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High Cost Consumer Credit

By Tim Edmonds

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Summary

This note outlines issues about high cost credit lending and attempts to reform it. It looks at evidence from various academic research and other reports into the impact of the sector on individuals both here and abroad. It also looks at the opportunities for other lenders to enter the market and to offer more competition to the current market leaders.

A section at the end of the paper looks at the implications and justifications for the cost of credit cap proposals published by the Financial Conduct Authority in July 2014.

Although the subject matter is linked closely with some of the problem areas mentioned in this note, it does not refer to the problems of financial inclusion/exclusion. This is dealt with at length in another Library Standard note (SN/BT/3197) available on the Parliament websites.

More details about the future regulation of consumer credit by the Financial Conduct Authority can be found in another Library Standard note (SN/BT/6842) available on the Parliament websites.

1. Introduction

> Data analysis indicated that up to 6.2 million low-income people aged 16-64 in the UK could not meet fairly modest expenditure without borrowing. In the course of a year, 1.8 million of them had borrowed money commercially. A million of these borrowers had very constrained access to credit, such that 750,000 had needed to use a high-cost lender.[1]

Credit on all levels has become an emotive issue: t'was ever thus. Money lenders and changers have had not the best of press ever since biblical times. Lenders are criticised both for lending too much and for not lending enough. Credit providers in the sub – prime or high cost credit (HCC) sector are often seen as anything from unscrupulous to positively demonic. There have been numerous recent attempts to curb the activities of home credit lenders, companies offering pay-day loans and criticism of credit card companies for increasing their interest rates at a time when base rates remain very low. This note looks at some of the proposals for reforming the consumer credit market, especially in the HCC sector.

Frequent arguments against the high cost firms are that:

- The market is uncompetitive, thus allowing a few firms to charge high interest rates
- They make it too easy for people to get credit or they persuade people to take credit they don't need
- They exploit desperate people
- They charge too much and
- They make it too easy for people to get into levels of debt that they cannot afford by rolling over loans.

On one level, it is very easy to criticise high cost lenders. Any quick internet search of sub-prime lending can turn up examples of interest rates at 200% and more. It is also the case that getting a loan at these rates is made to appear exceptionally easy. Many people using these loans are financially unsophisticated; may have irregular income streams and have few assets or resources to fall back on if anything goes wrong. Therefore, instances of the crude caricature of the desperate poor paying through the nose for a loan taken out because of seductive adverts, and then getting locked into a cycle of taking new loans simply to repay old ones, can be found. Naturally, many policy makers and commentators feel strongly that something ought to be done.

There have been numerous campaigns to reform (or end) HCC. A recent one led by the Compass political pressure group includes typical comments and criticisms:

> **End Legal Loan Sharking**
>
> The UK now has one of the highest levels of personal debt in the world - in April this year the British people owed over £1,460bn in private debt. Debt has become part and parcel of everyday life - many of us owe money on a credit card, loan or overdraft. Borrowing money can be beneficial, personally and economically,

[1] Affordable credit for low income households; Joseph Rowntree Foundation, 2005

> as is the case with student loans, business loans and mortgages. However, there is a tipping point at which borrowing becomes detrimental to the borrower.
>
> Irresponsible lending can cause debts to become unmanageable: some loan and credit companies are charging annual interest rates equivalent to over 2500% (despite the Bank of England base rate being just 0.5%). Borrowing at these rates repeatedly tips customers into inescapable cycles of debt and poverty. High debt repayments are linked to rent, council tax and utility arrears, constraints on job seeking behaviour, poor diets, cold homes, and mental and physical health problems. This is legal loan sharking, a national scandal which must be stopped. In response to our growing private debt crisis we believe now is the right moment to adopt the policy of lending rate caps for all consumer credit.
>
> Affordable short term credit is needed more than ever to help make ends meet as people face huge cuts in public services, reduced working hours, stagnant wages, and unemployment. Despite this because millions on lower and middle incomes are not catered for by many High Street banks, they have no choice but to borrow at usury rates. As a result, those most in need often pay the highest rates to obtain credit. Around 3 million people use high cost door to door loans which often charge £83 in interest and collection charges for every £100 borrowed.
>
> Irresponsible high cost lending played a key role in causing the credit crunch, and the ensuing worst economic crisis for over 60 years. Financial institutions are now using the economic crisis as a means to make profit from the most vulnerable in our society.
>
> [...]
>
> The policy of lending rate caps coupled with increasing access to affordable credit would enable the poorest households to become financially independent, helping to provide a route out of personal debt, encourage saving practices and generate demand for local businesses in our deprived communities. It would also reduce the demand for social and welfare services and therefore relieve pressure on public spending.
>
> The government should therefore take urgent action to put an end to high cost predatory legal loan sharking for good and introduce lending caps to cover all forms of consumer credit. Many countries across the world have shown that such a cap is viable, we need to follow their lead.[2]

This campaign was cited in a speech supporting a ten minute rule bill (*Consumer credit (Regulation and Advice) Bill*)[3] introduced by Stella Creasy. Introducing the Bill she said:

> Loan sharks are now circling Britain's poorest families, watching them struggle financially and sensing a business opportunity. The chief executive of one of them has stated that as a direct consequence of the spending review, he expects to see a growth in his target market. Indeed, following 20 October, his share price has already risen 5%, dependent as it is on unemployment and poverty. Such companies offer loans to those for whom credit cards and banks are out of reach-mainly women, the low-paid and those with a poor credit history. Research suggests that

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2 Compass, direction for the Democratic Left, website at: http://www.compassonline.org.uk/campaigns/campaign.asp?n=10420

3 Bill 103 2010/11

> approximately 6 million people in Britain are in that position, some 1.5 million of whom are currently indebted to these pay-day lenders.
>
> My Bill reflects my experience of working in Walthamstow with the Movement for Change and local campaigners. It also supports work being done nationally by the Better Banking coalition, Compass and Citizens UK as well as other Labour MPs. We have seen first hand how this is a market without competition. Just six companies control 90% of the loans made, which means that they can set the terms of trade. Such companies make money by locking people into cycles of debt, with interest rates starting at around 272%, and rising up to 2,500% or more. If people miss a payment by a day, they incur a charge, on which interest is added, and then there are the administration fees and fines, on which more interest is added. If they get into problems, they can always borrow more, thus starting the cycle of debt again.[4]

The same Member had a debate in Westminster Hall where many of the same points were made.[5] Other Members have made similar attempts to control the sector. During the Report stage of the *Financial Services Bill,* Rob Marris introduced amendments that would have had the effect of capping interest rates. His speech, and that of Ms Creasey, touched on many of the issues, consideration of which, are crucial to an understanding of the issue.[6]

The issue was also the subject of a backbench Member's business debate, proposed, again, by Ms Creasey, on 3 February 2011.[7] Her motion proposed:

> regulatory powers that put in place a range of caps on prices in areas of the market in unsecured lending which are non price-competitive, likely to cause detriment to consumers or where there is evidence of irresponsible practice

The debate was an excellent demonstration of the depth of feeling on this issue.

The rest of this Note looks at various economic aspects of the argument over the reform and functioning of the HCC market.

4 HC Deb 3 November 2010
5 HC Deb 9 November 2010, c21WH
6 HC Deb 25 January 2010
7 HC Deb 3 February 2011 c1060.

2. Is the consumer credit market a competitive one?

Size of market

A brief description of the size of the market can be found in various reports refereed to later in this paper. In one, the FCA noted,

> The CMA found that total payday loan revenue in 2012/13 was £1.1 billion, with 10.2 million loans issued, worth £2.8 billion. This was a significant increase on the previous year although the rate of growth has since reduced substantially. There were 1.8 million payday loan customers in 2012/13, and the average customer took out six loans in a 12‑month period (with 40% of customers using more than one lender in the year).
>
> **3.6** According to the CMA's figures, 83% of payday customers have taken out a loan online and 29% on the high street (with 12% having used both channels). The average loan was £260 (but £290 online and £180 on the high street).[8]

There is a strong prima facie case for regulation if a market is not competitive. Under 'normal' free market rules, if a company charges 'too much' for a product and hence makes 'super-normal profits' other companies will enter the market to undercut them and earn their share of supernormal profits. This continues until all companies in the sector are earning something like normal profits. Very few markets, or sectors, are as flexible as economic textbooks describe – established firms with strong reputations often have an advantage over newcomers and can sometimes maintain price premia for a sustained period (at least one lager manufacturer boasts of its beer that it is "reassuringly expensive").

The classic reasons for the long-term existence of a monopoly and hence super normal profits include:

- High costs of entry – it costs a lot to set up a new aircraft manufacturing company, or to build a nuclear power station for example; rather easier to open a cafe or set up as a gardener.
- Regulation – rules to control an activity by their nature limit new joiners and thus give an element of protection to those that qualify. This applies to banks and consumer credit companies as well as doctors, dentists and nurses. The 'cost' of the regulation is calculated to be less than the risk of having one's teeth removed by an unqualified person.
- Uniqueness – unique or exceptional abilities can generate a monopoly position because, by definition, no-one else can replicate it. Patents may have a similar impact. Microsoft, for example, has been accused of exploiting its opposition to keep out potential competitors. Commoner examples of a unique set of attributes contributing to super normal profits can be found at football matches – "there's only one Wayne Rooney".

Applying these three reasons to the consumer credit market, only the second truly stands out. The main cost of entry is raising the initial

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[8] FCA; Proposals for a price cap on high-cost short-term credit, p15

capital to lend. This is harder post credit crunch than before[9] but since the criticism of the sector applies to the pre-crunch period, one must conclude that it was not a serious barrier to entry.[10] Whilst not denying that some companies might be better or more efficient than others, there is no obvious 'uniqueness' barrier to entry. The process is relatively straightforward – raise money, lend it, get it back.

This leaves regulation. Is it the case that the regulatory barriers to setting up as a lender have the effect of reducing competition? In a sense yes, that is why true loan sharks – the unlicensed money lenders – exist. But it is doubtful if policy makers see this as a problem. Ignoring the unlicensed sharks for now, do the current rules make it difficult for a respectable institution to set up?

2.1 Licensing

The main barriers to entry in this market are regulatory – lenders have to be licensed. The main legislation is the *Consumer Credit Act* 2006 which substantially updated the old 1974 Act. The Department (now BIS) provide an outline to the Act:

> The Consumer Credit Act 2006 updates and amends the Consumer Credit Act 1974, establishing a fairer, more transparent and competitive credit market.
>
> It does this by:
>
> strengthening consumer rights by enabling consumers to challenge unfair lending agreements and making it possible for disputes to be resolved more easily
>
> improving consumer credit regulation by strengthening and improving the licensing system for consumer credit businesses, requiring consumers to be provided with minimum standards of information, and through targeted action to tackle unfair practices
>
> increasing the effectiveness of regulation by extending protection to all types of consumer credit and creating a more suitable regime for business[11]

The licensing provisions can be found in Section 21 of 1974 Act: "All consumer credit business or a consumer hire business or an ancillary credit business" require a licence.[12]

Details of the licensing arrangements can be found on the Office of Fair Trading (OFT) website. They provide the following advice for applicants:

> On 6 April 2008 certain changes to the statutory test of fitness to hold a consumer credit licence came into effect. These changes result from the Consumer Credit Act 2006. As a result we now apply a more rigorous test of fitness to those applicants who apply for certain categories of licence that we consider pose a

[9] Post the credit crunch the secured nonstandard sector has declined almost to nothing. In the HCC non-mortgage market several lenders have withdrawn completely such as Welcome, Blackhorse, CitiFinancial and HFC Beneficial.

[10] the OFT did identify a barrier to entry in the home credit market – see below.

[11] Department of Business Investment & Skills website at: http://www.bis.gov.uk/policies/consumer-issues/consumer-credit-and-debt/consumer-credit-regulation/consumer-credit-act-2006

[12] Consumer Credit Act 1974 s24A (4)

> higher risk to consumers. Those applying for these categories have to satisfy the OFT that they are both fit and competent to engage in higher risk activities.
>
> **All traders should therefore only apply for those licence categories that cover the activities they propose to carry out in the course of their business**. Applying for a high risk category which you do not need will mean that your application will be subject to more detailed scrutiny and you will be required to provide additional detailed information that otherwise would not be required. We may also need to visit you onsite. This may add to the time taken to process your application.
>
> **Consumer Credit Directive**
>
> The Consumer Credit Act and regulations are changing as a result of implementation of the Consumer Credit Directive (CCD). Regulations were laid on 30 March 2010 and are due to come into force on 1 February 2011. It will however be open to firms to comply before then if they choose. Details can be found on the Department for Business, Innovation and Skills (BIS) website.[13]

The OFT guide to the applications procedure includes material about the 'fitness' and credit competence' tests. 'Fitness' includes:

> evidence:
>
> - of any past misconduct
> - of the skills and knowledge that you and the people participating in your business have in relation to the licensed activity and any relevant experience, and
> - of the practices and procedures that you propose to operate in the running of the business[14]

'Credit competence' includes:

> We consider the skills, knowledge and experience of you and those participating in your business to carry out the activities covered by your licence to a reasonable standard. We also consider the practices and procedures you propose to operate in connection with your licensable business activities. Our consideration of your credit competence relates only to the credit activities to be undertaken under the credit licence, not competence to run the business generally.
>
> 2.7 All licensed businesses are expected to be competent to carry out the regulated activities for which they hold a licence. The levels of competence required and the corresponding type and degree of information we will seek from you will differ according to the categories of credit activity you engage in or propose to engage in. As noted above, the OFT considers that some business activities pose greater potential risks to consumers than others. The OFT will focus its resources on the higher risk activities.[15]

Current licence fees for a company are £970.

Of course, the sector is not just regulated at the entry stage. Regulations under the Consumer Credit Directive require lenders to provide adequate explanations to would-be borrowers. Lenders also have to meet OFT guidance on irresponsible lending and debt collection.

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13 OFT website
14 OFT, General guidance for licensees and applicants on fitness and requirements, p3
15 Ibid p6

Trading Standards Officers support the work of the OFT in ensuring that credit businesses comply with advertising regulations.

An example of the OFT's its ongoing monitoring work was given in the following press release:

> The OFT has taken action to address unsatisfactory business practices of payday lender CIM Technologies Ltd, known as Tooth Fairy Finance.
>
> Tooth Fairy Finance is a payday lender which typically lends amounts of between £100-£300 to students on a short-term basis via telephone or SMS.
>
> The OFT has imposed requirements on Tooth Fairy Finance which set out that it must not:
>
> - vary the repayment date or amount payable in respect of the loan, unless this is specifically agreed in advance with the debtor
> - trade using names other than those permitted by its credit licence
> - levy debt collection charges that are disproportionate to the amount owed.
>
> The company must also appoint a suitably qualified person to advise on, and administer as necessary, legal and regulatory compliance.
>
> Failure to comply with these requirements could lead to a fine of up to £50,000 per breach or to action by the OFT to revoke the company's credit licence.
>
> The OFT is also working with the Consumer Finance Association (CFA), the trade association for payday lenders, to promote higher standards across the payday loans sector.
>
> Ray Watson, the OFT's Director of Consumer Credit, said:
>
> 'Payday lending provides access to credit for consumers who have limited choices. It is imperative that those who offer payday loans do so responsibly and in accordance with the law. Where we are not happy with a business' lending practices we will not hesitate to take action to protect consumers.'[16]

Views may differ on whether this vetting procedure and subsequent regulations are strict enough to impose a serious barrier to entry for new firms wishing to join. However, comments made in Ms Creasey's speech suggest that they are not:

> We are here today to talk about the growth of the high-interest legal home credit market-a relatively recent phenomenon in the UK, and an industry that originated in America. As a result, many of the companies operating here are "exporters", either working online or in our town centres. A good example is Dollar Financial, a US-based lender that operates under the trading name of the Money Shop in the UK. The Money Shop has expanded from just one store in the UK in 1992, which dealt primarily with cheque cashing, to 273 stores and 64 franchises across the UK by 2009.

[16] OFT press release 9 November 2010

> Now, in communities such as mine in Walthamstow, these companies litter our high streets.[17]

The OFT Report - *High Cost Credit* – found that generally the market was open to new entrants, although in the pawn broking and home credit markets new entrants were likely to be small and hence unable to significantly affect market competitiveness. As the quote above regarding Money Shop indicates, this is not the case for payday loans where new entrants are generally larger.

Box 1:

By virtue of the *Financial Services Act 2012*, as of April 2014, regulation of the consumer credit market passes to the Financial Conduct Authority. Regulation will henceforth be by FCA rules rather than by the less flexible structure of legislation. FCA 'Permission' will replace the old licensing system. The impact on the competitive aspect of the market will be seen in time. The FCA has, as one of its statutory operational objectives, a competition objective to pursue.

2.2 Competitive pressures: the OFT Report

In her speech in Westminster Hall, Ms Creasey said that the market was highly monopolistic, "Six lenders account for 90% of the home credit market-Provident accounts for 60%-so there is little competition to drive down interest rates."[18]

Effective competition in any market is notoriously difficult to gauge. One needs to first define the market. Has it got any close competitors? In this case, does one view the home credit market as a discrete entity, or is it better to see it as part of a wider credit market? Are Payday loans effective substitutes for home credit or not? If one thought that credit cards, for example, were an effective substitute for home lending then this clearly reduces the overall levels of concentration. If mainstream banks were included, concentration levels become tiny.

Furthermore, simple percentages do not tell the whole story. Taken together, at the start of 2010 the big six supermarkets had 96% of the grocery market between them and yet, the sector is intensively competitive, mainly because customers are mobile and have good product information and the alternatives in other shops.[19] As comments from the OFT will show, the absence of some of these factors are significant contributors to lower levels of competition in parts of the HCC sector.

In its report on high cost credit the OFT defines the market as including "pawn broking, payday and other short-term small sum loans, home

17 HC Deb 9 November 2010, c23WH
18 HC Deb 25 January 2010 c24
19 Source: Kantar Worldpanel, February 2010

credit and rent-to-buy credit".[20] It concluded that there were some competitive issues with the sector:

> Second, and notwithstanding these comments, there are problems with the effectiveness of competition in these markets:
>
> - on the demand side, there is relatively low ability and effectiveness of consumers in driving competition between suppliers, given their low levels of financial capability
>
> - on the supply side, sources of additional supply such as mainstream financial suppliers seem to be limited, and
>
> - in such circumstances, competition on price is limited and there appear to be some suppliers charging higher prices than would be expected.[21]

In more detail it found:

> There appears to be little substitutability on the demand side between payday lending, pawn broking and home credit, because of:
>
> - different lending criteria by lenders, which result in different demographics for borrowers of different products, and
> - different inherent characteristics of the products, such as the length of the loan period, which limit the choice of products for different groups of consumers, because of affordability constraints.
>
> On the supply side, substitutability opportunities appear to be limited, since different products require different business models and skills. As a result, most suppliers specialise in offering one product. The most notable exception is the joint provision of payday lending and pawn broking, which are frequently offered by the same suppliers who take advantage of economies of scope by better utilising their high-street premises to attract a broader range of customers.[22]

The OFT therefore concluded that each subsector should be viewed as a separate market, hence it is valid to take the 90% market share figure quoted above. Its view on the competitiveness of each sector is shown below:

> Payday lending
>
> 2.12 While the rates charged by payday lenders are high, they can be lower than for some mainstream alternatives such as unarranged overdrafts.
>
> 2.13 Price does not seem to be a primary driver of competition, with suppliers attracting customers with the convenience and speed of the application process. An increasing number of suppliers are operating in the market and appear to compete with each other with different means to attract the growing demand. However, consumers do not seem to drive competition since they do not usually shop around for the best price.

20 OFT High Cost Credit Final Report, June 2010 p3
21 Ibid p4
22 Ibid p18

> 2.14 We are concerned by the confusion that brand proliferation is likely to be causing, in preventing consumers that do shop around from doing so effectively.
>
> Pawnbroking
>
> 2.15 The number of pawnbrokers across the country, the likely low level of barriers to entry (especially for established jewellers) and the low level of concentration suggest that this is a reasonably competitive market.
>
> 2.16 Competition on price appears mostly absent however, with customer service being the most relevant driver of competition. Protecting brand reputation and establishing trust with consumers are important competitive factors.
>
> Home credit
>
> 2.17 The market for home credit is highly concentrated, with one large supplier in the market. This market structure, combined with the lack of price competition, the presence of barriers to entry and expansion (in the form of the need for a network of agents, costs of business acquisition, importance of personal relationship with the agent and word of mouth advertising) imply that competition is limited and not very effective in this market.[23]

This section of this Note began by outlining the theoretical link between competitive markets and the existence of 'super normal' profits. The OFT also looked at the sector's profitability. It found that the evidence varied between sectors:

> We have found some evidence that levels of profit among pawn-brokers and providers of home credit are higher than those that might be expected in a competitive market. However, due to the small size of our sample in both cases, this conclusion can only be very tentative. Profit levels among payday lenders are more variable: some established providers appear to be making relatively high profits, but there is evidence of losses among new entrants. In the retail credit market, the majority of firms appear to be making returns on the credit they offer below those that might be expected in a competitive market. This result appears to support the view that firms providing both goods and credit may recover some of the cost of providing credit through increased levels of retail prices for the goods sold.[24]

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[23] Ibid p19
[24] Ibid p35

3. Why is high-cost so high?

The most eye-catching (or watering) feature of HCC is simply that the advertised interest rates are so high compared to 'normal' interest rates which the majority of the population are used to paying on bank loans, their mortgage or on overdrafts. Ms Creasey gave an example in her speech:

> In the "home credit" market, [...] loans range from £200 to £500 and have to be paid back over the course of a year. Although the companies involved claim not to charge for missed or late payments, if someone borrows £300 they have to pay back about £10.50 a week, which adds up to some £540 over the course of a year. That means a typical annual percentage of rate of 272%, compared with the 9% or 10% APR that is often offered by mainstream banks.[25]

In its 2010 consultation paper on the Social Fund, the Department of Work and Pensions gave the range as being "Typical Annual Percentage Rates (APRs) of interest range from 272 per cent to 545.2 per cent" for the HCC sector.[26]

The table below gives a snapshot of loan rates as at November 2010. It is not an exhaustive study and the author accepts that had the application process gone (for the sake of his own credit rating he did not actually make multiple applications) the actual terms and conditions of lending might differ from those given at the enquiry stage. However, it represents the truthful findings of an hour or so reasonably diligent searching across websites and advertisements.

Consumer credit loan availability

	Interest rate APR	Minimum amount £'s	Minimum Term	Criteria
Halifax	22.9%	1000	12 months	No CCJs, Must be in employment, Existing customer
Natwest	21.0%	1000	12 months	No CCJs, regular income, Existing customer
Lloyds TSB	20.9%	1000	12 months	No CCJs, regular income, Existing customer
Nationwide	24.1%	1000	12 months	No CCJs, must be in employment, existing customer
HSBC	19.1%	1000	12 months	Current account holder with minimum £700 per month into the account
Co-op	19.9%	2000	12 months	Minimum income of £10,000, homeowner or have a debit or credit card
Santander	18.9%	1000	12 months	Over 21, no CCJs, work more than 16 hours a week
Ocean Finance	17.1%	3000	3 years	Consider all circumstances' incl self employed, retired, CCJs and bad credit history; but loans are secured on property
Provident Financial	272.0%	50	1 week	Unemployed, CCJs, bad credit, no credit
Moneyshop	260.2%	90	1 week	Full time employment, bank account

Several things emerge from the table of loans shown above.

First, there is a very clear distinction between the size of mainstream lenders' loans and those in the HCC sector. The smallest loan available from the banks was £1,000. By contrast home credit loans tend to be up to £500 (£200 on average) and other lenders provide loans as small as £50. Pawnbrokers are not included in the table above however, one

[25] HC Deb 9 November 2010, c24WH
[26] Social Fund Reform, pp1.19 DWP, 2010

local to the House says that they are "able to exchange cash from £50 to £1 million".[27]

Second, the term over which the banks lend is very different to what the HCC sector operates in, or can operate in. In practice, most home credit loans last for about a year. Other HCC loans are for even shorter periods than this. Banks are not very interested in making loans over a short period.

Third, the delivery of the loan and the only option for repayment is by electronic transfer to an account by the banks, not by cash, which is the normal way of other mediums – especially the home credit market.

Fourth, most of the bank loans are closed to:

- people with any blemish on their credit record;
- non-customers;
- self employed or unemployed people; and
- in the case of Ocean Finance the loan is closer in comparison to a mortgage than the unsecured loans in the rest of the table

Fifth, the interest rates shown in the table are generally described as 'typical' rates. In practice, the rates offered by the big banks at least are frequently much higher for anyone other than a 'perfect' applicant. There is less variation with the HCC rates – most of their customers have poor credit records to start with and few people with good records need apply as they often have access to other ways of meeting short term financial needs, e.g. credit cards.

From this table it is clear that the person with £700 in their account each month, who can apply for, to take one example, an HSBC loan, is unlikely to want, or need, to apply for a £100 loan from Provident.

Box 2: "Buy me a pint"

The choice of interest rate comparator is the annual percentage rate (APR). This measure and the way that it is calculated are set by the CCA 1974 as explained on the OFT website:

> The APR must be included in credit agreements and pre-contract information. A typical APR must be included in most credit advertisements. This is intended to help consumers to compare the cost of different credit deals.
>
> The APR is based on the total charge for credit (TCC) which includes interest and other charges which affect the cost of borrowing - even if they are not payable under the credit agreement itself. The APR is an annualised rate reflecting the timing of such charges, as well as the rates and amounts.
>
> The rules for the calculation of the TCC and APR are set out in the Consumer Credit (Total Charge for Credit) Regulations 1980. These include a number of assumptions which must be used where information is unknown or cannot be calculated accurately.
>
> In the case of credit cards and other running-account credit, the assumptions are modified by the Consumer Credit (Advertisements) Regulations 2004 and the Consumer Credit (Agreements) Regulations 1983 as amended in 2004.[1]

Both sides of the HCC argument would probably agree that using the APR as the price comparator is not ideal for loans that are for much shorter periods of time – for example payday loans. Advertisements by such companies include the APR but direct customer's attention more strongly towards the actual cost of the loan - £10 as opposed to 250%. The consumer money 'expert' Martyn Lewis, in evidence to the Treasury Select Committee, gave the following example of the difference between the perception generated by quoting APRs and 'real' money costs might have –

[27] Suttons & Robinsons pawnbrokers

psychologically at least:

> I get so many e-mails and messages from people saying, "I've just seen an advert for a company charging 2,300% interest, that's disgusting, it should stop"-is that I did a pet calculation the other day which showed that if I lent you £20 and said, "Pay me back a pint of beer next week; buy me a pint for it," and the pint cost £3, that's 141,000% interest, if you compound it. Yet most people would say, "Buy me a pint and £20, is a pretty reasonable deal."

If one accepts that the market for mainstream credit and that for HCC are distinct and does not exert much in the way of competitive pressure on each other, the next question to ask is if there is any justification for HCC APRs to be ten times those of the mainstream lenders?

The HCC industry stress that the comparison is false. They point out that if you only look at the APR it's unlikely to give an accurate idea of what you will end up paying, particularly if you miss a payment at some point. At one end of the spectrum, the APR for home credit is completely all in - there are no extra charges even if a payment is missed or made late and in this market both are very common. By contrast, for a bank overdraft the APR is more of a 'price label' and things like arrangement fees or any penalties incurred during the course of the loan can quite legally be excluded. If the home credit lenders charged, say, for each visit made by an agent, they too could reduce the headline APR rate but this would leave the borrower no better off.

In the case of home credit, the fact that the cost of credit is fixed at the outset, means that any extension of the loan term, through missed payments for example, significantly reduces the actual, ex-post, APR paid.

These, not insignificant factors aside, the table above suggests that current loan rates for a person with a good credit score, from a mainstream bank will pay about 20% for a loan of no less than £1,000 over a period of a year or more. Each of those elements provides a reason for interest rates being higher in the HCC market:

- The likelihood of default on the loan is much higher so the lender needs to build in a bigger margin to reflect this. Non HCC lenders have various options open to them to reduce the risk of default. Bank loans to non-existing customers are now rare; hence, the bank has some sort of security on its loan if it also has the person's current or savings account with it. Penalties, see above, are another way of managing risk.
- The fixed costs of arranging the loan have to be spread over a much smaller principal (the loans are smaller)
- The fixed costs of arranging the loan have to be spread over a much smaller period of time (the loans are shorter)

Additionally:

- The HCC market borrows from the banks and capital markets for funds – banks have access to 'free' deposits for at least part of their funding
- The HCC market has additional costs of cash handling – most loans are made as cash or as a cheque

- In the case of the home credit market at least there are significant costs of agents visiting the borrower to assess the loan and then calling weekly to collect repayments

Given all this, one would expect interest rates in the HCC sector to be well above the 20% level, but is 270% justified?

In March 2009, the Joseph Rowntree Foundation funded a study with the title - Is a not-for-profit home credit business feasible? The researchers built two business models largely on the lines of existing home credit practice the main features were:

- low-value loans over short terms (similar to those offered by commercial lenders);
- a single fixed price with no penalties for late/missed payments or extended terms;
- weekly in-home collection, with some flexibility around payment irregularity;
- using agents paid solely by commission on collections made; and
- limited debt recovery.[28]

It also assumed that agents would earn £10 an hour from their rounds, but excluded any cost of funds and any centralised costs of training of agents etc. The Report's conclusions are shown below:

> Even on a not-for-profit basis, the cost of home credit would be high in order to make the service financially sustainable. The first-generation model (based on existing third sector lenders) had a break-even APR of 129 per cent on an average 56-week loan of £288, compared with a current advertised APR of 183 per cent for one major commercial lender. The second generation model (based on a stand-alone lender and no transitioning of customers) had a slightly lower break-even APR of 123 per cent for a similar loan. Both models would become cash positive by year five, given an investment of £18 million. It was assumed that public subsidy or social business investment would cover this investment and the cost of lending capital. If this were not the case, the APR would be significantly higher. On the second-generation model, an APR of 123 per cent would imply a customer saving of £50 on an average 56-week loan of £288, compared with commercial home credit. This would equate to a little under £1 a week.
>
> In a social lending context, an APR of 123 per cent might be unacceptably high. But the models showed that if APR were reduced to 100 per cent, the investment required over ten years would rise sharply, to nearly £90 million. Customer savings on the average loan of £288 over 56 weeks would be £72 (£1.29 a week on repayments), compared with using a commercial home credit provider. With an average frequency of 2.34 loans a year, this would translate to a saving of just under £170 a year.[29]

[28] Joseph Rowntree Foundation, *Is a not for profit home credit business feasible*; summary
[29] Ibid

It concluded therefore, that with a public subsidy, a non-profit making organisation would set interest rates at about 120 -130% on its loans. This is substantially lower than current rates in the sector but, and this is a rather large but, all of the HCC lenders are companies seeking to make profits and none have a public subsidy.

The study was conducted with participation from various organisations with an expert interest in the issue including the National Consumer Council and the Association of British Credit Unions, in an attempt to discover whether existing third sector lenders, such as the credit unions could supply home credit. The reaction of these groups to the study is reported below:

> The original assumption was to operate the new service through existing third sector lenders – credit unions and community development finance institutions (CDFIs). Discussions of the business model with these providers indicated that they were broadly supportive of the initiative and agreed with the underpinning assumptions. However, they had limited appetite for becoming involved in its delivery.
>
> The high APR was a major concern, especially when seen alongside the relatively small cash saving to customers. Credit unions are, in any case, restricted by legislation from charging an APR in excess of 26.82 per cent. Third sector lenders were also concerned about potentially high levels of default. The experience of serving financially excluded borrowers under the Financial Inclusion Growth Fund has created a new appreciation of the challenges involved in serving high-risk borrowers.
>
> After many years of subsidy, some third sector lenders are moving towards financial sustainability, and there were fears that involvement in a high-risk home credit service could jeopardise this. With many competing demands for new services for people who are financially excluded, third sector lenders saw developing a home credit service as a diversion, and likely to work against efforts to scale up the sector.
>
> In view of these reservations, a stand-alone not-for-profit provider would seem to offer the best way forward. More work would be needed to investigate the feasibility of this and the type of body that might be set up to deliver the service. One possibility would be a stand-alone CDFI, owned by a group of third sector lenders or one of the two main trade bodies – ABCUL (Association of British Credit Unions Ltd) and CDFA (Community Development Finance Association). Another option would be to establish a new friendly society.

'Expand the credit union movement' is a frequent policy response from many who wish to see that movement put the HCC lenders to the sword. But, the fact that "The experience of serving financially excluded borrowers under the Financial Inclusion Growth Fund has created a new appreciation of the challenges involved in serving high-risk borrowers" and has dissuaded them from rising to this particular challenge, illustrates the difficulties in providing substantially cheaper alternatives to what current commercial companies offer – without a substantial public sector investment. An assessment of the success of the Growth Fund was published by the Treasury in January 2011.[30] The finding most relevant to this aspect was that on average credit unions lost £70 plus per loan and that a 'break-even APR for them was nearer to 70% to make such lending viable in the future.

This finding also presents a difficulty for those who advocate interest rate caps as a way of dealing with the problems 'caused' by HCC lending. If 130% is some sort of interest rate 'floor', what is the 'ceiling'? Neither successive governments, nor the competition authorities appear to want the HCC sector to disappear. For all its supposed ills, unless this sector truly simply creates its own demand, a demand for credit from those people excluded from the mainstream lenders will continue. If the licensed HCC sector did not exist, the options for this group are not great: unlicensed lenders have more potential customers. If this outcome is not to be desired the calculation of a 'ceiling' might be 130% + profit + removal of public subsidy =? Potentially this number could be not far from what is advertised now, it certainly looks as though the number would be, in political terms, unattractive and, in practical terms (measured by amounts saved per week for example), be rather small. In its review the OFT specifically rejected price controls (interest rate caps):

> We are aware that price controls can represent an efficient way to address concerns around high profits among suppliers and could, initially, limit the headline prices paid by consumers in the high-cost credit sector. We are, however, also aware that the strategic responses by suppliers to price controls may lead to an outcome in these high-cost credit markets which is unlikely to be of benefit for consumers.
>
> The imposition of price controls in high-cost credit markets creates a risk for suppliers that they would generate lower profit levels. It would be reasonable to expect these suppliers to respond to the imposition of a price control by seeking to regain such lost profit by restricting the type and risk of consumers that they are willing to supply. In an extreme case of a highly restrictive price control for high-cost credit, some suppliers could cease offering a particular product or exit the market entirely.
>
> This potential for reduced access to high-cost credit would be of concern for the following reasons:
>
> - The supply of high-cost credit is already constrained, with many consumers having limited options and in some cases few practical, alternatives to high cost credit (particularly in the short term).
> - Many consumers using high-cost credit are using this for non-discretionary expenditure. Any reduction in access to this would have a significant impact on their ability to manage their finances effectively.
>
> We also consider that the development of a system of price controls for high cost credit in the UK would be complex, expensive and difficult to administer for the following reasons:
>
> - There are a number of different high-cost credit products available at different prices with different costs based on

[30] Evaluation of the Financial Inclusion Growth Fund, HM Treasury, January 2011. Other, older, material on financial inclusion can be found on the Treasury site here.

the product characteristics and target consumers. Imposing price controls would be difficult in these markets, as detailed investigations of the pricing and profits of suppliers would be needed at a product-by-product level.

- The imposition of price controls may lead to suppliers of high-cost credit responding by imposing a more stringent regime for late payments and default. We would be concerned with such an outcome, as these charges are not always transparent to even the most savvy of consumers. The low incomes of many consumers of high-cost credit would also increase the concerns around the impact of such changes if they were to occur.
- Circumvention of price controls is a relatively common problem for jurisdictions that already have a form of price control, and is likely to be the case for high-cost credit. While designing a sophisticated price control with substantial resources devoted to monitoring compliance could reduce the instances of known circumvention, the need for different controls for the range of high-cost credit products would make the possibilities for circumvention difficult to eradicate and manage on a proportionate basis.[31]

Put very simply, if the high cost lenders were forced to charge less for loans they would either find ways to wriggle around the rules or stop providing the loans. Since it is unlikely that the borrowers would simultaneously stop needing to borrow, borrowers would be forced to borrow from other sources, possibly even more expensive unlicensed lenders. For further reading on this readers may like to look at an academic study on the supply of credit to poor households commissioned by the Joseph Rowntree Foundation: Affordable credit for low income households.

[31] OFT High Cost Credit Final Report, June 2010

4. Cheaper alternatives?

If little can be done to substantially reduce the cost of HCC market loans, can other sources of credit provide cheaper options?

4.1 New banks

Successive governments have hoped that the structure of the banking industry post-crisis will change and that new entrants will provide increased competition to the established banks. So far, Metro Bank, has opened four branches in London. It encourages new customers to 'join the revolution' and emphasises new levels of service and convenience, in terms of access to credit however, it follows a traditional path with loans available from £1,000.[32] The supermarket chain Tesco is believed to be preparing to offer cheque accounts and mortgages in time, but its current loans, like those from other supermarkets, have a familiar, exclusive, set of conditions attached:[33]

Tesco Personal Loan - Are you eligible?

To apply you need to meet these requirements. Please tick the boxes to confirm you:

- ☐ Are aged between 18 and 74, earning over £10,000 a year
- ☐ Have a bank or building society account
- ☐ Have a good credit history
- ☐ Have a permanent UK address

At some time in the future, a reincarnation of the Northern Rock Bank might yet emerge. Possibly it could be owned by another existing finance company (Virgin Money was interested in buying it after it failed) although there have been calls for it to be re-launched as a mutual society. Alone however, it is unlikely to make a huge impact on the credit supply in the UK and it is likely that it would operate outside of the HCC customer base.

If these options are no solution the longer term hope for an 'assault' on the HCC sector rests, as it has done for many years, with a rise in alternative lenders, of which the credit unions are by far the most numerous and well supported.

4.2 Credit unions

Credit Unions are financial co-operatives owned and controlled by their members. They offer savings and great value loans plus they are local, ethical and know what their members want. Each Credit Union has a common bond which determines who can join it. The common bond

32 Details of other qualifications and lending criteria were not readily available on the website
33 Tesco Finance website: http://www.tescofinance.com/personal/finance/finance/loans/apply.jsp

may be for people living or working in the same area, people working for the same employer or people who belong to the same association, such as a church or trade union. As financial co-operatives, credit unions are part of the long established and fast growing co-operative movement in Britain.[34]

A fuller account of the development and history of government support for credit unions can be found in another Library standard note (SN/BT/1034). Current new initiatives are contained in the *Co-operative and Community Benefit Societies and Credit Unions Bill*.[35] In brief, credit unions have had considerable support from successive government attempts to allow them to grow and develop their services. They are generally seen as the archetypal 'good thing' in financial services offering a limited range of financial services – savings accounts and loans – at very good rates of interest, with low rates of default. But do they provide the answer to the HCC 'problem'?

Credit unions in Ireland and Northern Ireland have a much greater presence than they do in Britain and are often cited as an example that should be followed. A Treasury/Department of Enterprise Trade and Investment consultation paper notes:

> Credit unions in NI date back to the early 1960s. There are 180 credit unions, with over 400,000 members, serving 50 per cent of the adult population. In addition to the two main trade bodies, the Irish League of Credit Unions (ILCU) and Ulster Federation of Credit unions (UFCU), the Tyrone Federation with 13 members and several other independent CUs complete the total.[36]

The attraction is their localism, cheap loans and easy savings facilities. Under the current legislation the maximum loan a credit union may make is £15,000 on top of whatever savings a member has. Average loans are in the region of £3,000 but can be much smaller. Loan interest is capped at 1% per month on a reducing balance basis – thus avoiding one of the problems associated with over indebtedness from some HCC lenders here where arrears accumulate interest and problems are literally compounded. Loans are assessed on an ability to pay basis, possibly after just a short period of regular savings, which allows individuals with otherwise poor credit ratings access to funds. The network of independent institutions also benefit from support from the central Irish credit union organisation (the Irish League of credit unions) which, funded by levies from each union, provides extra services from the centre such as loan insurance and savings protection.[37]

Given these advantages, one might wonder how normal banks (in Ireland) get any customers at all. Clearly there are, even in a country with such an established network (there are over 500 credit unions in Ireland with 2.9 million members - almost half of the country),

34 Definition from Co-Operatives UK website
35 Bill 14 – 2008-09, for copy of Bill see http://www.publications.parliament.uk/pa/ld200809/ldbills/053/09053.i-i.html
36 Proposals for regulatory reform of credit unions in Northern Ireland; HMT / DETINI, March 2010
37 The following information about the Irish network was gained by interview with a Northern Ireland credit union manager

constraints on how big it can grow and the extent to which it can supplant other lenders. These constraints include:

- Credit unions don't offer the full range of banking services one would expect from a bank such as money transmission services and debt payments.
- Many of the people who run credit unions are volunteers. Only about 1/3 are employees, mainly involved in credit assessment and loan management. The movement can only grow as fast as a continuing supply of volunteers allows it.
- Access – linked to the volunteer staff dependency, access to credit unions is limited. Some approach normal working hours others may open for only a few hours a day, or a few days a week.
- No fractional lending. The credit unions can only lend that money which they take as deposits, and then only a portion of that. They do not have access to capital markets to borrow wholesale in the way that the HCC does.
- Credit unions don't have the advertising and marketing budgets that the big financial firms do and hence have a far lower profile.

Theoretically, compared to Ireland and Northern Ireland, there is tremendous potential growth for the credit union movement in Britain. According to 2009 figures, in Britain there are only 453 credit unions with less than 800,000 members.[38] To put the question of whether credit unions could supplant the home credit business into context, Provident Financial the main, but not sole, provider in this market has 1.8 million customers. Therefore, to replace just this one segment of the HCC market would require the credit union movement to more than double in size. This is no small challenge.

A report commissioned by the Friends Provident Foundation (a charity "working for improved access to appropriate financial services for those who are currently excluded")[39] makes the point that the credit union movement in the UK, rather than expanding is currently contracting. The difficulty in 'scaling up' despite official support is described below:

> A major purpose of the credit union movement is to encourage savings and promote the 'wise use of money'. This is often reflected in the requirement for individual members to save before being entitled to apply for a loan. As part of the co-operative movement there is an ethos of helping to providing affordable loans to those who mainstream providers may turn away or otherwise discourage. Since 2005 credit unions in Great Britain have been able to charge a maximum of 2 per cent per month on loans (previously 1 per cent), and pay dividends of up to 8 per cent.
>
> [...]
>
> Given the need to cover administrative and other expenses, offering short-term affordable credit in amounts often in the range £100–£1,000 creates serious challenges to those managing individual credit unions. Small, volunteer-run credit unions have in the past been viable given sufficient individual commitment and a limiting common bond to help reduce the risk of loan default.

38 World Council of credit unions database 2009
39 Friends Provident Foundation website

> As individual credit unions have grown in size and increasing numbers of paid staff are required to run day-to-day operations, major issues arise as to what can be expected from third sector lenders in terms of development towards becoming self-sustaining organisations. The questions around the best way forward for the movement if there is not to be a quasi-permanent state of dependence on grants, and other external forms of finance, may have become more rather than less acute given the impact of the policy agenda in recent years.[40]

The Report finds that the main driver of any growth in the movement since 2000 has been the influence of Growth Fund[41] capital support. This has dramatically increased the scale of those credit unions which used the funds and thus has polarised the sector significantly between the traditional small, and relatively expensive and inefficient lenders and a few bigger unions with substantial loan books. However, what has not happened is that the growth fund money has not generated increased deposits or membership by anything like the same amount. Therefore, the biggest unions are heavily dependent on state grants for their continued lending. There are signs that there is a loan book of about £2 million which, once reached, gives a credit union a chance of cost effectiveness and self-sustainability. Even the best example of a growing credit union – Bristol – is only approaching this figure:

> A similar pattern is repeated elsewhere among those that have grown more quickly – Bristol credit union, with a loan book approaching £1mn and more than 1,200 loans at the end of 2008, is one of the most rapidly growing credit unions in England and Wales following mergers in the middle of the last decade. In 2009 the city-wide credit union had developed to the point that it employed a total of 13 staff and is seen as one of the major forces promoting financial inclusion nationally.
>
> While the scope of its work continues to expand and partnerships are developed with social landlords and others, its own website pertinently comments that scale economies are helping to develop 'a more sustainable credit union'. The acute question of how far towards sustainability the credit union will move and when it might be achieved is, as elsewhere, an open one. In 2002, Bristol Inner City credit union made 59 loans to its members and had an income of £16,000, of which 75 per cent was grants; by the end of 2008 while the credit union's loan income was growing dramatically, more than half of its total income was still coming from grants.[42]

The author sees cost containment; management of bad debts and the provision of central services as being key issues to be addressed if the credit unions are to become self-sustainable and capable of growing to the extent that they could provide a real alternative for borrowers currently using the HCC sector.

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40 Promoting the effectiveness and efficiency of credit unions in the UK p14, Steven Hope , Roehampton University

41 The Growth fund was a DWP scheme introduced in 2006. Grants were made to third sector lenders to fund additional lending to those who are financially excluded, i.e. loans without the normal prerequisite of savings required by credit unions (although not CDFIs), and also the capital to finance the loans given. At the end of a credit union's involvement with the funding, the capital becomes a part of the credit union's assets.

42 Promoting the effectiveness and efficiency of credit unions in the UK p22

4.3 Social Fund

Individuals and families in financial need may be able to get help through the social security and tax credits systems, but assistance from these sources is unlikely to be a realistic alternative to commercial or quasi-commercial lenders.

Until April 2013, the **discretionary Social Fund** provided grants and loans to meet particular needs. It consisted of:

- **Community Care Grants** – mainly to help enable people on certain benefits with independent living or continued independent living, preventing the need for institutional care;
- **Crisis loans** – for people faced with an unforeseen emergency or disaster which left them without funds, where there was a danger to their health or safety; or to help with living expenses pending a first payment of benefit; and
- **Budgeting Loans** – to provide help to claimants of out-of-work benefits with occasional or "lumpy" items of expenditure, such as furniture and household equipment.

Under provisions in the *Welfare reform Act 2012*, from 1 April 2013 Social Fund **Community Care Grants** and **Crisis Loans** (other than "alignment loans" to tide people over pending their first payment of benefit) were abolished and funding was made available to local authorities in England and to the devolved administrations in Scotland and in Wales to provide such assistance in their areas as they see fit. The money was not ring-fenced in any way. In England, each local authority is entirely responsible for its own local welfare assistance scheme, and various different models exist. Scotland and Wales have opted for national schemes (the Scottish Welfare Fund and the Discretionary Assistance Fund, respectively), although in both cases they are administered locally.[43]

Other elements formerly covered by the discretionary Social Fund remain the responsibility of DWP. Social Fund Budgeting Loans and alignment loans are being replaced by a new nationally administered advance of benefit facility. From April 2013, interim payments and alignment loans were replaced by "**Short Term Advances**". "**Budgeting Advances**" will replace **Budgeting Loans** for Universal Credit claimants, but Budgeting Loans will continue to be available to people claiming "legacy benefits" (the benefits UC is replacing) until all such claims have been closed or the claimants moved onto Universal Credit. For claimants of Pension Credit – who are not affected by the introduction of Universal Credit – "Benefit Advances" will replace Budgeting Loans.[44]

The following table summarises the position before and after April 2013.

43 For background to the changes see Library standard note, Localisation of the Social Fund, 10 November 2012
44 See the Library briefing, Short Term Benefit Advances and Budgeting Advances, 12 July 2013

Social Fund payments and Interim Payments of benefits: equivalent provision from 1 April 2013 onwards

Before 1 April 2013	1 April 2013 to the full introduction of Universal Credit	When Universal Credit is fully introduced
"**Interim payments**" of benefit – made when a person has made a claim for a benefit but a decision on their claim can't be made straight away or **Crisis Loan "alignment payments"** – loans to people in advance of their first payment of benefit	**Universal Credit Advances** or **Short Term Advances** (for claimants of "legacy benefits" – ie those benefits being replaced by UC – and certain other DWP benefits including contributory JSA, contributory ESA, Pension Credit, State Pension, Carer's Allowance, Maternity Allowance, Bereavement Allowance/Benefit, and Industrial Injuries Disablement Benefit)	
Crisis Loans (other than alignment payments) **Community Care Grants**	**Local/devolved welfare assistance schemes**	
Budgeting Loans	**Budgeting Loans** for claimants of "legacy benefits" or **Budgeting Advances** for UC claimants	**Budgeting Advances** for UC claimants or **Benefit Advances** for Pension Credit claimants

The introduction of local/devolved welfare assistance schemes has resulted in significant changes to the support available to low income families, both in terms of what is provided, and who can access it.

In a report published in July 2013, Nowhere to turn? Changes to emergency support, the Children's Society gave some findings from a survey of local authority welfare assistance schemes in England, based on Freedom of Information requests. Its findings included:

> The localisation is likely to have major consequences for access to interest free credit in emergencies – nearly two thirds (62%) of schemes were identified as no longer providing loans.
>
> Broadly, the cash assistance of the previous provision has been replaced by "in kind" support – such as food, clothes and second hand furniture - with four fifths (81%) of local schemes providing support directly through goods or services, other than in exceptional circumstances.
>
> Some local authorities are using the funding from the Social Fund to directly support local voluntary groups like food banks and local furniture projects.
>
> There was some concern that the qualifying criteria for accessing local support could create barriers to access for those who need support. In particular, some local welfare assistance schemes:
>
> > Prevent low income working families from making a claim, even when they are living in poverty
> >
> > Restrict eligibility for those able to access other sources of consumer credit

> Restrict access for those deemed able to rely on borrowing and support from friends or family
>
> Have lengthy residency periods (up to a year) before someone can make a claim.
>
> In many cases schemes specified that awards were restricted in cases where claimants had already received previous assistance. Around one in eight local authorities (14%) said that those who had received assistance in the last year could not reapply to the scheme. In a further quarter of cases (23%) it was specified that only two claims could be made.

Further information on the experience so far in England was given in an article in *The Guardian* on 27 November 2013, "Will council crisis funds last the winter? As local assistance schemes take over from the social fund, families may have to choose between 'heat and eat'".

Neither the Scottish Welfare Fund, nor the Discretionary Assistance Fund in Wales, provides loans.

DWP is provided funding for local/devolved welfare assistance schemes for this year and next (the total amount transferred to local authorities and to Scotland and Wales for programme funding and administration is £216 million in 2013-14 and £213 million in 2014-15). The Government has however said that funding will cease after 2014-15, meaning that local authorities and the devolved administrations will have to fund their welfare assistance schemes (if they decide to continue with them) from their general budgets. The Local Government Association has major concerns about this – see their press release issued on 24 February 2014, Government should rethink scrapping of £347 million emergency welfare fund, councils urge .

Looking ahead, there are also concerns that the introduction of Universal Credit could have implications for low income households' usage of high cost credit. Universal Credit is to replace all existing means-tested benefits and tax credits for working age families.

The DWP's default position is that the whole of Universal Credit, including any amount for children, will be paid to the household on a monthly basis in arrears, and as a single payment. The thinking behind this is that Universal Credit should mimic work and receipt of a salary. Couples can decide which partner should receive the payment, or choose to have the payment paid into a joint account.

A number of concerns have been voiced about this approach including:

- The challenge this will present for families not used to budgeting on a monthly basis, e.g. because they are paid wages on a weekly or fortnightly basis
- The possible impact on individuals within families – women and children in particular – if the money coming into the household is not shared in such a way as to meet the needs of all its members
- A single payment risks becoming a "single point of failure" – disruption or delay to a claim could leave a household with no support at all

The Government has said that there will be scope for "payment exceptions", but the main emphasis will be on budgeting support and alternative payment arrangements will only be available in exceptional circumstances and on a time-limited basis, if certain criteria (set out in guidance) are met.

Through the Local Support Services Framework, DWP is working with local authorities and other organisations to give additional support to families claiming UC. It is hoped that arrangements will be in place throughout the country to provide advice and assistance to UC claimants, including advice on budgeting to enable people to manage their money under UC's monthly payment arrangements and ensure that rent and cash flow is well managed. However, there is concern that these plans are still at a relatively early stage. There is also concern that the Government may have underestimated the problems families might face adapting to the UC system, and the amount of support that will be needed.[45]

Concerns have also been voiced about the proposal for a seven day "waiting period" before new Universal Credit claimants subject to work-related conditionality would become eligible for support. The Government argues that a seven day waiting period for UC reinforces its "work first" approach by sending the message that from the outset of the claim "rights to benefits are conditional on the requirement to search for work." Welfare rights organisations and pressure groups have pointed out that Universal Credit brings together support currently delivered by a number of benefits and that the potential loss to individuals and to families could be substantial. There is particular concern about the impact on those with little or no savings, who may be forced to rely on payday loans, doorstep lenders, or food banks. Further information can be found in the Library briefing Universal Credit: proposals for a seven day "waiting period" for claims (31 July 2013).

4.4 Other third sector lenders

Credit unions are not the only alternative to the HCC sector. In September 2010 the Coalition Government, announced a new lending initiative call MY Home Finance. Details are shown below:

> My Home Finance is an innovative partnership led by the Federation and supported by the Department for Work and Pensions, the Royal Bank of Scotland, 26 housing associations and the Wates Foundation and will offer access to affordable credit, at lower rates of interest than those usually charged to people who are financially excluded.
>
> My Home Finance – which will be one of the largest ever not-for-profit financial services providers in England – plans to open 10 branches across the West Midlands by the end of October.
>
> After a face-to-face interview, eligible customers will be able to borrow relatively modest sums of around £500, repayable weekly. My Home Finance envisages this will help customers to buy

45 See for example Payments Council, Research reveals Universal Credit payment and budgeting advice gap, 1 October 2013; Citizens Advice, New research shows personalised support is key to unlocking help for "9 in 10" not ready for Universal Credit, 12 December 2013

everyday items such as school uniforms, a new washing machine, or furniture for their home.

The starting APR of a My Home Finance loan will be 29.9%, contrasting sharply with 200-2,000% APR, the typical range of interest rates charged by doorstep lenders and loan sharks.[46] It is envisaged that by borrowing at less expensive rates customers will be able to pay off debts or have more money left over to spend in their local community.

My Home Finance will also offer debt advice and help to open a bank account to encourage customers to build up their savings – with the ultimate goal of helping people to take control of their own finances.

There is a pressing need for schemes like My Home Finance. Currently, around 2.5 million borrow from doorstep lenders at rates often in the region of 272% for new customers. A further 200,000 are estimated to borrow from loan sharks. A majority of those financially excluded are social housing tenants.

The branches are part of an innovative pilot – and if they demonstrate that a national savings and loan scheme is viable, My Home Finance will open branches across England and write up to 150,000 loans to people on lower incomes over the next 10 years.

The pilot, created by the National Housing Federation, will begin in the West Midlands. The West Midlands has unemployment levels among the highest in the UK and is in particular need of affordable credit, access to bank accounts and money advice.

The branches will be located in busy high streets and shopping centres in eight local authority areas across the West Midlands, be run by East Lancashire Moneyline, one of the leading lenders of affordable credit in the UK, and create employment for around 40 people.

Branches have already opened in Hereford, Worcester, Walsall and Northfield, south Birmingham. By the end of October, further branches will have opened in Coventry, Tamworth, Dudley and Wolverhampton, and in Birmingham city centre and Erdington, in north Birmingham.

Federation Chief Executive David Orr said: "My Home Finance will provide an affordable, convenient and trusted option for people on lower incomes looking to build up their savings and borrow modest sums.

"By offering fair loans at fair prices, we hope to offer an alternative to both loan sharks, who cynically prey on hard up families, and doorstep lenders, who are all too willing to lend cash to the desperate at hugely inflated rates of interest.

"This ambitious not-for-profit sustainable scheme shows the determination of the housing association sector, the Government and RBS, to help financially excluded consumers join the financial mainstream by saving and borrowing in a fair and responsible manner."

Secretary of State for Work and Pensions Iain Duncan Smith said: "It is great to see new ideas coming through to help the poorest in our society access credit and advice on how to avoid unsustainable levels of debt.

46 This interest rate will rise to 49.9% when Growth Fund money ends in March 2011

> "As a Government, we are fully committed to helping people make responsible choices for themselves and their families and that includes making the right choices when it comes to personal finance."
>
> Gavin Hayes, general secretary of pressure group Compass, said: "We warmly welcome any scheme which aims to provide alternative sources of affordable credit but we must realise this doesn't spell the end of legal loan sharking in this country.
>
> "Low income borrowers are not price-sensitive so the only way to stamp out legal loan sharking is by capping the cost of credit."
>
> Bernie Morgan, chief executive of the Community Development Finance Association, said: "We're delighted that My Home Finance is offering a fair alternative to rip-off lenders, and are very glad to see that the Department for Work and Pensions is showing this commitment to financial inclusion.
>
> "My Home joins a network of existing non-profit lenders around the country. They are providing a lifeline to people on low incomes who would otherwise be at the mercy of loan sharks, doorstep lenders and payday loan companies.
>
> "But provision is patchy, and there are nowhere near enough affordable lenders to meet demand - even with the arrival of My Home Finance.
>
> "It is vital that the Government uses the forthcoming comprehensive spending review to put more investment into these organisations, so they can continue to help people manage their finances and take control of their lives."[47]

4.5 Other reforms

Consumer Focus, is a statutory body set up by *The Consumers, Estate Agents and Redress (CEAR) Act 2007* to act on behalf of consumers. It conducted an investigation into payday loans – Keep the plates spinning – in August 2010. It suggested the following reforms:

> Payday loan market:
>
> Limiting the number of loans: Consumer Focus recommends that the number of loans or rollovers should be limited to a maximum of five per household per year. This should prevent a potential debt trap scenario being established in the UK. This would be done through clarifying the definition of 'unsustainable' lending in the OFT Irresponsible Lending guidance for creditors.
>
> Where consumers have borrowed or 'rolled over' up to the maximum of five times in one year, this should be treated as an indicator of financial difficulty and lenders should be obliged to refer consumers to independent advice and support to deal with any financial problems.
>
> Further research: We also recommend that further work should be carried out by the OFT investigating the impact of banning payday loans within the context of the UK market, as current research focuses on the experiences of other countries.
>
> We support the OFT's recommendation in their review of high cost credit that it should collect essential information on the high-

[47] http://www.24dash.com/news/housing/2010-09-23-iain-duncan-smith-to-launch-new-affordable-credit-service-for-low-income-households

cost credit sector30. In the future, this will assist with better evidence in relation to the payday loans market, including judging the impact of interest rate caps or banning paying loans on the UK market.

Protecting long-term negative experience payday lending users:

The impact of payday loans on those identified as having long-term negative experiences could be addressed by the OFT (and, when it is formed, the Consumer Protection and Markets Authority) requiring lenders to:

- control the amount of money consumers can borrow by ensuring more thorough affordability checks when the first loan is taken out (including effective salary checks)
- ensure affordability checks are repeated when additional loans are taken out in case of change of circumstances
- limit the number of months that a loan can be deferred for (see above)
- limit the number of repeat loans (see above)
- limit the value of repeat loans
- share information to avoid people being able to take out payday loans from multiple lenders simultaneously

5. Experience abroad

Concern over the HCC sector and the experience of poor households and credit and debt is not confined to the UK. Several countries have controls like those discussed in this Note. This section looks at how some of these work and whether the remedies actually cause the problems that are sometimes given as a reason for not introducing them here. The first example is the banning of pay-day loans in various states of America. What follows is a summary of the findings of an investigation by the Federal Reserve Bank of New York in a report [Payday Holiday: How Households Fare after Payday Credit Bans](#) published in February 2008.

The Report outlines the state of the payday loan industry and its expansion:

> The number of payday credit stores has grown from essentially zero in the mid-1990s to over 20,000 today. As with mainstream banks, the distribution of payday lending firms is bimodal: a handful of very large corporate firms operate thousands of payday stores in virtually every state that allows it, while hundreds of small firms operate just a few stores within a single city, state, or region. Several of the multistate firms have publicly traded stock. Stegman (2007) documents the phenomenal expansion in the number of payday stores in states that permit them. In just five years, store numbers in Ohio and Oregon doubled, and in Arizona they tripled. Nationally, payday lenders are said to outnumber McDonald's restaurants (Stegman 2007).
>
> While rapid entry suggests low entry costs and/or high expected returns, recent profitability studies find relatively normal returns. After analyzing firm level data provided by two large payday lending corporations, Flannery and Samolyk (2005) conclude that payday lending prices seem roughly commensurate with costs. Huckstep (2007) concludes similarly after examining costs and returns of publicly traded payday lending firms. Normal returns suggest entry and competition work to limit payday loan prices and profits.[48]

This analysis suggests that the US industry is not dissimilar in structure to that in the UK and further analysis in the Report suggest that the customer base in the US is similar too, it therefore makes for a sensible comparison.

The Report starts with comments familiar to those heard in the UK:

> In 2004 and 2005 the governments of Georgia and North Carolina permanently closed all the payday lenders operating in their state. Payday lenders are "fringe banks" (Caskey 1994): small, street-level stores selling $300 loans for two weeks at a time to millions of mostly lower middle income urban households and members of the military. The credit is popular with customers, but despised by critics, hence the bans in Georgia and North Carolina. This paper investigates whether those "payday holidays" helped households in those states. Why might less credit help? Because payday loans, unlike loans from mainstream

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48 Payday Holiday: How Households Fare after Payday Credit Bans, Federal Reserve NY, p8

> lenders, are considered "debt traps" (Center for Responsible Lending 2003).
>
> The debt trap critique against payday lenders seems based on three facts: payday loans are expensive ("usurious"), payday lenders locate near their customers ("targeting"), and most payday customers are repeat ("trapped") borrowers. After documenting that the typical customer borrows 8 to 12 times per year, the CRL (Center for Responsible Lending) concluded:
>
> …borrowers are forced to pay high fees every two weeks just to keep an existing loan outstanding that they cannot afford to pay off. This …"debt trap" locks borrowers into revolving high-priced short-term credit instead of …reasonably priced longer-term credit (Ernst, Farris, and King 2003, p. 2).
>
> The CRL study went on to estimate that 5 million trapped American families were paying $3.4 billion annually to "predatory" payday lenders.[49]

Controls on payday loans have spread across America. Oregon and Pennsylvania recently joined Georgia and North Carolina in banning payday loans; Oakland and San Francisco limit the number and location of payday stores and in New York, New Jersey, and most New England states they have never been allowed. In many other States, however, they are permitted and are subject to few operational controls.

The broad conclusions of the study are shown in the summary below:

> Most of our findings contradict the debt trap hypothesis. Relative to other states, households in Georgia bounced more checks after the ban, complained more about lenders and debt collectors, and were more likely to file for bankruptcy under Chapter 7.
>
> The changes are substantial. On average, the Federal Reserve check processing center in Atlanta returned 1.2 million more checks per year after the ban. At $30 per item, depositors paid an extra $36 million per year in bounced check fees after the ban.
>
> Complaints against debt collectors by Georgians, the state with the highest rate of complaints to begin with, rose 64 percent compared to before the ban, relative to other states. Preliminary results for North Carolina are very similar. Ancillary tests suggest that the extra problems associated with payday credit bans are not just temporary withdrawal" effects; Hawaiians' debt problems declined, and become less chronic, after Hawaii doubled the maximum legal "dose" of payday credit in 2003.[50]

One reason for these findings is the different measures of 'harm' that the researchers used compared to other studies. In conventional studies 'harm' or dis-benefit is measured by the interest rate charged, if they are high the loans are automatically bad, disregarding the welfare benefit of the loan – i.e. what it was spent on and the number of repeat loans, again repeat loans are automatically negative and not an indication that they repeated because they are useful. They explain:

> We study patterns of returned (bounced) checks at Federal Reserve check processing centers, complaints against lenders and debt collectors filed by households with the FTC (Federal Trade

49 Payday Holiday: How Households Fare after Payday Credit Bans, Federal Reserve NY, p1

50 Ibid pp3-4

> Commission), and federal bankruptcy filings. The monthly complaints data are new to this study; we obtained them from the FTC under the Freedom of Information Act. We use changes in complaints within a state to identify changes in household welfare (well-being), a distinct advantage compared to the ambiguous measures (interest rates and repeat borrowing) emphasized by critics of payday lending. How do we know when credit is *so* expensive or burdensome that households are better off without it? The real test is whether household welfare is higher with or without payday credit, and complaints are a measure of welfare.[51]

The results of the study also emphasise the difficulty of making comparisons between countries. Each country has a set of 'elements' – institutions, legal structures and services - that collectively make a market function, transplanting one aspect to another set may either upset the way the recipient market operates or be ineffective. Three obvious differences between the UK and US are:

- 'Check insurance' is not specifically available in the UK as it is in the US. There the insurance guarantees that a cheque will not 'bounce' so acts as an alternative to either an overdraft or a payday loan.
- Credit card ownership is more prevalent in the UK than in the US.
- Credit unions are far more deeply entrenched in the US than in the UK.

Another American study - Restrictions on Credit: A Public Policy Analysis of Payday Lending – looked at the 'debt trap' argument.[52] This is one of the central arguments by critics that individuals get trapped into a cycle of loans, using a subsequent loan to pay off a previous one and getting further and further into debt. The authors found:

> Using state-level data between 1990 and 2006, and two different empirical approaches, we find no evidence to support that payday lending leads to more bankruptcy filings — a measure of consumers' welfare. This finding suggests that there is no evidence to support the "cycle of debt" argument against payday lending.
>
> We use the variation in the state laws during the same period to identify important payday-lending restrictions that influence payday lenders' presence. Based on variation across states and across time in restriction provisions, we construct six variables that capture price restrictions, licensing-related or entry restrictions, and other business practice restrictions. These variables rank the provisions across states and time. We find that the main restriction that influences the presence of payday lenders is price restrictions.[53]

This finding is interesting in that it finds no evidence for the main harm suggested by critics of the industry, but does recognise the effectiveness of one of their main policy remedies – namely interest rate controls or interest rate 'caps'.

51 Ibid
52 Restrictions on Credit: A Public Policy Analysis of Payday Lending, Stoanovici and Maloney, Cleminson University, October 2008
53 Ibid Summary

Interest rate caps exist in several European countries such as Italy, Germany, France and Slovakia. Some of these are absolute caps, others are relative caps.

An exhaustive study on interest rate restrictions in EU countries (with US comparisons) was published in September 2010.[54] In terms of the economic impact of caps (interest rate restrictions or IRR in the text) the Report's conclusions are summarised below:

> In summary, we find that there are less clear-cut implications of economic significance of interest rate restrictions than it is sometimes argued. It is apparent that IRR do shape the supply side of the consumer credit market in three respects:
>
> - Firstly, it is likely that the existence of interest rate restrictions excludes some customer groups from credit access (which might or might not be an explicit objective of the introduction of IRR).
> - Secondly, there might be a reduced set of credit types, as some credit types with very high interest rates are not offered in the presence of interest rate restrictions.
> - Thirdly, one needs to keep in mind that suppliers can (to some extent) structure their credit product in a way so that the existing interest rate regulation does not apply.
>
> We also conclude that many observations on credit markets are not only driven by regulatory conditions (affecting the supply side), but also by the actual behaviour of the demand side:
>
> - As particularly explained in our discussion of **H1** and **H2a**, it is more realistic to assume that there are clear patterns in the attitude towards credit across countries which may explain both the preferences for strict interest rate regulations prevailing in some countries and, e.g. reduced incidence of credit of their consumers.

The authors' conclusions were that they thought that the following effects of imposing IRRs were likely:

> The first hypothesis (H1: IRR reduce credit access, in particular for low-income borrowers) is generally found to be plausible:
>
> Hypothesis H2a (Without IRR, more product types exist in the market) appears plausible:
>
> It appears plausible that H7 holds (IRR lead to increased charges as providers will try to compensate the reduced interest revenues by increased charges).

The following were unlikely:

> In the light of our analysis, a second hypothesis (H2: IRR lead to a decline in the volumes of consumer credit granted) appears unlikely to hold in an economically significant way.
>
> The related hypotheses H5 and H5a address the effect of interest rate restrictions on the level of over-indebtedness and on its growth rate after an economic shock, respectively.

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[54] Study on Interest Rate restrictions in the EU, project ETD/2009/IM/H3/87, Prof. Dr. Udo Reifner, Sebastien Clerc-Renaud, RA Michael Knobloch, Institut für Finanzdienstleistungen e.V. (iff)

> We conclude that a direct influence of interest rate restrictions on the level of over-indebtedness [would IRR improve indebtedness?] as H5 suggests, is unlikely.
>
> Hypothesis H9 (IRR lead to lower levels of competition in the consumer credit industry) is found to be unlikely to hold, as the level of competition differs (according to several criteria) across countries regardless of the presence of IRR.

And the following inconclusive:

> With respect to H3 (IRR lead to credit from non-bank sources, such as paying bills late), our results remain inconclusive.
>
> A related claim in the context of interest rate restrictions is addressed in H4 (IRR lead to a substantial illegal market in lending).
>
> With respect to H5a, we obtain inconclusive results: the most current figures do not reveal a particularly pronounced increase of over-indebtedness in the aftermath of the financial market crisis.
>
> With respect to the hypothesis H6 (The average consumer - or even more so: low-risk consumer - would be granted cheaper credit in the presence of IRR), we find inconclusive results.
>
> The evidence on H8 (IRR represent barriers to consumer credit market integration) is inconclusive for two reasons.
>
> The last hypothesis H10 (IRR lead to a convergence of all consumer credit interest rates at the level of the interest rate cap) implies that providers use an exogenously given interest rate cap to coordinate their (non-competitive) price setting at a rate just below the cap. Other studies have found some evidence on this issue. We demonstrate that the results on this hypothesis are inconclusive:

At 434 pages, this is a substantial piece of academic work. The overriding impression from looking at it (briefly) is that the issue is very complex and the outcomes are affected as much by the surrounding legal context in which they operate as by economic factors. Many of the key issues are simply incapable of being proven one way or another.

Clearly since they exist in so many places there would appear to be therefore no doubt that interest rate caps can be made to work. But what does 'work' mean? If it means that the caps are effective and that lenders cannot get around the controls by using fees and charges, then they do indeed work. But if it means they effectively bring the industry to a close, or severely restrict it, as is claimed happened for controls on military loans introduced in the United States for example, is this a success or a failure? For those who argue that the industry provides no benefit, clearly this is a good outcome. But for existing customers is this a good or bad thing? If lack of borrowing opportunities increases skills like budgeting and saving from society's point of view this is welcome. But if the lack of borrowing opportunity simply means that the demand is driven elsewhere, to illegal lenders, or that there is a marked rise in personal bankruptcy, then the outcome is less obvious from society's point of view, let alone for the individuals.

6. Conclusions and next steps

6.1 Introduction

If nothing else, this note has tried to show that dealing with the HCC sector and achieving socially desirable outcomes is a complex matter. It has tried to bring together some of the evidence and ideas surrounding the sometimes emotive subject of sub prime lending or the high cost credit sector. It has tried to show that the credit market in the UK is a highly segmented one, with significant groups apparently shut out from mainstream borrowing opportunities. The cost to this group is high in terms of the interest rates charged and the potential for serious indebtedness leading to a catalogue of other social and possibly health problems is ever present.

It has also tried to show that the commercial lenders supply this sector meet a genuine need for credit and, in the absence of public subsidies provide funds at rates that may be far less extreme than the immediate reaction of many commentators would first indicate.

It has mentioned some of the problems and challenges that various ideas for reform face, namely the challenge for other bodies to grow in sufficient scale to be significant competitors to the current industry and the danger of over-regulation or price controls forcing even less desirable outcomes on current HCC sector customers. If there is a gap in the market for affordable credit who is going to fill that gap, or can it only be filled with substantial public funding?

Readers wishing to look further into this subject might want to start with the review of the high cost credit market which was recently published by the OFT[55] quoted several times in this note. Its conclusions however are shown below:

> The key features and characteristics of high-cost credit markets include:
>
> - Despite limited overlaps between consumers of different high-cost credit products, they share some characteristics:
>   - a need for credit and limited inclination to search for the most suitable option
>   - lower-than-average levels of income and financial capability, and
>   - many instances of poor or no credit history.
> - High-cost credit is by its nature expensive. This derives from a number of inherent elements of the products, including:
>   - the low value of the loan, meaning that administration costs are higher per loan
>   - high-cost business models, particularly for home credit, where a network of agents is needed to call at customers' homes to make loans and collect payments

55 Review of High cost credit, OFT1232, June 2010

> – the incidence of missed or late payments, and
>
> – the particular need in some markets to prevent fraud and to account for bad debts.
>
> Our analysis of this sector and its features lead to two main findings:
>
> - First, in some respects, the markets for high-cost credit work reasonably well. For example:
>   - suppliers have met the demand for easier access to their products
>   - they fill a gap in the market not served fully by mainstream financial suppliers
>   - there is evidence with some products that lenders show forbearance with repayment difficulties and do not penalise borrowers when payments are late or missed, and
>   - the level of complaints from consumers is low.
>
> Moreover, in the absence of mainstream financial suppliers, the likely counterfactual to the existence of this sector would seem to be that significant groups of people are denied access to licensed credit in the UK.[56]

Similarly, the Consumer Focus study illustrates the complexity of the task of finding a solution that meets all desirable outcomes. They said:

> While payday loans can cause substantial problems for some people and have a negative emotional impact, they can also play an important and useful role for others. Consideration needs to be taken to ensure those who are at the greatest risk are protected while those who derive real benefit from the loans with little negative impact continue to have reasonable access to them.

Current and future government action was set out by the Consumer Affairs Minister, Ed Davey, when he responded to the Backbench Member's debate on 3 February 2011 mentioned above. He noted the following developments, some of which had been initiated under the previous Labour Government:[57]

- Maintenance of anti - illegal money lending projects
- Improvements to the competitiveness of credit markets by encouraging credit unions and exploring a possible tie-in between the credit unions and post offices
- Establishment of the new Consumer Financial Education Body which will offer a free, impartial financial education to all along with an annual financial health check
- Coming into force of the Consumer Credit Directive which gives greater rights to borrowers such as a 14 day 'cooling-off' period and places new duties on lenders to assess the ability of the borrower to repay the loan
- Two ongoing consultations. One on the system of financial regulation in the UK which will include a review of the structure

56 Ibid Executive Summary
57 HC Deb 3 February 2011 c1110

> of consumer credit regulation.[58] The second is a review of consumer credit and personal insolvency.[59]

He concluded his remarks by explaining why the Government did not intend to respond immediately to the demands for price caps and other measures of reform:

> I cannot give any undertakings today about what will emerge as a result of those reviews, because we are still considering the evidence. Nothing has been decided and it would be irresponsible of me to stand here today pre-empting their results, but we are not afraid of taking action where the evidence justifies doing so. We will not hesitate to act where there is evidence of detriment to consumers or exploitation of them. The Government want poor households to be able to strike a better balance between how they save, insure and access credit, and we are looking at a lot of ideas.
>
> For example, we believe that there are great gains to be had from collective purchasing. We are working with the insurance industry and social landlords to develop and promote affordable home contents insurance for social tenants. If those products succeed, they will enable many more households to claim back the cost of household emergencies, rather than relying on high-cost credit to replace essential goods if they are burgled or a high-cost item, such as a washing machine, if it breaks down. We hope that the trials of such products will commence in March or April this year. Such measures will not be an immediate solution, but they could help those on low incomes even more than caps on high-cost credit.
>
> I come to the one specific issue that the hon. Member for Walthamstow wishes us to focus on: a cap on total credit. The motion calls on the Government to consider introducing a cap on the total cost that lenders can charge for credit. At first glance, that appears sensible. Yet, despite what she said, the evidence base for her new approach is limited, to say the very least. What seems sensible at first glance could have huge unintended consequences for those we are trying to help. Without a proper assessment of the evidence it would be rash and frankly negligent to rush into this proposal. We know that there have been studies carried out that show that an interest rate cap could have very detrimental impacts on the vulnerable-that was accepted by the previous Government. This year's OFT review of the high-cost credit market ruled out not just interest rate caps, but any price controls in the market. The EU review that the hon. Lady prayed in aid is ambiguous on this, to say the least.
>
> A forthcoming study, which has not yet been published, has been undertaken by Policis. It has had the advantage of collaborating with Claire Whyley, chair of the credit sub-group of the Financial Inclusion Taskforce and chair of the FSA consumer panel, and Paul Jones, who is the leading expert on social lending. The study concludes by saying that if a cap were to be constructed to take in the total cost of credit, including penalty charges and similar, more of those on low incomes would be likely to find access to mainstream options restricted or curtailed altogether. That is the only evidence I have seen that deals with this issue in detail. We have to assess these issues, because the hon. Lady's proposals do

58 A new approach to financial regulation: Consultation on reforming the consumer credit regime

59 Managing Borrowing and dealing with Debt

> not do what she claims. We need to gather evidence and properly assess it, and I reassure the House that we will do that. When we have analysed the evidence and got the results of consultations, we will report back to the House. We will not be afraid of taking tough measures if they are required.[60]

6.2 New Rules

From April 2014, by virtue of Section 7 of the *Financial Services Act 2012*. By virtue of the Act, consumer credit has been regulated by the Financial Conduct Authority (FCA) and not the Office of Fair Trading.[61] An argument for this was that regulation by rule, as opposed to regulation by law, was far more flexible and responsive. The FCA would be able to deal with issues more quickly than the OFT could since it required amendments to primary legislation to change the law. A government document outlining the regulatory structure, post transfer, can be found here. The biggest single change potentially of the new regime is the conversion of government to the idea of a 'cap' to the cost of consumer credit.

The *Financial Services Act 2012* had already given the FCA the *option* to impose such a cap. In the *Financial Services (Banking Reform) Bill*, the government moved a decisive step further. Now the FCA was mandated to impose one regardless.

The justification for the change in view was set out during the Lords proceedings by the Minister, Lord Newby, he stated that:

> FCA powers are already sufficiently broad to ensure that charges of all kinds can be covered in the cap. This Bill presents the ideal opportunity to ensure swift action to protect consumers from unfair and spiralling costs and to give the FCA a definitive parliamentary mandate to act now. That is why the Government are introducing this amendment to require the FCA to impose a cap on the cost of payday loans. Under this new duty, the FCA must use the powers given to it by the Government in the Financial Services Act 2012 in relation to such loans.[62]

The cap would come into effect at the latest by 2 January 2015. By this move the government has passed the key responsibility of actually setting the rate to a third party. It is noticeable that in all the material promoting the use of such a cap, none of the proposers has suggested what it should be. The unenviable task fell to the FCA. The cap proposals were published on 5 July 2014. The road to the announcement included several linked elements.

The Bristol Report

The report referred to in the government statement above, by Bristol University, was published, along with the government response to it.[63] The report considered three short term credit markets, namely payday lending (both retail and online), home credit and pawn broking and

60 Ibid c1111
61 The new system of regulation is dealt with in more detail in another Standard Note (SN/BT/6842)
62 HL Deb; 9 December 2013, c685
63 BIS, Government Response to Bristol University Report on High Cost Credit, March 2013

looked specifically at whether there should be a cap on total cost of credit within these markets.

The key finding by the Bristol study, echoing the finding of all previous studies, was that caps on the cost of credit were unadvisable:

> The findings of the Bristol report indicate that a variable cap on the total cost of credit in the short term credit market would not be the best way of addressing the causes and consequences of detriment in this market. The findings suggest that such a cap could reduce access to credit, reduce the supply of credit and weaken competition. It could also lead lenders to shift more to charges which fall outside the cap and to optional fees which are generally less transparent to consumers and therefore less conducive to competitive pressures. Consumers who cannot repay on time may also be shown less forbearance by lenders. It could stimulate the growth of other markets which carry a risk of consumer detriment, for example the sale of goods at higher prices for payment by instalments.[64]

But......

> However, the report found there to be worrying evidence of ***consumer detriment in these markets.*** In particular, the report identified concerns around:
>
> - the relatively high cost of credit;
> - high default charges and poor practice among some payday lenders in applying these charges;
> - the way in which lenders assess the affordability of credit for potential customers;
> - strong links between short term credit use and measures of financial difficulty;
> - repeated use of rollover loans by a significant minority of consumers;
> - significant rates of multiple or repeat borrowing.[65]

The OFT study

At roughly the same time as the Bristol Report, the OFT published work it had done into various aspects of the market. These included:

- Debt collection practices
- Debt management
- Irresponsible lending
- Review of compliance with irresponsible lending guidance

On each of these issues the OFT had concerns about the way that the industry operated. Material on this and links to the original documents can be found on this link here. It culminated in March 2013 in the OFT making a referral to the Competition Commission on top of an ultimatum to the industry to alter its practices. The OFT website explains:

> The OFT is giving the leading 50 payday lenders, accounting for 90 per cent of the payday market, 12 weeks to change their business practices or risk losing their licences, after it uncovered

64 Ibid p7
65 Ibid p7

> evidence of widespread irresponsible lending and failure to comply with the standards required of them.
>
> The OFT has also today announced that, subject to consultation, it proposes to refer the payday lending market to the Competition Commission after it found evidence of deep-rooted problems in how lenders compete with each other.
>
> The action was announced in the final report on the OFT's compliance review of the £2 billion payday lending sector. The review found evidence of problems throughout the lifecycle of payday loans, from advertising to debt collection, and across the sector, including by leading lenders that are members of established trade associations.
>
> Particular areas of non-compliance included:
>
> - lenders failing to conduct adequate assessments of affordability before lending or before rolling over loans
> - failing to explain adequately how payments will be collected
> - using aggressive debt collection practices
> - not treating borrowers in financial difficulty with forbearance.
>
> The fifty leading lenders, each of which was inspected, will have to take rapid action to address the specific concerns the OFT identified with each of their businesses. They must demonstrate within 12 weeks that they are fully compliant, or risk losing their licence. Failure to cooperate with this process will trigger enforcement action.[66]

The Compliance Review (final report) mentioned in this release can be found here.

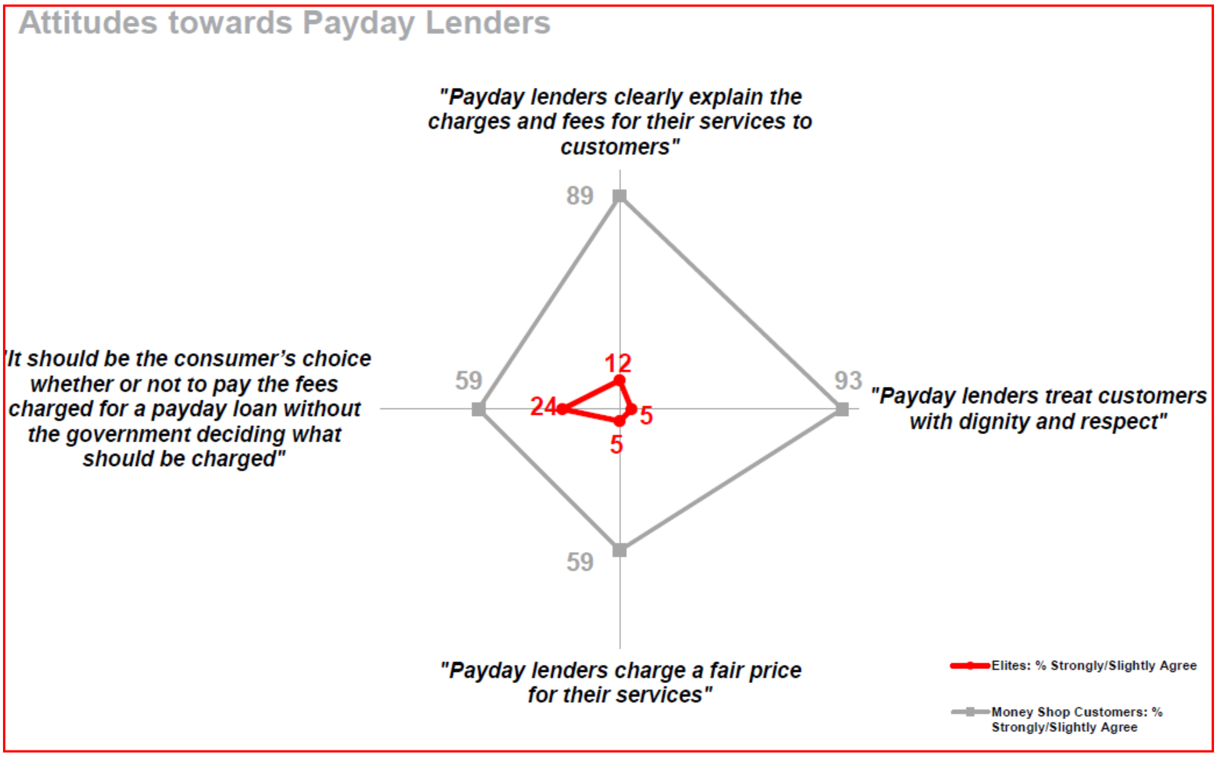
The industry's comment

Responding to the implicit, and at times explicit criticism of its members the Consumer Finance Association produced three publications which they hoped would inform policymakers about the true state of the industry.

Credit Crunched is a survey of HCC users; who they are and what they borrow.

Attitudes towards Payday loans and lenders is a small survey of the attitudes of users of HCC and policy makers including 100 MPs and 100 Peers to various aspects of the HCC industry. It includes the following graphic:

66 OFT website, March 2013



The results of the policy makers are shown by the central 'kite' shape and customers the outside 'diamond'. The difference between borrowers' perception of the cost of borrowing and policymakers (59% and 5%) is considerable; the difference on the measure regarding how customers are treated (93% and 5%) is so vast as to prompt questions about whether the groups were even talking about the same experience.

Transfer to the new credit regime is a survey of the industry and its views about the new financial regulation system proposed.

6.3 The cost of credit cap

15 July 2014 saw the publication of the FCA's major study and proposals for controls on the cost of credit: Proposals for a price cap on high-cost short-term credit.[67] The key elements of the proposed cap are shown below:

An **initial cost cap of 0.8%** of the outstanding principal per day, on all interest and fees charged during the agreed loan duration33 and when refinancing.

- The initial cost cap will be calculated as a percentage of the outstanding principal according to the number of days of the loan.
- Firms can structure their charges under the cap in any way they choose, e.g. a portion could be upfront fees or rollover fees.

2. A cap for those in **default** of:

- A total of £15 on fixed charges.

[67] FCA; Proposals for a price cap on high-cost short-term credit, CP14/1015 July 2014

- Interest at the same rate as the initial cost cap calculated per day on outstanding principal and fixed default charges.

3. A total cost cap of 100% of the total amount borrowed applying to all interest, fees and charges. Therefore the maximum anyone could ever pay on an individual loan in interest, fees and charges would be 100% of the original principal. A consumer borrowing £100 for 30 days would pay a maximum of:

- £24 during the agreed loan duration.
- Up to £15 fixed fees, if the loan is overdue.
- Maximum default interest charge of 0.8% per day, up to £61 (only if the loan remained unpaid for 67 days beyond the agreed loan duration).[68]

An illustrative cost table is shown below:

Costs to consumers for a £100 loan

Loan duration months	Loan duration days	Initial cap	Fixed default charge	Max default interest charges up to 100% total cost capital	APR (excludes default charges)
		£'s			
0.5	14	11.2	15	73.8	1492%
1	30	24	15	61	1270%
2	60	48	15	37	1270%
3	90	72	15	13	1270%

Source: FCA

It might be noted that under the proposals the default interest charges declines as the period of the loan increases due to the weighing down of the 100% total cost ceiling. Above a 105 day loan period in the above example, the lender could charge nothing by way of interest.

By way of contrast, a major online lender, below, currently has the following cost structure for a similar loan.

Current market borrowing costs
Costs to consumers for a £100 loan

Loan duration (days)	Interest rate costs £'s	Bank transfer fees	Total costs	Default fee £'s	Maximum fees
14	20.27	5.5	25.77	20	na
30	37.15	5.5	42.65	20	na

Source: Online quote

The FCA concluded that the impact on consumers of the cap was:

> **1.25** We believe there will be two main groups affected by the cap: consumers who will still be eligible for high-cost short-term credit and those who will no longer get loans.

[68] FCA; Proposals for a price cap on high-cost short-term credit, p31-32

1.26 Consumers who are still eligible for high-cost short-term credit will benefit from lower prices. We estimate their median saving per loan to be £14 and the median annual saving £76. The average annual saving would be £193. Total savings for consumers would be approximately £250 million per year.2

1.27 We estimate that 11% of individuals who would otherwise get high-cost short-term credit (about 160,000 people a year) would no longer get loans. However, we believe that for most of these people, a payday loan or other form of high-cost short-term credit is not the best outcome for them due to the high cost, particularly if they are unable to pay back on time.

The effect of our cap will prompt more people in financial difficulty to seek other ways of handling their situation, such as by seeking debt advice. Apart from a short initial period we believe these customers will be better off not having taken out a loan.

1.28 Our research indicates it is unlikely that these customers will turn to illegal money lending. Fewer than 5% of customers who had been turned down for a loan told us they had considered going to an illegal money lender, while 2% reported having used one since July 2013. (We recognise, however, that people may be reluctant to report using illegal lenders so the results of our survey may be underestimated.)[69]

And the impact on firms:

1.29 Introducing any price cap that delivers an appropriate degree of consumer protection will lead to a reduction in profits for firms, as most of their revenue is generated through interest charges and the number of loans they make will fall. However, only the largest lenders currently make significant profits – most are only marginally profitable, and some make no profit at all. (For some firms, this is not their core business.)

1.30 Our modelling shows that reducing the initial charge element of the cap increases the risk of firm exit, and hence the risk that very few firms remain in the market. The modelling suggests that at 0.8% the three largest online firms will be able to continue to offer high-cost short-term credit, and that it is possible that one high-street firm may be able to operate. Importantly, these impacts do not reflect firm responses to the cap, which would be expected to limit them. Looking at how price caps have affected other countries, it is difficult to predict how firms may respond. The firms that remain in the market will have some flexibility to choose their pricing structure, and we expect that they will continue to compete on non-price factors, including speed and convenience.

1.31 We will monitor the impact of the cap and review it in two years' time.

1.32 As high-cost short-term credit firms start to apply for authorisation from 1 December 2014, we will look at their business models to ensure they are treating consumers fairly and following our rules. We will pay particular attention to whether they are trying to avoid the price cap.[70]

The proposals are backed by an immense qualitative and quantitative study and modelling of the market (credit records of 4.6 million people

69 FCA; Proposals for a price cap on high-cost short-term credit, p11

70 FCA; Proposals for a price cap on high-cost short-term credit, p11

and a survey of 2,000 consumers; eight firms and 16 million loans). Some interesting facts emerged from this:

- The FCA has had to find some sort of balance between allowing the industry to function and to improve consumer outcomes. This is the first time that it has been publicly acknowledged that some people (people who only just qualify for loans) should not be allowed credit which at a stroke reduces the costs to consumers of limiting their access to the market i.e. it was a negative benefit anyway. The benefits for people who qualify for loans more easily is more nuanced: "Overall, borrowers with higher credit scores would experience smaller benefits from no longer having access to HCSTC but perhaps also smaller costs. For a particular structure and level of the cap, we must judge – based on the evidence on the various costs and benefits – whether, on balance, access to HCSTC makes consumers better or worse off. Accessing HCSTC at lower prices *may tip the balance* in favour of retaining access".[71] In short, the FCA find very little positive consumer evidence for the industry at all although they state, but don't say why, that "We do not think it is desirable to leave consumers entirely without the option of using HCSTC".[72]
- The main argument against restricted access is that people will go to illegal lenders. The FCA reject this – only 2% of declined borrowers claim to have gone to one. This begs the question who does go to illegal lenders then and what did the 98% do?
- The finding that "only the largest lenders currently make significant profits – most are only marginally profitable, and some make no profit at all" may be a surprise to many critics of the industry.
- The FCA has a competition objective as one of its statutory requirements yet this appears to sit well with the fact that it expects the industry to shrink to "three largest online firms [and] "it is possible that (only) one high-street firm" can carry on. It found that the three largest lenders have a combined market share of 72% by revenue.[73][74] It thought that competition would not be lessened in future because:
  - The cap itself will prevent prices rising, if there is upwards pressure due to the oligopolistic nature of the online market in future.
  - We expect the degree of non-price competition will not be lessened, on the basis that we expect consumer demand to continue to focus on the non-price aspects of product offerings (such as the speed of access to funds) in the future.
  - As forthcoming CMA remedies will tackle the currently limited degree of price competition that takes place,

71 FCA; Proposals for a price cap on high-cost short-term credit, p29

72 FCA; Proposals for a price cap on high-cost short-term credit, p36

73 FCA; Proposals for a price cap on high-cost short-term credit, p16

74 The FCA set out how they think that they have met this particular statutory duty in annex 2 of the Report. See p103 for details

resulting in potentially greater price competition in the future.[75]

- "Most firms' revenue is generated through interest charges".[76] This is an interesting finding as it contradicts much of the criticism of the industry and the findings of another recent report into the industry. It is often asserted that the industry deliberately encourages customers to roll over loans so that they earn money on default charges and repeat fees. A recent report – *Payday lending: fixing a broken ma*rket by the Association of Chartered Certified Accountants, argues that the only way the industry can make money is by repeat lending and fees – put simply the acquisition costs of a new customer are so high they can never be recouped by a single loan.[77] Since July 2014 firms are unable to roll over loans more than twice in a single year.
- With respect to the impact on individuals of restricted access to HCC the study found that 24% of customers applied for HCC because it was their only option and of those 55% said they used loans for everyday expenditure (housing, basic living costs and bills)[78]
- On personal responsibility the FCA say that "Our proposals will ensure that consumers are treated in a fair way while still being responsible for their own decisions. However, we believe that it is in the best interests of certain consumers not to have access to HCSTC given the unacceptable risk of default, the lack of benefits and the consequences of access to HCSTC to them".[79]
- On the consequences of a higher rate of declined applications the FCA say: "the survey results indicate that, if consumers no longer had access to HCSTC, approximately 60% would not borrow, 25-30% would go to family and friends (we have taken steps to differentiate between 'friends' and 'illegal lenders'), and around 10% would borrow from formal sources of credit, and 5-10% would find funds in other ways (e.g. decrease savings)".

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75 FCA; Proposals for a price cap on high-cost short-term credit; p37
76 FCA; Proposals for a price cap on high-cost short-term credit; p16
77 ACCA; Payday lending: fixing a broken market; May 2014
78 FCA; Proposals for a price cap on high-cost short-term credit; p17
79 FCA; Proposals for a price cap on high-cost short-term credit; p101

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