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Payday loans: regulatory reform

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Summary

The short-term loans market has flourished in recent years, in particular, the demand for payday loans. Payday lenders offer short-term, high interest loans to consumers, with the suggestion that the money is paid back within a month, when they receive their next pay cheque. Unlike standard secured or unsecured loans, payday loans are short-term borrowing solutions aimed at those facing immediate financial difficulty. Loans are generally available for amounts of between £100 and £1,000 and are usually used to bridge the gap until the next pay cheque. Usually borrowers take a short-term loan for a few weeks or months.

Payday lenders have faced criticism for encouraging irresponsible lending. They are criticised for exacerbating debt problems as borrowers face high rates of interest if they can't pay back the cash in the required period. However, others have argued that it is extremely misleading to compare the APR of payday loans to those of traditional loans, due to the very short period of time the customer borrows for.

Under the provisions of the, all Payday lenders used to be governed by the provisions of the *Consumer Credit Act 1974* and were licenced by the Office of Fair Trading (OFT) in order to operate. In April 2014, regulation of all consumer credit lenders passed to the Financial Conduct Authority (FCA).

The purpose of this note is to look at the current reviews of payday loans and proposals to reform the industry currently being taken forward by the OFT, the FCA and, currently the Competition Commission.

1. Payday loans an introduction

In simple terms, a payday loan is an advance on wages or salary by a commercial lender at an agreed interest rate. Under the provisions of the *Consumer Credit Act 1974* (CCA 1974), all payday lenders must have a valid licence from the Office of Fair Trading (OFT) in order to operate.

Payday loans are designed to be a vehicle for short term borrowing when people need money quickly and cannot wait until payday. Payday loans are usually easy to apply for. It is much quicker process than more traditional bank loans; the application is usually made online or by visiting a payday shop.

In general, as long as the applicant has a permanent job and a bank account that handles electronic money transfers, then the process for obtaining a loan is fast and straightforward. Once an application is processed, it is approved at the same time, and money is deposited directly into the borrower's bank account usually on the same day. Direct debit facilities are used by some payday lenders to give them greater control over the repayment of the short-term loan. Alternatively, the borrower will offer a post-dated cheque to the lender to cover the eventual repayment of the money borrowed, plus interest.

Payday lenders have been criticised by some bodies (such as Citizens Advice) for making it too easy for a vulnerable person to 'over borrow' at high interest, thereby creating long term financial hardship. The number of people with serious debt problems who also have multiple payday loans is on the increase. The companies are accused of encouraging irresponsible lending and for exacerbating debt problems as borrowers face high rates of interest if they can't pay back the cash in the required period. Their debt recovery operations have also been widely criticised.

1.1 Market statistics

There are few reliable or consistent sets of statistics on the size or nature of the market. Most of what is available comes from survey evidence and market estimates. A 2013 Report from the OFT provides the most recent data to date. It found:

> We estimate that the market was worth £2.0 to £2.2 billion in 2011/12, which corresponds to between 7.4 and 8.2 million new loans; this is up from an estimated £900 million in 2008/09.
>
> • The average loan is between £265 and £270 and is borrowed over 30 days.
>
> • Firms reported that the average cost of borrowing £100 was around £25, but ranged from £14 to £51.
>
> • The three largest lenders account for 55 per cent of the market by turnover and 57 per cent by loan value.
>
> • 28 per cent of loans issued in 2011/12 were rolled over at least once, accounting for almost 50 per cent of revenue. Five per cent of loans were rolled over four times or more, accounting for 19 per cent of revenue.
>
> • Responses suggested that around a third of loans are either repaid late (18 per cent) or not repaid at all (14 per cent).

The Government gave the following data in February 2011 in response to a PQ on the payday loans market:

[BIS] collects information from the YouGov Debt Track survey on the number and proportion of people both using payday loans and those that have applied for payday loans in the last six months. In October 2010, the most recent survey, it was estimated that less than 1% of the population currently had a payday loan and that approximately 0.5% had applied for a payday loan in the previous six months. [...] Consumer Focus reviewed the payday loan market in 2010. They estimated that around 1.2 million adults took out a payday loan in 2009. They estimated the size of the market at £1.2 billion with each payday loan being worth on average £292.[1]

The growth in the number of loans has been very rapid. The Consumer Focus report, Keeping the Plates Spinning, estimated that the number of payday loan borrowers in 2006 was only 300,000 which rose to 1.2 million in 2009.

In terms of typical APRs for payday loans, much will depend on individual circumstances, the amount borrowed and the term of the loan. However, it is not hard to find very high "representative APR" figures online from mainstream payday loan providers.[2]

1.2 Current regulation

Payday lenders have to comply with certain legal requirements - many of which are set out in the *Consumer Credit Act 1974* (CCA 1974) and its regulations.[3] Under this Act, all payday lenders (like all other providers of consumer credit) have to hold a credit licence granted by the OFT. The OFT sets out in guidance (including the Irresponsible Lending Guidance) the standards of conduct it expects from all lenders that it licences.

There are no restrictions on the interest rates payday loan companies can charge. However, advertising of payday lending is subject to the *Consumer Credit (Advertisements) Regulations 2004*;http://en.wikipedia.org/wiki/Payday_loans_in_the_United_Kingdom - cite_note-7 this means that the 'typical APR' must be stated in all advertisements.

The OFT can impose a range of penalties for breaches of a consumer credit licence. According to the OFT, the type of action taken will be guided by the level of actual or potential harm to debtors and by the scale or frequency of identified misconduct:

> We can impose 'requirements' on a business where we are dissatisfied with any matter in connection with the operation of the business. Failure to comply with such a requirement can lead to a financial penalty of up to £50,000. We may also compulsorily vary a licence, for instance to limit the activities for which a trader is licensed, or limit the life of the licence.
>
> In serious cases, where there is evidence tending to show that a person is unfit to hold a consumer credit licence, the OFT can refuse or revoke a credit licence. Engaging in unfair or improper business practices would constitute grounds for the OFT to consider fitness to hold a licence.[4]

[1] HC Deb 3 Feb 2011 c892W
[2] Moneysupermarket.com has some short term loan APR comparisons. See also Library standard note on High Cost Consumer Credit ', SN/BT/5849, 8 February 2011
[3] See a summary of the Consumer Credit Act
[4] http://www.oft.gov.uk/OFTwork/credit/payday-lenders-compliance-review/qandas

2. Current reforms and reviews of the payday market

2.1 OFT review

On 24 February 2012, the Office of Fair Trading (OFT) announced that it was going to investigate payday lenders amid concerns about:

- misleading advertising;
- lack of affordability checks;
- irresponsible rollover of loans;
- targeting vulnerable consumers; and
- unfair treatment of consumers in arrears and default

In particular, the OFT was concerned that some lenders were aggressively pushing loans to people who clearly could not afford to repay them. The OFT is also worried that lenders may be allowing customers' debts to spiral by rolling them over. In light of concerns about the market, and the potential for consumer harm, the OFT has stated that it is appropriate that it should review both compliance with relevant legal requirements and the extent to which businesses operating in the market are meeting the standards set out in OFT guidance.[5]

In preparing for the review, the OFT conducted an online advertising web sweep, which highlighted certain poor advertising practices in the sector.

Action taken

In March 2013, the OFT produced its final report: Payday lending compliance review. The Review found that:

> The payday loans market is not working well for many consumers. Our review has found evidence of widespread non-compliance with the Consumer Credit Act and other legislation (see page 35 for links to the annexes setting out our detailed evidence base). Payday lenders are also not meeting the standards set out in our Irresponsible Lending Guidance.
>
> We are particularly concerned by the evidence of irresponsible lending; too many people are given loans they cannot afford, and when they can't repay are encouraged to extend them, exacerbating their financial difficulties. This is causing real misery and hardship for a significant number of payday users.
>
> During the course of our review, debt advisers, complainants and consumer representatives have told us that problems in this market are continuing to grow. We have listened and we are determined to tackle these issues. We have made payday lending a top compliance and enforcement priority. We will use all the powers at our disposal - including, if appropriate, the power to suspend a credit licence - to drive up standards in the sector and to remove those lenders whose actions make them unfit to remain in the market.[6]

Specifically:

> Around a third of loans are repaid late or not repaid at all.
>
> • 28 per cent of loans are rolled over or refinanced at least once, providing 50 per cent of lenders' revenues.
>
> • 19 per cent of revenue comes from the five per cent of loans which are rolled over or refinanced four or more times.

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5 http://www.oft.gov.uk/OFTwork/credit/payday-lenders-compliance-review/qandas
6 OFT, Payday lending compliance review, March 2013

> • Debt advisers reported that borrowers seeking help with payday lending debts had on average rolled over at least four times and had six separate payday loans.
>
> • 30 of the 50 websites we looked at emphasised speed and simplicity over cost – in some cases making claims that, if true, would amount to irresponsible lending.
>
> • 38 of the 50 lenders we inspected failed to comply with at least one of the complaint handling rules of the Financial Ombudsman Service.

The OFT declared that it had made the payday loans market a top priority for action and had written to the top 50 lenders to respond to their specific criticisms and findings. The OFT does not believe that the problem is due to a few 'rogues lenders' instead it points out features of the market that encourage poor practice. In particular, it noted that the companies tend to compete on the speed and 'efficiency' with which they can lend money rather than the cost. This means that the process of credit evaluation and affordability testing hinders their business model rather than supports it. With this in mind the OFT began a process of consulting on a full market investigation by the Competition Commission.

The publication of the review was followed by a consultation period which ended in May 2013. However, the OFT continued to act against some of the worst payday lenders. In March 2013 a company called MCO Capital Ltd, had its consumer credit licence removed on a number of grounds:

> In August 2012, the OFT found that MCO had failed to put in place adequate identity checks for loan applicants. It is thought that this failure led to MCO being targeted by fraudsters who used the personal details of over 7,000 individuals to apply successfully for loans totalling millions of pounds.
>
> The OFT also found that MCO had engaged in unfair business practices by writing to people who it was aware may not have taken out loans, asking unequivocally for repayment. MCO ignored OFT requests to stop this practice.
>
> Additionally, the OFT found that MCO lacked the necessary skills, knowledge and experience to run a consumer credit business.[7]

On 27 June 2013 the OFT announced that it would refer payday lenders to the Competition Commission. Announcing its decision, it said:

> Features of the market of concern include:
>
> - Practices that make it difficult for consumers to identify or compare the full cost of payday loans, undermining competition over price for loans.
> - Barriers to switching between lenders when loans are rolled over that prevent other lenders competing for this business.
> - Variable levels of compliance with relevant laws and guidance leading to firms that do invest time and effort complying being at a competitive disadvantage to firms that do not.
> - A significant proportion of borrowers have poor credit histories, limited access to other forms of credit and/or a pressing need to borrow. The cost of the loan may therefore be a less significant factor for borrowers, which may weaken competition on price between lenders.
>
> In addition, the OFT is concerned that lenders are competing primarily on the availability and speed of loan approval, rather than price. The competitive pressure to approve loans quickly may give firms an incentive to skimp on the affordability assessment which is designed to prevent irresponsible lending and protect consumers.

7 OFT press release 19 March 2013

> The OFT is also concerned about business models that appear predicated on making loans which are unaffordable, leading to borrowers paying far more than expected through rollovers, additional interest and other charges. Lenders appear to derive up to 50% of their revenue from such practices.[8]

The Competition Commission enquiry is ongoing. Details of working papers supporting the review can be found on the Commission's website here.

The Bristol study

A study by Bristol University on behalf of the Department for Business, Innovation and Skills was published in March 2013. It focused particularly on the effectiveness of interest rate caps.

The study identified three main reasons why people used high cost lenders. Findings for the payday sector are highlighted:

> **Convenience and the ability to access credit quickly.** For online payday loan customers, satisfaction with the service also reflected the convenience of borrowing this way (35 per cent) and the speed of the loan decision (36 per cent).
>
> **Having no or limited access to other sources of credit.** The Consumer Survey showed that mainstream credit (potentially a cheaper option than short-term credit) was only a feasible alternative for a minority of customers at the time of the survey, ranging from 10 per cent of home credit customers to 24 per cent of online payday loan customers.
>
> **Customer service and lender reputation.** Customer service was the main reason that customers in the Consumer Survey were satisfied with the lender they had used, cited by over a half of pawnbroking and payday loan customers and seven in ten home credit customers.[9]

With respect to the impact of an interest rate cap the study found that the impact on lenders would be:

> The available evidence suggests that the headline prices charged by short-term lenders may tend to migrate over time towards the level of the cap. This depends on whether or not the cap is set at a level above the price that lenders typically charge. If a price cap is set low, arguably price convergence is not necessarily problematic. It does mean, however, that some borrowers who might have benefitted from even lower prices are not able to do so.
>
> Evidence from more than one country and also from the Business Survey indicates that some lenders may exit the market. This is more likely to be the case for smaller lenders (even though they tend to have lower charges) than larger ones. This is because smaller lenders' business models would no longer be viable if a price restriction was set below their current charges. Any costs to business associated with the introduction of a price restriction would also be likely to have a disproportionate effect on small businesses. The supply of credit by regulated lenders could reduce and competition within the sectors could be weakened, particularly at the local level.
>
> Both the international evidence and the Business Survey indicate that lenders who do not exit the market may tighten their lending criteria and improve their risk assessment practices. This has been shown to restrict credit access for some types of consumers, particularly people on low-incomes. On the other hand, a potential positive impact of tightened lending practices would be a reduction in the proportion of customers who are unable to repay their loan as they should. Restrictions on default charges could result in short-term lenders exercising less forbearance than they currently do.

And on borrowers:

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8 OFT press release 27 June 2013
9 The impact on business and consumers of a cap on the total cost of credit, Bristol University, March 2013

> The available evidence about the impact of price restrictions on the cost that consumers pay for credit relates to interest rate restrictions, however, not the total charge for credit. The evidence reviewed for this research does not show unequivocally that price restrictions (in the form of interest rate restrictions) reduce the cost of borrowing to consumers, particularly those on low incomes. There is no evidence about the proportion of customers who actually pay less for short-term credit after interest rate restrictions are introduced than they did before.
>
> International evidence indicates that interest rate restrictions lower the level of debt per head of population. As a result of improved lender risk assessment practices, detriment experienced by customers (especially of payday loans) who are able to take out loans they cannot afford or take out multiple loans from different lenders at the same time may reduce. However, customers (particularly those using home credit) may incur default charges where they did not do so previously; non-payers in other markets may also be shown less forbearance by lenders.
>
> The diversity of short-term credit products that are available may reduce, resulting in less choice for consumers. In particular, the availability of short-term home credit loans and very small sum pawnbroker loans is likely to reduce because these products would no longer be profitable for lenders to offer. Pricing structures may also become less transparent for consumers, making it more difficult for consumers to compare products and lenders based on prices.
>
> Access to credit may reduce, particularly for low income or other vulnerable consumers. The Consumer Survey for this research showed that if customers could not access short-term loans, most would either go without or turn to a friend or relative for help. A small number would try and borrow from somewhere else, including from another short-term lender. Using an illegal lender was not an option that the vast majority of customers in the Consumer Survey would currently consider. For many pawnbroking and payday loan customers, going without the money they borrowed from a short-term lender would potentially mean defaulting on other financial commitments (especially household bills) or defaulting sooner.[10]

The Government has published its response. It said that its main concern was with the payday lenders, not other forms of high cost credit. Its concerns were:

- The relative speed and ease of access to payday loans:
- The high cost of borrowing:
- The way in which lenders assess the affordability of payday loans:
- The frequency with which loans are rolled over and the way in which this happens
- The levels of multiple and repeat borrowing

With these in mind, the Government said that it thought that a cap on the cost of credit was not the answer. However, it announced a lengthy programme of measures it hoped to take in the short and medium term:

> The Government will ***start immediate work to clamp down on the advertising of payday lending***. The Government will work closely with the Office of Fair Trading, the Advertising Standards Authority, Committees of Advertising Practice and industry to make sure consumers are not encouraged into taking out a payday loan when it is not right for them.
>
> Today the OFT published the findings of its review of compliance by payday lenders and announced the action it intends to take to address key concerns about the way in which the payday market operates. Specifically, the OFT has set out its concerns and what it expects of lenders in terms of compliance with the law and its guidance. ***The OFT has announced that enforcement action is underway*** against a number of lenders, with more cases in the pipeline.

[10] `Ibid

> The Government also welcomes the OFT's announcement that it is consulting on a ***provisional decision to refer the payday market to the Competition Commission.***
>
> The Government notes that trade bodies have provided assurances that payday lenders continue to take seriously their voluntary commitments agreed under the ***payday lenders' codes of practice*** which were due to be implemented in November last year. Many of these voluntary commitments specifically address some of the Governments key concerns, notably around affordability assessments, CPA, rollovers and default charges. Trade associations report that they remain on track to review the effectiveness of their codes and publish their findings in summer 2013. We will work with them and with Citizens Advice, who have undertaken to monitor compliance through their bureaux, to ensure early results on the effectiveness of the industry's voluntary commitments. The Government has made clear its expectation that industry responds positively and effectively to the OFT's compliance report and its revised guidance on the misuse of CPA. We will press for further commitments to be set out in industry codes.[11]

Following the last point, it was announced on 25 June 2013 that pay day lenders would be invited to a 'summit' with the government *to* discuss issues.

2.2 Change of regulator and cost of credit cap

In the longer term, from April 2014, regulation of all consumer credit business will pass from the OFT to the new Financial Conduct Authority (FCA) – the successor body to the Financial Services Authority. This will be effected by Sections 107 and 108 of the *Financial Services Act 2012* and subsequent Treasury Orders. A full consultation document is available: A new approach to financial regulation: transferring consumer credit regulation to the Financial Conduct Authority

The *Financial Services Act* gave the FCA the option to impose a cap on the cost of credit. However, the next financial services reform bill, the *Financial Services (Banking Reform) Bill* included a provision which mandated the FCA to impose one regardless of its views, which had previously been against the proposition and was anyway announced before the end of the FCA consultation on regulation set out above, had ended.

The justification for the change in view was set out by the Government Minister in the Lords Report stage of the Bill. Lord Newby said:

> 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.[12]

The cap would come into effect at the latest by 2 January 2015. It is a major change of policy from a position supported by successive governments over a period of decades. It is effected by Section 131 of the 2013 Act.

[11] Government Response to Bristol University Report on High Cost Credit, BIS, March 2013
[12] HL Deb; 9 December 2013, c685

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