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The Impact of Borrower Characteristics on the Effectiveness of Small Loan Regulation

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1. Introduction

It seems trite to state that the effectiveness of regulation may depend upon the personality characteristics of those who are intended to benefit from regulatory protections, however notwithstanding that this may be an obvious statement, there is limited attention paid by regulators to the likely personality characteristics of those they seek to protect through regulation.

In this article we will consider some possible personality characteristics of small loans borrowers and will explore the impact that those characteristics might have on the effectiveness of current Australian regulation pertaining to small amount consumer and enterprise loans. While the focus of this article will be on Australian regulation, it will no doubt be of some interest to those exploring comparable regulatory regimes in other jurisdictions.

The article will also consider the current differences between the regulation of small consumer loans and small enterprise loans, and will raise the question as to whether those differences are likely to be justified on the basis that consumer and enterprise borrowers have different personality characteristics, thereby warranting different protections. It is suggested in the conclusion to this article that empirical research should be conducted to test this hypothesis, and also to ascertain whether there are consistently dominant personality characteristics amongst small loan borrowers, which warrant particular regulatory approaches. If not, then consideration should be given to extending a number of the protections currently afforded to consumer borrowers, to enterprise borrowers.

In the next section, we will provide an overview of three types of regulation applicable to small amount loans in Australia. The term 'regulation' is used in its broad sense, meaning 'the purposive control of social and economic activity [which] does not occur solely through 'traditional' instruments such as legal rules.' (Yeung & Dixon-Woods, 2010, p. 502) This definition encompasses any purposive activity designed to influence or control human behavior, whether through legislation or other forms of social design, such as schemes providing safe and affordable alternatives to exploitative credit products. For the purposes of this article, the regulation of small amount credit in Australia will be categorized into three types: (1) disclosure of information or financial literacy programs, both of which are designed to empower through knowledge and information and will therefore be referred to under the heading 'empowerment through knowledge and information'; (2) the more interventionist ex ante (before breach) regulatory interventions in the credit products available, and ex post (after breach) sanctions against lenders who have acted in breach of regulatory provisions, referred to a 'interventionist ex ante and ex post regulation'; and (3) the provision of safe products which can provide alternatives to the harmful products which might otherwise be the only option for financially excluded members of the community. These are described as 'safe' in the sense that they are provided on a not-for-profit basis and are structured with a view to affordability, making default less likely.

In the third section to this article, we will explore the psychological literature regarding those personality traits likely to be most relevant to borrower behavior, namely optimism, risk tolerance, and self-control. Other characteristics which can impact on debt behavior and which will be explored are financial literacy (itself a form of regulation but also a characteristic which can impact on the effectiveness of a regulatory strategy such as disclosure), and irrational behavior. In this section we will consider the possible impacts of such traits and behaviours on the effectiveness of the three regulatory types. It is suggested that empirical research should be conducted to ascertain the dominance of these traits and characteristics amongst small loans consumer and enterprise borrowers, in order to inform regulatory developments.

2. Australian regulation of small amount consumer and enterprise loans

In this section we will describe three types of regulation pertaining to small amount consumer and enterprise loans in Australia. In this regard we are focusing on small amount loans of up to $4000 for consumer purposes and small scale social enterprise and business loans of up to $20,000.[1] This will provide the basis for discussion in the following section where we consider the impact of personality traits and borrower behaviours on the likely effectiveness of these regulatory types.

Empowerment through knowledge and information

There are two key regulatory strategies which are designed to empower borrowers to protect themselves in relation to credit transactions- the disclosure of information to them, and ensuring that they are financially literate. Financial literacy can also be described as a 'borrower characteristic' that affects borrower behaviour and can impact on the effectiveness of a strategy such as disclosure. Financial literacy will therefore be discussed again as a characteristic in section three.

Mandating the disclosure of relevant loan terms and conditions to borrowers is a form of regulation that attempts to empower borrowers through knowledge and information. This form of regulation is premised on providing borrowers with detailed information about credit products to enable them to make an informed choice. This is designed to address assymetries of information in the credit market by ensuring that borrowers are as well informed about credit products as lenders, and to arm borrowers with the information that

[1] The small consumer loan amount of $4000 is based on the Foresters Community Finance Limited individual loans model: http://foresters.org.au/community-finance-for-individuals; and the small scale social enterprise and business loans amount of up to $20,000 is based on the loan amount that has typically been provided under the NAB Microenterprise loan scheme: http://www.nab.com.au/business/loans-and-finance/business-loans/nab-microenterprise-program.

they need to protect themselves and make sound decisions. As will be discussed in the following section, information disclosure may not be as effective or useful in protecting small amount borrowers as the regulation assumes.

The regulation for information disclosure in consumer loans in Australia is found in sections 16 and 17 of the National Credit Code which is schedule 1 to the National Consumer Credit Protection Act 2009 (Cth) ("NCC"). This Act requires the credit provider to disclose all relevant terms and conditions of the contract, including disclosure of an annual percentage interest rate, before the debtor enters into the contract. There is also a requirement under section 150 NCC of the disclosure of an annual percentage interest rate in advertising wherever a repayment amount is stated. However, this regulation requires disclosure only for consumer loans.

In relation to enterprise loans, it should be noted that the definition of consumer under section 12BC of the Australian Securities and Investments Commission Act 2001 (Cth) ("ASIC Act") extends to small businesses (employing less than 20 people; or less than 100 people if a manufacturing business) 'acquiring financial services of a kind ordinarily acquired for business use or consumption.' This means that the provisions under the "unconscionable conduct and consumer protection" part of the ASIC Act will apply in relation to financial services accessed by enterprise borrowers. There is, however, *no positive disclosure obligation contained within that part.* Rather, there is a prohibition on misleading or deceptive conduct. While there are disclosure provisions in Part 7 of the Corporations Act 2001 (Cth) as amended which apply to 'retail clients', defined to include any small business, these provisions do not apply to credit facilities. This means that *disclosure obligations do not extend to the provision of credit to small businesses or enterprises.*

This important difference in the regulatory regime applying to small amount loans to consumers for consumer purposes as compared with small amount loans to enterprise borrowers is inappropriate unless there is a difference between these two types of borrowers which makes one more vulnerable and in need of greater protections. To the contrary, it has been observed that small enterprise borrowers are likely to have more in common with consumers than with large commercial entities, suggesting that the regulatory regime applicable to small enterprise borrowers should be the same as that applicable to consumer borrowers. (Webb, 2013, p. 135) One justification for different regulatory treatment might be different personality traits and borrower behaviours demonstrated consistently as between small amount consumer and enterprise borrowers, and this possibility will be discussed further in section three of this article.

It should be noted at this stage that, quite apart from the impact of borrower characteristics upon the effectiveness of disclosure, which will be discussed in section three, many commentators have argued that disclosure regulation is an ineffective mechanism for consumer protection. Mandating disclosure by credit providers as a means of consumer protection is based on an assumption that if borrowers have all of the relevant information they will be in a position to make rational and appropriate choices. (Ramsay, 2007, p. 533) This type of regulation might be regarded as part of a pro-market trend towards the 'responsibilisation' of the consumer (Ramsay, 2007, p. 551) where it is expected that given appropriate information, consumers will be in a position to protect themselves and make appropriate, informed choices (Cartwright, 2004, p. 62). Many consumers and enterprise borrowers may feel that they have no real choice, however, in relation to the credit products available to them and therefore will not act on the information disclosed in any event (Howells, 2005, p. 357). Further, it has been suggested that the problems of lack of choice and inequality of bargaining power between lenders and vulnerable borrowers may be compounded by a reliance on disclosure to protect those borrowers, in that formalistic lender compliance with unhelpful disclosure requirements might prevent borrowers from pursuing remedies such as for misrepresentation or unconscionable conduct. (Ben-Shahar and Schneider, 2011, pp 738-739)

One significant problem with a reliance upon disclosure regulation is borrowers' inability to understand the information disclosed. This is closely linked to the question of financial literacy which will be discussed below and in section three. It is also compounded by any attempts on the part of lenders to be intentionally confusing in order to take advantage of borrower confusion. Engel notes the complexity inherent in many credit products, leading to confusion which is "most acute for people with low levels of literacy, both financial and general" and which has been found to lead to poor choices by borrowers who "often misperceive that the more complex products are less expensive than the simple ones." (Engel, 2014, p2) Willis argues that "firms not only will but must leverage consumer confusion to compete with other firms that do so. While firms are not always responsible for their customers' confusion, firms take advantage of this confusion to sell products." (Willis, 2015, p1)

Disclosure may provide effective protections for borrowers where relevant terms are specifically brought to borrowers' attention rather than being buried in loan documentation. Face to face disclosure of terms by customer service officers (Bertrand & Morse, 2011, p 1867) or by independent loan counsellors (Stark & Choplin, 2010, p. 113) may have some positive impact on borrowers' understanding. Making lenders responsible for designing and implementing effective disclosure of relevant terms, and then assessing borrower understanding through 'post-sale' testing with a view to penalizing lenders for ineffective disclosure, is another strategy which might lead to positive outcomes for borrowers. (Willis, 2015, p. 1; Engel, 2014, pp23-24)

In addition to these considerations, and as will be discussed in section three, the traits and characteristics of borrowers may also be relevant to the effectiveness of disclosure and should be taken into account in attempts to design effective disclosure regimes.

A further measure aimed at empowerment of borrowers through knowledge and information, which of itself can also have an impact upon the effectiveness of disclosure, is the focus on improving levels of financial literacy amongst borrowers. The effectiveness of financial literacy programs is difficult to measure and their impact on consumer understanding has been called into question in recent studies (Ben-Shahar & Schneider, 2011, pp 647, 667), however there is evidence of participant satisfaction in some programs. (Russell, Brooks & Nair, 2005, p.6) There is also a reasonably high degree of financial literacy generally in Australia, which may or may not be linked to government and other financial literacy programs. (Russell, Brooks & Nair, 2005; Worthington, 2013) The impact of financial literacy as a borrower characteristic will be discussed below, where the possibility of further empirical research to test financial literacy levels of small amount consumer and enterprise borrowers will also be canvassed.

Interventionist ex ante and ex post regulation

More interventionist regulation incorporating ex ante (before breach and therefore intended to be preventative) protections and ex post (after breach) sanctions against lenders in breach, have included ‘banning’ particularly exploitative credit products, placing caps on interest rates that can be charged in relation to consumer loans, and a ‘responsible lending’ requirement that lenders assess loan suitability. These protections with sanctions for breach are provided in Australia under the National Consumer Credit Protection Act 2009 (Cth) (“NCCPA”). An important aspect of the NCCPA has been to prohibit those aspects of consumer credit products which might be considered harmful or exploitative, such as high interest rates and loans rollovers, which will be discussed below.

Under section 13CA NCCPA the very short term ‘payday loans’ with terms of less than 15 days for amounts of $2000 or less, are prohibited. This removes from the market loans which are for such short periods of time that borrowers find them difficult to fully repay in time, and that very often need to be ‘rolled over’ at additional cost to borrowers. (Stegman, 2007, p.186)

In relation to cost, the maximum charge for a small amount credit contract of $2000 or less, for a term of between 16 days and one year, is now effectively 68 per cent per annum for a one year loan contract, although potentially a lot higher as an annualised rate for a shorter contract (for example, 24 per cent per month which is 288 per cent per annum for a one month loan contract).[2]

Loan rollovers have effectively been prohibited as part of the responsible lending obligations under the NCCPA. Where a borrower is having to ‘rollover’ a loan, that is, enter into a new loan contract to pay back an existing loan, it is presumed under the legislation that the loan is ‘irresponsible’ and in breach of responsible lending obligations. Specifically, section 188(3A) NCCPA states that it is presumed that a consumer can only meet financial obligations with substantial hardship (and that therefore the loan is unsuitable and will be irresponsible) unless the contrary is proved, where a consumer is a debtor under another small amount credit contract and is in default, or in the 90 day period beforehand, the consumer has been a debtor under two or more other small amount credit contracts. The credit provider must make reasonable enquiries regarding the borrower’s capacity to repay and can take into account the borrower’s other loans and credit history with the benefit of a comprehensive credit reporting regime under reforms to Part III Privacy Act 1988 that took effect on 12 March 2014.

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[2] This is because section 31A National Credit Code (Schedule 1 to the NCCPA) provides for a maximum establishment fee of 20 per cent of the credit amount and a monthly fee of 4 per cent of the credit amount for loans of $2000 or less for a term of between 16 days and one year. For all other consumer credit, pursuant to section 32A National Credit Code, the cap is 48 per cent per annum, although this cap does not apply to loans made by Authorised Deposit-taking Institutions, to allow for such products as ‘mainstream’ bridging loans.

With regard to assessing suitability of a loan and a borrower's capacity to repay, under sections 128 and 129 of the NCCPA a credit provider must not enter into a credit contract with a consumer without first making a preliminary assessment as to the suitability of the loan, in the sense of a consumer being able to comply with the financial obligations under it.[3] The preliminary assessment must be made within 90 days before the provision of credit. Prior to making the preliminary assessment, in accordance with section 130 NCCPA the credit provider must make reasonable enquiries about the consumer's financial situation, and must take reasonable steps to verify the consumer's financial situation.[4] As an example of the possible penalties for failure to meet responsible lending obligations, payday lender Nimble Australia Pty Ltd was ordered in March 2016 to refund more than $1.5 million to a total of approximately 7,000 customers after findings that Nimble had failed to meet its responsible lending obligations by not properly assessing the financial circumstances of many consumer borrowers before providing them with loans, and failing to recognise where those borrowers had obtained repeat loans from payday lenders within a short period of time. It was also found that Nimble had failed to make proper inquiries regarding consumers' requirements and objectives. (Australian Securities and Investments Commission, 2016)

Similar responsible lending provisions can be found in other jurisdictions such as the US and Europe. In the US, the Dodd-Frank Act of 2010 imposes an obligation on lenders to assess a consumer's ability to repay a residential mortgage loan, before making such a loan, although it does not focus more generally on consumer credit. Section 1411 of the Dodd-Frank Act requires a creditor to make 'a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan.' In Europe, the 2008 directive on credit agreements for consumers requires that a creditor assess a consumer's creditworthiness before the conclusion of a credit agreement,[5] and the 2011 directive on credit agreements relating to residential property contains the same obligation as well as a requirement that the creditor refuse credit where the assessment 'results in a negative prospect for the consumer's ability to repay the credit over the lifetime of the credit agreement.'[6]

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[3] Additionally, under section 131 NCCPA, the credit contract must be assessed by the credit provider as 'unsuitable' if the consumer will be unable to comply with the consumer's financial obligations under the contract- for example by being unable to meet the loan repayments- or could only comply with those obligations with substantial hardship; or the contract will not meet the consumer's requirements or objectives.

[4] Note that 'reasonable steps' may not be particularly onerous. In *Maisano v Car and Home Finance Pty Ltd (Credit)* [2005] VCAT 1755 (12 August 2005), for example, it was held that a car finance salesman could not have ascertained by reasonable enquiry of a borrower that she was unable to repay the loan, in part because she did not speak English.

[5] Article 8 Council Directive 2008/48/EC of 23 April 2008 on credit agreements for consumers.

[6] Article 14.2(a) Proposal for a Directive of the European Parliament and of Council on Credit Agreements Relating to Residential Property (EC2011).

The focus on consumer loans, to the exclusion of enterprise loans, in the Australian, US and European responsible lending provisions is noteworthy and raises the question as to why it is not equally appropriate for small amount enterprise borrowers to have the protection of a responsible lending regime, unless empirical research is able to demonstrate that enterprise borrowers consistently exhibit traits and characteristics that make them less vulnerable to inappropriate or potentially harmful loans. None of the NCCPA protections- 'banning' particularly exploitative credit products, placing caps on interest rates that can be charged in relation to consumer loans, and a 'responsible lending' requirement – extend to loans for enterprise purposes. The enterprise loan space in Australia and in other jurisdictions is remarkably unregulated when compared to consumer loans, leaving enterprise borrowers potentially more vulnerable to inappropriate or exploitative lending behaviour. In pursuing claims against lenders, enterprise borrowers in Australia are limited to relying on the common law or on provisions of the Australian Securities and Investments Commission Act 2001 (Cth) ("ASIC Act") which regulates conduct in relation to financial products and services. These provisions offer recourse through the courts in relation to misleading or deceptive conduct by lenders, or unconscionable conduct, although it is noteworthy that the threshold applied by the courts for a finding of unconscionable conduct is high. As noted by Webb:

> A lender may have behaved, in common parlance, 'unfairly' or 'harshly' and the borrower may have suffered a resultant detriment, yet the conduct will not be held to be unconscionable. The reason for this is that the entitlement to safeguard one's own business is regarded as paramount and, so long as in doing so the conduct is not regarded as excessive, the courts are seeking to ensure that this high threshold remains and the unconscionability standard is not blurred by notions of unfairness or unjustness. (Webb, 2013, p. 159)[7]

Small business borrowers who enter into Australian loan agreements after 12 November 2016 will have the additional benefit of provisions which protect against unfair loan terms in standard form contracts, pursuant to *The Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015.* This is a protection already given to consumers under The Australian Consumer Law, contained at Schedule 2 in the *Competition and Consumer Act 2010 (Cth)*. However, the small business or enterprise borrower is still left without the important protections contained within the NCCPA. As discussed above in relation to the lack of disclosure regulation for enterprise borrowers, the disparity in regulation seems unjustified given that enterprise borrowers may have far more in common with consumer borrowers than with large commercial borrowers (Webb, 2013, p. 135), and that hypothesis should be tested through empirical research, as will be discussed in section three of this article.

The benefit of having interventionist regulation, such as the effective banning of harmful loan products or loan characteristics under the NCCPA, is that it protects vulnerable groups from being strategically targeted by lenders with those harmful products. Payday lenders,

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[7] The narrow view of unconscionability adopted by the Australian High Court is illustrated by the decision in *Australian Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd* (2003) 197 ALR 153

offering short-term, high cost loans, have been found to target vulnerable, financially excluded borrowers, in that payday lending stores are over-represented in the two lowest socio-economic status quartiles identified by the Australian Bureau of Statistics. (Ali, McRae & Ramsay, 2015, p. 30) There have been similar findings in the US regarding strategic targeting of financially unsophisticated borrowers. (Carrell & Zinman, 2014, pp 2806, 2829) The effective banning of harmful loan products adopts a 'product safety approach' whereby credit products are treated in the same way as other consumer products which might face a ban where they are found to be unsafe. (Bar-Gill & Warren, 2008, p 201; Nottage, 2013, p.190) Such regulation will be particularly beneficial where borrowers are unable or unlikely to avoid harm as a result of knowledge and information, for example because of borrower traits and characteristics which render disclosure of information ineffective.

Providing safe, alternative products

We argue that any regulatory regime should ensure the ongoing availability of small amount credit notwithstanding the need for regulatory protections. Access to credit provides vulnerable members of the community with the opportunity to fund consumer needs such as replacing a broken refrigerator, or to fund the establishment or expansion of a small business enterprise. (The Centre for Social Impact, 2013) Access to credit has the potential to equip vulnerable people with the tools they need to help themselves rather than relying on handouts, and to empower economically and socially disadvantaged people, in particular women. (Hunt, 2013, p.16) It is for this reason that microfinance has been a popular avenue for support in the last few decades across the world. (Hermes & Lensink, 2007)

In Australia, there is a reasonably large percentage of the population who experience financial exclusion from mainstream finance products including credit products, and who might benefit from the availability of safe, alternative credit products rather than being limited to accessing potentially exploitative small loans products. Rates of financial exclusion in Australia remain high with the latest research report showing that 16.9 per cent of the Australian adult population (equating to 3,040,000 people) were either fully or severely excluded from access to appropriate financial products in 2013. (The Centre for Social Impact, 2014, p.9)[8] Those most affected by financial exclusion in the context of access to credit are those on low incomes. This is demonstrated by the data, namely that 43 per cent of financially excluded individuals earned under $15,000 per annum (1,297,000 people), 12 per cent (381,000 people) earned between $15,000 and $19,999 per annum, and 10 per

[8] The three financial products to which access is measured in these statistics are a transaction account, general insurance, and a moderate amount of credit. Being able to access a 'moderate amount of credit' is defined in the report as having ownership of a credit card, without stipulating a monetary amount. Fully excluded people had no access to any of these products and severely excluded people had access to only one, which in most cases would likely be a transaction account, given that a bank account is required for the receipt of welfare payments in Australia. While measuring access to credit by reference to access to a mainstream credit card is clearly not a perfect measure, the authors of the report note that 'if a consumer has a credit card, they would generally qualify for other forms of mainstream credit. The rate of credit card ownership closely tracks the general rate of mainstream credit use in Australia.' (The Centre for Social Impact, 2014, p.8)

cent (299,000 people) earned between $20,000 and $24,999 per annum. (The Centre for Social Impact, 2014, p.17) This means that those who are most vulnerable and disadvantaged have that vulnerability and disadvantage entrenched by a lack of access to appropriate and affordable financial products. This removes the ability of those people to develop financial capacity. The provision of safe and appropriate credit products seems a necessary response for those people experiencing financial exclusion.

As noted above, the key regulatory strategies employed in Australia to protect small amount borrowers have focused on consumer rather than enterprise loans. In relation to both small consumer and enterprise loans, however, there have been government funded programs making credit available on safe, non-exploitative terms. In relation to small amount consumer loans, government funding became available for a Community Development Finance Institution ("CDFI") pilot in 2009 in order to 'build financial resilience and wellbeing among those most at risk of financial and social exclusion." Under the pilot, CDFIs received funding to provide small amount consumer loans to financially excluded individuals, and such loans programs have continued. (Plant & Warth, 2013, p. 9) In relation to enterprise funding, there is the federally funded Social Enterprise Development and Investment Fund which facilitates lending by CDFIs to social enterprises to improve 'access to finance and support for social enterprises to help them grow their business and increase the impact of their work in their communities.' (Department of Employment, Australian Government, 2016)

Without doubt, offering consumer and enterprise borrowers safe alternatives to exploitative products is a regulatory strategy offering borrowers not only protection from harm, but also financial inclusion and its accompanying dignity and self-esteem benefits. (Wilson, 2012, pp 520-521). Government funding of CDFIs as part of a strategy to address financial exclusion in Australia for both consumers and enterprises represents a regulatory strategy which recognises that the role of regulation may simply be to enable those organisations already addressing a social or economic problem to survive. (Dunsire, 1996, p. 320) The extent to which financially excluded people will be likely to access these alternative forms of available credit, may depend upon their traits and characteristics, as outlined below.

3. Borrower Characteristics

We have identified three types of regulation applicable to small amount credit in Australia- information and knowledge regulation; product interventionist regulation; and the provision of safe, alternative credit products for those excluded from access to mainstream credit products. There is no evidence that in designing such regulatory responses, regulators have considered the likely personality traits and behavioural characteristics of those borrowers whom they seek to protect, nor the impact of those traits and characteristics upon the effectiveness of these regulatory responses.

In this section we will draw upon the psychological literature and consider traits and characteristics most relevant to credit. In doing so, we will consider what those traits and characteristics might mean for the effectiveness of each of the regulatory types identified. It will be a matter for further empirical research to identify the extent to which these traits and characteristics are dominant in consumer or enterprise borrowers or both, in order to inform regulatory responses. We have identified as those personality traits likely to be most relevant to borrower behavior: optimism, risk tolerance, and self-control. Other characteristics which can impact on debt behavior and which will be explored are financial literacy (itself a form of regulation but also a characteristic which can impact on the effectiveness of a regulatory strategy such as disclosure), and irrational behavior.

Optimism

Optimism can be viewed as both a personality trait and also a specific debt behaviour. It has been defined as 'generalised positive expectations about future events' (Puri & Robinson, 2007, p. 72) Optimism may provide insight into illogical consumer and enterprise debt behaviour. Optimism can have a significant impact on the quality of decision-making, which has been demonstrated by the literature regarding optimism and business behavior, but which is clearly also relevant to debt decision-making. In the business literature it has been found that optimism can lead to accepting the first best investment (Campbell et al, 2011, p.696) and that extreme optimism can make a person less prudent. (Puri & Robinson, 2007, p.92) On the other hand, moderate levels of optimism can actually result in overall better decision-making. (Puri & Robinson, 2007, p.96) Therefore it is extreme optimism which should be of concern as a borrower trait and should form the basis for empirical research. Interestingly, extreme optimism is likely to be found in entrepreneurs who may delude themselves about the likely success of their entrepreneurial endeavours. (De Meza & Southey, 1996, p.385)

Optimism bias, which may flow from extreme optimism, may lead to forecasting inaccuracy and impaired cognition (Lipkus et al, 1993, p.582; Sharot, 2011, p.943; Sharot et al, 2011, p.5) however it has been found that this can be countered with what has been termed 'Reference Class Forecasting.' (Flyvbjerg, 2008, p.5) External referencing involves making decisions regarding comparable (theoretical) situations and applying those decisions to the actual problem at hand. (Flyvbjerg, 2008, p.6) An example of incorporating external referencing into a small loans application process might be to require the borrower to consider a hypothetical borrower in a similar situation and with similar capacity, and to consider the ability of the hypothetical borrower to repay the loan without hardship and without adverse impact on cash flow. The borrower then has the ability to apply those considerations to his or her own situation.

So what might extreme optimism on the part of the borrower mean for the effectiveness of regulation to protect that borrower? Certainly, it could lead to a lack of cognition of, or attention paid to, disclosure, weakening the effects of disclosure of information. (Loewenstein et al, 2014, p.413) Notwithstanding the disclosure of information such as interest rate payable, repayment amount and the loan term, optimistic people may underestimate the repayment time and overestimate their future income, as was found to be the case in a study relating to student loan borrowers. (Seaward & Kemp, 2000, p.18) Optimism may also lead borrowers to believe that they can repay a short term, high cost loan without having to 'rollover' the loan at additional cost. (Landier & Thesmar, 2009, p.120) It is in fact possible that entering into some short term loans is, in and of itself, an indication that a borrower may be overly optimistic and unrealistic. It has also been found that unrealistic optimism can lead to lower sensitivity to interest rates. (Yang et al, 2007, p.171)

On the basis that extreme or unrealistic optimism can weaken or negate any benefits of disclosure, should empirical research confirm the hypothesis that both borrowers who enter into very short term loans and enterprise borrowers are more likely to be overly optimistic, then it would be expected that disclosure regulation would offer little protection to those borrowers. It would then be arguable that both enterprise borrowers and short term loan borrowers should enjoy the product interventionist regulation provided under the NCCPA. As discussed above, while consumer loans including small amount, short term consumer loans attract NCCPA regulation, enterprise loans do not.

It would also be appropriate that disclosure of information to overly optimistic borrowers would need to be enhanced in order to be effective, for example through techniques such as external referencing referred to above; or face to face disclosure and explanation by customer service officers or independent loan counsellors, as referred to in section two of this article. The requirement for post sale testing referred to in section two, where lenders would be assessed as to their borrowers' understandings of disclosure, would also be likely to improve the methods and impact of disclosing information.

In relation to safe alternative forms of small amount consumer and enterprise loans, an optimistic borrower may be disinclined to seek out such products, and settle for the first loan product encountered. Effective disclosure would ideally include information regarding alternative products offered under government schemes by not for profit organisations such as CDFIs.

Risk Tolerance

Risk tolerance has the potential to affect how much debt people feel comfortable taking on, and also whether they might be willing to enter into an enterprise loan agreement and take risks as entrepreneurs. Clearly, the amount of risk and uncertainty that a person is willing to tolerate will affect his or her behavior as a borrower. (Yang et al, 2007, p.182)

While risk tolerance may be more prevalent in enterprise borrowers in general, perhaps supporting an argument for extension of NCCPA protections to enterprise borrowers, it is interesting to note that female headed households have been found to have reduced risk tolerance compared with male headed households. (Sung & Hanna, 1996, p.15) How this might impact upon the implementation of regulation is a difficult question, and obviously it would not be desirable to have reduced protections for one group of borrowers based on gender. In fact, we argue that the regulatory framework should in every aspect ensure that the most vulnerable are protected, even though the protections also extend to those less vulnerable.

As with optimism, risk tolerance may weaken the effectiveness of disclosure, supporting a call for extension of the NCCPA protections to all borrowers likely to exhibit this trait. In relation to the responsible lending regime under the NCCPA, borrower risk tolerance (as with optimism) may give rise to a requirement for even greater vigilance by lenders as to borrowers' capacity to repay, paying close attention not just to information provided by borrowers but also to borrowers' other loans and credit history.

Self control

Self control has been described as an ongoing conflict between the aspects of the self which want 'immediate' rewards and those which want 'future' rewards. (Shefrin & Thaler, 1977, p.611) Research has indicated that the construct of self control is more important than financial literacy in explaining over-indebtedness, and that low self control combined with low financial literacy results in non-payment of debt and a higher perceived burden of debt. (Gathergood, 2012, p.596) There is also a relationship between optimism and self control, in that moderate optimists may face fewer self control challenges than extreme optimists. (Puri & Robinson, 2007, p.96)

As with optimism and risk tolerance, a low level of self control may weaken the effectiveness of disclosure of information and require the extension of the NCCPA regime to enterprise borrowers if they are found to exhibit low self control as a dominant trait. It may also lead to acceptance of the first loan product offered for immediate gratification, rather than pursuing safer and more affordable alternatives, the existence of which should be effectively disclosed to affected borrowers.

Financial literacy

While financial literacy is also a form of regulation and is not strictly a behavioural characteristic, a lack of financial literacy will create a psychological barrier described as 'lack of knowledge structures' preventing a borrower from being able to accurately evaluate the attributes of a loan product. (Stark & Choplin, 2010, pp.98-99) Where borrowers are behaving rationally and beyond the influence of a range of personality traits, there would be a choice to become financially literate if the immediate consumption costs and depreciation of financial literacy (in terms of its currency) justified such a choice. (Jappelli & Padula, 2013, p.27)

As indicated in section two of this article, it is difficult to measure whether financial literacy has any positive impact on borrower behaviour, however it has been found that an underlying financial literacy can reduce the effects of financial shock and increase savings rates. (Dupas & Robinson, 2009, p.13) Further, as stated in relation to the trait of self control, where financial literacy is combined with low self control, adverse debt behavior results.(Gathergood, 2012, p.596) In addition, low financial literacy has been found to be associated with a higher cost of credit, lower confidence, low improvement behaviours, and higher interest rates on loans. (Disney & Gathergood, 2013, p.2249) Indeed, lower financial literacy has been associated with a greater chance of seeking out and obtaining consumer credit in the first place. (Disney & Gathergood, 2013, p.2253)

Low levels of financial literacy are likely to impact upon the effectiveness of disclosure and, should there be empirical findings of low levels of financial literacy in small consumer loan borrowers or small enterprise loan borrowers or both, then work should be done on both improving the effectiveness and perhaps accessibility of financial literacy programs and on improving the effectiveness of disclosure, for example through incorporating face to face explanations by an independent loan counsellor, as discussed in section two of this article, and external referencing as discussed in relation to the optimism trait.

Irrational Behaviour

Borrowers may make decisions which can objectively be categorized as illogical or irrational (Gross & Souleles, 2002, p.345), and the extent to which consumer or enterprise borrowers or both may evince imperfect rationality has implications for the design of credit regulation. One relevant example of irrational behavior in relation to small amount loans is entering into short term loan agreements which cannot be repaid within the loan term, and allowing those loans to be 'rolled over.' (Sporleder & Wilson, 1974, p.132) The 'rollover' of small amount consumer payday loans has been described as 'one of the most controversial features of payday loans because it carries great financial risk for consumers and is perhaps the key to the lucrative nature if the business for lenders' (Lott & Grant, 2002, p. 22) This has led to what has been termed in this article as product interventionist regulation, effectively banning that harmful aspect of small consumer loans. It would be interesting to explore the nature and focus of irrational behaviour by borrowers in relation to both consumer and enterprise loans. This would enable a determination as to whether interventionist regulation such as a 'ban' is warranted to prevent other common, but harmful, characteristics of consumer or enterprise loans, on the basis that 'the risks associated with some products or activities may be so great that policy-makers may feel that it is inappropriate merely to inform affected parties about those matters.' (Baldwin & Cave, 1999, p. 49)

Implications and conclusion

The focus of this article has been on small amount consumer loans of up to $4000, and small amount enterprise loans of up to $20,000. This article has explored three types of regulation applicable to such small amount credit in Australia- information and knowledge regulation, which encompasses disclosure regulation; product interventionist regulation which is found in the NCCPA and seeks to regulate lender behaviour before breach and to impose penalties after breach; and the provision of safe, alternative credit products for those excluded from access to mainstream credit products. It is notable that neither disclosure regulation nor the product interventionist regulation encompassed in the NCCPA apply to small amount enterprise loans- only consumer loans.

This article has raised the question as to how the personality traits and behavioural characteristics of borrowers should be taken into account when designing regulation which has as its purpose the protection of those borrowers. It has suggested that empirical research should be undertaken to assess the dominance or otherwise of those traits and characteristics in small amount consumer or enterprise borrowers or both, to inform the regulation of small amount consumer and enterprise loan products. The focus in this article has been on the traits of optimism, risk tolerance and self control; and on the characteristics on financial literacy and irrational behaviour. These were selected as likely to have the most relevance to debt behaviour.

The outcome of such research would be to construct regulation so as to be more effective in protecting small amount borrowers. For example, the presence of such traits as extreme optimism, risk tolerance and low self control would potentially weaken the effectiveness of disclosure of information, such that disclosure would need to be strengthened through more effective conveyance of information. Some of the strategies explored in this article have been external referencing, face to face communication by a customer service officer or independent loan counsellor, and post sale testing of the effectiveness of disclosure with penalties applicable for non-effective disclosure. It has also been argued that effective disclosure needs to make borrowers aware of safe, alternative forms of small amount consumer and enterprise loans, available under government funded schemes.

It also needs to be recognised that where these traits are present, and disclosure is less likely to be effective, then product interventionist models of regulation such as those provided under the NCCPA are necessary. The lack of such regulation pertaining to enterprise loans has been noted and, subject to the results of empirical research but based on a hypothesis that many of the same personality traits are likely to be dominant in both consumer and enterprise borrowers, then much of the same regulatory oversight should be extended to small amount enterprise loans.

Traits such as optimism and risk tolerance in borrowers will also make it imperative that responsible lending assessments by lenders include objective data such as a borrower's credit history.

Further, where low financial literacy levels of borrowers are found, this is also a basis for requiring both more effective disclosure of information and product interventionist regulation to protect borrowers from harmful products. Irrational behavior may lead to borrowers accepting terms that render loan products harmful in some respect, such as loans in which loan rollovers are possible. These terms should be identified and there should follow targeted regulatory interventions to 'ban' aspects of loan products which are harmful, and on an objective basis, irrational for a borrower to accept.

This article commenced with what was described as a possibly trite statement, that the effectiveness of regulation may depend upon the personality characteristics of those who are intended to benefit from regulatory protection. Undertaking empirical research to ascertain which characteristics might be dominant amongst small amount consumer and enterprise borrowers can usefully feed into the debate around the effectiveness of credit regulation in Australia. This article has suggested possible regulatory outcomes in the event that some or all of these traits or characteristics are identified as dominant, and has also suggested that there may be a need for greater regulatory protections for small amount enterprise borrowers in particular.

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