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Making sense of the numbers

The harm from high cost lending

The case for increased and improved regulation

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Haratua 2019

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Making sense of the numbers

Lending is an essential part of a functioning economy, but some loans do more harm than good.

The New Zealand market for credit has changed over the past decade. While the banking sector has grown, the non-bank sector has become increasingly populated with third-tier lenders, offering short term loans with very high interest to vulnerable borrowers in New Zealand.

While non-bank lending has reduced in size as a component of the New Zealand lending markets, small high cost lending companies have become increasingly common in the past decade. The rapid decline of second-tier institutions, including building societies and credit unions, has opened the door for new lenders in the third-tier market, which has now grown to an $8.5 billion industry.

> ... a disability made her unable to continue working in her job, resulting in her being on a benefit ... much lower than her previous income level, her income was much too low ... only enough to cover just over half her expenses and payments for existing debts. She ... resorted to additional borrowing to pay her daily expenses, including two high cost loans. When she couldn't pay back these loans, they accumulated significant amounts of interest and was passed on to debt collectors.

There are some instances where high cost lending can be useful for very short term financing. However, vulnerable borrowers can find themselves trapped, with high cost borrowing as their only option.

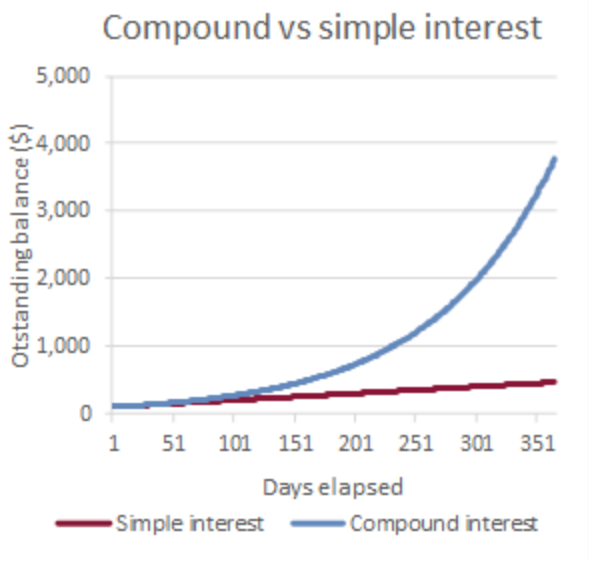
> ... rent and utility arrears were growing rapidly. After applying for WINZ recoverable assistance payments for rent arrears, high cost loans were used to cover other expenses. At this point, the income of the household is $250 per week short to pay for their expenses. In order to get out of debt, assistance from a local food bank was required to arrive at a budget where payments can be made and debt could start to be controlled.

Our analysis of a range of cases captured by financial capability and budgeting advice services database is sobering. We find many instances where short term high cost loans have amplified the financial distress of borrowers, pushing them deeper into debt and prolonged financial distress. This situation, along with accompanying psychological stress, can lead to long-term harm to individuals, families, whānau, and communities. Their ability to engage, participate, and contribute to community and economic productivity can only be severely curtailed in such instances.

It is clear that significant intervention in this market is required to protect those who are vulnerable. In light of our findings, and the proposed legislation before Parliament, the Credit Contracts Legislation Amendment Bill, we recommend, we recommend:

- greater enforcement of the CCCFA and the Code across the consumer credit and finance industry is necessary to ensure that appropriate enquiries are made into the substantial hardship of borrowers before loans are made
- the introduction of a limit on the total cost of a loan inclusive of fees and charges (e.g. 100%) and a cap on the interest rate charged (inclusive of fees and charges) of 0.8 percent per day
- a restriction be put in place on the value of loans that can be entered into as a proportion of the total income of the borrower, along with associated enforcement
- a clear definition of a high cost loan be adopted and used consistently when referring to the types of loans identified in this report

Simple and compound interest at 1 percent per day on $100 loan



- moving to an APR that is calculated based on compounding interest and this is regulated to be consistently used by all in the industry
- that the CCCFA be strengthened to require the lender to provide more detail to the borrower
- that before an individual can enter into a second high cost loan, or can enter into a high cost loan within one month of repaying their previous high cost loan, they be required to obtain independent financial advice from an accredited budget advisory service provider
- that the government consider increasing the level of funding provided to financial capability and budgeting advice services to limit and prevent harm caused by high cost loans
- the government consider increasing the financial support it provides to low income households in financial difficulty and when they face unexpected financial shocks.

With the exception of a cap on the total repayments, we believe that the recommendations in this report are what these lenders should be doing currently under the existing legislation and the principles of the Code. With an effective limit on total repayments, there is an incentive for lenders to increase their interest rate – thereby pushing borrowers faster towards that total limit and so encouraging another loan to be undertaken. Consequently, we believe a cap on the interest rate charged is also required, alongside the other measures to establish consistent definitions and regulations.

These recommendations are in line with the objectives of ensuring a properly functioning market providing services to informed consumers.

Lastly, for these policy recommendations to have a meaningful impact on the New Zealand credit markets, they will need to be pro-actively, robustly, and stringently enforced.

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1 Introduction

Credit markets around the world provide a valuable and necessary service, enabling investment for businesses and smoothing consumption. There is also another side to consumer credit, a market of predatory lending practices that exploit vulnerable families and communities.

The credit markets are constantly evolving and adapting. In the past decade, starting with the Global Financial Crisis, unprecedented changes in the lending environment in New Zealand have resulted in widespread shifts in the markets for credit. Second-tier lenders have exited the market, and with their absence opportunities for predatory lending have become abundant.

Predatory lending is often in the market for short term high cost lending. These loans often have very short processing times, and borrowers can get funds on the same day as application, making them a common choice for desperate individuals that are unable to get loans from other providers.

The recent growth in high cost lending poses a significant regulatory challenge, and effectively regulating this market to protect New Zealand's vulnerable communities is critical.

1.1 Short term high cost loans

Short term high cost loans are quick loans designed to bridge short term cash flow issues. These loans can be obtained very quickly, and often applications can be made online. Payments typically start on the day of the borrower's next pay, resulting in the common term of payday loans.

The terms and conditions for these loans vary between lenders, with interest rates of up to two percent per day, and often compounding daily.

Short term lenders are currently subject to lender responsibility principles in the Credit Contracts and Consumer Finance Act 2003 (CCCFA). The Responsible Lending Code (the Code) is an extension of these principles, offering guidance on how lenders can comply with the principles. High cost loans are defined in the Code as any loans with an annualised interest rate of greater than 50 percent.

2 The role of credit

The concept of credit has existed since the advent of money. While money is a 'store of value', credit enables use of money that is yet-to-be stored.

The role of credit relies upon people saving money that they presently have no immediate need for and people with an immediate need for money that they do not have themselves. Credit creates a market whereby the person saving money lends this money to the person who has an immediate need for it. This process plays an essential role in economic development around the world.

For a lender to decide to lend, they have two primary costs that need to be covered, the first being compensation for use of the money, in the form of interest. The other consideration is compensation for the risk that a loan will not be paid, which is often an additional interest payment. When considering the risk factors of lending, interest rates can vary widely based on how secure the loan is. This gives rise to the idea of providing an asset as collateral that can be taken by the lender if the loan cannot be repaid.

2.1 Saving

When saving for retirement or purchase of large assets individuals store up unused funds. These saved funds alone do not provide value to the saver until the money is required by them. By investing these funds in assets, or saving in a bank or financial institution, interest can be earned on these savings while they are not required. Typically the riskier the investment, the higher the interest that can be earned.

If funds are deposited into savings accounts in banks, who have a relatively low risk profile, interest returns are relatively low. Historically, individuals have also created their own non-bank companies and co-operatives, including building societies. These organisations can increase the return on savings, without a bank taking a share of the profits. These organisations are typically much smaller than banks and the lending often has a higher risk while providing a higher return.

2.2 Investment

Credit also plays a very important role in facilitating investment. Investment in assets requires a high up-front cost, while providing future income. When using credit for the initial cost of the assets, the future income generated can be used to pay off the loan and resulting interest. For example, credit to purchase a vehicle allows a person to access employment, the income from which, will enable them to repay the loan.

Credit is also important for investment of individuals, the most obvious example being residential mortgages. With credit available, individuals can purchase homes and their ongoing income can be used to pay off the home over their life. Mortgages are also commonly used to provide some funding for establishing small businesses.

These investments make credit availability a very important contributor to ongoing economic growth and improvement of wellbeing in New Zealand.

2.3 In the modern world

In the modern world, credit is constantly evolving. New products and businesses are emerging, driving increasing complexity of lending and banking markets. Products can now be tailored to the specific

needs of an individual or business. This increased complexity presents new opportunities and new challenges for the international credit markets while also making regulation increasingly difficult.

Legislation is not always able to keep up with the changes in the financial markets, which can result in widespread market failures. The Global Financial Crisis (GFC) in 2008 is a very large scale example of this challenge. Rapid expansion of the mortgage backed security market, followed by creation and expansion of collateralised debt obligations and credit default swaps resulted in excessive exposure to the property market, resulting in the Great Recession.

2.3.1 Modern challenges for individuals

Another downside of the increasing range of options available is the difficulty of individuals to make the optimal credit decisions for their situation. Markets for credit offer hundreds of options, and comparing the total costs for borrowers can be very challenging. With this asymmetry of information, individuals are likely to choose credit decisions based on the few companies that they are familiar with. This results in a tendency to use lenders with a presence in their local shopping areas or thorough exposure to advertising, rather than the option that will best suit their needs.

2.4 Tiers of lending institutions

The market for credit is very large and has a diverse range of companies. Parts of the market are subject to certain regulatory settings based on their practices and products offered. These areas are often classified into a three tier classification. These tiers are often related to the size of the institutions. The tiers are not a legal definition, though organisations in each tier face specific regulations. Institutions in the first-tier are the largest and most regulated lenders while the third-tier is made up of small lenders, with few regulations.

As the higher tier lenders tend to be larger institutions, they often take on less risky lending, preferring loans for relatively safe asset purchases. The lower tier institutions provide more risky lending, with higher costs for borrowing. The need of banks to maintain a low risk profile means individuals that are less financially stable are less able to borrow from the top-tier lenders. This forces more vulnerable individuals seeking credit to go to more risky lenders, resulting in a higher cost of borrowing than individuals with more wealth or income.

2.4.1 First-tier lenders

The first-tier of lenders are the registered banks. New Zealand currently has 26 registered banks, providing a significant majority of lending in New Zealand. These institutions are subject to a number of regulations and reporting requirements that are not imposed on other lenders. Banks are the largest group of deposit takers from individuals, using deposits to generate income through investment while also providing transactional services.

As typical New Zealand households are net borrowers, banks also receive credit from international markets and the Reserve Bank to further increase their ability to invest and provide credit.

New Zealand bank lending is primarily for residential mortgages and businesses. Banks also offer personal loans, though this is a very small part of the overall activity, and are agents for international credit card companies (Visa, MasterCard etc.).

2.4.2 Second-tier lenders

The second-tier lenders are more diverse, but the market has broad categories and specific regulations. The second-tier of lenders includes building societies, credit unions and deposit-taking finance companies.

As these lenders are not required to register as banks, they are not required to follow the strict regulations and reporting requirements of banks but are subject to a number of other regulations. Non-bank lenders that receive deposits are subject to the Non-bank Deposit Takers Act 2013.

Credit unions and building societies

Credit unions and building societies are types of mutual organisations; funded by members as investments to provide credit. Building societies tend to lend primarily for residential mortgages and property investment, while credit unions provide large amounts of business lending.

While not on the banking register, these lenders often function in a similar way to banks; taking deposits from individual investors, and use the funds for lending.

Building societies are subject to the Building Societies Act 1965, while credit unions are subject to the Friendly Societies and Credit Unions Act 1982.

2.4.3 Third-tier lenders

Third-tier lenders are the remaining lenders that are not included in the first and second-tiers.

The Ministry of Business Innovation and Employment defines third-tier lenders as all lenders other than:

- Registered banks
- Building societies
- Credit unions
- Brokers who do not directly provide credit
- Mortgage providers which do not provide other forms of consumer credit
- Entities which exclusively provide finance to businesses
- Retailers offering credit sales.

Deposit-taking finance companies have been included as second-tier lenders for the purposes of this report. This market is very loosely regulated, requiring disclosure of information to customers and being subject to the following responsible lending principles, found in section 9C of the CCCFA.

> **Principle 1**
>
> Lenders must exercise the care, diligence and skill of a responsible lender in all its dealings with borrowers and guarantors. This includes when advertising, before entering into a loan, and in all subsequent dealings relating to the loan or guarantee.

Some elements of this principle are set out in specific lender responsibilities and lenders can take guidance from the code as to how to comply. However, the “care, diligence and skill” principle stands alone, and to satisfy it, lenders might need to take an action that may not necessarily be specified in the lender responsibilities or in the code.

Principle 2

Lenders must comply with the specific listed lender responsibilities set out in the CCCFA.

For the purposes of this report, the third-tier lenders are the non-bank institutions, excluding building societies, credit unions and deposit-taking finance companies. Third-tier lenders are primarily based around consumer lending and have a high involvement in high cost lending. This market includes all of the short term high cost lenders, as well as some larger finance companies.

3 The rise of third-tier lenders

The consumer credit profile of New Zealand is constantly changing, with both domestic and international drivers playing a part in the overall credit landscape of New Zealand. The GFC and its subsequent monetary policy response has changed the dynamics of consumer credit markets around the world.

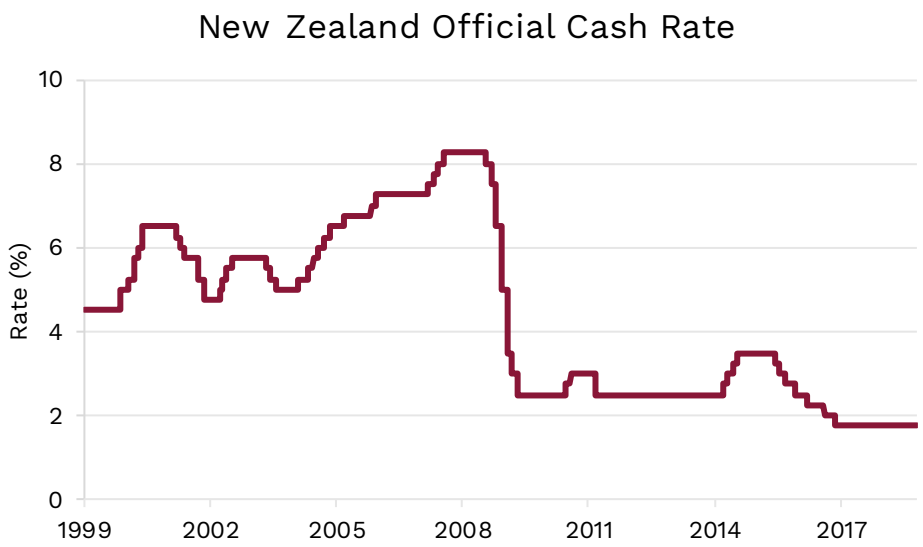
3.1 Wave of cheap credit

The early years of the GFC saw much of the world fall into recession, with a liquidity crisis stalling economic activity. With a lack of available money for investment and consumption, central banks around the world resorted to unprecedented levels of expansionary monetary policy. This policy involves reducing central bank interest rates while also increasing money supply through the purchase of corporate bonds and securities (quantitative easing). This expansionary policy works by reducing the costs of borrowing, which encourages the use of credit for investment and consumption, increasing economic activity. While the GFC was more than a decade ago, the expansionary policies to recover the global economy have only started to be phased out recently. The quantitative easing policy ended in the United States (US) in December 2017, while the European Central Bank ended their quantitative easing in December 2018.

In New Zealand, the baseline interest rate of the Reserve Bank is the Official Cash Rate (OCR). Banks are able to borrow from the Reserve Bank at the OCR to then lend to businesses and consumers.

Before the crisis, the OCR was at an all-time high of 8.25 percent. The response to the crisis was to quickly reduce the OCR to an all-time low of just 2.5 percent. The OCR has remained at record lows, continuously lower than any pre-GFC rate. Other countries have followed a similar policy, in many instances with interest rates much lower than the OCR in New Zealand. This allows banks to also borrow very cheaply from international credit markets, further reducing their costs of borrowing.

Figure 1 New Zealand Official Cash Rate



With a significant injection of credit around the world, it is unsurprising that the total debt levels around the world and in New Zealand have grown substantially. As at October 2018, New Zealand

individuals and businesses have a total debt of $386 billion, of which $373 billion are with registered banks. The remaining $13 billion, or three percent of the total market, is made up of non-bank lenders.

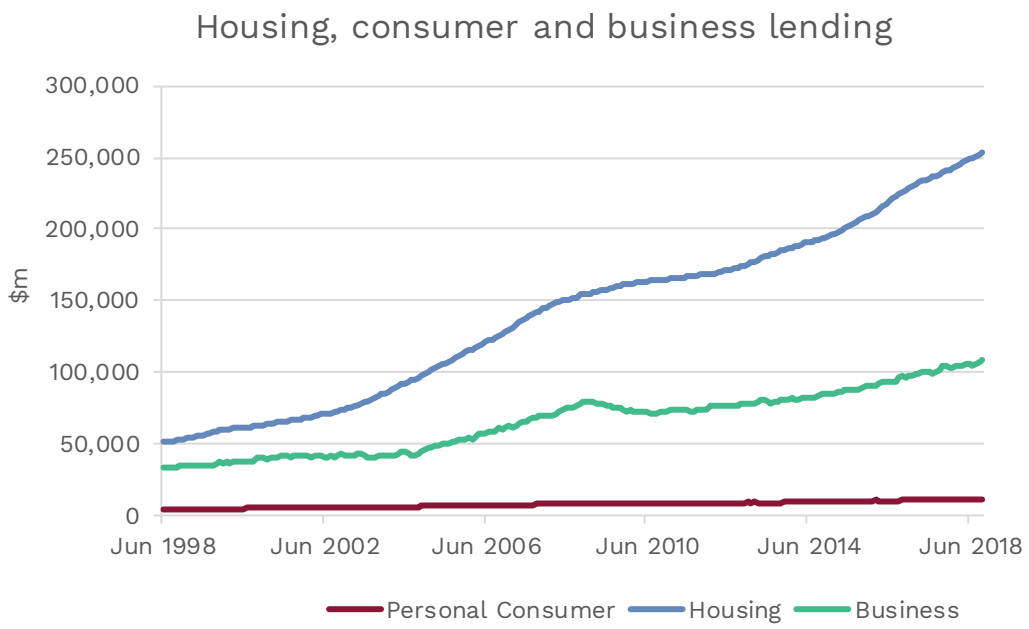
Figure 2 Expansion of debt in New Zealand

3.2 Changing composition of lending

While changes in the economic policies following the GFC have increased banks' ability to lend, it also allowed them to expand their lending criteria. Banks are usually the lowest risk provider of commercial lending, and offer the lowest rates, making them the first choice for individuals and businesses when considering borrowing options. When lending, banks will also prefer to lend to the safest individuals or businesses, turning some away to other institutions if the risk levels are not sufficiently low. With increased lending power as a result of the expansionary monetary policy, potential borrowers that historically used non-bank lenders were able to be serviced by traditional banks.

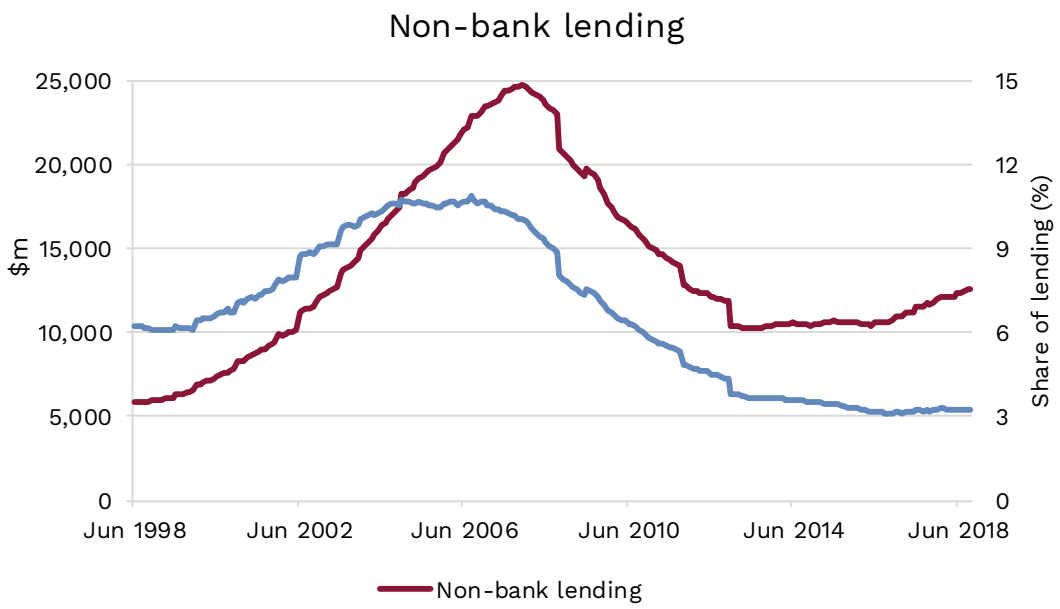
This has resulted in substantial growth in bank lending for housing and businesses as intended. Over the past two decades, the total lending from registered banks in both of these markets have grown significantly.

Figure 3 Bank lending by type



While this has been very successful for registered banks, second-tier lenders that served this market prior to the GFC have been forced out of the credit markets. A significant proportion of the second-tier market has now been swept into the first-tier, either by taking business, or second-tier lenders becoming registered banks. In New Zealand, PSIS registered as the Co-operative bank in 2011. While lending though registered banks has increased by $120 billion since 2008, non-bank lending has decreased both in total value and market share. Non-bank lending has fallen from $20 billion in 2017 to $12 billion in 2018 as shown in Figure 4. This has reduced the share of lending provided by non-bank organisations from more than 12 percent in 2008 to just three percent in late 2018.

Figure 4 Non-bank lending over time and share of total lending



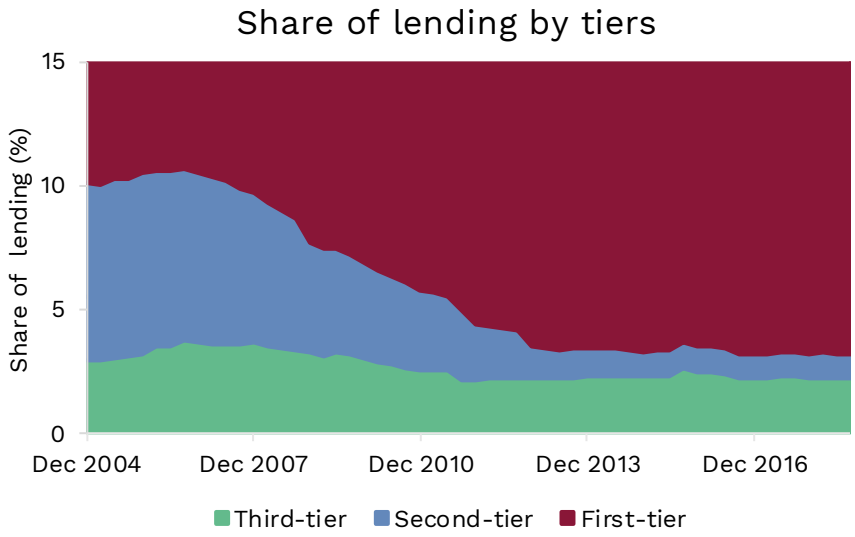
3.3 The decline of second-tier lenders

Data from the Reserve Bank[1] divides non-bank lenders (second-tier and third-tier) into three categories; savings institutions, deposit-taking finance companies and non-deposit-taking finance companies. These fit into the three tiers of lenders, with savings institutions, deposit-taking finance companies being second-tier lenders and the non-deposit-taking finance companies forming the third-tier lenders.

Rapid growth of banks in recent years has squeezed the second-tier lenders out of the market. Deposit-taking finance companies, the most similar non-bank credit provider to banks, have all but disappeared. From the 2007 peak, lending from these businesses has fallen by more than 80 percent. The total lending by savings institutions (credit unions, building societies) has also fallen by 60 percent from the peak in 2008. These two changes have resulted in a substantial shift in the overall makeup of the total lending market, as shown in Figure 5.

The total market share of the third-tier lenders has remained relatively constant compared to the total lending market, growing at a similar rate to the total New Zealand credit growth.

Figure 5 Non-bank lending by type of institution[2]



3.4 Changes in use of non-bank credit

The current non-bank lending market is the smallest share of total lending in recent memory, yet simultaneously there appears to be a rapidly growing market for high cost lending in the consumer credit market. This is a result of the changing make-up of the non-bank lending market and the decline of the second-tier lenders. The changing market structure has resulted in a corresponding shift in the types of lending offered by the non-bank credit providers. The lack of the second-tier lenders, and the lack of interest of banks to increase their position in the personal consumer credit market has left significant opportunities for growth of the third-tier lenders.

With low costs of credit and the banks increasing their involvement in business and housing lending, these policy changes have also increased the profitability of borrowing from major banks

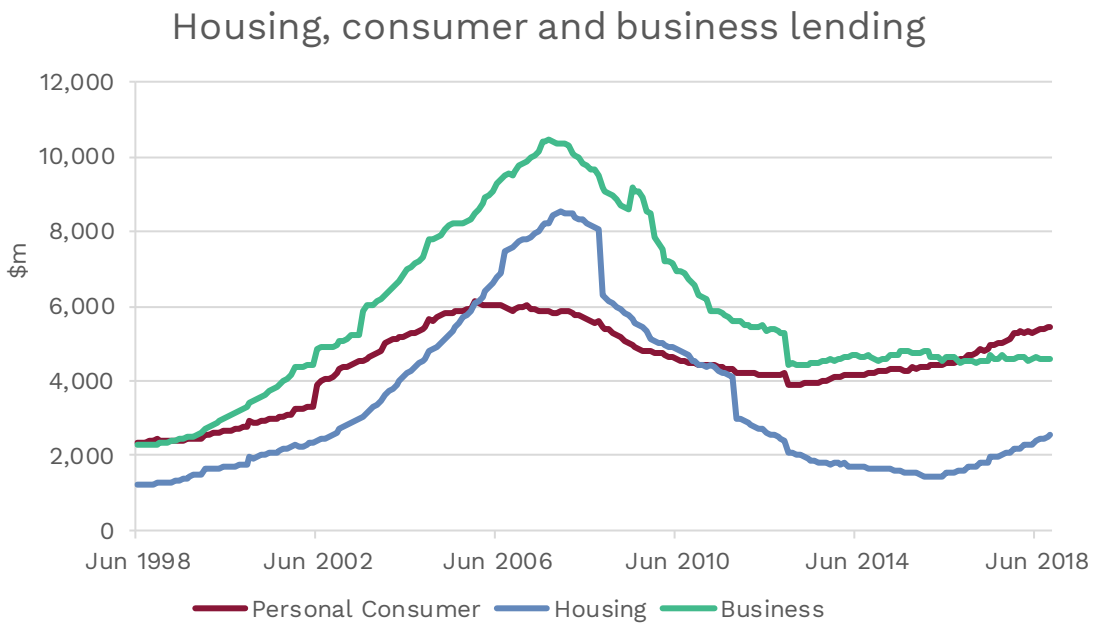
[1] Includes all financial institutions with total assets over $5 million.
[2] Excludes agricultural lending that is not separated by the RBNZ.

(domestically or internationally) at low interest, place a significant margin on lending and provide short term high cost loans to vulnerable communities in New Zealand.

Reserve Bank data divides the type of lending into broad categories for bank and non-bank lending; these categories include business, housing and personal consumer. While the types of lending are very broad, they paint a clear picture of some shifts that have occurred in the non-bank credit space. Prior to the GFC, personal consumer lending was the smallest component of the non-bank lending, with just $6 billion of lending for personal consumer uses compared to $10 billion for business lending.

As a result of the growth of bank lending for mortgages and businesses, non-bank lending for houses fell from a peak of more than $8 billion in 2007 to just over $2 billion in 2018, a fall of 70 percent. Business lending also reduced substantially; from the 2017 peak, non-bank business lending fell by 56 percent, from more than $10, billion to just $4.6 billion in 2018. While these changes occurred in business and housing lending, the personal consumer market went through a transition. While there were some large initial decreases in personal consumer lending, falling by 34 percent in 2013, the personal consumer lending market has largely recovered. These three shifts resulted in the largest type of non-bank lending being personal consumer lending for the first time since 1999.

Figure 6 Non-Bank lending by type



3.5 Effects on high cost lenders

The reduction in the second-tier lenders and the changing structure of the non-bank lending market has resulted in an abundance of market opportunities for third-tier lenders to expand in the personal consumer lending space. While the total quantity of the personal consumer lending is not greater than pre-GFC levels, the reduction of second-tier lenders in this market has allowed third-tier organisations to pick up the lending that was previously served by the second-tier lenders. These changes have driven the visible growth in third-tier lenders, particularly in the high cost short term lending market.

3.6 Funding for the lenders

Short term high cost lenders do not publish their funding mechanisms though some of the larger non-deposit-taking finance companies offer insights into the market.

One large non-deposit-taking finance company borrows from a large first-tier bank to then lend to other consumers. One method for this funding situation is securitising loans in a trust or company (special purpose vehicle), against borrowing from the major bank. This arrangement effectively allows companies to borrow and then lend at a premium while taking all of the risk of their lending.

The non-deposit taking finance companies in New Zealand, which includes the high cost lenders, are largely funded through debt. The aggregate balance sheet shows that with a total of $1.2 billion in capital and reserves these businesses hold large amounts of debt. The remaining funds ($9 billion) comes from borrowing, $4.7 billion from residents and $4.2 billion from non-residents.

4 The borrowers' perspectives – scenarios of distress

Every household has to work to balance their expenses with their income, either as an explicit budget, with approximate guidelines on how much to spend, or by measuring how much is left in their account at the end of each week. While some methods are more effective than others, there is no way to guarantee financial stability.

The fundamental balance between income and expenses can have far reaching effects. When income is higher than expenses, savings can be made that generate additional income from interest while making a buffer for any emergencies. When income is lower than expenses, borrowing is required, and the interest creates an additional cost that further tips this balance.

In this section we explore the data held by FinCap to highlight common situations where high cost loans increase the financial distress of households in New Zealand. The FinCap database is a collection of records of individuals seeking budget advice in the 2017 financial year. As each individual meeting with a budget advisor has case-specific needs, information available differs between individuals. For comparability, we have limited the data to individuals with at least a summary of income and a debt schedule. After this reduction, there is complete information for 13,600 individuals, of which 830 have loans with a known high cost lender.

The scenarios in this section are presented over four time periods, an initial position before financial distress, the event/factor that tips the balance of their position, their response to this change and their final outcomes. The final outcomes are informed by the FinCap data, while the pathway to this position is based on their stated reasons for their situation and any other notes on file.

Almost all borrowers (98 percent) with high cost loans also have other debts, with a median of six debts. For almost half of these borrowers, at least one of these debts is to Work and Income New Zealand (WINZ).

While high cost loans can cause financial distress on their own, often they occur in conjunction with a number of other challenges, with the cost of credit making the situation worse. Of the borrowers in the database with reasons recorded for their financial distress, 19 percent identify their use of credit and loan contracts as a main reason for their situation. For borrowers with a high cost loan, 27 percent listed this as a primary reason for their financial distress. The other main issues that were raised were increases in cost of living, identified by 29 percent of high cost borrowers and loss of jobs or reduction in income which was a primary reason for 30 percent of borrowers.

Those who accessed financial capability and budgeting advice services help early were able to avoid the financial distress experienced by individuals that found themselves overloaded with loans.

We illustrate four scenarios below with original causes of:

- Ongoing insufficient income for necessities
- Shortfall from one-off emergency
- Job loss or illness
- Debt spiral resulting from use of credit.

4.1 Ongoing insufficient income for necessities

The significant proportion of high cost borrowers that are beneficiaries shows that many individuals with high cost loans have insufficient income to meet their everyday needs. This is supported by the survey of budget advisors, where the significant majority of high cost loans were used to cover essential spending, including rent and housing costs. For beneficiaries and low income households, borrowing is available through WINZ, though without sufficient income to meet their daily expenses, they often also seek additional loans. Taking out high cost loans when already unable to meet expenses results in an amplification of struggles with debt with fees and interest accumulating quickly.

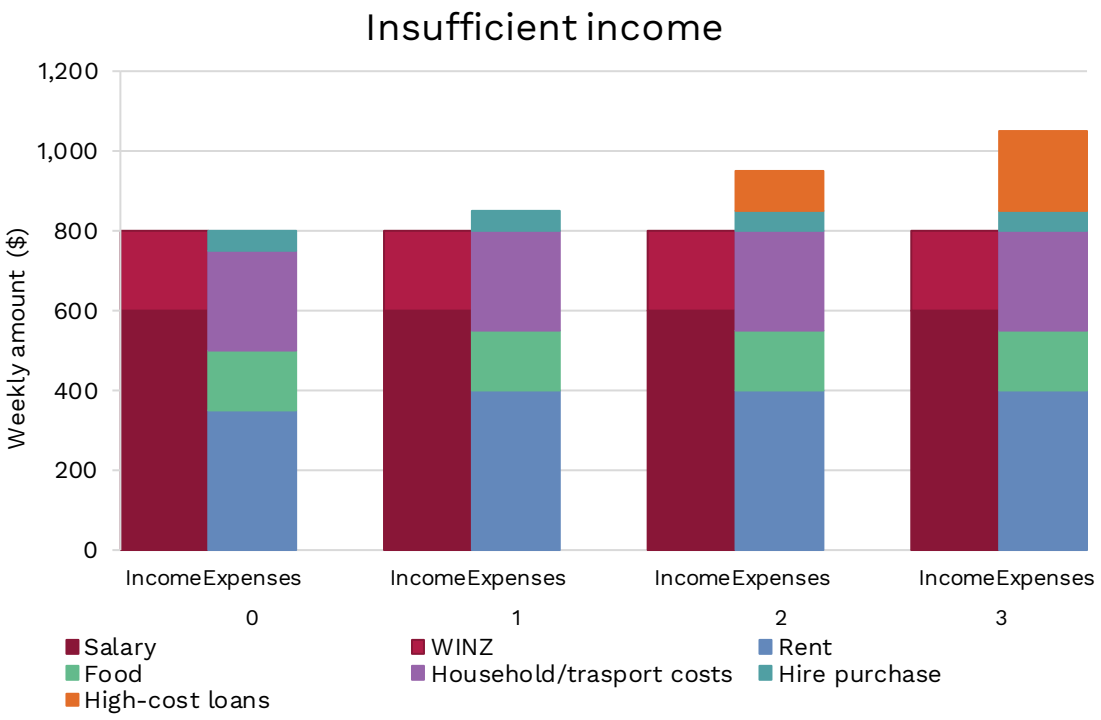
A young couple in their early 20s have a weekly income of $800 including an accommodation supplement and family tax credits. They live pay check to pay check so they needed to use hire purchase for any spending outside of their core living expenses, including for purchasing clothing online. After an increase in their rent, they didn't have enough income to cover their hire purchase payment, rent and their general living expenses.

Despite having insufficient income they continued to try and meet their payments. As this was not possible with their income level, rent and utility arrears were growing rapidly. After applying for WINZ recoverable assistance payments for rent arrears, high cost loans were used to cover other expenses. At this point, the income of the household is $250 per week short to pay for their expenses. In order to get out of debt, assistance from a local food bank was required to arrive at a budget where payments can be made and debt could start to be controlled.

This story is common in the FinCap database, and often the solutions rely on help from charitable organisations and family members. If these options are unavailable, or they seek help too late they are faced with no asset procedures and bankruptcy.

This story is presented visually in Figure 7. At the initial stage, their income of $800 was enough to cover their main expenses. At the next stage, following the increase in their rent they were $50 per week short to cover their core costs. After obtaining high cost loans to make up for the weekly shortfall, they then had additional cost, further disrupting the balance between their income and expenses and resulting in falling behind in these payments resulting in rapid growth in high cost debt.

Figure 7 Income inadequate for necessities



4.2 Shortfall from one-off emergency

For families and individuals that take out loans for short term shocks in income or expenses, being able to get back on track is critical. For many, high interest can push people over the edge, where they are unable to pay down debt while it spirals out of control.

This scenario could also be driven by spending for larger items, including appliances or car maintenance, or spending for cultural or social obligations, including traveling for a funeral or wedding.

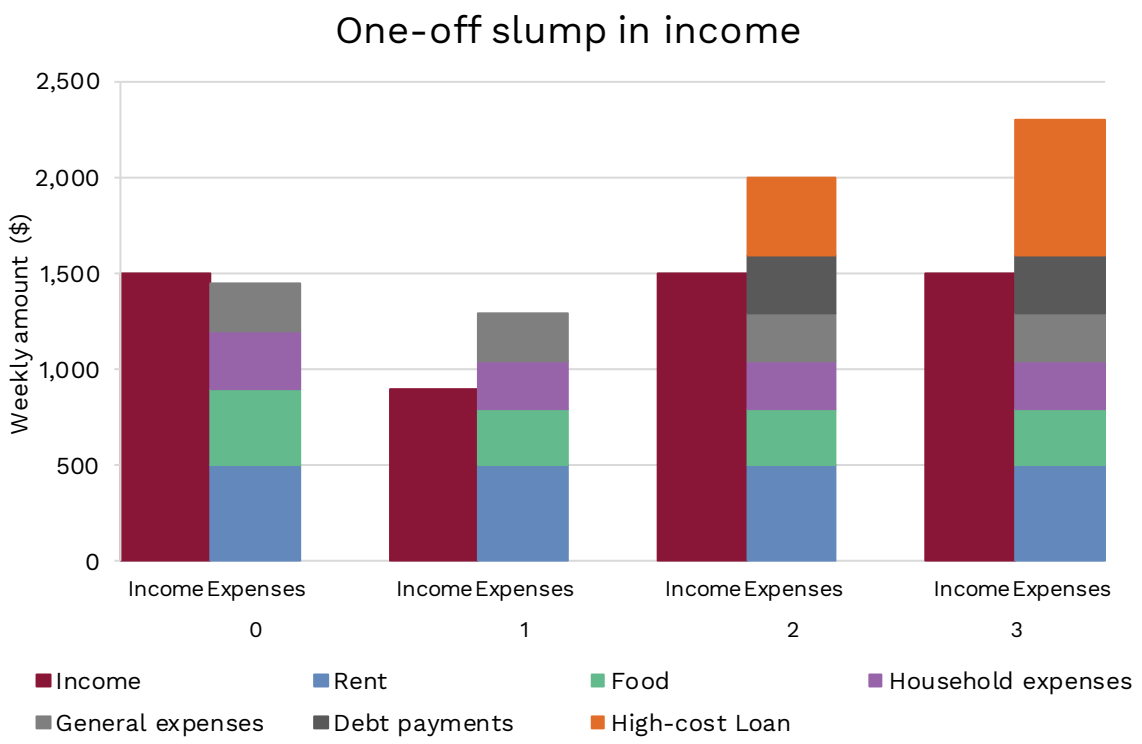
A family with two working parents in their early 40s were in a comfortable financial situation. While they were unable to save a large emergency fund, they were able to cover their typical expenses with some surplus for any small unexpected costs.

The family went down to one income while one earner was between jobs. This income reduction forced them to make some significant changes to their regular spending, including cutting back on household spending and their food budget. Despite their best efforts, they were still unable to cover their expenses with their income, and needed a number of loans to get by until they returned to their full income levels. They didn't know how long it would take to find employment, but needing money quickly loans were obtained through finance companies and a number of high cost lenders.

By the time they were both employed and earning more than $1,500 per week after tax, the repayments on their debts, and their new expenses were now higher than their new income. After missing debt payments, their total debt quickly grew even though they were now back at their original earning levels. By the time they sought budget advice, they had weekly debt payments of $1,000, two thirds of their weekly income. While high cost loans allowed them to continue in the short term, the

growth in repayments made any chance of repaying debt impossible without selling family assets to get the debt under control.

Figure 8 A one-off slump in income



This case is presented visually in Figure 8. Initially, the household's income is more than sufficient to cover household expenses and income. In the short term, cutting-back on food and household expenses reduced their weekly expenditure but they still had a shortfall of $400. With a shortfall this large, they quickly used their savings and had to borrow for expenses that could not be delayed.

When they managed to find new employment, and they returned to their full household income level the new debt payments had completely changed their ratio of household income and expenses. This resulting in growing debts that they were still unable to repay. The high cost loans accumulated interest rapidly, needing to pay $30 per day just to cover the interest, with additional payment fees and default fees accumulating.

4.3 Job loss or illness

The balance of income and expenses being disrupted by a significant event is also a common driver of high cost borrowing. Common shocks to income include loss of employment or reduction in hours.

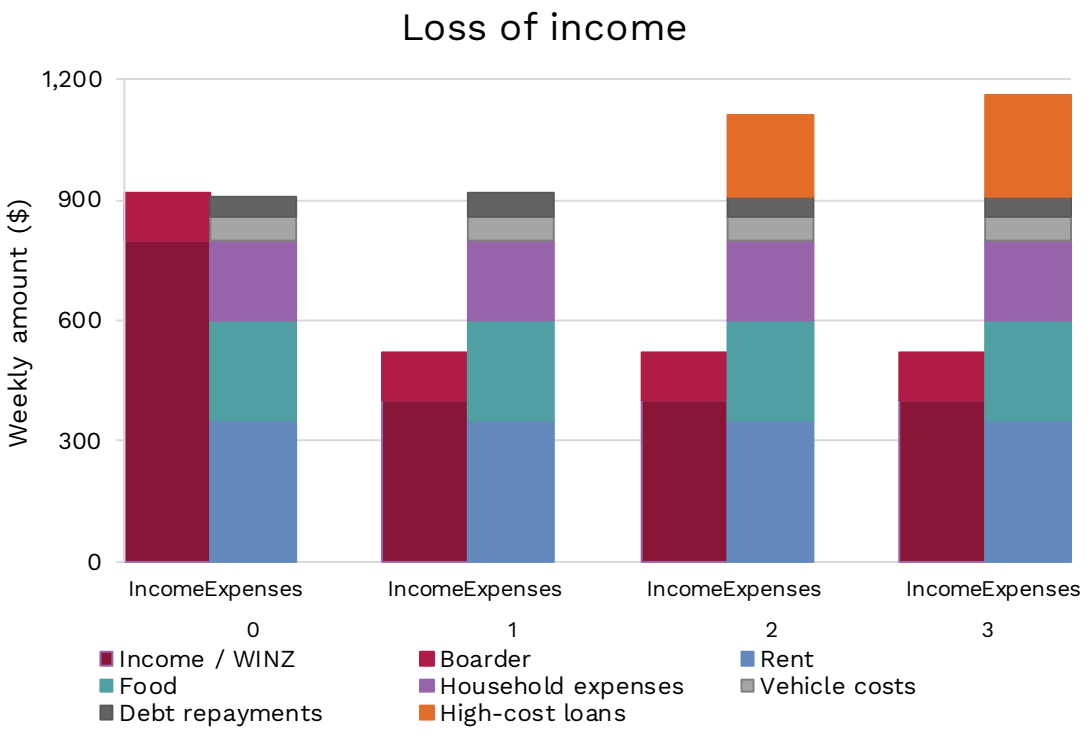
Unforeseen expenses, including car accidents, replacing a fridge, or dental work can also place a substantial short term spending requirement on households. Where these shocks are resolved by borrowing, the costs of interest and repayments can disrupt their balance of income and expenses, resulting in increasing debt on a regular basis.

A single mother in her late 40s was working full time. As a parent, she made sure that she could provide a good quality of life for her children, and as a way of making a bit of extra money she took on a boarder who contributed $120 per week.

While this household structure was sufficient to cover the family expenses, a disability made her unable to continue working in her job, resulting in her being on a benefit. As the benefits she received, including her disability allowance were much lower than her previous income level, her income was much too low to pay for her regular expenses. With a jobseeker support benefit, a disability allowance, an accommodation supplement and temporary additional support her income was $520 per week, only enough to cover just over half her expenses and payments for existing debts. She didn't know how long she would remain unable to work and resorted to additional borrowing to pay her daily expenses, including two high cost loans. When she couldn't pay back these loans, they accumulated significant amounts of interest and was passed on to debt collectors.

Of individuals seeking budgeting advice, having a health, disability or accident was a reason for financial distress of 12 percent of high cost loan borrowers. This case is presented visually in Figure 9. As this case involves a long-term reduction in income, the initial difference between income and expenses shows a stark contrast. After accumulating additional debts, still with no way to cover primary household expenses, the total costs of borrowing increase rapidly.

Figure 9 A longer-term loss of income



4.4 Debt spiral resulting from use of credit

A very common pathway to financial distress is to get into a debt spiral. For individuals with limited savings for purchase of the 'finer things in life'. People that often feel constrained by their income can be susceptible to marketing campaigns offering goods on no payments or interest for three months, or a series of "easy weekly repayments". As debts have increasing interest when payments are late, interest can quickly accumulate. As the increasing interest costs can result in further borrowing to meet expenses, this is commonly known as a debt spiral. Given the nature of the debt spiral, it can affect individuals with any level of income.

With no interest and low interest loans available, often on larger items, individuals with little savings are able to purchase items including white ware, appliances and other more expensive items. Low financing costs are often factored into the price of the goods, as a form of sale or promotion. People purchasing things on credit with no payments are not always able to save for the required payments by the time payments are required. Once the initial payment holiday ends, and repayments for loans fall due, these individuals are often unable to meet their repayments, resulting in often much higher interest. One third of high cost borrowers reported use of credit and loan contracts as a main reason for their financial distress.

An individual in his early 30s earned an after-tax income of $1,500 per week. With his rent, living costs and vehicle debt he struggled to build enough savings to buy some of the nice things that he wanted for his house. When he saw some good discounts and offering three months interest free with no repayments, he took this opportunity to purchase items he needed, giving him three months to save.

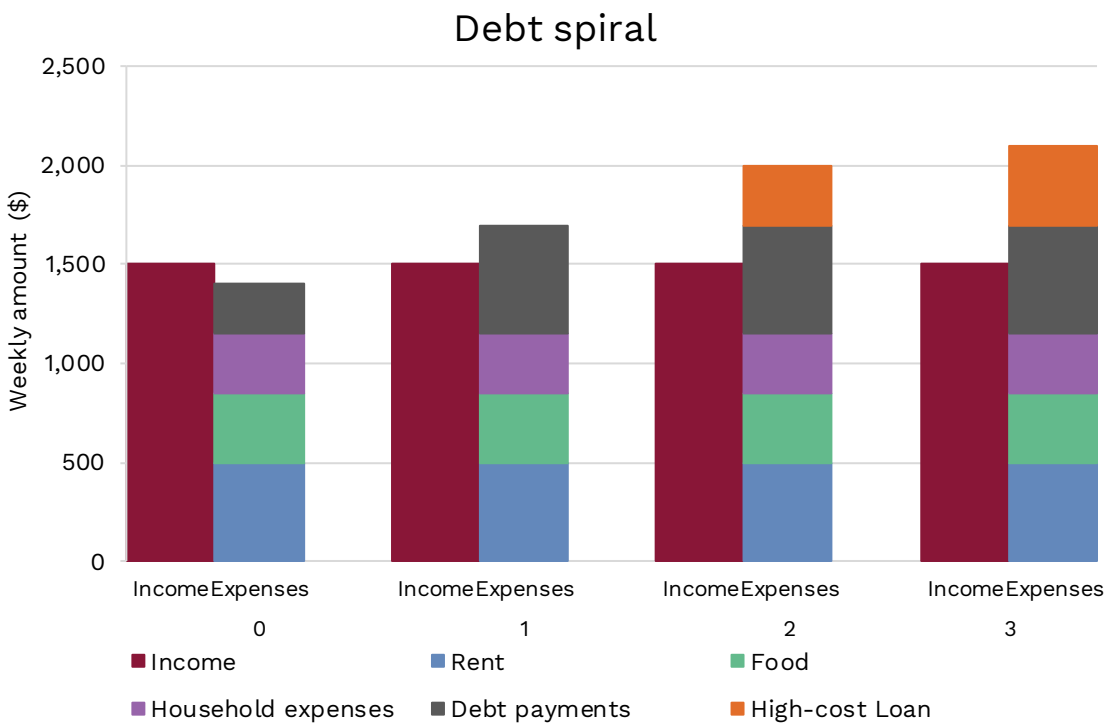
After accumulating these debts, he continued his normal spending habits, including putting he regular spending on his credit card to get bonuses. As he had no budget in place for when the loan payments started, he was short $200 in the first week of repayments.

With $250 per week in repayments for these loans, he was short $200 in the first week of repayments. As his income was now too low to meet his repayments, he used high cost loans for living expenses. At the point of taking out the high cost loans, there was no way that the repayments on these loans could be made. Rather than helping him financially, these loans simply added to his debt burden, and the high costs made the difference between his weekly expenses and income to be even greater. By the time he sought budget advice, he had accumulated thousands in high cost debt, while also being unable to pay off his credit card.

This scenario is presented graphically in Figure 10. Being unaware of the total upcoming payments of debt, the total expenditure grew to be larger than the total available income to make the payments. After getting short term loans to bridge the short term deficit, this placed them further behind on payments, with the debts spiralling out of control.

Use of credit contracts was identified as the sole reason of financial distress of 19 percent of the high cost loan borrowers.

Figure 10 Spiraling debt from credit use



4.5 Early interventions do succeed

In each of the prior scenarios, short term high cost lending is used as a short term fix for larger financial problems. As there are larger problems at play, rather than improving the financial situation they increase the debt burden, while also rapidly growing if payments are not met. Financial capability and budgeting advice services provide options for individuals to get back on track, including through help from charitable organisations. Through earlier interventions, there are opportunities for individuals to restructure their finances rather than using high cost loans often has more positive outcomes.

5 Regulation and policy recommendations

There are many ways that borrowing can cause adverse effects on borrowers, including the scenarios in the previous section. Over the past five years, there has also been rapid growth in complaints to the Commerce Commission regarding lending. In 2017, the Commerce Commission received more complaints than 2012 to 2014 combined.

We recognise that the industry does have a role to play in the New Zealand financial system, however we have observed that there are a number of individuals and families who are increasingly reliant on high cost loans to cover living costs or household expenses, or to meet the costs of a vehicle.

To protect these vulnerable individuals and families we recommend the following regulation and policy interventions to enable the people to meet their expenses and pay for necessities without having to go further into debt to do this and getting themselves into the debt spiral.

When we consider the current regulatory setting of the third-tier lending space, and the expansion of the third-tier presence in the lending markets and the harm that high cost loans can cause, there is a need for increased regulation in this market. Given the diverse nature of the third-tier market, and being made up of many small businesses, regulating this market will come with a number of challenges.

In light of our findings, and in the context of the proposed legislation before the House, we submit the following recommendations. These are intended to protect those who are vulnerable to high cost loans while ensuring that the industry remains competitive and available to those who make use of the short term high cost loan market. These recommendations, detailed in this section, are listed as follows.

- enhanced enforcement
  - greater enforcement of Section 9C of the CCCFA and the Responsible Lending Code
- interest and payment caps
  - a cap on total repayments and interest rate inclusive of fees
  - a limit on the total value of loans a person can enter into
- use of clearer definitions
  - changes to clarify the definition of high cost loans
  - changes to clarify the calculation of APR
- provision of and access to improved information
  - obliging lenders to better inform borrowers
  - ensuring financial advice is available prior to loans being obtained
  - increased funding for financial capability and budgeting advice services
  - better support for those unable to access loans other than high interest loans.

5.1 Enforcement and the Responsible Lending Code

We recommend greater enforcement of the CCCFA and the Code across the consumer credit and finance industry is necessary to ensure that appropriate enquiries are made into the substantial hardship of borrowers before loans are made.

The CCCFA was amended in 2015 to include preparation of the Code. The Code is largely focussed on disclosure of key information to customers. Where interest and fees are charged on daily, weekly or monthly intervals, the lender must also provide the equivalent annual interest rate.

Other principles are also included to ensure that marketing and information is not confusing, and gives the borrower enough information to make an informed decision. While information is available, as these are promoted as being fast and easy loans, the terms and conditions are often not fully understood by borrowers.

The data identified that a number of the people who sought advice from a budget advisor had more than one loan that they were repaying and/or that the high cost loan was being used to pay for everyday expenses such as food and other necessities.

Every lender must, at all times, comply with all the lender responsibilities specified in subsections 9C(3), (4) and (5)of the CCCFA. Based on the data reviewed for this report this does not always appear to be the case.

Section 9C(3) states that:

The lender responsibilities are that a lender must, in relation to an agreement with a borrower,—

(a) make reasonable inquiries, before entering into the agreement, so as to be satisfied that it is likely that—

i. the credit or finance provided under the agreement will meet the borrower's requirements and objectives; and

ii. the borrower will make the payments under the agreement without suffering substantial hardship;

The Code, while not being prescriptive, states that "a lender must, in relation to an agreement with a borrower, make reasonable inquiries, before entering into the agreement, so as to be satisfied that it is likely that the borrower will make the payments under the agreement without suffering substantial hardship (see s 9C(3)(a)(ii) of the Act). "

Findings from the survey of budget service providers found that in total, 70 of the 74 agencies who responded to this question noted that just 1-20 percent of clients (55 agencies) or 21-40 percent of clients (15 agencies) were able to repay their high cost loans within the original agreement.

The Code states that "To meet this lender responsibility, a lender should be satisfied that it is likely that the borrower will make the payments under the agreement without undue difficulty as well as:

a. meet necessities (such as accommodation, food, utilities, transport, required medical expenses); and

b. meet other financial commitments (such as repayments on existing debts), without having to realise security or assets (other than any security or assets that the borrower is, at the time of approval, willing and intending to dispose of or realise the value of).

The survey of budget advisors found that the top three reasons for people accessing high cost loans were:

- To cover living costs for household expenses (e.g. food)
- To meet the cost of a vehicle
- To cover rent.

People entering into high cost loans to cover household expenses and rent illustrates that the legislation is not acting as intended and requires greater enforcement. Where people are accessing high cost loans for these means indicates that enforcement of section 9C is not sufficient and should be improved across the sector, not just for high cost loans. The data collected showed that some earlier loans issued to people drove them to access high cost loans to cover repayments of the original loan they could no longer afford.

Further to this, the Code requires that "To meet this lender responsibility, a lender should be satisfied that it is likely that the borrower will make the payments under the agreement without undue difficulty." The findings of the survey of budget service providers indicates that lenders are not meeting this requirement.

5.2 Cap on total repayments and on interest rate inclusive of fees

We recommend the introduction of a limit on the total cost of a loan, inclusive of fee, charges, and interest (e.g. 100%); and a cap on the interest rate charged (or fee equivalent) of 0.8 percent per day.

The World Bank[3] looked at the use of interest rate caps around the world, including where used as a consumer protection mechanism in the context of high cost lending. The World Bank stated that interest rate caps could be justified in order to protect consumers from exploitation by guaranteeing access to credit at reasonable rates. The World Bank found that the other side of this is that caps can cause financial institutions to stop lending to those who need it most and have limited access to alternative sources of credit.

Caps on costs of borrowing can help avoid social harm by limiting access to credit to impaired and low-income consumers while also providing certainty to borrowers around how much they may have to pay. Data indicates that while people believe that they will be able to repay the principle of the loan, they do not consider the impact that interest payments and fees will have on the total amount to be repaid.

With an effective limit on total repayments, there is an incentive for lenders to increase their interest rate – thereby pushing borrowers faster towards that total limit and so encouraging another loan to be undertaken. Consequently, we believe a cap on the interest rate charged is also required.

A cap on the ongoing interest rate prevents lenders from charging excessive fees, making the costs more affordable for borrowers that are able to pay on time. A cap on the total costs of credit limits the worst case scenario in the event that borrowers are unable to pay on time.

Both of these restrictions need to look interest rates and fees together. Any restriction focussing on either interest rates or fees without considering the other will see lenders substituting between these charges to maximise their profits.

United Kingdom regulation

In 2015 the United Kingdom introduced a price cap on high cost consumer credit. The cap placed a total cost cap of 100 percent of the loan borrowed including all interest, fees and charges. Also

[3] Aurora Ferrari, Oliver Masetti, Jiemin Ren, *Interest Rate Caps The Theory and The Practice.* World Bank. April 2018.

included in the regulation was a limit on the interest and fixed fees of 0.8 percent per day of the amount borrowed and a £15 limit on the default fees.

The interest rate cap is intended to both reduce the costs for those consumers that would be eligible for a high cost loan under the regulation and to cut off the high cost loan option for those persons that are unable to afford a high cost loan and would have problems repaying.

A 2017 review of the cap by the Financial Conduct Authority (FCA)[4] found that after the introduction of the regulation there were decreases in the number of applications for loans, loan acceptance rates, and in the number of firms offering high cost loans. The FCA considered this to be because lenders are less likely to lend to consumers who cannot afford to repay as the cap limited the income they could receive from borrowers who did repay.

The FCA also found that after the interest rate cap consumers pay less, repay on time more often and are less likely to need help from debt charities as a result of a high cost loan. The FCA found that debt charities also indicated that consumers are presenting themselves earlier and with lower debts. This suggests that underlying problems are addressed sooner, before people take out a high cost loan.

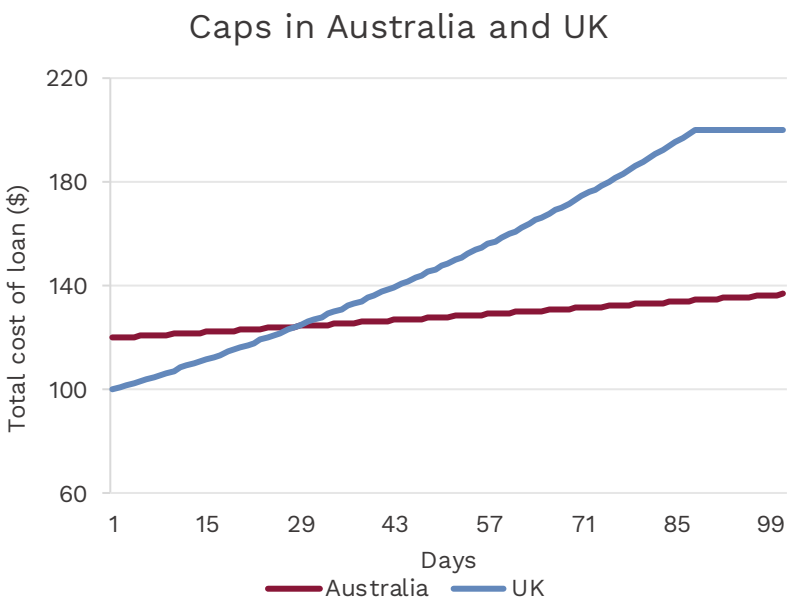
Additionally, despite concerns at the time of the introduction of the cap that borrowers would turn to other high cost products or to illegal moneylenders, the FCA found this has not proven to be the case.

Australian regulation

Australia introduced regulation on high cost lending in 2013. In Australia, one-off loan contracts for 15 days or less for amounts of up to A$2,000 are banned. For loans for amounts of up to A$2000 for longer than 15 days but less than one year, no interest can be charged but the lender can charge an establishment fee of up to 20 percent of the loan amount, a monthly fee of up to four percent, a default fee, enforcement costs and any government fee payable.

[4] Financial Conduct Authority. *High-cost credit Including review of the high-cost short-term credit price cap*. July 2017.

Figure 11 Comparison of interest rate caps in Australia and the UK



A 2015 review of the Australian regulations found a contraction in the market. However, there was an increase in the value of loans. The review found that high levels of repeat borrowing continued to be causing consumers financial harm and that the structure of the cap and industry costs appeared to promote repeat borrowing.

As shown in Figure 11, loans of shorter than 30 days are more expensive with the Australian cap than with the UK cap. This is due to the initial 20 percent fee at the start of the loan, which results in higher effective interest rates for shorter term borrowing. To prevent this from being used to charge excessive fees from very short term lending, Australian loans must be for longer than 15 days.

We recommend the UK daily cap of 0.8 percent is applied in New Zealand, with the cap of 100 percent maximum cost of credit. The UK was facing similar concerns as New Zealand and found that the 0.8% daily cap and 100% maximum cost combined saw consumers pay less for loans and are more able to repay them on time than before the regulation of the market and the cap. The FCA found that in the UK, Consumers who have been turned down have not generally turned to other forms of high-cost credit or illegal money lending. With hindsight, these consumers largely report that they consider it to be positive that were not able to get a loan.

5.3 Limit total value of loans per person

We recommend a restriction be put in place on the value of loans that can be entered into as a proportion of the total income of the borrower, along with associated enforcement.

The FinCap data, along with the survey of budget advisors showed a number of people who sought budget advice after getting a high cost loan had done so after they had already taken out a number of other loans and had found themselves in financial difficulty. Once someone is 'trapped' in the cycle of high cost lending they have no money available for essential costs and are driven to continue relying on this line of credit to purchase essential needs.

70 percent of survey respondents said clients used high cost loans as they were unable to access credit in other ways and 40 percent stated that clients took out high cost loans to pay off debt. This

results in what is often referred to as the debt cycle, where people seek out new debt opportunities to repay existing debt obligations. This results in the situation where people are accessing high cost loans to pay other debts that have become unaffordable.

Clearly section 9C, as it stands, is not effective at ensuring that high cost loans do not add to the debt repayment burden faced by individuals who enter into high cost loan agreements.

A limit should be set so that the value of repayments of all high cost loans should not exceed a proportion of the individual's normal income over a defined period. Prior to the loan borrowers should also be required to show that income to repay the loan will likely be continued over the period of the loan.

Amendments to the legislation should also include a limit on the value of loans or repayments as a proportion of income of the borrower.

Australia has a rule that for borrowers whose predominant source of income is beneficiary payments that the total amount payable under all high cost loans due and not repaid cannot exceed 20 percent of the borrower's gross income. The 2015 review of the Australian industry[5] for the Australian Treasury recommended restricting the limit to 10 percent. The report showed that a 10 percent net income cap would still allow consumers, regardless of their source of income, to access at least one A$500 high cost loan during a 12-month period. Those on average weekly earnings could access five A$500 loans concurrently in a 12-month period, while someone on the minimum wage could have three concurrent 12 month high cost loans or two concurrent six month loans.

To support this recommendation, enforcement should increase to ensure that high cost lenders are not allowing borrowers to take out multiple high cost loans at once.

5.4 Clearer definition of high cost loan

We recommend a clear definition of a high cost loan be adopted and used consistently when referring to the types of loans identified in this report.

As with the introduction of a cap on the total value of repayments, the definition of a high cost loan should look at more than just the headline interest rate or fees in isolation. Any restriction focussing solely on interest rates or fees without considering the other will see lenders substituting one for the other in order to maximise their profits.

One finance company has lower fees than typical high cost lenders, with a maximum interest rate of 29.95 percent, making it excluded from the proposed non-bank lending legislation as the loans are not considered high cost loans. Low value loans through this company, when also including the establishment fees have effective annual interest rates of higher than 50 percent. Once the establishment fee is included as part of the cost of the loan the effective annual interest rates can be much more substantial.

The definition of a high cost loan should include the total cost of interest and fees rather than just focussing on the interest rate. The interest paid on the loan is just one component of the loan and that the fees charged by the lenders often add significant costs onto the loan over and above the advertised interest rate. These fees result in a total cost of borrowing that is much higher, particularly when loans are small in value. For example, a loan of $500 may incur a fee of $100 to set up the loan.

[5] "Review of the Small Amount Credit Contract Laws, Final Report", March 2016 (Australian Government, The Treasury).

As the individual taking out the loan is unlikely to be able to afford the fee upfront this adds to the value or the amount loaned increasing the value of the loan to $600.

If the lender then charges an interest rate of 49 percent per annum or 0.13 percent per day to ensure this is below the current 50 percent threshold for a high cost loan. While 0.13 percent interest per day on a $500 loan is just $0.67 per day. The additional interest on the $100 dollar fee increases the interest cost to $0.81 per day. This is an effective interest rate of 0.16 percent per day based on the initial $500 loan.

Table 1 Finance company interest rates including fees paid

Loaned amount ($)	Establishment fee ($)	Quoted APR (%)	Effective APR (%)
200 to 500.00	100	29.95	95 to 56
500.01 to 1,000	190	29.95	79 to 55
1,000.01 to 3,000	300	29.95	69 to 43
3,000.01 to 10,000	400	29.95	47 to 35
10,000.01 to 20,000	500	29.95	36 to 33
20,000.01 and greater	600	29.95	34 to 30

If the loan were taken for a four-week period (28 days), assuming no compound interest, the interest would be $18.79 on the original loan plus an additional $3.76 in interest for the fee. Over the four weeks, the total interest would be $22.55.

Using current APR definitions that do not account for compounding interest and including the additional interest on the fee increases the APR of the original loan value ($500) from 49 percent per annum to 59 percent interest per annum, a ten-percentage point increase on the original interest rate advertised. At the end of the four weeks, the total interest cost of the loan assuming no compounding interest is $22.55 or almost 4.5 percent of the principle loan value compared with an advertised rate equivalent to just below four percent for the same period. In addition, the $100 fee is paid when the loan is repaid. This increases the total cost of borrowing to $122.55, 24.5 percent of the original loan compared to an advertised interest rate that would cost just $18.79 for four weeks. Taken over the 28 days of the loan this is equal to an interest rate of 0.875 percent per day without any fees, or 319 percent per annum.

Including the fees and interest as part of the overall cost of the loan would stop some lenders avoiding being considered a high cost lender by reducing their interest rate below the threshold while increasing fees to cover the difference.

5.5 Clearer calculation of APR

We recommend moving to an APR that is calculated based on compounding interest and this is regulated to be consistently used by all in the industry.

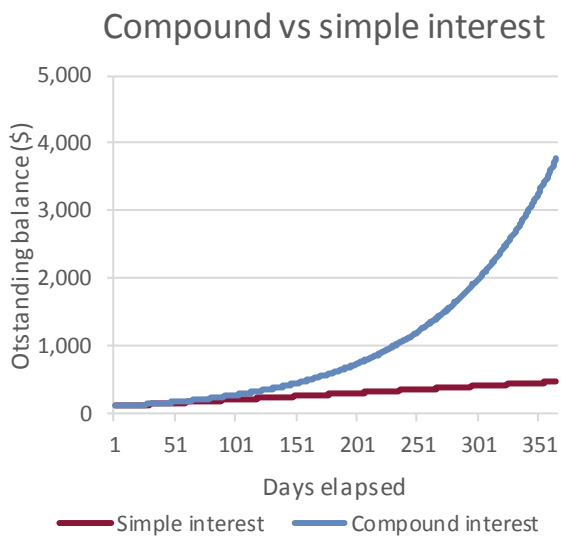
The market for high cost loans has lots of small companies, often with different interest rates and fees that make comparing loans challenging. In New Zealand the one consistent piece of information provided by lenders is the APR (or Annual Interest Rate (AIR)) which is the daily or monthly rate multiplied up to a year. For example, a one percent daily interest rate would have an APR of 365 percent, while a 10 percent monthly rate would have an APR of 120 percent. This appears to make loans comparable, but there are often other fees for establishment, extensions and certain methods

of payment. These fees result in a total cost of borrowing being much higher, particularly when loans are small in value.

In other countries, such as the United Kingdom, APR is calculated based on compound interest, providing the actual cost if a loan was held for a year. This is not the case in New Zealand. Most high cost loans calculate interest on the outstanding balance at the end of each day, resulting in the previous day's interest also generating interest. In the short term, as the interest is small there is little difference from simple and compound interest, though over time the difference grows.

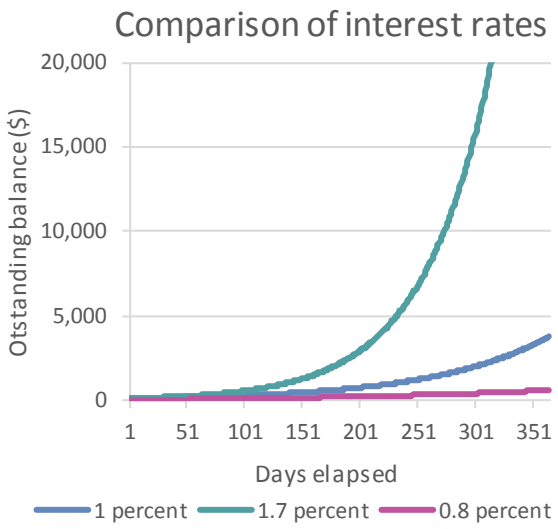
For example, an individual borrows $100 at one percent interest per day. Using APR, this is 365 percent, which means that by the end of a year, the outstanding balance will be 3.56 times the original loan. Using compound interest of one percent per day, over a year the balance will have grown to almost 40 times the original value. With one percent daily interest compounded daily, the balance doubles every 70 days.

Figure 12 Simple and compound interest at 1 percent per day on $100 loan



The effects of compound interest is very sensitive to changes in the interest rate; doubling the interest rate, results in the total balance doubling in half the number of days. With a common high cost loan rate of 1.7 percent per day the balance doubles every 41 days. After one year the balance can grow to as high as 500 times the original value. While these two rates appear comparable, over time the difference is stark. Both of these interest rates are offered in the current market.

Figure 13 Daily compounding interest on $100 loan



This compounding interest can impose an additional cost for loan borrowers. For clarity, the APR should be compounding to show the true cost of interest payments and to ensure people are aware of the full cost of the interest charges on the loans they take out.

Results from the survey show 40 percent of high interest borrowers use the loan to pay off other debt and 70 percent could not access credit in other ways. This indicates that borrowers are comparing loan options when making decisions on how to access credit. APRs that are compounding would give borrowers more accurate information of the actual cost of the loan and allow for better comparisons between loan options. This will also allow borrowers to make better-informed decisions over which loans are the best for them.

Figure 14 Effect of interest rate on the doubling rate of principal

Daily interest (%)	Days to double principal
2	35
1.7	41
1.5	47
1.2	58
1	70
0.8	87

5.6 Better informing borrowers

We recommend that the CCCFA be strengthened to require the lender to provide more detail to the borrower.

Currently section 9C(3)(b) requires that a lender must, in relation to an agreement with a borrower:

(b) assist the borrower to reach an informed decision as to whether or not to enter into the agreement and to be reasonably aware of the full implications of entering into the agreement, including by ensuring that—

I. *any advertising is not, or is not likely to be, misleading, deceptive, or confusing to borrowers; and*

II. *the terms of the agreement are expressed in plain language in a clear, concise, and intelligible manner; and*

III. *any information provided by the lender to the borrower is not presented in a manner that is, or is likely to be, misleading, deceptive, or confusing;*

Agencies asked about the level of understanding clients had of the fees and costs associated with taking out a high cost loan. The overwhelming response to the survey was that clients had at least a poor understanding of the costs they incur in taking out a high cost loan. Over 60 percent of survey respondents reported that the level of client understanding of high cost loan fees and costs were either poor or very poor.

The lender should be required to show the borrower how much the loan would cost them to repay at the time the loan is due. Additionally the lender should make clear, the monetary value of any penalties and payments that are required if the borrower fails to repay their loan and the frequency of these additional costs and charges if the loan is not repaid on time.

Increased enforcement of this section would also encourage lenders to better inform borrowers of their commitments and responsibilities under the loan agreements they enter into.

5.7 Financial advice prior to loans

We recommend that before an individual can enter into a second high cost loan, or can enter into a high cost loan within one month of repaying their previous high cost loan, they be required to obtain independent financial advice from a financial mentor or financial adviser.

The survey of financial capability and budgeting advice services found that beneficiaries and low income households are too vulnerable to be accessing consumer credit facilities and will not accurately ascertain their actual financial position prior, therefore should be recommended budget advice prior to all lending.

The survey found that over 80 percent of clients borrow because their general financial situation has worsened. This may be driven by the need for new and different spending (58 percent), or to repay prior debt (66 percent) and/or by the lender encouraging them to take out new debt. Other reasons given include:

- They are desperate to get cash
- Their benefit does not cover their cost of living
- They had no other option, they needed essentials for their children i.e. medication, food, clothing.

Further adding to this issue, agencies surveyed reported that many clients hold more than one high cost loan at a time. Three agencies reported that 80-100 percent of clients have more than one loan, but most agencies reported that 1-20 percent have more than one. Eighteen agencies reported 41-60 percent, and 14 agencies reported 21-40 percent, of clients have more than one high cost loan.

The reasons above on why people enter into high cost loan agreements indicates that these people are put into stressful situations where they are forced to make important financial decisions in a short time period, something high cost lenders take advantage of when advertising loan approval in 15 minutes.

Research[6] suggests that exposure to stress can negatively affect people's economic and financial decision-making. As a result, the pressures of a financial situation may impair decision-making, meaning consumers are even more likely to take out a high cost loan than they otherwise would under less stressful circumstances. The pressure of an overdue payment or car repair may cause borrowers to focus on getting access to high cost loans while neglecting the payments that will be required later.

To give an example, for an individual faced with a payment they cannot afford at that time, $100 today might feel as worthwhile as $150 in a week, because the value of the future $150 is discounted. To give an example of discounting in the contest of a high cost loan, a person borrowing $100 sees this $100 at that moment as more valuable than the amount to be paid back in a week, for example $150.

Because of the pressure from a payment that is due, person A might prefer to have $100 today to having $150 in a week. Person B might prefer to wait for $110 in a week than having $100 today. In this example, person A is a steeper discounter than person B, which means they are far more likely to take out a high cost loan as the value of the money to them now ($100) is worth more to them at that moment than they will pay back in the future ($150). Stress is just one reason that these discount rates can differ so significantly, and the short term relief of stress may result in even higher levels of stress when payments are due.

This intervention should help people to get their finances in order before they need to access a high cost loan. This should reduce the number of people who require access to a high cost loan.

5.8 Increased funding for financial capability and budgeting advice services

To support the recommendation above in section 5.7 and to support budget service providers we recommend that the government consider increasing the level of funding provided to financial capability and budgeting advice services to limit and prevent harm caused by high cost loans

Data from the FinCap database recorded 24,400 interactions with budget service providers and complete information was available for 13,600 individuals. This indicates that people are reliant on budget advisors for financial help and that these services fill an important need. When people are in this position spending additional funds on a budget advisor is not considered a viable option. For those in the position of financial difficulty where they are considering a high cost loan or have entered into a high cost loan agreement a free or partially subsidised budget advisor that can assist them with their financial difficulties is often their only option available for financial support.

Increasing the funding available to financial capability and budgeting advice services will support vulnerable individuals in two ways. The first is that additional funding will allow more budget advisors to be employed. This could happen either through increasing the number of budget advisors or by increasing the number of hours existing budget advisors are available. Both of these options would see the supply of budget advisor hours increase. Increasing available hours would enable financial capability and budgeting advice services to see more people or to see their existing users for longer. Allowing for a longer time would enable more comprehensive budgeting advice to be provided. Extending the availability of budget advice could also allow budget advisors to get into more detail with their clients and provide longer term advice to reduce the incidences of people getting into financial difficulty and preventing them from having to return to advisors. By seeing more people or

[6] Samuel M. McClure, David I. Laibson, George Loewenstein, Jonathan D. Cohen. *Separate Neural Systems Value Immediate and Delayed Monetary Rewards*. Science. 15 Oct 2004.

seeing them for longer, budget advisors could prevent people from entering into unnecessary high cost loans.

The second way increased funding could benefit those individuals with high cost loans or looking at high costs loans, is to increase the publicity of financial capability and budgeting advice services. With 13,600 individuals accessing financial capability and budgeting advice services, this is just 0.3 percent of the population. By increasing awareness of financial capability and budgeting advice services people facing or experiencing a difficult financial situation will be more aware of the support that is available to them. If these people access financial capability and budgeting advice services they would not have otherwise been aware of it is more likely that these individuals seeking help will get the support they need and will not be forced into taking out new or additional high cost loans.

5.9 Support for those in financial difficulty

We recommend the government consider increasing the financial support it provides to low income households in financial difficulty and when they face unexpected financial shocks.

The survey found that 70 percent of those who took out high cost loans did so because they were unable to obtain credit in other ways. The Code includes the following as examples of necessities; accommodation, food, utilities, transport, required medical expenses.

The data indicates that a there was a selection of people who took out a high cost loan and sought budget advice as the result of an unexpected shock. This shock either prevented them from being able to repay the high cost loan or forced them to take out the loan when they could not pay for essentials any other way due to the unexpected incident.

If a family or individual is able to show that an unexpected event has occurred that was outside the control of the individual or family the government should offer some form of support so that these individuals do not have to rely on high cost loans. Examples of shocks could include unexpected job loss or injury that leaves someone unable to work due to events outside their control.

This service should complement the existing support that is already available from the Ministry of Social Development. Almost half of all borrowers with high cost loans had debts to WINZ indicating that existing government provision for lending for essentials is unlikely to be an option available to them. Additional support should provide an alternative to high cost loans for people facing immediate financial problems.

Additionally, where the government is unable to directly support people facing the prospect of having to access high cost loans there should be additional support and publicity given to alternative providers of finance to those in need. This could include but not be limited to the No Interest Loan Scheme and the StartUp loan scheme. Eligible applicants can apply for a No Interest Loan (NIL) for up to $1,000 for a maximum of 18 months. Loan amounts are up to $1,000 for essential goods and services such as beds, dining room furniture, lounge suites and fridges. Loans are not for cash. Repayments are set up at an affordable amount over a set period.

6 Conclusion

Any intervention into the market should balance the costs with the benefits. The service provided by high cost lenders to individuals who use them for their intended purpose, needs to be weighed against the harm caused to vulnerable persons. The benefits from loans used for intended purposes, for example to keep a vehicle running until payday, are very different to those accessed as a last resort or without understanding the agreement they are entering into.

High cost lenders will argue that it is a few bad operators that are giving the industry a poor reputation and that these recommendations will place an excessive burden on lenders and will force them from the market.

With the exception of a cap on the total repayments and interest rate cap, we believe that the recommendations in this report are what these lenders should be doing currently under the existing legislation and the principles of the Code. Any additional requirements for lenders that are currently complying with the legislation and the code should be minimal.

The non-bank lending sector in recent years has evolved significantly in the past decade. From a large market of cooperative organisations the market has reduced to a market of small businesses charging very high interest rated to the vulnerable communities of New Zealand. With a market of non-bank personal lending of $6 billion, legislation is required to ensure the market is serving New Zealanders rather than driving them into financial distress.

As the third-tier lending market has grown, policy decisions to date have been insufficient to ensure that harm caused by this market can be removed.

The terminology used by the market, along with affordability tests for borrowers are major issues that need to be addressed, while asymmetry of information leaves borrowers at risk of not making fully informed decisions.

We acknowledge that the recommendations (including the increased support) will increase costs to both government and the sector. While consideration of the costs of these proposed interventions (or how they should be funded) was outside the scope of this study, our recommendations are in line with the objectives of ensuring a properly functioning market providing services to informed consumers.