



To their credit

Evaluating an experiment with personal loans for
people on low incomes

Rosanna Scutella and Genevieve Sheehan

May 2006

Brotherhood of St Laurence
67 Brunswick St
Fitzroy Vic. 3065
ABN 24 603 467 024

Ph: (03) 9483 1183

Internet: www.bsl.org.au

ISBN 1 876250 67 4

© Brotherhood of St Laurence 2006

Apart from fair dealing for the purpose of private study, research, criticism, or review, as permitted under the Copyright Act, no part may be reproduced by any process without written permission. Enquiries should be addressed to the publisher.

Contents

Acknowledgments	ii
Summary	iii
Findings	iii
Recommendations	iv
1 Introduction	1
2 Background	2
The market for credit	3
Credit options for low income groups	3
Use of personal credit by people on low incomes	5
3 The personal loan pilot	6
Program characteristics	7
The partnership	7
Key program statistics	8
Characteristics of the personal loan pilot clients	9
4 Furthering the availability of affordable credit: advocacy and program promotion	10
5 Meeting the credit needs of low income consumers: voices of our clients	11
Reason for obtaining a loan	11
Financial services used by participants	12
Attitudes to relationships with banks	14
Regulatory framework	20
Role of the Brotherhood	22
Role of the Bank	23
Processing of loans	24
6 Developing links between low income consumers and banks	24
Credit assessment	24
Demonstrating creditworthiness of many low income consumers	25
Views of Community Sector Banking staff	26
7 Sustainability	27
Net revenue	27
Program development and achieving financial sustainability	29
8 Conclusions and recommendations	30
Assessment of program outcomes	30
Recommendations	31
Final comments	32
References	33

Acknowledgments

This report was written by Rosanna Scutella (Economist) and Genevieve Sheehan (Microfinance Manager) from the Brotherhood of St Laurence.

We are grateful for funding for this research which was provided by the Consumer Credit Fund on the approval of the Minister for Consumer Affairs. The operation of the pilot loans program was funded by the Brotherhood of St Laurence and Community Sector Banking.

We would also like to thank a number of Brotherhood staff and volunteers for their generous assistance: Doug Looker for his insights on the operation of the program; Simone Jordon, Jacinda Kleidon, Casey Lo and Lucy Nelms for transcribing focus groups; Maree Boehm for surveying people about their demand for financial services; Julie Evans and Deborah Zinn for analysing the expenditure patterns of borrowers; Brian Larkins and June Gould for data entry; Catriona Larritt from Boston Consulting for preparing diagrams in the report; and Lara Olsen from Boston Consulting for undertaking some of the initial scoping for the project.

In addition, we are grateful to Community Sector Banking and Bendigo Bank for their willingness to incubate this program. We also thank staff for their time in discussing experiences of the pilot. Among others, we are particularly grateful to Greg Peel, Pat Cavanagh, Tim Furbank and Anthony Giffen for their patience and flexibility in operating the program and for sharing their experiences.

The following people generously read a draft of the report and provided comments:

Pat Cavanagh (Community Sector Banking)

Shane Dinnison (South Australian Council of Social Services)

Greg Fisher (Fitzroy and Carlton Community Credit Cooperative)

Adam Mooney (ANZ Banking Group)

Catherine Scarth (Brotherhood of St Laurence).

Deborah Patterson edited this report.

Most of all we would like to thank the participants of the personal loan pilot for so openly sharing opinions and for helping us to understand their financial needs and difficulties.

Summary

This study evaluates the Brotherhood of St Laurence and Community Sector Banking's personal loan pilot as at the end of 2005. This program, trialed across Melbourne, provided small personal loans (\$500 to \$2,000) for people on low incomes to purchase household goods and services. The pilot was designed to identify the barriers in accessing and providing credit for low income consumers, and to advocate ways to overcome these barriers.

This evaluation seeks to determine the extent to which the pilot achieved its objectives of:

1. Providing self-sustaining affordable credit to enable low income consumers to purchase household goods and services
2. Developing links between low income consumers and banks through advocacy and practical demonstration.

Research methods included interviews with borrowers and staff, as well as a literature review. Financial data was also analysed to determine the sustainability of the program.

Findings

As at 31 December 2005, 170 loans were provided with a total value of \$193,749; there had been a default rate of 0.9 per cent, with only one default of \$1,715; and 41 loans had been fully repaid. The remaining loans were on track. On a small scale, the pilot highlighted the creditworthiness of a group of people on low incomes.

Focus group discussions with borrowers showed that reasons for wanting a loan included the dignity of managing on their own, a lack of networks to assist and the cost efficiencies of repaying a loan rather than running an inefficient car or household item.

Many participants had mistrusted banks and not applied for credit at a mainstream institution for fear of being rejected. Some had belonged to local credit unions and regretted the loss of personal services after mergers. A few used fringe lenders: they appreciated the friendly service but felt the lenders were expensive.

For many participants, obtaining a loan was about more than just money, but also dignity, inclusion, trust and respect. It was an opportunity to not be just a passive recipient of welfare, but to gain some self-esteem by taking a positive, active role in the process. Participants felt a sense of pride at dealing with a bank:

I love the fact that ... it's through the mainstream bank who ordinarily, if you walked in off the street, they wouldn't have a bar of you ... It sort of makes you feel that little bit more special and more capable and just like everyone else standing in that bank ... and to go in there and pay that in person was a bit of a thrill.

Most participants expected to pay interest and felt the rate charged was cheaper than other alternatives. One woman said:

[A standard interest rate is] treating you like you are a normal person and you can pay your loan off and interest goes with any loan.

The most important loan features seemed to be low regular repayments that were fixed for the term of the loan.

At a practical level, contracts and application forms caused some confusion and discomfort among participants. Also, some participants felt the turnaround time for processing loans was too slow, so methods of streamlining need to be explored.

The focus groups highlighted a number of misconceptions and difficulties associated with Australia's credit reporting system. Some participants had defaults listed on their credit record, but did not realise this.

There were varying views on the role of the Brotherhood. While a number of participants felt embarrassed at visiting a community organisation, others appreciated the personalised approach.

Computerised systems for analysing creditworthiness would have automatically declined most of the pilot's loan applicants. A manual approach to credit analysis was able to take into account bill and rental payment histories, strategies for managing cash flow and the individual's budget.

At the same time, the pilot suggested that broadened involvement from a bank could help people to feel a greater sense of financial and social inclusion.

Comments from focus group participants suggested the program was able to reach a small group of people who were otherwise not able to access affordable credit. Hence, on a small scale, it seemed the pilot assisted to build links between a group of low income and a bank. In assisting people to better manage their cash flow to meet significant expenses, the program also helped overcome poverty traps associated with financial exclusion.

Bank staff felt personal satisfaction in being involved in the pilot, which raised awareness of the creditworthiness of people on low incomes. They felt a long-term commitment and adequate resources were needed to enable growth and process improvement.

At the end of the 2½ year pilot, the program had not yet achieved cost recovery, requiring a subsidy of over \$100,000. For it to become financially sustainable, the volume of loans (and therefore interest income) will need to increase substantially and the process made more efficient.

Recommendations

Partnerships between the private sector, community organisations and government are needed in the microcredit area. Many people on low incomes have been excluded from the mainstream market for credit and all parties are responsible for addressing this.

The community sector should continue to provide an individualised personal loan service to determine clients' ability to pay. Community organisations should also maintain a commitment to self-sufficiency and continue experimenting with various personal loan models to determine whether this is possible.

Banks need to work with the community sector to reach low income consumers that have been financially excluded. To this end, banks should also allow use of their systems so that a critical mass of borrowers can be reached. In addition, banks need to share the risk of default.

Finally, government should be committed not only to regulating against exploitative credit, but also to promoting alternative solutions. This needs to be done through a regulatory environment that is conducive to microcredit. Government also needs to ensure that servicing low income consumers remains within the role of banks.

1 Introduction

People may need to access a lump sum of money for a variety of reasons such as repairing a car, purchasing household appliances or paying for urgent dental treatment. Yet, as Bray (2001) shows, 36 per cent of Australians in the bottom income quintile report that if required, they would not be able to raise \$2,000 in a week.

There are many reasons why people on low incomes may be unable to easily obtain funds. For instance, they may not have a network of friends and family to help out in a difficult time; they may not be able to find alternative employment if a job is lost; and they are unlikely to have a buffer of savings or income from assets to fall back on. Given difficulties in obtaining lump sum amounts, an affordable source of credit is important for people on low incomes.

However, as Chant Link and Associates (2004) show, people on low incomes have limited access to appropriate credit. People in such circumstances may therefore be forced to rely on other forms of credit, which generally incur much higher charges and interest rates. Some may pay interest in excess of 100 per cent per annum to borrow funds.¹ Not having access to mainstream credit services also exposes those on low incomes to unregulated and 'predatory' lending practices:

Predatory lending seeks out the financially vulnerable, and offers them temporary relief from financial hardship but in the longer term exacerbates the vulnerability. Providing predatory loans to deal with financial hardship is like providing an alcoholic with whisky to deal with a hangover. (Malbon 2005, p.33)

For people either unwilling or unable to obtain these expensive forms of credit, often the only other option is to simply go without. Even this is not without its cost. Being unable to complete assignments on time due to limited access to a computer, or being unable to obtain employment without a car can impact on a family's longer term financial position. Alternatively, if someone's refrigerator breaks down they may store food in an esky, which is ultimately more expensive as it involves shopping daily. This was indeed the experience of one of the personal loan pilot clients:

I lived out of an esky for a while. Heaps of people do that now. You'd be surprised, how many people run their life out of an esky.

To improve access to appropriate forms of credit for people on low incomes, in May 2003 the Brotherhood of St Laurence, in partnership with Community Sector Banking (partly owned by Bendigo Bank), initiated a pilot loans program targeted to people on low incomes. The program provided small personal loans of \$500 to \$2,000 to people deemed capable of repayment without imposing financial burden. This kind of loan is known as microcredit.² The loans were initially designed for the purchase of household whitegoods, but since expanded to the purchase of other household durables and expenses such as car repairs or dental treatment. These loans carried a standard rate of interest. For customers they were intended to be a viable alternative to high interest 'payday' lenders or credit cards and finance companies.

The objectives of the pilot were twofold. Firstly, the program was designed to provide self-sustaining affordable credit to enable low income consumers to purchase household goods and services. A second objective was to develop links between low income consumers and banks. This objective was to be achieved through:

¹ In Victoria, NSW and the ACT payday loans are technically subject to a 48% interest rate cap, however Wilson (2002) notes that effective interest charges can be much higher than this. Pawnbrokers charge fees that are equivalent to annual interest rates of at least 200 per cent.

² Note that microcredit schemes originated in the context of economic development to alleviate global poverty. These schemes focus on the provision of credit to fund microenterprise. Microcredit schemes in developed nations are slightly different in that many focus on consumer lending.

- **practical demonstration**, by demonstrating to the banks that many low income consumers are creditworthy and can be served economically and working with the banks to further their servicing of this section of the community
- **advocacy**, working with other community groups and consumer advocates to further the availability of affordable credit for low income consumers.

This report evaluates the pilot against these initial objectives. A particular focus is on documenting the experiences of people taking out loans. The need for appropriate credit for people on low incomes is placed within broader debates of indebtedness and deregulation of the financial sector. In addition, the report seeks to document the way that the program was implemented to enable the success of further microcredit programs.

A range of research methods were used for the evaluation.

First, a literature search was conducted to provide background on financial exclusion and the credit market for low income consumers. The results of this are presented in Section 2. Section 3 then provides an overview of the personal loan pilot, discussing its characteristics, objectives and evolution over the last two years.

Individual interviews were conducted with Brotherhood and Community Sector Banking staff involved in various stages of the pilot. The views of Brotherhood staff were used to determine whether the program furthered the availability of credit by working with consumer and community groups (Section 4).

To determine whether the clients' needs were met, six focus groups were held in five locations around inner Melbourne and the Mornington Peninsula region. All successful applicants (as at August) were invited either by letter or by phone to participate. Thirty-three borrowers participated in the discussions and were compensated for their expenses in attending. In Section 5 we analyse the extent to which the product met their needs, and provided a more affordable, better option than otherwise available. Borrowers' views on pricing, product structure, processes, and feelings in dealing with banks or community organisations are discussed. Regulations and financial literacy emerged as issues subsequent to objectives being set and to some extent proved to be barriers. These areas are also discussed.

In Section 6, program outcomes and staff experiences at both the Brotherhood and Community Sector Banking are considered to determine whether the program succeeded in developing links between banks and low income consumers. Repayment rates and strategies for credit analysis are discussed with reference to the objective of demonstrating creditworthiness of these borrowers.

Financial sustainability of the pilot is assessed in Section 7 by examining the program's financial accounts at the Brotherhood. Costs borne by the Bank were based on estimates from Bank staff. Staff views were used to consider future financial sustainability.

Conclusions and recommendations are outlined in Section 8.

2 Background

A range of issues, such as deregulation, the structure of the banking industry and perceptions of levels of indebtedness have all served to limit the availability of affordable credit for people on low incomes.

Deregulation of the credit industry has seen a dramatic expansion in the availability of credit in Australia, but this has not been evenly distributed across society. There are many people, including those on low incomes, who lack access to appropriate credit. There is much focus in policy debates

on low income individuals who are over-indebted. Although this is a significant issue, it is important to consider that not everyone who is on a low income is over-indebted and experiencing major financial difficulties. Evidence suggests that the problem of being over-indebted is not a general feature of the low income population but is limited to a minority of the low income group (see, for instance, Chant Link and Associates 2004; Kelly, Cassells & Harding 2004 and Kohler, Connolly & Smith 2004). Indeed it is suggested that this over-indebtedness may be exacerbated by a lack of affordable credit options (Wilson 2002). The Brotherhood's experiences show that many people on low incomes are extremely careful money managers who are committed to living within their means. However, many are still unable to obtain appropriate mainstream credit for necessary goods.

The market for credit

Some of the reasons why low income consumers have limited access to affordable credit options are linked to the nature of the mainstream banking industry. The financial sector was deregulated in the early 1980s in an effort to maximise competition and promote efficiency in the market. However, it is questionable whether the level of competition anticipated is possible in the Australian banking sector. Australian Prudential Regulation Authority quarterly performance statistics show dominance by the four major banks which accounted for 71.6 per cent of total operating income of all banks for the twelve months to 30 June 2005. Given the dominance of a few large companies, economic theory suggests that there is 'market failure' in the banking industry.^{3,4} Australia's big four banks are indeed among the most profitable in the world (Standard and Poor's 2006).

Ideally, competition creates a better outcome for consumers, bringing about more choice at lower prices. Yet, given their minimal profitability, low income consumers appear to be missing out on financial services supplied by the major banks:

On the grounds that they are non-profitable and too risky to be regarded as serious customers, most mainstream credit providers make access to their services difficult, and often impossible, for people on low incomes. (Jones 2001, p.4)

This means that if low income consumers wish to access financial products other than basic banking services, they end up paying more for them. Despite deregulation and other innovations in the financial sector, this is particularly the case for credit, with low income people having to seek alternative forms of credit, rely on credit cards or simply go without.

Credit options for low income groups

Some of the more common credit products and options for people on low incomes are described here:

³ 'Market failure' refers to a situation in which markets are operating inefficiently and not at the competitive ideal. A perfectly competitive market requires many buyers and many sellers, that information be free and available to everyone involved, there be no transactions costs, no barriers to entry and no external effects of each individual transaction. Any violation of these assumptions can lead to market failure.

⁴ One reason why the banking industry is dominated by a few firms relates to the barriers faced by new entrants. These include the need to obtain bank licences and the cost of establishing a branch network, as well as investments required in infrastructure and technology. Due to the large fixed costs of setting up banks and offering products (in addition to transaction costs) the industry uses economies of scale and economies of scope in its quest for profit. This means that it is not easy for new banks to enter the industry and offer cheaper or more innovative products. Also asymmetric information, meaning that one party involved in a transaction has less information than the other party, can cause low income people to be financially excluded. In essence, it is time-consuming and difficult for banks to distinguish between those low-income borrowers that are likely to repay and those that may default. As a result, banks generally assume that low income borrowers are too risky to lend to.

- **Pawn brokers:** Loans from pawn brokers are obtained when personal items are provided as security. Usually the main cost components for the consumer are fixed fees and charges which depend on how much is borrowed. For instance, Cash Converters and Cash Centre in Frankston charge 35 per cent and 25 per cent per month respectively on loans secured by personal items.
- **Payday lenders:** Payday lenders provide loans until the next 'pay day' in exchange for a fee. Loans are typically for two to four weeks for amounts around \$250. Charges for payday lenders are equivalent to between 500 and 700 per cent per annum in interest (Wilson 2002). For some payday lenders, the proportion of customers that are receiving income from Centrelink is relatively low. For instance, Money Plus estimates only 5 to 15 per cent of their customers receive government benefits and Cash Converters estimated 80 per cent of their customers have wage income (see Money Plus 2005 and Cash Converters 2005 respectively). This is consistent with Wilson (2002) who found that the average income of consumers of payday lenders is \$24,500 (higher than average levels of Centrelink income). This suggests that the market for payday lenders is different from that of programs such as the Brotherhood and the Bank's personal loan pilot which work with people on lower incomes. Payday loans also often fund rent and bill payment (Wilson 2002), which again differs from the personal loan pilot which did not fund recurrent expenses such as these.
- **Credit cards and store cards:** A credit card allows people to repeatedly borrow money or buy products on credit. Banks generally promote this form of credit for smaller amounts (which are often all that people on low incomes want.) However, in a UK study Rowlingson & Kempson (1994) showed many people on low incomes were cautious about such an unstructured form of credit due to fear of running up large bills. They preferred to maintain closer control over their money through a carefully planned cash budget. Owning credit cards was a risk they were not prepared to take.
- **Personal loans:** Minimum personal loan sizes from major banks range from \$3,000 to \$5,000. Many people on low incomes are ineligible for bank loans or require smaller amounts and therefore obtain loans from organisations such as GE Money, which offers a minimum size of \$500 and interest rates of around 33 per cent per annum for unsecured loans (GE Money 2006)
- **'Interest free' credit tied to the purchase of goods:** Interest-free terms are often promoted in computer, department, electrical and furniture stores. Interest rates at the expiration of the initial interest-free term range from 20 to 30 per cent per annum. There are often fees for establishment, late payments and administration; and retail prices are sometimes inflated by stores offering credit (Dooley 2005).
- **Centrelink Advance:** Recipients of a Centrelink payment are able to obtain one \$500 advance each year. The advance is interest-free and usually has to be repaid over 6 months. Most Centrelink recipients are eligible for the advance payment and there seems to be a high level of awareness about this service (around half of the Brotherhood and the Bank's borrowers had the advance at the time of applying for a loan). Anecdotal evidence suggests that many long-term Centrelink clients re-apply for their advance as soon as they are eligible, so it is less likely to be available when unexpected expenses arise.
- **Other interest free loans:** Good Shepherd Youth and Family Service started the No Interest Loans Scheme (NILS®) in 1980. Loans are usually repaid over 1–2 years and the limit is generally between \$800 and \$1,000. As at 2005, there were 232 NILS programs operating across Australia. In the last 12 months, NILS loans totalled \$3.5 million across 4,500 people. The repayment rate was 97 per cent (McInerney 2005).
- **Other such as savings, lending from friends or family:** Anecdotal evidence suggests that many people on low incomes do not use credit to fund large purchases. Instead, many save, go without, borrow from family or friends or obtain assistance from community organisations.

For community organisations providing microcredit, it is important to recognise that there are valid reasons why low income consumers would make the choice to utilise fringe lenders. Such people

may choose to utilise fringe lenders because of ease of access, absence of a credit check or a non-stigmatising atmosphere that feels ‘mainstream’.

This view was supported by Wilson (2002):

Consumers also greatly appreciate the independence, privacy and self-esteem that comes from having access to credit in the financial services marketplace. Payday loans are not charity, but commercial transactions and this is important in fostering feelings of financial and social inclusion. (Wilson 2002, p 81)

As critics of fringe lenders often highlight, there are many disadvantages in utilising this form of credit, including inadequate consumer protection, relatively high charges and the prospect of entering into a cycle of debt. The extent to which people on low incomes recognise these disadvantages, but still proceed, is discussed further in Section 6.

Use of personal credit by people on low incomes

It is useful to consider the evidence on the distribution of debt across income groups to gain a general understanding of low income households’ holdings of debt. The material in this section is largely taken from Kohler et al. (2004), which examines the distribution of assets and debt in the Australian population by analysing the 2002 Household Income and Labour Dynamics in Australia (HILDA) survey.

Household debt by income quintile and type of debt is presented in Table 2.1. Low income households are much less likely to hold any form of debt than higher income households. Of particular interest are the low holdings of credit card and other personal debt by households in the lowest income quintile. Although these are the two most common forms of debt for the lowest income quintile, only 16 per cent of households have credit card debt and 12 per cent have other forms of personal debt—substantially lower percentages than the household population average⁵.

The findings of Kohler et al. (2004) and Kelly, Cassells & Harding (2004) are consistent with data from an ANZ study of financial exclusion, which showed that a significant majority of those surveyed on incomes less than \$20,000 did not have credit cards (Chant Link and Associates 2004).

Research in the UK by Collard (2005) suggests that for some low income households credit cards and personal loans remain from an earlier period of employment. Further research into this issue in Australia is recommended.

Table 2.1: Percentage of households holding debt, by type of debt

Income percentile	Home loan	Investor property loan	Business debt	Credit card debt	HECS	Other personal debt	Any debt
Lowest 20%	9	2	3	16	8	12	35
20 to 39.9	20	4	3	24	11	24	55
40 to 59.9	35	7	5	35	13	35	73
60 to 79.9	50	10	6	38	14	39	83
Highest 20%	56	17	10	35	17	40	86
All households	34	8	5	30	13	30	66

Source: Kohler, Connolly & Smith 2004, adapted from Table A.5

⁵ Note that the item for credit card debt only reflects households with debt outstanding after monthly repayments. The proportion of households that use credit cards is much higher, with credit card use increasing with income and higher income households more likely to use credit cards as a transactional account (Kelly, Cassells & Harding 2004).

Perhaps of more significance are the amounts of debt incurred. Median values across household income quintiles by type of debt are presented in Table 2.2. Median values of all forms of debt except HECS rise with incomes. Even for personal debt (our major focus), median values of credit card and other personal debt for households in the bottom 20 per cent of incomes (\$1,000 and \$3,000 respectively) are significantly lower than median debt levels in higher income groups.

Table 2.2: Median value of holdings for households holding debt (\$'000), by type of debt

Income percentile	Home loan	Investor property loan	Business debt	Credit card debt	HECS	Other personal debt	Any debt
Lowest 20%	51	50	31	1	8	3	8
20 to 39.9	65	64	60	2	8	5	16
40 to 59.9	81	100	27	2	7	8	39
60 to 79.9	98	113	50	2	7	10	72
Highest 20%	120	140	60	3	8	18	114
All households	90	113	50	2	8	9	50

Source: Kohler, Connolly & Smith 2004, adapted from Table A.5

It must be noted that although the median levels of debt may be relatively low, there are some people in the low income group (and other groups) that are over-indebted. The median measure (describing the *middle* of the range) will not reflect this. Such over-indebtedness cannot be ignored, but it is important to remember that it is not representative of all people on low incomes. There are many other people on low incomes that have little or no debt but potentially still have limited access to credit. These people are likely to be asset-poor and vulnerable to an unexpected change to their income or expenses. Many would be able to use credit responsibly if it were available to them. In these circumstances, finance can assist in improving people's welfare by allowing them to obtain items that they need.

3 The personal loan pilot

Access to the mainstream financial sector is an important aspect of social inclusion and economic development. Therefore the Brotherhood has been interested in this area for several years.

The personal loan pilot was initiated in May 2003 in partnership with Community Sector Banking (partly owned by Bendigo Bank). The program has been known by several names, including the most recent product title of Advance Personal Loan. Throughout this report, the program is primarily referred to as 'the personal loan pilot'.⁶

Prior to the pilot program, the Brotherhood had operated a No Interest Loans Scheme (NILS) (and continues to do so). While NILS had demonstrated that people on low incomes were able to repay small loans, the scheme was not really addressing the causes of the symptom—the financial sector's lack of services appropriate to this client base (Roberts 2000). In addition, NILS programs are relatively unsustainable as they require large start-up grants and fundraising for operational and default costs (Burkett 2003).

Due to these concerns with No Interest Loan Schemes, the Brotherhood was keen to offer a more commercial financial product in partnership with a bank. The objective of Community Sector Banking is to create financial solutions which meet the needs and enhance the overall effectiveness of the community sector (Community Sector Banking 2006.) To achieve this, they were willing to

⁶ In 2004, Good Shepherd Youth and Family Services and the National Bank initiated a similar program, 'Step Up'. An evaluation of this program will be available over the coming year and the Brotherhood looks forward to enhancing our program through lessons from the Step Up model.

provide in-kind contributions towards the pilot program, in the form of banking systems and human resources.

The following details of the program reflect the characteristics of the pilot from its inception to 31 December 2005.

Program characteristics

Loans sizes ranged from \$500 to \$2,000 for up to 2 years.

To be eligible for a loan, people needed to:

- hold a healthcare or pension card,
- have been living at their current home for more than six months, and
- demonstrate they could make regular repayments, as shown by household budget, credit record, and bill and rental histories.

The interest rate was 13.95 per cent per annum, Bendigo Bank's unsecured personal loan interest rate at the time the program commenced. Interest was calculated daily and charged monthly. For a loan of \$1,000 repaid over one year, this amounted to total interest of approximately \$70.

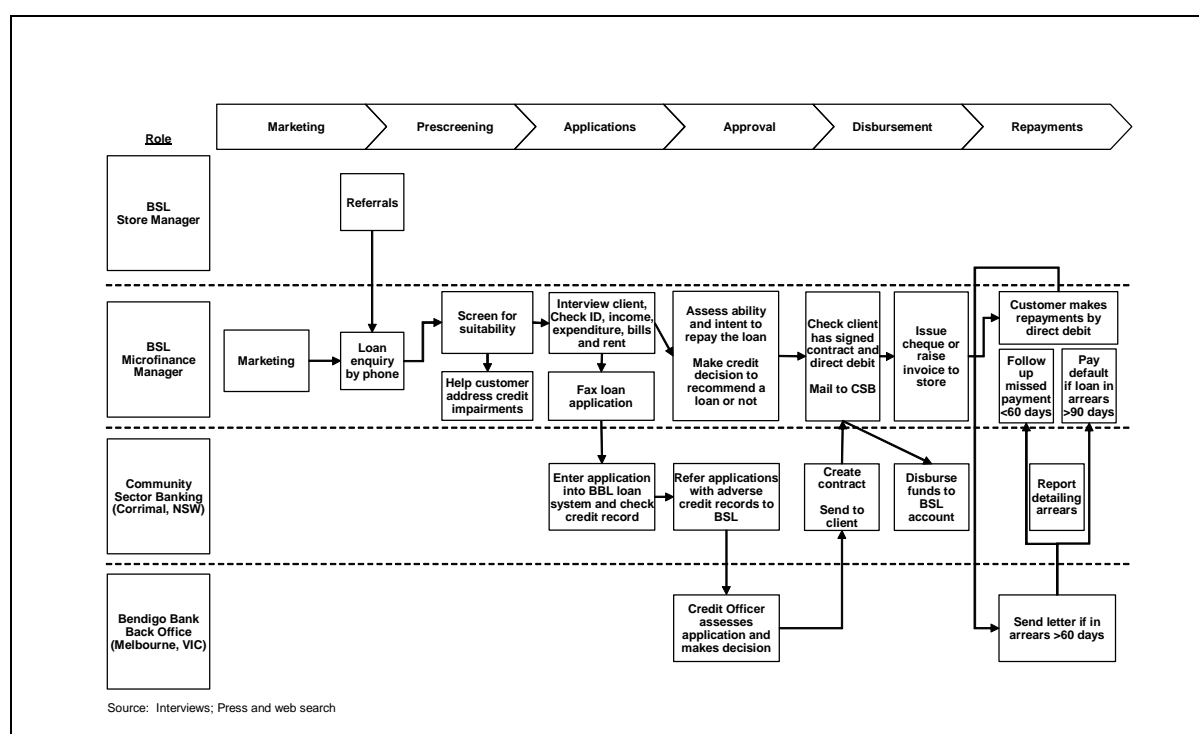
The Brotherhood guaranteed all loans over the course of the pilot. This was done so the pilot could commence. Given limited financial resources, the Brotherhood did not intend to maintain the role of guarantor over the longer term and it was planned from the outset that this arrangement would be reviewed subject to portfolio performance. At the end of 2005, Community Sector Banking had offered to reduce this to a guarantee of one dollar for every three dollars lent.

The partnership

The personal loan pilot was provided by the Brotherhood in partnership with Community Sector Banking and Bendigo Bank. Throughout the remainder of the report, Community Sector Banking and Bendigo Bank are mainly referred to as 'the Bank'.

There were considerable benefits and cost savings in partnering with a financial institution. These included access to an automated system for producing contracts and tracking payments which reduced some of the administrative burden of this work for the Brotherhood. The Bank was also able to provide expertise in the principles of lending.

The respective roles of the Brotherhood, Community Sector Banking and Bendigo Bank are presented diagrammatically in Figure 3.1. The Brotherhood of St Laurence had most of the direct contact with the client, took most day-to-day inquiries, met clients at the time of application and when they returned the contract, and followed up on arrears. Community Sector Banking and Bendigo Bank undertook formal credit checks, approved loans, issued contracts and tracked payments.

Figure 3.1 The personal loan pilot processes⁷

Key program statistics

By the end of the 2½ year pilot period, 194 loans were approved, with 170 of these provided. This amounts to a loans total of close to \$194,000. These and other key statistics of the pilot are presented in Table 3.1.

Table 3.1 Snapshot of personal loan pilot as at December 31 2005¹

Indicator	
Number of applications	212
Number of loans approved	194
Number of loans provided	170
Number of loans fully repaid	41
Number of inquiries to obtain a loan	1,253
Number of defaults	1
Average proportion of portfolio in arrears	4%
Total lent	\$193,749
Total repaid	\$89,607
Total outstanding as at December 31 2005	\$102,427
Dollar value of defaults	\$1,715
Dollar value of loan transferred to Brotherhood's No Interest Loans Scheme ²	\$865

¹ Table includes dollar amount of loans that were approved by 31 December 2005 for consistency with budget (discussed later). Some of these loans were advanced in early January 2006.

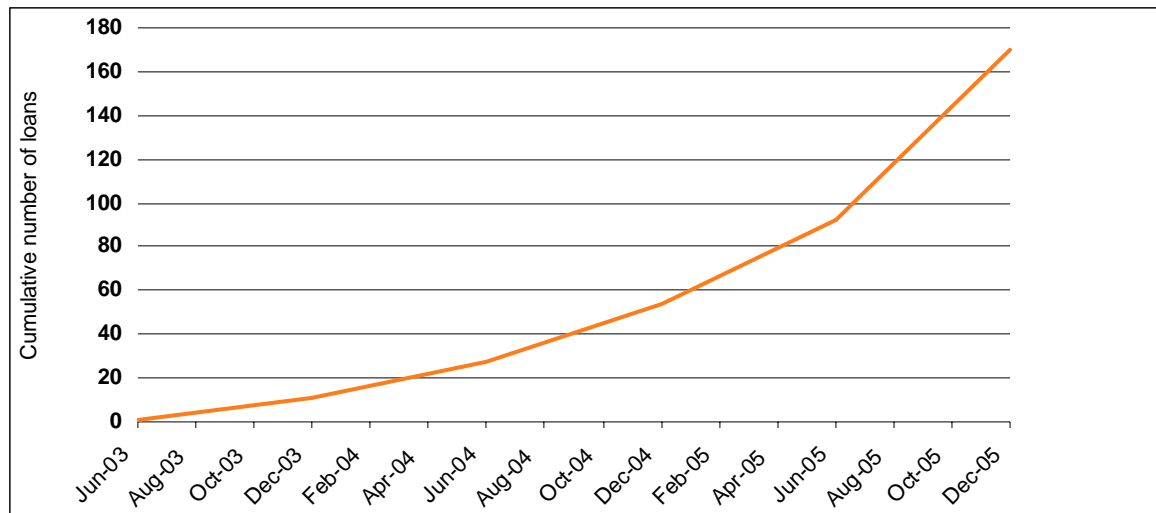
² One loan was transferred to the Brotherhood of St Laurence's No Interest Loan Scheme when a customer's house burnt down. This was done to help alleviate the customer's stress, and regular payments were being received at the time of writing.

⁷ We thank Catriona Larritt from Boston Consulting for creating this figure.

As of 31 December 2005, 41 loans to the value of \$89,607 had been fully repaid, with only one default due to death of the borrower and one loan transferred to the Brotherhood's No Interest Loans Scheme. Over the course of the pilot, there was an average of 4 per cent of the portfolio in arrears by more than one day.⁸

Initially the program grew very slowly. However, as the Brotherhood and the Bank improved processes and learned more about program promotion and risk, the customer base increased more rapidly. This can be seen in Figure 3.2 which shows growth in the cumulative number of borrowers over the pilot period.

Figure 3.2 Cumulative number of loans provided, June 2003–December 2005



Characteristics of the personal loan pilot clients

Table 3.2 presents the key demographic characteristics of the clients of the personal loan pilot. The program seems to be attracting certain demographic groups more than others. Two-thirds of the 212 applications were submitted by individual women. Twenty-six per cent were from men, and the remaining 8 per cent were joint applications. These people had passed the initial phone screening process and their application had been forwarded to the bank.

The main family type among loan applicants was single parents (43 per cent of applicants, 92 per cent of them women). A further 39 per cent of applicants were single adults without dependent children, 9 per cent were partnered without dependent children and the remaining 8 per cent were partnered with dependent children. Reflecting the large number of sole parent applicants, 62 per cent of loans applicants were aged between 25 and 49 years, and a further 26 per cent between 50 and 64 years. There were very few applicants 65 years or over, perhaps reflecting this age group's higher likelihood of having savings and assets, and lower inclination to acquire debt. Over the course of the pilot, there were 10 repeat borrowers.

Loans were most commonly taken for large household items—refrigerators (31%), washing machines (19%), computers (9%) and furniture such as sofas and beds (9%). The remaining applications were for a diverse range of expenses such as car repairs (11%), televisions, dental treatment, school expenses and air-conditioning units.

⁸ Arrears rate has been calculated by dividing the outstanding balance of loans in arrears by more than 1 day by the total outstanding portfolio on a monthly basis, then calculating the average of these monthly figures.

Table 3.2: Key characteristics of personal loan pilot applicants

Characteristic	Percentage of applicants
Gender	
Female	66
Male	26
Joint applications	8
Family type	
Single parent	43
Single, without children	39
Couple, with children	9
Couple, without children	9
Age	
Under 25 years	3
25 to 49 years	66
50 to 64 years	25
65 years plus	6
Item funded¹	
Refrigerator	31
Washing machine	19
Car/car repairs	11
Computer	9
Furniture	9
Television	5
Other	16
(Total number of applications)	(212)

¹These percentages based on the first item funded for each applicant.

4 Furthering the availability of affordable credit: advocacy and program promotion

One of the program's initial objectives was to work with other community and consumer organisations to advocate for further availability of affordable credit for people on low incomes. However, it became apparent that operational aspects of the program were more demanding than expected. This reduced staff time available to spend on the advocacy objective. In addition, program staff decided that a solid base of evidence was required in order to advocate.

Despite this, some links were built with community and consumer organisations. There were informal relationships with other organisations with similar objectives, such as the Fitzroy and Carlton Community Credit Cooperative and Good Shepherd Youth and Family Service. The Brotherhood also initiated a conference in 2003, 'Banking on the Margins', to highlight the links between poverty and financial exclusion and bring together about 150 people interested in the area.⁹ The Brotherhood also worked with other community organisations to promote the program, with varying success. In many instances, promotion was time-consuming and difficult. Community workers were often concerned that banks would exploit people referred or felt it was wrong to charge a standard interest rate. There was no simple mechanism of communication, so it was a slow process of contacting community workers, explaining the program and sending them information.

⁹ The Brotherhood was also represented on relevant committees, including the Australian committee for the United National International Year of Microcredit, the Good Shepherd No Interest Loan Scheme Network and Consumer Affairs Victoria's Working Together Forum. It joined the Consumers Federation of Australia to develop a better understanding of links between poverty and consumer disadvantage. It participated in various advisory groups, which assisted in developing networks and broader knowledge of microcredit and consumer issues. There have been other opportunities to present at conferences about preliminary lessons from the pilot.

Given low volumes, it was difficult for any one community worker to develop expertise in the program. Word of mouth, Brotherhood opportunity shops, other Brotherhood community services and schools proved more effective channels of promotion.

In the future expansion of the program, the Brotherhood hopes to work with other organisations to assist them in replicating the program so that a greater number of people on low incomes can benefit. There has been some limited interest from other community organisations. However, the current financial arrangement whereby a community organisation needs to provide a guarantee and to fund operational expenses could be a barrier for smaller organisations and hence limit their engagement.

Overall, advocacy and program promotion through the community sector did to some extent increase the availability of affordable credit to low income consumers. However, further effort is needed to ensure coordination between organisations, sharing of lessons and efficient program promotion.

5 Meeting the credit needs of low income consumers: voices of our clients

This section presents the findings of the focus group discussions and evaluates these against the objective of providing affordable credit to low income consumers. The demographic of borrowers attending the focus groups was broadly representative of all loan applicants. Two-thirds of those interviewed were women. A majority were also sole parents receiving single Parenting Payment and not working. The men tended to be older and their major source of income was usually the Disability Support Pension.

Each focus group canvassed people's general experience with banks and other lenders and their experiences with the personal loan pilot. Specific issues discussed were the application procedure, feelings about the role of the Brotherhood and the Bank in the process, thoughts on how the process could be improved, the cost of the loan, repayment amounts and repayment method, how getting the loan made people feel and what other avenues people would have taken if the program was not available.

A limitation of the present analysis is that only successful loan applicants participated in the focus groups, so it may be skewed towards positive observations. There was, however, an informal feedback process throughout the pilot from people who were declined or decided not to proceed.

Reason for obtaining a loan

People on low incomes may find it difficult to cope with unexpected expenses without financial support. Many focus group participants did not have a network of family and friends to help them in difficult times. One woman spoke of her lack of people to rely on:

I don't myself have any other resources for loans ... There's no-one, I can't borrow money off an ex or this one's going to buy me that or that one's going to buy me this. There's no-one. I solely rely on this service and if I didn't get it through this service, I'm one of those who's right down at the very bottom and I just would go without. You would see me with my pram with my washing in it, and pushing it to the laundromat.

Even if participants did have a network of family and friends, these people were often on low incomes themselves and only had a limited capacity to assist. A man who could have borrowed funds from a friend explained that he preferred a bank loan due to the systems for automatic payment and the formality of a repayment agreement:

It's better to borrow from the bank because you know you have an obligation to the bank. It's more easy to pay the money to the bank than to pay the money to a friend. Because it's very easy with a friend, when you're in trouble, to say to your friend, 'No I'll pay you tomorrow'. [Then] you don't pay anything.

People saw there was more dignity and convenience in obtaining a loan rather than going without, going to an opportunity shop or obtaining emergency relief. Participants preferred to repay a loan for something new than using second-hand items:

[The item purchased through the loan] is not second hand. Or somebody else's rubbish.

For many of the participants obtaining a loan was more cost-effective than other options. Several were spending more at the laundromat than in loan repayments for a washing machine. Others were spending more on purchasing food on a daily basis and living out of an esky than on repayments for a fridge. Being on a tight budget, people could recognise these cost efficiencies. One woman commented on saving on travel costs by being able to upgrade her car:

I travel roughly eighty kilometres a day ... Thanks to you guys, I managed to get a car on gas and save myself heaps of money, and I'm able to pay off my loan ... I'm paying less than forty dollars in gas, and the money I've saved, I've put into the new ministry house I'm in, my kids are getting new clothes now—it's just making life so much easier. And the repayments, being so low, and being over one or two years, having that option, it's just made life so much easier.

Overall, people's reasons for wanting a loan suggest the personal loan pilot was able to meet objectives of providing a better option than was otherwise available.

Key point

- Participants' reasons for wanting a loan included the dignity of managing on their own, a lack of networks to assist, the formality of dealing with a bank and the cost efficiencies of repaying a loan rather than running an uneconomical car or household item.

Financial services used by participants

The people interviewed had varied histories and a range of experiences with banks. On the whole, these experiences were negative, which is not surprising considering these people were all on low incomes and felt the need to apply for a loan at the Brotherhood of St Laurence. Some had been members of credit unions or utilised fringe lenders and spoke of these experiences.

Banks

Most focus group participants were aware that it is difficult for people on low incomes to obtain credit from banks, and there was a general feeling of mistrust. While many had tried to obtain credit from one of the mainstream banks in the past, most had given up trying, anticipating rejection. People took this rejection very personally seeing it as a refusal not just on the basis of creditworthiness, but on worthiness as a person. A woman saw the unwillingness of banks to advance credit to her as very disappointing and a personal slight:

It's awful if you've got a good credit rating, and then they won't give you one [a loan] because you're low income. That's the part that hurts.

Some people felt there was a lack of interest in them as a person, and instead they were seen as a mere borrower or finance unit. Although there are anti-discrimination laws designed to ensure credit decisions are made on the likelihood of repayment, many people still felt discriminated against on the basis of their socio-economic status. In this case, the perception of discrimination may be more significant than the reality. However, people felt that banks were unfairly assuming

that because they were on a low income that they were unreliable or could not budget. One woman expressed this saying:

It's horrendous! You know, apart from the fact that you feel like you're totally unimportant and totally judged, but just because you're not employed, or on disability or whatever ... or a single parent, that you don't pay your bills. And I think that's a disgraceful assumption. Because there are people who earn millions that don't pay their bills.

Many participants felt that banks were not a place where they belonged. As one woman said:

Banks are very, very dominant over you. You feel very intimidated ... You feel as though you shouldn't be in there. They're in this ivory tower, you shouldn't go near it.

Despite this negativity, it was acknowledged that visiting a bank had not always been a disappointing experience. Some people had previously had a relationship with their local branch manager and lamented the loss of this personalised service:

In the old days, before they became globalised, you could walk into a bank and talk to the bank manager, and he would make a decision there. There was more leeway. But now they say the book says no. That's it.

As the above comments suggest, many low income consumers would not have ordinarily approached a bank and therefore the program did further availability of affordable credit (albeit on a very small scale).

Credit unions

Some participants had been members of small local credit unions. They had appreciated the flexible and personal service, as well as the credit union's willingness to provide appropriate products for people on low incomes. However, over the past couple of decades, there has been a steep decline in the availability of such tailored credit union services. A woman spoke of the service her and her husband used to receive from the local credit union:

And we started with nothing...But we went for a loan at the credit union, and we wanted \$500 personal loans to buy bikes for our kids. And that was great. And we paid it off, and then we got another \$500. It was usually at Christmas time, that's when you look at the second hand stores and *Trading Post* and all that sort of stuff. And we used to get letters saying, 'Oh, you've paid your loan off, you're quite welcome to have more', and, we've had these since 1983. But now that bank, that credit union, they've just dumped us, more or less.

After several mergers, the credit union had stopped offering personal loans and transferred her and her husband to a credit card. She was finding it difficult to repay given its higher interest rate and unstructured nature:

So they more or less got rid of us because we were just small. And then interest rates have gone up, and ... It's just not getting paid off ... I'm paying fifty-two dollars a month, and only twenty dollars is getting paid off it. So, it's really quite hard.

While credit unions with a low income member base provided a personalised and appropriate service (Chalmers 1990), changes in the credit union movement have reduced the availability of affordable credit for people on low incomes (Burkett 2003). Programs such as the personal loan pilot can help to fill this gap.

Other lenders

Since accessing banking services can be difficult, people on low incomes sometimes turned to other forms of credit products. Most participants realised payday lenders were expensive and kept away from them. One woman commented:

I went in to see about it. One third is interest, of what they loan you ... and for every time you miss a payment ... it's doubled and doubled. So by the time, if you've borrowed two hundred dollars, you can owe a thousand dollars before the month's out ... and if you've got a cheque or something if you're going to cash it, they take half of it ... So what's the point for the easy transaction if they're going to take half the money?

Many others were aware of the traps associated with interest-free store credit and realised there were charges if repayment extended beyond a specified period:

It's not too bad with some places with interest-free. But then you've still got to work out how much it's going to cost you after three years.

In accessing payday lenders, others were aware that charges were high but felt there was no other option. It was their conscious decision to pay this amount in fees and suggests that some people on low incomes are not very responsive to the price of credit. This supports the finding of Malbon (2005) that this apparent irrational behaviour by lower income consumers is more likely to be a result of circumstance rather than their lack of knowledge relative to higher income earners. One woman spoke about how her only option prior to the personal loan pilot had been to borrow from a payday lender:

[I use] a finance service, where you have to pay the loan off in a month and you are allowed to borrow a certain amount according to income ... I borrowed up to \$500, and by the time we paid interest off you'll be paying back nearly \$700 and that's within a month.

Despite the charges, she felt grateful that someone was willing to assist her. While there is an element of exploitation in this transaction, these companies are meeting a need. This service is also often provided in a relatively friendly, non-stigmatising way. The same woman spoke of her relationship with the payday lender's staff:

They know me pretty well, so sometimes they'll extend it ... I've been pretty lucky with them.

The experiences of these borrowers again suggest limited access to affordable credit for people on low incomes. The personal loan pilot was able to reach a (small) group of people who could not otherwise access affordable credit.

Key points

- Many participants mistrusted banks and did not apply for credit at a mainstream institution for fear of being rejected.
- Some participants had been members of local credit unions which later merged to become larger. These participants regretted the subsequent loss of personalised service appropriate to their needs.
- A minority of participants used fringe lenders. Those that did appreciated the friendly service but felt the lenders were expensive.

Attitudes to relationships with banks

For some participants, obtaining the loan was just about getting an item that they needed and it was irrelevant whether it was from a bank or a community organisation; but for others, having a bank loan appeared to help them to feel pride and a part of mainstream society. It seemed to be the

documentation and systems rather than a personal relationship that people appreciated with the Bank. One woman conveyed this by saying:

I got my first statement with Bendigo Bank—with my payments, and I felt so proud because they put all the details on the statement—it shows you what you've paid.

Another felt a greater sense of inclusion when visiting a bank branch:

I love the fact that ... it's through the mainstream bank who ordinarily if you walked in off the street they wouldn't have a bar of you It's just like—when I went in there to pay ... it sort of makes you feel that little bit more special and more capable and just like everyone else standing in that bank ... and to go in there and pay that in person was a bit of a thrill.

Approval by a bank gave some recognition of people's capacity to be trusted and manage money. On the other hand, one participant was disappointed that his good repayment history from the Brotherhood's No Interest Loan Scheme was not recognised by banks:

I was ... quite naively thinking that once I try and pay everything back I'll start to develop a credit rating not realising that the Brotherhood loans program wasn't recognised by the banks.

He explained that the he was keen to progress into the mainstream system and had previously suggested that the Brotherhood develop a loans program in partnership with a bank:

I said, look this is all very well. I've had I think it's five loans, I've paid back all my debts and fines and I still can't get credit from a bank ... I want to go in a bank ... I don't care how much interest I pay, provided I can get a credit rating with some organisation.

He had been pleased when the opportunity arose to obtain a loan from the Bank and was one of the program's first applicants.

A woman spoke of the importance of having built a track record with a mainstream bank:

It gave me the confidence to go ask somewhere else for credit ... this time I walked in with my head high and I said I want this and that.

Another woman said obtaining a loan from a mainstream bank gave her more confidence to pursue her dream of eventually moving out of public housing and purchasing her own home. Since obtaining her first loan, she had moved from being principally dependent on Centrelink income and having an impaired credit record, to mainly obtaining wage income and having items cleared from her credit record:

I'm starting to get myself in a financial position where I can save. And my ultimate goal is to get that mortgage. It would be really cool if the Bendigo Bank would see me as a possibility even. I just see my opportunities getting a little bit better now that the bankruptcy is going to come off. It's given me more confidence ... I think that what the loan has brought out—it's the opportunity to get something that you wouldn't normally get and the opportunity to straighten things out financially—to set you on a better path. Hopefully with more opportunities ahead.

Building links between low income consumers and banks by improving consumers' individual credit histories is something that the Brotherhood would like to see but is difficult in the current climate. Banks usually assess credit applications on a variety of factors, an essential one being the absence of an adverse credit record. The Australian credit reporting system details only negative

items, such as defaults, and not positive items, such as fully repaying a loan.¹⁰ Together with the fact that banks assess credit applications based on a person's income, this means that programs such as the personal loan pilot currently have a narrow impact on overall access to credit as they do not necessarily improve the borrowers' capacity to obtain credit from other banks. If the program is to grow, it is recommended that the partnering bank develop a process for successful borrowers to be considered for repeat loans without the involvement of the Brotherhood so that the program could serve as a better bridge into the mainstream financial sector.

People's comments indicate that many low income consumers want to move away from welfare services and be part of the mainstream. The outcomes of the focus groups suggest that the pilot had some role in improving the relationship between low income consumers and the banks from the consumer's perspective. The wider impact of the pilot of improving this relationship is discussed further in Section 6 .

Interest rates

Charging interest was a contentious issue when the program commenced, particularly among other people from the community sector. Intuitively, the idea of providing no-interest credit for people on low incomes may be appealing. However, the Brotherhood and the Bank felt charging regular interest was important for sustainability and moving microcredit into the mainstream. If the program is overly dependent on donations, it is vulnerable. The Brotherhood's view is that it is best for customers to provide a service that will continue to be there.

Most people taking out the loan did not appear to be averse to paying interest. The issue was discussed in the focus groups with a general expectation of paying interest. One participant noted:

You get nothing for nothing in this world.

Many participants recognised that this was a business relationship, rather than one where things are given for free with no strings attached. One man compared the notion of not paying interest to that of parents giving to their children:

Like if you're a mother you can bring something for the kids but this one is business, is different, so we need to pay. Not too high, but something we need to pay. Because it's one service we have, if we have electricity, phone, gas, for service we need to pay for this.

Another woman noted that she felt paying interest was part of being in the mainstream and said:

[A standard interest rate is] treating you like you are a normal person and you can pay your loan off and interest goes with any loan.

There was also a general agreement that the interest rate was cheaper than other forms of credit. A woman supported this:

It's only a small amount of interest. I mean, I only paid back, what, fifty-five dollars interest, and that was on a five hundred dollar loan. So that was good interest. I didn't care. I did not worry about how much interest I had to pay. Because it was better than any interest I've ever had before.

Along a similar line, another woman commented:

I have to say it's better than having 15 per cent or 25 per cent because sharks are pretty much 18 per cent and over; it's pretty sharky out there. So I think it's pretty good. And I

¹⁰ The Victorian government has recently undertaken a consumer credit review, which among other issues, includes analysis of the credit reporting system.

don't notice it ... because [it] goes out the same day [as pension day] so you don't miss it because you don't notice it. So I think it's good.

The only focus group participants who did not think they should pay interest were clients who had previously received a Brotherhood-operated 'No Interest Loan'. One woman commented:

That's ... interest that I could have used to pay off something in a No Interest Loan.

Intuitively, the idea of a progression from the welfare sector to a mainstream bank sounds like a good idea. However some former No Interest Loan recipients felt that they could have used the additional money for other expenses. Despite this, they still decided to proceed with the bank loan and pay interest. There were other participants who previously had a No Interest Loan and did not seem too concerned with the interest rate.

Comments suggest that the inability or unwillingness of people on low incomes to pay interest was a perception of workers in the community sector rather than a reality. Overall, participants' experiences suggest the pilot loans' product pricing met the needs of most low income consumers interviewed. However, more detailed market research in this area would be useful to understand more about attitudes towards pricing.

Pride and commitment to repaying

Although most of the focus group participants had suggestions for how the program could be improved, the overall response to the program was positive (admittedly people who were positive about the program were most likely to attend focus groups). Several women spoke of how obtaining the loan boosted self-esteem and it was important to feel trusted:

I was rapt. And it really does make you feel like a worthwhile human being.

Like someone actually had faith in you. Like someone would give me the time of day.

Someone said they trust you.

Obtaining a loan and successfully paying it off brought about a lot of pride for many participants:

I feel proud each fortnight when I have made my payment

As most participants had a history of rejection by the mainstream banking sector, many felt overwhelmed that someone was willing to assist. One woman demonstrated this:

It made me want to cry. It made me want to sit down and cry, because, you know, it's the first time I've ever got a loan off anyone. Because I just kept saying, 'No, I'm not going to get it. I haven't got it, I haven't heard from them'. And yeah, it just made me feel like a child in a candy shop when I got the letter.

For this woman, the opportunity brought about a commitment to repaying. She appreciated that the Brotherhood and the Bank had been willing to trust her to repay and was keen to reciprocate this faith in her:

I thought, 'You trusted me enough to give it to me, I'm not going to reject [the payments]' so ... every fortnight the money was there for them. So they had no problems with me and I had no problems with them.

In a similar way, another woman who only worked during the school term spoke of her commitment to repay even when her budget was tighter during school holidays:

During the school holidays we don't get paid—we don't work so we don't get paid, so I will have to adjust my budget a lot ... I will find my loan hard to pay over the holidays—but I'm determined I won't miss it.

This suggests obtaining a loan was about more than just money for many people, but also dignity, inclusion, trust and respect. It was an opportunity for people to not just be a passive recipient of welfare, but to gain some self-esteem by taking a positive, active role in the process. In this way, it could give people a feeling of having some control over their lives.

For other people the approval of the loan did not have such a powerful impact. However, it was important that they were still able to obtain an item that they needed.

These experiences suggest there is potential to create customer loyalty and commitment to repaying by servicing a group that would be otherwise excluded from the financial sector. This pride and commitment could be expected to have some impact on the default rate, which thereby influences the financial sustainability of the model.

Structure of the loan

As noted in Section 2, banks do not generally lend small amounts of money, which marginalises those on low incomes, as they generally cannot afford to repay large amounts and are not seeking to borrow such amounts. This subsection therefore considers how well the loan structure was able to meet the needs of low income consumers.

Over 90 per cent of borrowers did not have a credit card. Those few who did were using at least 80 per cent of the available limit and were unwilling to increase their credit limit knowing that additional debt needed to be repaid at some stage. The unstructured nature of credit cards meant that focus group participants found them difficult to manage and preferred personal loans to purchase larger items, due to their low but regular repayments and a clear end date. One woman's credit card had become too great a temptation: she had used it for her son's birthday party and other day-to-day expenses, but later regretted this:

They [the bank] offered to increase it [the credit card limit] to \$1000. And then when it started getting totally ridiculous ... it was \$400 over, I went into the [bank] and I stopped it ... So, eventually, and it took me forever, to pay it ... With a humungous amount of interest—which I think is totally unfair. But what can you do?

The pilot's flexibility in offering smaller loans was also appreciated. Many people had tried to obtain small loans from banks and been advised these were unavailable:

I'd rang up a few places and I told them I had quite a substantial amount of funds that I had saved myself but they wouldn't lend me anything under \$5,000 ... I didn't want to get into that much debt, I only needed another, not even \$2,000, and they said, 'No, we don't do small loans'.

Some people did suggest that the maximum amount for the personal loans could be \$5,000 (higher than the existing pilot limit of \$2,000). This would be worth considering so that the program was able to provide a better bridge to mainstream products. For people wanting to purchase cars, it could also assist in obtaining a more reliable vehicle. Larger loans were not considered in the pilot because the Brotherhood had limited guarantee funds available and was keen to spread the risk.¹¹ In

¹¹ Lenders also need to work within the Code of Operation for Centrelink Direct Credit Payments, which restricts financial providers from entering direct debit arrangements for repayments more than 10 per cent of a social security recipient's payments. For information on the Centrelink Code see: [http://www.centrelink.gov.au/internet/internet.nsf/filestores/co098_0604/\\$file/co098_0604en.pdf](http://www.centrelink.gov.au/internet/internet.nsf/filestores/co098_0604/$file/co098_0604en.pdf) viewed 15 May 2006

addition, while people may want larger loans, they may not be willing or able to repay at a higher rate or over a longer term that larger loans would require.

Another important feature of the personal loan pilot was the fixed interest rate. This ensured that customers knew that repayments would not change over the term of the loan. The attractiveness of this feature was supported by one woman:

If you're on a fixed income, you don't have any flexibility to increase the payments over that period.

When asked whether having to make loan repayments had any effect on people's budgeting and other expenses, the general response was that an amount of re-juggling was necessary but that there were no great difficulties:

It's good because in 2 years you [have repaid], and it's an amount you can pay. It's not a huge amount, and once you get used to paying it ... Mine's \$22 a week.

A minority of focus group participants found loan repayments difficult. A man spoke about some financial strain in repaying a loan for car repairs:

I had to rearrange my budget, by a fair amount really ... [pay for] the other insurance, and my medications at the moment, and food and that. I've just got to cut down on lots of things ... my entertainment is down. And I watch my petrol bill ... I do all my own cooking, I can't afford meals on wheels ... [they cost] \$4.60 a meal now. That's about \$30 a week.

All of the focus group participants were using the direct debit option to make repayments. Payment dates were set up to coincide with the day that Centrelink payments were received. Many people were already familiar with the direct debiting system and felt the regular payments assisted in budgeting:

I like the direct debit part ... I do my gas, electricity, water, rent and the phone now ... I don't go to the bank until Saturday, and I know what's in there is mine ... No one can knock on the door for a dollar.

People felt direct debit helped them to prioritise the most important expenditure items such as rent and bills:

[Direct debit] is the only way to do it now, especially people who are on the pension ... If you've got a roof over your head, you don't have to worry.

Most people ensured there were always funds in their account when payments were due. However a few were charged large dishonour fees by their bank when there were insufficient funds to cover the repayment.¹² For these people, direct debits had caused distress. While there may be some cost involved for a bank, and a penalty can discourage people from overdrawing repeatedly, the size of these fees seems to be a disproportionate penalty (Stewart 2005). It would be worthwhile for banks to review the pricing structure of dishonour fees, or to develop a pensioner account that better caters for people who manage large bills through regular instalments by direct debit.

Despite this, automated payment mechanisms such as direct debits should continue to be the principal payment method. Cash payments at a branch are costly for all parties. There are administrative costs for the Bank and there is the opportunity cost of time spent travelling and waiting in a bank queue for the client. Added discipline is required in making regular repayments in person. Centrepay (direct payments from the Centrelink pension) is certainly the most convenient payment mechanism for the customer. Those participants who used Centrepay during

¹² Fees of the major banks range from \$30 to \$50 per dishonoured transaction.

the pilot were pleased it was available. However, this facility was not used for all borrowers due to administration costs for the Brotherhood.

Overall, the most important loan features seemed to be low regular repayments that were fixed for the term of the loan. Borrowers' comments suggest the product generally met their needs as it was more affordable and appropriate than other options.

Key points

- Focus group participants felt a sense of pride at dealing with a bank.
- Most expected to pay interest and felt the rate charged was cheaper than other alternatives.
- For many, obtaining a loan was about not only money, but also dignity, inclusion, trust and respect. It was an opportunity not just to be a passive recipient of welfare, but to gain some self-esteem by taking a positive, active role in the process.
- The most important loan features seemed to be low regular repayments that were fixed for the term of the loan.

Regulatory framework

At the inception of the pilot, the role of government in regulating consumer credit was not explicitly considered. It has since become apparent that this issue is important in considering the availability of credit to low income consumers. While regulations are certainly necessary for a fair and stable financial system, it is also important to consider whether some have unintended consequences that create disincentives for organisations to work with disadvantaged consumers.

Two particular issues relating to the direct impact of government regulation in the credit market on low income consumers arose in the focus group discussions: the credit reporting system and the level of paperwork required in applications and contracts for loans.

The credit reporting system

Early in the pilot, the credit reporting system emerged on the one hand as a useful tool for understanding prospective borrowers, but on the other as a barrier for a number of people. Many applicants did not appear to have a clear understanding of the credit reporting system. Some people did not realise that utility companies were able to list items on credit reports, or that even after defaults are paid off, they remain on the credit report. People often had not realised there were items on their credit record until they applied for a loan.

Many misconceptions about the functioning of the credit reporting system arose in the focus group discussions. Credit applications, overdue accounts (over 60 days) and court judgments are held on a person's file for 5 years from the date of listing. Bankruptcies or serious credit infringements remain for 7 years (Baycorp Advantage 2005). One woman understood that utility companies had access to her record, but did not realise that defaults would eventually be cleared. She incorrectly asserted:

[A default only drops off] if you've paid the bill. Otherwise it's stuck with you for life.

Although Australia's main credit reporting agency (Baycorp Advantage) allows people to order a copy of their credit report, many did not understand how to do this. One woman commented:

I've tried [to order a copy of my credit record]. I've tried by internet computer. I've tried ringing up. I've written letters to the credit reference association trying to get a copy of my credit record. They will only tell me who has checked up on it, like what businesses have looked into it. They won't tell me who I owed to or who was on it, they would only tell me who has made an interest in it.

While it is acknowledged that payment difficulties with another creditor can add to understanding creditworthiness, difficulties with small utility bills may only provide limited insight. It seems like a disproportionate penalty that a small utility bill—even if subsequently paid—remains on the credit record for five years. And given these defaults often arise from an unfortunate set of circumstances, such as illness or relationship breakdown, rather than an unwillingness to pay, the Brotherhood considers this a weak indicator of creditworthiness. The credit reporting system does not recognise the difference between temporary strains on the budget (inevitable for some people on a low income) and an inability or unwillingness to pay over the longer term. When focus group participants learned that this was how the system worked, they also felt it was unfair:

It stays on your record even if you pay it. That stinks. If you pay it out—I know a few people don't—but if you pay it out it should be taken straight off ... Even the electricity and the gas people put you on the black list if you're having difficulty and you can't pay.

Although consideration of the credit reporting system was not an initial objective of the pilot, there appeared to be so many difficulties associated with it, that the Brotherhood started to take a greater interest with its links to financial exclusion and poverty. With access to the credit reporting system extended to utility companies, there has not been an accompanying program to build awareness. This means that many people have defaults listed on their credit record, but do not realise it. They also do not understand how to order a copy of their credit record, how to find out how long a default will stay there, or whether there is a disputes process for incorrect information. This is unfair to consumers as the system has evolved but they have not been adequately informed. While companies understand the impact of listing an item on their clients' credit reports, many consumers do not. This is perhaps a case for an education campaign about the ramifications of not paying a bill and how to obtain a copy of a credit record.

Further research on low income consumers and the credit reporting system is recommended. This could include analysis of the usefulness of utility companies listing unpaid bills on credit records for predicting creditworthiness. It could also consider how well the system is understood by consumers.

Paperwork

Contracts and the small print on application forms caused some confusion among loan recipients. Women spoke of difficulties in understanding the paperwork:

I probably think it's probably a lot for people who are not that way inclined, it's an awful lot of information to take in.

I found them [forms and contracts] a bit daunting because I'm not very good with paperwork.

One person commented on difficulties for people with limited levels of literacy or those from a non-English speaking background:

For us we're lucky because we can read. But so many pensioners can't read and can't write. And this is another handicap for the person applying for the money. Because so many people have never been to school. And it's hard to understand all the questions.

Providing financial literacy training can help address some of the problems with making applications and understanding contracts. However, the Brotherhood feels that where possible measures should also be taken to ensure that contracts are sufficiently clear for consumers to make an informed decision about the risks that they are taking. The appropriateness of many terms and conditions of loan contracts should also be investigated.

It is recognised that finding the right balance between consumer protection, costs of complying with regulations and the consumers' capacity to understand conditions is difficult. Further research involving government, consumer organisations, banks and consultation with low income consumers in this area is therefore needed.

Key points

- There appeared to be many misconceptions and difficulties associated with Australia's credit reporting system. Some participants had defaults listed on their credit record, but did not realise this.
- Contracts and application forms caused some confusion and discomfort among participants.

Role of the Brotherhood

Some participants of the focus groups commented on the stigma associated with approaching an organisation like the Brotherhood, as many applicants did not associate themselves with a charity. One woman described how she felt about applying for a loan:

I was really scared about coming [to apply for the loan]. Someone told me about it, but I was really nervous and I was really scared that I'd get knocked back again and also just doing it, I sort of got a bit of pride so it was hard to come and do it anyway ... I've never even been for a food parcel or anything, because I try to make do myself, so it was really hard to go and ask ... [but] she didn't make me feel awful or anything she was just terrific. She was really good ... I found the experience really good.

Another woman discussed her discomfort at coming to the Brotherhood to apply for a loan:

I think if the charities—I don't know if that is the right word anymore—the Brotherhood, the Salvation Army, are the only places that will really help you, you feel marginalised. They have a social stigma and it's like the Ministry of Housing and I was sort of thinking 'Oh well, I'll probably come in' and I was surprised to see that the buildings were actually quite modern and the people were quite professional and I think it's quite empowering to feel that it's a professional, well run, quite aesthetically bureaucratic [sic] and whereas in the old days it might be sort of the local whores or the junkies hanging around out the front.

While these women were able to overcome their initial concerns around approaching the Brotherhood, it is unclear how many other people heard of the program but did not proceed due to this stigma. The stigma also extended to the loan payment being made by a Brotherhood cheque. One of the above women discussed her uncomfortable experience of presenting the cheque for payment of her bed:

When I gave the cheque to the shop for the bed she [the shop assistant] said 'Oh, um is this a donation?' and I was really embarrassed.

The product needs to look like a mainstream, commercial product, with all the bells and whistles, in order to reach and satisfy the target group. Low income consumers want to be treated like anybody else, in the same professional manner. This is difficult to achieve as the returns from these types of financial products are low, and often costs need to be restrained. However, if the product is to achieve its objectives of reaching and satisfying low income clients, then such issues need to be addressed.

In contrast another woman was just grateful that organisations like the Brotherhood were willing to help. She had been on a low income all her life and was used to navigating this system:

I don't really mind about stigma, I've been on it all my life ... Mum and Dad were always on charity handouts and there were always counsellors and I've had to do it myself for the

last few years ... I don't feel ashamed of it, I don't feel that it's a stigma because ... [I've] been through the ropes when I was a child and now with my own family, I just accept that the help is there and I'm pleased it's there.

Other people felt the Brotherhood's involvement led to a more personalised service. One woman noted:

They've [the Brotherhood] got personal service, whereas banks do not. So you know you can pick up the phone and dial that number and she'll be there, and if she's not there, there is somebody else there that can help you that has dealt with it as well. But banks - forget it.

The same woman felt the process in a bank was hostile and undertaken by a faceless operator. She contrasted her discomfort in a bank with the Brotherhood:

You go [to the Brotherhood] and it's so relaxed, you're thinking 'I'm not in a bank'. It's relaxed, it's open and there are people coming and going but you can look round and you can see people shopping and it's just like you're in a normal place. It wasn't as though you were stuck in this tiny little cubicle with a chair and a guy in front of you with a computer, busy tapping away on the computer, [and you're thinking] 'what the hell is he looking for? What's there in there that shouldn't be in there?'

This personalised service may not necessarily depend on the program being placed within a community organisation. Bank staff may also be able to provide a personalised service. However, issues of cost, as well as branch and call centre structures, may act as a barrier.

Overall, there is a difficult balance in the Brotherhood providing a financial service. In some ways, the Brotherhood's association with charity may have constituted a barrier for low income people who did not normally access Brotherhood services. On the other hand, given that banks were unwilling or unable to be involved in microcredit on their own and the Brotherhood was concerned by financial exclusion, there were few other options. Over the longer term, it would be worth considering the optimal branding of products like this. For borrowers, there is some tension between the stigma of visiting a community organisation and the awareness that organisations like the Brotherhood try to help people on low incomes where possible which may provide comfort and encourage some people to apply. This awareness differs from their perceptions of banks as previously discussed.

Key point

- There were varying views on the role of the Brotherhood. Many participants felt embarrassed at visiting a community organisation but some others appreciated the personalised approach.

Role of the Bank

As the Bank had a back office role, clients had limited contact with them and many saw their relationship largely as with the Brotherhood. This is consistent with the Bank's philosophy of enhancing the capacity of the community sector to deliver services to clients.

Most people who dealt with processing staff at the Bank were generally happy with this service. One man commented:

The guys in the Bendigo community section, they're pretty good ... They're happy to help you out with any questions you have.

The Brotherhood was interested in promoting increased branch involvement so clients could feel a greater part of the mainstream-banking sector. Many clients were also keen to utilise branches. However, efforts to have contracts returned through branches proved not to be effective. As low

income consumers become more aware of these programs, it would be worthwhile to broaden a bank's involvement.

Key point

- Broadened involvement from a bank could help people to feel a greater sense of financial and social inclusion.

Processing of loans

One aspect of the application procedure that frustrated participants was the length of time to process the application. From the time of applying, many applicants had to wait 3 to 4 weeks to receive their goods or cheque. People complained about the time taken to process loans and compared it with advertisements from banks for approval within 24 hours (based of course, on an approval process limited to automatic largely income-based criteria).

There are several reasons why a fast turnaround is important. Pawnbrokers and payday lenders ordinarily provide a very fast service. While this program is not necessarily a substitute for such services, it is still important to at least provide similar service standards given they broadly target the same market. Also, many applicants urgently needed items (such as a fridge or a bed) that the loan was funding.

There were a range of inefficiencies in the process, many of which related to limitations in resources available. In the future, the process should be streamlined so that loans can be approved and funds made available more quickly.

Key point

- Participants felt the turnaround time for processing loans was too slow so methods of streamlining need to be explored.

6 Developing links between low income consumers and banks

The previous section touched on the ability of the personal loan pilot to develop links between low income consumers and banks from the customers' perspective. In this section the success of the pilot in achieving this objective is discussed more generally. To assist in achieving this objective the Brotherhood first had to challenge the notion of the lack of 'creditworthiness' of many low income consumers and expand on the current credit assessment methods of the banks. This is described in further detail below.

Credit assessment

There are a variety of views on the creditworthiness of people on low incomes. Rosalind Copisarow (founder of microcredit organisations in UK and Poland) states,

What has happened ... is a shift in the meaning of the word 'creditworthy' from 'being able to repay a loan' to 'being able to offer a minimum profit to a lender'. Muhammad Yunus, Managing Director of Grameen Bank has declared credit to be a human right ... I would disagree—I believe one must be creditworthy to take on credit. However, my definition of creditworthiness would be the original one and includes anyone who can repay a reasonably priced loan, however small a profit it may generate for the lender.
(Copisarow 2000, p. 24)

Most applicants for the personal loan pilot would have been declined by the Bank's automated computer programs for credit assessment. The Brotherhood and the Bank therefore had to develop a system for analysing creditworthiness of low income consumers on an individual basis. So far this has yielded a low default rate (see the following subsection). This means of assessment is not new for banks: lending has been based on trust for centuries. In the past, local branch managers of banks had greater discretion in making credit decisions. It seems that with the introduction of computerised systems for credit assessment, a body of expertise—or an approach to dealing with customers at the grassroots—has also been lost.

Over the term of the pilot, the Brotherhood and Bank staff developed an understanding of indicators of good money management among people on low incomes, which assisted in manual assessment.

Assessing capacity to repay is important. Loan repayments need to be affordable and not exacerbate poverty. It is important to understand the expenditure patterns of people on low incomes and the way they manage their cash flow. The program's process for assessing capacity to repay was based on a budget prepared by the client, which helped determine affordability of loan repayments.

It is also important to assess 'behavioural factors', such the strategies people use to manage their money. People on low incomes often have a strong appreciation of the importance of managing cash flow. Many clients overcame difficulties in paying large bills by paying a set amount each fortnight throughout the year. Other people developed systems whereby they put money aside for bills on a fortnightly basis in jars or envelopes. Many people ensured payments for bills and rent were in advance in case of an emergency, such as a child becoming ill or a car breaking down. All these systems show a determination to meet commitments and therefore suggest a likelihood of repaying a loan.

Key points

- Computerised systems for analysing creditworthiness would have automatically declined most of the pilot's loan applicants.
- A manual approach to credit analysis was able to take into account bill and rental payment histories, strategies for managing cash flow and the individual's budget.

Demonstrating creditworthiness of many low income consumers

As noted in Section 2, one of the reasons that banks are reluctant to service people on low incomes is their high perceived risk of default. It is acknowledged that banks need to ensure lending is responsible and fits within prudential guidelines. A key aim of the Brotherhood was therefore to demonstrate to the banks the capacity of low income consumers to be creditworthy and to advocate for greater financial inclusion. Due to earlier experience with No Interest Loans Schemes, the Brotherhood was confident that a low default rate could be achieved, but was keen to demonstrate this within the context of the mainstream banking system.

Over the 2½ years of the pilot, default rates were low. Based on the total dollar amount of loans written, the default rate was 0.9 per cent. Based on the number of loans written, the default rate was 0.6 per cent. There was just one default, which occurred due to the death of the borrower. Another loan was transferred to the Brotherhood's No Interest Loan Scheme following a house fire, and regular repayments were being received from this customer. With such a small portfolio size, it is difficult to use these figures to predict future default rates. However, early observations of the small sample suggest relatively high repayment rates are achievable.

This rate of default seems to compare favourably with standard bank rates. For ANZ, 60 day delinquencies were generally less than 0.7 per cent for mortgages or from 1.2 to 2 per cent for

credit cards (ANZ 2005). While there seem to be no published personal loan default rates, sources in the banking industry indicate they are less than 1.5 per cent.

The risk of customers falling into arrears is another concern for lenders. The average rate of arrears over the pilot was 4 per cent.¹³ As the portfolio size increased, this rate rose to 6 per cent. By 31 December 2005, only about 15 per cent of borrowers had ever fallen into arrears and only 1.3 per cent had remained in arrears for more than 90 days.

Due to this demonstration of low income consumers being creditworthy, the bank was now able to assume more of the initial risk, rather than rely on the Brotherhood to guarantee every dollar lent with a cash term deposit. Community Sector Banking was able to reduce this to a guarantee of one dollar for every three dollars lent: that is, the Bank would underwrite a default rate exceeding 33 per cent.

The pilot loan program has been successful at highlighting that there is an alternative to automatically rejecting low income consumers, which does not necessarily lead to a high default rate. In this way, the pilot has satisfied its objective of developing links between low income consumers and banks.

However, in order to reach a critical mass of people on low incomes, banks need to embrace this challenge and apply their expertise and resources to this group.¹⁴ Lending and understanding risk are banks' core competencies. The Brotherhood was willing to bear the risk of defaults during the pilot in order to demonstrate to banks that people on low incomes can repay loans and do have a genuine need for these services. However, community organisations do not have the resources to bear this level of risk over the longer term, although bearing some risk may contribute to a more effective partnership.

Key point

- On a small scale, the pilot has highlighted creditworthiness of a group of people on low incomes with a default rate of 0.9 per cent.

Views of Community Sector Banking staff

As part of the review, staff at Community Sector Banking were interviewed. Topics discussed included their experiences in the pilot, its sustainability, the processes, and their views of the benefit for the customer and for the Bank.

All staff members interviewed highlighted the lower risk than they had initially expected. The issues of sustainability and long term expansion of the program were discussed. Community Sector Banking was resource constrained by its size as an organisation. One bank staff member indicated that the pilot was a small-scale program designed to 'test the waters'. The pilot was thus to highlight the potential of a full-scale microfinance scheme. All Bank staff interviewed agreed that if this potential was to be realised, there was a need to improve the efficiency of the process. However, Bank staff also realised that a long-term commitment was needed to enable growth and process improvement, with adequate funds and resources to support it.

When staff members were asked if they had benefited from the pilot, there was universal positive agreement. As individuals, they felt that they had received a great deal of personal satisfaction at

¹³ The arrears rate expresses the outstanding balance of loans in arrears by more than 1 day as a percentage of the total outstanding portfolio. This figure was calculated each month and the average then taken.

¹⁴ This is in line with a key recommendation of the Victorian government's recent Report of the Consumer Credit Review which suggests that banks should provide vulnerable and disadvantaged consumers with more access to low cost, small amount and short term credit.

being able to help those in need. One staff member mentioned his feelings of satisfaction out of 'providing something to people that was a need rather than a want'.

Staff felt that the Bank had benefited from the program as well. They felt the Bank's reputation had improved as a result. The organisation had also benefited from having created a platform to reach clients that had been excluded through prior systems. Other business ideas had also developed from the Bank's lessons from the pilot.

Overall, the staff response from the Bank's perspective was very positive, with feelings that the pilot was a 'well worthwhile exercise' and 'outcomes exceeded expectations'. Admittedly some things could have been done better but the general feeling was that 'we have made a difference'.

These comments suggest that links were made on a small scale between people on low incomes and staff at one banking institution. The program had been able to raise awareness among Bank staff of the creditworthiness and financial plight of people on low incomes and a foundation was created for this to be done on a broader scale.

Key points

- Bank staff felt personal satisfaction in being involved in the pilot, which raised awareness of the creditworthiness of people on low incomes
- Bank staff felt a long-term commitment was needed to enable growth and process improvement, with the funds and resources behind it.

7 Sustainability

Net revenue

Financial sustainability for microcredit in developed countries may be difficult to achieve. Interest income on small loans is low. There are also fixed costs in providing loans, regardless of the amount of the loan and the volume of loans. In the pilot, the volume of loans was small, making it difficult to generate enough revenue to break even. As for marginal costs, credit assessment was time-consuming. Each application was assessed individually and given applicants were low income borrowers who demonstrated low levels of financial and/or other literacy, considerable time was needed in assisting people with paperwork and bank processes.

This is highlighted in Table 7.1, which shows the revenue generated and costs incurred by the program. Over the 2½ year pilot period, 212 applications had been processed, with 170 loans provided. The low number of loans and high costs associated with each application mean that overall the program cost \$136,284 to operate over this period, with the Brotherhood's investment \$118,276. The Brotherhood funded this through discretionary income, which includes donations from fundraising appeals, bequests and the profits of social enterprises, such as the Brotherhood retail stores.

Table 7.1 Revenue and expenditure from pilot loans program

		\$
Revenue		
Interest earned on loans		
– BSL	3,230	
– CSB/BB	5,782	
– Total interest		9,012
Interest earned on term deposit		16,252
Application fees		3,000
Margin from sale of white goods.		8,937
Total revenue		37,201
Expenditure		
Salary		
– BSL	(96,045)	
– CSB ¹	(23,790)	
– Total salary		(119,835)
Management and administration		(32,570)
Rent, travel and other administrative costs		(17,633)
Defaults		(1,715)
Marketing		(1,732)
Total expenditure		(173,485)
Net revenue²		(136,284)

¹ This estimate is based on 3 months of a full-time Bank staff member's time used in the set up and development of the program and a marginal cost of 2 hours per loan. Staff salary costs were estimated using ABS data and reflect average weekly full-time earnings for private sector employees at August 2005, of \$1045.70 a week. Many costs to the Bank were absorbed into their general systems and processes, making it difficult to estimate the program costs to the Bank. This estimate should therefore be seen as a lower bound estimate of the total costs to the Bank.

² A value in brackets refers to the total subsidy necessary for the pilot. Because the Bank was willing to absorb their staff and system costs, the total investment necessary from the Brotherhood was \$118,276.

As the portfolio size grew over time, the net deficit per loan dropped. Over the period July to December 2005, the deficit per loan was around \$300.

Revenue

The program generated revenue from application fees, interest charged on loans, interest earned on the term deposit (held as security with Bendigo Bank) and a margin received from sale of goods. This income totalled \$37,201.

Total interest income earned on loans was \$9,012. Interest income was to be shared between the Bank and the Brotherhood. The Bank received 8.95 per cent (the interest rate for a secured personal loan at the time of the program commencing) and the Brotherhood 5 per cent (the difference between secured and unsecured interest rates).

The Brotherhood's retail division had for a time partnered with electrical goods suppliers to offer the option of 'store credit'. The margin on the sale of goods provided an additional source of income. However, this model was changed to simplify processes. Other pricing models therefore need to be trialled.

Costs

While ideally an analysis of costs should separate fixed costs from variable costs, it is difficult to do in this case. Many activities associated with fixed costs of promotion and program delivery occurred concurrently, with more time initially spent on understanding the market. The following discussion therefore considers the total cost of the program.

Total costs include the nominal cost of each loan and the cost of staff time. The loan costs over the 2½ year period were approximately \$173,485. This primarily comprises staff and managerial costs—a proportion of the current project manager's salary and two short-term assistants. This salary time also includes advocacy and program development, as it has been difficult to separate these fixed costs from the marginal cost of providing each loan.

The salary expenses of this type of program are increased because many people on low incomes are inexperienced in dealing with the banking sector or have financial and other literacy problems. They therefore have difficulty with paperwork and processes and require a higher level of support than banks may otherwise provide. In fact, there was an average of 7 contacts per customer (either by phone or meeting in person) which added considerably to staffing costs. The personalised approach may have led some borrowers to demand an uneconomical level of service. Processes need to be streamlined, and written documentation made clearer to reduce costs.

At \$1,715, the cost of defaults was less than expected.

In reality, it would have been more expensive to operate the program if the Brotherhood had not been able to access networks of low cost or free resources. Many professionals assisted on a pro-bono or voluntary basis. In addition, free space was provided in newsletters and local newspapers and brochures were displayed at a variety of organisations for no cost, so marketing costs were reduced. The Brotherhood's retail division did not charge rent, giving the program the flexibility to experiment across a range of geographic locations. Because of the generosity of people and organisations, it is difficult to determine the true investment made into developing this model.

Part of the Bank's philosophy was to provide in-kind support through use of systems and staff time. The Bank was willing to absorb their portion of costs in operating the pilot. The figures presented in Table 7.1 are a lower bound estimate of total Bank costs. In terms of revenue, the Bank earned interest income on loans of around \$5,782 and also earned a margin on the term deposit used to secure loans by reinvesting funds. While interest covered the cost of funds and the Bank did not need to allow for the cost of default, this income did not cover the Bank's costs in processing loans or in program management. The net cost for the Bank in being involved in this program was able to be subsidised by profits.

The pilot did not meet the ideal objective of generating enough revenue to cover program costs. The program would need to grow quite substantially, with more efficient processes in place, before it could break even.

Program development and achieving financial sustainability

The main ways to achieve financial sustainability would be to increase income, via either higher interest rates and fees or increasing the volume of loans provided, and/or to make the process more efficient, thereby reducing salary costs per loan. Financial analysis needs to be undertaken experimenting with changes in each of these variables to determine the breakeven point.

The next step is to increase the scale of the program and the number of customers. It is important to combine this strategy with improving efficiency. As mentioned previously, the process throughout the pilot was largely manual and therefore expensive. In addition, the personalised nature of the service was also expensive. Streamlining this process to reduce the cost per loan is necessary.

Raising income by increasing the interest rate or other charges to better reflect marginal costs is a difficult issue. The purpose of interest—in pricing for the risk of default and the cost of funds—should not be forgotten. However, at a particular point this principle becomes counter-productive. Very high charges may exacerbate the likelihood of default. In addition, high charges may serve to erode potential benefits for a bank in being seen as a good corporate citizen. Clearly a balance

needs to be found between charging fees and interest that allow the program to be sustainable and avoiding financial stress to customers.

In the pilot, the loan establishment fee was \$20. This compares with a standard personal loan establishment fee of around \$150. While the full standard fee is probably excessive for small loans, the possibility of charging a fee that more accurately reflects the costs needs to be explored.

Social benefits

On a broader level, it does not make sense to only evaluate the benefits of microcredit products on their private financial returns alone (Tulchin 2003). As the exclusion of low income consumers from credit markets may arise from market failure, there is a role for intervention in the market to generate outcomes that are closer to the social optimum. Programs such as the personal loan pilot are addressing this market failure, and as such may have long-term wider benefits to society, such as a capacity for low income consumers to obtain necessary items in a dignified, inclusive way. It is important to keep this in mind when thinking about the broader concept of sustainability.

Although this section has focused on the immediate financial returns of the program, to correctly assess its benefits it is necessary to consider the broader social benefits. These broader returns are, however, less tangible and much more difficult to estimate. Also, over the longer term, programs of this type may be cheaper to operate than No Interest Loans Schemes, as at least the cost of default can be recovered through interest and community organisations can benefit from banks' computerised systems. Once the initial investment is made, loans are also more cost-effective than material aid, as there are revolving funds that can be lent many times.

Having said this, the financial viability of microcredit programs is important, particularly if banks are to incorporate such products in their mainstream banking systems.¹⁵ Further analysis of the size and needs of the low income segment of the market and experimentation with the loan product is needed to determine whether loan products of this kind can be offered without subsidies. Part of this program development is to provide a range of microcredit options that include loans, savings products and financial literacy. This allows the microcredit provider to create economics of scale and scope.

Key points

- The program was not financially sustainable over the 2½ year pilot period, in that it required a subsidy of \$136,284.
- A substantial increase in volume combined with an improvement in processes is required for the program to approach sustainability.
- Analysis of sustainability also needs to consider long-term, wider benefits to society, such as a capacity for low income consumers to obtain necessary items in a dignified, inclusive way.

8 Conclusions and recommendations

Assessment of program outcomes

This report has evaluated the Brotherhood and Community Sector Banking's personal loan pilot, a microcredit program providing small personal loans to people on low incomes. The program has been evaluated on the basis of achieving its initial objectives of providing self-sustaining affordable

¹⁵ Along a similar line, the Victorian government's recent Report of the Consumer Credit Review observes that the long-term viability otherwise depends on the goodwill and corporate social responsibility of credit providers.

credit to enable low income consumers to purchase household goods, and in developing links between low income consumers and banks through advocacy and practical demonstration.

In many ways, the program has met its initial objectives. It has been able to meet customers' needs, by providing affordable, mainstream credit and assisting them to obtain household items. To some people, obtaining the loan was just about getting an item they needed, but to others it was about much more than that. To these people the loan provided a sense of dignity, trust and self-esteem.

The pilot has shown, on a small scale, that people on low incomes can reliably repay loans. There has only been one default, which occurred due to the death of the borrower. The arrears rate has been low, with an average of 4 per cent over the course of the pilot.

However, the pilot did not reach the point of sustainability. To be more sustainable the volume of borrowers will need to increase and the process be made more efficient. Areas for improvement were identified from the clients, from staff at the Brotherhood and from staff at the Bank. Further experimentation is needed to determine the appropriate model over the longer term to be able to reach sustainability.

In terms of advocacy for low income consumers, the Brotherhood and the Bank have been able to benefit from community networks to promote the program and have been able to speak about the issues with consumer groups. In future, it is hoped that other community organisations and banks can replicate this model across Australia.

Recommendations

Partnerships between the private sector, community organisations and government are needed in the microcredit area. Many people on low incomes have to date been excluded from the mainstream market for credit and all parties are responsible for correcting the failures and imperfections of the market. We have suggested areas that banks and government need to consider, as well as areas for further research (see panel).

The **community sector** should:

- continue to provide an individualised service to establish relationships with clients and determine a true ability to repay
- continue experimenting with various personal loan models to determine whether self-sufficiency is possible.

Banks need to:

- work with the community sector to reach low income consumers that have been financially excluded, using the banks' efficient systems to reach a critical mass of borrowers
- share the risk of default with community organisations
- involve branch and call centre staff in the operation of microcredit programs so that low income people feel included in the mainstream financial sector
- create processes whereby repayment of a personal loan in a community-operated program is considered in assessing a borrower's future applications so that there is a progression into the mainstream banking system.

Government should:

- commit not only to regulating against exploitative credit, but also to promoting alternative solutions, through a regulatory environment that is conducive to microcredit
- improve the transparency of the credit reporting system
- ensure that servicing low income consumers remains within a banks' role.

Further research should be undertaken into:

- low income people's attitudes to pricing of credit
- the regulatory framework and its impacts on the provision of microcredit
- the potential social benefits of programs of this kind and of the broader raft of microcredit products.

Final comments

Programs such as this pilot assist in moving people towards greater control of their lives. There are considerable returns in affording people that dignity and helping them to take more responsibility. Microcredit programs can also provide a bridge for many people wanting to get into the mainstream credit market and thereby assist them to better manage their cash flow to meet significant expenses. In this way they help overcome poverty traps associated with financial exclusion.

It is hoped that lessons from this pilot can assist to move microcredit to a new phase within the mainstream financial sector. This would mean that more people on low incomes would be able to build a base of assets and take more responsibility for their financial circumstances.

References

- Advisors Group to the UN International Year of Microcredit 2005, *Statement of the Advisors Group to the United Nations International Year of Microcredit 2005*, viewed 17 May 2006, <http://www.yearofmicrocredit.org/docs/Advisors_Group_UN_IYOM_8Nov2005.pdf>.
- Australia and New Zealand Banking Group Limited, 2005 Annual results presentation, slide 13, viewed 17 May 2006, <<http://www.anz.com/aus/shares/finance/newarchive.asp>>.
- Australian Bureau of Statistics 2005, *Average weekly earnings, Australia*, August, Cat. No. 6302.0, ABS, Canberra.
- Baycorp Advantage 2005, *Frequently asked questions*, viewed 2 December 2005, <www.mycreditfile.com.au/faqs/frequently_asked_questions_default.aspx>.
- Bendigo Bank 2005, Preliminary Final Report Appendix 4E, p 8, August 15, viewed 6 February 2006, <http://www.bendigobank.com.au/public/about_us/investor/investor_financial_reports.asp>.
- Bray, J R 2001, *Hardship in Australia: An analysis of financial stress indicators in the 1998–99 Australian Bureau of Statistics Household Expenditure Survey*, Department of Family and Community Services Occasional Paper No. 4, viewed 17 May 2006, <[http://www.facs.gov.au/internet/facsinternet.nsf/vIA/occasional_papers/\\$file/No.4.pdf](http://www.facs.gov.au/internet/facsinternet.nsf/vIA/occasional_papers/$file/No.4.pdf)>.
- Burkett, I 2003, *Microfinance in Australia: current realities and future possibilities*, School of Social Work and Social Policy, University of Queensland.
- Burrus, W 2005, *Lessons and trends of microcredit in the United States*, speech given at the CEAMI conference Microcredit in Developed Countries: Problems, Challenges and Proposals, Madrid 16–17 March 2005, viewed 17 May 2006, <http://www.accion.org/file_download.asp?f=16>.
- Cash Converters 2005, Cash Converters submission to Victorian Consumer Credit Review, viewed 7 December 2005, <<http://www.consumer.vic.gov.au>>.
- Chant Link and Associates 2004, *A report on financial exclusion in Australia*, viewed 17 May 2006, <<http://www.anz.com/aus/aboutanz/community/programs/pdf/FinancialExclusion-FinalReport.pdf>>.
- Collard, S & Kempson, E 2005, *Affordable credit: the way forward*, The Policy Press for the Joseph Rowntree Foundation, Bristol.
- Community Sector Banking 2006, *A community of interest*, viewed March 2006, <<http://www.csbanking.com.au/communitySector.asp>>.
- Copisarow, R 2003, 'International perspectives on extending the margins of banking', in *Banking on the margins: promoting a more financially inclusive community*, Proceedings from a conference to mark the 2003 International Day for the Eradication of Poverty, Federation Square, Melbourne, 16 October 2003, viewed 17 May 2006, <http://www.bsl.org.au/pdfs/Banking_on_margins_conf.pdf>.
- Copisarow, R 2003, *Discovering soul work: my personal journey*, Sambell Oration 16 October 2003, viewed 17 May 2006 <http://www.bsl.org.au/pdfs/Sambell_Transcript.pdf>.
- Dooley, A 2005, 'Shop smart with store credit', *Choice*, June.
- GE Money 2006, *GE Money personal loan*, viewed 19 May 2006, <<http://www.yourwish.com.au/questions.html>>.
- Jones, P A 2001, *Access to credit on a low income: a study into how people on low incomes in Liverpool access and use consumer credit*, The Cooperative Bank, viewed 17 May 2006, <http://www.creditunionresearch.com/uploads/access_to_credit.pdf>.
- Kelly, S, Cassells, R & Harding, A 2004, *Household debt in Australia – walking the tightrope*, AMP-NATSEM Income and Wealth Report, viewed 17 May 2006, <www.amp.com.au>.
- Kohler, M, Connolly, E & Smith, K 2004, *The composition and distribution of household assets and liabilities: evidence from the 2002 HILDA Survey*, Reserve Bank of Australia Bulletin, Economics Group, Reserve Bank of Australia, Sydney.
- Malbon, J 2005 'Do the poor pay more for credit?' in A Stewart (ed.), *Do the poor pay more? A research report*, Consumer Law Centre Victoria, Melbourne.

McInerney, C 2005, *Microcredit: more than just small change, history and growth of NILS*, Good Shepherd, Melbourne.

Money Plus 2005, Money Plus submission to Consumer Credit Review, viewed 7 December 2005, <<http://www.consumer.vic.gov.au/>>.

Roberts, M 2000, *Interest free loans: a*, review commissioned by The Ian Potter Foundation, Roberts Consultants Pty Ltd, viewed 17 May 2006, <http://www.ianpotter.org.au/6-0_pubs/pdfs/6-03-03-ifl.pdf>.

Rowlingson, K & Kempson, E 1994, *Paying with plastic*, Policy Studies Institute, London.

Standard and Poor's 2006, *Asia Pacific banking outlook 2006*, January, viewed 9 March 2006, <http://www.hkcma.org/Whats_new/AP_Banking_Outlook_2006.pdf>.

Stewart, A 2005, *Do the poor pay more? A research report*, Consumer Law Centre Victoria, Melbourne.

Tulchin, D 2003, *Microfinance and the double bottom line: measuring social return for the microfinance industry and microcredit with education programs*, Social Enterprise Associates, viewed 17 May 2006, <http://www.socialenterprise.net/pdfs/mf_double_btm_line.pdf>.

Wilson, D 2002, *Payday lending in Victoria: a research report*, Consumer Law Centre Victoria, Melbourne.