Working Paper no.13:
Problem Debt and Poverty

Expert Advisory Group on Solutions to Child Poverty

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Purpose

1. This paper was prepared to provide the EAG with an overview of how family indebtedness may be contributing to child poverty. There have been several recent and comprehensive New Zealand studies on this topic. This paper summaries key elements most relevant to child poverty, but does not attempt to replicate those reports here.

2. This paper has informed the direction and recommendations of the EAG's *Solutions to Child Poverty in New Zealand: Issues and Options Paper for Consultation*. These are preliminary findings, and a final report will be published in December 2012. The findings in this paper do not necessarily represent the individual views of all EAG members.

3. The EAG wish to acknowledge the members of the Secretariat for their work on this paper.

Overview

4. The purpose of this background paper is to provide an overview of the issue of problem debt and its effects on children. The paper also considers possible ways of alleviating the high debt levels experienced by many low-income families.

5. Many New Zealand families are in some form of debt – 64 percent of single families (single individual with or without dependent children) and 82 percent of couple families (two individuals in a social-marital relationship with or without dependent children). Mortgage debt alone makes up a significant amount of family debt – 69 percent for single families, and 82 percent for couple families (Families Commission (FC), 2008). The Living Standards Survey 2004 revealed that 30 percent of all families interviewed had experienced at least one of six defined forms of 'financial strain'[1] (FC, 2009b).

6. However, it is important to differentiate between 'normal' and 'problem' debt, i.e. those who have debt but manage it well, and those who are unable to for various reasons. There are many factors that lead to debt going from manageable to 'problem'. As the Families Commission report (2009a, p.6) rightly points out, "debt can potentially be a

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[1] The six defined forms of financial strain are: a) not being able to keep up with electricity, gas or water costs, b) not being able to keep up with mortgage or rent, c) not being able to keep up with hire purchase or credit card payments, d) having to borrow money from family or friends, e) receiving help from a community agency, and f) selling belongings to meet everyday living costs (FC, 2009b, p.8).

problem for any family in New Zealand, but it is likely to be worse for families who are on limited incomes; are without assets; do not possess the skills and resources needed to get out of debt; and whose options to improve their financial situation are limited". Thus, it is important to consider the level of debt in relation to a family's income, and their capacity to service the debt.

7. This paper will specifically focus on 'problem debt', as the increased struggle to make ends meet from the pressure of excessive debt can have far-reaching consequences for children. It will firstly define the differences between debt and problem debt and their causes, discuss the pros and cons of various means to mitigate problem debt, and offer some practical solutions.

Definition – problem debt

8. The Families Commission (2008) defines debt as: "Any financial obligation, leveraged against an asset (secured debt) or against future income (unsecured debt)… [for example] mortgages, student loans, bank loans, hire purchase, credit cards, store credit, being in arrears and use of fringe lenders" (p47).

9. Problem debt, however, is defined as "unmanageable debt leading to financial strain" (Families Commission, 2009a, p6). The Families Commission report (2009b) puts problem debt into three categories:

   a) a family is lacking sufficient income to cover their expenses, and does not have access to, or has already exceeded/exhausted, financial options such as overdraft or credit cards
   b) a family is experiencing financial strain despite having access to debt or formal lines of credit – that is, they are currently exhausting the financial debt options available
   c) a family not only has high debt levels, but is in a negative equity position (liabilities are greater than assets) (2009b, pp7-8).

10. Unfortunately, while we have data on the overall level of debt (as noted above), there is no information specific to problem debt or debt for families living in poverty.

Impacts of problem debt on children living in poverty

11. The effects that problem debt can have on children are far-reaching and well documented (Valins, 2004). Problem debt is a significant barrier to families enjoying a meaningful life where children can flourish and reach their full potential in society.

12. Children in families with problem debt have less money to meet essential needs such as food, clothing, and other housing expenses. There are also negative impacts on family well-being – such as increased strain on family relationships, stigma and mental health

issues, and children missing out on activities that are generally perceived to be normal (FC, 2009a).

How people get into debt

13. There are numerous ways that families get into debt. In a qualitative study interviewing 27 beneficiary and 13 working families, the Families Commission (2009a) identified the following reasons for accumulating problem debt:

    a) inadequate income to meet basic needs – low levels of education mean earning potential can be limited
    b) rising price of necessities (e.g. food, power, rent, transport)
    c) family member with a significant health issue or physical or mental disability – issues were the cost of care and time spent out of the workforce
    d) certain spending behaviours – three behaviours were identified:
        i) lack of control with personal spending. "Problem debt [is] often related to consumption rather than asset accumulation" (FC, 2009a, p7).
        ii) helping other family members
        iii) alcohol, drug, gambling addiction
    e) spiralling debt – one initial debt leading to other debts
    f) experiencing a major change of circumstances – changes included having a child, buying a home, change in employment or income
    g) lack of financial literacy, leading to take-up of high interest loans from finance companies
    h) being in debt to the government.

Debt to the government

14. The government has a significant role as a collector of debts through the Inland Revenue Department (e.g. child support payments), Work and Income (e.g. benefit related payments/advances), Ministry of Justice (e.g. Court-imposed fines), Housing New Zealand arrears, and infringement fines through local councils, the Police, and other prosecuting authorities (e.g. speeding tickets, parking tickets, dog registrations fees, etc).

15. According to Valins (2004, p69) "fines appear to be a relatively small but still significant component of the monies owed by people who have debt problems." Court fines are the most widely used penalty for offenders; making up 33 percent of all convictions in 2001. Judges consider fines to be a useful sanction for minor offenses, but are also concerned at the number of people who are brought before the Courts who cannot afford to pay them. A key contributing factor to this, according to Valins (2004), is the increase in 'instant fines' (e.g. traffic, parking, dog control, underage drinking etc.). While fines are fairly easy to administer, they do not discriminate on the basis of a person's ability to pay and a series of minor fines can easily mount up quickly from one initial offence – e.g. a

seatbelt fine ($150) leading to an unregistered vehicle fine and no warrant of fitness fine ($200 each), etc. Judges cannot impose fines on offenders if they cannot be expected to repay them within a reasonable timeframe, yet fines for vehicles are fixed and not means related. A Judge quoted in Valins' report commented that such an approach brings the system of justice into disrepute.

16. Penalties are added onto fines if they are not paid in time; further compounding problem debt for those on low incomes. If recipients of a fine do not pay within 28 days, it is passed on to the District Court with a $30.67 filing fee. After the next 28 days an enforcement action fee of $102.22 is added, after which the Court can take enforcement action to collect the debt. This can include:

- compulsory deductions from wages, benefit, or bank account
- the seizure and selling of property
- preventing overseas travel
- arresting the debtor (Ministry of Justice, 2012).

17. Applications can be made to the Court for an extension of the due date or to make payments by instalments. Financial information about the debtor is usually needed to make sure there is a genuine need to grant further time to pay. It would be useful if there were greater capacity to take individual cases to a Judge to get approval for a debt write-off (currently the high level of authorisation means that it is only done in rare cases). However, it would also be useful to consider other models, as Judge-only processes are time consuming and costly.

18. Berkana Consulting Services (2002, cited in Valins 2004, p47) identified debt to government departments as one of three factors that lead to financial crises for former beneficiaries. In the study, of those former beneficiaries who were indebted to Work and Income, 34 percent stated that it was due to mistaken benefit overpayments, 27 percent were late in notifying Work and Income that they had a job, 23 percent had received emergency grants, and 23 percent had received advances on benefits.

19. The New Zealand Christian Council of Social Services (NZCCSS, 2008) undertakes qualitative research into foodbank usage. Using Hamilton as an example, Table 1 sets out the type of debt foodbank users had in 2004, highlighting debt to Work and Income. The majority of foodbank users have a benefit as the sole form of their household income.

Table 1: Hamilton Combined Christian Foodbank applicants in debt, 2004 and 2007

Debt type	**2004**	**2007**	**Percentage change**
% of applicants on benefit as sole form of household income	85%	84%	-1%
% of applicants in debt	77%	89%	16%
% of applicants in debt to Work & Income	63%	71%	12%
Number of clients paying over $40/w to Work & Income	25	22	-12%
% of applicants in arrears on utility bills	31%	6%	-79%
% of applicants in arrears with electricity bills	22%	25%	14%
Survey Sample	367	348	-5%

SOURCE: (NZCCSS, 2008).

Recommendation 1:

The government should review its debt accumulation and recovery processes for low-income families to ensure they take the well-being of children into account.

Recommendation 2:

The government should explore whether a whole-of-government approach could be applied to assist households with debt to more than one government department.

Options for addressing problem debt

20. There are various options for addressing problem debt amongst low-income families. The following sections consider the regulation of credit, provision of budget advice and financial literacy services, and social lending.

Access to credit and the accumulation of debt

21. Loans from finance companies are often a problematic form of consumer credit, with high interest rates, additional administration costs, and strict repayment times. Loan sharks, fringe lenders, and mobile shops are prevalent throughout low income areas, such as South Auckland and Porirua East. The ease with which these loans are able to be taken up, especially by those with poor credit ratings, has serious implications for debtors. Interest rates are commonly very high. Sometimes people use the entire contents of their house as collateral (Francis, 2012).

22. Interviews undertaken by the Families Commission (2009a) revealed that some families

did not always understand the contracts for credit advances that they signed. Others knew the risks but felt they had no other alternatives. Common reasons for taking out consumer credit loans are for vehicle-related costs (repairs, repossession), whiteware or technical equipment, pay day advances, and funeral costs. A common amount borrowed by survey participants to cover immediate costs was $100, leading to repayments of $160 - $180 (after interest) within a two to four week period.

Consumer credit legislation

23. One of the most practical ways to combat the issue of problem debt is through the regulation of financial loan companies that lend to those on low-incomes and are active in low socio-economic areas. Unlike many other countries (such as the United States, Canada, and Australia), New Zealand does not use regulations to set upper limits on the interest rates charged by loan agencies.

24. In New South Wales, Queensland, and the ACT a cap of 48 percent per annum is imposed on credit contracts regulated by the Uniform Consumer Credit Code (UCCC). In Victoria, a cap of 48 percent is imposed on unsecured credit and a cap of 30 percent imposed on secured credit regulated by the UCCC (Howell, 2009). While these may still be very high, they are nonetheless a good starting point in considering future options. They are certainly better than the current situation where finance companies are charging interest rates of up to 400 percent.

25. However, the evidence suggests that introducing interest rate caps on financial loan companies has mixed success, and often brings with it unintended consequences. One of the greatest risks is greater financial exclusion. If a lender is constrained in the rate of interest they can charge, they will not lend to anyone whose rate of risk they calculate to be above the cap. If lenders can't lend according to risk, this could also lead to higher prices for all customers. Interest rate caps are often described as a 'blunt instrument' since not all high interest loans are necessarily unfair or result in over-indebtedness, and not all consumers may underestimate the risks of high cost credit.

26. Changes to the New Zealand Credit Contracts and Consumer Finance Act 2003 (CCCFA) are currently under consideration. In April 2012, a Consultation Draft was released detailing lender responsibilities as a new principle in the CCCFA, and strengthening the legal rights and protections of consumers when they borrow money (Ministry of Consumer Affairs, 2012b). The CCCF Amendment Bill is expected to be tabled in Parliament in September 2012.

27. The proposed amendments to the CCCFA will likely include introducing a Responsible Lending Code for creditors (e.g. contract transparency, making it illegal to lend where repayments would likely cause substantial hardship, and allowing for lenders to be banned from the industry for non-compliance (see: Cabinet Business Committee, 2011)); extending the 'cooling off' period from three to five days; better control of misleading

advertising; and borrowers not having to pay the cost of interest or fees if their lender is not a registered financial service provider.

28. The specific measures in the proposed amendments to deal with loan sharks and fringe lenders are: credit offered must be reasonably expected to meet the needs or purposes of the borrower; the borrower must be reasonably expected to repay the loan without substantial hardship; and the lender must be honest and transparent in dealing with the borrower (Ministry of Consumer Affairs, 2011a).

29. A major concern regarding the proposed amendments is a lack of any mention of an upper limit on the interest rates that can be charged by finance companies. As unscrupulous lenders make most of their money through very high interest rates, not including limits in the proposed amendments could undermine effectiveness of regulations.

30. The Ministry of Consumer Affairs (2011a) noted the following issues with imposing caps:

- A limit set too high can result in that limit being a price goal for lenders, thereby increasing the overall cost of credit to users of fringe services.
- A limit set too low leads to lenders leaving the market, potentially channelling borrowers to inappropriate credit products (black market/illegal money lenders).
- If a cap is introduced at a level insufficient to generate a lender's required margin, the price of credit can be transferred from the interest rate into fees and other charges, thereby negating the intention of the price control.

31. Enforcement of price controls, including interest rate caps, is expensive and difficult to administer. A European Commission report found interest rate caps tended to reduce access to credit, particularly for low-income borrowers; reduce the choice of products available to consumers; and increase the overall cost of credit in parts of the market. The study also found little evidence that credit price restrictions helped to reduce over-indebtedness.

32. Thus, there is no clear view on what approach to interest rate caps works. After evaluation of overseas experiences which appear to confirm the arguments for not introducing interest rate caps, the Ministry of Consumer Affairs does not support such a policy. However they have stated that they will continue to monitor this issue.

Changes to repossession laws

33. In April 2012, the Law Commission released a report on consumers and repossession. The Law Commission (2012) recommends wide-ranging changes to New Zealand's credit repossession laws, with a view to establishing a fairer, more transparent and efficient regime for all parties. Under the proposed changes, consumers entering credit contracts would have to be told explicitly when repossession could occur, and which goods could

be repossessed. The Commission also recommends that goods such as bedding, washing machines, and portable heaters, as well as passports and identity documents, should not be subject to repossession at all. If the Commission's recommendations are accepted by the Government, in the future repossession agents will need to be licensed and could lose their license for breaching the new laws. The Commission is recommending that the Credit (Repossession) Act 1997 Act be repealed and that provisions covering the repossession and sale of goods be incorporated into the Government's proposed amendments to the CCCFA.

34. The EAG supports the Law Commission's recommendations to changes in New Zealand's credit repossession laws.

Budget advice and financial literacy services

Budget advice services

35. Families interviewed by the Families Commission believed that budgeting services had made positive improvements to their financial situation (Families Commission, 2009a).

36. The Minister of Social Development, Hon Paula Bennett, recently announced a one-off funding boost of $589,000 from the Ministry of Social Development (in addition to the $8 million annual funding currently allocated for these services) for 155 community groups that provide budgeting services. However, a major provider of budgeting advice, the Salvation Army, reports that it is struggling to cope with the increasing number of people using its services (33 percent increase in 2012 and 52 percent in the last three years). It is clear that despite the $8 million annual funding to community budgeting advice providers, and the recent one-off funding boost, funding for this essential service is currently not keeping pace with demand.

Recommendation 3:

The government should increase funding for budget advice services to keep pace with demand by low income families for these services.

Financial literacy

37. The second ANZ-Retirement Commission Financial Knowledge Survey, conducted in 2009, is a benchmark for assessing adult financial literacy in New Zealand. It found that there was an overall improvement of financial knowledge since the original survey conducted in 2005. However, 16 percent of respondents indicated that they had difficulty managing money, with 26 percent of those with a lower level of financial knowledge having difficulty. People in the low-knowledge group (31 percent of the total) were more likely to be: 18-24 years old; Māori or Pasifika; only primary or secondary educated; tenants, not homeowners; unemployed; in semi-skilled occupations; and low-income.

38. Evidence shows that financial literacy is an effective tool for people to avoid getting into problem debt. The Families Commission report (2009a) noted that a number of its survey participants lacked financial management skills, which led to them entering into loan schemes that resulted in high debt accumulation. Budget advisors have noted an intergenerational lack of financial literacy amongst families they deal with.

39. Addressing the lack of financial literacy should be a priority. One practical way to make progress would be to implement a nation-wide educational campaign that is primarily targeted to low-income and beneficiary families. Currently the Sorted campaigns (conducted by the Commission for Financial Literacy and Retirement Income) are largely aimed at middle-class families. For instance, a recent poster campaign had an 'average' household's weekly budget at $1200, more than double that of many low-income families.

40. Financial literacy is being introduced incrementally into the schooling system. There is currently a National Strategy for Financial Literacy with the Ministry of Education and the Commission for Financial Literacy and Retirement Income is taking a lead role in its implementation. Work is underway with various education providers and private sector associations, and financial literacy courses have been introduced into the New Zealand curriculum. However a progress update by the Commission for Financial Literacy and Retirement Income (2011) noted that "on the Ministry of Education's TKI website there are resources for teachers but they are not as widely used by teachers as we would like. The Ministry is currently developing resources for teachers which show how financial concepts and behavioural economics can be integrated into the social sciences learning area."

41. Although some progress is being made, the EAG welcomes ongoing initiatives from government in this area that will accelerate progress.

Recommendation 4:

The government continue to implement a nation-wide education campaign on financial literacy, with a specific focus on low-income and beneficiary families in the community and at schools.

Social lending

42. Social lending is where "an organisation provides no or low cost loans to people where a social benefit, rather than a profit, is the main outcome. It is not well developed in New Zealand but there is an increasing appetite for it" (Ministry of Consumer Affairs, 2011b). These community organisations have an important role to play as they fill the void between banks who will not lend to those with bad credit or little ability to meet loan conditions, and predatory loan sharks who charge high interest rates.

43. There is a role for the government to encourage and support philanthropic social lending. A discussion paper from a recent financial summit on social lending (Ministry of Consumer Affairs, 2011b) recommended the following:

    a) Social lending should be encouraged. Any social lending model will need adaptation to meet the needs of New Zealanders. Clear criteria need to be established regarding loans for necessities as opposed to wants.

    b) Partnerships between communities and non-finance groups with financial organisations – be they banks, second or third tier lenders, and especially credit unions, perhaps with some funding and promotional assistance from government.

    c) The government should aim to reduce compliance costs to social lending initiatives and to make the process as easy as possible. Increased compliance is likely to mean that lenders would have to adopt the same approaches as first tier lenders have already, which low income customers find confusing and inappropriate.

Good Shepherd Microfinance

44. A good example of social lending is the Australian based Good Shepherd Microfinance (GSM). As a community finance-credit organisation, GSM helps those living on low incomes and financial hardship through microfinance programmes. Microfinance is defined as "the provision of financial services – such as loans (microcredit) and savings accounts (microsavings) – to people on low and limited incomes who can't easily access mainstream financial services" (GSM, 2012). GSM has four main services: the No Interest Loan Scheme (NILS); StepUp (low interest loans); AddsUp (matched savings program); and Good Money (community finance hubs).

45. NILS offers interest-free loans to the value of up to $1,200 for essential household goods and services. Repayments are made in affordable amounts for a period of between 12 and 18 months. In 2011 18,000 NILS loans were issued with a borrower default rate of less than 5 percent.

46. StepUP provides low interest loans to individuals and families on the Family Tax Benefit Part A, or a holder of a current Centrelink Concession Card. StepUp offers loans between $800 and $3,000 for personal or household purposes such as car repairs, furniture, medical and housing expenses etc. Interest is charged at a fixed low rate, and loans can be repaid over three years with no added fees.

47. AddsUp is a savings plan in collaboration with the NAB which helps those on low incomes to develop financial independence. The scheme matches savings of $300 or over dollar for dollar up to $500.

48. Good Money community finance hubs incorporate services such as NILS, StepUP and financial counselling, which offer customers a more integrated way of accessing financial assistance and support. Good Money is a socially responsible alternative to fringe lending.

49. In order to help develop and facilitate its services, GSM has a number of corporate and business partners, including: the Federal Government's Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) (which oversees more than 220 accredited community organisations to deliver NILS loans); the National Australia Bank (NAB); and the Victorian and Queensland Governments.

50. The Federal Government's 2011 Budget allocated $18 million over three years to GSM for no interest and low interest loan schemes, including NILS and StepUP. This funding helps to subsidize overhead costs (including the salaries of some of the staff employed to manage the loans) and research to assess the impacts of the various schemes. The NAB has committed $130 million for the expansion of NILS to over 400 outlets nation-wide, and is the principal partner of the StepUp and AddsUp programmes. The funding from the NAB involves an implicit subsidy of several million dollars per annum, and forms part of its philanthropic activities. The Victorian Government has committed $6.7 million since 2006, with the Queensland Government providing $1.2 million during 2008-2010 and ongoing support for NILS worker training, marketing and coordination.

51. It is interesting to note that the NAB owns the Bank of New Zealand (BNZ). Thus, there may be some potential for the NAB to expand its microfinance services into its New Zealand subsidiary. Aside from this, other banks in New Zealand, such as Kiwibank, have expressed interest in the GSM model and there are a number of local charitable organizations that are keen to collaborate with GSM.

52. While a predominant view amongst the social lending sector is for it to operate outside of the realm of government (Benedict, 2010), the GSM example shows that there is a practical role for the government (or perhaps local government) to play in providing funding and support to microfinance schemes. Indeed, the Australian evidence highlights that a great deal can be achieved (under the appropriate conditions) with only a modest financial contribution from the state. Benedict notes that "government will want to

provide some direct funding in order to help the private social lending system accomplish some of the government's goals" (2010, p.50).[2] It is to be hoped that this sentiment might apply in New Zealand.

Recommendation 5:

The government should investigate a private-public-partnership model with the banking sector and community groups to establish schemes similar to those operated by Good Shepherd Microfinance.

[2] Laura Benedict has many other recommendations for government involvement in the social lending sector, including tax policy, charitable status, and regulation of financial markets. Due to the length of some of these recommendations and their complexities, this paper will not attempt to summarize them, but readers are encouraged to refer to Benedict (2011), especially pages 45-60 for the roles that government can play.

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