COMPETITION
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# Benefits and detriments from short term lending model

[redacted] (Ph.D.)

August 2019

COMPETITION ECONOMISTS GROUP

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# 1 Introduction

1. I, [redacted] have been engaged by ExpertsDirect to provide an independent expert report in relation to a proposal by ASIC to apply a Product Intervention Order that would have implications for the short term lending business model supported by Cigno Pty Ltd and Gold-Silver Standard Finance Pty Ltd (GSSF). I have been specifically asked to address the following questions.

   *1. What is the benefits of access to credit for consumers? What are detriments to consumers who are denied access to credit?*

   *2. What are the factors that are relevant to the determination of the price that is offered for credit? What is the effect of legislative price caps on the availability of credit?*

   *3. Do you consider that the use of the short term lending model without centrally-determined price caps will cause, or is likely to cause, significant detriment to consumers? If so, what features of the short term lending model contribute to significant detriment to consumers?*

   *4. Do you consider that a legislative prohibition on the use of the short term lending model (or the imposition of centrally-determined price caps below market-determined prices for credit offered under the short term lending model) will cause, or is likely to cause, significant detriment to consumers? If so, what is that detriment and how is it measured?*

   *5. What alternatives to prohibition (or price caps) can be taken to prevent significant detriment to consumers from the use of the short term lending model? Are those alternatives superior to prohibition and price caps? Why or why not?*

   *6. What, if any, indirect or secondary effects will result, or will likely result, to other persons in the community, if a consumer who would otherwise get credit offered through the short term lending model cannot source price-capped or cheaper sources of credit in the market?*

2. I hold the following qualifications:

   - Bachelor of Economics (Honours First Class), Monash University (1989); and
   - PhD in Economics, Monash University.

3. From 1990 to 2000 (both prior to, during and after the completion of my PhD in economics) I was employed by the Commonwealth Treasury. Since 2001 I have worked as a consulting adviser specialising in economics: first with Arthur Andersen, then NERA Australia and, since 2007, for my own firm (Competition Economists

Group). I have advised private clients, regulators and other Government agencies on a large number of competition law cases and matters of financial economics.

4. I have more than 25 years of experience in the economic analysis of markets and in the provision of expert advice in regulatory, litigation and policy contexts. I have provided expert testimony before courts and tribunals and in numerous regulatory forums in Australia but also in the United Kingdom and New Zealand.

5. A copy of my curriculum vitae with full details of my qualifications and experience is provided separately.

6. In preparing this report I have had regard to the materials specifically identified throughout the report, in the form of footnotes or in the text.

7. Signed on 7 August 2018

Director
CEG

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# 2 Answer to questions

## 2.1 What are the benefits of access to credit for consumers? What are the detriments to consumers who are denied access to credit?

8. Credit refers to an arrangement in which the borrower first receives a benefit such as cash, goods, or services and promises to pay for it in the future. The arrangement usually incurs fees and interest costs, such that the consumer's total cost when paying in the future will be higher than the amount borrowed.

9. Consumers benefit from access to credit in two main ways:

   - Credit allows consumers to manage lumpy cash flows by trading future consumption for present consumption; and
   - Credit can be used to make investments from which the consumer derives future benefits that exceed the corresponding costs.

10. Credit provides consumers with the option of meeting payments in the current period based on their future incomes rather than having to prefund all expenditures by saving prior income. Rational consumers will choose to make use of credit if they conclude that the benefits of doing so outweigh the costs. As described by Kapoor *et al* (2012):[1]

> *The use of credit provides immediate access to goods and services, flexibility in money management, safety and convenience, a cushion in emergencies, a means of increasing resources, and a good credit rating if you pay your debts back in a timely manner. But remember, the use of credit is a two-sided coin. An intelligent decision as to its use demands careful evaluation of your current debt, your future income, the added cost, and the consequences of overspending.*

### 2.1.1 Credit allows consumers to manage lumpy cash flows by trading future consumption for present consumption

11. The ability to use credit to optimally allocate consumption across time is a standard aspect of consumer decision making and its modelling is core to all macroeconomic models of how the economy – such as those used by central banks. This study of intertemporal optimisation of consumption is a significant field in economics – in

[1] Kapoor, Dlabay and Hughes, Personal Finance, 10th Edition, McGraw-Hill, New York, 2012, p. 173.

large part because how consumers adapt their consumption profiles to household cash-flow shocks has important implications for how the wider economy behaves.

12. Irving Fisher was one of the first economists to tackle intertemporal choice in his *Theory of interest* (1930).[2] Fisher demonstrated that a rational forward looking consumer would choose consumption for the present and future to maximize their lifetime satisfaction. Whether they were a net borrower or lender at any given point in time would depend on their preferences, the cost of credit that they faced and other factors (such as current and expected future income).

13. Later economists, including Nobel Prize winners Milton Friedman and Franco Modigliani built on the work of Fisher to develop what is known as the 'life cycle theory of consumption' or the 'permanent income hypothesis'.[3] This model assumes that consumers have a preference for smooth consumption over their lifetimes, based on their long run expected average income. It predicts that individuals will rationally borrow smooth consumption between periods rather than have their income in any given one period determined by their consumption in that period. This includes:

    a. Borrowing when the individual is young and their expected future income is higher;

    b. Borrowing (or running down precautionary saving) when they experience a negative cash-flow shock.

14. Household cash-flow is not perfectly predictable. The vicissitude of life invariably result in households facing some cash flow volatility, including periods where their consumption expenses exceed their incomes, and other periods where they will have a surplus of income over current consumption expenses.

15. Negative cash flows in a period may reflect deliberate consumption choices, such as the decision to fund a child's overseas 'gap year' adventure or to travel interstate for the purpose of attending a close friend's wedding. Negative cash flow shocks may also occur due to adverse unexpected shocks to household cash flow, such as an unanticipated dental emergency or a reduction of casual employment income due to illness.

16. Households can manage this volatility in two main ways:

    - **Save first** by building up a buffer of liquid assets (precautionary saving) such as deposits in a bank account. This requires the household to have spent less than

[2] IRVING FISHER, T*he theory of interest, as determined by impatience to spend income and opportunity to invest it* (New York: Macmillan, 1930)

[3] See: Milton Friedman, *A Theory of the Consumption Function* (chapter: The Permanent Income Hypothesis), Princeton University Press, 1957.

they earned over a sufficiently long period of time **before** the negative cash flow shock occurred; and/or

- **Save second** by borrowing to pay off the shortfall, in which case the household will have to pay back the loan in future by spending less than they earn in order to fund repayment of the loan **after** the negative cash flow shock occurred.

17. In both cases, there will be periods where the household is a net spender and can consume more than it earns, as well as periods where the household is required to be a net saver by consuming less than it earns. The primary difference between prior saving and the use of credit pertains to whether the household will be a net spender/saver before or after the negative cash flow shock occurs. In addition, the amount of saving that is required is typically lower if prior saving is used to smooth future cash-flow volatility. This reflects the fact that credit providers have costs (such as administration and default risk) that are typically higher than for a household self-providing liquidity via precautionary saving (although prior saving can still expose a household or a household member to the risks that they will lose the value of that saving before they can benefit from it).[4]

18. Of course, it is quite possible for a household to engage in prior saving and the use of credit. This is, standard practice for households who buy a dwelling – saving a deposit first and using credit to fund the remainder of the purchase. Similarly, a household may develop a level of liquid precautionary savings that helps to smooth cash-flow shocks but which is not always sufficient in the face of larger negative shocks – in which case they may resort to credit to more fully smooth their cash-flow.

19. Optimal consumption smoothing can take place over a long horizon (e.g., a recent university graduate going into debt to fund consumption in excess of income on the assumption of a steadily rising salary). However, optimal consumption smoothing may also take place with very short term horizons.

20. For example, if a household faces a negative short term income shock (e.g., a casual worker being sick or, for whatever reason, working fewer hours). Such a household may find it optimal not to cut consumption by the same amount as income fell but instead to borrow. This will ameliorate the current period reduction in consumption and spread the required reduction in consumption over the period of the repayment of the loan. Indeed, this may be necessary if precautionary savings plus discretionary consumption (i.e., consumption above and beyond rent and essential grocery expenses) is less than the income shock. (The same logic applies if a household faces an unanticipated large consumption expense in a period (such as attending an interstate funeral or replacing a household heater).)

[4] For example, other people or household members may steal, extort or simply pressure the saver in order to access any prior saving.

### 2.1.2 Credit can be used to make investments for which the household derives future benefits that exceed the corresponding costs

21. Households can also use credit to make investments for the purpose of earning income. This would be rational if the expected return on the investment exceeds the cost of funds required to make the investment (that is, the investment has a positive net present value) and is consistent with the household's risk profile.

22. Credit will often be necessary where investments are large relative to the size of a household's existing net assets and is thus only accessible through credit. Households that are well-off may use credit to make large long-term investments such as purchasing an investment property. Households that are less well-off, on the other hand, may make investments that are more modest and short-term in nature but are nevertheless large relative to their net assets (and just as meaningful in the context of their lives). For example, some of these investments may be necessary for households to maintain employment, such as:

    - Repairing a motor vehicle that may be required to attend a place of employment or maybe used in their employment;
    - Paying rental shortfalls in order to avoid eviction and, in so doing, avoiding even more substantial cash flow problems in the future due to loss of earning potential that flows from the instability of life with insecure housing; or
    - Repairing or replacing a home appliance the continued operation of reduces other expenditure (e.g., an operational refrigerator may avoid the higher expense associated with reliance on food prepared outside the household, an operational washing machine may avoid the costs of a coin operated laundry etc).

23. Of course, the financial position of a household choosing to use credit in order to fund an investment property is likely to be much stronger and more stable than a household taking out a short-term loan to repair a motor vehicle. Nonetheless, these are, as a matter of economics, fundamentally similar decisions. They both involve rational households assessing the future income with and without the credit funded expenditure and making such decisions in their own perceived best interests.

### 2.1.3 What are the detriments to consumers who are denied access to credit?

24. The ability to access credit reflects an additional option that households can choose to pursue. As a matter of economics, it must be assumed that, provided borrowers are rational and well informed, then their choice to access credit (be it a financially distressed lower socio-economic household or a financially stable middle-class household) should be expected to provide them with a net benefit. Conversely, households that are not expected to benefit from gaining access to credit would in turn choose not to seek credit.

25. For this reason, denying credit access (be that payday loans or mortgages for investment properties) cannot be expected to benefit rational well-informed households. Specifically, households that would not have obtained payday loans anyway would be unaffected by being denied credit access, but households that would have rationally obtained credit through payday loans will lose any net benefits from being denied access to such credit, as set out in sections 2.1.1 and 2.1.2 above.

26. A similar observation was made in ASIC's own report, which implicitly acknowledges the benefit of accessing the type of short term loans facilitated by Cigno. Under the heading "Targeting of vulnerable consumers" ASIC states:[5]

> *Consumers who use short term credit are often from low socio-economic backgrounds and/or are experiencing financial stress. In the examples we have seen, consumers have generally used these loans to pay for basic expenses such as food, bills, and car-related expenses.*

27. The first sentence of this statement would appear very likely to be factually correct. A middle class household from a high socio-economic background will be unlikely to wish to access loans of the kind that Cigno facilitates. For the reasons set out in my answer to question 2 below, the overall cost of these loans is high relative to most alternatives available to a middle-class household (such as drawing down on precautionary savings or lines of credit (e.g., credit card debt or mortgage redraw facilities)). It is typically only households that are experiencing financial distress (i.e., that do not have access to the aforementioned lower cost alternatives) that will receive benefits from accessing credit in this form.

28. Similarly, for the reasons set out above, those customers will rationally access credit for precisely the sort of reasons listed in the second sentence of ASIC's statement. It is the ability to smooth consumption between periods (i.e., fund "food and bills" now by reducing future consumption) and to invest in potential income generating assets (such as car repairs) that is valuable to borrowers. This is why households would rationally seek short term credit.

29. There is therefore nothing in the above statement from ASIC that suggests to me, as an economist, that consumers who seek short term credit are making irrational decisions to do so. A necessary, but not sufficient, condition to believe the contrary is that:

    - households from "low socio economic backgrounds" are generally incapable of making rational decisions, or are specifically unable to do so in relation to obtaining short term credit; and/or

5 ASIC, Using the product intervention power: Short term credit, Consultation Paper 316, July 2019, p. 16 at [44].

- households who are 'financially distressed' are not capable of making rational decisions in general or in relation to obtaining short term credit.

30. If either of these propositions could be made out on a factual basis then it is possible, although far from obvious that borrowers are worse off as a result of having access to credit. However, I am aware of no evidence presented by ASIC that would support these propositions.

## 2.2 What are the factors that are relevant to the determination of the price that is offered for credit? What is the effect of legislative price caps on the availability of credit?

### 2.2.1 What are the factors that are relevant to the determination of the price that is offered for credit?

31. A credit provider will only seek to offer a service if the expected revenues from its services at least match the provider's costs (including a return on any investments necessary for the credit provider's operation). The costs of a credit provider can generally be broken down into three components:
    - The risk adjusted cost of funds to the credit provider;
    - The administration costs of arranging and managing the loan; and
    - The expected cost of default.

32. The cost of default is an uncertain cost for each individual loan but, over a larger portfolio of loans, the expected portfolio cost is more predictable. That is, at the time of making any individual loan the credit provider does not know how much, if any, of the loan will be paid back. If the credit provider did know this in advance then no loans would ever materially default because they would not be made in the first place. However, the credit provider must form a view on what proportion of loans are expected to default and how severely. This will determine the actuarially expected cost of default on any individual loan and the portfolio as a whole.

33. A core function of a credit provider, especially a provider of unsecured loans, is to make an assessment of the probability and severity of default. The profit maximising credit provider must then both:
    - reflect the expected cost of default for loans (along with the costs of administration and funds) in the price that they set for a loan; and
    - deny credit to customers whose expected cost of default is higher than the amount allowed for in the provider's price.

34. Only if the credit provider does this accurately can they expect to recover their full costs and make a risk adjusted return on their investments.

35. This is the same process that a bank or any other financial institution will go through when arranging a mortgage over residential property or a business loan. Naturally, the expected costs of default will depend on the characteristics of the loan and the financial position of the borrower. For example, a secured loan will, other things equal, have a lower expected cost of default than an unsecured loan. Similarly, a loan to an individual/entity in a strong financial position will have a lower expected cost of default than a loan to an individual/entity in a weaker financial position.

36. This is a description of how all finance markets work. The same principles apply whether the loan is in the form of: bonds issued by an A rated corporation; "junk bonds" sold by low rated corporations; home mortgages; credit card lending; and 'payday' loans.

37. ASIC, at paragraph 55 of its consultation paper, estimates an annualised interest cost associated with a hypothetical Cigno/GSSF loan of 938%. Without having verified the accuracy of the assumptions and calculations, it is relevant to make a number of observations about this presentation of the "price" of a loan;

- The loan size modelled by ASIC is for $200. Clearly, for small loan amounts such as this administration costs can be a very high proportion of the loan amount. Consequently, converting this into an annual interest rate on a $200 loan can be misleading.
  - For example, the Commonwealth Bank has a $150 application fee for a personal loan plus a $10 per month service fee.[6] In ASIC's example, the Cigno/GSSF loan has total repayments in excess of the original principal of $207 over a two month period. This is only $37 above the fee level charged by the Commonwealth Bank ($170=$150+2*$10);
  - It is true that, in contrast to ASIC's hypothetical Cigno/GSSF loan, the Commonwealth bank has a minimum loan amount of $4,000. However, it is not obvious that administration costs are materially different when the loan is $200 vs $4,000.
- The $37 difference between Cigno/GSSF total loan costs and the $170 Commonwealth bank fees could easily be fully accounted for by:
  - Higher expected cost of default for a Cigno/GSSF loan given that such loans are, as ASIC acknowledges, sought by borrowers in financial distress who have typically been denied credit by other providers; and

6 https://www.commbank.com.au/personal-loans/fixed-rate-loan.html (accessed at 1.18pm on 6 August 2017)

- Higher volatility of default rates for the Cigno/GSSF loan portfolio which may raise the overall riskiness of Cigno/GSSF loan portfolio.
- The interest costs on a Commonwealth Bank personal loan of around 13% pa (ASIC's hypothetical loan repayments of $407.6 includes both fees and interest charged by Cigno/GSSF).

38. Once one properly has regard to the above considerations, there is nothing surprising or unusual about the pricing of the hypothetical Cigno/GSSF loan referenced by ASIC.

### 2.2.2 What is the effect of legislative price caps on the availability of credit?

39. Legislative price caps will, for any credit provider caught by the regulation, deter the provision of credit to customers whenever the expected cost of providing credit is higher than the legislative price cap allows to be charged. That is, lowering the maximum price that can be charged by credit providers will not result in all existing customers continuing to be served at lower prices. Rather, any customer whose cost to serve is above the legislative price cap will go unserved.

40. Of course, the fact that it is prohibited for certain entities to profitably serve the needs of these customers does not mean these needs disappear. Rather, those unserved customers will need to resort to the alternatives available to them – alternatives that they, by definition, found more unpalatable than being served by credit providers absent the prohibition.

41. These alternatives may include the following:

    a. Not accessing any credit and, therefore, adapting their current period expenditures to their current period income. These consequence were discussed in my response to question 1 but might include:

        i. Failing to invest in maintaining employment/housing with consequent material reductions in future income. That is, consuming less now **and** less in the future due to loss of future income. For example, being unable to fund repairs to a motor vehicle that is necessary for them engage in employment.

        ii. Severely limiting their personal consumption in the current period in a manner that they regard as less optimal to spreading the burden across multiple periods. Examples of this might include:

            - Going hungry and/or eating less healthily;
            - Failing to attend an important life event (such as an interstate funeral for a parent);
            - Failing to have a pet treated by a veterinary surgeon at some risk to the health/life of that pet;
            - Etc.

b. Seeking unregulated forms of credit. This might be in the form of loans from black market credit providers or loans from family and acquaintances.

c. Engaging in income generating activities that were perceived by that consumer as less desirable than taking out a loan. Included in such activities might be a resort to crime other 'grey market' means of income production.

42. Clearly, a relevant question in the current context is whether customers that would be denied credit due to a legislative cap, would be better off as a result.

43. Assuming that the customer is rational and well informed then, by definition, they perceive that they will be worse off as a result of any legislative cap that effectively excludes them from what would otherwise be legally provided credit. Unless we assume we know better than the borrower the value of credit to them, then effectively denying them access to credit must be expected to make them worse off. Thus, for rational well informed customers there must be a detriment from a prohibition.

44. Of course, it is possible that some customers who would be denied credit (from those entities captured by the legislation) are irrational and poorly informed and would be better off not taking out credit. For these customers it is conceivable that a legislative price cap that denied them credit would make them better off. However, it is not enough to assume the existence of irrational customers. One must also assume that these customers do not seek out alternative credit providers – those not captured by the legislative cap (either as a matter of law or because the providers operate in the black market).

45. That is, if the legislative price cap simply shifts supply of credit from regulated to unregulated sources then the benefits, even for irrational consumers, of the price cap is limited (and maybe negative if the alternatives chosen are even less suitable).

46. In fact, as noted by ASIC, a large proportion of Cigno/GSSF's clients have already been rejected by other suppliers. I can only assume that this is because the cost to serve these customers is lower than the regulated price that other providers (not utilising the Cigno/GSSF short term lending model) are allowed to charge those customers. That is, Cigno/GSSF's customer base is largely driven by regulations that have diverted customers to Cigno/GSSF. There is no reason to believe that prohibiting Cigno/GSSF from serving these customers will not simple divert their demand elsewhere.

47. In fact, Bhutta et al. (2016)[7] exploit variation in payday-lending laws across US states in order to estimate, amongst other things, whether customers simply shift to other sources of credit. Neil Bhutta is a Principal Economist with the US Federal Reserve Board. The paper's conclusion is summarised in the abstract.

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7 Neil Bhutta, Jacob Goldin, Tatiana Homonoff, *Consumer Borrowing after Payday Loan Bans*, Journal of Law and Economics, vol. 59 (February 2016)]

> *High-interest payday loans have proliferated in recent years; so too have efforts to regulate them. Yet how borrowers respond to such regulations remains largely unknown. Drawing on both administrative and survey data, we exploit variation in payday-lending laws to study the effect of payday loan restrictions on consumer borrowing. We find that although such policies are effective at reducing payday lending, consumers respond by shifting to other forms of high-interest credit (for example, pawnshop loans) rather than traditional credit instruments (for example, credit cards). Such shifting is present, but less pronounced, for the lowest-income payday loan users. Our results suggest that policies that target payday lending in isolation may be ineffective at reducing consumers' reliance on high-interest credit.*

48. This result in entirely consistent with the simple observation that legislating away the ability of certain providers to serve a customer's perceived need does not make that customer's need disappear. That customer will instead seek to access credit elsewhere if one avenue is denied to them.

49. Importantly, this is true for both rational well-informed customers and any irrational/poorly informed customers. Both types of consumer will act in accordance with what is in their perceived best interests (not what the regulator perceives as their interest). Indeed, it is entirely possible that restricting prohibiting the Cigno/GSSF short term lending model will result in:

    - Rational well-informed consumers choosing not to seek credit from alternative (potentially less savoury) providers on worse terms but instead bearing the costs identified in paragraph 41.a above;
    - Less rational and poorly informed customers continuing to seeking credit from alternative (potentially less savoury) providers on worse terms than are available from current providers.

50. That is, such a prohibition may well lead to the worst of both worlds. With customers deriving a benefit ceasing to derive a benefit and customers currently deriving a detriment (relative to a hypothetical ideal course of action) deriving an even worse detriment (because they respond by pursuing a course of action even further from the hypothetical ideal).

51. Mann and Hawkins' (2007) similarly observe that consumers who lose access to credit from payday loans are likely to shift towards borrowing from other sources that are less beneficial to them:

> *The core problem, however, is that bans are unlikely to keep consumers from borrowing. Rather, the evidence suggests that bans may well cause consumers to borrow from sources that provide products that are less*

*beneficial-products that consumers are more likely to avoid in markets that tolerate payday lending.* [8]

And

*To us, the evidence makes it at least possible that the consumers that have made payday lenders so profitable have done so for one general and rational reason: The products of payday lenders provide a better mix of benefits and risks than the competing products consumers would choose if payday lenders were banned.* [9]

## 2.3 Do you consider that the use of the short term lending model without centrally-determined price caps will cause, or is likely to cause, significant detriment to consumers? If so, what features of the short term lending model contribute to significant detriment to consumers?

### 2.3.1 Do you consider that the use of the short term lending model without centrally-determined price caps will cause, or is likely to cause, significant detriment to consumers?

52. To the extent that the customers of the short term lending model are rational and well informed, I consider that the short term lending model without centrally-determined price caps can be expected to provide net benefits to those customers of the kind outlined in my answer to the first question put to me.

53. Of course, even rational well-informed customers may enter into an arrangement that, due to the vicissitudes of life, turns out to be a mistake *ex post*. That is, they would, on an *ex post* basis, have been better off not entering into the arrangement. However, on an *ex ante* basis and as a matter of economic theory, I consider that voluntarily entering into that arrangement would, on the balance of probabilities, give rise to an expected net benefit.

54. The net benefit to rational and well informed customers of accessing the short term lending model should be measured as the difference between the value they perceive from credit provided by the short term lending model and the alternatives – as summarised in paragraph 41 above.

[8] Mann and Hawkins, Just Until Payday, UCLA Law Review, vol. 54, 2007, pp. 855-912, at pp. 886-887.

[9] Mann and Hawkins, Just Until Payday, UCLA Law Review, vol. 54, 2007, pp. 855-912, at pp. 887-888.

55. However, for irrational and less well-informed customers the answer is less clear. These customers may still receive a net benefit from the use of the short term lending model relative to the counterfactual of that lending model not being available. This is possible even if they have, due to irrationality or lack of information, incorrectly estimated the size of that benefit. However, if the customer is irrational and not well informed then we cannot simply rely on the fact that they seek credit to infer an expected benefit to them from the supply of credit.

56. Irrational or poorly informed customers may systematically underestimate the negative consequences to their future welfare (happiness) resulting from the sacrifice to future consumption that is required to repay the loan. Similarly, irrational or poorly informed customers may overestimate the benefit to their current welfare (or future income) of being able to meet the expenses that the provision of credit facilitates.

57. Of course, even if poorly informed irrational consumers are, to their detriment, obtaining credit from the short term lending model, this does not imply that the existence of the model results in a detriment to those customers. For this to be the case it would also be necessary that, absent the short term lending model, the poorly informed irrational consumers did not pursue equally or even more detrimental courses of action (see discussion at paragraphs 44 to 51 above).

58. The assumption of irrationality makes any quantification of detriment to these customers problematic. It means that we cannot rely on their own perceptions of benefits and costs but must, instead, superimpose a paternalistic assessment on them. It also requires us to be able to predict how they will respond to the short term lending model being unavailable to them. The assumption of irrationality makes it more difficult to predict responses – and arguably more likely that the response may be a course of action that is even more irrational (judged from a paternalistic standpoint).

### 2.3.2 If so, what features of the short term lending model contribute to significant detriment to consumers?

59. Any significant detriment to consumers from the short term lending model is dependent on the number of irrational or poorly informed customers using the service. I am unaware of any aspect of the short term lending model that contributes to the number of irrational or poorly informed customers using the service. However, as a matter of theory the following (hypothetical) practices could contribute to such customers inappropriately using the service:

- A failure to fully disclose fees and interest rates associated with the provision of credit or disclosure of such information in a confusing manner;
- Deliberately misleading the customer about aspects of the contract that they are entering into;

- Design of the credit repayment schedule in order to take advantage of any myopia amongst possible customers. For example, offering low monthly repayments for several years with a large balloon payment in the distant future such that a myopic borrower may incorrectly discount the difficulty of making that final payment;
- Pressure based sales techniques, including door to door sales, aimed at cajoling customers into taking the credit before they can fully consider the offer or 'shop around' for better offers; and
- Marketing campaigns specifically aimed at cognitively impaired potential customers.

60. I am aware that ASIC has taken a different view of the contribution of the short term lending model to consumer detriment. This is summarised in the below quote from the consultation paper.[10]

> 43 *Subject to the consultation process, in ASIC's view, it is likely that the short term lending model used by Teleloans/FLD and Cigno/GSSF, has resulted in significant consumer detriment. This is because the contracts provided through the short term lending model:*
>
> (a) *targeted vulnerable consumers experiencing financial stress;*
>
> (b) *have significantly higher upfront costs compared to regulated credit products, or if the short term credit exemption was strictly applied;*
>
> (c) *have high and uncapped fees payable on default creating a financial incentive to offer credit to consumers who are unable to meet repayments;*
>
> (d) *funnelled consumers to a high-cost alternative, given that the cheaper direct loan option is offered on terms which make it impractical for the target market; and*
>
> (e) *required consumers to repay the credit amount and fees via direct debit, which can adversely affect the consumer's financial situation when they are charged overdrawn fees as a result of attempts to deduct repayments from the consumer's account when it has insufficient funds.*

61. I consider that ASIC has incorrectly identified the above as 'detriments'. As already noted in my answer to question 1, ASIC's view (expressed in point a) above) that a detriment exists due to Cigno/GSSF targeting vulnerable consumers experiencing

10 ASIC, Using the product intervention power: Short term credit, Consultation Paper 316, July 2019, p. 16 at [43].

financial stress is problematic. Under the heading "Targeting of vulnerable consumers" ASIC states:[11]

> *Consumers who use short term credit are often from low socio-economic backgrounds and/or are experiencing financial stress. In the examples we have seen, consumers have generally used these loans to pay for basic expenses such as food, bills, and car-related expenses.*

62. As I have already noted, this statement is likely a factually accurate description of Cigno/GSSF's customers and their motivations for obtaining credit. However, there is nothing in this logic to suggest that those customers suffer a detriment from voluntarily obtaining credit from Cigno/GSSF. Indeed, the above description suggests to me that these are precisely the customers, provided that they are rational and well informed, who can expect to benefit from the service provided by Cigno/GSSF.

63. Similarly, point b) cannot be described as a detriment to consumers unless it can be shown that, absent Cigno/GSSF, customers would have been able to access terms consistent with those if "*the short term credit exemption was strictly applied*". If Cigno/GSSF customers could not access these terms, e.g., because they are set well below the market costs of serving those customers, then those terms are entirely hypothetical from the perspective of Cigno/GSSF customers and are irrelevant to any assessment of the detriment to them from choosing to access market rate credit from Cigno/GSSF.

64. I am sceptical about the relevance or accuracy of point c). I am dubious that a provider of credit would structure its fees and portfolio in an attempt to lend to customers in the expectation that they will default and the credit provider will collect material revenues in the form of default fees. Once a customer is in default the probability that the existing loan amount will be repaid falls materially – let alone that any default fees will ever be collected.

65. Point d) is just a variant of point b). The fact that GSSF offers a lower priced stand-alone product is irrelevant to the customers of Cigno/GSSF if they would not qualify for that loan or they would not seek that loan because the non-price terms were unattractive to them.

66. Finally, point e) is not, in my view, a reasonable characterisation of a detriment to consumers. Requiring direct debit payments is a sensible business decision for Cigno/GSSF that lowers their costs and, consequently, lowers the average price that they can charge their customers. If some customers have insufficient funds in their accounts and incur overdrawn fees then, while this is a cost to those customers, it is no more reasonable to describe this as a 'detriment' to borrowers than it is to describe

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[11] ASIC, Using the product intervention power: Short term credit, Consultation Paper 316, July 2019, p. 16 at [44].

the requirement to repay the loan, interest and fees as a 'detriment'. Direct debit arrangements would appear to be a sensible aspect of the business design aimed at lowering the expected cost of default and administration costs – allowing Cigno to offer lower prices overall to its customers. (I note that the same generic point applies to default fees.)

## 2.4 Do you consider that a legislative prohibition on the use of the short term lending model (or the imposition of centrally-determined price caps below market-determined prices for credit offered under the short term lending model) will cause, or is likely to cause, significant detriment to consumers? If so, what is that detriment and how is it measured?

67. A legislative prohibition of the short term lending model (including if given effect by setting a price cap below the cost of service provision) will cause that model to cease to be provided. This will cause a significant detriment to consumers to the extent that:

- There are rational and well informed customers that are currently deriving net benefits from accessing the consumption smoothing and positive NPV investment options afforded by credit provided under the short term lending model (see my answer to question 1).
- There are irrational or poorly informed customers who, while they may not be optimally using credit supplied under the model (relative to an idealised rational/well informed course of action), nonetheless derive benefit from the model relative to the conduct that they would undertake were the model prohibited. This subset of customers includes:
  - Customers who would shift to other forms of credit where they would suffer an even greater detriment;
  - Customers who are currently making mistakes (relative to some assessment of their 'true preferences') and are accessing more than the optimal level of credit under the short term lending model – but where the optimal level of credit is above zero; and
  - Customers who are currently making mistakes (relative to some assessment of their 'true preferences') and are accessing less than the optimal level of credit under the short term lending model – but who are still deriving benefits from that credit that they do access.

68. The detriment to the first set of rational and well informed customers should be measured as the difference between the value they perceive from credit provided by

the short term lending model and the alternatives – as summarised in paragraph 41 above. However, for the second set of customers the detriment that they experience is harder to conceptualise because the assumption of irrationality means that we cannot rely on their own perceptions of benefits and costs but must, instead, superimpose a paternalistic assessment on them.

## 2.5 What alternatives to prohibition (or price caps) can be taken to prevent significant detriment to consumers from the use of the short term lending model? Are those alternatives superior to prohibition and price caps? Why or why not?

69. In my answers to previous questions I have explained that rational well informed customers receive positive expected net benefits from the use of the short term lending model. I have also countenanced the likelihood that irrational poorly informed customers are not making optimal use of the short term lending model. Prohibition would clearly harm the first group of customers. However, it is far from obvious that prohibition would benefit the latter group of customers because:

- The actual course of action for these customers absent the short term lending model may be even further from a hypothetical optimum; or
- They optimal course of action for these customers may involve some use of the short term lending model (different from their current usage) and prohibition will deny them that.

70. In this context, any policy intervention must be justified by the existence of irrational poorly informed customers. It follows that the policy intervention itself should be focussed on ameliorating any harm to (or maximising the benefits for) irrational poorly informed customers. This is consistent with the standard refrain amongst economic policy experts that solutions should focus on, and be directly linked to, the identified problem. This is encapsulated in the below quote from the Productivity Commission.[12]

> *Any policy intervention should target a clearly identified set of problems.*

71. ASIC has provided very little evidence of customer irrationality or of customers being poorly informed (either about the nature of the Cigno/GSSF product or the availability of alternatives). However, to the extent that there is evidence that customers are making irrational poorly informed decisions, then any policy

[12] Productivity Commission, Inquiry into the National Third Party Access Regime for Natural Gas Pipelines (the Gas Access Regime), 2004, p. 87.

intervention should target those decisions. The nature of any such intervention would depend on the nature of any evidence of a problem but might:

- Address any of the potential problems associated with actions by Cigno/GSSF that fall into the categories of potentially detrimental actions by a credit provider described at paragraph 59 above. Specifically:
  - Require Cigno/GSSF to fully disclose in a clear and easy to understand manner, all fees and interest rates associated with the provision of credit;
  - Prosecute Cigno/GSSF should it act in a deceptive or misleading manner when dealing with customers;
  - Prohibit a pricing structure or other product terms that have no legitimate business rationale but that can be shown to have the effect of exploiting certain aspects of customer irrationality.
    - For example, ASIC has argued that default fees and direct debit repayment result in detriment to customers. I have expressed scepticism about ASIC's logic in these specific cases (see paragraphs 64 and 66 above). However, whatever the merits of the case, if these are the source of detriment then any policy solution should focus on amending these – not on complete prohibition the entire product.
  - Prohibit pressure based sales techniques, such as door to door sales, aimed at cajoling customers into taking the credit before they can fully consider the offer or 'shop around' for better offers; and
  - Prohibit marketing campaigns specifically aimed at cognitively impaired potential customers.
- Ameliorate the likelihood that irrational poorly customers make sub-optimal decisions via means other than imposing restrictions on Cigno/GSSF. Of course, some of these solutions will be outside the scope within which ASIC operates but, nonetheless, may include:
  - General education and financial literacy programs – potentially targeted to subpopulations that are perceived to be acting in a manner that is not consistent with their own interest;
  - Programs that promote precautionary savings – such as the "Saver Plus" program supported by the ANZ, charities such as the Brotherhood of St Laurence, and the Department of Social Services;[13]
  - Changes to the welfare system that currently penalise people in insecure work for building up a precautionary savings in liquid assets. For example,

[13] See ANZ Saverplus report 2018 "Pathways to Wellbeing", May 2018 available at https://www.bsl.org.au/fileadmin/user_upload/documents/Research/MM_REP_SaverP_pathwaysToWellbeing.pdf

the liquid assets waiting period denies Newstart to the recently unemployed for a period that increases with the amount of liquid assets they hold.[14] For those in insecure employment who perceive a high probability of future employment, this acts as an effective tax on precautionary savings.

- Other policy changes that reduce the probability of households falling into financial distress. These may include changes to housing and land use policy aimed at reducing low income housing costs etc.

## 2.6 What, if any, indirect or unintended consequences will result, or will likely result, to other persons in the community, if a consumer who would otherwise get credit offered through the short term lending model cannot source price-capped or cheaper sources of credit in the market?

72. If the short term lending product is prohibited to a set of customers (or effectively prohibited by capping prices at less than the cost to serve a customer) then those customers will resort to the types of alternatives set out in paragraph 41 above. The individuals in question, and their household members, will bear the costs and consequences associated with resort to those alternatives. However, other individuals and entities may also be affected. For example, potential consequences for other parties include:

    a. Employers may loss access to an employee or may see the quality of the employee's work deteriorate should a lack of access to credit prevent them from investing in activities that allow them to work more effectively. This might include: i) investing to maintain access to a working automobile for transit to and from work (or for use during work); or ii) investing in maintaining secure housing that allows the employee an degree of stability in their personal life that is necessary for them to function as an employee.

    b. Alternative providers of credit, such as black market credit providers, will derive a benefit as demand is shifted from the short term lending model to these alternatives;

    c. Some customers may resort to more strident (than would otherwise be the case) appeals for credit from their network of family friends and acquaintances. If

[14] https://www.humanservices.gov.au/individuals/topics/liquid-assets-waiting-period/28631 accessed on 7 August 2019 at 9.54 am. For example, an individual with $8,000 saved in liquid assets will have to wait 6 weeks before accessing Newstart. If the individual is in insecure employment and regularly goes from employed to unemployed status then they will correctly perceive that this aspect of the welfare system is an effective tax on precautionary saving – because precautionary savings of $8,000 will cost them 6 weeks of Newstart payments each time they become unemployed.

credit is not successfully obtained these attempts may sour relations for all parties. If credit is successfully secured but defaulted on then, in addition to souring of relations, the individual lender will suffer detriment (and this will likely be in excess of the detriment that Cigno/GSSF would suffer in the same circumstance (due to the latter's diversified portfolio of loans));

d. Some customers may resort to crime to manage their cash-flow shortfall and, if so, the victims of those crimes will be adversely affected. In addition, this will impose a cost on the criminal justice system (and ultimately taxpayers) as any such crimes are investigated and prosecuted;

e. Some customers may resort to 'grey areas' of income generation.