1984 Act provided that the Commercial Tribunal of NSW could set a maximum interest rate, but did not have to. It preferred not to, and discussion of the merits of interest rate caps continued against the background of very high commercial interest rates resulting from the Commonwealth's then very tight monetary policy.

In 1991 the government asked the Commercial Tribunal to investigate the costs of consumer lending. The Tribunal reported (1992) that high-interest lending was mostly carried out by small businesses, many of which had low overheads – some did not have offices, but operated from the owner's home. The clientele comprised people with low incomes, requiring small loans of less than $2000. Such loans were not available from the banks, due to the high administration costs of each little loan. The Tribunal judged that the small moneylenders were exploiting their clients, because the clients were gullible and there was little competition between moneylenders – each moneylender tended to serve a particular suburb. The Tribunal recommended a cap of 48 per cent, in line with that in Victoria. Meanwhile the government had changed, and the Bill to introduce the 48 per cent cap was introduced by cap-proponents who were now in Opposition. This, and popular agitation about high interest rates, prompted the new government to act, and in 1993 it amended the Credit Act.

To differentiate itself from the Opposition, the government set a cap that would be relative to the prevailing level of interest rates, rather than an unchanging percentage. Its 1993 amending Act set a cap equal to four times the interest rate prescribed under the Supreme Court Act, a rate which in turn was subject to six-monthly review. At the time this rate was 10.5 per cent, yielding a cap of 42 per cent. The amending Act provided that, for loans of less than $2000 where there had been no previous credit relationship between the moneylender and the client, the cap could be exceeded by seven percentage points (i.e. 49 per cent) or by $35, whichever was the larger. It was argued that that these exemptions reflected Credit Union practice, and would be sufficient to cover establishment costs for small loans. It was intended that the cap would be calculated to include all fees and charges, but the legislation did not specify a precise formula for calculating the cap rate, and it appears that lenders could still charge fees provided they were careful in their wording. There was some principled opposition to the introduction of an interest rate cap from the mainstream financial sector, but they had to acknowledge that the caps would not affect them in practice, and the amendment was passed with bipartisan support.

The 1993 amendment did not last very long. The 1995 Consumer Credit (NSW) Act provided that the Uniform Consumer Credit Code, developed for all Australia, applied in NSW. However, the Act included additional provisions outside the Code, among which was an interest rate cap which, reverting to the 1984 approach, was to be set by regulation. A regulation was duly promulgated precluding lenders from recovering interest in excess of 48 per cent. As a result, the interest rate cap for loans of more than 62 days duration is now similar in both NSW and Victoria, with the courts having power to re-open unjust contracts even where the rate of interest is less than 48 per cent.

2.2 Payday loans

The 1990s credit boom saw a revival of moneylending in NSW, as in other states, including the new concept, imported from the USA, of 'pay-day loans' or very short-term consumer credit. A consequence at the national level was a review of the Uniform Consumer Credit Code, which, as originally enacted, did not apply to short-term credit. Presumably this was because consumer-protection provisions were not thought applicable to short-term instruments of largely transactional nature. The new moneylenders took advantage of this. In 2000 the State of Queensland, as keeper of the Uniform Consumer Credit Code, appointed a Working Party to investigate the regulation of payday loans. The Working Party (2000) reported that payday lending was of recent origin, and was carried out by a small number of businesses that ran branch or franchise networks and advertised their services. This would appear to be a different business model from the small low-overhead operators whose activities persuaded NSW to impose an interest rate cap in 1993. The main recommendation of the Working Party was that the Uniform Consumer Credit Code should be amended to bring payday lending under the Code, without ‘unintentionally catching other short-term products offered by mainstream lenders, such as bridging finance’. Inclusion under the Code would bring an obligation to disclose the interest rate charged for each loan, and the Working Party indicated that regulators should issue guidelines to ensure that this quoted rate included all fees and charges.

The Working Party considered the question of whether there should be an interest rate cap, which would completely ‘remove any concerns about usury or exploitation of vulnerable consumers by payday lenders’. The Working Party limited itself to considering a single cap rate that would include fees. Given the minimum costs of loan establishment, estimated at 45 minutes of clerical time, a cap of 48 per cent would be very tight for short-period loans while permitting possibly unconscionable interest rates to be charged for long-period loans. A cap set as low as 48 per cent was effectively a prohibition on short-term small-amount lending other than by credit card. The Working Party believed that it would be preferable ‘to allow the industry to operate in a regulated way rather than to kill the industry altogether and force consumers into the jaws of loan sharks’. Accordingly, it was against interest rate caps, and indeed recommended that ‘in order to maintain uniformity, NSW and Victoria should review the 48 per cent ceilings on interest rates in those States and the effect this will have on the payday lending market’.

This report found its way to the Ministerial Council on Consumer Affairs, who adopted its main recommendation. From December 2001 the Uniform Consumer Credit Code was amended to include short-term (less than 62-day) loans where the fees charged are greater than 5 per cent or the interest rate is greater than 24 per cent. This brought payday lenders under the requirements of the Code throughout Australia.

The extended coverage of the Uniform Consumer Credit Code applied in all states and territories including those with interest rate caps. Despite the Queensland Working Party’s recommendation that they reconsider, both Victoria and NSW retained their caps.. NSW eventually altered its regulations to define the 48 per cent cap for loans of less than 62 days as an annual percentage rate including fees, with a detailed formula which makes it very difficult to keep fees out of the cap. For longer-duration loans, the detailed formula did not apply.

These provisions engendered a lively debate in the NSW Legislative Assembly, with a strong sense of déjà vu to anybody who had read the equivalent debates from a century ago. The case for the cap was put, with much indignation, by people who considered payday loans clearly usurious due to their high annual interest rates. The main opposition to the cap came from the Revd Fred Nile, and independent member who combined conservative Christianity with knowledge of the finances of poor people derived from his experience running a mission in Sydney’s red-light district. In 1993 Mr Nile had supported the imposition of the interest rate cap, but in 2003 he argued that its extension to payday loans would simply drive poor borrowers into the clutches of criminal loan sharks.

The cap has indeed had an effect on the availability of payday loans in NSW. Whether or not the criminal loan sharks are fattening is debateable. However, there have been complaints that short-term moneylenders in NSW are trying to survive legally by concentrating on loans of 63 days duration. This has caused the NSW government to extend the fee-inclusive cap to all consumer loans whatever their duration. This new law is scheduled to commence on 1 March 2006.

“Some other countries” 3

The de-regulatory, free market fervour which swirled out of the USA and through the English-speaking countries during the 1980s was not uniform in its effects elsewhere. There are many countries where the financial system much more closely resembles the regulated Australian post-war system than the current deregulated system. Again, not all countries have experienced a consumer boom of Australian or US proportions, and Australia is almost alone in the vulnerability of its indebted consumers. The following account is based on papers by Schierenbeck (2004) and the Department of Trade and Industry (S.Africa) (2004).

In Western Europe, with variation between countries, the level of consumer indebtedness is not generally as high as in Australia and the distribution of income is generally more equal. One would therefore expect a lower demand for fringe credit, but this is not a variable that is easily measured. Though there are moves towards the negotiation of a European Union Directive on consumer credit, the area has remained one of divergent national regulations. In the UK, the 48 per cent statutory cap that survives in Victoria and NSW was abandoned in 1974, despite a recommendation by the Crowther committee that it should be retained. Among Western European countries the UK stands with Luxembourg, Portugal, Sweden and possibly Spain as lacking controls on consumer credit interest rates. In the remaining countries the controls take various forms.

- In Ireland there are no ceilings, but controls are imposed in the course of licensing financial intermediaries. A moneylender who claims high operating costs will be refused a licence.
- There may be a flat statutory ceiling, as was once the case in the UK and is still the case in Greece and Switzerland.
- Ceilings may be defined by the courts and varied with market interest rates, as in Austria.
- There may be a range of ceilings, with different interest rates for particular types of loan.
- Ceilings may be determined periodically by government, as in Belgium.
- Ceilings may be defined in relation to a reference rate or rates. In France usury rates are defined by the Banque de France every quarter at 133 per cent of the average market rate for each type of loan. A similar but more complex system applies in Italy. Germany has a rule of double the market rate – save that the ceiling is less than double when the market rate gets into double figures. Finland uses the European Central Bank reference rate.
- There may be a specific cap on default interest, as in Austria and Finland.

In the USA the situation is not unlike Australia in that consumers are heavily indebted. The income distribution is unequal, and many incomes are insecure. There is no national cap, but twelve states have caps. These caps are effective for payday loans, but not for credit cards, since they can be avoided by basing the credit card operation in an uncapped state.

Japan has a national cap, currently set at 29 per cent. However, as dramatised in Miyabe's novel 'All She Was Worth', there is a substantial illegal lending sector whose debt recovery practices leave much to be desired.

South Africa is in the process of replacing a statutory usury cap set in relation to the prime lending rate. Within this cap, it was not possible to lend profitably to small, short-term and high risk borrowers. Small loans were accordingly exempted from the cap. New legislation is now before the South African parliament to introduce caps that will apply to all consumer credit, with the actual levels being specified by regulation. It is proposed that the caps should be structured so as to reflect the most common approach to loan product costing.

“The major policy alternatives” 4

Leaving aside countries where credit is strictly controlled as part of macroeconomic or economic development policy, there are two major approaches to controls on the cost of consumer credit. The first is based on the concept of a usurious rate of interest that should not be exceeded for any loan, with the implication that lenders should either get their costs down below the cap rate, or if this is not possible should simply refuse to lend. The second approach is directed towards preventing lenders from exercising market power, and is much more sensitive to the structure of lender costs.

4.1 Two approaches to credit price caps

Concerning the first of the two approaches, we have noted that it is difficult to define a single usurious interest rate. To get round this difficulty, some countries using the approach have simply resorted to a high rate defined as some multiple of the prevailing rate, often differentiated by loan type. This approach is most defensible where the main purpose of the interest rate cap is to discourage over-indebtedness by preventing lenders from making loans at interest rates which are likely to lead borrowers into a downwards debt spiral. However, such interest rate caps imposed to prevent debt spirals are both blunt and indirect. They are blunt because the correlation between credit prices and unrepayable debt is poor: many high-interest loans can be and are repaid; some low-interest loans contribute to the impoverishment of the borrowing household. They are indirect, since the obvious method of tackling spiralling debt is improved loan assessment, backed up by limitations to permissible debt-recovery techniques (so that lenders bear some of the cost of controlling debt burdens). Even so, they may have a role as a second-tier mechanism.

The second approach, directed more towards preventing lenders from exercising market power, has much in common with the price caps imposed on monopoly providers in other industries, such as the caps on bulk transmission and distribution tariffs in the National Electricity Market. The intention of such caps is to allow service providers to earn market profits, and they are usually accompanied by service standard requirements to ensure that the providers do not profit by cutting costs at consumers’ expense. The applicability of this approach to consumer credit is contested by those who argue that that credit provision is not a natural monopoly, and that competition can be relied on to minimise prices. As we have seen, the contrary argument is that the consumer credit market is at best oligopolistic, and that individual borrowers may find themselves in a position where the lender has a considerable degree of monopoly power. It can also be pointed out that, because lenders are dealing in contracts which are ultimately enforced by government, and the scope of which is limited by government, standards of service are already regulated, much as in a natural monopoly. Why not, therefore, add a price cap? A fundamental judgement underlying this paper is that the market power approach to price caps for consumer credit is worth exploring, and that it might even yield insight into the prevention of excess indebtedness.

Following the natural monopoly precedent, the next step is to carry out a detailed analysis of industry costs and cost drivers. Though this is the approach proposed for South Africa, so far as is known it has not been applied in any other jurisdiction. The following account of industry cost patterns owes much to work done for the South African reformers, and ultimately to the Microfinance Product Costing Tool prepared by the Product Costing Resource Centre of CGAP (2004). The discussion relates particularly to the costing of small consumer loans, and does not cover the costing of other financial services except in passing.

4.2 The services provided by financial intermediaries

To begin with the basics, financial intermediaries are businesses providing two broad classes of service, transactions services and financing services.

Transactions services facilitate the settlement of debts. Though cash transfers are the hallmark of the transfer services provided by financial intermediaries, transfer services may also involve facilitating the sale and purchase of non-cash assets. Various kinds of brokers exist to facilitate transfer of assets such as shares and businesses, while real estate agents specialise in the transfer of land and buildings. Businesses that facilitate the transfer of illiquid assets make considerable use of cash and near-cash transfers, and may have strong links with, or even be part of, businesses that provide cash transfer facilities. In this area there is no absolute boundary separating financial intermediaries from other businesses.

Financing services arise as a result of transactions separated by significant periods of time. These can involve the intermediary both in acceptance of liabilities (it receives deposits) or acquisition of assets (it makes loans).

Transactions and financing service are closely related. Simple cash transactions are commonly accomplished by transferring the ownership of deposits. At the other end of the spectrum, complex business sales involve financing as well as asset transfer, and are commonly packaged by merchant banks. Despite these relationships, it is possible to distinguish businesses that are almost wholly providers of transaction services (for example, postal or telegraphic money-order businesses) and businesses that are almost wholly providers of financial services (for example, traditional moneylenders). Our present concern is with financing services, and more specifically loans, but the relationship and frequent complementarity with transactions services should be remembered.

Financial intermediaries with significant financing business may be identified as institutions whose balance sheets are heavily weighted with financial assets and generally also with financial liabilities. They incur costs in administering these assets and liabilities, and recoup their costs by charging the parties to whom they lend more than they reward those parties who lend to them. The simplest contract for this purpose is the bill of exchange: the borrower promises to pay a specific sum on a specific future date, which the lender discounts into a smaller present sum. Given the period in question, the discount can easily be expressed as a rate of interest, but for analytical purposes it comprises at least three portions.

- Compensation to cover income foregone from possible alternative uses of funds – if compensation for risk is separately accounted, this will be the so-called ‘risk free’ interest rate.
- Compensation for risks that the sum will not be repaid.
- Compensation for administrative and transaction costs incurred.

In current practice, financial intermediaries recoup these three types of cost in two ways: by charges calculated proportionally to principal and time, and by imposing fees which are precipitated by particular events such as the signing of a loan contract. All three types of cost may be recouped either way or by a combination of the two ways.

An important issue in the design of financial instruments, and hence in the determination of charging patterns, is the allocation of risk. Legally speaking, there are two classes of loan:

- Those where the liability is determined in the contract as a cash amount or series of such amounts, relief being legally available to the debtor only in very restricted circumstances such as bankruptcy or the contract being found unconscionable. Lenders bear the risk that contract will not be fulfilled due to bankruptcy as well as due to lawbreaking (as when a debtor absconds), but otherwise all risks (other than inflation risk) are borne by the borrower.
- Those where the liability is determined in the contract as a contingent amount, typically dependent on the profitability of the borrower's business ventures. There is an obvious moral hazard in such loans – the borrower will be tempted to fritter the loan away, show a loss and not have to repay – so the contracts generally include rights for lenders to supervise the use of the loan, rights which are not usually included in fixed-interest contracts.

This distinction is not hard and fast. A contingent element can be introduced into the first type of loan by insurance contracts, or other provisions limiting the circumstances in which the debtor has to pay. Similarly fixed-liability elements can be introduced into contingent loans, such as limits on the profit-share to which the creditor is entitled. However, the basic distinction remains. It is convenient to refer to loans with a schedule of definite cash payments from the debtor to the creditor as fixed-interest loans.

Even the simplest of financial intermediaries making fixed-interest loans – say a moneylender who makes loans out of his own funds – faces the decision as to how much cost to recoup from interest and how much from fees, and within the fee category, what events should precipitate charges, and how much for each. Venture capitalists making contingent loans face the much more daunting task of defining the circumstances in which they will be entitled to dividends and repayments.

With balance sheet complexity comes complexity of decision as to how much to charge for each loan product and how much to reward each class of creditor. There is considerable discretion in these decisions. Intermediaries can raise funds in various ways, and often have discretion as to what combination of interest rates, services and fee discounts to offer for these funds. Similarly, intermediaries can loan funds in various ways, again with discretion as to the combinations of interest and fees. Finally, intermediaries that also provide transactions services have discretion as to how to charge for these services. Since financial services necessarily involve transactions, intermediaries that impose transaction fees are likely to include these as part of their cost-recovery for financing services.
On the other hand, it is common for intermediaries that serve high-income personal customers to provide free transactions as a quid pro quo for low returns on deposits. Such free transactions are worth more to the customers than interest income on which they will be taxed.

4.3 Financial intermediary product costing

The conventional cost analysis for loans follows the steps in the loan-making process. Once again we follow the Product Costing Resource Centre (2004).

Institutional overheads

The first step in making a loan is to set up a business capable of doing so. This gives rise to business establishment costs, which, once sunk, do not vary with the number or value of loans made – at least until a major change is required in the scale of the business. In addition, maintenance of the business will require a minimum of ongoing annual costs. These sunk and ongoing costs have to be spread over the loans made (and any other products), and mean that there is likely to be an element of economies of scale in financial intermediation. (This is not the only reason for economies of scale, for which see below.)

Cost reductions in business overheads have been sought in two contrary directions. One is to seek to expand the business without increasing the overheads, generally by mechanisation; the other is to seek economies of relationship.

The increased scale approach seems to offer more scope for cost reductions in transactions processing than it does in lending, since the loan assessment process is more difficult to automate while maintaining any particular standard of risk assessment. The basis of credit assessment is knowledge of the probability of a loan being repaid. For large business loans there are obvious economies of scale in knowledge of industries and of the business performance of potential borrowers, not to speak of economies of scale related to sophistication in risk management. In consumer lending the amounts are generally smaller, and large lenders have tended to adopt a credit scoring approach. This has been much facilitated by access to credit bureaux.

Whether or not there are economies of scale, total business overheads are likely to increase with broad indicators of the size of the business. Both size of portfolio and events can be used as such indicators, and overheads do not seem tied to one or the other in particular. Accordingly the cost analysis provides no particular rule about whether they should be recovered from fees or interest.

Borrower recruitment

A second step involves the recruitment of borrowers, who may also be customers for other products offered by the intermediary, such as depositors. It reduces costs later in the process if borrowers can be recruited in such a way that the intermediary already knows something about their reliability as debtors. Recruitment can be fairly simple if a customer base already exists, as for store-based credit, but except where customers are personally known to the storekeeper this method of recruitment says little about credit-worthiness. Recruitment from established affinity groups, as by credit unions, can reduce advertising costs, improve credit assessment and, through group moral suasion, improve loan recovery rates.

However it is done, recruitment adds to overheads, and again there is no particular reason why these costs should be recovered from fees or interest.

Loan assessment

Making loans involves a number of activities. Potential borrowers may need advice, which may involve the lender in significant work in client education. An application form must be made available, completed and assessed, and if the loan is approved it has to be disbursed. Most of these activities involve staff time, including indirect staffing costs: training to ensure that staff know what to do, and supervision to ensure that they do it and to guard against corrupt lending.

An important function in loan assessment is refusal of credit where it is unlikely to be repaid. Examples where extension of consumer credit is not in the best interests of either borrower or lender include the following.

- Where debt is added to a load that is already difficult or impossible to service.
- Where prospects of repayment are otherwise dim through lack of uncommitted income (including people with high spending commitments on necessities, and those who spend on addictions).
- Where repayment is reasonably certain but is expected to require sale of collateral essential to the operation of the borrowing household.

It will be noted that the last of these is a trap where lending assessment emphasises collateral, while the other two are traps where lending assessment emphasises income prospects.

Lending assessment based on collateral is low-cost and simple when borrowers can offer marketable assets to which they have secure, non-contested and readily-transferable title. The obvious instance is mortgage lending, though even here there is an irreducible minimum of work required to check the documents. In the case of mortgages on property in suburbs affected by the recent land boom, the lender may also want to discount values in case they fall.

Pawnbroking provides another example. The work required to estimate the metal content of jewellery is fairly small provided expert staff are available, but there are often uncertainties as to whether the borrower has secure title to the item – pawning is just too easy as a method of getting rid of stolen goods.

Collateral of any kind thus has assessment costs. As against these, it has the advantage that seizure is a possibility in the event of non-repayment of the loan (or, in the case of pawnbroking, simple non-return of the pawned item – though here storage costs are incurred). Mortgages, pawnbroking and other loans on collateral therefore have considerable establishment expenses but low risk of default provided the loan is safely below the sale value after subtraction of recovery costs. Apart from the difference between pawnbroking and mortgages, the amount of checking required is likely to be independent of the size of the loan. Mortgage establishment costs are such that a mortgage will not be considered worth arranging for short-term, low-value loans.

An alternative approach is lending based on income prospects. This is inherently more risky, in that there is nothing to seize in the case of default, though garnishee orders provide a substitute if incomes are steady and their source is known. In rural communities, local lenders often have the necessary knowledge, or can easily check it. The greatest uncertainties lie in the areas of prior commitments and excess household costs (such as those caused by addictions), where local community knowledge is advantageous but may be used to discriminate unfairly. Within any given income/occupational group, the amount of checking required is likely to increase with the size of the loan, with fairly little checking being required for small loans to people who can claim unencumbered status and a regular income.

Financial institutions may attempt to minimise the costs of loan assessment by standardising conditions for the grant of loans. Inevitably this omits significant difficult-to-observe variables, such as whether the applicant has relations who are likely to siphon off the loan proceeds. Such variables tend to be common knowledge in small affinity-based credit unions, and are likely to form grounds for loan refusal.

The high long-run costs of bad debts give lenders a strong incentive to engage in rigorous loan assessment. However, bad lending decisions (not counting the inevitable occasions when a risk was detected and turned out badly) occur for several reasons.

- Failure to allocate sufficient, or sufficiently skilled, resources to the task.
- Failure to appreciate the risks properly – this is particularly likely to take place during cyclical booms, when lenders are seeking market share.
- Failure to carry out an arm's length assessment.

It is an important role of prudential regulators to recognise these problems when they are incipient and insist that they be remedied. There is a strong case for recouping the cost of prudential regulation from the affected institutions. Such costs add to the costs of loan assessment.

Whether for large or small enterprises, there are likely to be a modicum of paper, printing and computer costs, and maybe also the costs of reference to a credit bureau.

The more thorough the assessment of an application, the better the lender's appreciation of the risks involved. This appreciation can result in variations in charges for risk, and should also result in refusal of loans where it is likely that they can only be repaid under stress. Thorough assessment is partly a matter of the resources devoted to it by the lender, but is helped by backup resources: credit bureaux and other means by which the lender can gain information about the potential client's balance sheet and prospective income. If collateral is taken, or a claim is entered against income, it is important that these claims should not be subjected to disturbance by subsequent lenders (and should not disturb the claims of prior lenders). Thorough assessment reduces the risks borne by the lender, but at a cost: both the cost of the assessment itself, and the cost of the income potential of marginal loans rejected.

Lenders sometimes seek to attract custom by offering rapid assessment. This raises costs by being less thorough than time-consuming assessment, and also because extra personnel have to be employed to deal with the ebb and flow of applications. However, rapid assessment is of undoubted benefit to people who need money quickly to deal with unforseen financial demands. This raises a question for caps: should they be based on rapid assessment costs, or on regular costs? The problem here is that the people most likely to be in need of rapid assessment are also likely to be those who require careful assessment, at least at the yes/no level.

It obviously reduces costs if the intermediary can discourage hopeless applications, or recognise and refuse them quickly – but again there will be costs, in that some good applications will be discouraged or rejected too quickly. It also reduces costs if applicants know the process, and do not have to be guided through it. This reduces costs for people who are applying for the second or subsequent time – an offset being that too many applications may be an indicator of poor financial status.

The conventional cost driver suggested for loan application costs is the number of applications. Other drivers may include

- Amount applied for – intermediaries generally devote more time to the assessment of the larger applications.
- Source of application – assessment may be simpler and easier for some classes of customer than others. In co-operatives, members have borrowing rights, and the costs of loan assessment are transferred to the approval of membership.
- Repeat applications – repeat customers have a track record and know the process, and the lender has already collected information on their financial affairs.
- Presence of collateral, which needs to be verified and may occasion legal and inspection costs.
- Guaranteed speed of assessment.

The conventional cost driver approach suggests that the costs of making loans should be recovered from a once-off application fee, which may be related to loan size. However, there is also an argument for recovery from interest rate differentials, in so far as thorough assessment reduces the risk of default and is more costly, because more thorough, for the larger loans. Intermediaries may also wish to vary application fees for different classes of customer. Lower fees for repeat customers are consonant with the cost analysis, but may conflict with marketing strategies. They also conflict with the aim of emergency credit, which is to meet a once-off credit need which is often of short duration. Higher fees for loans with collateral may be offset against lower interest rate differentials for risk.

Ongoing administration

Once a loan is in place, it requires ongoing administration. Where a borrower meets all payments on time, this is a simple transaction function, with attendant accounting costs. The conventional driver would be the number of transactions, proxied by loans outstanding – hence a justification for a periodical service charge. Many intermediaries are likely to consider this cost so trivial that it can be absorbed into the interest charge.

The cost of funds

The cost of funds lent depends on the liability side of the lending institution's balance sheet. It is also affected by items on the asset side, including low-return assets essential to the conduct of the business (premises, cash and other liquid asset reserves) and, where funds are limited, may be affected by rates of return available in alternative lines of lending.

The cost of liabilities varies by class of liability.

- Deposits may bear interest rates well below the lending rate, but often occasion additional costs, such as transaction costs not recouped from fees, and variability that requires balancing holdings of cash and liquid assets. The less liquid the deposit, the higher the rate of interest which must be offered to compensate the financier's creditors for reduced liquidity, but the less the requirement to hold liquid assets to guarantee its prompt repayment.

- The cost of the medium to long-term borrowings of a financial intermediary depends on its credit rating. Intermediaries perceived as making risky loans are likely to have to pay risk premiums. Lending policies thus feed back to borrowing costs.
- Financial intermediary liabilities also include equity. There has been a tendency for prudential regulators to reduce their insistence on cash holdings as a guarantee of prompt repayment of deposits (other liquid assets being recognised as close substitutes) but to increase their insistence on capital adequacy, as a guarantee that all creditors will receive their due in the event of the business being wound up. As in non-financial businesses, equity bears the residual risks and is accordingly more expensive than loan capital.

The cost of funds lent depends not only on the cost of funds borrowed, but on the costs of low-return assets maintained for prudential reasons. These costs vary across financial intermediaries, depending on prudent assessment of the need for funds of various degrees of liquidity and in turn on the availability of backup such as borrowing of last resort and deposit guarantees. In addition, funds may have to be held in assets bearing less than desired returns during periods when lending opportunities are limited. The greater the proportion of funds which is maintained in low-return assets, the smaller the asset base available for lending out at profitable rates, and the higher the lending rate required to generate profits.

The cost of funds for any particular loan thus depends on

- costs incurred on the liability side of the balance sheet
- costs incurred on the asset side of the balance sheet (low-return assets) and
- cost allocation conventions.

Whatever the cost of funds allocated to any class of loan, it is conventional practice for the cost to be expressed as an interest rate; that is, to vary with the funds committed and the duration of the loan. Cost differentials for different kinds of loan become mixed up with risk assessments, and costs of funds may be quoted which include a risk assessment for the loan class. This may be fair practice, especially if the intermediary's borrowings are at enhanced interest rates due to the risks perceived in its loan portfolio. However, there is also a case for making a distinction between the cost of funds in a cash flow sense (cost of liabilities plus cost of prudential assets) and risk premiums that are the result of the intermediary's assessments. These in turn may be distinguished from the cost-plus mark-up.

Delinquency costs

Delinquent loans absorb staff time chasing the loans and seizing collateral, not to speak of the costs of write-offs. These costs provide a cost-based rationale for delinquency fees, which, however, cannot recover bad debts, and indeed increase the likelihood that a debt will go bad.

Delinquency fees are not so open to limitation by competition as other fees, though consumers may take them into account when selecting a credit card. Another possibility for a consumer threatened by a delinquency fee is to take short-term credit from a marginal moneylender. If the term of loan required to avoid delinquency is short, the bridging loan may come at very high cost in annual percentage rate terms but still be cheaper than incurring the delinquency fee.

Outside credit cards, the mainstream approach to delinquent loan costs is to recover them from interest rate differentials – from the risk premium charged over and above the cost of funds. In other words, the lender makes a risk assessment, and adds a risk premium that, on average, is expected to cover delinquency costs. This implies that the cost varies with the quantum and duration of funds on loan, coupled with the type of loan: loans secured with collateral are less likely to go completely bad than unsecured loans, but there is a risk that the revenue from sale of the collateral will be less than the loan, after allowing for costs. It is arguable that some delinquent loan costs are independent of the amount outstanding, in which case they may be recouped from a periodical service charge.

Early repayment

The opposite of delinquency occurs when loans are repaid early. Lenders argue that this imposes costs – the administrative cost of cancelling the loan, and the opportunity cost of interest foregone while they find a new borrower. The former cost is brought forward from the due repayment date, and may be somewhat increased by being out-of-course. The latter cost can be minimised and perhaps eliminated if the borrower has to give due notice of early repayment. There are likely to be economies of scale, in that lenders with large portfolios are constantly adjusting their asset patterns, and the early repayment of a particular loan scarcely perturbs the balance sheet. In other words, the direct costs of early repayment are small and perhaps negligible.

Despite this, a number of lenders impose fees for early repayment. This strategy is particularly noticeable where monetary policy is loose, and lenders are accordingly seeking to maximise loans outstanding, particularly to credit-worthy borrowers – and what borrower could be more credit-worthy than one who seeks to repay early? Accordingly the fee can be interpreted as a discouragement to repayment rather than a bona fide recovery of costs.

Early repayment can also occur in the course of debt re-finance. The comparison here is between fixed and variable interest rates. A borrower who agrees to a variable market-related interest rate will make payments that vary according to the lender's cost of funds. A borrower who agrees to a fixed interest rate benefits if the interest rate rises, but pays more if it falls. If borrowers can freely re-finance if the interest rate falls but the rate is capped if it rises, there is an apparent asymmetry. It can be argued that this justifies a renegotiation fee greater than that required to recoup administrative costs. On the other hand, if lenders offer fixed interest contracts that are in effect inflexible upwards but flexible downwards, a market price can be calculated to allow for the asymmetry of risk. There is nothing intrinsically unfair about this asymmetry.

Policy has been divided on early repayment fees. They are prohibited in some countries on the grounds that early repayment without penalty encourages household saving. These countries accept the consequence that fixed interest contracts will be flexible downwards, and will accordingly (if competition prevails) bear a higher differential vis a vis flexible interest contracts than they will in countries which make it difficult for borrowers to renegotiate.

Relationship to other products

The above cost analysis assumes that the costs of joint products can and should be wholly allocated to individual products. However, this may not be appropriate where a financial intermediary bundles products. A typical case is the requirement that a borrower must also have a deposit account, and may be required to maintain a minimum balance in that account. The reasons may include establishment of savings habits, provision of capital for the intermediary, establishment of a credit record, and convenience in administering loans. Charges such as membership fees may relate to more than one product, and low-earning deposits may be a (serial) quid pro quo for low-rate loans. Cost analysis may reveal apparent cross-subsidy which disappears once allowance is made for packaged products.

From a regulatory point of view, it will be important to understand the more common of these relationships. Judgement as to whether they are desirable can then be explicit.

The cost-plus rule

In most areas of production – manufacturing, retail and the like – the simplest and safest business pricing rule is cost-plus, achieved by adding a profit margin to costs. Provided competitors' cost structures are similar, a business that follows this rule will generate normal profits, more or less. However, in financial intermediation prices are complex and joint costs are prevalent, typically covering a range of products with impacts on both sides of the balance sheet. Intermediaries have considerable discretion as to the pattern of fees and interest rates that they adopt, and a wide variety of patterns has the potential to cover costs and earn profits. The range is further increased by the existence of numerous options to manage risk, and hence a wide variety of cost patterns, not to speak of residual risk exposures.

As in most markets, in the absence of price controls the ultimate limit to pricing patterns is imposed by competition. In any jurisdiction comprising an array of financial markets, competition will establish boundaries to pricing in each market. However, the processes by which it is recognised that products are mispriced are slow and uncertain. Under-priced products generally do not come to light until there is a financial crisis, usually in the course of the trade cycle – which is currently running at about ten year intervals on an international basis. Over-priced products may persist indefinitely if competition is limited in the markets concerned. The competitive limits to pricing thus take years to be established, and even then may be quite broad: hence the recourse to cost analysis to establish whether products are under- or over-priced, in the sense of under- or over-recovery of costs.

As in our discussion above, cost analysis allocates costs to products, and hence indicates the costs to be recovered if each product is to contribute equally to profitability. Analysis of loan cost drivers helps in identifying costs which are related to amounts lent and to the duration of lending (and hence suited to recovery from interest) and costs which are related to events (and hence suited to recovery from fees), though, as we have seen, there are many costs which exhibit both relationships. Cost analysis is particularly helpful in setting interest rates and fees if the intermediary can be reasonably certain that the cost analysis that it uses is similar to that used by its competitors. If this is the case, and after assuming that its costs are not out of line with its competitors, it can apply cost-plus pricing rules and expect to be competitive.

An alternative to the simple cost-plus approach with joint costs spread more or less evenly across products (according to the rules developed in the cost analysis) is that the intermediary 'cross-subsidises' – it loads some products with more than their rule-based share of joint costs. This is particularly likely in cases where a firm is operating in several markets with different degrees of competition and therefore has the opportunity to price keenly in its competitive markets and monopolistically in markets where there is less intense competition. Loss leaders are also common practice where a firm is endeavouring to enter new markets.

In an industry with such high joint costs as financial intermediation, unconventional pricing may also result when particular firms adopt an unconventional costing model. The resulting lower prices for at least some products may attract an unconventional customer base. Leaving the herd is risky but sometimes the decision pays off. Just as decisions to introduce new products, shave profit margins and the like are fundamental to competition under cost-plus pricing (which otherwise deteriorates into oligopoly), so decisions to introduce new products and revise cost allocations are fundamental to the maintenance of competition in financial intermediation.

The definition of over-pricing as over-recovery of costs, resulting in excessive profits, contrasts with the approach commonly found in the welfare-oriented literature, which instead regards credit as over-priced when it is unaffordable to an important social group, particularly poor people. It is perfectly possible for credit that barely recovers costs (and hence is neither under- nor over-priced in relation to costs) to be considered excessively priced in its impact on the budgets of low-income households. This impact may be diagnosed in two ways.

- Credit is an outstanding case where the poor pay more than the rich. The sense of the injustice of this can remain even if it is shown that the higher prices reflect higher costs.
- In jurisdictions where high-cost loans are permitted, and are taken up by poor people because no other credit is available to them, it is not usually hard to find people who are living in penury due to debt burdens.

Reaction to these impacts can be as follows.

- Where the impact is due to lenders over-recovering costs, reliance has been placed chiefly on competition to offer the borrowers a better deal. In many countries this has emphasised the fostering of financial institutions aimed at providing low-cost loans for poor people. This works all the better if the new institutions have ways to reduce costs.
- Competition has also been promoted by measures to make it easier for potential borrowers to compare the prices of loans.

- Loan targeting has been tried, with financial intermediaries directed to make a certain proportion of loans to poor people. The intermediaries naturally resist unless it can be shown that the loans are profitable.
- There is also a long tradition of capping costs to borrowers, to be considered below.
- In the last analysis, loan refusal has its place. Unless they are subsidised as part of a program of redistribution, financial intermediaries are limited in the extent to which they can contribute to the uplift of the poor. They are not set up to make gifts.

Practical investigation of cost patterns

Having outlined the theory of financial product costing, the next step should be practical analysis. This hits the snag that accurate product costing information is only available within lending businesses. Not only is it commercially confidential, it accords to accounting conventions and policies that vary from lender to lender. Even with the best will in the world, data from different firms are not always comparable. Worse, though regulators can require the provision of information, the regulated parties who provide the information have so much at stake in the regulator's decision that games of cat and mouse are inevitable. A quantitative investigation of the costs of credit, undertaken as part of the South African reform process, struck all these problems, but even so the data conformed to expectations, and were considered sufficiently reliable to form the basis of for credit price controls. An alternative approach to the data problem is for the regulator to run his own financial services business just to gain accurate information – this was one of the purposes of the state banks of the first half of the 20th Century.

Despite the uncertainties of detail, the broad outlines of cost structures are common knowledge, and can be checked from the specification of products on the market. If competition is semi-effective, it can be sufficient to set caps that catch outliers but leave the bulk of the market unaffected. It is also possible to design controls that bear down heavily on some elements of price (for example, early termination fees) while allowing scope for largely market determination of other elements (for example, the interest rate differential over prime rate).

The price pattern resulting from cost analysis

On our analysis, a cost-based system of loan charges would comprise

- an application fee (charged on all applications) and/or a loan establishment fee (charged only loans granted)
- possibly, a periodical service fee,
- an interest rate differential, and
- possibly, delinquency fees.
- Early repayment fees would probably be prohibited.

It would be expected that application or loan establishment fees would cover part, but not necessarily all, of the costs associated with application. They might vary by class of loan, with differences (eg) for secured and unsecured loans. They might include an insurance component (in which case it would be reasonable to allow for additional annual premiums for long-running loans). It would be expected that the fee would be higher for classes of loan where collateral is required, and that, generally, higher application fees would be associated with lower interest rates. If the fee is regulated, this should include any charges loaded into the price of goods and services bought, though this would be difficult to enforce and might require further thought.

A periodical service fee would cover current transaction costs and part of loan delinquency costs. If insurance is offered over a long period, this fee would also be included.

The interest rate would cover the reasonable cost of funds (i.e. not cross-subsidising other products offered by the same intermediary), plus mark-up, plus risk premium if not covered by the periodical service fee, and delinquency costs not covered by delinquency fees if allowed.

Delinquency fees are a moot point. It can be argued that delinquency fees are appropriate for credit cards provided to well-off people, who might otherwise neglect to make regular payments. However, delinquency fees have in the past been used to tie people up in debt. Perhaps the general approach should be prohibition of fees with a capped rate on delinquent outstandings (as in Austria), with a discretion to allow fees on products aimed at the well-heeled market.

We now consider a variety of proposals.

4.4 Policy alternatives

A cap on interest only

The classic interest-only cap is expressed as a percentage of the outstanding loan, calculated per specified time period. This diverges considerable from an apparently-similar cap expressed in cents per dollar lent without reference to time. The latter cap is effectively much higher for short-term loans, and much lower for long-term.

As our product costing has shown, and Islamic bankers have demonstrated, conventional interest rate caps are likely to be no more than cosmetic as controls over the overall price of credit. The flexibility of product costing makes it possible to run a profitable lending business without any resort to interest charges, substituting fees and other techniques such as asset sale and repurchase. From the point of view of capping monopoly pricing, interest-only controls can easily be circumvented. However, the public readily understands an interest-rate cap. The psychological advantages of an interest-only cap include assuaging vague public feelings that interest rates should not be too high, and limiting the ongoing exposure of debtors, at least in the case where the lender makes up for the cap with a stiff establishment fee. (The limit to ongoing exposure is less certain if the lender also imposes periodic, termination and delinquency fees.)

Where an interest rate cap is specified, with or without controls on fees, the costing model requires that the cap should vary with the cost of funds. In the costing model, the costs to be recovered from interest comprise the cost of funds, measured by a risk-free interest rate, and the various allowances for risk. There is ample overseas precedent for specifying an interest rate cap related to a selected low-risk or prime rate, or perhaps an average of rates. The cap will be well above this risk-free rate, to allow for the fact that it applies to risky lending. To guard against changes in market structure that alter the practical relevance of marker rates, there is much to be said for inserting a break at this point, in the form of a suitably august institution which will revise the cap having regard to changes in general interest rates, rather than tying the cap to a particular multiplier of a particular rate.

Interest-only caps can be supplemented by controls on particular types of fees, for example early termination fees. If controls are applied to some fees but not to others, the fee controls should be justified in their own right. The regulator should be under no illusions that a patchwork of controls can contain overall credit pricing. Cost-recovery and profit-making will merely shift to the uncontrolled areas. Circumstances in which particular fee controls may be justified include the following.

- The regulator wishes to control a particular aspect of pricing, for policy reasons. Examples are the prohibition of early termination fees to encourage household saving, and limits to delinquency and late payment fees to reduce the chances that the debt burdens of defaulting households will accumulate out of control.
- The regulator wishes to ensure that certain elements of cost are recovered indirectly. In Victoria there is a longstanding prohibition of direct charging for the legal fees incidental to loan establishment.
- The regulator believes that the particular aspects of pricing are anti-competitive but that other aspects are competitive. Regulators may thus prohibit or limit types of fee that are easily hidden in the small print in order to force cost-recovery into areas where prices are more exposed.

Interest-only caps have also been specified with interest payments broadly defined to include all payments from the borrower to the creditor other than recovery of the loan principal. This approach has been taken in NSW in applying the traditional 48 per cent cap to short-term credit. Having defined interest broadly and published a formula to calculate the annual percentage rate, the next step is to pick a high number for the cap and stick by it. This approach can be defended by starting from our first rationale for caps on the cost of credit – the general feeling (perhaps folk memory from the days before 1854) that action should be taken against usury. A supplementary rationale is the demand from welfare agencies that action be taken against high-cost loans that threaten to precipitate borrowers into downwards debt spirals. However, as pointed out above, this is a blunt instrument. The correlation between high interest rates and debt spirals is fairly loose. Again, the approach does not accord with the cost analysis. Effectively, it prohibits short-term small-amount loans, where establishment costs are inevitably high in relation to the amount lent and cannot be fitted within a 48 (or whatever) per cent all-encompassing interest rate cap. Equally, it exercises virtually no pressure on large or long-term loans, even in cases where the lender is profiteering. If the policy goal is specifically to prohibit short-term small-amount lending, the instrument is ideal, but policy-makers should be aware that this indeed is its effect: legal short-term small-amount loans will disappear from the market except for those who have unused credit card debt limits or those with items to pawn. If the policy aim is to prevent profiteering in lending, the all-encompassing single-rate cap is fairly useless.

A cap specified in cents per dollar lent makes sense from a product costing point of view only if limited to short-period lending (say under three months) and if it is inclusive, rather than interest-only. For short-term loans, administrative costs dominate, and time-variant costs are not enormously different for a two-week as compared to a two-month loan. Such a cap is specified in terms that accord with the customary pricing of payday loans, and accordingly should be understood by borrowers. However, difficulty may arise in aligning this cap with whatever cap is applied to longer-term loans.

If the cents per dollar cap applies merely to 'interest' and fees may be charged in addition, it is useless except for cosmetic purposes.

A structured cap

In so far as the aim is the control of monopoly pricing, cost analysis leads inexorably to a structured cap, the basic elements of which were detailed above. A structured cap requires definitions of fees and interest, constructed in such a way that every possible element in price is included in one or the other. The suggestion is that interest should be the residual category, with all payments in excess of loan principal and not defined as fees incorporated into the calculation of interest payments.

The cost analysis suggests the following classification of the elements in the price of credit.

- Fees precipitated by the act of application or by the establishment of a loan.
- Periodic service fees, precipitated by the passage of time but not related to the size of the loan.
- Periodic interest payments, precipitated by the passage of time and related to the size of the loan.
- Delinquency payments, precipitated by breach of any condition of contract, including both lump-sum charges and interest on arrears.
- Early repayment fees, precipitated by repayment of the loan before term.

Contingent fees and interest payments

Delinquency and early repayment fees are not part of the price of a loan contract. In both cases they relate to costs that the lender incurs over and above the costs of a contract where no condition is broken, and in both cases incentive effects may influence the pricing and result in lenders over-recovering the relevant costs. Failure to regulate can therefore result in excessive cost-recovery from borrowers who repay early, and from borrowers who fail to keep up regular payments. Not only is this unjust, there can be indirect effects. Over-recovery of early repayments can discourage household saving, while over-recovery for default can increase borrowing costs for borrowers with fluctuating incomes. This can occur even in the absence of caps – the banks have been accused of publicising their 'reasonable' rates of interest on credit cards, while making their profits from the unpublicised charges levied on delinquent borrowers.

Possible approaches to these imposts include the following.

- As argued in the cost analysis above, prohibition is a strong contender for early repayment fees, and a possible contender for delinquency fees.
- A possible approach to delinquency fees and early repayment is to bring them within some aspect of the general overall cap.
- Alternatively, they can be separately defined and separately capped.

In a country that wishes to encourage household saving, the main argument against prohibition of early repayment fees is that they discourage re-financing of fixed-interest loans in the event of a fall in interest rates. Such refinancing does not contribute to household savings – indeed, sometimes the reverse, as households take advantage of the lower interest rates to increase their indebtedness. However, in the context of a structured cap a disincentive is still provided by the need to pay establishment fees on the new loan.

Prohibition of delinquency charges would reduce the probability of borrowers being precipitated into downward debt spirals, but condones the decisions of delinquent borrowers who miss due payments without pressing cause, and so has unfortunate incentive effects. Delinquency charge related to costs and significant enough to have an incentive effect in these cases can accordingly be justified.

Delinquency charges can be brought under a general cap in two ways.

- Delinquency charges may be allowed until the cap is reached for each individual loan, after which they are prohibited. This would be quite difficult to administer, and could offer perverse incentives to deliberately delinquent borrowers (as distinct from those whose delinquency reflects financial necessity).
- A 'standard' level of delinquency could be assumed in determining whether a given contract respects the cap, the actual charges under that contract being disregarded.

Neither of these approaches accords with the cost analysis, which recognises delinquency as a distinct cost driver. We return, therefore, to a separately-specified cap for delinquency charges, separately defined. This cap should be plausibly cost-related, sufficient to have a disincentive effect, but otherwise defined on the low side so as to limit its contribution to snowballing debt. An alternative approach would be to consider re-finance as part of a continuing credit contract, and hence require it to fit within the cap (if any) on periodic loan service fees. However, this could only be enforced if the loan was refinanced with the same lender. To maintain equity between same-lender and new-lender refinance, it would be preferable to treat refinance as a case of establishment of a new loan.

Periodic loan service fees

Periodic services costs tend to be small, and there is something to be said for incorporating them into the interest rate cap. The contrary argument is that such costs do not vary with loan size. Incorporating them into the interest rate therefore penalises lenders more heavily for small loans than for large.

Periodic service fees are particularly important for continuing credit contracts, such as credit cards. Because of this importance, it is likely that a structured cap would include a periodic fee cap.

Upfront fees

Upfront fees raise a number of questions.

- Should there be separate caps for application fees and establishment fees?
- What about membership fees charged to join a group prior to applying for a loan?
- How far should a cap on upfront fees be structured to take into account differential costs of loan assessment? Two relevant drivers have been suggested: increases in costs with loan size, and increases in costs with the presence of collateral.
- Should the cap on upfront fees also include any fee payable to cover administrative costs on termination at the end of the loan, or should this be regarded as a form of periodic payment?

The simplest approach to the application/establishment distinction is to disregard it, with a joint cap on upfront fees for both purposes. Whether lenders charge application or establishment fees will then be left to their own marketing decision. If they want to encourage applications, they will keep application fees low or zero; if they want to minimise costs by discouraging frivolous application they will charge application fees. There is no particular social interest in interfering with this marketing choice. However, the law should be so worded that application fees paid to a third party are included in the definition.

Membership fees are not currently a major concern, and can probably be left to the market – i.e. unregulated – since loan clubs will not be attractive unless they can match open market lending. However, the law should be so worded that bogus membership fees, which are in effect application fees, are caught.

The cost assessment strongly favours variation in the upfront fee cap with loan size and between loans where collateral must be valued and secured and those where less extensive legal work is required. The obvious problem is that these two variations complicate the cap, at least from the point of view of customer understanding. (The paperwork of calculating a cap that varies with loan size and security is a cinch compared with the GST, and should cause no problems to lenders, to consumer advocates or to the regulator.)

According to conventional cost analysis, loan termination costs are low, and any regular-course termination fees (as distinct from early termination fees) are probably best included in the calculation of the interest rate.

Interest

The cost analysis suggests two things.

- As discussed above, interest should be capped as a mark-up on a marker rate.
- The mark-up for risk should be less for loans with collateral than for unsecured loans. This differential is already present in the Victorian legislation.

The mark-up for risk effectively determines the default rate that the lender can bear, and accordingly the cut-off assessment of credit-worthiness at which a rational lender will be willing to lend and the importance of collateral. The more vigorous the debt-collection mechanisms which the state sanctions, the lower the mark-up required for a borrower of given credit-worthiness; however, this hardly constitutes an argument for standover tactics in debt collection. Better to combine reasonable debt collection techniques with a moderate mark-up, and accept the consequence that not everybody will qualify for additional loans.

It should be remembered that an interest-rate cap is no answer to the problem of over-optimistic lenders, who get both borrowers and themselves into trouble by approving ill-judged loans. The financial sector is notorious for its bouts of over-optimism, which are an important contributor to the trade cycle. However, the curbing of over-optimism is not the primary task of consumer regulators, but is rather a responsibility of the Reserve Bank.

Similarly, an interest rate cap is no answer to the problem of lenders who make high-risk loans in the confidence that they will be able to extract repayment by unconscionable means. This problem has to be addressed directly.

Complexity

An obvious problem with the structured cap is its complexity – though the structure is not much more complicated than the elements in the Schumer Box used to provide a standardised outline of loan conditions in the USA.

Complexity is unavoidable when caps must respect a variety of cost-drivers that differ loan by loan. However, in the case of short-term low-amount loans it may be possible to simplify the cap by multiplying out the components and specifying this as a cents-per-dollar cap. This approach could be applied, for example, in the case of pay-day loans, where all loans for less than 63 days and for less than (say) $5000 could be given the same cents-per-dollar cap as a 63-day loan for $5000. Such a specification would fit neatly into a more general structured cap.

A related problem is that of stifling innovation. Most obviously, structured caps with an emphasis on cost-recovery through interest rate differentials are not suited to the development of Islamic banking, but more generally innovative lenders may wish to exceed the cap in some directions while remaining well within on others. This problem could be circumvented by multiplying out the arguments of the cap for each loan, specifying the result as an equivalent annual percentage rate, then allowing lenders to vary the components provided they meet the overall cap. However, this introduces an additional complexity into the determination of excessive credit price. The alternative may be to allow exemption for specific loan products, such as Islamic contracts.

A claimed advantage of the structured cap is that it encourages a distinction between costs recoverable from interest and those recoverable from fees. As compared with an overall cap expressed in annual percentage interest rate terms, this allows the quoting of relatively ‘reasonable’ interest rates. This in turn may encourage the entry of mainstream lenders into short-term small-amount lending, since they can do so without quoting interest rates that the public may regard as outrageous.

Sliding scales

The implication of the above discussion is that a structured cap would include sliding scales related to cost drivers. Such differentiation is no problem in two circumstances.

- The cap element is determined by formula from a readily-defined base. An example is the interest rate cap, which is determined from the loan principal.
- The cap element reflects readily-defined circumstances, for example secured and unsecured loans, or contingent and non-contingent fees.

The sliding scales incorporated into our discussion of a possible structured cap do not go beyond these limits. However, discrimination between loan types can become contentious if there are not based on tightly-defined differentials. Two examples follow.

- There are strong economic arguments for discrimination between loans by purpose. Lenders used to be instructed to discriminate in favour of house purchase, but so many mortgages are now used effectively for other purposes that this is no longer possible. More generally, purposes are so difficult to define, and there are so many ways of ignoring the definitions, that general instructions to favour loans for certain purposes are unlikely to be obeyed.
- There is a potentially vague boundary between secured and unsecured loans. The boundary is precise enough when secured loans are restricted to those where the collateral is mortgages over real property or marketable financial assets, but becomes hazy when the collateral is not easily repossessed or is of uncertain market value. In the above discussion, it is assumed that a fairly high standard of collateral is set as the cut-off point for a secured loan.
- If desired, it may be possible to maintain a distinction between continuing and terminating credit contracts. However, financial innovation has been blurring this distinction. The cost analysis does not give it any great prominence as a cost driver, so there is no particular call to include it in the arguments of a structured cap.

A non-prescriptive standard

As observed in recounting the history of credit regulation, the re-regulation of lending after the de-regulation of 1854 began with allowing the courts to re-open harsh or unconscionable contracts. The courts proved able to recognise procedural unfairness, but did not consider themselves competent to declare prices unconscionable. The 48 per cent cap was introduced to counter this understandable reluctance.

When the problem is identified as unconscionability, it may be either a general sense that the price of credit is 'too high' or that unmanageable credit is being granted. As we have seen, the first of these problems is not quantifiable – hence the reluctance of courts to deem unconscionability. The second is more interesting.

The primary line of defence against the granting of unmanageable credit is and must remain the lender's interest in being repaid. It should be remembered that granting credit always carries risks, and there will always be loans that become unmanageable due to bad luck, such as natural disaster, unemployment or sickness. Such cases of unmanageability cannot be controlled by improved lender practices, and require policies to prevent unethical debt recovery, to assist over-indebted consumers with debt management, and at the limit to relieve them through bankruptcy. However, there are cases where unmanageable loans are granted through lender malpractice or negligence. These include the following.

- The lender has failed to carry out checks of credit-worthiness. A hard case is where the applicant has lied and this has not been picked up by the lender's independent checks. Exposure of lenders to this type of error can be reduced by positive credit reporting, but this is opposed on civil liberties grounds. Attempts can be made to introduce disincentives to lying, such as criminal punishments, but these can get out of proportion to the offence, and may not be particularly effective when the borrower is more confused than mendacious. The South African Bill includes a provision that loans will not be recoverable in the case of reckless lending, defined in practice as failure to carry out elementary checks of credit-worthiness.

- The lender is relying on unacceptable methods of debt recovery. In addition to standover tactics, these may include jumping the queue of creditors. Enforcement of fair debt recovery techniques and of the law of bankruptcy is the obvious answer here.

In neither of these cases are high credit prices any more than a warning sign that other malpractice may be taking place. A regulator who is primarily motivated to curb unmanageable lending will keep a weather eye on credit prices, but will devote major effort to improving checks of credit-worthiness and policing the limits of acceptable debt recovery.

It has been suggested that, rather than disallow unconscionable lending, the authorities should disallow lending at exorbitant rates, with exorbitant defined as excess cost recovery. This would resemble a structured cap, save that the cap would not be published but would be administered on a case by case basis. To administer such a system by assessing loan contracts in arrears and declaring those with high costs unenforceable, the regulator would have to gather much the same cost information as is required to specify a structured cap. Charges which appear exorbitant (or profiteering) by the standards of this body of information would be disallowed, and if there is appeal a body of case law would develop which would yield the equivalent of a structured cap – probably a very complex one. If there is no scope for appeal, the regulator is likely to disallow only the more outrageous cases, in which case there is likely to be little pressure on excess profits. This may, of course, be the policy intention.

The Irish precedent

The Irish have developed the non-prescriptive standard further by shifting the emphasis from the regulation of contracts to the licensing of lenders. They require lenders to submit cost analyses as part of their licence application. Those whose costs appear high are simply not licensed. Managed carefully, this can solve the information problems that arise when structured caps have to be specified – the lenders provide the information in the course of application to be licensed, and have an incentive not to over-state their costs lest they be not licensed. What ensues is not so much a price cap as a cost cap.

Even under this system, many of the difficulties of administering a structured cap are likely to remain. Keeping costs low is ultimately a surrogate for not making high-risk loans, so the regulator cannot avoid the problem of the risk cut-off. If licensing is to bear down on costs across the whole range of risk, including relatively low-risk loans, the regulator still has to second-guess aspects of the lenders' cost structures. Similarly it is likely that the regulator will require that accounts be prepared in a standard format, and this may discourage innovation in cost analysis and control. De-registration may also turn out to be a blunt instrument, as in the case of a lender whose overall costs are acceptable but who, according to the regulator's cost analysis, is providing a mixture of 'high' and 'low' cost loans.

An interesting problem could arise if lenders were involved in particular classes of loans where there is considerable competition, and in other types of loan where there is restricted competition – say housing loans and micro loans. In this case competition will result in generally low cost recovery in the first case, and high cost recovery in the second. If the regulator does not have an independent cost model but relies on reported averages, the result will be the institutionalisation of excess cost recovery in the high-recovery area – the exact opposite of the regulatory intention. This result can also arise under a structured cap.

Experience in the regulated utilities shows that, where productivity gains are available, it is possible to regulate prices downwards without affecting output quality or quantity, but this experience will be difficult to transfer to a multi-product industry like consumer finance, where outputs are not easily measured and it is therefore difficult to estimate the scope for productivity gains.

From a business point of view, the Irish approach has the advantage that it does not interfere with any of the details of credit pricing. Providers can innovate and cross-subsidise, and will probably not be prevented from writing loans which are high or unconscionably priced when these are offset by others which are low priced – assuming that regulators give up on trying to second-guess cross-subsidies. A disadvantage from a lender point of view would be the uncertainty of never quite knowing the boundary of acceptable business practice.

From a consumer point of view, the effect of the Irish system should be to bear down on business costs and hence on prices. The effect on consumer awareness would depend on product disclosure regulations, which would presumably be included in the licensing requirements. The absence of a published cap would deprive consumers of a possible measure of credit price – the differential between the quoted price and the cap. We do not know the effect of this, since there are no current instances of structured caps, and we therefore do not know whether the cap would act as a comparison rate. However, consumers would certainly be deprived of an objective measure for whether or not they should report a credit provider to the regulator. It is a moot point whether this would result in more or less reports.

In Australia, cost data is not required as a condition of state licensing of lenders, but the Commonwealth's requirements through ASIC include the provision of financial information (Lanyon 2004). It is possible that ASIC might implement a version of the Irish approach, leaving the states with a somewhat more tractable task of regulation at the level of individual contracts.

Conclusion

We have isolated three main arguments for controls on credit pricing. The first is that, despite the deregulations of 1854 and 1984, custom demands that interest rates should be capped. In Victoria the 48 per cent cap meets this requirement, but has little effect since it is above market rates for nearly all capped loans. By contrast, the NSW cap of 48 per cent all-inclusive (including short-period loans) is of rather more than symbolic effect. It is below cost-recovery for short-period loans, which it therefore prohibits.

The second argument is that prohibition of high-cost credit assists in preventing consumers from contracting unmanageable debt burdens by preventing lenders from making high-risk loans where their costs are more than the cap. However, a cap is a blunt instrument for this purpose. It does not address all causes of over-indebtedness, and also prevents loans being made that would not result in over-indebtedness. It is necessarily secondary to other approaches, such as controls on debt recovery, controls on reckless lending, debt counselling and bankruptcy.

The third argument is that lenders exercise monopoly power to over-price credit, at least in some sectors of the market. The sector of most concern is that serving poorly-informed, marginally credit-worthy consumers. The conventional answer to monopoly pricing is the promotion of competition. Thus the Uniform Consumer Credit Code attempts to facilitate competition by the imposition of uniform disclosure provisions, the purpose of which is to prevent lenders from creating monopolistic niche markets by bamboozling borrowers. It is a matter of judgement whether pro-competition strategies of this kind are practically effective. However, the consequences for consumers of failure of competition, in terms of wrecked household accounts, are such that a case can be made for controls that supplement competition policies by disallowing high credit prices.

This argument leads inexorably to a cap set at levels that allow lenders reasonable cost recovery and profit. Such a cap has to cover all credit-related charges – credit costing is so flexible that lenders who are aiming for excess profit will have no compunction in increasing their uncontrolled charges. The logic of this leads to a structured cap that reflects major cost drivers. It also requires that the regulator make a judgement (or judgements) as to the cut-off level of risk for acceptable lending.

A structured cap can be published, or alternatively can be kept in the regulator's private conscience and used with discretion to identify outrageous cases. This latter approach leaves a gap as to how the outrageous cases are to be prosecuted. The non-prescriptive approach is likely to work best when it is used as a condition of discretionary licensing of providers, rather than to disallow particular contracts.

Approached this way, the various options of legal specification tend to merge. The fundamental distinction is between a system with gaps, so that profits can be made by raising the uncapped portions of total credit price, and a system with complete coverage. If coverage is complete, the choice is either a flat-rate cap or a structured cap. The former, such as the NSW all-inclusive 48-per cent, is effective in prohibiting short-term high-risk loans, but is safely above market for most other loans, including profiteering loans. In principle, structured caps can be specified to bear down on profiteering in all areas of the market, but this may require an impractical level of complexity coupled with detailed and accurate cost analysis. It must also be admitted that structured caps are a new idea, and there is little experience with their administration. Indeed, the costing principles on which a structured cap is based are also a fairly new area of analysis, and experience may prove that the costing is not as robust as required for regulatory purposes. Certainly there are difficulties in obtaining accurate data on which to base the cap, though these should not be insurmountable. Given the deficiencies of other specifications, it is difficult to get away from the structured cap as a possibility for further investigation.

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Consumer Affairs Victoria

February 2006
FS-27-01-903

Confident Consumers, Protected Communities.