Tackling the high cost credit problem:
The importance of real-time regulatory databases

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Summary of Recommendations

1. In order to prevent high cost lenders from evading future responsible lending requirements these should be framed in such a way that they apply to all high cost credit agreements regardless of the form of the product or its duration.

2. The Financial Conduct Authority should establish a real-time database of all high cost credit agreements from 1st April 2013 onwards. The costs of establishing and maintaining this database should be met by the high cost lenders themselves.

3. The FCA should use the regulatory database to ensure the effective targeting of its enforcement activity and to inform the ongoing development of responsible lending requirements, including the level of any caps on the total cost for credit, over time.

4. However, the FCA should also consider putting in place a package of responsible lending requirements alongside the introduction of a database. This package should be informed by empirical evidence from the US concerning the impacts of different measures.

5. We therefore recommend that the FCA bring forward proposals to introduce a package of responsible lending requirements which includes:

    a. A reasonable limit on the total level of high cost credit borrowing per person relative to their income;

    b. Prohibitions on rollover lending and the refinancing of agreements;

    c. Reasonable caps on the total cost of credit, including in respect of default charges and on charges for the collection of payments.

6. In the event that any responsible lending requirements introduced by the FCA result in people being refused credit then these should be referred to a national call centre operation, which provides an initial diagnostic interview and refers callers onto provision capable of meeting their needs, including:

    a. Debt and Welfare Rights advice;

    b. Grants and other assistance such as may be available from the local welfare schemes now being provided by local authorities;

c. Payments from charitable trusts, including those established by utility companies;

d. Affordable loans from Community Development Finance Institutions (‘CDFIs’) or from credit unions, including access to the proposed ‘rescue fund’ (see recommendation 7, below);

e. For people in receipt of qualifying benefits, assistance from Department of Work and Pensions in the form of Short Term and/or Budgeting Advances, and if in receipt of Universal Credit, for possible alternative payment arrangements to be put in place;

f. Financial education programmes and tools.

7. Government should establish a ‘Rescue Fund’ of at least £50 million per year to provide ‘heavy high cost credit users’ and those turned down for credit because of the responsible lending requirements, with an opportunity to access affordable alternatives.

8. To help ensure that the Rescue Fund is properly targeted; delivers a return on investment, benefits local authorities and social landlords and puts the finances of borrowers on a long term sustainable footing:

    a. Access to the programme should be restricted to those borrowers identified on the regulatory database as ‘heavy high cost users’ or those turned down for credit as a result of the responsible lending requirements that have been put in place;

    b. Participating credit unions should draw up a sustainable budget for participants and, by providing these with budgeting accounts, should create a debt management plan for the repayment of arrears on priority bills;

    c. A consolidation loan, supported by the rescue fund, should be provided to clear any outstanding high cost credit agreements;

    d. The loan should be recorded on the regulatory database and the borrower ‘locked out’ of future high cost borrowing until the consolidation loan has been repaid;

e. Credit unions should also provide small sum savings facilities and additional ‘buffer’ loans as they would for their existing members, creating long term customers from people entering the programme;

f. Borrowers entering the programme should also be encouraged to take up budgeting courses and other financial advice services. Take up of the courses could, for example, be incentivised by offering a preferential interest rate on future borrowing once the courses have been completed.

Chapter 1: Introduction

There has been a considerable expansion of small sum, high cost, consumer credit products in the UK in recent years. The expansion of these products, which are typically sold to households with below average incomes, has led to concerns about the wider impacts of borrowing on the ability of some households to pay for essential services and on living standards more generally. In addition, there has been considerable criticism of lending practice, with consumer and debt advice agencies and the Office of Fair Trading ('OFT') indicating that many borrowers are likely to be over-indebted and lacking in other credit options prior to turning to the small sum, high cost, credit sector[1]. Although most high cost credit products are advertised as a solution to short-term cash flow problems, many borrowers struggle to repay in accordance with the terms of their agreements, in which event lenders have been found to frequently refinance agreements or offer loans on a repeated basis – practices which appear to be highly lucrative for lenders but which can also lead to borrowing spiralling out of control with negative impacts on the overall welfare of consumers and for wider society.

This report reviews the evidence regarding these issues and provides a critical assessment of the regulatory response made to the expansion of high cost credit markets in the UK. In so doing, the report draws on our earlier work comparing international approaches to the regulation of high cost credit (Gibbons et al, 2010; Gibbons, 2012). Further to this, the report is particularly focused on the role that real time databases, established by regulators in a number of US states, can play in enforcing effective responsible lending requirements and help to deliver more effective support to over-indebted borrowers.

The report is structured as follows:

Chapter two provides details of the current policy context - reviewing the debate that is currently raging concerning possible regulatory interventions in the high cost credit markets.

Chapter three proceeds to set out further detail of the regulatory approaches taken in several US states, particularly in respect of payday lending. The chapter focuses on those states where lenders have been required to log details of their loans on real-time databases

[1] In line with the scope of the OFT's review of high cost credit conducted in 2010 we define the high cost credit market as comprising pawnbroking, payday and other short term small sum loans, door to door moneylending (also referred to as 'home credit'), and rent-to-own agreement such as are provided by Brighthouse and PerfectHome.

as a means of enforcing responsible lending requirements. The chapter also considers the difference between the use of a real-time database as a regulatory tool and more traditional credit data sharing systems.

Chapter four then considers how establishing a real time database of high cost credit agreements could also help to deliver a more integrated offer of support to over-indebted consumers who need support to deal with their debts and manage their finances more effectively.

Finally in **chapter five** we present our conclusions and recommendations.

Chapter 2: Policy Context

As at the time of writing it is virtually impossible to avoid the debate that is raging over how best to regulate the UK's high cost credit markets, and in particular the payday lending sector. Hardly a day now passes in which there is not some new development or high profile intervention. Indeed, in the immediate period preceding this report we have witnessed:

- **A Ministerial Summit** held with consumer groups and the payday lending industry to consider what measures the incoming regulator, the Financial Conduct Authority ('FCA') could introduce to 'reduce consumer harm' in the industry when they take over the responsibility for the regulation of consumer credit from the Office of Fair Trading ('OFT') in April 2014. The Summit focused on the 'key areas' of advertising, rollovers, and affordability checks.

- **Paul Blomfield MP** introduced a Private Members Bill[2] that would require the FCA to set out rules for high cost credit lenders to follow when assessing affordability, including a potential cap on the amount of lending relative to the borrower's income. The Bill's provisions also encourage the FCA to establish a 'regulatory database' of all high cost credit agreements and would require lenders to check this database to ensure that any cap on lending levels was observed. Importantly, the Bill also encourages use of the database to identify over-indebted individuals who may need to be referred to debt advice or other sources of support.

- **The Archbishop of Canterbury**, Justin Welby, has indicated that he would like to see the Church of England playing a more active role in the promotion of credit unions in order to 'compete payday lenders out of business'.

- **Plymouth City Council** ban payday loan advertising on billboards and bus shelters across the city and prevent access to the 50 most popular payday loan websites

[2] http://services.parliament.uk/bills/2013-14/highcostcredit.html . The Bill received its second reading in the Commons on 12th July 2013 but this has been adjourned. It is expected to resume on 6th September.

across the Council's entire computer network, including libraries and community centres[3].

We consider the current high level of attention on the high cost credit sector to be a product of three factors. Specifically, these are:

- The opportunity provided by *regulatory regime change* – with the transfer of responsibility for consumer credit regulation from the OFT to the FCA due to take place in April 2014. Associated with this, is a growing consensus that enforcement action against individual firms is an inadequate response to the problems that consumers face and that alternative approaches are required. In this respect, the FCA will have considerably greater powers than those currently available to the OFT. For example, the Financial Services Act 2012 provides a power for the FCA to cap prices, and it may also create rules setting out required behaviours of lenders or prohibiting agreements from containing features which it considers harmful to consumers. The FCA is expected to consult later this month on its proposed rules for consumer credit firms, including new requirements where there is evidence of harm being caused to consumers[4].

- Growing concern about the *financial pressures faced by households*. For example, the Money Advice Service's 'Financial Capability of the UK' report, published this month, shows that:

  - The proportion of people struggling to keep up with their bills and credit commitments has risen from 35 per cent in 2006 to 52 per cent in 2013;

  - 9 million people are in urgent need of help to manage their money and a further 10.5 million are 'on the edge' and showing signs of beginning to struggle;

  - Of these 19.5 million people, around one third (6.5 million) either always run out of money before the end of the month or do so 'most of the time'.

[3] See http://www.plymouthherald.co.uk/Plymouth-City-Council-bans-payday-loan-websites/story-19552645-detail/story.html . Similar measures are now being considered by a number of other local authorities including across Merseyside and in Blackburn and Darwen.

[4] Para 16, 'Payday Lending Market: Statement of Issues', Competition Commission, 14th August 2013

- Growing evidence concerning the *extent of high cost credit use and a rise in associated debt problems:* Payday lending has grown particularly rapidly. The Office of Fair Trading estimates that the market was worth £2.0bn to £2.2bn in 2011/12, which corresponds to between 7.4 and 8.2 million new loans. This is up from an estimated £900m in 2008/09[5], and there has been an exponential rise in the number of associated debt problems:
    - In the first six months of this year the debt charity StepChange has helped 30,762 people with payday loan debt problems. For the whole of 2012 this figure was 36,413;
    - In the first quarter of 2013, National Debtline received 6,992 calls about payday loan debts; an increase of 33 per cent on the same period in 2012. In that year, the service dealt with 20,000 payday loan debt problems – an increase of 94 per cent on 2011.
    - Over 11,000 people sought help with payday loan debts from Citizens Advice in the four month period from 26th November 2012 to 31st March 2013, and the service has reported a ten-fold increase in the number of people seeking advice about payday loan debt problems over the last four years.

These three key factors, combined with considerable media and political interest in each of them, have now coalesced to create a 'policy window' (Kingdon, 1984) holding the potential for a radical change of regulatory approach. However, there is now a battle of ideas taking place with respect to the approach that should be adopted.

A battle of ideas

This battle of ideas is, at its most fundamental level, a reflection of two opposing schools of thought. The first of these, promoted in the main by industry representatives, stresses the benefit of consumer credit as a tool with which households manage short-term *cashflow* problems. This school highlights the potentially negative impacts of restricting access to

[5] It should be noted that other areas of the high cost consumer credit market have also expanded in recent years. According to the National Pawnbrokers Association, the number of stores has more than tripled to 2,204 since 2007 and total revenues have surged to £865m from £300m. Likewise, considerable growth has occurred in the rent-to-own sector, with the market leader, Brighthouse, reporting that customer numbers have more than doubled since 2006/07 to just over 227,000 as at the end of 2011/12. The company has also embarked on an ambitious programme to increase its high street presence, opening over 100 new stores in the same period to take its total number to 253.

credit that could result from regulatory interventions. The argument generally runs that increasing regulatory or supervisory requirements risks:

- Directly affecting levels of access. For example, imposing price caps could limit the profitability of serving lower income groups; or
- Leads to higher operating costs for lenders. For example, the need to comply with onerous supervisory requirements could subsequently impact on the ability of firms to make profits and could lead to market exit, so restricting access.

However, the cashflow argument for consumer credit extension is opposed by a second school of thought that focuses instead on the problems arising from credit use for households with longer-term *structural budget deficits*[6]. In these cases, it is argued that credit use leads to a spiral of increased indebtedness over time. This school therefore emphasises evidence of lenders deriving considerable revenue from lending to housholds that are, in effect, 'credit dependent' – often rolling over agreements and/or borrowing more to pay off previous debts. Advocates of this school, notably consumer agencies and debt advice services, therefore argue for more robust consumer protection measures to be put in place. We now provide further detail of these arguments in turn.

The 'cashflow argument' for consumer credit

In a recent report the main payday lender trade association, the Consumer Finance Association ('CFA'), perfectly encapsulates what we term the 'cashflow argument' in favour of its members products when it states (2013, p.42) that:

> *"…borrowing small sums on a short-term basis enables customers to manage personal* ***cashflow*** *by smoothing out the peaks and troughs of income and expenditure" (our emphasis).*

For these advocates evidence of increased financial pressure on households is therefore a justification, rather than a cause for concern, for their expansion. Indeed, the CFA report goes on to highlight how rising fuel, food, and housing costs have combined with low earnings, changing employment patterns, a reduction in the availability of credit card

[6] This tension between high cost credit as a cash-flow management tool and the use of credit by people who cannot reasonably afford to repay was particularly well articulated by Dr John Gathergood in his evidence to the BIS Select Committee inquiry on Debt Management conducted in late 2011 and early 2012. For further details, see para 36 of the Committee's final report.

lending, and increased distrust of banks, to create the conditions for the growth of the 'alternative' credit market. In the light of these factors, the CFA argues (2013, p. 7) that many households are:

> *"…being compelled to consider short-term loans as a part of their overall money management tools."*

Similarly, the major door to door or 'home credit' lender, Provident Financial, in its most recent annual report[7] provides a customer testimonial, giving the reasons for borrowing as follows:

> *"Children don't come cheap and some months there just isn't enough in the pot. Home credit helps to smooth out the peaks and troughs."*

In further support of this *cashflow argument*, lenders are at pains to point out the high proportion of customers who clear their debt in line with the original terms of their agreements. For example, the CFA points[8] to an October 2012 survey of 1,100 payday customers, which found that 85 per cent of these had no difficulty repaying their loan.

The industry then argues that if *access* to short-term consumer credit is restricted, for example by imposing greater regulatory burdens on lenders or by capping the prices that can be charged, then this is likely to hinder the ability of households to manage their finances effectively, leading to:

- **Problems in meeting essential bill payments and increased costs for the consumer**. For example, the CFA have highlighted (2013, p.24) that the 'instant cost of missing a utility bill payment is at least £26 (£14 late payment fee and a £12 bank charge for a returned direct debit)' and argue that taking out a payday loan rather than having insufficient funds to meet direct debit payments therefore makes 'financial sense'; and
- **Lower living standards**, as people would have to 'go without' pending saving towards, for example, the cost of Christmas or for larger household items.

[7] See http://www.providentfinancial.com/files/reports/ar2012/business-review/consumer-credit-division/key-activities/index.shtml

[8] http://www.cfa-uk.co.uk/media-centre/press-releases/current-press-releases/cfa-comments-on-plymouth-city-councils-payday-website-and-advertising-ban.html

In addition, the industry also argues that if access to credit is unduly restricted this could lead to people resorting to illegal lenders. As the CFA put it in a recent submission to the FCA[9]:

> *"…the FCA must consider the possibility of reduced availability of credit and market exit as a result of a more expensive and in depth supervisory regime…If the burden of increased costs on firms leads to market exit, this will reduce the range of credit and credit-related products available to consumers [and]…if credit supply is reduced, some consumers may be more likely to borrow from illegal lenders, which could have significant adverse social and financial consequences."*

Indeed the spectre of a rise in illegal loan sharking has consistently been raised by opponents of price caps. For example, in a jointly authored report submitted to the then Department of Business, Enterprise and Regulatory Reform[10] in 2006, Policis and the Personal Finance Research Centre ('PFRC') at the University of Bristol argued (p.89):

> *"…commercial lending to high-risk borrowers will invariably come at a very high cost…however, the alternative may be unregulated black-market lending at much greater cost and on significantly worse terms."*

And in another joint report, evaluating the operation of the Illegal Moneylending Pilots for the Department in the following year, the same authors stated (p.82):

> *"The most effective strategy for combating illegal lending would appear to be a regulatory environment which maximises legal, regulated credit options while seeking to provide alternative credit solutions for those unlikely to have access to legitimate credit."*

Most recently, the PFRC was commissioned by BIS to provide an assesment of the likely impact of caps on the cost of credit in the home credit, pawnbroking and payday lending sectors. Their report, published in March this year, again highlighted the risk that capping the cost of credit *could* result in some consumers turning to illegal lenders. However, it should be noted that a telephone survey of 1,451 consumers conducted as part of the research indicated that very few people would actively consider this as an option (p.108):

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[9] FCA consultation CP 13/7: High level proposals for an FCA regime for consumer credit: Response from the Consumer Finance Association.

[10] Now the Department for Business, Innovation and Skills ('BIS')

"When asked what options they would consider if they needed to borrow a similar amount of money for a similar purpose as their most recent short-term loan, very few customers in the Consumer Survey said they would consider using the option of an illegal money lender (one per cent of online payday loan customers, two per cent of retail payday loan and home credit customers and five per cent of pawnbroking customers."

Finally, it should be noted that three additional arguments are also frequently advanced by advocates of the small sum, high cost consumer credit sector in response to the threat posed by more intensive regulation:

- The majority of firms act responsibly (and have made a number of voluntary commitments through their trade associations to demonstrate this), only promoting products designed for short-term borrowing and which are affordable to the borrower[11];
- However, some flexibility is often required to accommodate changes in the borrower's circumstances and/or in recognition of the fact that budgets are stretched and that there may be repayment problems from time to time[12]; and
- The cost of making small sum loans is expensive relative to the amount lent because of high fixed costs and the default risk inherent in lending to people on lower than average incomes. For example, Provident Financial have argued (2006, p.33) that imposing price caps would result in the 'least affluent and most vulnerable home

[11] In November 2012 the CFA introduced a new code of practice for its members. This requires, amongst other things, that these undertake 'a sound, proper and appropriate assessment of the creditworthiness of the customer to assess the borrower's ability to afford any proposed credit commitment, or specific additional commitment'. Members are also required to 'highlight to the customer the short-term nature of the loan…encouraging the customer to consider longer term implications if it becomes apparent that the customer is using short term loans for sustained borrowing'. In addition, the Code prohibits CFA members from allowing customers to 'roll over' or extend their loans on more than three occasions. In May 2013, the CFA also announced that it has put in place a 'Short Term Lending Compliance Board' which is working with KPMG to design and implement a 'robust Code compliance regime'.

[12] For example, lenders in the home credit sector do not typically charge for occasional missed payments, but in fact 'cost in' to the headline price their expectation that there will be some missed payments over the lifetime of the loan. The Competition Commission inquiry into this market conducted found (2006, para 3.29) that over 90 per cent of customers missed at least one payment in the life of a loan and over three quarters either 'usually' or 'often' missed payment. In the payday lending sector, Dollar Financial has indicated (Fiscal Third Quarter 2013 Results) that adhering to the OFT's Irresponsible Lending Guidance has caused a 'temporary credit crunch' for customers with multiple loans [as it has not been able to refinance these and maintain compliance with the guidelines] and caused an increase in loan defaults.

credit customers having restricted access to legal sources of credit, particularly smaller sum and shorter term loans'.

Taken together, these arguments therefore stress the importance of maintaining access to consumer credit products for low to middle income households whilst also seeking to maintain confidence in lenders in this sector as responsible firms, without unduly compromising their discretion to determine who to lend to, how much to lend, and at what price.

Structural budget deficits and 'credit dependency'

However, this view of short-term, high cost consumer credit as an aid to cashflow management for lower income households is challenged by evidence that high cost credit results in increased levels of indebtedness and a form of 'credit dependency' (Gibbons & McCartney, 2008). This is particularly the case for those households who use this sector not as a short term tool to cope with peaks and troughs in cashflow or unexpected one-off expenditures, but on a long term basis to bridge the gap between the cost of essential spending and inadequate income levels.

These households, it is argued, have *structural budget deficits*. Rather than helping households manage peaks and troughs in expenditure over time, the use of high cost credit makes these deficits much worse, as the consequent repayments limit the ability of households to maintain expenditure in other areas of the budget. This view is supported by a long standing and extensive research literature. Examining the interaction between low income, credit use, and poverty for the Child Poverty Action Group over twenty years ago, Janet Ford (1991, p.51) noted that:

"The evidence indicates that debt is closely associated with poverty, and the growth in debt is closely (but not solely) connected with the growth in poverty, particularly in households with children. Those with low incomes have to borrow to secure basic needs, but in many instances their incomes are too low to sustain repayments. In addition to consumer credit default, debt can occur from the failure to pay for services, for example housing, fuel, water rates and poll tax."

More recently, Dearden et al's (2010, p.6) twelve month long study of credit and debt amongst sixty low-income families, found that:

"…living on an inadequate income for a sustained period severely limits people's ability to meet their day-to-day expenses, to avoid taking out further credit or to avoid becoming over-indebted."

And Orton's (2010, p.31) three year longitudinal study of fifty three low-income households, reported the:

"…depressingly familiar finding of low income holding back people's ability to move beyond indebtedness – even when people had rejected credit use and were committed to careful budgeting, insufficient income meant they still faced a dilemma of how to meet basic and specific needs. There remained no examples of interviewees having savings, and half the sample had borrowed money between years 2 and 3 of the research."

Reviewing the findings from ten relatively recent studies in 2011[13], Gibbons et al identified the most common reasons for low income households to use credit and the consequent impacts of making repayments on other areas of the household budget, as set out in table 1, below.

Table 1: Common uses of credit and the impacts on low income households

Uses of credit	Christmas presents Birthday presents Clothing (especially for children, including school uniforms and children's shoes) Furniture, beds and bedding Children's toys Electronic goods White goods (fridges and washing machines) Holidays School trips Car purchase and repairs Food and payment of household bills Mortgage and credit repayments[14]

[13] The literature from which the table is derived comprised: Dowler and Calvert 1995; Farrell and O'Connor, 2003; Whyley and Brooker, 2004; Collard and Kemspon, 2005; Policis, 2006; Orton, 2008; 2009; 2010; Harris et al 2009; Ellison and Whyley, 2010; Dearden et al, 2010; and Ben Galim et al 2010

[14] For households with mortgages who have experienced a dramatic drop in income there is evidence of the use of credit cards to make repayments, and there is also evidence that households take on additional borrowing as a means of consolidating prior debts and releasing further cash.

Impacts of repayments on household expenditure	Cutting back on food expenditure (buying cheaper brands, lower quality foodstuffs, reducing the number of meals, sharing meals with relatives, and in some cases going hungry) Reducing expenditure on social activities and not taking holidays Rationing fuel use Arrears on credit repayments Arrears on household bills (mortgages or rent, council tax, fuel and water) Forgoing or losing out on other life opportunities (e.g. not taking driving lessons, struggling to continue in education[15])

Not all of these uses of credit, nor all of the potential impacts, arise simultaneously and it is important to recognise that there are variations in the levels of credit use amongst low income households. The degree to which credit is used will depend on the needs (and wants) of the household at any particular point in time and on attitudes towards credit use, money management, and levels of financial capability. For example, Policis (2006, p.26) find that:

> *"…some low income borrowers appeared to have a greater appetite for credit than others. This appears to be driven primarily by a higher sense of entitlement to material norms, greater expectations of consumption and aspirations to a higher standard of living. These borrowers were determined to provide their families with what they see as a nice home, consumer electronics, trendy clothing, brand name trainers, big Christmas presents, etc. and were prepared to go to very considerable lengths to do so."*

Attitudes to credit use are also dynamic, changing with social expectations concerning acceptable living standards and also, as Jones reports (2005, p.11), in the light of experience:

> *"Many of the women spoke of how they got into debt with home credit companies and catalogues when they were young single mothers and how it took them many years to realise the impact on their lives of such borrowing. Some were now strongly averse to using home credit due to personal experience of debt."*

[15] Turley and White (2007) report that people with debts were unable to pay their tuition fees and fell behind with their work, when they had to take on paid employment to help make ends meet

However, it should be noted that even where borrowing does not take place, either because of choice or due to a lack of credit options, this can also have significant welfare impacts - with low income households often (Policis, 2006, p.23) having to go without essentials and with living standards significantly curtailed as a consequence.

Where credit is used by lower income groups to purchase essential goods and services the impact of this on other areas of the household budget, and therefore on living standards over the longer term, will vary according to the number of credit commitments and the level of repayments required. As Orton (2008, p.15) notes, it is 'self-evident' that credit repayments reduce the amount of income which is available to spend on other areas of the household budget, but it is a combination of both the extent of credit use and its cost which determines by how much this happens.

Acknowledging that some households are unlikely to be able to take on much credit (particularly if this comes at a high cost) without the repayments negatively impacting on their ability to fund other essential expenditure is important because those cut-backs, particularly if required over a long period of time, can give rise to a range of 'knock on' effects. These are well documented and, for over-indebted individuals, include the build up of rent, council tax and utility arrears[16]; mental[17] and physical health problems (for example as a result of living in cold homes[18]); distraction from, and barriers to, jobseeking, and negative impacts on the sustainability of employment[19] (for example, where the level of debt repayments remove the financial incentive to continue in employment). The long term effects of high cost credit use also have wider societal impacts - contributing to a significant increased cost for public services to address the problems that arise for housholds, and should be seen as an economic externality of the high cost credit markets – warranting substantial public policy intervention in the way that those markets are regulated as well as supporting the case for investment in more affordable alternatives.

The second school of thought therefore emphasises the need for regulators to ensure that high cost lenders *behave responsibly*, and in particular that they conduct effective

[16] We report on this further in Chapter Four of this report.
[17] Fitch, C., Hamilton, S., Basset, P., & Davey, R. (2010) Debt and mental health: what do we know? What should we know?. Royal College of Psychiatrists.
[18] Gibbons, D. & Singler, R. (2008). Cold Comfort: A review of coping strategies employed by households in fuel poverty. Energywatch
[19] Gibbons, D. (2010) The Impact of Financial Problems on Jobseeking. Centre for Responsible Credit

affordability assessments prior to advancing credit. In this respect, campaigners have been sceptical of leaving lenders with too much discretion – pointing out that:

- Many low income households will be desperate for cash – making them both price insensitive and prone to take on levels of borrowing that they cannot realistically afford to service but may nevertheless attempt to do so; and

- Unscrupulous lenders will take advantage of this by charging prices that are higher than would otherwise be warranted, and will seek out borrowers that are willing to refinance their agreements on a rolling basis;

These two factors give rise to a 'debt trap' or 'credit dependent' relationship which is lucrative for the lender but which is not sustainable for the borrower in the long term and which, during the period of the relationship, gives rise to negative social welfare consequences for the borrower and increased costs for wider society.

These arguments are not new. Indeed, some six years ago, the campaign group Debt on our Doorstep (2007, p.12) noted with regard to what was then the nascent payday lending market that:

> *"The growth of payday lending in the UK reflects that the main selling point of credit amongst the poor is the provision of fast and easy access to cash with the minimum of questions. To prevent competition, lenders then look to trap borrowers in a cycle of refinancing with them."*

And (p.10):

> *"The result is to deepen the level of hardship and poverty amongst the poorest and to create a group of people who must continue to take credit at high prices in order to meet their need for current consumption. This is credit being used at its most unproductive and destructive."*

These arguments have now been boosted by the findings from recent official inquiries and evidence from debt advice agencies.

The OFT's High Cost Credit and Payday Lending Compliance Reviews

The most recent official inquiry in this respect has been the OFT's review of payday lending, which was launched in 2012 and reported in March of this year. The headline finding reported by the OFT (2013, p.2) is 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. Payday lenders are also not meeting the standards set out in our Irresponsible Lending Guidance."*

This represents a volte face by the OFT, which also considered the payday market as part of a wider High Cost Credit Review conducted in 2010. Following that review, the OFT concluded (p.5) that 'in a number of respects, these markets work reasonably well' and, reflecting the cash-flow arguments in favour of high cost credit, that if the sector did not exist then 'significant groups of people' would be 'denied access to licensed credit in the UK'. Indeed, although the 2010 review identified some potentially 'deep seated' problems due to a lack of effective price competition it did not identify the need for further action in the payday lending sector beyond increased data sharing by lenders and the development of a voluntary code of practice.

In the event it took the payday lending industry over a year to produce a code of practice, and this was disappointing. The OFT's 2010 Review recommended that payday lenders establish a code that included:

- Complaints processes and advice to customers
- Policies on the rolling over of loans
- Rules of thumb on typical amounts to be lent to customers
- Guidance on avoiding the misleading of customers through advertisements, and
- Steps to ensure that consumers are aware of the ultimate owners of brand names

However, the code launched by the CFA in July 2011:

- Merely alerted people of their right to complain the Financial Ombudsman Service and stated that they 'may be able to seek assistance from the trade association,

without providing any details about the role that the CFA would undertake to investigate, andconsequently act on, any complaints made about its members;

- Did not mention the practice of rolling over loans;
- Failed to set out any 'rules of thumb' on typical lending amounts;
- Was also completely silent on the issues of advertising or on the misleading use of brand names.

The code was also criticised by us at the time[20] for failing to provide any information as to how compliance would be monitored.

By late 2011 it was generally accepted that the code of practice was inadequate to protect consumers. A year previously BIS had launched a call for evidence in response to its Consumer Credit and Personal Insolvency Review. This initially indicated that Government was considering capping prices in the credit and store card markets. However, following a campaign led in Parliament by Stella Creasy MP, the Department indicated that it would look carefully at evidence presented to it about payday and other high cost credit lending practices and consider whether or not it needed to take further action, including capping prices in these markets[21]. In its subsequent response to the review, published in November 2011, the Department indicated that it had commissioned further research into the potential impacts of price caps on levels of access to credit, and also noted the need for lenders to do more to address 'the upsurge of concern' by enhancing their existing codes of practice (BIS, 2011, p.13):

> *"…the Government believes that more can be done to address some of the increasing concerns that are being raised about the payday loan market more generally. The Government will work with the main trade associations representing payday lenders to introduce enhanced consumer protections in their existing codes of practice. The Government sees this as a real opportunity for lenders operating in this market to show that they are serious about responsible lending and about giving consumers the protections the Government believes they need from some of the practices that appear to be blighting this market."*

[20] http://www.responsible-credit.org.uk/uimages/File/cfrc%20payday%20code%20statement.pdf

[21] This commitment was given by David Willetts MP on behalf of the Department in response to a Westminster Hall debate called by Stella Creasy MP on 9th November 2010.

Pressure on the industry (and on Government and the OFT to act more decisively) continued to build throughout late 2011 and early 2012 when the BIS Select Committee inquired into issues of consumer credit and debt management. During the course of this inquiry, the OFT indicated that it would conduct a detailed compliance review of the payday lending industry against its Irresponsible Lending Guidance (published two years previously in March 2010). Importantly, the Select Committee's final report from the inquiry noted (para 73):

> *"For self regulation to be effective it has to include transparent and enforceable sanctions. We understand that more vigorous codes of practice are under development by the industry. The Government must ensure that self regulation can deliver the necessary enforcement sanctions and demonstrate that they are sufficient to protect consumer interests. Therefore, we recommend that the Government provide us with an update on the development of the codes of practice by the end of 2012. If it cannot be demonstrated that self regulation can deliver the necessary protections then the Government will need to intervene with statutory regulation."*

Responding to this pressure, and with campaigners in Parliament by now successful in obtaining an amendment to the Financial Services Bill[22] to provide the Financial Conduct Authority with the power to cap prices in consumer credit markets, the CFA introduced a new code of practice in November 2012. This requires, amongst other things, that CFA members undertake 'a sound, proper and appropriate assessment of the creditworthiness of the customer to assess the borrower's ability to afford any proposed credit commitment, or specific additional commitment'.

Members are also required to 'highlight to the customer the short-term nature of the loan…encouraging the customer to consider longer term implications if it becomes apparent that the customer is using short term loans for sustained borrowing'. In addition, the Code prohibits CFA members from allowing customers to 'roll over' or extend their loans on more than three occasions. In May 2013, the CFA also announced that it has put in place a 'Short Term Lending Compliance Board' which is working with KPMG to design and implement a 'robust Code compliance regime'.

[22] An amendment to this effect was moved in the Lords stages of the Financial Services Bill 2012 by Lord Parry Mitchell, and under threat of losing the vote this was accepted by Government. http://www.bbc.co.uk/news/uk-politics-20531126

However, the effectiveness of self regulation is called into question by the findings from the OFT's payday lending compliance review and subsequent evidence from debt advice agencies. The OFT's compliance review was published in March 2013. Key findings from the review, which cost £1 million to conduct in 2012 and is set to cost an equivalent figure in respect of follow up enforcement activity this year[23], included:

- Over a quarter of loans (28 per cent) are not repaid in accordance with the original terms of the agreement but are 'rolled over' or refinanced at least once – a practice which is lucrative for the lender but significantly increases the cost of borrowing;
- Although only 5 per cent of loans are rolled over or refinanced four or more times, these loans provide 19 per cent of lender revenues;
- The majority of lenders are not conducting adequate affordability assessments;
- Many lenders are not treating borrowers in financial difficulty with understanding or forebearance and promote rollovers when borrowers would be better served by a repayment plan;
- Lenders are misusing Continuous Payment Authority[24] to collect payments and in some cases leaving borrowers with insufficient funds to cover their most basic needs.

The enforcement action taken by the OFT in response to these findings has been well publicised[25]. Following the review, the OFT began writing to the fifty leading lenders, which together account for 90 per cent of the market, giving them 12 weeks to prove that they had taken steps to improve their practices. On 30th July, the deadline for all lenders had passed and the OFT released details of the impact of its action, revealing that:

- 46 out of the 50 lenders met the OFT deadline;
- Three lenders have surrendered their consumer credit licences entirely;

[23] Figures provided to the author by e-mail from the OFT dated 15th May 2013
[24] A Continuous Payment Authority (CPA) authorises a business to withdraw sums from a customer's account without having to seek repeat authorisation for each payment. Problems arise because lenders repeatedly us the CPA to 'siphon' money from bank accounts often charging the consumer multiple fees in the process.
[25] See, for example, http://www.theguardian.com/money/2013/mar/06/payday-lenders-reform-ultimatum-oft

- A further eleven lenders have stopped offering payday loans but continue to trade in other areas of the consumer credit market[26];
- One business did not meet the deadline, but has informed the OFT it is no longer trading.

In addition to leading to enforcement action against individual firms, the OFT's review made the important finding (p.11) that:

> *"One in three loans is rolled over or refinanced, accounting for almost 50 per cent of revenues…Lenders are not competing for these revenues. Customers in this position are largely captive...Our evidence suggests that encouraging rollovers is a deliberate commercial strategy for some firms. For example, staff in two large high-street firms told us that rollovers were regarded as key 'profit drivers' and that staff were encouraged to promote them - in one case this was even written into their training manual. In extreme cases, our inspectors found examples of customers having 12 or more consecutive rollovers."*

This recognition that irresponsible lending forms part of the core commercial strategy of some firms led the OFT to conclude (p.30) that:

> *"…the problems in this market go deeper than a very poor compliance culture, and that a full investigation by the Competition Commission is needed to understand how the market works and identify lasting solutions. This analysis will help inform the Financial Conduct Authority's work on payday lending when it assumes responsibility for consumer credit regulation next year."*

Following a period of consultation, the reference to the Competition Commission for a full market inquiry was made on 27th June. In doing so, the OFT identified five features of the payday lending market[27], which it suspects either 'prevent, restrict, or distort' competition and which could be having an adverse impact on consumers. The five features are:

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[26] On 14th August it was reported that a further four payday lenders had quit the market, bringing the total number to 18. http://www.telegraph.co.uk/finance/personalfinance/borrowing/10243103/Four-more-payday-lenders-quit-the-market.html

[27] The Market Investigation Reference is available at http://www.oft.gov.uk/shared_oft/markets-work/payday-MIR.pdf

- *Variability in compliance* - the OFT Compliance Review found varying levels of non-compliance with relevant law and guidance by payday lenders. The OFT suspects that those firms which invest more time and effort in complying (for example with requirements to conduct proper affordability assessments) may incur greater costs and be placed at a competitive disadvantage to those which invest less.

- *Lack of cost transparency* - the OFT identified practices which make it difficult for consumers to identify or compare the full cost of payday loans effectively at the point when loans are taken out. The OFT suspects that these practices undermine price competition by rendering consumers as a whole less effective at constraining prices.

- *Price insensitive customers* - a significant proportion of payday borrowers have poor credit histories, limited access to other forms of credit and/or pressing needs. This may make them less price sensitive which, the OFT suspects, weakens price competition between payday lenders.

- *Barriers to switching* - there are barriers to switching between payday lenders or to alternative products or options at the point of rollover. The OFT suspects that these barriers benefit incumbent lenders and prevent, restrict or distort competition from possible alternative lenders at the point of rollover.

- *Market concentration* - the OFT suspects that high concentration and barriers to entry and expansion exacerbate the prevention, restriction or distortion of competition arising from the features identified above. In particular, the OFT found that the largest three payday lending firms (Wonga, Cash Amercia, and Dollar Financial Corp) account for approxoimately 70 per cent of the market by turnover, and that the largest 15 firms account for about 90 per cent.

Following the market reference, the Competition Commission has now its published timetable for the inquiry, indicating that it intends to publish a final report in November/ December 2014. The Commission has also now published a 'Statement of Issues' indicating how it will take forwards the inquiry in respect of each of the features that may be affecting competition that have been identified by the OFT.

However, it is important to note that the Commission's Statement of Issues (para 19) makes clear that, beyond 'ensuring a competitive market in which customers are able to make informed choices', it is not their role to 'reach judgements on the affordability of short-term

credit for individual consumers and people's access to it'. Ensuring lenders properly assess affordability and behave responsibly will therefore remain issues for the FCA, rather than the Competition Commission, to resolve.

The experience of the Competition Commission's Home Credit Inquiry

Prior experience of the Competition Commission's work in respect of the 'Home Credit' or door to door moneylending market does not give us confidence that the underlying issues identified by the OFT in respect of the payday lending sector will be tackled effectively.

The Home Credit market was referred to the Competition Commission in September 2004, following the submission of a super-complaint by the National Consumer Council ('NCC') in June that year[28]. At the time, the NCC (Whyley & Brooker, 2004) identified a number of concerns about lending practices within the Home Credit market which are very similar to those now uncovered by the OFT in respect of payday lending. For example, the NCC highlighted (p.4) how:

> *"Rollover loans appear to be very common practice. The way interest charges for these loans are structured ties customers into increasingly expensive loans, and encouragement from trusted agents to take out rollover loans is likely to add to switching costs for customers wishing to move out of the home credit market. Also, the psychology of the relationship between the customer and agent, which is often built on friendship and is conducted in the emotionally significant environment of the home, may leave the customer vulnerable to exploitation in this regard."*

The subsequent market referral from the OFT to the Competition Commission is also now echoed by the referral made in respect of payday lending, with the OFT identifying:

- Many Home Credit customers are in a poor bargaining position and their financial need may mean that they are not price-sensitive;
- Customers may have difficulty comparing loans and do not appear actively to do so

[28] The genesis of this super-complaint is to be found in the work of the Debt on our Doorstep campaign, which published a paper in 2003 identifying possible grounds for the referral of the industry to the Competition Commission and which informed the work of the National Consumer Council in this respect.

- Step-up[29] and 'roll-over' loans tend to tie customers in to existing lenders

- Agents'[30] relationships with customers contribute to making them unlikely to switch lenders

- Aspects of the structure of the market may deter entry, particularly on a significant scale givin rise to market concentration

The consequent Competition Commission inquiry took another two years to complete, and led to the publication of a final report in November 2006. The key findings from the inquiry (pp.6-8) were that:

- Profits had been ‘persistently and substantially’ in excess of the cost of capital for firms that represented a substantial part of the market;

- The prices that Home Credit customers paid were higher than they would need to be to reflect the costs of providing the service, and were higher than they would be in a competitive market. The Commission estimated that this was costing consumers at least £75 million per year;

- Price competition among home credit lenders was weak. Demand was unresponsive to changes in price and there was no evidence of selective price competition either in response to local market conditions or to attract and retain particular customers;

- Where customers are insensitive to price and competing for new customers increases the risk of default, there is only a limited incentive to compete on price. Lenders preferred to compete to make larger loans available to their best customers at the times when customers most needed them.

In addition, the Competition Commission also identified[31] that a large proportion of Home Credit lender revenues derived from the making of roll over or ‘renewal’ loans to existing customers:

[29] Whereby small loan amounts are provided in the first instance and offers of credit for larger amounts are made later on the basis of a satisfactory repayment history.
[30] Home Credit is typically collected from the borrower’s home by an agent acting on behalf of the lender on a self-employed basis.
[31] Home Credit Inquiry, Final Report: Appendix 2.3, para 67.

"From the information provided by suppliers, we estimated that renewals account for over one-third of new loans issued—around 1.5 million loans a year. In 2004, the average balance outstanding on loans that are renewed was £134, for those suppliers for whom we have this data. Our analysis suggests that £150 million to £200 million in outstanding balances on home credit loans are refinanced through renewal loans each year."

Importantly, the Commission found that[32] 'companies…have financial incentives to offer renewal loans' because[33] the costs of issuing a renewal or rollover loan are lower than the costs of issuing a new loan to a new customer, 'as suppliers have already conducted their initial checks on the customer' and 'the credit risks of offering a renewal loan…were lower than for a loan to a new customer'.

The Competition Commission's Remedies

Consequent to its findings, the Competition Commission introduced a package of remedies comprised of:

- **Data sharing** – this required that Home credit lenders with over 60 agents or £2 million in annual turnover from home credit loans were required to share data on the payment records of their customers (subject to those customers' consent) with at least two of the three credit reference agencies. The stated objectives of this measure were two-fold:
    - to reduce the 'incumbency advantage' of existing lenders in the market by making sure that information on the prior repayment history of customers was available to new market entrants – so encouraging new firms to enter the market and improve competition for customers; and
    - to enable customers to build up a transportable record of their repayments which they could then use to access less expensive forms of credit.
- **Price transparency** – in order to increase customer' awareness of price differences between different home credit lenders, reduce search costs for consumers and increase the incentives for lenders to compete on price all home credit lenders were required to:

[32] Ibid, para 29
[33] Ibid, paras 19 - 20

    - Provide specified information on the price (TCC per £100 advanced and typical APR) and other terms (eg the term in weeks) of all their loans to an independent price comparison website, (LendersCompared.org), the costs of which were to be met by the largest lenders;
    - Put a reference to LendersCompared.org on (i) any advertisement that was required by the Consumer Credit (Advertisements) Regulations 2004 to include the typical APR; and (ii) all payment books, statements, flyers and direct mail and;
    - Provide pricing information about their home credit products on request, either orally or in writing, to the customer within one week of a request.

- **Improved information to consumers** – in order to provide consumers with better information about their borrowing and the cost of this, and to provide them with a record of payment that they could potentially use to demonstrate their repayment record to other lenders, the Commission required:
    - Upon request, all home credit lenders to give their customers one free statement per quarter or one per loan (whichever is greater);
    - On legally required annual statements, that home credit lenders give details of the Total Cost for Credit, information about possible Early Settlement Rebates, and details of the LendersCompared.org website and the right to request additional statements.

- **More generous rebates for customers settling their loans early or refinancing their borrowing** - at the time of the Commission's final report, home credit customers that discharged their loan early for any reason, including by taking out a 'rollover' or 'renewal' loan were entitled to a rebate calculated in accordance with the Consumer Credit (Early Settlement) Regulations 2004. Under this legislation, the lender was entitled to defer the settlement date for the purposes of calculation. The deferment period allowed was up to 28 days on a loan that was less than a year and eight weeks on a loan that was over a year. The Commission's remedies required that, home credit lenders were not allowed to defer the settlement date for more than 13 days. The remedy was aimed at addressing the customer detriment (specifically the low level of rebates being given to customers who were rolling over or

refinancing agreements), which the CC said were not 'fair' in terms of what the lender would receive if rebates properly reflected the cost savings to the lender. It was thought that this remedy would also increase price transparency and that it might lessen incumbency advantages because more generous rebates would reduce switching costs.

The package of remedies introduced by the Competition Commission came into effect in 2008, and an evaluation of their effectiveness was conducted in February this year. Unfortunately, the Commission's own evaluation reveals that:

- They have been 'unable to quantify the impact of the ***data sharing remedy*** on switching (either between home credit lenders or from home credit lenders to other forms of credit)' and 'are unable to form a firm view on the effect this remedy has had on the customers';

- They have been 'unable to ascertain whether the ***LendersCompared website*** has led to an increase in switching';

- 'Customers do not appear to be using ***statements*** in the way the Competition Commission expected or to a great extent'.

As regards changes to the rules for ***Early Settlement Rebates***, the Commission finds that this has created a transfer of lenders to consumers of approximately £35 million – addressing just under half of the amount of consumer detriment caused by a lack of effective price competition. However, the Commission also notes (para 168) that 'similar numbers of borrowers still appear to be refinancing their loans with the same lender'.

Does increased data sharing really benefit low income consumers?

Despite being unable to determine the impact of its data sharing remedy on consumers, the Competition Commission's evaluation of its remedies (2013, para 178) went on to conclude that:

> *"The data-sharing remedy, where used effectively by lenders, has reduced information asymmetries between lenders, which has helped reduce incumbency advantages."*

However, this view is challenged by our own research in this area (Gibbons, 2013). Reviewing published information concerning the operation and impacts of data sharing in

the home credit, rent to own, and payday lending markets, and conducting follow up discussions with rent to own lenders and credit reference agencies, we reported that:

- Assessing the impact of increased data sharing is hampered by a lack of access to credit reference agency (CRA) held data and analysis[34];
- A good repayment record with a high-cost provider is unlikely to be predictive of repayment behaviour on more mainstream products – for example, some high-cost credit products are subject to frequent (weekly as opposed to monthly) repayment obligations; are associated with more intensive collection methods (e.g. home collection); or are more likely to be secured on goods (rent-to-own) than mainstream credit products;
- Although the Competition Commission required home credit lenders to share data from March 2008 onwards, the mechanisms used to do this are not adequate to enable lenders to identify the 'best' payers. Specifically, the data sharing protocol that was put in place aggregates the weekly repayment profile of home credit borrowers into a single monthly report. As a consequence it is possible for a home credit borrower to miss three payments in a row and still be reported as up to date with their payments;
- There is little evidence that data sharing has increased price competition between home credit firms, or that it is resulting in downward pressure on prices by encouraging more mainstream providers to compete for home credit customers;
- There is also no evidence that home credit firms have used the available information to differentiate the prices charged to their customers;
- More data sharing does not necessarily lead to more responsible lending decisions. Although over half of all payday loan transactions are now reported to CRAs there is now considerable evidence of irresponsible lending in this sector.

[34] The sharing of analysis is restricted by the Standing Committee on Reciprocity ('SCOR), which comprises the main industry trade associations. All requests for analysis (beyond very basic data) have to be approved by SCOR. This prevents consumer agencies and the regulators from conducting empirical analysis of, for example, the extent to which data sharing helps people to migrate from high cost products to more affordable forms of borrowing.

Evidence from Debt Advice Agencies

The initial response of the CFA to the OFT's payday compliance review was to claim that the failings reflected practice at the time of the review and that the new code was already proving effective in addressing concerns[35]:

> *"We recognise there are concerns about the industry however…work is already underway. Since the industry was investigated last year we have introduced a series of safeguards to ensure that our members are dealing with customers responsibly. From credit checking all new applications, to limiting loan rollovers and providing help for those who get into financial difficulty, we have raised standards all the way through the loan process. We go far beyond the legal requirements but if the Government wants us to do more, we will consider its proposals."*

However, this position has now been sigificantly undermined by the continued, exponential, increase in the number of people reporting problems with payday loan debt.

The basic statistics in this respect are set out on page 9, above. In addition to those, StepChange has provided further details of the indebtedness levels of payday borrowers, and Citizens Advice has reported on the extent to which lenders are breaching their own codes of practice.

StepChange has reported specific concerns about the amount of payday loan debt that was being taken on by people turning to its service for help. Between January and June of this year, the charity helped just fewer than 31,000 people with payday loan debt problems. However, over 20 per cent of these had five or more payday loans outstanding at the time of seeking assistance. Further to this, in the January to June period, the average monthly income of a StepChange debt charity client was just £1,298, whereas the average payday loan debt of those clients was £1,665 – revealing that it would be impossible for these clients to repay the debt within the usual monthly period of the loan agreements.

In fact, StepChange has provided further evidence that not only are its clients considerably over-indebted with payday loans themselves, but that these debts are frequently incurred in addition to other consumer credit debt, including credit card and bank overdrafts. Of the payday borrowers seeking help from StepChange in 2012:

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[35] http://www.cfa-uk.co.uk/media-centre/press-releases/current-press-releases/cfa-responds-to-bis-and-oft-reports.html

- 60 per cent had overdraft debts averaging just over £1,500;
- 57 per cent had credit card debts averaging £3,500;
- 50 per cent had personal loans averaging just over £6,000
- A third of borrowers had catalogue debt averaging £1,500.
- One in ten had store card debts outstanding of around £750.

Importantly, many payday borrowers have also incurred priority debts – building up arrears on rent, council tax and with their energy suppliers. In these respects StepChange reports[36] that of the payday borrowers seeking help from them in the first half of this year:

- 21.2 per cent had outstanding Council Tax arrears, averaging £750 per person;
- 15.2 per cent had outstanding rent arrears, averaging £959 per person;
- 11.5 per cent were in arrears with their electricity supplier, on average by £487; and
- 8.4 per cent were behind with payments to their gas provider, with arrears averaging £484.

Commenting on the increase in payday loan debt problems, StepChange's Head of Policy, Peter Tutton, said[37]:

> *"The problem of payday loan debts continues to worsen despite the introduction of new codes of practice by the payday loan industry. The fact that we are still seeing increasing numbers of people with five or more loans and clients with loans in excess of their monthly income clearly shows that payday loan companies are still failing to lend responsibly."*

Indeed, over the period from November 2012 through to July this year, **Citizens Advice** analysed customer feedback on 2,718 payday loans from 126 different payday lenders. This was conducted to monitor whether lenders were abiding by their own customer charter. The findings from this are shocking:

- 71 per cent of payday borrowers reporting that they were put under pressure to roll over their loan;
- Three quarters of people reporting repayment difficulties;

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[36] Figures provided by e-mail to the author on 13th September 2013
[37] http://www.stepchange.org/Mediacentre/Pressreleases/Paydayloanproblemsworsen.aspx

- 80 per cent of people stating that they were not told by their lender how they could complain if they had a problem.

In fact, this report followed an earlier media release made by Citizens Advice in May of this year which revealed that payday lenders are breaking 12 out of 14 promises they made to treat customers fairly. And, at the beginning of August, Citizens Advice reported the results from an in-depth analysis of 665 payday loan cases, reported to its consumer service between 1 January and 30 June 2013, finding that at least 76% could have grounds for an official complaint to the Financial Ombudsman[38] including:

- 1 in 5 were possible cases of fraud – where a person was chased for a loan they hadn't taken out.
- More than a third involved issues with continuous payment authorities including money that was not authorised to be taken.
- 12% involved harassment whereby lenders pester people with phone calls and text messages rather than accept affordable repayment offers.
- 1 in 10 were about lenders' unfair treatment of people in financial difficulties.

Whilst the focus of these debt advice agencies has been on payday lenders, it is important to note that problems in other sectors of the high cost credit market may be being overlooked.

Self regulation in the Rent-to-Own market

Throughout 2011 and 2012 the Centre for Responsible Credit worked with Church Action on Poverty, Thrive[39], and the three leading Rent to Own firms (Brighthouse, PerfectHome, and Buy as you View) to secure a set of seven key customer commitments[40]. These were:

- To ensure that goods are competitively priced[41];

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[38] As a consequence, Citizens Advice launched a month long campaign urging people to report problems to the Financial Ombudsman Service.

[39] Thrive project is a community organising project in Stockton on Tees established by Church Action on Poverty, and working in partnership with Durham University's Centre for Social Justice and Community Action. The project has successfully engaged local residents around issues of concern and, in 2011 identified a high level of use of rent to own companies in the area. The project then approached the Centre for Responsible Credit to provide it with technical assistance.

[40] For a full account of the project see Gibbons, D. (2012). 'Improving Practice in the Rent to Own Market'. London: Centre for Responsible Credit

- To use mystery shopping exercises to evaluate how prices are explained to their customers;
- To provide customers with a range of payment options;
- To limit default charges to no more than the actual cost incurred to the company;
- To put in place policies and procedures to help people in financial difficulty and to refer customers in arrears to free, independent, debt advice agencies;
- To develop clear policies for future complaints handling, and
- To provide clear annual statements of account.

The seven commitments have been incorporated into customer charters, which the three firms undertook to promote to customers, both in store and on their websites. However, the main trade association – the Consumer Credit Trade Association ('CCTA')[42] – which was involved in discussions throughout the lifetime of the project, refused to incorporate these commitments into its existing Code of Practice. Had it done so, these commitments would have been required of all CCTA members providing rent to own agreements, rather than be restricted to the three largest firms. In addition, the commitments would also have been subject to the CCTA's monitoring and compliance procedures.

In view of the failure of the CCTA to take this forward, the project therefore recommended that the three main firms develop their own 'proposals to ensure that they are effectively monitoring the operation of their customer charters, including through the commissioning of independent reviews and inclusion of the main results from these in their annual reports'. Unfortunately, this recommendation does not appear to have been acted upon, and there remains a lack of transparency concerning how far the commitments are actually being delivered.

An additional recommendation, that BIS discuss the need for rent to own specific addendums to be made to the CCTA and Finance and Leasing Association codes of practice with these trade associations also appears not to have been progressed.

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[41] For example, the Brighthouse Charter committed the company to 'ensure our prices are competitive against comparable high street retailers'.

[42] It should be noted that during the project Brighthouse left the CCTA and joined the Finance and Leasing Association.

Problems of affordability in the home credit market

The Competition Commission inquiry into home credit uncovered that there were considerable financial incentives for firms to encourage borrowers to rollover loans. As a result it implemented changes to the level of Early Settlement Rebate that borrowers should receive in these cases. However, as indicated by its recent evaluation of remedies, this has not resulted in any significant reduction in the numbers of people refinancing their loans with the same lender.

In addition, media reports continue to highlight problems in this market. For example, on 4th April 2012 the Daily Mirror reported[43] on the case of an 86 year old woman living in sheltered accommodation who was paying £61 per week from her £108 per week pension to Provident Financial in debt repayments. As the Mirror noted, this position had arisen from a long term dependency on Provident loans:

> *"Since 2007 [she] has taken out 18 loans totaling £8,600 costing £6,354 in interest alone - that's £1,000 more than her annual pension. She's never once been clear of Provident debts and the repayments have almost doubled from £33 a week. The loans were used, according to [her son], to pay bills and to keep up payments to Provident, which allowed her to 'roll them over' 15 times."*

The reporting of this case, part of the Daily Mirror's long running 'End Legal Loan Sharking' campaign, proved the catalyst for a cross party group of MPs[44] led by the Chair of the All Party Parliamentary Group on Credit and Debt, Yvonne Fovargue MP, to write to the Director of Consumer Credit, David Fisher, at the OFT and request that the scope of the payday compliance review be expanded to include home credit lenders.

Unfortunately this request was rejected, with the OFT citing resource pressures as one of the main reasons for this. This lack of resources for enforcement activity has been highlighted most recently by the Public Accounts Committee[45], whose inquiry into the regulation of consumer credit concluded in May of this year also noted (para 6):

[43] http://blogs.mirror.co.uk/investigations/2012/04/86-year-old-olive-hands-two-th.html
[44] The signatories to the letter were Yvonne Fovargue MP, Stephen Gilbert MP, Tracey Crouch MP, and Nic Dakin MP.
[45] The Committee noted that the OFT spent approximately just £1 on enforcement activity in 2011/12 for every £15,300 lent to consumers.

> *"We have serious reservations about the predatory techniques used by some home-credit providers to sell and target loans to low-income customers, encouraging people who cannot afford it to take out further loans for new expenditure. This is made worse when loans are rolled over with the resulting extra interest. As a result, small loans quickly become out of control debts. We do not believe repeated rollovers for what are meant to be short-term loans should be encouraged or proactively promoted. We recommend a strict limit set at three rollovers (or extensions) per loan."*

This recommendation – made specifically in respect of the home credit market – has apparently gone ignored in the clamour over payday lending, although in a response to the Public Accounts Committee report made in June of this year, David Fisher from the OFT said:

> *"We will, of course, consider carefully the points they made. But it's fair to say we were disappointed that the committee overlooked the legislative constraints under which we operate."*

Chapter 3: Database driven enforcement in the U.S

Problems with high cost consumer credit markets are not limited to the UK, and we have previously reported on international approaches to regulation, particularly in respect of the U.S, Canada, and Japan[46].

In our initial report on payday lending[47], published in 2010, we reviewed the regulatory approaches being pursued in the US and Canada. This reported that:

- Fifteen states in the US had prohibited payday lending altogether either by introducing a ban on this form of lending or by introducing a cap on the total cost of credit at such a low level that it has made the payday lending unviable;
- Thirty five states in the US and eight provinces in Canada have introduced legislation which allows payday lending to take place. These laws frequently include a cap on the total cost of credit but the level of the cap is sufficiently high for payday lending to remain viable;
- Payday lending laws in the US and Canada also incorporate measures to ensure responsible lending, notably placing restrictions on:
  - the amount of loan relative to the borrower's income;
  - the maximum number of loans permitted to be taken out at any one time;
  - the number of loans that can be provided in any given period;
  - the number of times a loan can be 'rolled over';
  - the level of fees that can be charged for overdue loans.

The report also highlighted that regulators in a number of US states had established databases in order to enforce their responsible lending requirements – for example in order to avoid borrowers taking out loans from multiple providers at the same time. To ensure these types of restrictions are observed payday lenders in these states are required to enter the details of all loans they provide within the state into the database, and must check the

[46] Gibbons D. (2012). 'Taking on the moneylenders: lessons from Japan'. Centre for Responsible Credit

[47] Gibbons, D., Malhotra, N., & Bulmore, R. (2013), 'Payday lending in the UK: a review of the debate and policy options'. Centre for Responsible Credit

database in order to ensure that the borrower is eligible for a new loan before advancing credit.

We further considered the use of regulatory databases in these states in a policy briefing paper published in December 2011[48]. This particularly focused on the experience of Florida which, particularly in UK terms, would be considered a tight regulatory environment comprising:

- A prohibition on multiple payday loans per borrower (only one payday loan can be outstanding at any given time);
- A maximum limit of $500 on any payday loan;
- A prohibition on rollover lending with a requirement that there must be an interval of at least 24 hours between loans (in order to prevent a new loan being taken out simply to pay off a previous loan). In the event that the borrower is unable to pay on time, there is also a requirement for lenders to provide them with an automatic loan extension or 'grace period' of 60 days at no additional cost; and
- A limit on the total cost of credit fixed at 10% of the amount advanced, plus a verification fee of $5 to cover the administration costs of lenders accessing the database to determine the borrower's eligibility.

The 2011 briefing highlighted how, contrary to lender arguments that tighter responsible lending requirements would put firms out of business, Dollar Financial, which trades in the UK under the Moneyshop brand, had actually bought into the Florida market - acquiring 23 stores in 2006 and a further 82 payday lending stores in 2007. In its press release announcing the acquisition the lender described the regulatory environment as 'favourable'.

Further to this, we also reported independent academic analysis of data provided from Florida's regulatory database by the University of Massachussetts[49]. This indicated that despite the tight responsible lending requirements in place in the state, the payday lending

[48] 'How to regulate payday lending: learning from international best practice', 2011, Centre for Responsible Credit.
[49] Perspectives on payday loans: the evidence from Florida‟, July 2010 available from http://www.veritecs.com/News.aspx

industry continues to ‘flourish, and was ‘growing rapidly in terms of the number of customers, number of transactions, and the total advance’.

Explaining this experience, the authors of the University of Massachussetts report noted that lenders had benefitted from the imposition of responsible lending requirements as this reduced their default rates and provided for an increase in profitability:

> *“Although the average loan advance and average fees per loan have remained stable, industry profits have benefited from both a decline in the default rate from 2.7% to 1. 7% and a similar decline in the ratio of loans defaulted to fees earned from 28.1% to 17.4%.”*

Our 2011 policy briefing was submitted to the BIS Select Committee inquiry on Debt Management, which subsquently recommended (para 64) that ‘the Government studies the Florida example to see what lessons can be learned for the UK market on successful regulating of the payday loans market’. In its response to the Select Committee, the Department indicated that the Florida example would be included within the scope of research being commissioned from the PFRC at Bristol University. Whilst this was done, it should be noted that the scope of the PFRC report was limited to reporting on the potential impact of *cost capping measures only*. Whilst the report presented information concerning Florida’s broader regulatory environment and noted that its experience contradicts the claim that caps on the cost of credit result in levels of supply being constrained, the report did not consider how effective the non price cap elements of the Florida law have been in ensuring more responsible lending practice. As a consequence, Government has only partially taken forwards the Select Committee’s recommendation.

This chapter now sets out further detail of the regulatory approaches taken in thirteen US states which have regulatory databases in place, and sets out the rules that the databases have been established to enforce and how the databases operate. We then present some empirical evidence of the impact of different responsible lending requirements based on trend reports from the data held by state regulators.

Which States, which responsible lending requirements?

We have reviewed the responsible lending requirements in place for thirteen US states, which currently have regulatory databases in place. A summary of the main requirements in each of these is now provided in the table on the following pages. A commentary on the findings begins on page 47.

Table 2: Summary of main responsible lending requirements by US State

U.S State	Max loan amount and restrictions on loan numbers	Restrictions on rollovers	Default charges	Database and/or verification fee allowed[50]?	Cap on the cost of credit?
Delaware	$1,000 maximum on any individual loan. In addition, borrowers may only take out a maximum of 5 loans in any 12 month period	A loan can be rolled over a maximum of four times and a rollover counts as a new loan so is therefore counted in respect of the limitation on the total number of loans allowed in any prior 12 month period; rollovers cannot be provided if the borrower has a debt 'workout' agreement[51] is in place	Lenders may charge additional fees if cheques or ACH requests[52] are returned unpaid. Multiple service charges for a single loan are permitted to allow for multiple cheques or ACH requests being submitted in respect of that loan	No	None in place
Florida	$500 maximum on an individual loan. The maximum number of loans permitted to be outstanding at any time is just 1, and there must be a 24 hour break between loans	No rollovers are permitted	Lenders may charge additional fees for returned cheques and ACH requests	Yes, a verification fee up to a maximum of $5.00 is allowed per loan	Yes, the maximum transaction fee is 10 per cent of the amount advanced

[50] Because the state places a requirement on lenders to use the regulatory database there is sometimes permission for the lender to make an additional charge for this. These charges often fall outside of the formal caps on the cost of credit charges that are in place in a number of states.

[51] A number of states provide for lenders to offer payment plans or debt 'workout' agreements to borrowers under certain conditions. In chapter four we present a proposal for a programme of social investment in credit unions to provide this type of assistance in the UK.

[52] ACH requests refer to electronic requests for payments from the borrower's bank account made through the US Automated Clearing House system.

Illinois	There is a total cap on lending, which is the lesser of $1,000 or 25% of the borrower's monthly income, but this can be made up of up to two payday or 'payday instalment[53]' loans (the maximum is the lesser of $1,000 or 22.5% of the borrower's monthly income if they already have a 'payday instalment loan' outstanding). Where the borrower already has a payday loan or payday instalment loan outstanding then the repayments required on that loan must be deducted from the $1,000 or % of monthly income when calculating the maximum that can be provided on any additional loan.	The maximum consecutive number of days that a borrower can be in the product is 45 days. If a new loan is provided within 6 days of the last then the term of the new loan is added to that of the previous loan when calculating the number of days that the borrowers has been in the product. E.g - a loan is provided for 31 days and paid off. Five days later the borrower applies for a 20 day loan. This is not allowed as the two terms are counted as being consecutive (i.e. 51) and this exceeds the 45 day limit. Once a borrower has had payday loans for a consecutive period of 45 days then the lender must wait until the balances on those loans have been repaid in full and also provide for a breathing space of 7 days thereafter.	Not specified	Not specified	Yes, the maximum transaction fee is 15.5% of the amount advanced

[53] A 'payday instalment' loan is defined in Illinois as a loan of up to 180 days in duration, payable in instalments. As we report later, in some other states there has been a considerable expansion of these longer term instalment loans as a means of evading responsible lending requirements.

Indiana	There is a total cap (industry wide) on the amount that can be advanced to the borrower of $605. The total amount outstanding (taking account of fees and charges) is not allowed to exceed 20% of gross monthly income. The maximum number of payday loans permitted per borrower at any one time is two and individual firms cannot provide more than one loan per borrower.	Lenders are required to offer an extended repayment plan to borrowers that have entered into three or more consecutive loans. For the purposes of working this out, a loan is consecutive if it is taken out within 7 days of a previous loan. Where five consecutive loans have been taken out then a waiting period prior to new lending is imposed of 7 days.	Insifficient funds or returned ACH fees of $25 can be collected but only once in relation to a single loan	Not specified	Yes, the maximum is calculated as 15% of the first $250 of the loan; 13% on the amount between $250 and $400, plus 10% on the amount above $400 (to the max of $605)
Kentucky	There is a total cap on the amounts that can be advanced to the borrower of $500 but this can be made up of up to two loans.	None specified	None specified	Yes, a database fee of $1.00 per loan is permissible	Yes, 15% of the amount advance
Michigan	There is a $1200 limit in total but this can be made up of up to two loans. There is a $600 limit on a single loan and individual firms cannot provide more than one loan per borrower	Can extend the term of a loan by 31 days but at no extra charge to the borrower. Must offer a repayment plan once the borrower has entered into their 8th loan in any 12 month period	None specified	None specified	15% of first $100 advanced; 14% on second $100; 13% on third $100; 12% on fourth $100; 11% on fifith $100; 11% on sixth $100. So max amount of cost on $350 is $48

North Dakota	The maximum total amount permitted to be advanced to a borrower of $500, but there is no limit on the number of loans that can make this up.	Rollover or 'renewal' loans are permitted only once and the maximum obligation that can be created on renewal is $600 comprising the renewal amount advanced plus all fees and charges. The renewal fee must also be less than 20% of the renewal amount	None specified	Included in the general cap	Yes, 20%: this makes the maximum 'obligation' that can be created $600. This includes the advanced amount, fees, interest and any database fee
New Mexico	Total indebtedness must not exceed 25% of the customer's gross monthly income. However, there is no limit on individual transaction amounts so long as this overall limit is observed.	None specified	In the event that cheques or ACH requests are returned unpaid then the lender can charge a maximum of $15. Only one charge is allowed for each returned cheque or ACH. However, all transactions are also eligible for a payment plan of at least 130 days. Once a customer is in a payment plan then they are ineligible for any further loans and for a further 10 days after the completion of the payment plan and repayment of prior payday loans.	A fee of $0.50 can be added for database verification	Yes, the maximum 'administrative fee' is $15.50 per $100 advanced

Oklahoma	The maximum amount of any individual transaction is $500 and no more than two loans may be outstanding at any one time, so there is a total cap on borrowing of $1000	Payment plans are available once people have taken out 3 consecutive loans (consecutive defined as taking out a loan within 7 days of paying off a previous loan). The payment plan provides for repayment of outstanding amounts in four equal instalments (usually monthly but dependant on the customer's wage cycle). A customer may not take out any additional loans once they are in the payment plan and for 15 days following its completion. Lenders may charge a maximum of 10% of the oustanding amount or $15 (whichever is lower) for the payment plan. A customer must have a break from the product once they have taken out five consecutive loans. The break is 2 days following payment in full of the fifth loan.	None specified	Yes, verification fee of $0.46 per transaction	Yes, maximum amount is 15% on the first $300 and 10% on any amount over $300
South Carolina	The maximum amount of any individual loan advance is $550 and borrowers are only permitted to have one loan outstanding at any given time	Can't take out a new loan if the borrower repaid a previous loan on the same business day. Can't take out a new loan if they repaid a loan on the previous business day if this is their eighth loan in a 12 month period.	None specified - also has a payment plan option but only one payment plan is possible in a 12 month period. Lenders have discretion over whether to put payment plans in place but cannot charge for them. The payment plan provides for repayment in four instalments. Further to this lenders are not permitted to make additional charges for returned cheques	Yes, a database fee of $0.40 is allowed	Yes, 15% of the amount advance

Commonwealth of Virginia	The maximum amount of any individual loan advance is $550 and borrowers are only permitted to have one loan outstanding at any given time	A fifth payday loan within a single 180 day period will mean that (i) the borrower will then be ineligible for any further loans for a period of 45 days after the loan has been repaid; (ii) or the borrower can opt to repay the loan through an extended payment plan (provided they haven't had one of these in the past 12 months) or (iii) the loan is made on an extended term of 60 days and is repayable in 4 equal instalments. If a loan is taken on these terms then the borrower will be ineligible for any more loans for a period of either 90 days from the date the loan is repaid or 150 days from the date the loan is taken out (whichever is the longer)	Yes, can charge up to $25 for a returned cheque and can also charge up to $250 for legal expenses if the case is taken to court for recovery	Yes, but limited to $5	Yes, can charge simple interest at 36% of the loan amount, *plus* a loan fee of up to 20% of the loan amount
Washington State	There is a total lending limit of $700 or 30% of the borrower's gross monthly income, whichever is the lower and borrowers are prohibited from taking out more than 8 loans in any 12 month period	Term of loans can be extended but no charges can be applied for this.	Borrowers can request a payment plan, but only one payment plan is possible in a 12 month period. Lenders have discretion over whether to put payment plans in place but cannot charge for them. If the borrower defaults on the payment plan then the lender can charge a max of $25 for the life of the loan (this includes fees for returned cheques). There is a cap on the total amount of default charges that can be applied for any single loan of $25	None specified	Yes, 15% on the first $500 and 10% on any amount above $500.01 and up to $700

Wisconsin	There is a total lending limit of $1500 or 35% of the borrower's gross monthly income, whichever is the lower. There is no limit on the number of loans that can be taken out at any one time provided the overall lending limit is observed.	Only one rollover or loan refinancing can take place and this 'subsequent loan' must be fully repaid and the borrower then wait for at least 24 hours before they become eligible for a new loan.	Can charge up to $15 for a returned cheque or ACH, and can charge mutiple times if mutliple returns	Not allowed - specifically prohibited	None in place

It is important to note that the definition of what constitutes a payday loan varies between states. For example, Delaware's responsible lending requirements relate to 'short term consumer loans' - defined as loans of less than $1,000 and 60 days in duration[54] whereas the requirements in North Dakota specifically refer to 'deferred presentment transactions' and stipulate that these must be for a minimum of seven days and a maximum of forty five days in duration. Of particular interest is the state of Illinois, which in 2010 passed a law to regulate not just short term payday loans, but also longer term high cost instalment loans and auto-title lending (commonly referred to as 'log book loans'). The rules require that short term payday loans have a minimum term of 13 days and a maximum term of 45 days. The total cost of credit is capped at $15.50 per $100 on these loans. This cap also applies to 'payday instalment loan' agreements of up to 180 days in duration. In addition, the Illinois law also specifies that longer term loans (of six months or more and including auto-title loans) are capped at 99% APR for loans of less than $4,000 and at 36% APR for loans of more than this amount. It is to be noted that the regulatory database in Illinois is used to enforce responsible lending requirements in respect of payday loans, payday instalment loans, and longer term high cost loans including auto-title lending[55].

Defining what is and what is not included within the scope of state responsible lending requirements has proved problematic, and there is evidence that lenders have sought to evade the requirements by designing new products that fall outside of the definitions used in some states[56]. For example, responding to the introduction of the law in Delaware, which limits the number of payday loans to just 5 in any 12 month period, Cash America declared in its annual statement that this "only affects the Company's short-term loan product in Delaware (and does not affect its instalment loan product in that state)." The company has therefore expanded its provision of a seven-month instalment loan product in the state.

Likewise, in New Mexico the number of longer term instalment loan products expanded following the introduction of payday lending restrictions in 2007. This led to the Attorney

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[54] The precise definition in use in Delaware is "any single extension of closed-end credit of $1,000 or less made to an individual borrower that charges interest and/or fees for which the stated repayment period is less than 60 days and is not secured by title to a motor vehicle."

[55] For further details of the Illinois law see http://www.citizenaction-il.org/node/8

[56] The case of Ohio is also interesting, where there has been a reported move into auto-title loans by some payday lenders in order to evade the state's price cap of 28%. Some payday lenders have also set themselves up as credit repair organisations in order to charge an additional 'brokerage' fee for arranging loans on top of the charges allowed for the loan itself. For further details see http://www.policymattersohio.org/auto-title-loans-dec2012

General taking court cases against lenders for seeking to evade the rules. In one of these – against FastBucks – the court ruled that the company should provide restitution to its customers for charging an estimated $20 million in excessive interest. This has now led to the company filing for bankruptcy protection.[57]

Problems of definition notwithstanding, it is clear that the vast majority of the states in this review have put in place restrictions with respect to the maximum loan amounts that can be obtained by borrowers at any one time and/or the total number of loans that are permitted to be taken out in a given period (although the precise requirements in these respects do vary). The rationale for these restrictions is that whilst it is recognised that borrowers do often need access to small sum credit to manage immediate cash flow problems, they also need protection from taking out loans which are excessive given their level of income and which could lead to them becoming trapped in a 'debt spiral' of repeat and rollover borrowing. Regulators are therefore seeking to balance the arguments for and against high cost credit provision as set out in chapter two of this report.

What is apparent is that once regulators have determined that the best way to protect consumers from falling into a debt trap by seeking to prevent concurrent multiple payday loan use and the continued refinancing or rolling over of agreements, then a database of agreements becomes of paramount importance. This is not only essential to protect the borrower from unscrupulous lenders who would otherwise ignore the rules, but also critical for those lenders who wish to operate within the law and who therefore need information concerning any currently outstanding loans in order to do so.

By way of illustration, the Kentucky law that prohibits borrowers from taking out more than two payday loans (totalling up to a maximum of $500) has been in place since 1998. However, enforcement of this law was limited as lenders needed only to obtain a written statement from the borrower that they did not breach these limits at the time of advancing a loan. Following concerns about widespread abuse, the Kentucky law was amended in 2009 to provide for a regulatory database to be established in order to better enforce the Kentucky requirements, and the database was implemented in April 2010.

[57] For an account see http://www.propublica.org/article/how-payday-lenders-bounce-back-when-states-crack-down

Importantly, the establishment of the regulatory database in Kentucky was supported by the payday lender trade association, the Community Financial Services Association. Writing in December 2011[58] its Kentucky spokesman, Tres Wilson, commented:

> *"Kentucky has a new database to track payday loans because of legislation supported by payday lenders in 2009. The industry supported the database to give consumers and policy-makers absolute confidence that payday lenders are following the law in Kentucky. The database has prevented some people from borrowing more than the law allows, which means it is working. The first month the database went into effect, over 40 percent of loan applications were denied, and issued loans dropped 24 percent over the first six months."*

How do the regulatory databases work?

The main purpose of the regulatory databases is to ensure that lenders have the means to check whether or not a borrower is *eligible* for a loan in accordance with the state's rules. The databases therefore only require lenders to upload information to the database about borrowers to the extent that this is required to ensure compliance with state laws and are designed to be as simple to use as possible. The databases provide for secure access via a web portal. When a lender is licensed by the state they are provided with access to the database, and are able to set up their staff as authorised users to input data about their loan transactions and to use the database to check eligibility prior to making the decision to lend.

Every time that a lender receives a loan application they must check the database to determine eligibility and they must input details of all loans made onto the database. The information on the database is therefore updated in 'real time'.

The information required to be input by lenders falls into two categories:

- Borrower information - Lenders are required to identify borrowers on the database by entering the name, address and date of birth of the borrower and, typically, their social security number[59]. In those states where there are lending limits based on a percentage of the borrower's income then firms are also required to enter the borrower's income details onto the database;

[58] http://www.kentucky.com/2011/12/19/1999280/ky-law-sets-limits-on-payday-lending.html
[59] Alternative ID can be used in respect of people with no social security number, for example drivers licence, or for people who have immigrated to the US, the Alien Registration number.

- Transaction information – the agreement date (assigned automatically by the database), the due date or maturity date; the amount of the advance and details of any fees and charges.

The database therefore holds details of all open agreements taken out by a particular together with information about the date on which these are due for payment. The lender is then placed under an obligation to report onto the database what happens once the due date has arrived. In Florida, the state database automatically closes a loan fourteen days after the due date unless the lender updates the database to indicate that the loan, or any part of it, remains outstanding. In other states, this 'auto-close' feature is not present and the lender must pro-actively update the database to close an agreement that has been paid off or enter additional information concerning any returned cheques or missed payments.

There are pros and cons to both of these approaches, with the former clearly reducing the administrative burden on lenders but risking that some loan agreements will be closed on the system when they have not, in fact, been paid off; whilst the latter is perhaps more rigorous a system but clearly requires lenders to expend more time inputting information into the database. The extent of the additional administrative burden has been recognised by a number of states by allowing lenders to charge an additional 'database verification fee'. We comment further on this later in this chapter when discussing the costs of establishing and maintaining the regulatory databases.

Regardless of the variation in this respect, the databases provide vital information for supervisors and allow for reports of all loan transactions to be produced broken down by individual lenders and, in the case of lenders operating from store-front premises, by the store which originated the loan. These reports are then used by supervisors who can check a sample of loan documentation and cases against the database entries to ensure that lenders are complying with state requirements.

Supervisors are also able to perform a number of searches on the database in order to identify potential problems. For example, supervisors can:

- Obtain reports highlighting instances where a cheque or electronic request for payment from the borrower's bank account has been returned unpaid and a new loan has subsequently been opened on the system (demonstrating that loans may be being taken out to refinance previous borrowing); and

- Identify entries on the database where the borrower's income level has increased in comparison with the amounts stated for previous loans (indicating that lenders may have encouraged borrowers to inflate their income on the application in order to obtain a loan or have failed to check the borrower's stated income appropriately);
- Compare information from the database concerning the number, cost, and performance of loans made by any given lender with its reported revenues and profits to assess the validity of business models, levels of price competition, and the extent of market concentration in order to inform the use of measures including caps on the cost of credit to ensure that borrowers are getting a fair deal.

The databases allow state regulators to establish their own specific search and report criteria and to determine the reporting schedule, providing credit examiners with the information needed to enable them to target their time effectively. However, they do not remove the need for supervision entirely. Indeed, one of the most important functions of credit examiners is to review a sample of loan documents against the database entries in order to ensure that lenders are being honest when uploading information onto the system. Being found to have uploaded false information would have major repercussions for any lenders license to provide credit in the state.

In addition to the benefits to regulators, it should be noted that there are also some advantages in the use of the database for very small lenders, as the databases are able to provide these with a list of their loan originations, borrower details, and relevant due dates, allowing them to track performance on their loans. Regarding larger firms, many of these have integrated the database software with their own point of sale systems so that information concerning the borrower and any transactions only needs to be entered once and feeds into both the state regulatory database and their internal systems. Indeed, the contracts for several state databases require this functionality in the sofftware from the IT provider and it should be noted that two of three largest payday lenders in the UK – accounting for approximately 70 per cent of the market by turnover – also operate in US states which have regulatory databases in place. They are therefore already familiar with the requirements and have adapted their systems accordingly.

How regulatory databases differ from credit reference agencies

It should be noted that the implementation of regulatory databases differ significantly from 'data sharing' through credit reference agencies. In particular, the regulatory databases do not allow for information about a borrower's loans with one firm to be seen by another, nor do they provide information about the borrower's payment history with other firms, which may otherwise be used by lenders to inform their loan decisions. Lenders can therefore only see detailed information about their own loans to a particular borrower and, when checking the database to see if a new loan can be made or not simply receive a notice on the system telling them whether or not this is possible within the state. If a borrower is not eligible for a loan then the lender dealing with the application is informed in general terms of the reason for this and is required to provide the customer with the phone number of a call centre where they can obtain more information.

This clearly distinguishes the regulatory databases from credit referencing, where details of customer repayment histories and outstanding balances with other creditors are shared on a reciprocal basis by lenders. Although it may appear incongruous for this information not to be made available on a database designed to ensure more responsible lending practice, there are a number of advantages. In particular[60]:

- Providing a full credit referencing service would be more expensive;
- Credit reference agencies have not traditionally provided 'real-time' services, having developed to meet the needs of more mainstream creditors which report on a monthly payment profile;
- Requiring lenders to report data through existing credit reference agencies would put critical information beyond the reach of the regulator. The data provided through credit reference agncies remains the property of the lenders and is not shared with regulators to inform their enforcement policy or to assess market trends;

It is also important to appreciate that regulatory databases are simply a means of enforcing the state responsible lending requirements. In this sense, checking the information on the

[60] Also see chapter two, above, where we set out a number of reasons to be sceptical of the claim that more data sharing through credit reference agencies is an effective means of ensuring greater responsibility in lending in the high cost credit markets.

database will tell a lender whether or not a loan can be legally provided. However, it does not tell a lender whether or not making a loan would be a sensible credit decision. Lenders remain responsible for developing their own credit assessment processes and it is not the intention of regulators to assess lending risk on their behalf.

Does introducting a regulatory database increase the cost of credit?

A potential concern about the introduction of regulatory databases is that these will increase the administrative burdens on lenders, and that the associated costs of these will be recovered from consumers. We therefore now examine information from three states (Oklahoma, Kentucky, and Florida) in order to explore this issue further.

Although an open tendering process has been used by state regulators to commission the databases these processes have not set out indicative budgets and the final contract values are commercially sensitive. However, it is possible to assess the costs paid by consumers from the annual market trend reports published by regulators in the three jurisdictions. This is because the regulators have all stipulated that the costs of the database are to be funded entirely by levying fees on each new loan that is made and entered onto the database. There is therefore no state subsidy for the databases.

- In Oklahoma the verification fee is restricted to just $0.46 per loan transaction and in the 12 month period between April 2008 and March 2009, a total number of 1,058,000 transactions were recorded, leading to total verification fees being sought from consumers of approximately $486,000. According to the market trend report from the IT provider of the database (Veritec Solutions), the total number of borrowers was around 115,000 (with each taking out an average of 9.2 loans over the 12 months). As a consequence, the average amount sought from each borrower toward the cost of the database over the course of the year was just $4.23.

- Higher costs are reported in Kentucky, which allows for a verification fee of $1.00 per loan transaction. Data for 2010 indicates that some 2.11 million loans were transacted by just under 204,000 borrowers, creating an average number of loans per borrower of 10.3 in the 12 month period. The total average amount sought from each borrower to cover costs associated with the database over the course of the year was therefore $10.30. However not all of this amount is paid to the database provider, as the rationale for allowing a higher verification fee to be charged in

Kentucky is to provide lenders with some revenue to cover the administrative costs associated with the database.

- In Florida, the permitted maximum verification fee is much higher ($5 per loan) but lenders are charging beneath this amount. Veritec monitors the average amount of the verification fee being charged by lenders, which must be entered separately on the database alongside details of the cost of credit. In its most recent market trends report for Florida, covering the twelve months from June 2012 through to May 2013, Veritec report that the average verification fee charged was $3.18 – nearly $2 beneath the state limit. Unlike in Oklahoma and Kentucky, it can reasonably be assumed that lenders in Florida are therefore charging a verification fee which is in line with their actual administrative costs. As there were 7.5 million loan transactions in the year, this would have led to a total of $23.85 million being sought from consumers in respect of costs associated with the operation of the database. The total number of borrowers in the 12 months was 872,000, with each taking out an average of 8.6 loans in the year. As a result, the average amount sought from each borrower in respect of the database in the year was $27.34.

To bring the Florida verification fee figures into a clearer perspective, table 3, below, sets out details of the average loan amount advanced in the period together with the average cost of credit charged by lenders. We then calculate the average verification fee charged as a percentage of total loan costs.

Table 3: Calculation of verification fees as percentage of total charges levied on average loan amount

Average amount advanced ($)	Average cost of credit (as % of amount advanced)	(1) Average cost of credit fees ($)	(2) Average verification fee ($)	Total charges (1) + (2)	Verification fee as % of total charges
396.19	9.94	39.38	3.18	42.56	7.5%

The table reveals that verification fees make up, on average, just 7.5 per cent of the total cost of borrowing for consumers in Florida. Despite this, it should be noted that overall loan costs are still much lower in Florida than is the case in the UK. In fact, the total cost of borrowing averages as just $10.74 per $100 borrowed.

It should also be noted Florida's average total cost of credit (including the verification fees) is lower than for either Oklahoma and Kentucky[61] (see table 4, below), further suggesting that the costs associated with regulatory databases are not a significant component of the overall cost of borrowing for consumers.

Table 4: Average advances, fees and total cost of credit (Florida, Oklahoma, & Kentucky)

US State	Average advance ($)	Average total fees ($)	Average total cost of credit (%)
Florida	396.19	42.56	10.7
Oklahoma	383.44	51.34	13.4
Kentucky	313.63	51.61	16.5

In fact, we consider that the price differentials between the three states are more likely to be explained by the different caps in place on the cost of credit charges. In Florida, the maximum permitted charge for credit (excluding the verification fee) is just 10 per cent. The comparable cap in Oklahoma is 15 per cent on the first $300 advanced and 10 per cent on the remainder; and in Kentucky the comparable cap is 15 per cent.

Empirical evidence as to the impact of responsible lending requirements

In addition to providing state regulators with information that can be used to better target their enforcement activities, the databases also allow for greater understanding of market trends. This has been particularly lacking in the UK in recent years. Indeed, the recent Public Accounts Committee report regarding the regulation of consumer credit in the UK noted that (para 1):

> ***"The OFT does not have the information on lenders it needs to regulate them effectively.*** *The OFT does not have up to date information about companies that provide consumer credit such as the amount of lending by each firm and its customer base." (Emphasis in the original)*

In stark contrast the regulatory databases in use in the US provide precisely this information and, because comparisons can be made across states with different responsible lending requirements, this can be used to improve our understanding of the impacts of different types of requirements.

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[61] Data for Kentucky comes from http://media.kentucky.com/smedia/2011/03/04/22/Payday_-_B_I_Committee_Presentation_with_Data_Updated_Thru_Dec_2010_ver2.source.prod_affiliate.79.PDF

For example, there continues to be a great emphasis in the UK debate on the potentially negative impact of caps on the cost of credit on levels of access to credit. However, and as we reported in 2011, the evidence from Florida contradicted the argument that caps will inevitably result in a reduction in access levels. Indeed, more recent data from the state confirms our position. In the 12 month period from June 2012 to May 2013:

- The total number of loan transactions has continued to grow – up by an average of 4.1 per cent per month when compared to the same months in the previous year; and
- The total number of customers has increased by 9.1 per cent in the year.

It is important to note that these growth rates have been observed in a state which has a comparably tight cap on credit charges of just 10 per cent and even when the additional database verification fees are taken into account has an average observed total charge for credit of just 10.7 per cent. As previously reported, the continued viability of payday lenders in this environment appears to result from the low default rates that result from greater responsibility in lending practice. In particular, the low absolute limit on the level of payday borrowing that can take place in Florida (just one $500 loan is permitted to be outstanding at any given time) appears to have had a considerable impact on loan loss rates.

Utiising information held on the database, Veritec provides an estimate of loan loss rates by assessing the number of loans which remain outstanding more than sixty days beyond the date of the agreement (including loans that have been placed in a 'pending' status, for example because a cheque or ACH request has been rejected by the borrower's bank) or which have been closed by the lender on the system because they are bad debts.

Using this method, the loan loss rate in Florida is reported as just 1.6 per cent of all loans originated for the period April 2012 to March 2013. Further to this the value of outstanding amounts on these loans represents only 1.3 per cent of the total $3.31 billion value of all loans[62] contracted in the period. This contrasts sharply with the OFT's finding that 14 per cent of loans advanced by UK payday lenders are never repaid.

Table 5, below uses figures provided by the OFT's compliance review concerning the average advance, proportion of loans repaid on time, and loan loss rate and models the impact of tighter responsible lending requirements on loan revenues to demonstrate how a

[62] Calculated as the total amount of advances plus all fees and charges due on the agreements.

move towards lower default levels and less rollover lending still provides for lenders to remain viable.

Table 5: Models of payday lending: the importance of low default rates

Total cost of credit	Individual loan revenue if repaid on time	% repaid on time	Total revenue from loans repaid on time (£)	% rolled over three times	Total revenue from rollover loans	Default rate (%)	Lost revenue due to default (£)	Net revenue position (£)
25	331.25	68	22525	28	12985	14	1750	33760
10.7	331.25	98.4	28866			1.6	469	28397

The first row in the table shows a model of lending based on the OFT's findings. The total cost for credit is provided as £25 per £100 lent. Assuming the average level of advance found by the OFT of £265, this provides for revenue of £331.25 if the loan is paid back on time. Assuming that 100 loans are made and applying the OFT's finding that 68 per cent of loans are paid back on time, this provides for revenue of £22,525. However, the OFT also reported a significant proportion of loans being rolled over, with 28 per cent of loans were rolled over at least once, and 5 per cent rolled over four or more times. Since the OFT review the CFA has introduced a requirement for its members to restrict rollovers to three. As a consequence, we model that 28 per cent of loans will be rolled over between 1 and 3 times[63], providing additional revenue of £12,985. We then factor in the average default rate reported by the OFT of 14 per cent of loans not being repaid at all, which leads to a net revenue position of £33,760.

The second row then posits an alternative model based on Florida. This includes a reduction in the total cost of credit from £25 to just £10.7 per £100 lent, and assumes repayment levels similar to those found in Florida of 98.4 per cent. There is no revenue from rollover lending. Total revenue is £28,397. Although lower than in the first model this still covers the initial outlay of £26,500 and would return a profit for the lender even allowing for reasonable costs of capital and operational expenditure.

Comparing the Florida experience to other US states with higher caps on the cost of the credit indicates that other responsible lending requirements in place in those states but absent from Florida have a greater impact on the market.

[63] We have assumed that the split is even in terms of the proportion of loans being rolled over each number of times.

For example, Washington State has a higher price cap than Florida – permitting charges of 15 per cent on the first $500 lent and 10 per cent on amounts above this up to the state lending limit of $700. Both states have similar rules relating to rollover lending – with this prohibited in Florida, whilst in Washington State lenders are not permitted to levy any charges if the loan is extended beyond its original term. Importantly, however, Washington State has a limit on the total number of payday loans that borrowers can enter into in any 12 month period. Just eight such loans are permitted in the state. Florida, by comparison, has no such limit. The impact of this additional requirement in Washington State, introduced in 2009, has been dramatic. In the year before the restriction came into effect more than 3.2 million payday loans were taken out, but the following year this fell to just 856,000. Likewise, the number of payday loan stores in Washington State reduced by 42 per cent[64].

The reasons for this are not difficult to understand. As in the UK, a large proportion of revenue comes from a relatively small proportion of borrowers using the payday loan product on a repeated basis[65]. In the US, analysis conducted by the Consumer Financial Protection Bureau reveals that 75 per cent of loan revenue is derived from those borrowers taking out more than 10 loans in a 12 month period. Turning off this source of revenue by limiting the number or loans to eight has inevitably made it harder for payday lenders in Washington State to turn a profit on the product, and has led to further problems as those that remain have sought to develop new products in order to evade the state rules.

In comparison, in Florida there remains the opportunity for borrowers to obtain small sum payday loans throughout the year. According to the latest market trends report for the state, 23 per cent of customers took out 12 or more loans in a year, and taken together these loans accounted for 49 per cent of the total volume of business.

Similar findings are noted in the most recent market trends report for Illinois, which although not strictly limiting the number of loans that can be obtained in the year, restricts the number of consecutive days that a borrower can be 'in the product' to just forty five. Importantly, loans taken out within six days of each other are linked together for the purposes of calculating the duration that the borrower has been using the product. For example, a loan is provided for thirty one days and then paid off. Five days later the borrower applies for a

[64] See http://www.propublica.org/article/how-one-state-succeeded-in-restricting-payday-loans for further details.

[65] The OFT report that 15 per cent of UK payday customers take out more than 5 loans per year, accounting for 36 per cent of payday lender revenues.

new twenty day loan. This is not allowed as the two terms are counted as being consecutive (i.e. fifty one) and this exceeds the forty five day limit. Once a borrower has had payday loans for a consecutive period of forty five days then the lender must wait until the balances on those loans have been repaid in full and also provide for a breathing space of seven days thereafter.

The evidence from the Illinois state database indicates that this is having a considerable impact on lending volumes. In the past two years:

- The number of payday loans has fallen by 30 per cent;
- The number of payday instalment loans has reduced by 18 per cent;
- The number of auto-title loans has declined by 23 per cent.

The reduction in the number of payday and payday instalment loans in Illinois is matched by high numbers of customers declined for loans as a result of eligibility checks on the database. Throughout 2011/2012 around 40 per cent of total transaction requests made to the database resulted in borrowers being declined. The Illinois database records the reasons for these loan declines and we set these out in table 6, below.

Table 6: Percentage of declined eligibility checks by reason, Illinois 2011 - 2012

	Waiting period	Customer has entered a repayment plan due to financial problems	Consecutive days in the product	Over the state dollar limit	Two open transactions	Other
2011	11.63	0.41	33.97	21.12	23.13	9.74
2012	10.31	0.52	42.96	18.86	25.89	1.45

As can be seen the far highest percentage of declines occurs in Illinois because consumers are caught by the restriction concerning the number of consecutive days they can have in the product (42.9 per cent of all declines in 2012). This is followed by the further restrictions in Illinois that a consumer can only have two outstanding loans at any one time (25 per cent of declines), and by the state limit on the total amount of lending allowed to an individual borrower (18 per cent of declines).

Again, we point out that it is these types of restrictions which have a greater impact on lending volumes than the caps on the cost of credit (Illinois has a cap on payday and payday instalment loans of 15.5 per cent).

In our view the data held on regulatory databases in the US is worthy of greater investigation by BIS and the FCA in order to inform which particular package of responsible lending requirements is likely to prove most successful in balancing the twin needs of consumers for small sum, short-term, credit products with protection against the risk of over-indebtedness.

It is therefore disappointing that the recommendation made by the BIS Select Committee that further study of the Florida experience be conducted to inform UK regulation has not been properly taken forwards.

Further to this, it is also clear that the establishment of a regulatory database in the UK would be a positive step forwards – regardless of whether or not this was initially accompanied by responsible lending requirements of the types to be found in the US.

The US approach to the use of regulatory databases has been to use these to enforce 'hard stops' – rules such as strict maximums on the amount that can be lent or the number of loans that borrowers can take out in a given period. However, a regulatory database could instead be used in conjunction with 'softer' reporting requirements simply designed to ensure that the regulator is provided with greater levels of information that can be used to better target their supervisory and enforcement activities. For example, a regulatory database could be established to require that lenders seek more information about a borrower's income and financial situation once they have been identified on the system as a 'heavy user' of high cost credit.

Whether a regulatory database is established in conjunction with 'hard stop' rules or softer responsible lending reporting requirements, it is clear that simply putting a database in place would provide the regulator with much more detailed information about high cost credit use and market trends than is currently available. Indeed, establishing a database of high cost credit agreements could be viewed as an essential first step in the process of determining the precise requirements to be put in place in the UK. For example, by gathering information on the costs of credit currently being charged to different groups of consumers a regulatory database would enable a far more considered judgment to be reached by the FCA when it comes to considering whether or not, and how, to use its price capping powers.

Chapter 4: Improving support for over-indebted consumers

One of the key concerns of policy makers in the UK is that introducing more rigorous responsible lending requirements, or capping the cost of credit such that this limits the risk that can be taken by lenders, will impact on levels of access to credit by lower income households. As indicated in chapter two, this concern about levels of access to credit originates from the view that low income households mainly benefit from high cost credit as it helps them to manage short term cashflow problems. However, it is also now clear that many lower income households are not benefitting and that these are caught in a cycle of borrowing which impacts on their ability to afford other essentials.

Nevertheless, even where households are already considerably indebted and cannot realistically afford to take on more consumer credit, they clearly often do so. Whilst putting in place more stringent responsible lending requirements, backed up by a real-time regulatory database would prevent these already indebted households from getting into even greater difficulties, it would not address the underlying financial difficulties that they are facing. Opponents of tighter responsible lending requirements, and of price caps, frequently raise the spectre of illegal lenders waiting to take advantage of people who are refused access to licensed credit. Whilst it is by no means clear what proportion of people refused access to legal forms of consumer credit would be motivated to use an illegal lender (assuming they know how to come into contact with one if they were so motivated), we accept there is a potential risk of a growth in illegal lending if legal sources of credit are limited without other options being made available. Just as importantly, people who are rejected for high cost credit on the basis that they are unable to afford this clearly need help and support with their finances even if the risk of them turning to illegal lenders is low.

The remainder of this chapter therefore considers what forms of support might be made available to over-indebted borrowers and how putting a regulatory database of high cost credit agreements in place could assist in providing them with a more integrated offer of support.

What forms of support are needed?

We consider that already over-indebted consumers seeking further credit are likely to have a need for support in respect of their immediate needs (which have prompted their application for credit) and to help them get their finances under greater control in the longer term.

Pulling together an effective offer of support is therefore likely to involve consideration of the loan applicant's need for:

- Debt and Welfare Rights advice;

- Grants and other assistance such as may be available from the local welfare schemes now being provided by local authorities;

- Payments from charitable trusts, including those established by utility companies;

- More affordable loans from Community Development Finance Institutions ('CDFIs') or from credit unions. However, access to these may be limited if the borrower is already in debt unless these loans are used as a means of rescheduling existing borrowing. We return to this issue later in this chapter;

- For people in receipt of qualifying benefits, assistance from Department of Work and Pensions in the form of Short Term[66] and/or Budgeting Advances[67], and once in receipt of Universal Credit, for possible alternative payment arrangements to be put in place;[68]

[66] Short Term Advances of benefit were introduced in April 2013 to replace the interim and alignments payment aspects of Crisis Loans and are designed to cover living expenses up to the point of receipt of the first benefits for new claimants. Short Term Advances are available to all claimants of any contributory or income related benefit from April 2013, provided that the claimant is in 'financial need'. Short Term Advances will be repaid by deductions from benefit and the maximum period for repayment will usually be three months, although this can be extended to six months in 'exceptional circumstances'.

[67] Budgeting Loans from the Social Fund are being replaced with 'Budgeting Advances' as Universal Credit is rolled out. They are desiged to provide an interest free lending facility for those who are least likely to be able to access mainstream sources of credit. Budgeting Advances 'reflect existing Budgeting Loan eligibility requirements and available amounts', therefore requiring most claimants to have been in receipt of Universal Credit or one of the previous qualifying benefits for 26 weeks. However, there will be an exception for people who need a Budgeting Advance in order to meet costs associated with gaining employment or where items are needed in order to retain work. Budgeting Advances are also expected to be paid back over a shorter period than the Budgeting Loans available from the Social Fund – normally within 52 weeks, although this can be extended to 78 weeks in exceptional circumstances. Further to this, people will not be able to obtain a Budgeting Advance if they have a previous Budgeting Advance or Budgeting Loan outstanding. Transitional arrangements are in place so that Budgeting Loans remain available to benefit claimants who have not yet been transported onto Universal Credit

[68] Universal Credit will be paid to claimants in ways which are intended to provide them with greater responsibility for their finances and to mirror the receipt of wages. Specifically, Universal Credit people will be paid monthly, and in arrears; and working age social housing tenants will no longer have their Housing Benefit paid directly to their landlords, but will receive this money as part of their Universal Credit payment. However, it is possible for people experiencing financial problems to be

- Financial education programmes and tools.

However, it needs to be recognised that access to most of these services will vary considerably at the local level due to resource constraints and differences in eligibility criteria. This problem is particularly apparent in respect of debt advice provision, local welfare schemes and access to affordable credit.

Debt and Welfare Rights Advice

The provision of good quality advice to individuals at an early stage can have a significant impact on people's lives – for example, an incorrect decision about benefit entitlement that goes unaddressed can result in the accumulation of debt, hardship, arrears and eviction, resulting in increased risk of poverty. Further to this, advice and support services are in a position to identify systemic problems and to highlight the need for changes in national and local policy and service delivery.

However the advice sector is under considerable financial pressure and, at the same time, many providers are also experiencing increased demand as a result of welfare and other service reforms as well as the impact of the economic downturn. The financial pressure, which has included limitations on the types of advice that can be funded by Legal Aid, is driving significant changes to funding and delivery models. These include the merger of Citizens Advice with Consumer Focus, and, in line with Government's wider strategy to promote digital services, a shift toward cheaper channels of delivery and away from intensive face to face provision in the delivery of debt advice (Money Advice Service, 2012). These developments, as well as pressure on local authorities – the traditional funder of local, face to face, debt and welfare benefits services – are likely to affect the degree to which people in financial difficulties are able to access services, as well as impact on their overall effectiveness.

Local Welfare Schemes

In March of this year we reported (Gibbons, 2013) that the devolution of elements of the discretionary Social Fund budget to local authorities for interest free Crisis Loans and Community Care Grants has been accompanied with major cuts in expenditure. Our analysis of expenditure on Community Care Grants and Crisis Loans for the period since the

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provided with alternative payment arrangements, for example to be placed on a more regular payment cycle or to have rent paid to the landlord.

election of the Coalition Government indicates that these forms of support had already been reduced significantly prior to devolution, with total expenditure (excluding Crisis Loan alignment payments) falling by over a quarter (26.7 per cent) in the year from 2010/11 through to 2011/12. This cut in the level of support is likely to have had most impact on unemployed working age claimants and lone parents. What is more, this spending reduction has been achieved through the use of administrative measures, rather than through any attempt to address the underlying causes of demand.

These cuts in support have already been associated with a significant increase in the numbers of people turning to charities and food banks for help, with the largest provider of food parcels in the UK, the Trussell Trust, reporting that the number of people using its food banks more than doubled from 61,000 to 128,000 in the 12 months between 2010/11 and 2011/12.

Further to this, we noted that the budget being devolved to local authorities to support the creation of new local welfare schemes was further reduced by some 17.3 per cent as compared to the level of spend in 2011/12, and that the way in which the budget was allocated across England reflected existing inequalities in access to the Fund at the local level rather than being based on a genuine assessment of levels of need for support in different areas.

Whilst local schemes *have* been developed in local authority areas, it is also clear that these vary considerably in terms of eligibility requirments; access arrangements; the types of assistance provided, and in respect of the quality and speed of decision making, reviews, and appeals. In fact, there can be little doubt that in many areas the level of support will be considerably reduced compared to what was available prior to April 2013.

As we noted in our report:

> *"…we find that the devolution of budgets and creation of local welfare schemes will result in a 'postcode lottery'. Given the significant reduction in budgets at the point of devolution, local authorities have, rightly, been wary of putting in place schemes which are unaffordable and which could leave them faced with a level of demand that cannot be met. In this respect, it is logical for them to look at ways in which demand can be best managed. However, it is also clear that the main mechanisms to achieve this, at least in the initial period, will be the imposition of tighter eligibility requirements and a*

move away from the provision of cash in most areas. This appears to run counter to the original policy intentions of localisation, which were instead centred on the development of more holistic solutions to address underlying needs and on supporting greater financial independence."

Affordable Credit

Successive Governments have recognised the potential of credit unions and CDFIs as an alternative to high cost credit and have taken steps to support their expansion. These have included:

- Department for Work and Pensions (DWP) enabling the direct payment of benefits into credit union accounts;
- The passage of the Co-operative and Community Benefit Societies and Credit Unions Act 2010 and a Legislative Reform Order (LRO) which allows credit unions to widen membership more easily, including by accepting corporate membership; allowing interest to be paid on deposits; and raising capital through the issuance of deferred shares;
- Direct investment in a £100 million Growth Fund for credit unions and CDFIs through Department for Work and Pensions for the period 2006 – 2011, with a further £38 million Credit Union Expansion Project currently being delivered by ABCUL, in order to:
    - Increase credit union membership by at least 500,000 people on lower incomes by March 2015, increasing to 1 million people by 2017.
    - Increase access to affordable credit so that members save an additional £1 billion in interest payments compared to the charges they would otherwise have to pay to high cost commercial lenders between the start of the project and 2019; and
    - Ensure that credit unions deliver this expansion in a way that makes them financially sustainable.
- Increasing the maximum APR chargeable by credit unions from 12.68% to 26.8%, in 2006 in order to enable credit unions to meet the needs of higher risk customers. In June this year Government announced it would legislate this autumn to allow the maximum rate to be raised still further to just over 42% APR (3% per month).

- Providing the Financial Services Authority with the responsibility to supervise credit unions, and giving a guarantee to depositors through the Financial Services Compensation Scheme.

However the sector continues to face considerable challenges and is struggling to compete with high cost lenders. This is despite the fact that some affordable credit providers are seeking to make products available which directly compete with the high cost credit sector. For example, London Mutual Credit Union ('LMCU') has recently evaluated a 12 month pilot scheme which offered a payday loan product at a rate of just 26.8% APR. The pilot scheme included an automated online application and assessment process in order to replicate the ease, speed and instantaneousness of the high-cost payday companies. The evaluation indicates that:

- The product is popular – a total of 2,923 payday loans with a value of £687,757 were distributed over the course of the pilot to 1,219 different borrowers;

- The savings to borrowers are considerable - by borrowing through LMCU instead of high cost payday lenders, the 1,219 who borrowed during the pilot have collectively saved a minimum of £144,966 in interest charges alone, equivalent to almost £119 per borrower;

- Loan loss rates were significantly lower than for payday lenders, with just 6.3% of all credit union loans made in the pilot going in arrears. However, arrrears levels were higher for people joining the credit union because of the pilot product (12%) compared to existing members (4.8%);

- Payday lending through a credit union is an effective way of diverting borrowers away from high cost lenders - before accessing their first LMCU loan, 74% of surveyed borrowers had taken an average of 3.2 over the 12 months before their first payday loan from LMCU and 17% of these had taken six or more loans. However, over two-thirds of surveyed users would be unlikely to borrow from other payday companies again;

- Credit Union membership encouraged people to build their financial resilience through the accumulation of savings. Almost £18,000 was accumulated by the 331 new members during the pilot – a £53 average saving level per member.

However, the scale of credit union and CDFI provision varies considerably according to local area and the level of investment in affordable credit is dwarfed by that being pumped into the promotion of high cost credit. For example, the Bureau for Investigative Journalism has recently highlighted how British banks as well as investment from the US have helped to fuel the expansion of payday lending in the UK[69] and in a recent speech in the House of Commons, Chris Evans MP indicated[70] that the advertising expenditure alone of the five largest payday companies in the past 12 months amounted to £36.5 million – nearly as much as being invested by DWP in the expansion of credit unions over the four years to 2017.

How could a regulatory database help?

In our view one of the major difficulties faced by over-indebted borrowers is that the offer of support, in terms of the services that are available to help them meet both their immediate needs and gain better control over their finances in the longer term, is fragmented. It is currently extremely difficult for over-indebted borrowers to determine where to begin to find help particularly if they have a pressing need for cash and have not yet arrived at the point of self motivation to seek debt advice.

In this respect, it should be noted that many of the US states with regulatory databases in place also provide call centre support to people declined as a result of ineligibility for loans[71]. In these states the call centre service is restricted to providing a simple explanation of why the system has rejected the consumer as ineligible – for example by explaining which specific responsible lending requirement has affected their ability to obtain a loan. However, there is no reason why a similar call centre operation in the UK could not go further and provide a diagnostic interview and direction to other sources of assistance that may help the over-indebted borrower to address their needs.

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[69] http://www.thebureauinvestigates.com/2013/06/13/the-money-pouring-into-a-boom-for-consumer-loans/

[70] High Cost Credit Debate, Thursday 5th September, Commons Hansard

[71] The cost of these call centre operations is covered in the total cost of operating the regulatory databases as described in chapter three.

Further to this, a regulatory database could also be used to support a national scheme to help people replace their high cost credit debts with more affordable loans from credit unions, funded by a programme of social investment.

The case for social investment

As we noted in chapter two, StepChange reports that a large proportion of people approaching them with payday debt problems have also built up considerable arrears on their Council Tax, rent and utility bills. Using the figures provided to us by StepChange, we calculate that payday borrowers using their services in the first half of this year alone owe a combined total of £13.3 million on these priority commitments. Table 7, on the following page, provides a breakdown of this figure.

Table 7: Priority debts of payday debtors approaching StepChange in first half of 2013

Type of arrears	Number of payday debtors with arrears	Average arrears (£)	Total amount outstanding (£ millions)
Council Tax	7005	750	5.3
Rent	5027	959	4.8
Gas	2788	484	1.3
Electricity	3801	487	1.9
Total			**13.3**

Helping people to replace their payday borrowing with, for example, the type of product developed by LMCU would greatly assist them to start to pay down these priority debts. .

To illustrate this we have looked at the potential impact on Council Tax arrears of a social investment programme to replace payday borrowing with credit union loans. As indicated by table 7, above, some 7,000 people approached StepChange in this position in the first six months of this year. Together they comprised just over 20 per cent of all payday borrowers approaching that organisation for help in the period and held an average outstanding Council Tax debt of £750.

Using the figures regarding the average level of savings reported by borrowers in the LMCU pilot of its payday lending product, we calculate that individuals currently borrowing from payday lenders on more than six occasions in the year would save approximately £300 in interest costs alone by switching to the credit union. Had the 7,000 payday debtors approaching StepChange had access to the credit union product then they would collectively have saved £2.1 million in interest and possibly much more once other fees commonly

charged by payday lenders are taken into account. Assuming all of these savings were directed toward the repayment of Council Tax debt this would provide an 18 per cent social return on investment (see table 8, below).

Table 8: Modelling the social return of investment in credit union payday products (7,000 borrowers using payday loans an average of six times per year)

Number of people	Average value of payday debt (£)	Assumed value of individual loans, based on six per year[72] (£)	Funding requirement (£ millions)	Average saving to borrower, based on six loans per year (£)	Total savings (£ milliions)	Return on investment (%)
7000	1665	277.5	11.655	300	2.1	**18**

It is, however, important to note that that the evaluation of the London Mutual Credit Union pilot reported that the payday loan offering was a 'loss leader', finding that on average each loan would require a subsidy of £6.85 to break even. This was despite LMCU also making an additional administration charge of £11 where borrower's required instant payment of the loan amount into their bank accounts[73].

The average revenue per loan in the LMCU model was £12.02 and the average loss per loan £6.85. As a consequence the total charge for credit needed to break even on the loans would be £18.87. As the average size of loan made in the pilot was £238, this would indicate that credit unions could provide an alternative payday lending product if they were allowed to charge £7.92 per £100 lent. However, this would represent an APR of 95% on a loan of £100 repaid within a month and will not be possible even after the maximum allowable interest rate for credit unions is raised this autumn. As a consequence, if credit unions are to provide a payday alternative product this is likely to require some level of subsidy in order for them to keep their interest rates down. .

Nevertheless, with a combination of higher rates and some form of subsidy, credit unions would be able to provide an alternative payday product to deliver savings to the borrower. In our view a subsidy of £20 per loan of £277.50 would be more than sufficient at the current maximum of 26.8% APR and would negate the need for administration charges for instant payment to be paid by the borrower. Reflecting this subsidy back into the figures provided in table 8, this would reduce the total savings in our model by around £840,000, leaving total

[72] This is close to the average amount of loan requested by borrowers in the London Mutual Credit Union in its pilot, which was £238.
[73] 86% of borrowers in the pilot selected this option rather than having the loan paid by BACS, which would take longer to clear.

savings of £1.26 million – still a 15 per cent return on investment.of 10.1 per cent[74]. Although further work to establish the optimum means of funding credit union payday loan replacement products is required, there will clearly be scope for payday replacement products to be offered and for significant social returns on investment to be made from these.

Organising a programme of social investment would, however, hold some risks. In particular, borrowers benefiting from the programme may:

- Fail to direct the savings toward the repayment of priority debts; and/or
- Continue to use high cost credit products alongside borrowing from the credit union.

In our view the first of these could be mitigated by also providing people with access to 'jam jar' or 'budgeting account' products[75] and ring fencing amounts for the repayment of Council Tax and other priority bills (including an agreed amount to reduce existing arrears) within these. In effect this would create a debt management plan regarding the priority areas of household expenditure.

Establishing a regulatory database would also be critical to the success of the programme. Not only could the database be used to identify potential programme beneficiaries – for example by identifying those borrowers who have taken out six or more payday loans in any 12 month period or those rejected for credit because they are already heavily over-indebted - but it could also mitigate the second risk by:

- Ensuring that affordable credit products subject to the investment are provided as 'replacement loans', paying off existing high cost credit agreements registered on the database;
- Recording the existence of the replacement loan on the database; and

[74] This does not take account of the LMCU evaluation finding that there are longer term advantages to credit unions of using payday loan products to encourage people to join the credit union, because many of these new members went on to save with the credit union. As a consequence the final level of subsidy required may be lower.

[75] For further details of these products see http://www.socialfinance.org.uk/work/financial-inclusion/jam-jar-banking-products

- Enforcing a ‘lock out’ from further high cost borrowing whilst the credit union replacement product remains outstanding.

We further consider that efforts should then be made to place the finances of participants on a more sustainable long term footing by credit unions offering small sum savings facilities and additional ‘buffer’ loans as they would for their existing members, thereby creating long term customers from people entering the programme.

Finally, borrowers entering the programme should also be encouraged to take up budgeting courses and other financial advice services. Take up of the courses could, for example, be incentivised by offering a preferential interest rate on future borrowing once the courses have been completed.

Chapter 5: Conclusions and Recommendations

This report has reviewed the policy debate currently taking place in the UK regarding how we can best regulate our high cost credit markets. Although high cost credit can provide low to middle income households with a means to manage their short term cash flow problems, it is now clear that a growing number of customers are becoming trapped in a cycle of increased borrowing leading to over-indebtedness. This has implications for a wide range of public services and justifies regulatory intervention in the high cost credit markets in order to protect the interests of consumers and the taxpayer.

The precise nature of that intervention remains to be decided, but there is currently a major window of opportunity to put in place responsible lending requirements which both preserve access to genuinely short term products and protect consumers from over-indebtedness.

In order to inform the precise package of regulatory reforms, this report has considered prior research findings and the prior experience of the Competition Commission inquiry into the home credit market. In these respects, we find that:

- Self regulation in the payday lending market is not proving adequate to prevent what are now clearly widespread irresponsible lending practices;
- Other areas of the high cost credit market, particularly in the door to door moneylending or 'home credit', and rent to own sectors, are being overlooked by regulators who have not conducted any compliance reviews with responsible lending requirements in these areas;
- There is little evidence that most of the Competition Commission remedies put in place following its home credit inquiry have had any positive impact on levels of consumer detriment. The exception to this is in respect of the Early Settlement Rebate remedy which has benefited consumers, particularly those who are taking out new loans to pay off existing borrowing. Nevertheless, even in this market the number of consumers refinancing loans remains high;
- Claims made by policy makers, regulators and the industry concerning the benefits of more data sharing for people using high cost credit markets have been over-stated and we do not consider that this will lead to more responsible lending practice or help lower income customers migrate to cheaper forms of borrowing.

We have therefore reviewed the responsible lending requirements of thirteen US states with regulatory databases in place in order to draw out potential lessons for improvements in the UK's regulation of high cost credit markets.

The majority of these states have introduced caps on the total cost of credit that can be charged by payday lenders and have also put in place additional measures to protect consumers, including measures to control:

- the amount of loan;
- the maximum number of loans permitted to be taken out at any one time;
- the number of loans that can be provided in any given period;
- the number of times a loan can be 'rolled over';
- the level of fees that can be charged for overdue loans.

In a number of states payday lenders have, however, sought to evade the impact of responsible lending requiremnts by designing new products that fall outside of the definitions used in state legislation. This is particularly apparent where the definition of a payday loan is based not only on its cost but also on the duration of the loan agreement. For this reason, **we recommend that any additional responsible lending requirements that may be introduced in the UK should be framed in such a way that they apply to all high cost credit regardless of the form of the product or its duration.**

Despite problems of defining the loans that are subject to their responsible lending requirements, the regulators in the thirteen US states under review have introduced state databases as a means of improving their enforcement. This approach appears to have been particularly effective in stopping borrowers from taking out multiple loans within the same month and in limiting rollover lending and the refinancing of debts by taking out further borrowing. Indeed, in Kentucky the payday lending industry welcomed the introduction of a regulatory database in 2010 as a means of giving consumers confidence that lenders were observing these rules.

It should be noted that the implementation of regulatory databases differs significantly from 'data sharing' through credit reference agencies. Regulatory databases do not allow for information about a borrower's loans with one firm to be seen by another, nor do they provide information about the borrower's payment history with other firms, which may otherwise be used by lenders to inform their loan decisions. Whilst it may appear that data

sharing through credit reference agencies would lead to more responsible lending practice, it is important to note that this approach would put critical information beyond the reach of the regulator. This is because data shared through credit reference agencies remains the property of the lenders and is not available to regulators to inform their enforcement policy or to assess market trends. Regulators in the UK have recently been criticised for failing to gather sufficient information in these respects, notably by the House of Commons Public Accounts Committee.

Indeed, although the US databases have been introduced alongside a number of 'hard stop' responsible lending requirements, there would be advantages to their introduction in the UK even without these, as:

- The regulator would have much better information that they could then draw upon to assess the need for additional responsible lending requirements moving forwards ensuring that they were able to respond effectively to market developments;
- This would include information about the cost of credit being charged by different lenders and inform analysis of the numbers of borrowers who would be impacted by caps on the cost of credit at different levels;
- The databases also provide vital information for supervisors, allowing them to effectively target their enforcement activity – for example by helping them to identify instances of loans being provided to refinance previous agreements.

The presence of a regulatory database would not remove the need for supervision entirely. In particular, there will remain a need for credit examiners to review samples of loan documents against the database entries in order to ensure that lenders are being honest when uploading information onto the system. Nevertheless, once established the database is likely to reduce enforcement costs considerably. Given the fact that the most recent OFT compliance review of payday lending conducted in 2012 cost approximately £1 million to undertake and that consequent enforcement action is forecast to cost a further £1 million in the current year, we consider that introducing a regulatory database would provide good value for consumer credit firms who would otherwise be expected to meet the regulator's costs by paying higher fees to obtain a permission to trade.

The costs of establishing and maintaining the databases in the US are met by levying a fee for every loan agreement that is entered onto the system from the lender. This ensures that

larger lenders, who use the database most often, are the ones that pay the most towards its costs. There are concerns that the requirement to enter details of loan agreements on the database increases the administrative burden on lenders and that this could be passed onto consumers in the form of higher prices. However, it has proved possible in some US states to implement a regulatory database for as little as $0.46 per loan agreement. It is unlikely that this amount does more than pay for the provision of the database itself, and some US states have recognised this by allowing lenders to charge an additional database verification fee in order to recoup some of their administrative costs. This approach appears sensible where there are caps on the total cost of credit that lenders could otherwise charge.

We therefore recommend that the Financial Conduct Authority establish a database of all high cost credit agreements from 1st April 2013 onwards. The costs of establishing and maintaining this database should be met by the high cost lenders themselves.

The FCA should use the regulatory database to ensure the effective targeting of its enforcement activity and to inform the ongoing development of responsible lending requirements, including the level of any caps on the total cost for credit, over time.

However, the FCA should also consider putting in place a number of responsible lending requirements alongside the introduction of a database. This package should be informed by the empirical evidence about the impacts of different measures which is available from the US.

We note that a previous recommendation of the BIS Select Committee that the experience of Florida be further investigated to inform the development of responsible lending requirements in the UK has not been fully taken forwards by the Department – its research in respect of Florida having been limited to the impact of its cap on the cost of the credit.

Comparing the regulatory environments in the thirteen US states subject to this review, and particularly in Florida and Washington State, we find that it is possible for payday lending to expand despite the presence of:

- Limits on the total amount of borrowing,
- Limits on the number of agreements that can be entered into at any one time,
- Reasonable caps on the total cost for credit,
- Prohibitions on rollover lending and on borrowing to refinance prior agreements
- Limits on default charges and on the cost of collecting payments.

In particular, it is noticable that in Florida a cap, including the database verification fee, of just $10.70 for every $100 lent has not prevented the growth of the sector but is significantly less than the price paid by UK consumers. This is despite the fact that lenders in Florida are also required to provide borrowers in financial difficulty with a ‘grace period’ of 60 days to repay loans at no extra cost.

The main reason for the continued viability of the Florida payday lending industry is the low level of loan loss compared to the UK. In Florida just 1.6 per cent of loans remain outstanding 60 days beyond the due date. This compares to a reported loan loss rate of 14 per cent amongst UK payday lenders. The presence of a regulatory database appears to have played a critical part in shifting the model of payday lending in Florida from one based on high levels of rollover lending and default to one based on more responsible lending and low loan losses.

However, Florida’s payday loan businesses continue to benefit from repeat business. This is contrasted to Washington State, where a limit on the total number of payday loan agreements that can be taken out in a 12 month period has had a dramatic, negative, impact on the payday lending sector. We therefore urge caution in this respect, as a similar rule in the UK is likely to lead to a loss of revenue for lenders and market exit at a time when alternative provision is limited.

We therefore recommend that the FCA bring forward proposals to introduce a package of responsible lending requirements which:

- **Places a reasonable limit on the total level of high cost credit borrowing per person relative to their income[76];**
- **Prohibits rollover lending and the refinancing of agreements;**
- **Places a reasonable cap on the total cost of credit, including in respect of default charges and on charges for the collection of payments.**

Whilst putting in place a package of sensible responsible lending requirements, backed up by a real-time regulatory database, would prevent already indebted households from getting

[76] Evidence from the London Mututal Credit Union pilot indicates that it is possible for payday loans to break even at a total cost for credit of just under £8 per £100 lent. As a consequence, we believe that a cap could be introduced for commercial lenders at around £12 per £100 lent – less than half the average price (£25 per £100 lent) currently being charged in the UK.

into even greater difficulties, it would not address the underlying financial difficulties that they are facing.

Opponents of tighter responsible lending requirements, and of price caps, frequently raise the spectre of illegal lenders waiting to take advantage of people who are refused access to licensed credit. Whilst it is by no means clear what proportion of people refused access to legal forms of consumer credit would be motivated to use an illegal lender, we accept there is a potential risk of a growth in illegal lending if legal sources of credit are limited without other options being made available. Just as importantly, people who are rejected for high cost credit on the basis that they are unable to afford this clearly need help and support with their finances even if the risk of them turning to illegal lenders is low.

As a consequence we consider it essential that the offer of support to over-indebted borrowers be significantly improved. At the present time, the system of support is fragmented and critical services are under-resourced.

We therefore recommend that in the event that any responsible lending requirements introduced in by the FCA result in people being refused credit then these should be referred to a national call centre operation which is funded to provide an initial diagnostic interview and to refer callers onto provision capable of meeting their needs, including:

- **Debt and Welfare Rights advice;**
- **Grants and other assistance such as may be available from the local welfare schemes now being provided by local authorities;**
- **Payments from charitable trusts, including those established by utility companies;**
- **More affordable loans from Community Development Finance Institutions ('CDFIs') or from credit unions. However, access to these may be limited if the borrower is already in debt unless these loans are used as a means of rescheduling existing borrowing. We return to this issue later in this chapter;**
- **For people in receipt of qualifying benefits, assistance from Department of Work and Pensions in the form of Short Term and/or Budgeting Advances, and**

once in receipt of Universal Credit, for possible alternative payment arrangements to be put in place;

- **Financial education programmes and tools.**

Further to this, information from the regulatory database should be used to pro-actively identify people who are heavy users of high cost credit agreements and every effort should be made to provide these with access to more affordable credit products.

Reviewing the number of payday debtors presenting to StepChange debt charity in the first half of this year we calculate that these also owe a total of over £13 million to priority creditors including local authorities, social landlords, and utility providers. Providing these borrowers with access to affordable credit products would help them to make in-roads into the repayment of these debts.

We therefore recommend that Government should establish a 'Rescue Fund' of at least £50 million per year to provide 'heavy high cost credit users' and those turned down for credit because they are already over-indebted, with an opportunity to access affordable alternatives.

To help ensure that the Rescue Fund is properly targeted; delivers a return on investment, benefits local authorities and social landlords and puts the finances of borrowers on a long term sustainable footing:

- Access to the programme should be restricted to those borrowers identified on the regulatory database as 'heavy high cost users' or those turned down for credit as a result of the responsible lending requirements that have been put in place;
- Participating credit unions should draw up a sustainable budget for participants and, by providing these with budgeting accounts, should create a debt management plan for the repayment of arrears on priority bills;
- A consolidation loan, supported by the rescue fund, should be provided to clear any outstanding high cost credit agreements;
- The loan should be recorded on the regulatory database and the borrower 'locked out' of future high cost borrowing until the consolidation loan has been repaid;

- Credit unions should also provide small sum savings facilities and additional ‘buffer’ loans as they would for their existing members, creating long term customers from people entering the programme; and
- Borrowers entering the programme should also be encouraged to take up budgeting courses and other financial advice services. Take up of the courses could, for example, be incentivised by offering a preferential interest rate on future borrowing once the courses have been completed.

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