

# Responsible Lending or Restrictive Lending Practices?: Balancing Concerns Regarding Over-Indebtedness with Addressing Financial Exclusion

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## **Abstract**

This chapter will challenge the idea that there is a contradiction between encouraging financial institutions to lend to people on low incomes in order to overcome financial exclusion on the one hand, and requiring financial institutions to lend responsibly, taking into account a potential borrower's capacity to repay in order to avoid over-indebtedness on the other hand. It will assert that it is in fact the *failure* of mainstream financial institutions to lend to people on low incomes that *exacerbates* over-indebtedness and financial exclusion.

## **Introduction**

On the face of it, there may appear to be a contradiction between encouraging financial institutions to lend to people on low incomes in order to overcome financial exclusion, and requiring financial institutions to lend responsibly taking into account a potential borrower's capacity to repay, in order to avoid over-indebtedness. This article will assert that it is in fact the *failure* of mainstream financial institutions to lend to people on low incomes that *exacerbates* over-indebtedness and financial exclusion.

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Financial exclusion in the Australian context has been defined as:-

The lack of access by certain consumers to appropriate low cost, fair and safe financial products and services from mainstream providers.<sup>1</sup>

The definition emphasises cost and safety of available products, thus distinguishing between mainstream products and alternative ‘fringe’ products that may be unsafe in the sense of involving high fees and charges and often onerous and unfair terms. It is people on low incomes in Australia who are most likely to be excluded from access to mainstream credit products, and who are most likely to turn to unaffordable and unsafe forms of credit with the result that they find themselves in positions of financial stress and indebtedness.<sup>2</sup> A report prepared in 2001 noted that:

In Australia, there appears to be a particular emphasis on affordability as a cause of financial exclusion...Low income consumers therefore bear the brunt of financial exclusion in Australia.<sup>3</sup>

Exclusion of low income consumers from access to mainstream credit products is one aspect of financial exclusion that ‘unquestionably leads to the poor paying more’<sup>4</sup>, and exacerbates problems of over-indebtedness which can have wide-ranging social

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<sup>1</sup> Chant Link & Associates, 'A Report on Financial Exclusion in Australia' (ANZ, 2004), at 58.

<sup>2</sup> Australian Bureau of Statistics, 'Income Distribution, Australia' (1999-2000); T Eardley, 'Australian Social Trends No. 2: Economic Resources- Household Assets, Liabilities and Financial Stress' (2004); B McColl, L Pietsch and J Gatenby, 'Income and Welfare. Special Article- Household Income, Living Standards and Financial Stress' (2002)

<sup>3</sup> C Connolly and K Hajaj, 'Financial Services and Social Exclusion' (Financial Services Consumer Policy Centre, University of NSW, Chifley Research Centre, 2001), at 22

<sup>4</sup> P Cartwright, *Banks, Consumers and Regulation* (Hart Publishing 2004), at 212

consequences including burdens on the health system, burdens on legal aid, impacts on productivity due to stress and absenteeism, and child poverty.<sup>5</sup>

This chapter will outline the regulatory sources of the ‘responsible lending’ duty in Australia. Whilst arguing that these regulations are to some extent ‘toothless tigers’, a fear of being accused of irresponsible lending causing over-indebtedness is one of the reasons financial institutions give for not lending in the low income market. In this regard, I will draw on empirical interviews that I have undertaken with banks and finance companies, investigating the credit products currently available to people on low incomes and exploring the barriers to the provision of safe and affordable credit products to those people.<sup>6</sup> The chapter will consider the extent to which irresponsible lending causes over-indebtedness and will then argue that in fact mainstream financial institutions *not* lending to low income consumers on fair and reasonable terms is an important structural cause of over-indebtedness, as it leads consumers to access credit through the more expensive fringe market.

The chapter will conclude by advocating for the need to encourage small amount lending on fair and reasonable terms to people on low incomes by mainstream financial institutions, as an important strategy in combating the problem of over-indebtedness.

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<sup>5</sup> Department of Trade and Industry (U.K.), 'Fair, Clear and Competitive: the Consumer Credit Market in the 21st Century' (2003) at 77 -78

<sup>6</sup> In 2006 I conducted 12 interviews (small information-rich sample) with major banks, regional medium-sized banks, finance companies, credit unions and mutuals, community organisations and fringe credit providers.

## ***The obligation to lend responsibly***

The obligation on the part of financial institutions in Australia to lend responsibly with respect to consumer credit largely arises under the Uniform Consumer Credit Code<sup>7</sup> (“UCCC”) and under voluntary codes of conduct such as the Code of Banking Practice 2003 (amended 2004).

In relation to the UCCC provisions, the duty to lend responsibly by assessing capacity to repay before lending is said to arise under section 70 which gives the court power to reopen unjust transactions. Once a transaction has been reopened, section 71 gives power to grant relief from payment, revise or alter an agreement, and make ancillary or consequential orders. A relevant factor in making the assessment as to whether or not a transaction is unjust, is stated to be whether at the time the loan contract was entered into the credit provider knew, or could have ascertained by reasonable enquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or without substantial hardship.

Despite the fact that some financial institutions regard the duty to lend responsibly under the UCCC as a barrier to ‘subprime lending’ I argue that the provision is, in reality, something of a ‘toothless tiger’. Rather than imposing a clear ‘up front’, or ex ante, obligation to assess capacity to repay before lending, the provision merely allows consumers to complain to the court ‘after the fact’, or ex post, that this was not done. The reliance on consumers to commence litigation in order to protect their own interests under the provision is undoubtedly one reason for the dearth of

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<sup>7</sup> The *Uniform Consumer Credit Code* commenced in all Australian jurisdictions on 1 November 1996 by legislation passed in each State and Territory, for example, the *Consumer Credit (Queensland) Act* 1994.

decisions under section 70. Vulnerable people and people on low incomes, who are most likely to be the recipients of loans that they cannot afford to repay, are not likely to be in a position to pursue litigation. This seems intuitively correct and has been confirmed by empirical research undertaken in both the U.K. and in Australia.<sup>8</sup> The UK research demonstrated that low-income consumers are unlikely to take legal action in relation to a loan dispute, on the basis of factors such as cost, a sense of powerlessness, and a fear of acrimonious disputes.<sup>9</sup> The most recent Australian research undertaken in New South Wales referred to earlier studies which demonstrated that disadvantaged Australians failed to seek legal advice or take legal action where appropriate.<sup>10</sup> The reasons given included people not knowing their legal rights, not knowing that there was a legal solution or where they could go for assistance, and concerns about cost.<sup>11</sup> In the NSW research study itself, 2431 residents of disadvantaged areas were interviewed, and it was noted that there was ‘a substantial rate of inaction in response to legal events’.<sup>12</sup> 12% of the ‘legal events’ referred to were described as credit/ debt disputes.<sup>13</sup>

Not only are there likely to be issues of access to justice for consumers who might have grounds to complain under section 70, but there are also likely to be difficulties in proving that the credit provider knew, or could have ascertained by reasonable enquiry, the borrower’s lack of capacity to repay without substantial hardship. This is

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<sup>8</sup> H Genn, *Paths to Justice: What People Do and Think About Going to Law* (Hart Publishing 1999), at 101; C Coumarelos, Z Wei and A Zhou, 'Justice Made to Measure: NSW Legal Needs Survey in Disadvantaged Areas' in Law and Justice Foundation of NSW (ed), *Access to Justice and legal Needs, Volume 3* (2006) , at 99.

<sup>9</sup> H Genn, n. 8 above at 101.

<sup>10</sup> C Coumarelos, Z Wei and A Zhou, n. 8 above at 30

<sup>11</sup> C Coumarelos, Z Wei and A Zhou , n. 8 above at 30.

<sup>12</sup> C Coumarelos, Z Wei and A Zhou, n. 8 above at xix.

<sup>13</sup> C Coumarelos, Z Wei and A Zhou, n. 8 above at xix.

illustrated by the case, *Maisano v Car and Home Finance Pty Ltd (Credit)* [2005] VCAT 1755 (12 August 2005), that came before the Victorian Civil and Administrative Tribunal (“VCAT”) in 2005. The Consumer Credit Legal Service, Victoria acted on behalf of the borrower, Rosa Maisano, and argued breach of section 70. Although breach of section 70 was successfully argued and the transaction was reopened, it was on grounds other than the ‘lack of capacity’ ground.<sup>14</sup> The Deputy President of VCAT, Cate McKenzie, found insufficient evidence to establish that Mr Leeworthy, an employee of the credit provider, Car and Home Finance, knew or could have ascertained by reasonable enquiry that Rosa was unable to repay the loan. Given the facts of this case (outlined briefly below) and the finding of the Deputy President, it seems difficult to imagine a case where it *could* be argued that a credit provider could have ascertained upon reasonable enquiry that there was an incapacity to repay without substantial hardship. Pertinent facts were that Rosa Maisano was an elderly Italian woman on a pension. Her car (required as security for the loan) was her only asset. She could not read or write in either English or Italian and had limited spoken English. She was brought into Car and Home Finance’s premises to sign documents as co-borrower by her son who was the instigator behind the loan being taken out. Undoubtedly language difficulties may have impeded the enquiry process for Mr Leeworthy in this case, but in those circumstances it would surely be reasonable to go to greater lengths than might otherwise be expected to ascertain details of the borrower’s financial position. I suggest that this case demonstrates a weakness in the UCCC provisions to the extent that they seek to impose a liability on credit providers to assess capacity to repay.

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<sup>14</sup> The grounds that were held to demonstrate that the transaction was unjust were lack of bargaining power, the loss of the borrower’s sole asset if it were repossessed, an inability on the part of the borrower to protect her own interests and obtain legal advice, and the fact that the credit provider should have taken greater steps to ensure that she understood the nature of the transaction. The contract and mortgage were set aside as against Rosa.

The obligation contained in the Code of Banking Practice is found in clause 25.1 which provides that the signatory banks agree to exercise the care and skill of a diligent and prudent banker in selecting and applying credit assessment methods and in forming their opinion about a customer's ability to repay, before offering a credit facility. This provision might also be regarded as something of a 'toothless tiger'. It is a voluntary Code and so only signatory banks are bound by it. A signatory bank is contractually bound by the Code and so could be sued by its customers for breach of contract if it failed to comply, however as indicated above, an opportunity to litigate is unlikely to be of assistance to vulnerable and low-income consumers. The other enforcement mechanism attached to the Code is through the Code Compliance Monitoring Committee ("CCMC") which is responsible for monitoring compliance with the Code and naming banks in connection with Code breaches- a 'name and shame' method of regulation, the effectiveness of which remains to be determined. By way of example as to how the CCMC processes can work, the CCMC reported in its first annual report<sup>15</sup> that one of the most common causes of complaints were in relation to clause 25.2, under which banks agree to help customers overcome financial difficulties with any credit facility the customer has with the bank. It conducted an inquiry into this in 2005, pursuant to which compliance visits to five banks were undertaken, and a general report in relation to the inquiry was released to the media.<sup>16</sup> The report did not name any particular banks, and noted that 'the reviewed banks understand and take seriously their obligations under the Code'<sup>17</sup> and concluded that 'all indications are that the banks are generally committed to fulfilling their

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<sup>15</sup> Code Compliance Monitoring Committee, 'Annual Report' (2004-5) at 4.

<sup>16</sup> Code Compliance Monitoring Committee, n. 15 above at 8-10.

<sup>17</sup> Code Compliance Monitoring Committee, 'Inquiry into Bank Compliance with clause 25.2 of the Code' (2005), at 1

obligations under the letter and spirit of this clause to the Code'<sup>18</sup>. This could either be indicative of a process that works and successfully brings about compliance without the need for a 'big stick' in regulatory terms, or it could be indicative of another 'toothless tiger', such as I have spoken of above in relation to the UCCC provisions. One cannot help but wonder why a failure to comply with clause 25.2 of the Code was a common cause of complaint to the CCMC, if the picture is truly as 'rosy' as the report indicated.

Despite the weak nature of Australian regulation imposing the obligation to lend responsibly with respect to consumer credit, as indicated in the CCMC report<sup>19</sup> most mainstream financial institutions seem to take the obligation seriously, to the point that they cite it as a reason for not becoming involved in lending to low income consumers. The next part of this chapter explores the apparent fear on the part of some financial institutions of being accused of 'irresponsible lending' causing over-indebtedness, which prevents them from engaging in lending to people on low incomes. It will also consider whether such lending does in fact contribute to problems of over-indebtedness in society.

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<sup>18</sup> Code Compliance Monitoring Committee, n. 17 above at 5.

<sup>19</sup> Code Compliance Monitoring Committee, n. 17 above.



## ***Irresponsible lending and over-indebtedness***

Both statistical and anecdotal evidence points to an increase in consumer debt levels in Australia and consequential problems of over-indebtedness.<sup>20</sup> Over-indebtedness has been recognised as a serious social problem that:-

...fuels poverty, and social and financial exclusion, as well as having a real impact on the health and well-being of individuals<sup>21</sup>

It has been found that there is a close link between over-indebtedness and low income, and that consumers who find themselves over-indebted may suffer stress, depression, anxiety; become violent, suicidal or homicidal; and face barriers to access to further credit and barriers to work.<sup>22</sup> The consequential social costs of these impacts have also been noted, including costs to public health and loss of productivity in the workplace.<sup>23</sup> It is argued that lenders have a role to play 'in preventing over-indebtedness through responsible lending practices'.<sup>24</sup>

The contribution of lenders to over-indebtedness through irresponsible lending seems best exemplified in the fringe credit market. Submissions made to the recent Victorian Credit Review point to small amount credit lenders lending without giving due consideration to a consumer's financial circumstances or otherwise assessing capacity

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<sup>20</sup> Reserve Bank of Australia, 'Household Debt: what the data shows' (2003) (March) *Reserve Bank of Australia Bulletin*, p.1; Consumer Affairs Victoria, 'The Report of the Consumer Credit Review' (2006), at 66.

<sup>21</sup> Department of Trade and Industry (U.K.), n. 5 above at 74

<sup>22</sup> Department of Trade and Industry (U.K.), n. 5 above at 75, 77-78.

<sup>23</sup> Department of Trade and Industry (U.K.), n. 5 above at 75, 77-78.

<sup>24</sup> Department of Trade and Industry (U.K.), n. 5 above at 89.

to repay the loan.<sup>25</sup> It is possible that payday lenders, a category of fringe lender, will actually target consumers who will be unable to repay the payday loan within the average 14 day loan period, so that the loan has to be 'rolled over' by payment of an additional fee, which may occur as many as 8 to 12 times<sup>26</sup>, without the borrower having made any reduction to the principal amount owing.<sup>27</sup> This process has been described both as 'the foundation of the payday lending business model'<sup>28</sup> and as 'the beginning for many [consumers] of an uncontrollable debt spiral'.<sup>29</sup> There is said to be 'significant anecdotal evidence in Australia that payday lenders are actively targeting low and fixed-income consumers',<sup>30</sup> such anecdotal evidence including the opening of payday lending outlets in predominantly low-income suburbs, and experiences reported by financial counsellors.<sup>31</sup> It is notable that, when converted to annual interest rates, the fees charged with respect to many payday loans can range from between 235% to 1300% per annum.<sup>32</sup>

A number of causes of over-indebtedness might be cited, some cultural and some structural.<sup>33</sup> One structural reason given for over-indebtedness is the deregulation of the credit industry particularly with regard to interest rates which will be discussed in more detail in the next part, and the consequent development of a sub-prime credit

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<sup>25</sup> Consumer Affairs Victoria, 'The Report of the Consumer Credit Review' (2006), n. 20 above at 66 & 92

<sup>26</sup> Office of Consumer and Business Affairs South Australia, 'Payday lending in South Australia- options to increase consumer protection' (2006), at 5

<sup>27</sup> I have discussed payday lending in more detail in T Wilson, 'The inadequacy of the current regulatory response to payday lending' (2004) 32 *Australian Business Law Review* 193.

<sup>28</sup> U King, L Parrish and O Tanik, 'Financial Quicksand: Payday lending sinks borrowers in debt with \$4.2 billion in predatory fees every year.' (Center for Responsible Lending, U.S., 2006), at 3.

<sup>29</sup> P Syvret, 'The Quick and the Debt' (2001) *The Bulletin* 30.

<sup>30</sup> C Field, 'Pay Day Lending- An Exploitative Market Practice' (2002) 27(1) *Alternative Law Journal* 36 at 37

<sup>31</sup> C Field, 'n. 30 above at 37

<sup>32</sup> Queensland Office of Fair Trading, 'Payday Lending- a report to the Minister of Fair Trading' (2000), L Petschler, 'How to borrow at 972% pa' (2001) 86 *Consuming Interest* 6

<sup>33</sup> See discussion in J Braucher, 'Theories of Over-Indebtedness: Interaction of Structure and Culture' (2006) *Arizona Legal Studies Discussion paper No 06-04* <<http://ssrn.com/abstract=826006>>

market,<sup>34</sup> meaning a market under which credit is provided to consumers who would be excluded from ‘mainstream’ lending on risk grounds. Braucher notes that:

Creditors have become more sophisticated in developing profitable business models that allow them to dip lower in the credit risk pool and still reap profits<sup>35</sup>,

and argues that:

While creditors sometimes portray these sorts of products as promoting the democratization of credit, they can also be seen as a form of cultural exploitation, resulting in redistribution from the poor and from minorities to creditors’ investors.<sup>36</sup>

Whilst there is evidence of irresponsible lending by some credit providers leading to over-indebtedness, one should not lose sight of the fact that some small amount lending to low income consumers can have a positive impact on their financial positions. This is where the distinction between ‘sub-prime lending’ to people who may not qualify for ‘mainstream’ loans, and ‘predatory lending’, becomes important. Examples of ‘sub-prime lending’ can be found in low interest loans programs currently being piloted in Australia (predominantly in Victoria) by ANZ and Brotherhood of St Laurence; and by NAB and Good Shepherd Youth and Family Service. In 2006, ANZ and Brotherhood of St Laurence commenced a pilot of the ‘Progress Loan’ under which loans of between \$500 and \$3000 are offered to low income consumers to assist in the purchase of essential household items. An interest rate of 12.7% applies and the loan repayment term is flexible to suit the borrowers’

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<sup>34</sup> J Braucher, n. 33 above at 5 & 6

<sup>35</sup> J Braucher, n. 33 above at 6

<sup>36</sup> J Braucher, n. 33 above at 10.

needs and can range from a 1 year to a 3 year period. To be eligible for a 'Progress Loan', borrowers must be Centrelink<sup>37</sup> Healthcare cardholders, have lived in the same residence for more than 6 months, and be up to date with rent and utility bills.<sup>38</sup> NAB and Good Shepherd Youth and Family Service have been offering their 'Step Up Loan' since 2004. It is currently offered in select locations in Victoria, NSW, WA and SA. These loans are for amounts between \$800 and \$3000, with a current applicable interest rate of 6.99% per annum. The loans are, again, for essential household goods as well as second hand cars, medical expenses and training course fees. As with the 'Progress Loans', to be eligible for a 'Step Up Loan' the borrower must be a Centrelink Healthcare cardholder.<sup>39</sup>

Representatives of the banks involved in these loans refer to having undergone a 'learning process' through providing loans to people on low incomes, one representative commenting that their bank had come to understand two things:

One, that low income earners can actually meet obligations in terms of credit repayments and I think even more importantly secondly, that being able to provide people with access to credit gives them a whole lot of self esteem benefits that people would not traditionally I suppose tie to a loan and therefore I think it was for senior management an acknowledgement that they had quite a powerful role in shaping the lives of these people if we were able to provide affordable credit options.<sup>40</sup>

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<sup>37</sup> Australian Social Security

<sup>38</sup> ANZ and Brotherhood of St Laurence, *ANZ and Brotherhood of St Laurence team up to offer small loans for people on low-incomes* (2006) <<http://www.bsl.org.au/main.asp?PageId=3952>> , T Wilson, 'Major Bank Interview' (2006)

<sup>39</sup> T Wilson, 'Major Bank Interview' (2006), R Kendall, 'Our Huge Need for Tiny Loans' (2006) *Ethical Investor*

<sup>40</sup> T Wilson, 'Major Bank Interview' (2006)

Not all financial institutions have learned such lessons, in the sense that banks and finance companies which do not provide small amount credit services to low income earners, tend to give as one of their major reasons, the need to lend responsibly and not exacerbate over-indebtedness by extending credit to people on low incomes. A representative of a medium-sized, regional bank commented that the bank did not engage in 'sub-prime' lending because:

The guiding principles of the UCCC sort of drive the way our policies are written-around, you know, being responsible and understanding customers' capacity to repay and then obviously the voluntary obligation that we've got to the industry as well.<sup>41</sup>

A representative of a major Australian bank stated that he did not consider that mainstream banks had a role to play in offering credit services as an alternative to exploitative credit services because of the regulatory framework in place. He stated that the bank was concerned to:

...make sure we don't inadvertently breach any of our obligations under the UCCC or indeed the Code of Banking Practice. You can't lend to people who clearly can't afford to repay so there's got to be that ensuring there is a capacity, there's some kind of capacity to repay, or you know we would not have done that person any favours by lending them money. They will end up with a poor credit rating. So it's those trade offs that I think, serviceability of the loan, just making sure we're not inadvertently engaged in some kind of maladministration for a social benefit, hoping for the best.

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<sup>41</sup> T Wilson, 'Regional Bank Interview' (2006)

That's the trade off that we're very keenly concerned about because we have compliance obligations to the law and to our Code.<sup>42</sup>

A representative of a finance company, in response to questions concerning the extension of its credit services to people on low incomes, responded that:

We would never lend to anyone who we couldn't ascertain has a capacity to repay the debt. What we wouldn't want to do is enter into an unconscionable arrangement. I don't know, if someone doesn't have the capacity to repay, how do you structure that in a way that you're not putting undue pressure on them in terms of debt?<sup>43</sup>

A 'high street bank' in the U.K., Barclays Bank, has echoed these sentiments in a 'Corporate Responsibility Report'.<sup>44</sup> Whilst noting that it has 'a responsibility to provide fair access to loans', in the same sentence the bank states that its 'lending decisions are based on our customers' ability to repay'.<sup>45</sup> The report spends some time dealing with the importance of exercising responsibility in lending in order to deal with increasing consumer debt.<sup>46</sup> In justifying its decision to support community organisations in providing small amount credit to people on low incomes, rather than providing that credit itself, the bank states in its report that:

A high street bank like Barclays is not always the most appropriate organisation for some types of loans. For example, big volumes of very low volume loans, particularly for those with limited credit histories, do not fit easily into our business. However, we

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<sup>42</sup> T Wilson, 'Major Bank Interview' (2006)

<sup>43</sup> T Wilson, 'Finance company interview' (2006)

<sup>44</sup> Barclays Bank, 'Corporate Responsibility Report: Responsible Banking' (2005)

<sup>45</sup> Barclays Bank, n. 44 above at 12

<sup>46</sup> Barclays Bank, n. 44 above at 14 & 15

realise that there is a need for these types of loans, and that is why we support other organisations that are better set up to do this.<sup>47</sup>

In recognising ‘the need for these types of loans’, the report quotes Peter Kelly, the head of Barclays’ financial inclusion team, as saying that

Quite simply we need viable alternatives to high-cost lenders to provide more choice to the most disadvantaged in society.<sup>48</sup>

Notwithstanding that, the bank regards the extent of its role in this area as being to support community organisations. This is an unfortunate position, given that such initiatives may never reach the necessary or desired scale to ensure the provision of affordable and fair small amount credit to people on low incomes, and because it would seem that a major contributor to the problem of over-indebtedness has in fact been a failure on the part of mainstream financial institutions to adequately service this market on fair and reasonable terms.

### ***An argument that NOT lending causes over-indebtedness***

Braucher writes that, in addressing the structural causes of over-indebtedness, one key solution would be to provide alternatives to high cost credit ‘needed for the many people who will continue to face financial crises not covered by safety net programs’<sup>49</sup>. She goes on to say that:

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<sup>47</sup> Barclays Bank, n. 44 above at 12

<sup>48</sup> Barclays Bank, n. 44 above at 12

<sup>49</sup> J Braucher, n. 33 above at 14

Another form of targeted regulation is to promote alternative forms of lending that give borrowers access to loans for emergency needs at more reasonable rates.<sup>50</sup>

Such targeted regulation is necessary and justified, given the clear relationship between a failure on the part of mainstream financial institutions to adequately service this part of the market, and problems of over-indebtedness. This relationship has been recognised in a number of reports tackling such issues as payday lending, fair consumer credit markets and financial exclusion.<sup>51</sup> The failure of banks and other mainstream credit providers to provide necessary credit services to people living on low incomes is given as a reason for recent increases in the number of fringe credit providers,<sup>52</sup> with evidence that

Banks, notwithstanding their public relations efforts, are not strongly committed to cultivating lower income clients or branches which serve lower income areas which do not generate sufficient profits in this age of shareholder-driven capitalism.<sup>53</sup>

Financial deregulation following the Campbell Inquiry report of 1981<sup>54</sup> is one possible cause of the current focus of mainstream financial institutions on more 'profitable' customers. Deregulation involved the removal of official controls on interest rates, the removal of restrictions on lending and borrowing thus allowing more entrants into the financial services market, and a move to a system based on

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<sup>50</sup> J Braucher, n. 33 above at 16

<sup>51</sup> See for example C Connolly and K Hajaj, 'Financial Services and Social Exclusion' (Financial Services Consumer Policy Centre, University of NSW, Chifley Research Centre, 2001), Consumer Affairs Victoria, n. 20 above, Department of Trade and Industry (U.K.), n. 5 above, E Kempson et al, 'In or Out? Financial Exclusion: a Literature and Research Review' (Financial Services Authority, 2000), I Ramsay, 'Access to Credit in the Alternative Consumer Credit Market' (Office of Consumer Affairs, Industry Canada and Ministry of the Attorney General, British Columbia, 2000).

<sup>52</sup> I Ramsay, n. 51 above at 5.

<sup>53</sup> I Ramsay, n. 51 above at 5.

<sup>54</sup> Campbell Committee, 'Australian Financial System: Final Report of the Committee of Inquiry into the Australian Financial System' (1981)



prudential guidelines and monitoring rather than direct controls.<sup>55</sup> Whilst the Wallis Inquiry<sup>56</sup> predicted that deregulation would lead to increased competition in the financial services market that would bring about affordable financial services for all Australians, such competition has failed to emerge in relation to servicing the financial needs of low-income consumers.<sup>57</sup> Field has referred to low income consumers as the ‘losers’ of competition<sup>58</sup> in the financial services arena, giving as an example the fact that bank fees tend to be lower for those customers with residential mortgages, but higher for those customers ‘without a loan, who have low balances and have a high volume of transactions’.<sup>59</sup> Other examples of low-income consumers ‘losing’ under deregulation include the closure of bank branches in areas populated by low-income consumers,<sup>60</sup> and the heavy fees imposed for cheques that have bounced or accounts that have become overdrawn, which are most likely to be borne by those on low and fixed incomes.<sup>61</sup> Langmore writes that:

Ironically, in this era of deregulation, the impediments and barriers to use of financial services seem to have grown. Charges and fees for many financial services have been sharply increased, especially for small savers. In many ways, deregulation has benefited the rich and further oppressed the poor.<sup>62</sup>

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<sup>55</sup> A Tyree and P Weaver, *Weerasooria's Banking Law and The Financial System in Australia* (2006), at 8-9

<sup>56</sup> S Wallis, 'Financial Systems Inquiry Final Report' (1996)

<sup>57</sup> See discussion in C Connolly and K Hajaj, n. 3 above.

<sup>58</sup> C Field, 'Competition, Consumer Protection and Social Justice- Providing a Consumer's Voice' (2005) 33(1) *Australian Business Law Review* 51 at 54.

<sup>59</sup> C Field, n. 58 above at 54 quoting from *Banking Fees in Australia, Reserve Bank Bulletin, April 2003*.

<sup>60</sup> C Connolly and K Hajaj, n. 3 above at 10 and 16.

<sup>61</sup> C Connolly and K Hajaj, n. 3 above at 10 and 16.

<sup>62</sup> J Langmore, 'Microcredit: More than just small change.' (Paper presented at the Microcredit: More than just small change conference, Melbourne, 2005) at 12.

Further, and most relevantly to the concerns of this chapter, people on low incomes are left without access to 'safe credit'. Access to credit has become an essential part of access to financial services, in a society where most consumers rely on credit in order to purchase what have come to be regarded as essential items such as refrigerators, washing machines and television sets.<sup>63</sup> One research paper has noted that:

A growing necessity for credit to purchase essential household items and services has placed low-income consumers in an even more precarious position in an increasingly deregulated financial services market.<sup>64</sup>

As Kempson notes:

While borrowing money to supplement a low income may not be desirable it may, in some circumstances, be unavoidable- either to buy essential household items or to make ends meet.<sup>65</sup>

Whilst the duty to lend responsibly and assess capacity to repay before lending is important, this does not need to negate the possibility of lending to people on low incomes. The position is well summarised in the following statement in the recent Victorian credit review:-

The debates about over-indebtedness and access to affordable credit are interrelated because the same group- low income, vulnerable and disadvantaged consumers- is often the subject. Efforts to control over-indebtedness should not deny access to

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<sup>63</sup> See discussion in C Connolly and K Hajaj, n. 3.

<sup>64</sup> V Ayres-Wearne and J Palafox, 'NILS: Small Loans- Big Changes' (Good Shepherd Youth and Family Service, 2005), p.1.

<sup>65</sup> E Kempson et al, n. 51 above at 41.

credit by low income, vulnerable and disadvantaged consumers who are capable of managing their finances effectively. But the risks to these consumers should be recognised, because they are more exposed to the micro-lending market, in which credit is often more expensive and the risk of unfair contract terms is higher.<sup>66</sup>

A joint submission to the Credit Review by Brotherhood of St Laurence and Good Shepherd Youth and Family Service makes the clear point that people on low incomes are capable of managing small loans:-

We believe it is important to consider that not everyone who is on a low income is over-committed and experiencing major financial difficulties. Many low income earners are extremely careful money managers who are determined to live within their means: they have stable income and housing. However, many people are still unable to obtain access to the full range of financial services, including mainstream credit for necessary goods.<sup>67</sup>

A report prepared by Brotherhood of St Laurence in relation to its pilot loan programs offered in 2005 in partnership with the Community Sector Banking arm of Bendigo Bank, also refers to the clear evidence emerging from that pilot that ‘people on low incomes could indeed repay loans’.<sup>68</sup>

Lending to a person on a low income, at a reasonable rate of interest and on reasonable terms, is *unlikely* to lead to over-indebtedness for that person. The fact that that person may not be able to access such credit and will need to turn to the often

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<sup>66</sup> Consumer Affairs Victoria, n. 25 above at 8.

<sup>67</sup> Consumer Affairs Victoria, n. 25 above at 72.

<sup>68</sup> R Scutella and G Sheehan, 'To their credit: Learning about personal loans for people on low incomes' (2006) August *Brotherhood Comment* 10

exploitative forms of fringe credit available *is* likely to lead to over-indebtedness for that person.

### ***Overcoming concerns that lending to people on low incomes is necessarily irresponsible***

It seems that one reason for the concern that lending to people on low incomes is irresponsible and likely to exacerbate over-indebtedness, is a lack of information about the risks or otherwise of lending to that sector of the market. Standard credit scoring models used in Australia automatically exclude most low income consumers from being eligible for loans. A report in relation to a pilot low interest small loans program offered by the Community Sector Banking arm of Bendigo Bank and Brotherhood of St Laurence in 2005, noted that:

Computerised credit approval systems would have automatically declined most of the loan applicants. The pilot's manual approach, however, took into account bill and rent payment histories, strategies for managing cash flow, and individual budgets.<sup>69</sup>

Obtaining such 'positive credit' information can, at present, involve an expensive and time consuming process for financial institutions. While it is a contentious issue, some consideration needs to be given to the introduction of 'positive' or 'comprehensive' credit reporting in Australia. In the U.S. lenders make extensive use of the information contained in consumer payment histories. That information is applied to scoring models in order to assess risk and decide whether or not to lend. In Australia, under the *Privacy Act 1988* (Cth), only negative reporting of credit histories is

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<sup>69</sup> R Scutella and G Sheehan, n. 68 above.

allowed, that is, information on defaults and bankruptcies, not on positive account payment histories. A study has been conducted that demonstrated that the detailed credit histories available in the U.S. greatly enhanced the accuracy of the 'risk scoring process' and led to a wider range of consumers being successful in their applications for credit than would have been the case applying with respect to the same consumers the limited negative credit histories available in Australia.<sup>70</sup> One concern about the introduction of a positive credit reporting regime, is that it could lead to increased corporate information gathering for undesirable purposes, such as aggressive marketing of credit products, no doubt aggravating problems of over-indebtedness. If, however, a positive credit reporting regime that adequately addressed that concern was possible, then it may result in more low income consumers being found eligible for mainstream credit. Those consumers may prove to be lower risk borrowers than might otherwise have been assumed.

The possibility that the low income market is not necessarily a 'risky' market is supported by the experience in the U.S. under the *Community Reinvestment Act 1977* (U.S.) ("CRA") regime. The CRA is not without its critics in the U.S.<sup>71</sup> Most recently, concern has been expressed over the increase in 'sub-prime mortgage lending' in the

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<sup>70</sup> M Staten and J Barron, 'The Value of Comprehensive Credit Reports: Lessons from the US Experience' (Paper presented at the Australian Retail Finance Conference, Sydney, 2000). The study took credit information and applied it to a risk scoring model in order to assess the credit risk of certain individuals and decide whether or not to lend to them on the basis of an acceptable percentage default risk. The limited negative information available in Australia was applied, and then the more extensive information available in the United States. One example of the findings was that, using a target rate of 4% defaults on loans, 76.5% of the sample group would have obtained the loan using the information available in the United States, while only 57% would have obtained the loan using the more limited information available in Australia. The conclusion drawn from the study was that, due to a lack of information available to lenders in Australia, consumer credit is less readily available in Australia than in the United States.

<sup>71</sup> See discussion in M Barr, 'Credit Where it Counts: The Community Reinvestment Act and its Critics' (2005) 75(6) *New York University Law Review* 101

U.S., which it is feared will result in a ‘housing led recession’.<sup>72</sup> However, as one commentator notes it is important to distinguish between sub-prime loans, which are simply loans to people who may not be eligible for ‘mainstream loans’ and predatory loans such as the payday loans described above, because to put it simply, ‘sub-prime is good, predatory is bad’.<sup>73</sup> The evidence is that the CRA has helped to overcome market failure in credit markets in the U.S. by enhancing access to credit for low income borrowers.<sup>74</sup> The purpose of the CRA’s enactment is said to have been to require banks to ‘serve the credit needs of [their] entire communit[ies], including low-and-moderate-income neighbourhoods’.<sup>75</sup> The four federal agencies that enforce the CRA have focused their attention on residential mortgage lending, but there has been a call for greater focus on the more general provision of banking services to people on low incomes to overcome reliance by those people on fringe credit providers.<sup>76</sup> In response to this call, it has recently been announced that banks that provide affordable small loan products for customers ‘who may otherwise be victimized by high-cost overdraft and payday loans’ will be rewarded in terms of their CRA rating.<sup>77</sup> To qualify for this ‘reward’, banks will need to provide these small loans at rates of 36% per annum or less, with a steady reduction of principal and financial counselling for frequent borrowers.<sup>78</sup> Under the CRA banks are rated on the extent of their lending to borrowers at different income levels, and the provision by them of community development loans. Large banks (with assets from US\$1 billion) are also rated on an

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<sup>72</sup> Anonymous, 'Could Tremors in the Subprime Mortgage Market be the First Signs of an Earthquake?' (2007) *Knowledge@Wharton* <<http://knowledge.wharton.upenn.edu/article.cfm?articleid=1664>>

<sup>73</sup> Anonymous, n. 72 above.

<sup>74</sup> M Barr, n. 71 above at 101

<sup>75</sup> W Apgar and M Duda, 'The twenty-fifth anniversary of the Community reinvestment Act: Past accomplishments and future regulatory challenges' (2003) 9(2) *Economic Policy Review- Federal Reserve Bank of New York* 169 at 169

<sup>76</sup> See discussion in W Apgar and M Duda, n. 75 above.

<sup>77</sup> Center for Responsible Lending, 'FDIC pushes for affordable loans: Regulator offers CRA incentive for 36% interest rate cap and other measures' (2007) *Center for Responsible Lending NewsBrief*

<sup>78</sup> Center for Responsible Lending, n. 77 above.

investment test, concerned with community development investments and responsiveness to credit and community development needs; and a service test based upon the range of services provided by the bank including technical expertise given to 'not for profits'.<sup>79</sup> A poor CRA rating can affect a bank's application for deposit facilities including applications for mergers with and acquisitions of deposit-taking institutions. CRA ratings are also taken into account in the approval process for opening or closing bank branches<sup>80</sup> and banks must have a satisfactory CRA rating to be allowed to engage in extended financial activities such as insurance and securities.<sup>81</sup>

It is interesting to note that, according to a Federal Reserve Board survey, default rates on CRA loans have been low, and that those loans have proven to be generally profitable and not particularly risky after all; that 'pushing into low-income markets has not weakened banks' profitability and soundness'.<sup>82</sup> Further, by encouraging banks to lend to people on low incomes that market has become 'thicker', thus reducing information asymmetries brought about by a lack of information in relation to lending to that market. Barr notes that:--

As lenders obtain information about creditworthy low income borrowers and develop expertise in lending to those borrowers, the transaction costs associated with overcoming information asymmetries also decrease...with lower information asymmetries, loan prices can be reduced so that they become commensurate with measurable risk, and thus adverse selection and moral hazard pose less of a problem

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<sup>79</sup> R Marsico, 'The 2004-2005 Amendments to the Community Reinvestment Act Regulations: For Communities, One Step Forward and Three Steps Back' (2006) 39 *Clearinghouse Review Journal of Poverty Law and Policy* 534 at 535-536

<sup>80</sup> M Barr, n. 71 above at 105

<sup>81</sup> M Barr, n. 71 above at 115

<sup>82</sup> M Barr, n. 71 above at 167

to reaching further into the market of potential borrowers in low income communities.<sup>83</sup>

The argument is that by mandating lending by banks in the low income market, banks will become more experienced at assessing risk in that market. It is possible that with greater information becoming available about the low income credit market, small personal loans to low income consumers could be offered and priced profitably and according to risk, without involving the prohibitive interest rates currently imposed by the fringe credit lenders on low income consumers.<sup>84</sup>

## ***Conclusion***

A practice of lending to people who are not in a position to repay a loan in accordance with its terms will undoubtedly lead to problems of over-indebtedness. There is evidence of this occurring, particularly in the fringe credit market, with payday lenders being an example. Equally, however, this paper has sought to demonstrate that *not* lending to people on low incomes on fair and reasonable terms is a key cause of over-indebtedness. Whilst some mainstream financial institutions cite concerns about irresponsible lending as a reason for not lending in the low income market, it seems likely that a desire to pursue more profitable customers in the deregulated financial market is also a major concern.

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<sup>83</sup> M Barr, n. 71 above at 128

<sup>84</sup> See discussion in this regard in T Wilson, 'The inadequacy of the current regulatory response to payday lending' (2004) 32 *Australian Business Law Review* 193



Policy makers need to consider appropriate regulatory action to encourage or require mainstream financial institutions to provide small amount credit to low income earners, in a bid to overcome *both* financial exclusion *and* problems of over-indebtedness. As indicated in the above discussion concerning the CRA, the perceived risk of lending in this market might be overcome by increasing ‘market thickness’. Further, allowing financial institutions access to positive credit information may be an important mechanism to facilitate lending in this market. It may also be necessary to develop alternative credit scoring models for lending in this market.

The empirical evidence available demonstrates that:

Mainstream credit can be tailored to suit people on low incomes and help them establish creditworthiness;

that:

people on low incomes could indeed repay loans;

and most importantly that:

Obtaining a loan was not only about money, but also dignity and inclusion. It was an opportunity not to be just a passive recipient of welfare, but to gain self-esteem by taking an active role.<sup>85</sup>

These lessons must not be lost amidst concerns about irresponsible lending and over-indebtedness.

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<sup>85</sup> R Scutella and G Sheehan, n. 68 above.

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