The impact on business and consumers of a cap on the total cost of credit

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Executive summary

This research was commissioned by the Department of Business, Innovation and Skills (BIS) to inform understanding of the likely impact on lenders and consumers of introducing a variable cap on the total cost of credit that can be charged in the short-to-medium term fixed-rate credit markets. The purpose of the research was not to make a recommendation to BIS on whether or not a cap should be introduced, but to provide an up-to-date evidence base that would help inform policy decision-making in this area.

The research covered home credit, pawnbroking, retail payday lending (carried out in-store) and online payday lending. It comprised (1) A brief **Evidence Review** to draw out key findings from recent research; (2) A **Business Survey** involving in-depth interviews with representatives from five trade associations and 24 lenders, between them representing 28 different companies; (3) A **Consumer Survey** of 1,451 telephone interviews with customers of home credit companies, pawnbrokers and payday lenders; (4) **Depth Interviews** with 17 people who had used home credit, a pawnbroker or a payday lender; and (5) Analysis of the 2006-2008 **Wealth and Assets Survey** to identify the extent to which the use of high-cost credit impacts the financial well-being of individuals and households.

Why do consumers use short-term credit rather than lower cost or more mainstream credit products?

The amounts borrowed by customers in the Consumer Survey reflected differences in the typical loan terms for home credit, pawnbroking and payday loans. Customers of home credit typically borrowed the biggest sums, which they generally used to pay for larger expenses that occurred periodically, particularly birthdays, Christmas or other special occasions. In contrast, pawnbroking and payday loan customers typically borrowed smaller sums of money and used them primarily to pay for essentials such as bills and everyday spending.

The main reasons why customers in the Consumer Survey used short-term credit over other types of borrowing related to:

- **Convenience and the ability to access credit quickly.** Convenience was the most commonly reported reason why customers had used short-term credit on this occasion rather than borrow in some other way. This was true for six in ten online payday loan customers, a half of retail payday and pawnbroking customers and four in ten home credit customers. For online payday loan customers, satisfaction with the service also reflected the convenience of borrowing this way (35 per cent) and the speed of the loan decision (36 per cent).
- **Having no or limited access to other sources of credit.** Being unable to borrow from anywhere else was the second most common reason customers gave for using short-term credit. The Consumer Survey showed that mainstream credit (potentially a cheaper option than short-term credit) was only a feasible alternative for a minority of customers at the time of the survey, ranging from 10 per cent of home credit customers to 24 per cent of online payday loan customers. Where customers did have access to mainstream credit, this was typically a credit card or overdraft.

- **Customer service and lender reputation.** Customer service was the main reason that customers in the Consumer Survey were satisfied with the lender they had used, cited by over a half of pawnbroking and payday loan customers and seven in ten home credit customers. The reputation of the lender was also an important factor for home credit customers, and online payday loan customers in the Depth Interviews valued the anonymity of borrowing online.

What are the issues associated with short-term credit?

Six main issues associated with short-term credit were indicated by this research. Two relate to the cost of credit: the total charge for credit and default charges. The other four relate to affordability assessment; financial difficulty; multiple and repeat borrowing from short-term lenders; and loan renewal.

Other concerns related to the payday loan industry are the use of lead generators and brokers of online payday loans; and problems with the use of continuous payment authority to collect payday loan payments. In the Consumer Survey for this research, four per cent of online payday loan customers said they had applied for their most recent loan through a credit broker or other intermediary. Other online borrowers may not have been aware of using a broker or intermediary, however. The Consumer Survey included customers whose most recent payday loan was not yet due for repayment, as well as those who had repaid their most recent loan. Of the 1,451 short-term credit customers that participated in the Consumer Survey, four payday loan customers reported dissatisfaction with the lender they had used due to payment problems, either because the lender had taken more money than they expected or on a different date.

The cost of borrowing

The Consumer Survey showed that potentially lower cost mainstream credit was not a viable alternative for the majority of short-term credit customers. The headline costs of short-term credit of all kinds are high relative to other forms of credit. In the Business Survey, the highest charges were made by online payday lenders.

Although they were aware of the (high) cost of their loans, customers of short-term credit valued other factors above price and would still borrow if the cost was higher. Nonetheless, for a minority of customers, particularly of pawnbroking (28 per cent), the credit they used had (so far) cost them more than they expected.

Like previous research, the Consumer Survey showed that most borrowers do not conduct any form of price comparison before taking out a short-term loan. The exception was online payday lending, where 46 per cent of customers had compared costs before taking out their most recent loan.

Default charges

Default charges made by some payday lenders in the Business Survey seemed high relative to loan size. In the Consumer Survey, most payday loan customers said they had not incurred any extra fees such as penalty charges or charges for default letters. Ten per cent of retail payday lending and six per cent of online payday lending had incurred extra fees. Since not all customers had reached the end of their loan term, the true figure could be higher. In comparison, default charges were rarely levied by home credit companies. Reflecting this, only one per cent of home credit customers had incurred extra fees such as penalty charges or charges for default letters.

Affordability assessment

A major element of credit risk assessment is whether or not the loan or advance is affordable for the customer. In the Consumer Survey, the majority of short-term credit users said they had been asked by their lender for information that could be used to assess affordability, either when they took out their most recent loan or on a previous occasion. The proportion was lower among online payday loan customers (87 per cent, compared with 94 per cent of home credit and 97 per cent of retail payday loan customers). And only a small number of online customers said they had been asked for proof of income or bank statements when they applied for their most recent loan (although they may have provided them on a previous occasion).

The online lenders covered by the Consumer Survey may have used other ways of assessing affordability as substitutes for proof of income or bank statements. Even so, it remains a concern that so many borrowers could not recall being asked for this information.

Financial difficulties

The Wealth and Assets Survey analysis showed a strong link between short-term credit use and measures of financial difficulty, but not the direction of the relationship. The Consumer Survey found financial difficulty to be a widespread issue for people who used pawnbrokers, retail payday lenders and online payday lenders, but not for users of home credit.

- Large proportions of customers used their most recent pawnbroker or payday loan to pay for everyday expenses or household bills (66 per cent in the case of retail payday loan users, 52 per cent of pawnbroking customers and 54 per cent of online payday loan customers).
- Significant numbers of these customers had missed payments on credit commitments or household bills in the past 12 months (46 per cent of retail payday loan customers, 45 per cent of pawnbroking customers and 41 per cent of online payday loan customers).

For customers who had already paid off their most recent short-term loan, most had repaid it in full when it became due. Significant minorities of pawnbroking (38 per cent) and retail payday loan customers (26 per cent) had not repaid their most recent loan as they should, however, leading them renew their loan (see below) or take some other action. For 12 per cent of pawnbroking customers in this situation, they had lost the items they had pledged. There was also evidence of customers borrowing to repay borrowing, particularly among pawnbroking customers (14 per cent) and retail payday loan customers (10 per cent).

Moreover, large minorities of customers were in difficulty with other financial commitments, ranging from a quarter of home credit customers to more than four in ten of pawnbroking and payday loan customers. In the Depth Interviews for this research, where people took out short-term credit to mitigate lost income or to avert existing financial difficulties, it generally compounded the problems that they faced rather than resolved them.

Multiple and repeat borrowing from short-term lenders

Multiple borrowing was particularly evident among home credit customers in the Consumer Survey. Around half (45 per cent) had two or more home credit loans at the time of the survey interview, bearing in mind that home credit loans tend to be repaid over a longer term than payday or pawnbroker loans.

Multiple borrowing was also notable among pawnbroking and retail payday loan customers in the Consumer Survey, although it was still only evident among a minority. Two in ten retail payday loan customers (22 per cent) and 25 per cent of pawnbroking customers had two or more of these types of loan at the time of the survey interview.

In relation to repeat borrowing over a period of time, for retail payday loan customers, the average (mean) number of loans in the past 12 months was 5.1 loans. For pawnbroking customers it was 2.5 loans (bearing in mind that a standard pawnbroking agreement is six to seven months). Combined with the fact that these customers tended to borrow for everyday expenses or to pay household bills, this indicates that they used short-term credit to bridge recurrent shortfalls between their income and outgoings. For home credit customers, the average was 2.3 loans in the past 12 months.

Loan renewal

Loan renewal is possible for payday loans and pawnbroker loans. In the Business Survey, the estimated proportion of customers renewing loans varied by lender. For payday lenders, estimates ranged from less than 10 per cent (for a large online lender) to around 60-70 per cent (for a small office-based lender).

Customers in the Consumer Survey were drawn from a sub-set of lenders that took part in the Business Survey as well as lenders that did not take part in the Business Survey. Among the customers whose most recent loans had already fallen due, the numbers who said they had renewed their loan were small: 14 per cent in the case of both pawnbroking and retail payday loan customers and 10 per cent in the case of online payday loan customers. Repeated loan renewals can be a sign of financial difficulty. Rolling over loans three or more times was fairly uncommon in the Consumer Survey: seven per cent of retail payday loan customers had rolled over their most recent loan three or more times, as had three per cent of online payday loan customers.

What are the existing proposals or possible remedies for issues said to be associated with the short-term credit market?

All consumer credit activity in the UK is regulated under the Consumer Credit Act. The Consumer Credit Directive brought in additional measures, mainly around transparency. Lenders must have an Office of Fair Trading (OFT) consumer credit licence and comply with the OFT's guidance on irresponsible lending, debt collection, and the use of credit brokers and intermediaries. The Competition Commission inquiry into home credit resulted in remedies that related to data sharing, publication of prices, better information for consumers and early settlement rebates.

Some action has been taken to address issues said to be associated with short-term credit:

- In 2012, BIS announced a commitment to strengthen enforcement powers across the consumer credit market by giving the OFT authority to suspend a consumer credit licence immediately where there is an urgent need to do so to protect the interest of consumers;
- New provisions have been developed by four trade associations to tighten up payday loan renewal practices; and
- Government has committed further investment to the expansion and modernisation of credit unions to improve access to credit and savings.

Other measures that have been mooted include a cap on the total cost of credit encompassing interest, fees and auxiliary costs, which was proposed in the Consumer Credit (Regulation and Advice) Private Members' Bill. The case for the introduction of a cap on the cost of credit in the UK was previously explored by the OFT in its review of high-cost credit, published in 2010. A cap on the annualised total cost of credit per £100 borrowed was one of the controls considered. Other types of caps the OFT looked at were floating caps (to keep pace with the market). Overall, the OFT concluded that the introduction of any price cap would be complex, expensive, and difficult to administer.

What are the pros and cons of a variable cap on the total cost of credit in the short-term credit market?

The research examined the international evidence of the impact of price restrictions of any type, not specifically a cap on the total cost of credit. The Business Survey explored how short-term lenders in the UK might respond if a cap on the total cost of credit were introduced.

If price restrictions were introduced, there were concerns generally among the lenders and trade associations in the Business Survey about issues such as the uncertainty this would create for lenders which may in turn affect business development and investment; downward pressure on any price cap over time; and how compliance would be monitored and reviewed. They also felt strongly that any price restrictions should apply to the wider credit market, not just short-term credit.

The Business Survey found that lenders and their trade associations were unclear how a cap on the total cost of credit would be calculated and were concerned about the inclusion of default charges that the majority of customers did not pay. In their view, the variation in loan products between and within the different sectors meant that a variable cap or caps would be challenging to set, monitor and review. There was some support for more effective controls on default charges among a number of lenders in the Business Survey.

Taking the evidence as a whole, this research has identified the possible impacts of introducing a cap on the total cost of credit in the UK in relation to lenders and markets; and consumers.

Potential impacts on lenders and markets

The available evidence suggests that the headline prices charged by short-term lenders may tend to migrate over time towards the level of the cap. This depends on whether or not the cap is set at a level above the price that lenders typically charge. If a price cap is set low, arguably price convergence is not necessarily problematic. It does mean, however, that some borrowers who might have benefitted from even lower prices are not able to do so.

Evidence from more than one country and also from the Business Survey indicates that some lenders may exit the market. This is more likely to be the case for smaller lenders (even though they tend to have lower charges) than larger ones. This is because smaller lenders' business models would no longer be viable if a price restriction was set below their current charges. Any costs to business associated with the introduction of a price restriction would also be likely to have a disproportionate effect on small businesses. The supply of credit by regulated lenders would reduce and competition within the sectors could be weakened, particularly at the local level.

Both the international evidence and the Business Survey indicate that lenders who do not exit the market may tighten their lending criteria and improve their risk assessment practices. This has been shown to restrict credit access for some types of consumers, particularly people on low-incomes. On the other hand, a potential positive impact of tightened lending practices would be a reduction in the proportion of customers who are unable to repay their loan as they should. Restrictions on default charges could result in short-term lenders exercising less forbearance than they currently do.

Home credit lenders in the Business Survey expressed concerns about the impact of any cap on the viability of the shortest-term home credit loans (e.g. 14-16 weeks) which are an important part of lenders' 'low and grow' customer acquisition strategy. They were also unclear how a variable cap or caps on the cost of credit would work in the home credit market, given the wide range of loan terms offered by home credit lenders. The scope for lenders across the markets to allow consumers to extend their loans would reduce.

Depending on its design, a price cap could result in the restructuring of home credit charges and the introduction of default charges. This would undermine the traditional home credit lending model and result in less transparency for consumers.

While a price cap may reduce the availability of short-term home credit loans, other types of short-term lender are likely to focus on areas of their business other than lending: particularly sale and buy-back of goods (which is not covered by consumer credit legislation) and the purchase of second-hand goods for re-sale among retail lenders, and longer-term instalment loans among online lenders.

For online lenders, another possibility is to move their business offshore to a jurisdiction that does not have price restrictions. There is evidence that this creates challenges for regulation and enforcement. It could, for example, create regulatory arbitrage whereby identical-looking online lenders are subject to different rules.

Potential impacts on consumers

Reducing the cost of credit would benefit short-term credit users by lowering credit repayments and increasing the amount of disposable income available to them. In theory, a cap on the total cost of credit would reduce the cost of short-term borrowing. The available evidence about the impact of price restrictions on the cost that consumers pay for credit relates to interest rate restrictions, however, not the total charge for credit. The evidence reviewed for this research does not show unequivocally that price restrictions (in the form of interest rate restrictions) reduce the cost of borrowing to consumers, particularly those on low incomes. There is no evidence about the proportion of customers who actually pay less for short-term credit after interest rate restrictions are introduced than they did before.

International evidence indicates that interest rate restrictions lower the level of debt per head of population. As a result of improved lender risk assessment practices, detriment experienced by customers (especially of payday loans) who are able to take out loans they cannot afford or take out multiple loans from different lenders at the same time may reduce. However, customers (particularly those using home credit) may incur default charges where they did not do so previously; non-payers in other markets may also be shown less forbearance by lenders.

The diversity of short-term credit products that are available may reduce, resulting in less choice for consumers. In particular, the availability of short-term home credit loans and very small sum pawnbroker loans is likely to reduce because these products would no longer be profitable for lenders to offer. Pricing structures may also become less transparent for consumers, making it more difficult for consumers to compare products and lenders based on prices.

Access to credit may reduce, particularly for low income or other vulnerable consumers. The Consumer Survey for this research showed that if customers could not access short-term loans, most would either go without or turn to a friend or relative for help. A small number would try and borrow from somewhere else, including from another short-term lender. Using an illegal lender was not an option that the vast majority of customers in the Consumer Survey would currently consider. For many pawnbroking and payday loan customers, going without the money they borrowed from a short-term lender would potentially mean defaulting on other financial commitments (especially household bills) or defaulting sooner.

There are other potential changes that might help improve outcomes for consumers who use short-term credit. These include the development of better data sharing systems (particularly for payday loans), and implementation of the Good Practice Customer Charter for payday and other short-term credit. Other changes include potential limits on the amount that can be applied in default charges or restrictions on the number of times a loan can be extended. While these measures may address some of the consumer detriments identified in this research, they are not directly aimed at reducing the headline cost of credit.

Contents

Acknowledgements ... iv

1 Introduction ... 1

1.1 Research questions ... 1

1.2 Research methods ... 1

1.3 Reporting conventions ... 2

2 The UK's short-term credit market ... 3

2.1 Home credit ... 4

2.2 Pawnbroking and retail payday lenders ... 6

2.3 Online payday lending ... 8

2.4 The costs of lending ... 9

3 Who uses short-term credit? ... 11

3.1 Credit use in the general population ... 11

3.2 Who uses short-term credit? ... 13

3.3 Are short-term credit customers vulnerable? ... 15

4 Why do consumers use short-term credit? ... 17

4.1 How much do consumers borrow? ... 17

4.2 What do consumers borrow money for? ... 18

4.3 Why do consumers say they use short-term credit? ... 20

4.4 Could consumers use mainstream credit instead of short-term credit? ... 23

4.5 Do consumers consider non-credit alternatives to short-term loans? ... 26

4.6 What impact has the economic downturn had on short-term credit use? ... 26

5 Competition and consumer choice in short-term credit markets ... 27

5.1 Price competition ... 27

5.2 Do consumers shop around for short-term credit? ... 29

5.3 Is there a lack of information for consumers about short-term credit? ... 31

6 The cost of short-term credit ... 34

6.1 Home credit ... 34

6.2 Pawnbroking ... 35

6.3 Retail payday lending ... 35

6.4 Online payday lending ... 36

6.5 Instalment loans ... 36

6.6 How does the cost of short-term credit compare with mainstream credit? 36
6.7 Consumer views about the cost of short-term credit 38
7 Business practices: loan acquisition and risk management 40
7.1 The use of credit brokers and lead generators by online payday lenders 40
7.2 Risk assessment 42
7.3 Continuous payment authority 46
8 Business practices: loan re-financing 48
8.1 Extending payday loan agreements 48
8.2 Refinancing home credit loans and renewing pawn agreements 50
8.3 Rolling over loans, renewing and refinancing: Consumer experiences 51
9 Business practices: managing arrears 53
9.1 What proportion of consumers repay to the contractual loan term? 53
9.2 How lenders manage arrears 56
9.3 Default charges 57
10 The outcomes of short-term credit use 60
10.1 How satisfied are customers of short-term credit with the service they received? 61
10.2 The positive impacts of using short-term credit 64
10.3 Does use of short-term credit indicate consumer financial difficulties? 65
10.4 Does short-term credit increase consumer indebtedness? 67
11 Are there detriments associated with short-term credit? 74
11.1 Cost of borrowing compared with customers' expectations 75
11.2 Impact of short-term credit on customers' financial situation 76
11.3 Patterns of borrowing 77
11.4 Unredeemed property 79
11.5 In the absence of short-term credit, what actions would consumers take? 79
12 The impact of price restrictions on short-term credit 83
12.1 Actions underway to address issues associated with short-term credit in the UK 85
12.2 Other proposals to address issues said to be associated with short-term credit 85
12.3 The types of price restrictions that exist elsewhere 86
12.4 The impacts of price restrictions 87
13 How might short-term lenders respond to price restrictions in the UK? 94
13.1 Profitability and excess profits 95
13.2 The structure of a price cap 96

13.3 The level of a price cap 97

13.4 Other possible consequences of introducing a price cap 100

13.5 Default charges 101

14 Evaluating the evidence: the potential role for a cap on the total cost of credit 102

14.1 To what extent is cost an issue for consumers who borrow in the short-term credit market? 102

14.2 Competition and profit 103

14.3 What impact would a cap be likely to have on the cost that consumers pay for short-term credit? 103

14.4 Other possible impacts of a price cap 105

14.5 Other issues for people who use short-term loans 108

14.6 Summary: What are the main issues in the short-term credit market and how might they be addressed? 115

References 119

Additional volumes:

Appendix Tables

Technical Appendix

Consumer Survey questionnaire

Annex 1: Wealth and Assets Survey analysis

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1 Introduction

In December 2010, the Department for Business, Innovation and Skills (BIS) published a Call for Evidence in relation to its Review of Consumer Credit and Personal Insolvency. Although the Call for Evidence did not specifically cover the introduction of price restrictions, BIS received many responses calling for the Government to take action to reduce the cost of credit paid by consumers in the short-to-medium term fixed-rate credit market. Rather than proposing a flat-rate interest rate cap, submissions called for the introduction of a variable cap on the total cost of credit. This refers to a range of caps that could operate in different sectors of the credit market and would include fees and charges in addition to interest.

BIS commissioned this research to better understand the impact on lenders and consumers of introducing a variable cap on the total cost of credit that can be charged in the short to medium term fixed-rate high cost credit market. The purpose of the research was not to make a recommendation to BIS on whether or not a cap should be introduced, but to provide an up-to-date evidence base that would help inform policy decision-making in this area. The scope of the research covered the following types of short-term credit: home credit, pawnbroking and retail payday lending (carried out in-store) and online payday lending. The research does not cover other types of credit that may be high cost for consumers, and therefore does not represent the views of all lenders or credit users.

The research was carried out by the University of Bristol's Personal Finance Research Centre and TNS-BMRB.

1.1 Research questions

BIS required the research to address the following questions:

1. Why do consumers use payday lenders, home credit companies or pawnbrokers rather than lower cost or more mainstream credit products?
2. What are the issues associated with payday lending, home credit and pawnbroking?
3. What are the existing proposals or possible remedies for issues said to be associated with payday lending, home credit and pawnbroking?
4. What are the pros and cons of existing interventions in these markets?
5. What are the pros and cons of a variable cap on the total cost of credit in the payday lending, home credit and pawnbroking markets?

1.2 Research methods

This was a mixed-methods research project comprising:

- A brief ***Evidence Review*** which focused on recent research studies. We mapped the key findings against the research questions.
- A ***Business Survey*** which comprised qualitative in-depth telephone interviews with senior representatives from five trade associations and 24 lenders (which between them represented 28 different companies).
- A ***Consumer Survey*** carried out by TNS-BMRB which comprised a total of 1,451 telephone interviews with customers of payday lenders, home credit companies and pawnbrokers.

- Consumer qualitative ***Depth Interviews*** with 17 people who had used home credit, payday loans or a pawnbroker. Six were recruited through a debt advice agency. The other 11 were customers who had taken part in the Consumer Survey and were selected purposively from respondents who agreed to be re-contacted based on the type of short-term credit they had used.
- Analysis of the 2006-2008 ***Wealth and Assets Survey*** to identify the extent to which the use of high-cost credit impacts the financial well-being of individuals and households.

The Consumer Survey comprised customers who had had a short-term loan in the period from 1 November 2010 to 31 December 2011. Table 1.1 shows the breakdown of the survey interviews by credit type. The survey included customers who had repaid their loan in full, others whose loan was not yet due at the time of the survey interview, as well as those who should have repaid their loan but had not done so.

Table 1.1: Breakdown of Consumer Survey by credit product

Credit product	Number of survey respondents
Home credit	399
Pawnbroker	264
In-store payday loan	393
Online payday loan	395
Total	***1,451***

The survey focused on customers' most recent use of the sampled credit product and use of other sources of credit over the past 12 months. Further details about the research methods are provided in the Technical Appendix.

1.3 Reporting conventions

The focus of this research was home credit, pawnbroking and payday lending. Although the typical loan terms differ across the three loan types, we refer to them collectively in the report as short-term credit.

Throughout this report we distinguish between evidence from the Business Survey, the Consumer Survey and the Depth Interviews. We also draw on evidence from previous research, as referenced in the text.

Findings from the Consumer Survey that are based on fewer than 50 cases have not been included in the tables, and have instead been reported qualitatively where appropriate. Figures based on fewer than 100 cases should be treated with caution. All tables that are based on the Consumer Survey are based on unweighted data. Pearson Chi-square has been used routinely in tables to test statistical significance between loan types at the 95 per cent level of confidence, and logistic regression analysis has been used to test these differences while controlling for other characteristics. In all tables '-' indicates that there were no cases in the sample; '<1' indicates a value of greater than zero but less than one; 'n/a' indicates that this item was not applicable.

2 The UK's short-term credit market

Summary

Home credit is a long-established industry offering cash loans typically over six to 12 months. Most of the 500 home credit lenders are small, and operate within local communities. A few large firms that operate nationally account for much of the market.

Retail lenders offer payday loans and pawnbroking in their stores alongside other products and services. A few offer payday loans online as well. Some started out as pawnbrokers, others as cheque cashers or second-hand retailers. Business was generally growing for these lenders, as was competition on the high street. This was attributed to the recession, the widespread advertising of payday loans and the high price of gold.

Online lending is the newest of these types of credit, and trade associations have around 30 specialist online lenders among their members. Most offer short-term payday loans. A few offer longer-term instalment loans.

In July 2012, £157.1 billion was outstanding in unsecured consumer credit in the UK. This comprised £54.6 billion on credit cards and £102.5 billion on other loans and advances (Bank of England, July 2012). The most common sources of unsecured credit in 2009/2010 (excluding student loans) were credit cards, overdrafts and personal loans (other than home credit, pawnbroking or payday loans). In this report, these types of credit are referred to as mainstream credit for consistency with earlier definitions (BIS, 2011).

The focus of this research was the three main short-term credit products, which are sometimes referred to as non-mainstream or high-cost credit: home credit, pawnbroking and payday lending. In 2008, the total value of home credit, pawnbroking and payday loans was estimated to be £2.8 billion (OFT, 2010). This research distinguished between retail payday loans (made in a store or office) and online payday lending, where loans are transacted mainly or wholly online. It is common for store-based short-term lenders to offer pawnbroking and payday lending, as well as a range of other products and services.

Six industry trade associations represent lenders that offer short-term loans. They may represent other lenders as well. Lenders may be members of more than one trade association.

- BCCA: Payday lenders, pawnbrokers
- Consumer Credit Association (CCA): Home credit
- Consumer Credit Trade Association (CCTA): Home credit, payday lenders
- Consumer Finance Association (CFA): Payday lenders
- Finance and Leasing Association (FLA): Payday lenders
- National Pawnbrokers Association (NPA): Pawnbrokers.

With the exception of the CCTA, these trade associations were interviewed for the Business Survey.

An overview of short-term credit

Home credit refers to small unsecured cash loans repaid in fixed instalments collected by agents who call at the customer's home. The length of a home credit loan is typically 26-52 weeks, although money can be borrowed for between 14 and 106 weeks. It is estimated that six million home credit loan transactions are made every year. Nine home credit companies took part in the Business Survey for this research: the four largest firms, plus three medium-sized and two small lenders. The average loan amounts made by these lenders varied from £250 to £760, with most loans between £250 and £350.

Payday or short-term small-sum loans often end on the borrower's payday. Some lenders offer products which charge daily interest according to the actual loan period and irrespective of when payday occurs, which are also referred to as payday loans. Ten lenders in the Business Survey made payday loans from retail premises (six large, one medium and three small lenders). For three of these retail lenders, payday lending was their main business activity, for the other seven it was a relatively small part of their business. The average payday loan made by these lenders was £300-£400 over 28 to 31 days. Eight of them provided details of the number of payday loans they had made in the last year, which totalled over 1.25 million.

In addition, five lenders in the Business Survey specialised in online lending. They ranged in size in terms of the number of loans they made per year. Four offered payday loans; one only offered longer-term instalment loans. Online payday loan products ranged from a 30-day loan to 15-20 day loans with a daily charge where the amount could be repaid early without penalties. Average loan sizes ranged from £140 to £320. The firm that specialised in online instalment loans made loans over four to six months, depending on the loan amount. The average loan size was £200. Between them, these five online lenders had made approximately 3.3 million loans in the past year, of which most were payday loans.

Pawnbroking loans are generally offered for a period of six or seven months. The borrower pledges something of value which is held as collateral against the loan until the amount borrowed and the interest payable are repaid and the pledge is redeemed. In the Business Survey, nine of the lenders that made payday loans from retail premises also offered pawnbroking. The average loan size was £150-£200. Six of them provided details of the number of pawnbroking loans they had made in the last year, which totalled around 1.2 million.

Source: OFT, 2010; Business Survey

2.1 Home credit

There are currently around 500 firms in the home credit market, which is, on the whole, fairly stable. The Consumer Credit Association is the main trade body for home credit lenders. Analysis of its membership shows that the great majority (over 90 per cent) are small lenders with fewer than 10 agents; half have no agents. Medium-sized companies with between 10 and 99 agents comprise seven per cent of the membership. Large lenders, with 100 or more agents, make up two per cent of members. The two largest concentrations of members are in the North West and South East of England.

Home credit has traditionally been characterised by a few large national companies and a large number of smaller firms. Following the merger of two long-standing firms, there are currently four large firms, of which one has a very large share of the market. There have been no significant new entrants for many years. The only new entrant of any real size left the market within a very short period of time. The four largest home credit firms participated in the Business Survey, along with three medium-sized and two small lenders.

The Business Survey indicated that two of the four large companies (with 11,500 and 500 agents respectively) were relatively stable in terms of profits, numbers of loan and numbers of customers – perhaps with a slight increase over recent years. The two other large home credit lenders were previously owned by companies that had got into financial difficulties when they ran down their home credit business in favour of larger loans repaid by direct debit. In both cases, the home credit business was the only part to survive and at the time of the Business Survey was in the process of being rebuilt. These two companies have approximately 2,000 and 400 agents respectively. Both firms broke even financially in 2010 and made a small profit in 2011.

Medium-sized home credit companies tend to have regional coverage, while small lenders serve local communities. Business in medium-sized companies seemed to be stable, except in one case where growth was due to the acquisition of another medium-sized home credit firm. In small firms it was either stable or contracting as the owners deliberately ran down their business in anticipation of retirement. Over the past ten years, there has been continued consolidation of small- and medium-sized businesses, but there have been no major acquisitions by the largest firms in last five years.

Although a few large companies account for much of the market, there can be competition at a local level where consumers often have a choice of small- and medium-sized companies. The level of competition, however, is nowhere near as great as the payday lending or even pawnbroking markets operated by retail lenders and online lenders. Compared with these, the home credit market seems well-established and sticking to tried and tested models of lending.

2.1.1 Product range

Home credit loans were the primary business of all the home credit firms in the Business Survey, and for home credit firms more generally. Home credit lenders talked about offering a range of loan products, which meant cash loans of different loan terms. Some offered loans over periods as short as 14-16 weeks; for others the shortest loan was 32-33 weeks. Average loan amounts varied from £250 to £760 (for a longer-term loan), with most between £250 and £350. New customers would typically receive smaller loans to start off with, generally in the region of £100.

To generate new business, the home credit lenders in the Business Survey canvassed products such as shopping vouchers, stored value cards, hampers and soft goods. Some firms offered other financial services in addition to home credit, either as part of the same business or as a separate entity. One large company offered a credit card; another offered hire purchase loans and motor finance. One sole trader acted as an agent for a mail order catalogue.

There seems to be little overlap between home credit and other types of short-term credit. The trade association was not aware of any home credit firms that were also pawnbrokers, and none of their members offered payday loans. One of the nine companies in the Business Survey, a medium-sized family business, had moved into online payday lending through a sister company, but was in the process of winding this down. It also operated a pawnbroking store as a separate business.

2.1.2 Market size

Home credit lenders make an estimated six million loan transactions per year. The Competition Commission estimated that in 2005, home credit loans with a total value of £1.3 billion were made. OFT estimated that there were 2.3 million customers (OFT, 2010).

A Competition Commission market investigation carried out before the financial crisis found evidence that the home credit market was slowly declining or at best stable (Competition Commission, 2006). Research published in 2009 reported a rise in home credit customer numbers following the credit crunch. Tightened lending criteria used by home credit lenders in these new conditions resulted in higher refusal rates within their existing customer base (Kempson et al, 2009).

Among home credit lenders in the Business Survey for this research, the picture was one of stability or (for small lenders) gradual decline rather than significant growth in customer numbers. The four largest lenders in the Business Survey interviews had, between them, made approximately 2.93 million loans in the last year.

2.2 Pawnbroking and retail payday lenders

Lenders that operate from retail premises often offer both pawnbroking and payday lending, as well as other services such as the purchase and sale of gold, cheque cashing, foreign exchange, money transfer, and buying and selling second-hand goods. We refer to these lenders as retail lenders.

It is difficult to estimate the number of retail lenders in the UK, even based on trade association membership, because lenders may be members of one or more trade association. The BCCA has over 60 members that offer financial services from retail premises, but not all of them necessarily offer payday loans. Over 1,800 pawnbroking outlets are members of the NPA, and around 20 NPA members are also members of the BCCA or the CFA.

The ten retail lenders in the Business Survey comprised six large lenders that each had 100 or more stores; one medium-sized lender that had 15 stores; and three small lenders that each had fewer than 10 stores. Lenders had different origins, including pawnbroking, second-hand goods, cheque cashing, and payday lending.

Most of the retail firms in the Business Survey were very well-established, and had been operating for well over 10 years. A few were relatively new entrants to the UK market. Firms reported that business was growing but that payday lending and pawnbroking were both highly competitive. They commented on the number of firms entering these markets, the entry of large US payday lending firms into the UK and also the rapid growth in online lending. For example, one small firm had seen 13 competitors set up in the vicinity of its four shops in the past few years. Another small firm had 10-12 other pawnbrokers in its local area. They attributed this growth to the recession; advertising (payday lending); and the price of gold (pawnbroking) which made people more likely to pawn than sell gold jewellery. Several likened the boom in payday lending and pawnbroking to the early days of the gold buying industry and expected there to be a shake-out in which some firms would exit the market.

All the retail lenders in the Business Survey reported making a profit, buoyed by the high gold price. One new entrant had only recently started to make a profit, but expected profit levels to increase over the next four or five years. Several other lenders also mentioned a period of four or five years from opening a new store or business to moving into profit, due to the high set-up costs.

2.2.1 Product range

Retail premises offer opportunities for cross-selling, and all the firms in the Business Survey had diversified into a wide range of financial products and services.

Payday loans

All ten companies offered retail payday loans. For three companies, it was the major part of their business; for the other seven it was a minor element of their business activities.

Three of the ten companies were reducing their payday lending activity and a fourth was diversifying its offering in order to reduce its dependence on payday lending. This was partly because of the fierce competition from online lenders and partly for reputational reasons; one lender described it as *my least favourite bit of the business*. The withdrawal of the cheque guarantee card and the implications for risk management was another important consideration (see below).

In contrast, five companies were proactively building this side of their business and one large company was letting it grow organically. Three of them (all large companies) had also developed online payday lending; for one of them, the number of online loans was now double the number of retail loans, and they envisaged a continuation of this shift to online lending.

The average retail payday loan was typically between £300 and £400 over a loan period of 28-31 days. One lender offered a 35-day payday loan which could be repaid at any time between seven and 35 days.

Pawnbroking

Nine of the ten companies also offered pawnbroking**.** Two were originally pawnbrokers, and this remained the mainstay of their business. For the others, pawnbroking was a minor part of their business, albeit one that they were seeking to increase in response to rising demand as a result of the increase in gold prices. The average loan amount was between £150 and £200; pawnbroking agreements are generally for six months.

Other products

Although not covered in the remit for this research, five firms offered unsecured instalment loans, typically over 12 months and on terms that were similar to their payday loans. The average instalment loan amounts mentioned by lenders ranged from £300 to £1,000.

The other main area of growth for these firms was gold buying, where profits had increased considerably. In contrast, cheque cashing had declined as the electronic transfer of funds increased and cheque usage fell. Other services (foreign exchange and money transfer) provided a steady income and helped maximise the profit from retail premises. The specialist second-hand retailers all reported growth in the scale and profitability of this side of their business, in part because eBay had made the purchase of second-hand goods more respectable.

2.2.2 Market size

The value of payday loans (both retail and online) in 2008 was estimated to be between £700 million and £900 million. Based on an average loan of £300, this equated to around 2.3 to three million retail and online payday loans (OFT, 2010), a figure that is likely to have grown considerably since 2008.

Eight lenders in the Business Survey (five large and three small lenders) provided information about the number of retail payday loans they made in the previous year. In total, they had provided over 1.25 million loans.

In 2008, the total value of the annual loan book for pawnbrokers was estimated between £500 million and £600 million, with approximately six million pawnbroking agreements made each year (OFT, 2010). Based on information provided by six lenders (four large and two small) in the Business Survey, the number of pawnbroking loans they had made totalled over 1.2 million in the last year.

In contrast to the home credit market, there has been a striking increase in the number of retail stores on the high street that offer (among other things) pawnbroking and payday loans since the onset of the credit crunch. All the large retail lenders in the Business Survey reported strong growth in store numbers over the last five years, much of it in the last year. Some lenders reported that they had opened on average around 50 new stores per year. This growth was in part attributed by lenders to households borrowing more as disposable incomes stagnated or declined and prices increased. But just as important was the rise in gold prices as a result of global economic uncertainty, which had resulted in greater volumes of pawnbroking as well as gold buying.

2.3 Online payday lending

Online lending is the area of most rapid growth, facilitated by the Consumer Credit Act 1974 (Electronic Communications) Order 2004, which permits consumer credit contracts to be signed online. By its very nature, operating online allows lenders to go for scale and some of the largest volumes of payday lending were transacted in this way among the companies we interviewed. There are around 30 specialist online lenders that are trade association members. It seems likely that most of these will offer payday loans; some may offer instalment loans. Online lending is supported by software and technology firms that develop and test new credit products and automated decision-making systems for online lenders.

Five specialist online lenders took part in the Business Survey, and these ranged in size in terms of the number of loans they made in a year. One only offered unsecured instalment loans. The other four only offered payday loans, although two were also considering offering instalment loans.

Three of the five online lenders were US companies that had begun operating in the UK in the last three to four years. A fourth was also a new entrant, having started trading five years ago. The fifth and smallest company among them had experimented with various forms of short-term credit since it was established 30 years ago. For the past 18 months it had concentrated on online payday lending.

All the online lenders in the Business Survey indicated that online lending is a very competitive market. Even so, recently-established firms were moving fairly rapidly into profitability. All were seeing steady, if not meteoric growth. Four of the five online lenders were in profit; the exception was one small lender that had started operating in the UK in 2008.

2.3.1 Product range

Some online payday lenders offered a 30-day loan. Others offered loans with a daily charge where the amount could be repaid early without penalties; the typical loan term among these lenders was 15-20 days. Average loan sizes ranged from £140 to £320.

The firm that specialised in online instalment loans offered loans over four to six months, depending on the loan amount. The average loan size was £200.

2.3.2 Market size

As noted above, the OFT estimated the total value of payday loans (both retail and online) in 2008 to be up to £900 million, equating to up to 3 million loans (OFT, 2010).

Online payday lending is a recent phenomenon in the UK as, prior to 2004, it was not possible for consumer contracts to be signed online. Since that time, there has been rapid growth in online lending and very short-term payday lending in particular. Four of the five online payday lenders in the Business Survey had started operating in the UK in the past five years. As with pawnbroking and retail payday lending, pressure on household finances combined with much tighter credit conditions generally must account for a sizeable proportion of this growth.

Bank of England data for the period May 2010 to May 2012 shows a downward trend in credit card lending to individuals and a steady rise in other unsecured lending (Bank of England, July 2012). It is reasonable to assume that payday lending has played some part in this rise in personal loans and advances.

Between them, the five specialist online lenders in the Business Survey had made approximately 3.3 million loans in the past year, most of which were payday loans. During the course of the research, we collected information from another nine specialist online lenders that did not take part in the Business Survey. When we include these as well, we estimate that the 14 lenders made around 4.1 million loans in the last year.

2.4 The costs of lending

The main costs of lending varied across the sectors but also within sector by the size of the company. Bad debt was a significant (and generally increasing) cost for most lenders. The costs of capital were important for large lenders.

2.4.1 Home credit

For the home credit industry as a whole, the costs associated with collecting payments in the customer's home are a significant part of the overall cost. For large and medium-sized firms this also includes the branch infrastructure to support home collection.

The large and medium-sized companies in the Business Survey mentioned a number of factors that drove costs: the rising cost of borrowing; the cost of client acquisition; and the increasing level of bad debt – partly because of the impact of the economic downturn on their customers and partly as a result of client turnover and higher debt levels among new customers. They also mentioned the financial impact of changes to the early settlement regulations. The medium-sized companies did not, however, have the economies of scale of their larger counterparts and this could explain their higher charges to customers.

For small companies, the key driver of cost was compliance with regulation – which had had a significant impact on the firms in the Business Survey. In particular, they mentioned the financial impact of changes to the early resettlement regulations. Other than this, they incurred no costs of borrowing and none for the acquisition of new customers as they had a very loyal customer base and were not seeking to expand their business. As a consequence, bad debt levels were low. This goes a long way to explaining the lower costs of borrowing from these small companies.

2.4.2 Pawnbroking and retail payday lenders

The costs of operating retail outlets were a significant part of the overall cost for retail lenders and any growth in new stores acted as a drag on profitability. Several larger companies also mentioned the rising cost of borrowing.

Gold buying was generally considered to be the most profitable part of their businesses; the sale of second-hand goods was also highly profitable. Pawnbroking was generally considered more profitable than payday lending, because of the rise in bad debt associated with the latter.

2.4.3 Online lenders

Two significant costs for online lenders were client acquisition (advertising, lead generation; see section 7.1) and application screening. The larger companies mentioned the costs associated with high levels of fraud (including organised fraud); all mentioned the costs of screening applicants to assess their credit-worthiness (see section 7.2.4). Rejection rates were generally in the region of 90 per cent (or more), and consequently firms incurred the cost of screening 100 customers in order to make ten loans. Even so, one large company that engaged in significant volumes of both retail and online payday lending said that online lending was more profitable.

3 Who uses short-term credit?

Summary

The 2006-2008 Wealth and Assets Survey showed that one per cent of adults used short-term credit. Most had only one commitment of this type.

The Consumer Survey found some overlap in the profile of customers who used home credit, pawnbroking, retail payday and online payday lending. But on the whole they were distinct groups.

Home credit customers were generally women (65 per cent), on low incomes (72 per cent), and social housing tenants (60 per cent). Similarly, most pawnbroking customers were women (59 per cent) and on low incomes (70 per cent). Pawnbroking customers were younger than their home credit counterparts, however: 72 per cent were under 50, compared with 52 per cent of home credit customers.

Retail payday loan customers comprised an even mix of men and women. Like pawnbroking customers, the majority were under 50 years of age (80 per cent). Most were in paid work (76 per cent). About half were on low incomes, the other half not. A significant minority of retail payday loan customers in the Consumer Survey were non-White (18 per cent), which was also the case for pawnbroking customers (22 per cent).

Online payday loan customers tended to be younger and better-off than other customers. The majority of online borrowers in the survey were men (61 per cent). Almost all of them were in work (90 per cent), and as a result far fewer of them were on a low income compared with other customer groups.

Using an OFT measure of vulnerability based on age, employment status, income and ethnicity, three-quarters of home credit and pawnbroking customers were classified as vulnerable, compared with 60 per cent of retail payday and 37 per cent of online payday loan customers. There was a similar pattern in relation to the proportion of customers that were banked.

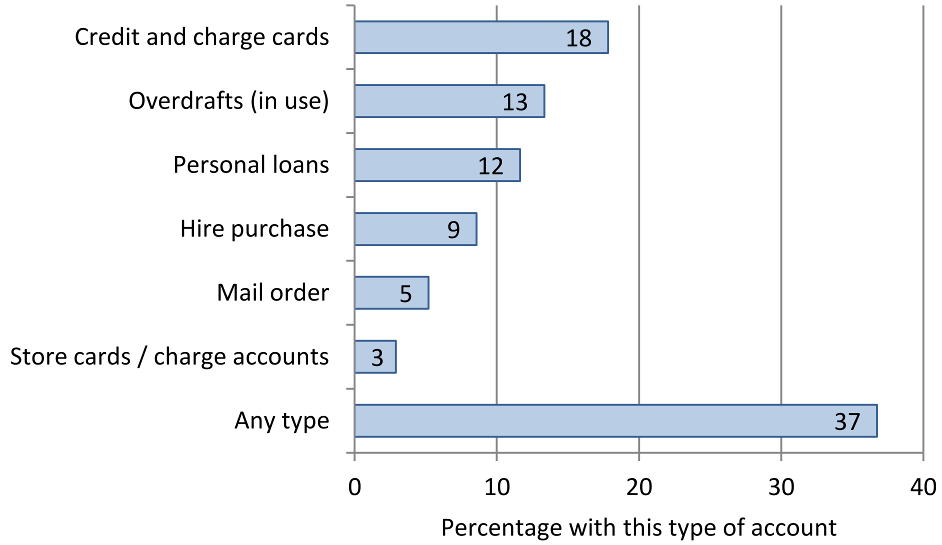
3.1 Credit use in the general population

The main results from the first wave of the Wealth and Assets Survey examined credit use at the household level (Daffin, 2009). In this analysis, we consider credit use by individuals.

More than a third (37 per cent) of all adults in 2006-08 had one or more active commercial credit commitments of some kind. Credit and charge cards were the most common type of commitment held (18 per cent), while mail order and store cards were held by only a very small minority of people (five per cent and three per cent respectively; Figure 3.1).

A half of those with any type of credit commitment had only one commitment (52 per cent; equivalent to 19 per cent of all adults). A further quarter (24 per cent) had two commitments and the remainder (24 per cent) had three or more. The mean number of commitments held by those with any was 1.9 commitments.

Figure 3.1 Active credit commitments, all adults in Great Britain 2006-08



See Annex 1, Technical Note 1. Source: 2006-2008 Wealth and Assets Survey. *Unweighted base: 53,298.*

The use of home credit, payday loans and loans from a pawnbroker in the period 2006-2008 was very uncommon (Table 3.1). One per cent of people had one or more types of high cost credit across the three types: one per cent had home credit accounts (cash loans or hire purchase), and less than one per cent had pawnbroking or payday loans. It is clear that short-term credit use was dominated, in terms of numbers in the sample, by home credit.[1] Among those with any of these types of credit, a large majority had only one commitment (79 per cent), 17 per cent had two and four per cent had three or more. This picture is likely to have changed in the intervening years, because of the growth in the payday lending and pawnbroking sectors.

Table 3.1 Active short-term commitments, all adults in Great Britain 2006-08

Percentages	Percentage with this type of account
Pawnbroking loan	<1
Payday loan	<1
Home credit loan	1
Any type	**1**
Unweighted base	*53,298*

Source: 2006-2008 Wealth and Assets Survey

When these commitments are excluded from the measure of active credit commitments, we observe a small decrease in the rate of borrowing overall, from 37 per cent for all types to 36 per cent for mainstream types of credit. The percentage of adults holding mainstream personal loans and hire purchase agreements reduced to nine per cent and eight respectively.

[1] Of the 436 cases in the sample with any high cost credit commitments, 416 had home credit, 18 had pawnbroking loans and six had payday loans (the survey did not distinguish between online and retail payday loans). As such, there were insufficient numbers to undertake analysis for individual types of high cost credit.

Regression analysis was used to examine the demographic and socio-economic predictors of using home credit, payday loans and loans from a pawnbroker in the general population (noting that home credit dominated these types of loans).[2] Housing tenure was the strongest predictor overall. People living in a rented home were considerably more likely than those owning their homes outright to have these types of commitments, all other things being equal. Other aspects of socio-economic status were also strong predictors. Those with non-degree level qualifications or no qualifications, those with backgrounds in routine occupations and those living in households in the lowest earnings quintile or dependent on income-replacement benefits were among those most likely to have used these types of loans, all other things being equal.

Age and gender were also significant predictors of using these types of loan. The odds were highest among 25 to 34 year olds and remained high among the 35 to 44 and the 45 to 54 age groups compared with people over State Pension Age, and they were higher among women than men. Compared with other household types, people living in a lone parent household with dependent children were at the higher end of the range. See Annex 1 for more details.

3.2 Who uses short-term credit?

The Consumer Survey indicated statistically significant socio-demographic differences between home credit, pawnbroking, retail payday and online payday loan customers. The differences between consumers who use online payday loans and those who borrow from home credit companies were particularly marked (Appendix Table 1). The following sections describe the profiles of the four groups of credit users in the survey. Some of the key differences between the groups are summarised in Table 3.2.

3.2.1 Home credit customers

The majority of home credit customers in the survey (65 per cent) were women. They were about evenly divided between those aged under 50 (52 per cent) and those aged 50 or over (49 per cent). Around one in ten (13 per cent) were aged under 30.

Table 3.2 Key differences between the four groups of credit users

Percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Gender	Mostly women	Mostly women	Even mix of men and women	Mostly men
Aged under 30	13	28	32	37
Non-White	5	22	18	9
Lone parent family	15	14	14	9
Social tenant	60	39	35	19
On a low income[1]	72	70	46	31
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. [1] Survey respondents were categorised as being 'on a low income' if they or their partner had no earned income or they received working tax credit or pension credit.

[2] Regression analysis examines the extent to which customer characteristics relate to the outcome of interest, after holding constant the influence of all other characteristics included in the analysis. Further details are provided in the Appendix Tables.

About half of home credit customers in the survey (46 per cent) were either single adult households or couples with no children. This largely reflects the age profile of the customers surveyed. About a third (35 per cent) lived in families with children, of which 20 per cent were couple families and 15 per cent lone parents. Eight in ten home credit customers (79 per cent) lived in a rented property. Most of them (60 per cent) rented their home from a housing association or local authority. Most of the rest (12 per cent) owned their home with a mortgage.

Seven in ten home credit customers (72 per cent) were categorised as on a low income. This was defined as respondents (and partners where present) not having any earned income or receiving working tax credit or pension credit. Only four in ten home credit customers (36 per cent) lived in a household with a full-time earner.[3]

3.2.2 Pawnbroking customers

In some respects, pawnbroking customers were similar to their home credit counterparts. Most pawnbroking customers in the survey, for example, were women (59 per cent). On the whole, though, they were rather younger than home credit customers. Seven in ten (72 per cent) were aged under 50; 28 per cent were under 30. And a significant minority of pawnbroking customers (22 per cent) in the survey were from a non-White ethnic group, compared with only five per cent of home credit customers.

Four in ten pawnbroking customers (40 per cent) lived in households without children. Single adult households (23 per cent) were more common than couples without children (17 per cent). A further 22 per cent lived in couple families, and 14 per cent in lone parent families.

Most (63 per cent) lived in rented accommodation and were generally tenants of a local authority or housing association (39 per cent). The remainder generally either owned their home with a mortgage (18 per cent) or lived with their parents (10 per cent).

Like home credit customers, seven in ten pawnbroking customers in the survey were categorised as being on a low income. Only four in ten (38 per cent) had a full-time earner in their household.

3.2.3 Retail payday loans

Unlike home credit and pawnbroking, the customers in the survey who used retail payday loans comprised a fairly even mix of women (51 per cent) and men (49 per cent). In other ways they were quite similar to the pawnbroking customers we interviewed. The majority of retail payday loan customers (80 per cent) were under the age of 50. About a third of them (32 per cent) were under 30 years of age. And, like pawnbroking customers, a significant proportion of retail payday loan customers (18 per cent) were non-White.

About four in ten retail payday loan customers (43 per cent) lived in households without children, evenly divided between single adults and couples without children. Most of the rest (32 per cent) lived in couple families (18 per cent) or lone parent families (14 per cent).

[3] This is based on respondent and partner where present.

Retail payday loan customers generally lived in rented accommodation, with a third (33 per cent) renting from a private landlord and a third (35 per cent) renting from a housing association or local authority. Two in ten (17 per cent) owned their own home with a mortgage.

The major difference between customers with retail payday loans and those who used a pawnbroker or home credit was their income and employment status. Eight in ten retail payday loan customers (76 per cent) were in paid work, compared with 46 per cent of pawnbroking customers and 40 per cent of those who used home credit. And 70 per cent lived in a household with at least one full-time earner. As a consequence, a far lower proportion of retail payday loan customers (46 per cent) were on a low income.

3.2.4 Online payday loans

The customers with online payday loans were a quite different group. This was particularly compared with those in the survey who used a pawnbroker or home credit, but even in relation to customers with retail payday loans. Overall, the users of online payday loans were younger but also better-off financially than other customers.

Unlike the other credit customers in the survey, the majority of customers who used online payday loans were men (61 per cent). The age profile of online payday loan users was younger, with 85 per cent under 50 years of age. Nearly four in ten (37 per cent) were aged under 30.

Online payday loan customers were different in terms of their household composition as well. Of the four groups of customers in the survey, they included the highest proportion of childless couples (27 per cent) and the lowest proportion of lone parent families (nine per cent). Online payday loan customers were more likely than other credit users to be single and live with their parents (12 per cent) or in shared households (seven per cent).

About half of payday loan customers (54 per cent) rented their home, more often from a private landlord (35 per cent) than a housing association or local authority (19 per cent). A quarter of them (25 per cent) owned their home with a mortgage, the highest proportion across the four groups of customers. Reflecting their younger age profile, 14 per cent overall lived with parents.

The great majority of online borrowers (90 per cent) were in work. And eight in ten (82 per cent) had a full-time earner in their household. As a result, only 31 per cent were categorised as on a low income, the lowest of the four types of customers in the survey.

3.3 Are short-term credit customers vulnerable?

The OFT identifies that consumers may be vulnerable for two reasons. First, some may have greater difficulty than others in obtaining or assimilating the information needed to make decisions about which goods and services, if any, to buy. We discuss the Consumer Survey findings on access to and use of information in section 5.

Second, they may be exposed to a greater loss of welfare than other consumers as a result of buying inappropriate goods or services, or of failing to buy something when it would be in their interests to do so. We discuss the potential detriments associated with short-term credit in section 11. Both forms of vulnerability may be experienced by the same individual.

In addition, the OFT describes the types of consumers it considers to be potentially vulnerable. These include people at or above pensionable age; young people aged below 16; the unemployed; people with a limiting, longstanding illness, disability or infirmity; people living in low-income households; members of ethnic minorities; and people with no formal educational qualifications (Burden, 1998).

Based on the data collected in the Consumer Survey, we derived a measure which captures most of these dimensions of vulnerability: age, employment status, income and ethnicity.[4] The survey data showed marked differences in the proportion of consumers who were vulnerable according to this measure. Three-quarters of home credit and pawnbroking customers (77 per cent in each case) were vulnerable, compared with 60 per cent of retail payday loan users and 37 per cent of online borrowers (Appendix Table 2).

As a bank account is nowadays an important part of everyday life for most people, we might also consider consumers to be vulnerable if they do not have a current or basic bank account. The pattern here was the same: much higher proportions of home credit customers (17 per cent) and pawnbroking customers (15 per cent) were unbanked compared with retail or online payday loan customers (one per cent in each case). This is hardly surprising, given that payday loan customers generally must have a current or basic bank account in order to take out a loan (Appendix Table 2).

Other important aspects of consumer vulnerability, such as being in financial difficulty or having limited credit options are explored in subsequent sections.

[4] The survey did not collect data on disability or educational qualifications.

4 Why do consumers use short-term credit?

Summary

The reasons for taking out short-term credit varied markedly by the type of credit customers had used, as did the amounts borrowed.

Home credit customers in the Consumer Survey borrowed the biggest sums, which they generally used to pay for larger periodic expenses such as Christmas and birthdays. Pawnbroking and payday loan customers (both retail and online) were much more likely than their home credit counterparts to borrow smaller sums of money to pay for essentials such as bills and everyday spending. The same was true of customers who had seen their financial situation deteriorate in the past five years.

Customers reported using short-term credit for two main reasons: it was quick and convenient, and because they could not borrow from anywhere else. Consumers' also perceived that they had more control over short-term credit products than credit cards and overdrafts. Lenders' flexibility and reputation were important for home credit customers, as was anonymity for online payday loan customers.

A significant proportion of customers in the Consumer Survey (particularly payday loan customers) had mainstream credit at the time of the survey interview. An objective measure of credit access was derived from the survey data, based on whether customers had unused balances on their overdraft or credit card or said they were most likely to have used mainstream credit if they could not have borrowed from a short-term lender. On this measure, mainstream credit was only a feasible alternative to short-term credit for 10 per cent of home credit customers; 14 per cent of retail payday loan customers; 18 per cent of pawnbroking customers and 24 per cent of online payday loan customers. In most cases this would have meant using a credit card or overdraft.

Payday loan and pawnbroking customers were more likely to have mainstream credit options than home credit customers. If customers had a poor credit history or they were not in work, they were less likely to have the option of using mainstream credit. Regardless of the type of short-term credit they had used, customers in the Consumer Survey had generally not considered any non-credit options before they took out their most recent loan.

4.1 How much do consumers borrow?

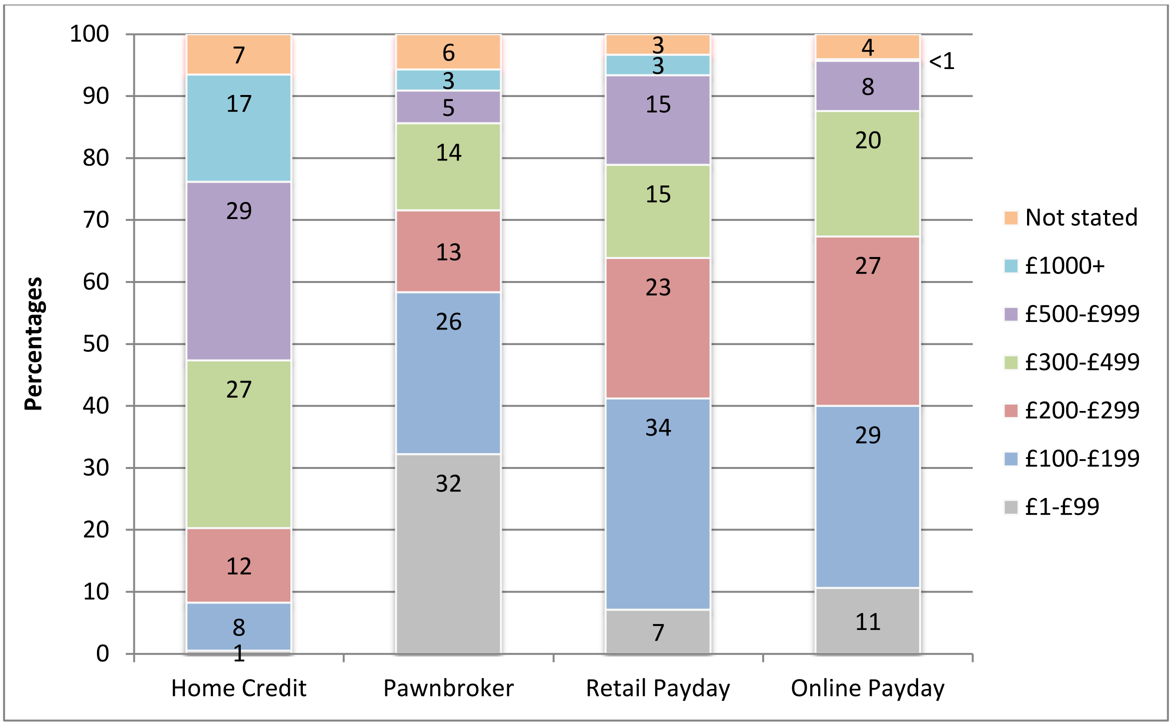
The amounts borrowed by customers in the Consumer Survey reflected differences in the typical loan terms for home credit, pawnbroking and payday loans.

Based on their current or most recent loan, home credit customers tended to borrow larger sums of money (the median loan amount was £450), compared to pawnbroking customers (median loan £130) and retail and online payday loan customers (median loan £200 in both cases).

Looked at another way, fewer than one in ten home credit customers had taken out loans for less than £200, compared with six in ten pawnbroking customers, and around four in ten payday loan customers. At the other end of the scale, about half of home credit customers had taken out loans of

£500 or more, compared with two in ten online payday loan customers and fewer than one in ten pawnbroking and retail payday loan customers (Figure 4.1).

Figure 4.1 Average amount customers borrowed when they took out their most recent loan



Source: Consumer survey. Base is all respondents. *Bases: Home credit, 399; Pawnbroker: 264; Retail payday, 393; Online Payday, 395.*

4.2 What do consumers borrow money for?

Just as the loan amounts varied by credit product, so did the purpose for taking out a loan. Again, the main distinction was between home credit and the other credit types (pawnbroking and payday loans).

Home credit loans were generally used to pay for larger expenses that occurred periodically, rather than to meet everyday expenses or to pay household bills (Table 4.1). The most common uses were to pay for birthdays, Christmas or other special occasions. Other uses were to pay for repairs or to decorate, to make some other purchase or to pay for a holiday. It was notable that home credit customers were much more likely than other borrowers to agree that '*it helps me to buy things I couldn't otherwise afford*'. Nine in ten home credit customers (89 per cent) agreed with this statement, compared with 62 per cent of retail payday and 49 per cent of online payday loan customers (Appendix Table 3).

A similar picture emerged among the home credit users who took part in the Depth Interviews. It was typical for these people to have used home credit loans routinely to buy white goods or cover seasonal events such as Christmas or the summer holidays, even where they did so only periodically. It was notable, however, that one had taken out a loan, as a one-off, to cover her Council Tax Arrears and avoid a Court Summons.

Table 4.1: How consumers used their most recent loans

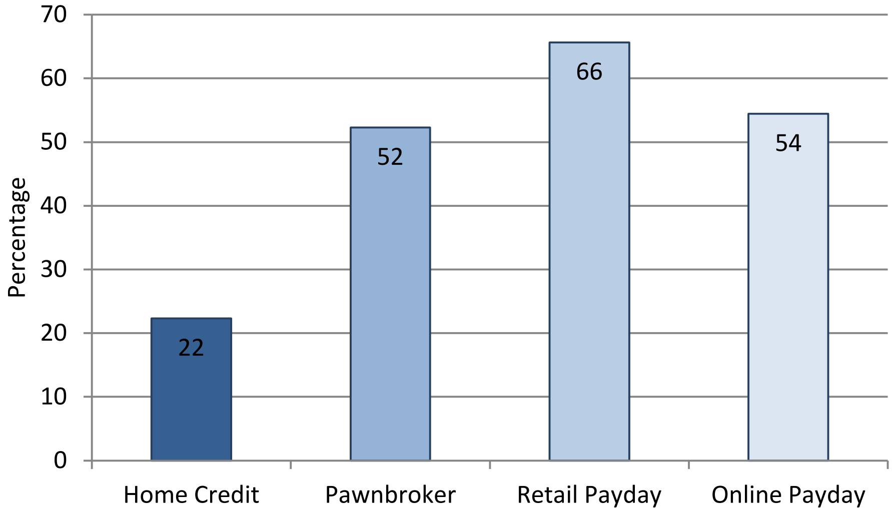
Percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Used loan to meet everyday expenses (expected/unexpected) *	14	36	43	35
To pay other household bills e.g. gas, electric, water and telephone (including arrears) *	14	28	36	28
To pay for a Birthday/Christmas/other special occasion (e.g. presents, catering) *	38	13	7	15
To pay for repairs (e.g. to a car or washing machine) or to decorate *	18	5	5	8
To make any other purchase *	16	8	7	6
To pay rent or mortgage (including arrears) *	1	4	8	7
To pay for a holiday *	10	5	3	5
To pay off another loan from the same lender	1	1	1	1
Used loan to repay any other borrowing	2	4	4	3
Other	3	7	6	3
Don't Know	2	4	3	3
Refused to answer	-	1	-	-
Base	*369*	*256*	*366*	*372*

Source: Consumer Survey. Base is all respondents, excluding respondents from the pilot. Percentages may sum to more than 100 as more than once response was allowed. * Indicates that the variation across the groups for this measure is statistically significant (p<.05)

In contrast, pawnbroking and payday loan customers primarily used these very short-term loans to pay for everyday expenses or to pay household bills (Figure 4.2). Although only a minority of consumers overall used a loan to pay their rent or mortgage, it was a more common use of payday loans than either home credit or pawnbroking (Table 4.1). The Depth Interviews confirmed that pawnbroking and payday loan customers had used their loans to bridge a shortfall between their income and expenditure. For several of them this shortfall had only arisen recently, for example as a result of a change in circumstances or a loss of income.

Regression analysis of the Consumer Survey indicated that, all other things being equal, pawnbroking and payday loan customers were much more likely than home credit users to borrow to pay for essentials such as bills and everyday spending. The odds were four times higher for online payday loan customers and almost seven times higher for those who used retail payday loans.

Figure 4.2: The percentage of customers who used their most recent loan for household bills or everyday spending



Source: Consumer Survey. Base is all respondents, excluding respondents from the pilot. *Base: Home Credit, 369; Pawnbroker, 256; Retail Payday, 366; Online Payday, 372.*

Customers' financial situation was another important predictor of using short-term credit to pay for essentials. Customers who reported that their financial situation had got worse over the last five years had almost twice higher odds of borrowing for essentials, compared with customers whose situation had improved (Appendix Table 4). In the Depth Interviews, debt advice clients had generally used loans from a pawnbroker or payday lender to pay household bills such as rent and Council Tax that they could not otherwise cover. Some debt advice clients were already behind with bills when they borrowed the money.

Across the four credit types, it was unusual for customers in the Consumer Survey to say they had used their most recent loan to repay other borrowing (Table 4.1).

4.3 Why do consumers say they use short-term credit?

Although it is high-cost compared to other forms of borrowing, short-term credit in the form of home credit, pawnbroking and payday lending has attractions for consumers such as speed and convenience. Lack of access to other credit or to non-credit alternatives also play a part in explaining why people use these types of credit.

4.3.1 Convenience

Previous research consistently showed that convenience was an important reason why consumers used home credit, pawnbroking and payday loans (Burton, 2010; OFT, 2010; Collard and Kempson, 2005; Dominy and Kempson, 2003; Jones, 2002; Rowlingson, 1994). In particular, consumers valued the quick and easy loan application process for short-term loans.

In the Consumer Survey for this research, upwards of nine in ten customers agreed that the short-term credit they used was '*a good way to raise cash quickly*' (Table 4.2).

Table 4.2: Customers perceptions of the short-term credit products they used

Column percentages		Home Credit	Pawn broker	Retail Payday	Online Payday
It is a good way to raise cash quickly*	Agree	93	93	89	90
	Disagree	5	6	10	9
	Don't know/doesn't apply	2	1	1	1
It helps me to buy things I couldn't otherwise afford*	Agree	89	71	62	49
	Disagree	9	27	34	48
	Don't know/doesn't apply	2	2	4	3
I use [this type of loan] because I can't borrow from anywhere else*	Agree	56	47	57	50
	Disagree	41	50	42	49
	Don't know/doesn't apply	3	2	1	1
It makes it easier for me to manage when money is tight*	Agree	85	82	77	81
	Disagree	12	15	21	17
	Don't know/doesn't apply	3	3	3	1
Base		*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05)

Customers in the Consumer Survey were also asked directly why they had used this particular form of credit on the most recent occasion, rather than borrowing in some other way. Convenience (including that it was local or it was easy or quick to get the money) was by far the most important factor for all customers. This was particularly true for customers who had taken out an online payday loan. Six in ten (61 per cent) online payday loan customers said they had chosen this type of credit because it was easy and convenient, compared with 44 per cent of home credit customers (Figure 4.3; Appendix Table 5).

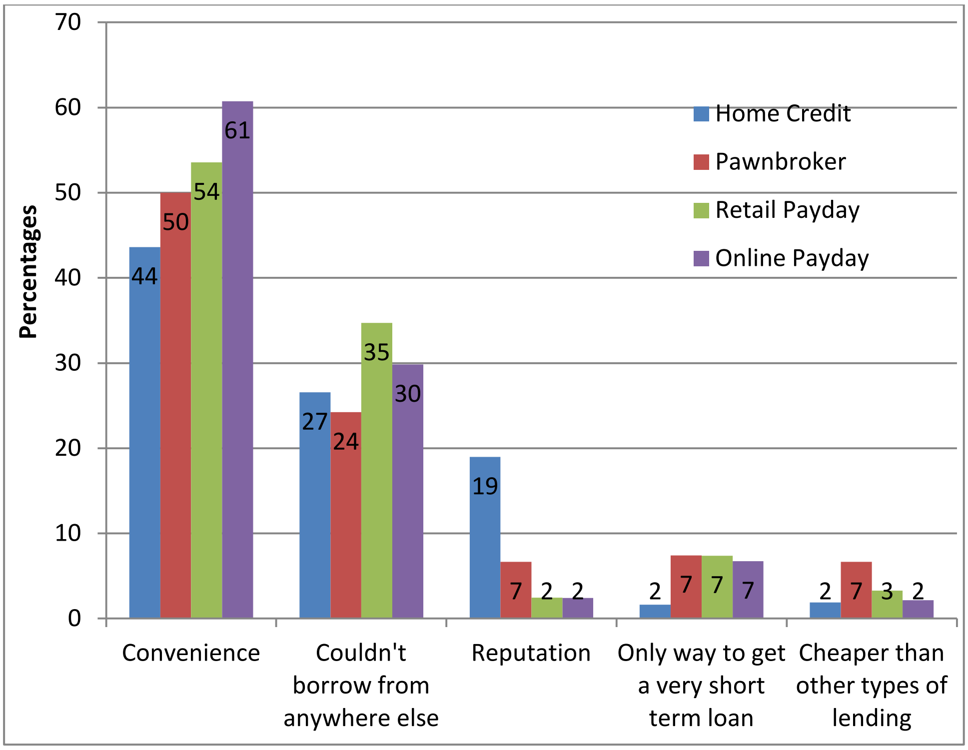
4.3.2 Access

Another attraction of short-term credit is that consumers know in advance that they have a reasonable chance of borrowing the money they want, even in cases where they have a poor credit record (Policis, 2011; OFT, 2010; Collard and Kempson, 2005).

In the Consumer Survey for this research, half or more of customers agreed with the general statement '*I use this type of loan because I can't borrow from anywhere else*' (Table 4.2).

Customers in the Consumer Survey were also asked directly why they had used this particular form of credit on the most recent occasion, rather than borrowing in some other way. Higher proportions of payday loan customers said they could not borrow the money from anywhere else on this occasion (35 per cent of retail and 30 per cent of online payday loan customers) than home credit customers (27 per cent) or pawnbroking customers (24 per cent) (Figure 4.3; Appendix Table 5).

Figure 4.3: Five most common reasons for taking out a loan on the most recent occasion, rather than borrowing in some other way



Source: Consumer Survey. Base is all respondents, excluding respondents from the pilot. *Base: Home credit, 369; Pawnbroker, 356; Retail Payday, 366; Online Payday, 372.*

Regression analysis indicated that, all other things being equal, retail and online payday loan customers had higher odds of using this type of credit on the most recent occasion because they could not borrow from anywhere else compared with home credit and pawnbroking customers. As we might expect, regardless of credit type, customers who had a poor credit history had three times higher odds of saying they lacked access to other credit than those who had not experienced a bad credit event in the last five years (Appendix Table 6). In the Depth Interviews, most of the debt advice clients had taken out short-term credit because previous financial difficulties meant they could not borrow from anywhere else. We examine objective measures of customers' access to mainstream credit in section 4.4.

4.3.3 Control

Previous research showed that home credit customers valued the fact that repayments were collected in cash, usually every week, from their home. Apart from being convenient, these features reduced the chance of customers' defaulting on their loan (Kempson et al, 2009; Collard and Kempson, 2005; Rowlingson, 1994). Similarly, payday loan customers may feel that short-term payday loans give them more control over their spending than an overdraft or credit card and in some circumstances can work out less costly (Policis, 2011; Burton, 2010; Financial Inclusion Taskforce, 2010; Dominy and Kempson, 2003).

In the Consumer Survey for this research, upwards of half of customers agreed with the statement '*I use this type of loan because I am less likely to get into difficulty using it compared with a credit card* *or overdraft'*. The proportion of customers that agreed with the statement was higher among home credit (71 per cent) and pawnbroking customers (68 per cent) than retail payday loan (63 per cent) or online payday loan customers (54 per cent) (Appendix Table 12).

4.3.4 Other factors

Previous research highlighted some other factors that helped explain why consumers used short-term credit. For home credit, the lenders' flexible approach to payment difficulties was a strong attraction (Kempson et al, 2009). For payday loan customers anonymity could be important, particularly for users of online lenders (Burton, 2010).

In the Consumer Survey for this research, the reputation of the lender (including having been recommended the lender or used the same lender before) was another important aspect of their most recent credit choice for home credit customers. It was far less important for other borrowers (Figure 4.3; Appendix Table 5). In the Depth Interviews, the home credit users were mostly long-time users who either took loans out regularly, or else frequently to cover periodic costs. Even though many of the payday loan and pawnbroking users in the Depth Interviews (both customers and debt advice clients) had made repeat use of these types of loans, some habitually so in recent times, they were not long-time users of these types of credit. In addition, the anonymity of applying for a loan online was valued by some payday loan customers in the Depth Interviews.

4.4 Could consumers use mainstream credit instead of short-term credit?

Analysis of the 2006-2008 Wealth and Assets Survey showed that credit use in Great Britain was dominated by the mainstream types of borrowing. Among all credit users, 98 per cent had *only* mainstream credit. There was some overlap, with two per cent of credit users using both short-term credit and other types. One per cent had only short-term types of credit (Table 4.3).

Table 4.3: Types of credit held, among all credit users in Great Britain

Column percentages	Percentage with this type of account
Short-term credit and mainstream borrowing	1.5
Mainstream borrowing only	97.7
Short-term credit only	0.8
Unweighted base	*18,388*

Source: 2006-2008 Wealth and Assets Survey. Figures do not sum to 100 due to rounding.

Previous research showed that borrowing from mainstream lenders such as high street banks or building societies was not seen as a realistic option for some sections of the population, particularly those on lower incomes (Burton, 2010; Kempson et al, 2009; Competition Commission, 2006).

The Consumer Survey for this research showed that a significant proportion of customers had mainstream credit. [5] Overall, upwards of half of customers had some form of mainstream credit. There were however large variations between the customer groups which reflected their different socio-demographic profiles. So home credit customers were least likely to have mainstream credit

[5] Credit cards were classified as mainstream credit. It was not possible in the Consumer Survey to distinguish between sub-prime and mainstream credit cards.

and online payday loan customers most likely. This was true overall and also in relation to individual credit types (Table 4.4).

Table 4.4: Customers' use of mainstream credit

Percentages	Home Credit	Pawn broker	Retail Payday	Online Payday
Currently has an agreed overdraft*	36	40	45	56
Currently has one or more credit cards*	21	22	30	49
Used mainstream fixed term credit in last 12 months*[1]	18	21	21	30
Any of these*	47	50	62	76
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05). 1. This encompasses hire purchase and mail order, a store card or a loan from a bank, building society or other financial institution. We have not included a loan from a credit union in this measure

Regression analysis indicated two main drivers of whether or not customers in the Consumer Survey had mainstream credit. The first was housing tenure. Customers who owned their home with a mortgage had three times higher odds of using mainstream credit than those who rented. The second driver was the type of short-term credit they used. Customers who used a pawnbroker, a retail payday lender or an online payday lender had higher odds of using mainstream credit than home credit customers. For online payday loan customers, the odds were almost three times higher. Ethnicity and income were also significant predictors of mainstream credit use (Appendix Table 7).

But even if consumers have mainstream credit, it might not be a feasible alternative to short-term credit. For example, consumers may not have sufficient credit for what they want or they may rule out mainstream credit as an option, even if they have used it in the recent past.

To gauge in an objective way whether mainstream credit was a viable alternative to short-term credit, the Consumer Survey asked customers whether they had credit lines available to them in the form of overdrafts or credit cards. It also asked what customers were most likely to do if they had been unable to borrow from a home credit firm, pawnbroker or payday lender, including whether they would have used mainstream credit.

Bringing these responses together provides a measure of ready access to mainstream credit and consumers' propensity to use mainstream credit. This shows that mainstream credit only appeared to be a feasible alternative for a minority of customers, and for most this was in the form of an overdraft or credit card. The majority of customers in the Consumer Survey either did not have mainstream credit or, if they did, it was not an appropriate substitute for short-term credit.

Access to mainstream credit options varied by the type of short-term credit that customers used. The analysis showed that a quarter (24 per cent) of online payday loan customers might have been able to borrow the money from a mainstream lender. This was true for only 10 per cent of home credit customers (Table 4.5).

Table 4.5: Do customers have mainstream credit options?

Percentages	Home Credit	Pawn broker	Retail Payday	Online Payday
Has unused overdraft or unused credit card *	8	15	12	22
Are most likely to have used mainstream credit if couldn't have borrowed from sector	3	3	2	3
Could have used mainstream credit source (either of the above)*	**10**	**18**	**14**	**24**
Base	*399*	*264*	*393*	*395*

Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05)

Regression analysis showed that employment status, credit history, spending orientation and the type of short-term credit were all predictive of whether or not customers had viable mainstream credit options. When we controlled for other characteristics, the odds of being in a position to use mainstream credit were ***higher*** for:

- Customers who did not have a poor credit history, compared with those who did.
- Customers who had a strong non-spending orientation, compared with those with a moderate spending orientation.
- Customers who used a pawnbroker, retail payday or online payday lender, compared with home credit customers.

The odds of having mainstream credit options were ***lower*** for customers who were not in work compared with those in work. For customers who were looking after the home or family, the odds were almost eight times lower (Appendix Table 8).

Most of the customers and debt advice clients in the Depth Interviews felt they had no real alternative to the short-term credit they had used. Some did not have a credit card or overdraft that they might have used instead. Others (mainly debt advice clients) were at or over their credit limits on credit cards or overdrafts and could not borrow any more (at least without the risk of incurring charges).

A few customers in the Depth Interviews (all payday loan customers) seemed to have viable mainstream credit options, but they had chosen not to use them. For one retail payday loan customer, his overdraft was not sufficient to cover the bills he needed to pay, and he was reluctant to ask the bank to increase his overdraft limit. Another had an overdraft and several credit cards but decided to borrow from an online payday lender because he wanted to borrow and repay the money quickly. Similarly, another online payday loan customer wanted to avoid using his credit card because he worried that he would put off repaying the balance.

The option of taking out a bank loan was rarely mentioned by customers or debt advice clients in the Depth Interviews. This is not surprising, given that personal loans from a bank, building society or finance house are generally for larger amounts than people wanted to borrow. In addition, some of the customers in the Depth Interviews had no bank account or had debt problems. The OFT similarly found limited scope for substituting short-term credit products with mainstream credit (OFT, 2010).

4.5 Do consumers consider non-credit alternatives to short-term loans?

It was uncommon for customers in the Consumer survey to have considered other, non-credit options before they had taken out their most recent short-term loan (Table 4.6). Among the minority of customers who had looked at non-credit options, these varied quite markedly depending on the type of short-term credit they used.

Payday loan customers were more likely to have considered using money they already had saved than their home credit or pawnbroking counterparts. Pawnbroking customers were more likely than other credit users to have thought about selling something to raise the money they required (which could include selling the items they pawned). This suggests they had pawned valuables with a retail lender that also bought second-hand goods. And home credit customers were more likely to have considered saving up the money, which fits with the larger items they generally wanted to fund (see Table 4.1). Ultimately of course, customers rejected these non-credit options in favour of borrowing.

Table 4.6: What non-credit alternatives had customers considered before taking out their most recent loan?

Column percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Using savings *	7	9	12	13
Saving up the money *	25	16	19	15
Selling something *	16	37	27	24
None of the above *	63	51	56	62
Don't know	<1	-	<1	-
Base	*369*	*256*	*366*	*372*

Source: Consumer Survey. Base is all respondents, excluding respondents from the pilot. Percentages may sum to more than 100 as more than once response was allowed.* Indicates that the variation across the groups for this measure is statistically significant (p<.05).

4.6 What impact has the economic downturn had on short-term credit use?

Significant proportions of customers in the Consumer Survey reported that their financial situation had worsened in the last five years. This ranged from 31 per cent of online payday loan customers up to 46 per cent of pawnbroking customers. As reported above, customers who reported that their financial situation had worsened had almost twice the odds of using short-term credit for essentials, compared with customers whose situation had improved. In the qualitative research, job loss or reduced earnings was a driver for short-term credit use among some debt advice clients.

5 Competition and consumer choice in short-term credit markets

Summary

Lenders in the Business Survey considered their respective markets to be competitive and to offer consumer choice, in terms of price but also other features such as customer service.

As reported in the previous section, customers in the Consumer Survey generally used short-term credit because it was convenient and they had few other options. With the exception of online payday loan customers (44 per cent), most would have taken out their most recent loan even if it had cost more (61 per cent of home credit, 56 per cent of pawnbroking and 56 per cent of retail payday loan customers). Customers with a strong spending orientation and those who did not have mainstream credit were more likely than other customers to say they would take out a short-term loan even if it was higher cost.

Only a minority of customers had compared the costs of borrowing from other lenders at the time they took out their most recent loan (14 per cent of home credit, 22 per cent of pawnbroking and 26 per cent of retail payday loan customers). Again, online payday loan customers bucked the trend and were much more likely to have compared costs than other customers (46 per cent). The comparators used by customers tended to be other short-term lenders of the same type.

The majority of customers had considered some form of cost information from the short-term lender they had used (93 per cent online payday, 89 per cent home credit, and 86 per cent of retail payday loan customers). Pawnbroking customers were less likely to have considered cost information than other customers (75 per cent). The most important cost information from the customers' perspective was the amount of money in pounds and pence they would have to repay. For home credit customers, this meant the loan repayments. For pawnbroking and payday loan customers, it was the total amount they would have to repay when the loan became due. Only a minority of customers considered the APR and other fees and charges to be the most important cost information (ranging from three per cent to 10 per cent of customers).

Although most consumers in the Depth Interviews had received terms and conditions and in some cases also had them explained by the lender, it was common for them to say they had not paid close attention to them.

5.1 Price competition

According to economic theory, competition between suppliers in a functioning market should drive down the prices that consumers pay for goods. As already noted, one argument for introducing price restrictions in a market is where excess profit is made due to weak (price) competition.

In its inquiry into the home credit market, the Competition Commission found weak price competition, based on consumers' insensitivity to price and the potential barriers to large-scale entry through adverse selection and incumbent advantages. The detriment experienced by home credit customers as a result was the high cost of credit in that market. To address these issues, among other things the Competition Commission required home credit lenders to share data about their existing customers and to provide clearer information on the cost of loans (Competition Commission, 2006).

The OFT's high cost credit review also concluded that there were problems with the effectiveness of competition within high-cost credit markets, including home credit, pawnbroking and payday lending. These included: low ability and effectiveness of consumers to drive competition generally (given low financial capability); other factors than price (e.g. convenience) driving competition in the payday lending market; among pawnbroking customers service and brand were important and there was less price competition than in the payday lending market; and little competition between agents in the home credit market and very little price competition. The OFT's recommendations included, among other things, helping consumers to make informed credit decisions and improving consumers' ability to build up a documented credit history (OFT, 2010).

The findings from the Business Survey for this research provide general support to previous research on price competition. Prices did vary, however, depending on the size of lender (see section 6). The home credit market continues to comprise a few large firms that tend to charge broadly similar prices. One large lender that was not included in the Business Survey does, however, charge considerably less. There was also variation in the prices charged by small and medium-sized home credit lenders.

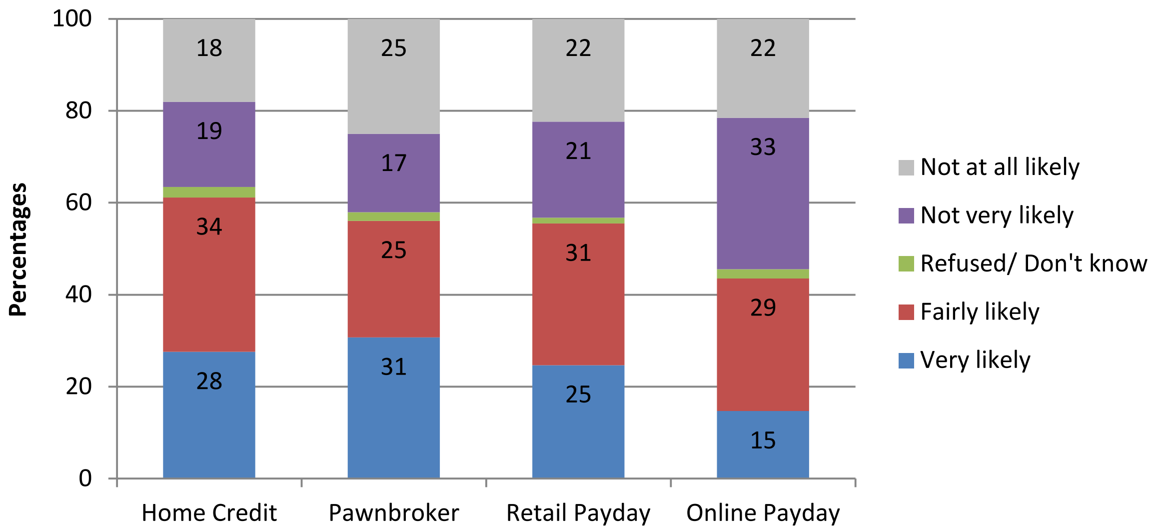
There has been a rapid growth in stores that offer retail payday loans, pawnbroking and other services. Lenders in the Business Survey reported stiff competition on the high street. That said, charges for pawnbroking were very similar across lenders, with lower charges again reported by smaller lenders. In respect of retail payday lending, the main price distinction was between loans repaid by cheque, which were cheaper, and loans repaid by continuous payment authority, which were more expensive. On the whole, smaller lenders charged less for both cheque and debit card lending.

Among online lenders in the Business Survey, there was an apparently wide variation in prices. It was difficult to compare prices, as some charged per day, others for 28 or 30 day loan terms.

Like earlier research, the Consumer Survey found that customers were relatively insensitive to the price charged by lenders. There were, however, significant differences between credit types, reflecting the fact that some customer groups had more credit options than others. Customers were asked how likely they would have been to take out their most recent loan if the cost had been higher. Six in ten home credit customers (61 per cent)[6] said they were likely to have still taken out the loan. The picture was similar for pawnbroking and retail payday loan customers. In contrast, a smaller percentage of online payday loan customers said they would still have been likely to borrow the money if it had been more costly (44 per cent; Figure 5.1).

[6] Note that figures may not appear to sum properly due to rounding.

Figure 5.1: If the cost of taking out a loan from this lender on this occasion had been higher, how likely are you to still have taken the loan out? *



Source: Consumer Survey. Base is all respondents. .* Indicates that the variation across the groups for this measure is statistically significant (p<.05). Base*: Home Credit, 399; Pawnbroker, 264; Retail Payday, 393; Online Payday, 395.*

Regression analysis showed that customers with a strong spending orientation had higher odds of taking out a loan even if it cost more, compared with moderate spenders. The same was true of customers who did not have mainstream credit, compared with those who did (Appendix Table 9).

5.2 Do consumers shop around for short-term credit?

Previous research showed that the majority of customers did not consider other credit options at the time they took out a loan. The reasons customers reported for not shopping around included satisfaction with an existing lender, convenience, and a degree of certainty about being able to borrow from the same lender (Collard and Hayes, 2010; OFT, 2010; Kempson et al, 2009; Collard and Kempson, 2005). The Consumer Survey for this research also highlighted convenience and access to be important drivers of short-term credit use (see section 4.3).

The Consumer Survey asked customers whether they had compared the costs of borrowing from other lenders at the time they took out their most recent loan. Like earlier research, the survey showed that for the most part only a minority of customers compared costs in this way. There were significant differences between customers of different credit products, however. Half of online payday loan customers (46 per cent) compared costs in some way, but this was the case for only 14 per cent of home credit customers (Table 5.1).

Where customers had compared costs, their comparators tended to be other lenders of the same type (i.e. retail payday loan customers checked out the cost of other retail payday lenders), rather than other types of lender (Table 5.1).

Table 5.1: Whether or not customers compared the costs of borrowing before taking out their most recent loan

Percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Found out cost of loans from other lenders of this type*	10	16	20	42
Found out cost of loans from other types of lenders*	5	12	16	18
Used www.lenderscompared.org.uk[1]	5	n/a	n/a	n/a
Any of these	**14**	**22**	**26**	**46**
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05). n/a Question not asked of this sector. [1] www.lenderscompared.org.uk is an independent website to help home credit customers compare the costs of borrowing from home credit lenders and other lenders such as credit unions that offer similar credit products.

In addition to asking whether or not customers had *compared* the costs of borrowing, the Consumer Survey asked whether or not customers had actually *tried to borrow* in some other way when they had taken out their most recent loan.

The majority of customers across all four credit types had not made any attempt to borrow the money in some other way before taking out their most recent loan. As with comparing the costs of borrowing, the proportion of those who did not try to borrow elsewhere was rather higher among home credit and pawnbroking customers than it was for retail or online payday loan customers (Table 5.2).

Table 5.2: Whether or not customers tried to borrow in some other way before taking out their most recent loan *

Column percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Yes	11	15	19	21
No	89	85	81	79
Don't know/refused to answer	<1	<1	<1	1
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this question is statistically significant (p<.05)

Where customers *had* considered alternative credit options, for payday loan customers the most common was a loan from a bank, building society or finance house (nine per cent of all retail and seven per cent of all online payday loan customers), followed by a loan from a friend or relative (five per cent). A small proportion of retail (two per cent) and online (three per cent) payday customers had tried to borrow from another payday lender. The pattern was broadly similar for home credit and pawnbroking customers, for whom friends and family were an important alternative source of funds. It was rare for any borrowers to have approached a credit union before they took out a payday loan. And none of the customers in the Consumer Survey had tried to borrow from an unlicensed lender (Appendix Table 10).

5.3 Is there a lack of information for consumers about short-term credit?

The Consumer Survey and the Depth Interviews explored the provision and use of information in relation to the cost of credit and consumers use and understanding of the terms and conditions of the loans they had taken out.

5.3.1 Information about the cost of credit

Previous research on home credit, pawnbroking and payday lending indicated that consumers were generally aware of the total cost of borrowing in money terms, even if they could not give the APR (see, for example Collard and Hayes, 2010).

In the Consumer Survey for this research, the majority of customers had considered some form of cost information at the time they took out their most recent loan. Only a minority had not considered any cost information. The proportion was considerably higher among pawnbroking customers (24 per cent) than it was for other customers (Table 5.3).[7]

Table 5.3: Cost information considered by consumers when they took out a short-term loan

Percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
The regular repayment amount	86	n/a	n/a	n/a
The total amount you had to repay, including the original amount borrowed plus interest*	65	69	80	89
The total amount of interest that would be charged*	56	57	67	75
The APR	49	43	46	49
Other fees or charges, such as early resettlement or penalty charges*	41	44	42	52
None of these*	10	24	13	7
Don't Know	<1	1	<1	-
Base	*369*	*256*	*366*	*372*

Source: Consumer Survey. Base is all respondents, excluding respondents from the pilot. * Indicates that the variation across the groups for this measure is statistically significant (p<.05). n/a Indicates that the item is not applicable to this sector. Values sum to more than 100 as more than one response was allowed.

The type of information that customers used depended on the credit product. Among home credit customers, most had considered the amount of money they would have to repay every week or month. Payday lending customers (and to a lesser extent pawnbroking customers) considered the total amount they would have to repay. Across the four types of credit, between four in ten and five in ten customers considered the APR. The same was true of other fees or charges (Table 5.3). Most respondents had used more than one type of information. On average, pawnbroking customers had used 2.1 of pieces of information, rising to 2.4 among retail payday customers and 2.6 among online payday loan customers. Home credit customers had considered 3.0 pieces of information.

[7] Unlike other forms of short-term credit, if pawnbroking customers have entered into a pawn agreement with the lender during the preceding three years, the lender does not have to provide a pre-contractual information form unless the borrower requests it. Cost information would, however, also be included in the pawn agreement.

The *most* important cost information (or the only information used) was the amount in pounds and pence that customers would have to pay. For home credit customers, this was the regular repayment amount (rather than the total amount they would repay). For customers who borrowed very short-term from a pawnbroker or a payday lender, it was the total amount they would have to repay when the loan became due. The APR or other fees and charges were most important only for a minority of customers in the survey (Appendix Table 11).

The customers and debt advice clients who took part in the Depth Interviews were asked in more detail about the information they received at the time they took out their loan. These interviews confirmed that, across the loan types, users were most interested in repayment amounts, payment frequency, the total cost of credit and default charges. For the home credit customers the most important piece of information was the cost of weekly repayments (i.e. whether users could afford them). Across the interviewees, the APRs associated with their loans were not easily understood and most had not engaged with them beyond noticing that rates looked 'high' or 'reasonable'.

5.3.2 Terms and conditions

In the Depth Interviews, customers and debt advice clients across the loan types recalled receiving a credit agreement and 'terms and conditions' (T&Cs) for the loan or loans they had taken out.

Most of the home credit customers said they did not read the T&Cs, but that they had a general awareness of the basic terms, particularly in relation to repayments and costs. Reflecting that many home credit customers are repeat users, one said she did not bother reading the T&Cs as she had never had any problems previously, while another had received a call from the lender to confirm that the agent had both provided the agreement and explained it adequately.

Retail payday lending and pawnbroking customers were provided with the T&Cs in the store at the point of taking out the loan. In some cases the terms of the loan were also read out and explained to customers. Not all customers paid close attention, however. One payday loan customer said that most of the information 'went over his head', while another did not pay much attention to the terms because she was desperate to get the loan. Both said they were broadly aware of the terms. None of the pawnbroking customers had read the T&Cs in full.

The experience of online payday lending customers was more variable. One customer was very clear about the key terms of his credit agreement. He had received a 'verbal walkthrough' of the 'most salient points in terms of legal obligation and repayment term' and he had kept a hard copy of the terms to refer to. Another customer said he couldn't be bothered to read the T&Cs because they were too long, although he was content that he had been provided with the information that was of most importance to him. One customer expressed concern about the ease of accepting loan agreements within smartphone apps. In her case the T&Cs had been provided in a small font at the end of the application process, with a check box to agree the terms placed above them at the top of the page. Only one person had paid no attention at all to the terms, not even the total cost of credit because she 'just needed the money'.

Across the loan types, it was generally acknowledged that, when it comes to contractual terms and conditions, 'no one reads the small print'. Despite this most said that they were aware of the important terms and the key features of the product. Only a small minority had not engaged with the terms of their loan at all. This seems to be because they felt their financial situation was so dire that they were willing to take out a loan no matter what the cost.

6 The cost of short-term credit

Summary

The Business Survey showed that the costs of credit paid by consumers varied markedly between the four sectors (home credit, pawnbroking, retail payday and online payday lending). Within the four sectors, smaller lenders generally charged lower prices than their larger counterparts.

Online lending (payday loans but also instalment loans) were by far the most costly form of borrowing in terms of interest charges. Online payday lenders were also more likely than other lenders to apply additional charges (e.g. optional faster payment charges).

In retail payday lending, the main distinction was between cheque-based loans which were cheaper, and debit card loans which were more expensive. Some charged additional fees for retail payday loans, others did not.

There was evidence of similar price levels among home credit lenders and also among pawnbrokers. It was very uncommon for either of these lenders to levy additional fees or charges.

In the Consumer Survey, customers recognised that short-term loans were an expensive way of borrowing, and that there were cheaper forms of credit. These views were less commonly held by pawnbroking customers.

6.1 Home credit

The wide variety of loan terms makes it very difficult to compare the costs of loans from different home credit companies, other than by using the APR (which is standardised by European legislation) – a measure that the industry and others believe is a poor indicator of their cost.

Generally speaking, loans from the medium-sized companies in the Business Survey tended to be the most expensive and the lowest rates were offered by some of the small companies. The prices charged by the large companies tended to be very similar; there was much wider variation among the medium and small firms, with some small firms charging much less than the large companies and some medium-sized ones charging a lot more.

- Short-term home credit loans of 14-16 weeks, which were mainly offered by small and medium-sized companies, had APRs ranging from 210% to 1834.5% but were typically about 1000%. For example, the cost of borrowing £100 for 16 weeks from one lender was £44 (APR 963.9%).
- Loans between 23 and 26 weeks had a very wide variation of costs, although medium-sized companies generally had the highest charges. At the extremes, it would cost £30 to borrow £100 for 26 weeks from one small lender (APR 187%) but £57.50 to borrow the same amount for only 21 weeks from a medium-sized lender (APR 916%).
- Loans of 30 to 35 weeks were most common among the large firms and APRs were in the region of 400%. For example, a £100 loan repaid over 33 weeks from one large company would cost £65 (APR 433.5%).

- Loans between 40 and 48 weeks were most common among the small and medium-sized firms and costs ranged from £44 per £100 for a 48 week loan from one small company (APR 128.2%) to £88 per £100 for a 47 week loan from a medium-sized company (APR 366%).
- Longer-term loans were only offered by large companies. A loan of 50 to 52 weeks had a typical APR between 250% and 270%.[8]

There were no additional charges associated with taking out a loan from home credit providers. Where firms offered shopping vouchers or stored value cards on credit, the APRs were invariably lower than those for a loan of comparable length – and were as little as half the cost.

6.2 Pawnbroking

Of the four types of credit covered in this research, the charges for pawnbroking were the most standardised, and were generally expressed as a percentage of the loan per month.

A 26 week loan of £100 would typically cost slightly less than 8% interest a month, with interest only charged for the period over which the money was actually owed. For example, one large company charged 7.85% a month, an APR of 118%. Again, lower charges could be found among the small companies. One small company accepted a much wider range of goods than most others, and its charges ranged from 3.5% a month (for gold) to 10.5% a month (for electrical goods); the average was 5% per month. Like home credit companies there were no other charges associated with pawnbroking.

Sale and buy-back tended to be more expensive than pawnbroking, for example 9% a month for three months or 15% for 28 days.[9] Such 'loans' were made against a much wider range of goods and were not typically for gold.

6.3 Retail payday lending

There was a very wide variation in the interest charges made for payday loans, which were typically expressed as a percentage per month. Charges made for lending against cheques (generally to established customers) were lower than those for lending against debit cards using a continuous payment authority to collect the sum due.

Where it was possible to compare like-with-like, smaller firms tended to have lower charges than larger ones. This was largely because small firms tended to lend against cheques, while the larger ones mainly lent against debit cards.

- Interest charges for cheque-based loans ranged from 12% to 15% per month for small firms; and 15-18% for large ones
- Interest charges for debit card loans ranged from 20% to 30% per month for large companies; the one small firm lending in this way charged 15%, plus a processing fee of 3%.

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[8] One home credit lender that was not included in the Business Survey has a typical APR of 104% for a loan of £500 repaid over 51 weeks.

[9] Sale and buy-back is not a credit agreement but the cost is included here for comparison. The customer sells goods to a retailer but retains the right to buy the goods back within a certain time period, typically 28 days.

6.4 Online payday lending

Online payday lending is generally more expensive than its retail equivalent in terms of the charges for borrowing. Four lenders in the Business Survey specialised in online payday lending. They either charged 1% a day for the length of the loan; or they charged a fee of between 25% and 36% for a 28 day and 30 day loan respectively. Two lenders made additional charges: one charged an optional £15 'faster payment fee' to guarantee that funds were transferred on same the day as the loan application; the other charged a flat £5.50 fee that most people incurred.

Of the two large retail payday lenders that also offered online payday loans, one charged 15% per month (the same as its retail payday loan); this lender had only recently moved into online payday lending and it represented a small proportion of its overall business. The other conducted a substantial amount of online payday lending, and charged 25-30% over 28 or 29 days.

6.5 Instalment loans

Six lenders in the Business Survey offered instalment loans, one online and the others either in-store or through a subsidiary company. The loan terms were 26 weeks or, more commonly, 52 weeks. One online instalment lender had terms of 16, 20 or 26 weeks, depending on the sum of money borrowed. The APRs on these loans varied widely. The online lender had a typical APR of 3,042%; it also had a £15 faster payment charge. Retail lenders' APRs were a good deal lower, ranging from 148% to 281%. The second highest APR – 449% – was charged by a company that generated its loans online but processed them offline.

6.6 How does the cost of short-term credit compare with mainstream credit?

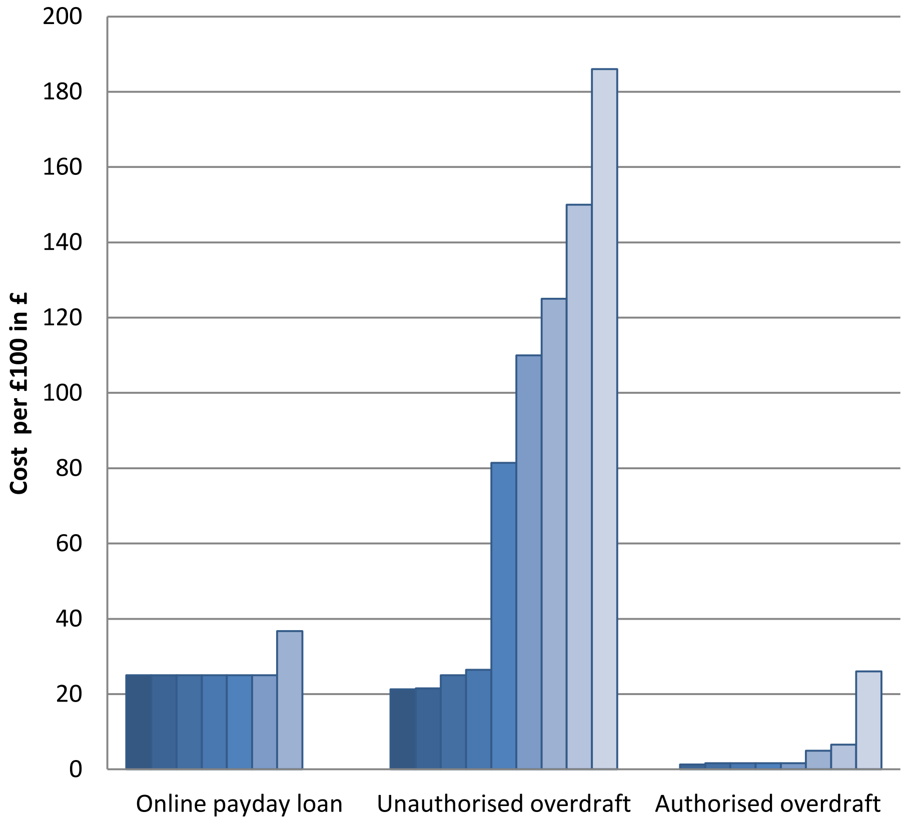
Public debate about the comparative costs of short-term credit and mainstream credit has focused predominantly on the costs of payday lending compared with unauthorised bank overdrafts.

The OFT compared the costs of an unauthorised overdraft from three banks with a payday loan costing £25 per £100 borrowed (OFT, 2010).[8] For consumers who used an unauthorised overdraft and made multiple withdrawals from their account on different days of the month, the OFT found that a payday loan would be cheaper. For consumers who did not make multiple withdrawals from their account, the unauthorised overdraft might be cheaper. The OFT highlighted the transparency and certainty of payday loan charges compared with unauthorised overdraft charges.

The consumer organisation Which? compared the costs of online payday loans and unauthorised bank overdrafts in 2011.[10] The cost of borrowing £100 for one month from an online payday lender ranged from £20 to well over £30. The equivalent cost for an unauthorised overdraft ranged from around £21 up to £150 or more in some cases. For authorised overdrafts, the cost was typically below £2, although in some cases it was upwards of £5 (Figure 6.1).

[10] www.which.co.uk/news/2011/09/payday-loans-and-bank-overdrafts-compared-266802 [accessed 19.07.12]. Payday loan and overdraft charges may have changed since this time.

Figure 6.1: Comparative costs of online payday loans and bank overdrafts



Based on Which? analysis of online payday loan and bank overdraft charges. www.which.co.uk/news/2011/09/payday-loans-and-bank-overdrafts-compared-266802

The cost of prolonged minimum credit card repayments has been modelled, based on behavioural scenarios for low-income borrowers. This modelling indicated that for an average low-income borrower making minimum repayments, the cost of credit was £44 per £100. This would increase if minimum repayments were made over a longer period or penalty charges were incurred. Under these scenarios, borrowing from a payday lender could be cheaper, provided the loan was not rolled over (Ellison and Whyley, forthcoming).

Based on the findings from the Business Survey for this research, pledging items with a pawnbroker or taking out a loan from some retail payday lenders could be less costly than using an unauthorised overdraft.

Because home credit loans are normally repaid over a longer period of time, unauthorised overdrafts seem an inappropriate comparator in terms of cost. It would be more appropriate to compare home credit with other types of personal loan. This is also problematic, however, as banks, building societies and finance houses lend much larger sums of money over longer time periods.

Another possible comparator for home credit is a credit union loan or a personal loan from a community finance lender. Both offer small value loans and would be significantly cheaper than a home credit loan, although neither offer loans on a home collected basis. Evaluation of the DWP Growth Fund (which was delivered by credit unions and community finance lenders) estimated total interest savings per Growth Fund borrower of between £377 and £425 over the lifetime of their current credit obligations (Collard et al, 2010).[11] Not everyone has access to a credit union or community finance lender, however. And some credit unions require members to save before they can borrow.

The feasibility of a home credit service delivered by credit unions or other community finance lenders has also been explored (Kempson et al., 2009). The study tested various models and found that to make the service financially sustainable, even on a not-for-profit basis, the cost of home credit would be high. For example, with a subsidy of £18 million, the APR on an average 56-week £288 loan would need to be 123% in order to break even in ten years and cover running costs in five years. Not-for-profit lenders expressed limited appetite for delivering such a service.

6.7 Consumer views about the cost of short-term credit

The great majority of customers in the Consumer Survey had not paid any up-front fees or charges when they took out their most recent short-term loan. The proportion that had paid up-front fees was rather higher among retail payday loan customers (12 per cent) than other credit users (Appendix Table 12).

Customers' general views about the cost of the short-term credit they used were gauged using three attitude statements:

- It [home credit/pawnbroking/payday lending] is an expensive way of borrowing
- I use this type of loan because they are cheaper than other types of borrowing
- The rate of interest I pay is fair.

The majority of customers in the Consumer Survey agreed that the short-term fixed rate credit they used '*is an expensive way of borrowing'*. This was a view shared by 81 per cent of home credit customers, 79 per cent of online payday loan customers and 71 per cent of retail payday loan customers. It was an opinion less commonly held by customers who had used a pawnbroker (63 per cent).

Similarly, customers generally had not used short-term credit because they thought it was a cheaper alternative to other types of borrowing. Only two in ten online payday loan customers (19 per cent) agreed that '*I use this type of loan because they are cheaper than other types of borrowing'*, as did just over a third of home credit (35 per cent) and retail payday lending (37 per cent) customers. A half of pawnbroking customers shared this view (50 per cent). Regression analysis showed that, all other things being equal, customers who did not have a bad credit history and those who did not have mainstream credit were more likely to agree with the statement (Appendix Table 13).

Customers in the Consumer Survey expressed mixed views about whether or not '*The rate of interest I pay is fair*'. Six in ten pawnbroking customers (62 per cent) agreed that the interest rate they paid was fair, as did 53 per cent of retail payday loan customers. Levels of agreement were somewhat lower among online payday loan customers (46 per cent) and home credit customers (43 per cent) (Appendix Table 12).

[11] The objective of the DWP Growth Fund was to raise levels of access to affordable credit by building the capacity of third sector lenders such as credit unions and community finance lenders to serve financially excluded households.

The high cost of borrowing was the negative aspect of short-term credit most often mentioned by customers and debt advice clients in the Depth Interviews. But because they generally had few alternatives to short-term credit to raise the money they required, cost was often not a major consideration when they took out a loan. They placed greater importance on being able to access the money quickly and straightforwardly.

7 Business practices: loan acquisition and risk management

Summary

Lead generators and brokers of online payday loans have been the focus of concern by some commentators. Several Business Survey respondents also expressed their concerns about some of the practices used.

Four per cent of online payday loan customers in the Consumer Survey said they had applied for their most recent loan through a broker or other intermediary. Other online borrowers may not have been aware of using a broker or intermediary, however. Most online payday loan customers said they had not paid any up-front fees for their loan.

While the risk assessment practices of home credit and pawnbroking lenders are well established, the practices among payday lenders are less developed and fraud was reported to be a significant issue for them.

Payday lenders in the Business Survey employed a range of methods to assess risk, some online lenders having invested heavily in these methods, and mentioned refusal rates ranging from a half to nine in ten loan applications. They offered widespread support for the development of real-time credit reference sources.

The majority of customers in the Consumer Survey said they had been asked by their lender to provide information that could be used to assess affordability, either when they took out their most recent loan or on a previous occasion. A minority had not been asked for such information and, all other things being equal, this was more common among home credit and especially online payday loan customers than retail payday loan customers.

Although there is growing wider evidence of consumers experiencing problems with the use of continuous payment authority to collect payday loan payments, only four respondents to the Consumer Survey said they were dissatisfied with the service they received from their lender because of repayment problems.

7.1 The use of credit brokers and lead generators by online payday lenders

The specialist online lenders in the Business Survey acquired new customers using a combination of pay-per-click advertising (recognised to be costly), buying leads and working with brokers. Other methods that were mentioned included radio and TV advertising, event sponsorship, word of mouth, and re-marketing to existing customers via text message and email.

Using pay-per-click advertising through internet search engines, such as Google AdWords, adverts can be shown alongside search results or on relevant web pages if the internet user searches using one of the keywords in the advert.[12] The lender pays each time a user clicks on their advert and is redirected to their website.

Online lenders may also acquire new customers through firms that specialise in lead generation. Online lead generation involves the generation of interest or enquiries from prospective borrowers via the internet. The 'lead' generally refers to the internet user's contact information and in some cases demographic information about them. There are two types of leads: marketing leads are brand-specific leads that are sold only once. In contrast, sales leads (which are used in online lending and other financial services) are resold to multiple advertisers. Sales leads are generated on the basis of demographic criteria such as income, age and credit rating.

Online lenders work with lead generators to generate new customer leads but also to drive traffic to their websites and increase their brand awareness. Individual lenders may work directly with one or more lead generators. Alternatively, lead generators may develop a 'ping tree', which is a panel of online lenders that are ranked in order of how much commission they pay for each lead. The 'first look lead' pays the highest commission and the 'last look lead' pays the lowest commission in the ping tree. The lead generator works with a network of 'affiliates' (e.g. online loan brokers, email and SMS marketers) that run marketing campaigns to increase the volume of leads.

The lead (i.e. prospective borrower) submits one loan application via an affiliate's website. Their details are passed across the 'tree' of lenders until one of the lenders accepts (or else presumably the application is rejected). The most common ways in which lenders pay for these services seem to be pay per lead (e.g. for each application that is submitted) or pay per sale (i.e. when a loan is made).

Lead generation firms that use ping trees include pingtree.co.uk (which lists the biggest online lenders among its panel of lenders), thelendinghub.co.uk and quiddi.com. One website (whichwaytopay.com) lists 14 brokers for payday and instalment loans; it seems likely that these firms are part of networks of affiliates.

A number of lenders in the Business Survey expressed concerns about the practices of lead generators and brokers, which they had either heard about or experienced. These included instances of borrowers acquired through lead generators who ended up with multiple payday loans or on a debt management plan; the fees charged by some lead generators and brokers; and consumers who were charged fees by loan brokers despite the fact that they had little or no chance of being accepted for a loan (e.g. because they were dependent on welfare benefits).

In 2010, the OFT reported that the websites of some lead generators were not transparent, so that consumers might believe they were dealing directly with a lender. It noted that credit intermediaries are required to disclose the extent to which they act independently and in particular whether they work exclusively with a lender (OFT, 2010).

In March 2011, Citizens Advice submitted a super-complaint to the OFT related to the marketing and charging practices of credit brokerage firms and other ancillary credit businesses. The complaint focused on up-front fees and cold calling by firms.

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[12] The general information on online advertising in this section is mostly sourced from Wikipedia plus information from 'ping tree' websites.

In November 2011, the OFT issued guidance for brokers, intermediaries and consumer credit and hire businesses. The main focus of the guidance was improved standards of conduct related to transparency of status, the payment of fees, the consumers' right to refunds and the disclosure of commission.[13]

In the Consumer Survey for this research, only four per cent of online payday loan customers said they had applied for their most recent loan through a credit broker or other intermediary. The majority of customers (96 per cent) said they had applied directly to the online payday lender they borrowed from (although, as noted in the 2010 OFT report, others may not have been aware that they had used an intermediary). And most said they had not paid any up-front fees at the time they took out the loan. In the Depth Interviews, online payday loan users said they had applied directly to the lender they used, after hearing about the lender from a friend or through an advert.

7.2 Risk assessment

Credit risk assessment refers to a set of processes that help lenders decide who to lend to, how much they should lend, and whether they should lend to the same customer again in the future given their past payment history. The following sections describe the different ways in which lenders in the Business Survey said they assessed and managed risk. Risk assessment and management practices for home credit and pawnbroking are well established. In contrast, the tools for risk assessment are much less developed for payday lending and fraudulent applications were reported to be a significant threat to lenders in this sector – especially those operating online.

A major element of credit risk assessment is whether or not the loan or advance is affordable for the consumer. The OFT's Irresponsible Lending Guidance aims to clarify the business practices that it considers may constitute irresponsible lending practices for the purposes of section 25(2B) of the Consumer Credit Act 1974. The Guidance sets out some of the ways lenders might assess affordability which includes records of previous dealings with the borrower; evidence of income; evidence of expenditure; a credit score; a credit report from a credit reference agency; and information obtained from the borrower (OFT 2010, updated 2011).

Poor practice in assessing affordability can result in consumers getting into (worse) financial difficulty because they are able to borrow from lenders even though they may not be able to repay what they owe. In 2012, the OFT reviewed the payday lending sector to investigate levels of compliance with the Consumer Credit Act and the extent to which businesses in the payday sector are meeting the standards set out in the OFT's irresponsible lending guidance.

> *Assessing affordability... is a 'borrower-focussed test' which involves a creditor assessing a borrower's ability to undertake a specific credit commitment, or specific additional credit commitment, in a sustainable manner, without the borrower incurring (further) financial difficulties and/or experiencing adverse consequences*. Source: OFT, Irresponsible Lending Guidance, page 36

[13] www.oft.gov.uk/OFTwork/credit/credit-brokers/ [accessed 19.07.12].

7.2.1 Home credit

Traditionally, lending in the home credit market has relied on the customer-agent relationship; collecting details of household income and expenditure; and the 'low and grow' strategy of low-value initial loans followed by larger successive loans for customers with a good repayment record. New customers are also recruited by word-of-mouth recommendation by existing customers. Home credit lenders manage the risk of default by setting affordable repayments, weekly collection in the customer's home and a willingness to use forbearance and reschedule loans without the imposition of default fees. This formula has stood the test of time and continues to be the main method of operation for small firms.

Medium and large home credit businesses have begun to supplement this tried and tested method. Since the Competition Commission requirement that they share data with the credit reference agencies, they have started to use basic credit reference checks, although these remain secondary to the traditional methods of risk assessment described above. Now that all larger home credit companies have to share information in this way, lenders in the Business Survey considered that credit reference data has become more predictive and, because it is relatively cheap to access, it offers an additional means of risk assessment.

Large firms have gone one step further and developed behavioural scoring systems to help agents manage existing customers, such as whether or not to grant a loan or to increase the customers' credit limit. Some have developed application scoring too, to assist the decision-making of agents in relation to new customers.

Larger firms have needed to supplement word-of-mouth recommendations to recruit new customers. This has led to a high rate of rejection of new applicants, so that typically three quarters or more are turned down.

7.2.2 Pawnbroking

Since a loan from a pawnbroker is secured against the value of the goods pledged, risk assessment is primarily about the value of the pledge. There are no application forms, no interviews and no credit checks. The standard pawnbroking agreement also contains a clause whereby the customer confirms that he or she has '*good and marketable title to the property or has the unqualified authority of the owner to pledge it*'. The *Pawnbroker's Guide* states that it is in the pawnbroker's interest to make reasonable enquiries to ensure that the customer has the right to pawn the property.

7.2.3 Retail payday lending

Retail payday lenders refuse a high proportion of loan applications. Lenders in the Business Survey mentioned refusal rates that ranged from 50 to 90 per cent.

Until cheque guarantee cards were phased out, they were used by retail payday lenders as a crucial risk assessment tool to support cheque-based lending. Customers were also required to provide proof of identity, proof of earnings (in the form of one or more pay slips) and one or more recent bank statements.

Lenders continue to require recent bank statements and pay slips. In the Business Survey, this ranged from one to three of each. Bank statements are scrutinised for recurring unpaid cheques or direct debits; overdraft charges; loans from other payday lenders; and remaining income at the end of the month. They are also used to corroborate income. Some lenders stipulate a minimum monthly income; others require customers to be in paid employment.

The withdrawal of the cheque guarantee card has seriously affected lenders' ability to manage risk. Although some long-established customers can still borrow against cheques with only bank statements to back them up, lenders have had to find other methods for new customers. Regardless of the size of their business, most payday lenders carry out checks with one of the credit reference agencies. In the Business Survey, opinion was divided on the relative merits of the traditional agencies (e.g. Experian, Equifax) and agencies that specialise in short-term lending (e.g. Teletrack, LendProtect). There was, however, a unanimous view that neither really meets their needs. This is because the data are not comprehensive, nor are they sufficiently up-to-date in an environment where lead generators and near-instantaneous loan decisions mean that borrowers can potentially take out several payday loans in a very short period of time.

> *The best single tool we've had in the last 10 years has been whether the customer is in the possession of a cheque guarantee card... possession of the card indicates from somebody who knows that customer's affairs better than any credit referencing agency, i.e. the bank, is the biggest single indicator as to whether that person is likely to repay.* (Trade association)

As a result, there was widespread support among payday lenders (retail and online) for the development of a real-time credit reference data source, coupled with a realisation that this was difficult to achieve. There was also a surprisingly high level of (volunteered) support for payday lenders to be required to share information. This was possibly because lenders realised that the industry itself was unlikely to instigate widespread data-sharing, or at least not quickly. There is a parallel here with the home credit industry, which resisted sharing data because of the cost and the fact that, at that time, the data were not very predictive. The requirement to share information means that the data has become more predictive and is therefore of more value to home credit lenders.

For repeat payday loan customers, lenders typically talked about reassessing risk every three months. A few checked for each loan application, and one checked every six months.

7.2.4 Online payday lending

If the demise of the cheque guarantee card and the advent of lead generators has made risk assessment more challenging for retail payday lenders, it is more difficult still for online lenders who cannot easily check bank statements or payslips either. Reflecting this, online lenders in the Business Survey said they routinely declined about nine in ten loan applications.

Risk assessment practices among online lenders varied depending on the size of the lender. The large specialist online payday lenders in the Business Survey had invested heavily in their own credit scoring systems. These systems used a combination of public credit reference data, information from mobile phone providers and behavioural data related to would-be borrowers (e.g. based on their use of the lender's website). One of the large retail lenders with a growing online payday loan book had likewise developed its own credit scoring system.

One small online payday lender used a new system (Lending Metric’s Dynamic Application Search) which provided up-to-date information on customers’ existing payday loans (at least those made by other lenders that subscribed to the system). Others (small online lenders and retail lenders with a small online payday loan book) relied on specialist credit reference agencies. This was supplemented in one case by a routine telephone call to the employer to verify the applicant’s identity and earnings. Another lender required loan applicants to speak to someone in their call centre to verify the information they had given in support of their application. They also required pay slips and bank statement to be emailed or faxed to them.

7.2.5 Assessing affordability: Consumer experiences

The Consumer Survey asked home credit and payday loan customers about the information they were asked to provide when they took out their most recent loan.

The majority of customers reported being asked for some information that could be used to assess the affordability of the loan they had applied for. A significant minority had not provided information for their most recent loan application, but said they had done so on a previous occasion (Table 7.1).

Table 7.1: Information provided by customers applying for short-term credit

Percentages	Home Credit	Retail Payday	Online Payday
Information about your income*	80	65	65
Pay slips or other proof of income*	43	52	6
Copies of bank statements*	24	68	3
Details of your outgoings*	62	23	19
Information on any other credit commitments you had at the time*	45	18	13
None of these, but asked on previous occasion*	12	20	20
None of these*	**5**	**2**	**11**
Don't know	1	1	2
Base	*369*	*366*	*372*

Source: Consumer Survey. Base is payday loan and home credit only. * Indicates that the variation across the groups for this measure is statistically significant (p<.05). Note: these are the percentages of each loan type answering that they have received that type of information.

There were marked variations between lenders in terms of the information that customers recalled being asked to provide. In particular, home credit customers were much more likely to report being asked for information about their income and details of their outgoings than either retail or online payday loan customers. Home credit customers were also more likely to be asked for information about their other credit commitments compared to payday loan customers. This reflects the fact that home credit lenders may be less likely than payday lenders to routinely carry out checks with a credit reference agency.

Only a very small proportion of online payday loan customers said they had been asked for proof of income or copies of their bank statements (although some customers may have provided these on a previous occasion).

A minority said they had not been asked to provide such information, either on the most recent occasion they took out a loan or on previous occasions. The proportion who reported that they had not been asked for any information was highest among the online payday loan customers (11 per cent) and was concentrated among customers of two lenders. It was lowest among the retail payday loan customers (two per cent). In regression analysis, loan type was the only predictor of not being asked to provide any information that could be used to assess affordability. Compared with retail payday customers, the odds of not being asked for the information were five times higher among home credit customers and some nine times higher among online payday loan customers (Appendix Table 14).

The Depth Interviews with customers and debt advice clients provide some further insight into the variation between lenders in the information that borrowers were asked to provide. Among home credit customers, long-standing customers of the same company remembered being asked for information about their income and outgoings when they first took out a loan but not subsequently. An occasional home credit customer of the same firm was not asked for any information about her income or outgoings on the one occasion she had taken out a loan. Another regular customer (of a different company) was required to provide proof of her income every time she took out a loan.

The retail payday loan customers who took part in the Depth Interviews had generally been asked to provide information to the lender about their income and outgoings. One customer had been able to borrow after providing some proof of identify and their bank details; they were not asked for bank statements or payslips.

Among the online payday loan customers in the Depth Interviews, one borrower had been asked to provide three months bank statements, two utility bills and three payslips when he first took out a loan. In contrast, three other borrowers (who all used the same lender) filled in an online application which asked for information including employer and bank account details. They were not required to provide any documents such as payslips or bank statements.

7.3 Continuous payment authority

With the decline of the cheque, a significant development in the business of retail payday lending is the use of continuous payment authority (CPA) to collect loan payments.

In the Business Survey, small firms that offered retail payday lending were still mainly lending against cheques, while the larger lenders mainly used CPAs. All the lenders in the Business Survey who transacted loans online collected payments by CPA.

Used properly, there is no reason why this payment method should cause problems for consumers, particularly since the Financial Services Authority confirmed that banks *do* have the ability to cancel them at the customer's request. Mystery shopping carried out by Consumer Focus in 2012, however, found that bank advisers often gave incorrect advice or could not give an answer at all when asked by consumers how to cancel a CPA.[14]

Until recently, the difficulties with CPA experienced by consumers mainly related to their use by organisations such as gyms and retail clubs (such as book clubs and wine clubs). There is growing

[14] www.consumerfocus.org.uk/news/consumer-focus-research-shows-continuous-payment-authority-confusion [accessed 21.07.12].

evidence that consumers experience problems with CPAs exercised by payday lenders as well, which can create or exacerbate financial difficulties. Examples include payday lenders that take larger sums of money than agreed from consumers' bank accounts or continue to exercise CPA after the consumer has been issued a default notice.[15]

The Financial Ombudsman Service (FOS) reported a nine-fold increase in complaints about payday lenders between 2009/10 and 2011/2012. Of the 296 complaints it received in 2011/12, most involved the way the lender exercised the CPA given to them by the consumer. Of all the complaints FOS received about payday lenders in 2011/12, 81 per cent were resolved in favour of the consumer (FOS, 2012).

When asked why they had been dissatisfied with the service they had received, a total of four customers in the Consumer Survey reported problems whereby the lender had either taken more money than they expected or on a different date. One customer had used a retail payday lender, while the other three had used an online lender. In the Depth Interviews, one CAB client reported that a retail payday lender had taken a larger sum than he had expected from his account. This appeared to happen after a repayment plan was put in place by the CAB.

[15] www.citizensadvice.org.uk/evidence_spring2012.pdf. www.cccs.co.uk/Portals/0/Documents/media/reports/additionalreports/CCCS_response_OFT_supp_continuous_authority.pdf [accessed 21.07.12].

8 Business practices: loan re-financing

Summary

While the OFT's responsible lending guidelines do not set a limit on the number of times a loan can be extended, new provisions developed in 2012 by four trade associations representing payday lenders are designed to tighten up re-financing practices. Some limit the number of times short-term loans can be extended.

The provision to rollover payday loans was a common business practice among the retail and online lenders in the Business Survey. Some lenders restricted the number of times that a customer could rollover a payday loan (either three or five times); others did not. The estimated proportion of customers renewing their loans ranged from less than 10 per cent (reported by a large online lender) to around 60-70 per cent (reported by a small office-based lender).Some payday lenders felt that re-financing practices across the industry could be improved. Others had reservations about limiting or even banning re-financing.

Pawnbroking customers may renew their loan for a further six months at the end of the loan agreement, usually upon payment of the interest and any other charges. The most common policy operated by the home credit lenders was that customers must have repaid at least half of their existing loan before they could refinance.

Customers in the Consumer Survey were drawn from some lenders that took part in the Business Survey as well as others lenders that did not take part in the Business Survey. A small minority of payday loan and pawnbroking customers in the Consumer Survey who had either repaid the loan or should have done so had extended the loan (14 per cent of pawnbroking and retail payday loan customers and 10 per cent of online payday loan customers). It was rare for payday loan customers to have done so three or more times (seven per cent of retail and three per cent of online payday loan customers who had not repaid their loan as they should have). The characteristics of the consumer and the loan type did not predict which customers had extended their loan. This may be because individual lenders' policies and practices are much more powerful factors.

For over one third of home credit customers, their most recent loan had either been used to extend a previous loan or to pay off at least a part of the previous one.

8.1 Extending payday loan agreements

If a customer is unable to repay a payday loan when it falls due, a lender may allow them to extend the loan for a further period of time (e.g. until the next payday). To extend the loan, the customer generally has to pay the interest and any other fees or charges that are owed. They do not repay any of the principal (i.e. the original amount borrowed). Concerns have been expressed by some commentators about the potential detriment to consumers who extend or roll over their payday loans. These concerns were shared by some (non-payday) lenders in the Business Survey.

8.1.1 Industry guidance and trade association codes of practice

In the OFT's irresponsible lending guidance, repeatedly refinancing short-term credit products in a way that is unsustainable or otherwise harmful to borrowers is given as an example of deceptive and/or unfair practices by lenders (paragraph 6.25). The guidance does not set out a limit on the number of loan extensions.

Four trade associations include payday lenders among their members: the BCCA, CFA, CCTA and the FLA. In 2012, these trade associations drew up a customer charter for payday and short-term lenders which comes into effect in November 2012. Alongside the charter is an addendum to existing trade association codes of practice which sets out new standards of consumer protection for consumers who take out payday or other short-term loans from members of these trade associations.

Among other things, the charter and addendum have specific provisions on extending loan terms. These include not pressuring customers to extend their loans; carrying out a sound, proper and appropriate affordability check before extending the loan; explaining any additional costs of extending the loan and requiring customers to repay any fees, charges or interest before the loan is extended. The addendum does not specify an upper limit on loan rollovers, but lenders have to tell customers if there is a limit.[16]

Once implemented, the charter and addendum will sit within or alongside trade associations' existing codes of practice. The FLA Lending Code 2012 has specific commitments for short-term loans that already include a limit of three loan extensions; not encouraging loan extensions; conducting credit assessments before loans are extended; and clearly explaining the costs of loan extensions (section 2E.11).

The CFA lending code was updated in July 2012 to reflect the customer charter and addendum. Its new provisions on extending a loan also include putting a limit of three on the number of occasions a loan can be extended.

The current CCTA code of practice has specific provisions for credit cards, store cards and mortgages, but not short-term loans. It has provisions for dealing with customers who experience financial difficulties, but not specifically for loan extensions. The BCCA consumer code of practice does not currently cover loan extensions or customers in financial difficulty.

8.1.2 Lenders' policy and practice

Fourteen lenders in the Business Survey offered payday loans. Four of these lenders (two large and two small) only operated online. The other ten were mostly retail lenders that offered payday loans through stores; two also offered payday loans online as well as in-stores.

Only two of these 14 payday lenders did not allow customers to rollover or extend their loans. One, a small online lender, offered payday loans over a period of one to four months, which meant that customers could spread the cost of repayment without extending the loan. The other, a large retail lender, generally tried to arrange a payment plan for customers to pay off what they owed if they were unable to repay the loan on time.

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[16] The customer charter and addendum are available from www.cfa-uk.co.uk/codeofpractice.asp [accessed 27.07.12] and other trade association websites.

Among the 12 lenders that did allow rollover loans, the approximate proportion of customers rolling over loans varied from less than 10 per cent (for a large online lender) to 60-70 per cent (for a small office-based lender). Four of the lenders we interviewed estimated that at least 40 per cent of their customers extended their loans; notably these were all small lenders.

Most of the lenders that allowed rollover loans estimated the average number of rollovers to be three or fewer. One large retail-based lender estimated the average number of rollovers to be more than five; the proportion of their customers that rolled over was relatively low, however, at around 10 per cent. They acknowledged that this pattern of loan rollovers was at odds with the payday loan industry as a whole; they were unable to explain why this was the case.

Among the lenders that allowed loan rollovers, six (five large and one small lender) exercised a maximum limit on the number of times a customer could extend their loan. The limit ranged from three to five rollovers. Once the limit had been reached, the lender started a discussion with the customer about repaying the loan principal (i.e. the amount borrowed).

The other six lenders (four small and two large) did not place a limit on the number of times a customer could extend their loan. Instead, where customers had extended their loan several times and on a case-by-case basis, the lender opened a discussion about repaying the loan principal. At the time of the research, one lender was changing its procedures for rollover loans, to ensure that customers were clear about the additional cost of extending a loan at the time they took out the loan and if they requested an extension.

The options that lenders discussed with customers who had extended their loans several times included setting up a payment plan to pay back what was owed without further interest being incurred; switching to an instalment loan product that provided a cheaper way of repaying the loan over a longer period of time; or, in the case of one lender that also retailed used goods, offering to buy goods from the customer to pay off the loan in part or in full. The same lender would, in certain circumstances, reduce the principal amount, freeze the interest and set up a repayment plan.

At the time of the Business Survey in early 2012, payday lenders had mixed views about whether or not rollover loans should be limited or even banned. A few thought that industry practices could be improved, for example to ensure that customers were not encouraged to rollover loans or were not faced with high charges if they did. Several mentioned the work of their trade associations in this respect. Others considered that rollover loans served a useful purpose for some customers. Moreover, if rollover loans were limited or banned, should the same not apply to minimum credit card repayments?

8.2 Refinancing home credit loans and renewing pawn agreements

The practice of using a second home credit loan to pay off an existing loan is known as refinancing or re-serving customers. Among the home credit lenders that took part in the Business Survey, most estimated that the majority of their customers refinanced. The proportion ranged from an estimated 15-20 per cent of customers (for a large lender) up to 90-95 per cent of customers for other lenders.

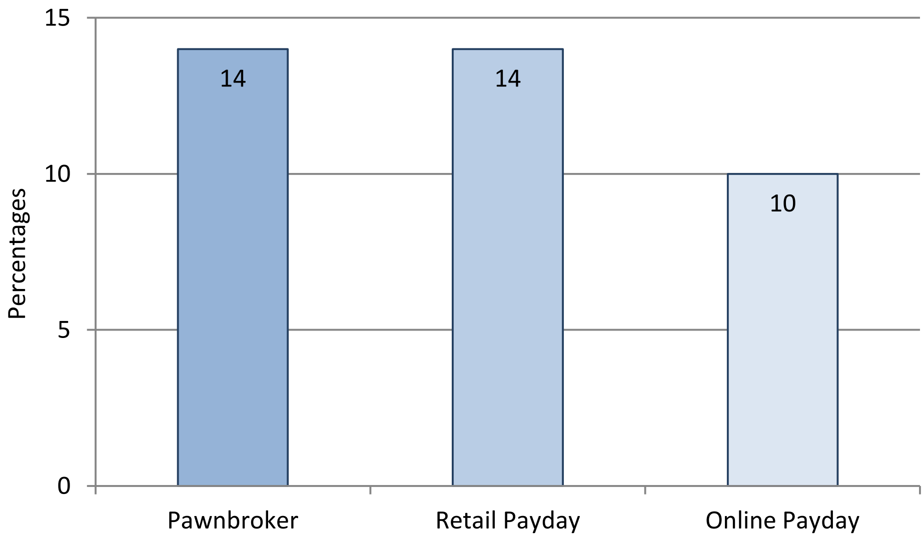
The CCA code of practice does not set out any guidance in relation to refinancing. The most common policy operated by lenders in the Business Survey was that customers must have repaid at least half of their existing loan before they could refinance. In some cases, this proportion was higher (two-thirds or three-quarters). A few lenders stipulated that customers had to receive at least half of the new loan 'in their hand'. Where a second loan is used to repay an existing loan before the end of the original loan term, customers receive an early settlement rebate.

The standard repayment period for a loan from a pawnbroker is six months. The contract can be renewed for a further six months. This may involve closing the original agreement and issuing a new one, or providing a modifying agreement. The Pawnbroker's Guide (published by the NPA) strongly recommends that customers pay the accrued interest prior to renewal.

8.3 Rolling over loans, renewing and refinancing: Consumer experiences

Customers in the Consumer Survey were drawn from some lenders that took part in the Business Survey as well as other lenders that did not take part in the Business Survey. The Consumer Survey was designed to include some customers who had repaid their loans and others who had not. Around one in ten (nine per cent) of all retail and online payday loan customers in the survey had renewed their payday loan. Some had subsequently gone on to repay the loan in full; others had not yet done so. If we exclude payday loan customers whose loan was not yet due at the time of the survey interview, 10 per cent of online and 14 per cent of retail payday loan customers who had either repaid their loan or should have done so had extended their loan (Figure 8.1; Appendix Table 15).

Figure 8.1: Customers who had extended or renewed their loan, based on customers who should have repaid their loan



Source: Consumer Survey. Base is Pawnbroker and Payday loan customer respondents whose loans had been repaid or should have been repaid by the time of the interview. Significance testing could not be undertaken. *Base: Pawnbroker: 129; Retail Payday, 250; Online Payday, 333.*

As described above, there have been concerns expressed about the number of times customers are able to extend their loans. Some lenders in the Business Survey limited the number of times a customer could extend a loan, others did not. Among the retail payday loan customers, seven per cent of those who had or should have repaid their loan had extended their loan three or more times (equal to four per cent of all retail payday loan customers). This was the case for three per cent of online payday loan customers who had or should have repaid their loan (equal to two per cent of all online payday loan customers) (Appendix Table 16).

The picture with regard to loan extensions was broadly similar for pawnbroking customers as it was for payday loan customers. Seven per cent of all pawnbroking customers in the Consumer Survey had renewed their pledge. If we exclude customers whose loan was not yet due at the time of the survey interview, the figure was 14 per cent. Most customers who had renewed their pledge had done so only once (Appendix Table 17).

Regression analysis to predict whether customers had extended a payday loan or renewed a pawnbroking pledge showed that social-demographic and other characteristics, including loan type, did not have any statistically significant explanatory power (Appendix Table 18). One possible reason is that external factors, such as a lender's policy on extending loans, are a much stronger predictor than customer characteristics.

As the Business Survey showed, refinancing loans is a common practice in the home credit industry. In the Consumer Survey, six in ten home credit customers (57 per cent) already had a loan with the same lender at the time they took out their most recent home credit loan. Most of these customers used the new loan to pay off their existing loan. They may have been entitled to an early settlement rebate as a result. The rest mainly continued to repay their existing loan alongside repaying the new loan (Appendix Table 19)

9 Business practices: managing arrears

Summary

A third of home credit customers in the Consumer Survey had missed at least one payment (so far) on their loan. Only a fraction overall (one per cent) had been charged any extra fees, such as a penalty charge or a charge for a default letter. Provided they made up their missed payment, home credit customers were not considered to be in default by lenders in the Business Survey. Most lenders said they did not charge default fees. The built-in flexibility of these loans is one of their main attractions.

Among pawnbroking customers whose loans had already fallen due, a significant number (38 per cent) had not repaid their loan as they should have; 12 per cent had forfeited the items pledged. The pawnbrokers in the Business Survey generally did not make penalty charges. Nonetheless a small number of the pawnbroking customers had incurred extra fees of some kind (six per cent).

Among payday loan customers whose loans had already fallen due, a quarter of retail payday loan customers (26 per cent) had not repaid their loan as they should have, reducing to one in ten among the online customers (13 per cent). Online payday lenders use continuous payment authority to collect the payment.

Penalty charging for missed payments was a common business practice among the payday lenders in the Business Survey. The structure of these charges varied from a single flat rate fee to a combination of a default fee plus default interest. Overall, one in ten retail customers and six per cent of online customers in the Consumer Survey had incurred extra fees relating to their most recent loan.

How lenders managed arrears varied by type of lender. A few used external debt collection agencies or talked about using court action. Some described implementing forbearance measures, such as repayment plans and partial write-offs.

More commonly, lenders in the Business Survey managed arrears by making multiple attempts to contact the borrower through a variety of channels, including by telephone, emails, texts and letters, and, for one retail lender, doorstep collections.

9.1 What proportion of consumers repay to the contractual loan term?

There is considerable variation in the proportion of consumers that repay their loans according to the loan agreement, depending on the type of lender they use. Taking into account the fact that customers were at different stages of loan repayment, the Consumer Survey nonetheless indicated that relatively small proportions of borrowers across all four types of credit had experienced serious repayment problems (at least so far).

9.1.1 Home credit

In the Business Survey, home credit lenders estimated that most customers missed at least one weekly repayment over the course of their loan agreement. Provided they made up the payment, customers were not considered to be in default. This flexibility is one of the main attractions of home credit for low-income borrowers. It also means that customers typically repay their loans over a longer period than set out in their loan agreement. A similar pattern of repayment was reported by lenders offering other types of instalment loan.

Most home credit customers in the Consumer Survey were still in the process of repaying their most recent loan at the time of the survey interview. Only a minority (five per cent) had repaid their loan in full. Across home credit customers as a whole in the survey, 63 per cent had not (yet) missed a loan repayment. Some 34 per cent had missed one or more, including 10 per cent who had missed three or four, and nine per cent who had missed five or more repayments.

The majority of home credit customers who had missed loan repayments had arranged with the lender to repay what they owed and were doing so (equal to 25 per cent of all home credit customers in the survey). Most of the rest were still in arrears with their loan repayments (equal to seven per cent of all home credit customers). These customers tended to be either repaying their arrears or else said they could not afford to.

Regression analysis showed that home credit customers who had a poor recent credit history were more likely to have missed payments, all other things being equal, than those who did not. Customers with no mainstream credit also had higher odds of missing payments than those who had access to mainstream credit (Appendix Table 20).

9.1.2 Pawnbroking

Among the pawnbroking customers in the Consumer Survey, 30 per cent had repaid their loan and redeemed their valuables in accordance with the loan agreement. A further 46 per cent had not yet repaid or renewed their loan because it was not yet due.

Two in ten of all pawnbroking customers (19 per cent) had not repaid their loan in full when it became due. These include seven per cent overall who had renewed their pledge. Some of these had subsequently gone on to repay their loan in full and redeemed their valuables; others had not yet done so (Table 9.1). Six per cent of all pawnbroking customers in the Consumer Survey had lost the items they pledged because they did not repay their loan or renew the loan agreement.

Table 9.1: Loan status for all customers in the Consumer Survey*

Column percentages	Pawnbroker	Retail Payday	Online Payday
Repaid loan in full when it was due	30	47	72
Repaid loan in full after loan extended/renewed	3	4	8
Repaid loan in full after making arrangement with lender/some other action taken (inc no other action)	3	1	2
Loan not repaid because not yet due	46	34	15
Loan not repaid but should have been, renewed/extended	4	5	1
Loan not repaid but should have been, arrangement made with lender/some other action taken (inc no other action)	9	6	1
Not stated	6	2	1
Base	*264*	*393*	*395*

Source: Consumer Survey. Base is pawnbroking and payday loan customers only. * Indicates that the variation across the groups for this measure is statistically significant (p<.05).

When considering only those pawnbroking customers whose loans had already fallen due by the time of the survey, six in ten (62 per cent) had repaid to term. The other 38 per cent had not repaid their loan as they should. Of these, 14 per cent had extended or renewed their loans[17]. A quarter (24 per cent) had taken some form of action (including no action) (Table 9.2); these included one in ten (12 per cent) who had lost the item they pledged.

Table 9.2: Loan status for customers whose loans had already fallen due*

Column percentages	Pawnbroker	Retail Payday	Online Payday
Repaid loan in full when it was due	62	74	86
Repaid loan in full after loan extended/renewed	6	7	9
Repaid loan in full after making arrangement with lender/some other action taken (inc no other action)	6	2	2
Loan not repaid but should have been, renewed/extended	9	7	1
Loan not repaid but should have been, arrangement made with lender/some other action taken (inc no other action)	18	10	1
Base	*127*	*249*	*332*

Source: Consumer Survey. Base is pawnbroking and payday loan customers only whose loans had fallen due for the first time. * Indicates that the variation across the groups for this measure is statistically significant (p<.05).

9.1.3 Payday lending

Among retail and online payday lenders in the Business Survey, the estimated levels of non-payment of loans ranged from less than 10 per cent for a small number of lenders, to between 10 and 20 per cent for most of the lenders we spoke to. A few lenders estimated that more than 20 per cent of their customers did not repay on time. These included two large retail lenders who reported these higher levels of non-payment for payday loans repaid by debit card, which they had only recently begun offering. As higher levels of non-payment were associated with new customers, they expected this to decrease over time.

Retail payday lending

Among retail payday loan customers in the Consumer Survey, half (47 per cent) had repaid their loan in full when it first came due, in line with the loan agreement. A further 34 per cent had not repaid or extended their most recent loan because it was not yet due. Two in ten retail payday loan customers (16 per cent) had not repaid their loan in accordance with the loan agreement. Of these, nine per cent had extended their loan. The remainder had generally come to an arrangement with the lender to repay what they owed (Table 9.1).

Looking only at the retail payday loan customers whose loan had already fallen due, three-quarters (74 per cent) had repaid when it first came due. A quarter (26 per cent) had not repaid their loan when it fell due. Of these, 14 per cent had extended or renewed the loan; 12 per cent had made some other arrangement or taken some other action (including no action) (Table 9.2).

[17] This differs from the figures in the table due to rounding.

Online payday lending

The majority of online payday loan customers (72 per cent) had repaid their loans to the contractual loan term. Another 15 per cent had not yet repaid or extended their loan because it was not yet due. One in ten online payday loan customers (12 per cent) had not repaid their loan as they should have. Nine per cent had extended their loan over a longer period. The rest had mostly come to an arrangement with the lender to pay what they owed (Table 9.1).

When looking at customer's loans that had already fallen due, online payday loan customers were more likely than customers of pawnbroking and retail payday loans to have repaid to schedule (86 per cent). Of the 13 per cent who had not repaid their loan when it fell due, 10 per cent had renewed their loan while the other three per cent had made some other arrangement or taken some other action.

9.2 How lenders manage arrears

The Business Survey indicated considerable variation in arrears management practices between home credit, retail and online lenders. The Consumer Credit Act 1974 and the OFT's debt collection guidance provide the legislative and regulatory framework for all parties engaged in the recovery of consumer credit debts. The following sections describe how lenders in the four different sectors managed arrears.

9.2.1 Home credit

The agent-customer relationship is an integral part of arrears management in the home credit industry, regardless of size of lender. Agents aim to collect *some* payment from the customer, even if it is not the full weekly amount or else try and come to a payment arrangement with the customer. Telephone calls or visits from managers to non-paying customers were also part of the arrears management process for two medium-sized home credit companies.

It was fairly common for medium and large home credit lenders to send letters to customers after a certain period of non-payment. The first letter was typically sent after two or three weeks of non-payment. Small lenders generally did not bother sending letters.

A few companies (two large and one medium) used external debt collection agencies. Only two companies (both large) reported using court action to recover debts. One lender described an increase in their use of court action; in their view, if they did not pursue debtors, there was a heightened risk of other borrowers defaulting.

> *I just go and bang on their door and just talk to them about it because what's the point of sending a letter... you just reason with people and see why they're missing payments.* (Small home credit lender)

Other arrears management practices mentioned by home credit lenders included the employment (by a medium-sized firm) of a Customer Support Manager to act as intermediary and provide early assistance to debtors; the use of internal debt recovery teams; and partial write-offs (i.e. the lender offered debtors a discount if they settled their debt within a certain time period).

9.2.2 Pawnbroking and retail payday lenders

A few lenders (two large and one small) either sent a text message or telephoned customers before their payday or instalment loan repayment was due, to remind them about it. If a customer missed a payment, lenders attempted to make contact straightaway by telephone, letter, or a combination of both. Where possible, lenders tried to set up a repayment plan; one lender talked about 'resting the debt' for six months if customers were unable to pay what they owed.

Four of the ten lenders (two large and two small) used external debt collection agencies if they were unable to collect the debt themselves; one of the large lenders acknowledged that this approach was not very effective. Three lenders (two large and one small) resorted to court action in certain situations, for example for loans above £500 or if the debtor was in work and there was the potential to recover the debt through an attachment of earnings.

> *... if we lose the principal amount it wipes out the profitability on five other customers, that's the logic of this, so we can't afford to make bad decisions.* (Large retail lender)

In addition to these common practices, one large lender used doorstep collection (to confirm that the debtor was at the address); another large lender sometimes tried to recover the principal only, rather than the principal and interest, in an effort to collect the debt.

If pawnbroking customers do not repay their loan on the due date, they can either extend the loan for a further period (see above) or forfeit their goods.

9.2.3 Online lenders

Online lenders use continuous payment authority to collect the amount owed. One small lender mentioned sending an email and text message before the payment was due. This alerted the borrower to the repayment date and also set out repayment options which included rolling over the loan.

Lenders generally described making multiple attempts (sometimes of different amounts) to collect the money owed on the due date. If they were unable to collect, the process was similar to the retail lenders: to attempt contact by text message, telephone, email and/or letter and to set up a repayment arrangement where possible. This activity tended to be particularly intensive in the day or few days after the payment had been missed. Only one small online lender used an external debt collection agency. Another small lender talked about using court action (attachment of earnings) as a last resort.

One large online payday lender had a range of forbearance measures in place, including pre-default repayment plans for those at risk of financial difficulty; data protection arrangements with debt management companies to facilitate processing of debt management plans where these were set up; and customer referrals to advice services.

9.3 Default charges

Like the interest that customers paid on loans, there was considerable variation between the four types of short-term credit in relation to default charges. Home credit lenders and pawnbrokers in the Business Survey generally did not make penalty charges for missed payments, whereas this was a fairly common business practice among payday lenders.

The traditional home credit business model is predicated on not charging penalties for missed payments. This is one of its main attractions for low-income borrowers. Home credit lenders in the Business Survey did not typically charge any default fees. Some had a one-off default fee of between £5 and £15 as a deterrent to late payment, but rarely imposed it in practice. Indeed, most saw default charges as undermining the model of home credit.

Only one of the nine home credit companies in the Business Survey, a medium-sized firm, imposed default charges which comprised £10 for a default letter and £30 for a bounced cheque.

If you start adding additional interest and bounced, missed payment charges it can spiral and you attract bad press for that. And also as the figure gets bigger the customer's more likely to say I can't afford to pay you back so you're not going to get anything back. (Retail lender)

The picture was broadly similar for the retail lenders that offered pawnbroking. One large company charged a £25 fee when goods were sold at auction (their normal practice for the sale of unredeemed pledges).

In contrast, default charges and default interest were relatively commonplace for retail payday lending, although both opinion and practice were divided. Two large retail payday lenders had default charges and also continued to charge interest once the payday loan account was in default. One levied a default fee of £25 and generally charged interest up to 90 days. The other had an £8 default charge and charged interest up to 60 days. In both cases, the default charge could be waived if the customer contacted the lender to arrange repayment.

The other lenders generally had default charges for payday loans but did not continue to add interest to a loan account once it was in default. The charges ranged from £8 (for a large company) up to £25-£30 (also large companies). Two (large) lenders waived the charge if the customer made contact and arranged a repayment plan. And two other lenders (one large, one small) said they did not usually apply charges.

All four of the specialist online payday lenders made some form of default charge. In two cases this was a single flat fee only (£12 and £12.50). The other two charged both a default fee and interest during the default period.

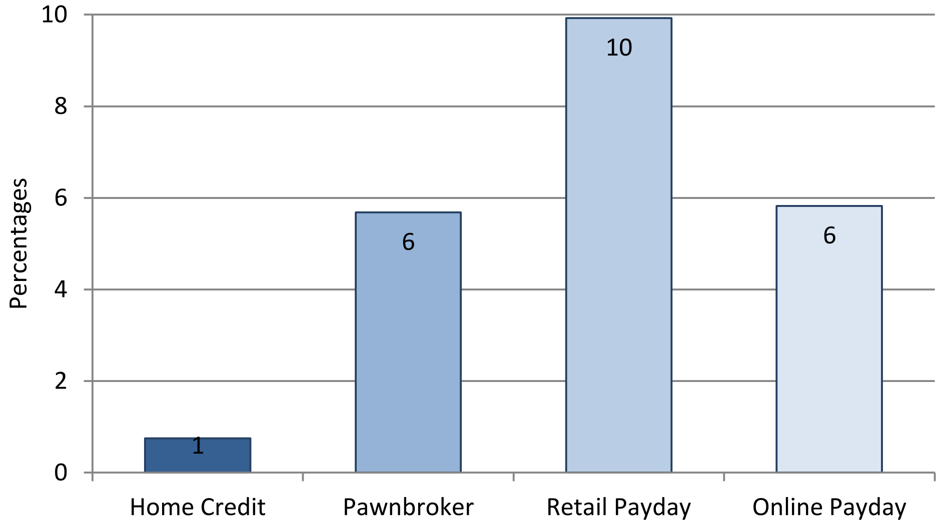
- One large company charged a default fee of £20, plus interest for the first 60 days of default, making the total maximum default charges £80 on a £100 loan.
- The other, a small company, made a number of different charges, including a £12 missed payment fee, £2.50 per letter for each of two letters (after seven and 14 days) and a £12 default notice. It also charged interest for up to 63 days. This meant that the maximum additional charge for a £100 loan in default was £193.

As with payday lending, there was a split in lenders' views and practices with regard to default fees for instalment loans. Three companies (two large retail lenders and one small retail lender) made no default charges. The other three lenders made a £12 charge for failure to pay on the due date.

In the Consumer Survey, customers had not generally been charged any extra fees such as penalty charges or charges for default letters. The proportion that *had* been charged extra fees was higher among the retail payday loan customers (10 per cent) than among customers who had used a pawnbroker (six per cent), an online payday lender (six per cent) or home credit (one per cent)

(Figure 9.1; Appendix Table 12). Section 11.1 goes on to describe whether the cost of short-term credit was more, less or about what customers had expected.

Figure 9.1: Whether lender had added any extra fees or charges other than the interest charged on the loan*



Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05). *Base: Home Credit, 399; Pawnbroker: 264; Retail Payday, 393; Online Payday, 395.*

Regression analysis showed that, even controlling for other factors, lender type was highly predictive of customers paying extra fees and charges. As a result, customers who had used a pawnbroker or a payday lender had far higher odds of incurring extra charges than home credit customers. The other highly predictive factor, not surprisingly, was whether or not customers had repaid their loan to term (Appendix Table 21).

10 The outcomes of short-term credit use

Summary

The Consumer Survey found high levels of satisfaction with the service received from lenders. For three of the loan types (home credit, pawnbroking and retail payday lending) this mainly reflected satisfaction with the customer service received; for online payday loan customers it reflected the convenience of borrowing and the speed of the loan decisions.

A minority were satisfied because of the cost of borrowing, ranging from six per cent of home credit customers up to 15 per cent of online payday loan customers. The Depth Interviews indicated that the ability to access this type of borrowing in the absence of other options was a source of satisfaction. Any dissatisfaction typically reflected the cost of borrowing or poor customer service. Upwards of seven in 10 customers said they would recommend the lender they had used to someone else. Most customers in the Consumer Survey would either borrow from the same type of lender again if they needed to borrow a similar amount, or borrow from friends or family.

Analysis of the 2006-08 Wealth and Assets Survey indicated a strong independent association between the use of short-term credit and multiple measures of financial difficulties. Reflecting this, there was evidence of financial stress on a number of measures in the Consumer Survey.

All other things being equal, pawnbroking customers in the Consumer Survey were more likely to fail to repay their loans to term than online payday loan customers. Lone parents and customers who had taken out larger loans also had increased odds of not repaying their loans to term.

A quarter of home credit customers had missed payments on credit commitments or household bills in the past 12 months. The figure was higher among other short-term credit users (46 per cent of pawnbroking customers; 45 per cent of retail payday loan and 41 per cent of online payday loan customers).

The Depth Interviews found that existing or pending financial difficulties (typically with household bills) had been the driver for using short-term loans. Use of the loans had not eased or averted these difficulties as intended in many cases and had instead compounded them. In a few cases, however, the loans had enabled people to get their finances back on track or averted more serious financial difficulties.

Almost half of home credit customers (45 per cent), two in ten retail payday loan customers (22 per cent) and 25 per cent of pawnbroking customers had two or more of these types of loan at the time of the survey interview. In relation to repeat borrowing, for retail payday loan customers the average (mean) number of loans in past 12 months was 5.1 loans. For pawnbroking customers it was 2.5 loans, and for home credit customers it was 2.3 loans.

About one in ten customers across the loan types reported borrowing to pay off borrowing. This was higher, all things being equal, among pawnbroking than home credit customers, and it was higher among those with a bad credit history.

10.1 How satisfied are customers of short-term credit with the service they received?

The Consumer Survey asked customers how satisfied they were overall with the service they had received from the short-term lender they had used. The majority of customers were very or fairly satisfied. Between five and ten per cent of customers were dissatisfied (Table 10.1).

Table 10.1: Levels of satisfaction with short-term lender*

Column percentage	Home Credit	Pawnbroker	Retail Payday	Online Payday
Very satisfied	67	53	51	55
Fairly satisfied	27	37	38	39
Satisfied	***94***	***90***	***89***	***94***
Fairly dissatisfied	3	3	5	3
Very dissatisfied	3	5	5	2
Dissatisfied	***6***	***8***	***10***	***5***
Don't know	1	2	1	1
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05)

Regression analysis to predict customers who were very satisfied with the lender they had used showed that loan type was not independently associated with this measure. Controlling for other factors, women and customers who did not have a recent adverse credit history had increased odds of saying they were very satisfied. Non-White customers, those whose financial situation had got worse in the last five years and customers who had not repaid their loan to term had reduced odds of feeling very satisfied (Appendix Table 22).

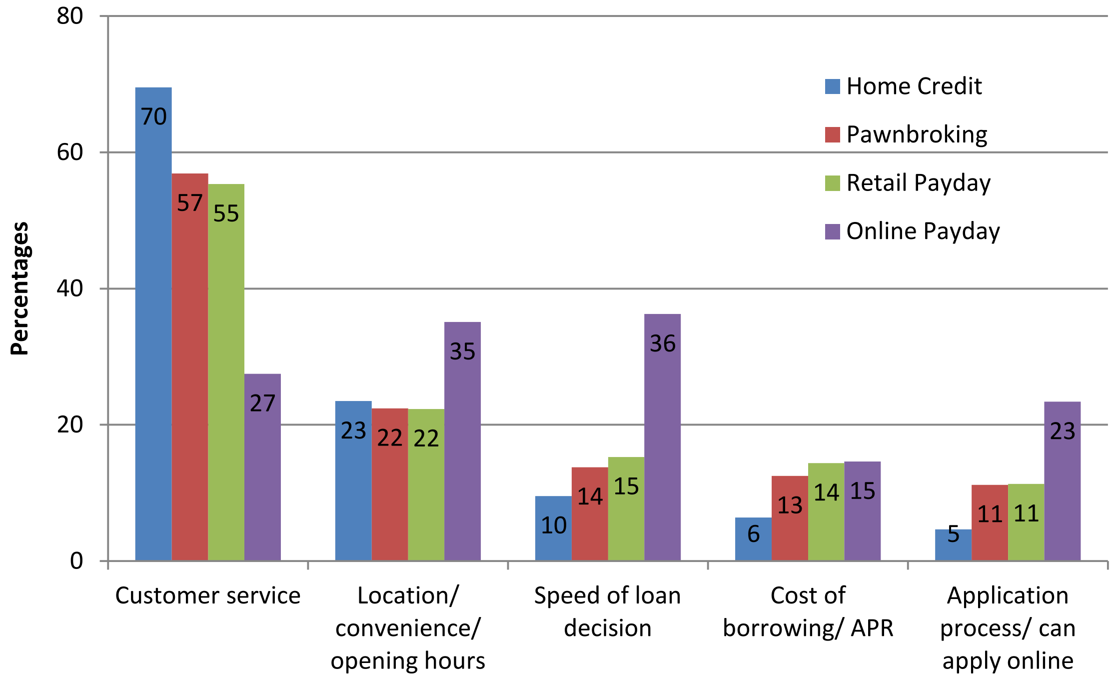
For customers who had used home credit, pawnbroking or retail payday lending, customer service was the primary reason for expressing satisfaction with a lender. Not surprisingly, it was a much less important factor for online payday lending customers. Convenience was the other main driver of customer satisfaction, especially for online payday lending customers. These customers also valued the speed of the loan decision more than other customers (Table 10.2).

Table 10.2: Reasons for expressing satisfaction with short-term lenders

Percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Customer service*	70	57	55	27
Location/convenience/opening hours*	23	22	22	35
Speed of loan decision *	10	14	15	36
Cost of borrowing/ APR *	6	13	14	15
Application process/ability to apply online*	5	11	11	23
Ability to renew/extend/rollover loan agreement	8	5	5	5
Did exactly as it said it would/expected/no hidden/extra charges*	1	4	3	11
Other	13	15	16	15
Don't Know	4	2	4	1
Base	*345*	*232*	*327*	*342*

Source: Consumer Survey. Base is all respondents who said they were very or fairly satisfied with the service. Percentages may sum to more than 100 as more than once response was allowed.* Indicates that the variation across the groups for this measure is statistically significant (p<.05).

Figure 10.1: Five most common reasons for expressing satisfaction with short-term lenders



Source: Consumer Survey. Base is all respondents who said they were very or fairly satisfied with the service. Percentages may sum to more than 100 as more than once response was allowed. *Base: Home Credit, 345; Pawnbroker: 232; Retail Payday, 327; Online Payday, 342.*

The findings from the Depth Interviews shed some additional light on the reasons why people had been satisfied. For some, regardless of loan type, it reflected simply that they had been able to secure the money they needed in the face of no or limited other options. A payday loan customer had been pleased with the loan limit imposed by the lender, which he felt was a manageable loan amount to take on, and home credit users perceived the lender as fair and reasonable. Online payday loan customers valued the speed of securing a loan, particularly if it helped them avoid incurring bank charges; the anonymity of applying online because it was less embarrassing if the application was rejected; and the lack of bureaucracy involved in obtaining the loan. And pawnbroking customers liked that they could get ‘cash in hand’ by pledging items they weren’t strongly attached to. Because they were satisfied with their experience, many in the Depth Interviews said they would consider using the same lender again.

Among the minority of customers in the Consumer Survey who were dissatisfied, poor customer service and the cost of borrowing were the main reasons they gave. These views were echoed in some of the Depth Interviews. People who had used home credit and online payday loans felt, in retrospect, that it might be ‘too convenient’ to borrow in this way. A few (all debt advice clients) had come to see online payday lending as potentially exploitative and too easy for other, ‘vulnerable’ people to obtain loans. This latter point contrasts with others who, as noted above, welcomed this lack of ‘bureaucracy’.

The Consumer Survey asked customers what options they might consider if they needed to borrow an amount of money similar to their most recent loan for a similar purpose. The two most common responses across all four types of credit were (1) to borrow from the same type of short-term lender again, ranging from 50 per cent of home credit customers to 69 per cent of online payday loan customers or (2) to borrow from a friend or relative (from 39 per cent of home credit customers to 76 per cent of online payday loan customers). Using an overdraft or credit card were other common choices (Appendix Table 23).

Between two in ten and four in ten customers said they would consider borrowing from a credit union or other community finance organisation. A very small number said they would consider using an illegal money lender. This ranged from one per cent of online payday loan customers, to two per cent of retail payday loan and home credit customers, up to five per cent of pawnbroking customers (Appendix Table 23). Many of the payday loan customers who took part in the Depth Interviews said that given the choice, they would prefer not to use the service again and would consider other alternatives such as selling items or applying for a Crisis Loan from the Social Fund before doing so.

The Consumer Survey also asked if customers would recommend the short-term lender they had used to someone else who needed to take out a loan. Upwards of seven in ten customers said they would (Table 10.3).

Table 10.3: Would customers recommend the short-term lender they had used to someone else who needed to take out a loan?*

Column percentage	Home Credit	Pawnbroker	Retail Payday	Online Payday
Yes	79	85	74	77
No	20	14	25	22
Don't know	1	1	<1	1
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measures is statistically significant (p<.05)

Despite some of them having experienced financial difficulty, a similar pattern emerged in the Depth Interviews. Most of the home credit and pawnbroking customers said they would recommend the lender to others. One person, a pawnbroking customer, had done so. Where others were wary of recommending short-term credit to other people, this reflected a concern that people might pledge items of sentimental value, and – among payday loan customers – because of problems that can arise if people are unable to repay.

10.2 The positive impacts of using short-term credit

The Depth Interviews with customers and debt advice clients explored the short and long-term impacts of using home credit, pawnbroking and payday lending.

The short-term positive impacts described in the Depth Interviews reflected closely the reasons why people had borrowed in the first place. Therefore, for some it related to an enhancement in their (or their family's) lifestyle, such as being able to attend an important social occasion. These were typically people who had used home credit or pawnbroking. For others, short-term credit enabled them to secure the essentials they needed for daily living, such as paying for rent, food, school shoes for children and making repairs to the home. This was particularly the case among people who had borrowed from a retail payday lender.

For a third group, the benefit of using short-term credit was more overtly financial in nature. This included avoiding bank charges or falling into arrears with bills (or other loan commitments), and in one case court proceedings for non-payment of bills. For some, it related more generally to helping ease ongoing financial strain. Although not exclusively so, it was very often people who had used payday loans (both retail and online) who had been impacted in this way, again reflecting the reasons why they had taken out their loans. This group included people recruited from the Consumer Survey (and who weren't in financial difficulty) and through the CAB (who had been in unmanageable debt situations). The sums they had borrowed were typically small (less than £200).

It was very unusual for people in the Depth Interviews to explicitly identify longer-term positive impacts of using short-term credit. The longer-term benefit of some of the larger items purchased, such as a laptop bought by a home credit customer for her grandchild, was implied. For another home credit customer, the short-term positive impact of buying a tumble dryer did not have longer-term benefit, since she would have saved up for it had she not been able to borrow the money. One pawnbroking customer had borrowed in order to improve his credit rating in the longer term.

For a customer who had taken out payday loans to pay his rent, the long-term positive benefit was that he avoided being evicted from his flat. Another home credit customer felt better-off in the longer term as a result of taking the loan because it helped her cope with a financial pinch-point. As a result, she was able to get her finances back on track instead of spiralling into potential difficulty.

10.3 Does use of short-term credit indicate consumer financial difficulties?

Analysis of the 2006-2008 Wealth and Assets Survey evidenced a strong link between financial difficulties, credit use generally, and short-term credit in particular.[18] Even after controlling for the influence of socio-economic and attitudinal predictors of financial difficulties (many of which were in themselves strongly related to these outcome measures), short-term credit use increased the odds of an individual being in arrears on any household commitment by a factor of 5.1 among those with one short-term credit commitment, rising to 5.7 among those with more than one.

Among individuals with any non-mortgage borrowing, analysis of the Wealth and Assets Survey indicated that short-term credit use also strongly predicted being in arrears on one or more credit commitment, with relative odds of 5.8 and 6.8 respectively. And short-term credit also increased the likelihood of finding borrowing a burden or a heavy burden and running out of money always or most of the time independently of other characteristics.

In the Consumer Survey for this research, significant proportions of customers showed signs of financial difficulty, based on two different measures: (1) whether customers had repaid their most recent short-term loan when it fell due; (2) whether customers had difficulties paying other credit commitments or household bills in the last 12 months.

10.3.1 Do customers pay their short-term loans when they fall due?

Failure to repay short-term loans when they first become due can indicate financial difficulty. Patterns of loan repayment vary by the four loan products, as do the implications of missed payment for customers.

As reported in section 9.1, around a third of home credit customers (34 per cent) in the Consumer Survey had missed at least one loan repayment on their most recent loan. Home credit loans are generally rescheduled to take account of occasional missed payments and customers do not incur any extra charges as a result.

It was also fairly common for pawnbroking and payday loan customers to fail to repay their loans when they first became due. As Table 9.2 illustrated, 13 per cent of online payday loan customers in the Consumer Survey who should have repaid their loans had not paid their loan to term, rising to 26 per cent of retail payday loan customers and 38 per cent of pawnbroking customers. Even controlling for other factors in regression analysis, online payday loan customers had lower odds of failing to repay their loan to term compared with pawnbroking customers. All other things being equal, lone parents and customers who had taken out larger loans had increased odds of not repaying their loans to term (Appendix Table 24).

[18] Short-term credit, as measured using the Wealth and Assets Survey, was dominated by home credit. The findings should be interpreted in this context.

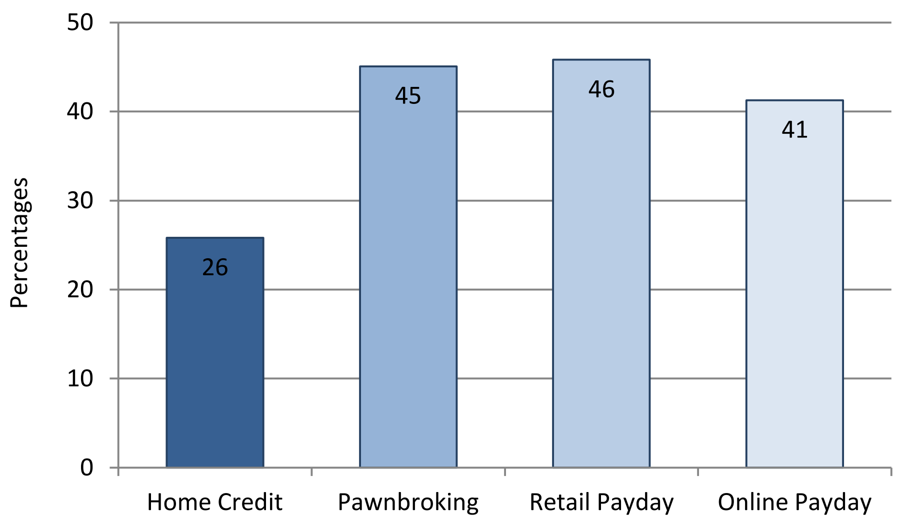
One possible option for customers in this position is to renew or extend the loan agreement, which generally involves paying the interest that is owed so far (see section 8). Payday loan customers may incur a penalty charge if they do not renew or extend the loan or arrange to repay what they owe in some other way. Pawnbroking customers might forfeit the valuables they have pledged.

10.3.2 Are customers keeping up with other credit commitments and household bills?

The proportion of customers in the Consumer Survey who had missed payments on their other credit commitments in the past 12 months ranged from 20 per cent of home credit customers, to 26 per cent of pawnbroking customers and 31 per cent in the case of both retail and online payday loan customers.[19]

Customers were also asked if they had been unable to pay household bills (such as rent or mortgage, utilities or TV licence) due to lack of money in the past 12 months. Two in ten home credit customers (19 per cent) said they had been unable to pay bills, as did 24 per cent of online payday loan customers. The proportion was higher among retail payday loan customers (35 per cent) and pawnbroking customers (39 per cent).

Figure 10.2: Were customers unable to pay household bills or did they miss consumer credit repayments in the past 12 months? *



Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05). *Base: Home Credit, 399; Pawnbroker: 264; Retail Payday, 393; Online Payday, 395.*

Figure 10.2 brings these two measures together, to show the number of customers who had either been unable to pay household bills or missed other credit repayments in the last 12 months. Almost half of pawnbroking and retail payday loan customers showed signs of financial stress according to this combined measure, as did four in ten online payday loan customers and a quarter of home credit customers.

[19] This measure comprised having missed a payment on a personal loan (other than the short-term credit they were sampled on), used an unauthorised overdraft or been unable to make the minimum payment on a credit card in the past 12 months.

Even controlling for other influences in regression analysis, customers who used a pawnbroker or any payday lender had double the odds of missing payments, compared with their home credit counterparts. Other factors that significantly increased customers' odds of missing payments were:

- A deterioration in their financial situation in the last five years
- Being unable to repay their most recent short-term loan when it first became due, and
- Being non-White.

Customers who had not experienced a recent adverse credit event had *reduced* odds of missing payments than those who had (Appendix Table 25).

10.4 Does short-term credit increase consumer indebtedness?

National debt charities report increasing numbers of clients who experience difficulties with payday loans. In the first three months of 2012, National Debtline received 4,725 calls for help in relation to payday loans, 133 per cent more than the same quarter in 2011.[20] Citizens Advice in England and Wales reported an increase of payday loan problem debts from 1.4% of all debt problems in 2009 to 8.9% in 2011.[21]

The Wealth and Assets Survey analysis and the Consumer Survey indicate a strong link between short-term credit and consumer indebtedness. However, the analysis does not tell us the direction of the relationship. It is possible not only that short-term credit use may lead to financial difficulty, but also that financial difficulty may lead to the use of short-term credit.

By virtue of how the Depth Interview participants were recruited (through a mixture of survey respondents and CAB debt advice services), several of the payday loan users (retail and online) were in some degree of financial difficulty when interviewed for this research. There were cases where payday loans had compounded existing debt problems, which mostly related more to arrears on household bills (such as rent, Council Tax and utility bills) rather than difficulties with mainstream or sub-prime credit. In all these cases, the original cause of people's financial difficulties was a major fall in household income. They had taken out payday loans in an effort to mitigate (unsuccessfully) the difficulties they found themselves in. Instead, their difficulties had either escalated or displaced from household bills to payday lending, in some instances through repeat use of payday loans.

There were other cases in the Depth Interviews where people had turned to payday loans, home credit or pawnbroking to avert financial difficulties. These difficulties related to household bills as well other types of credit. They included people who wanted to avoid bank charges for unauthorised overdraft use or bounced payments and those who were at the limit existing credit lines. Like the people described above who were already in difficulty, use of short-term fixed-term credit had not eased the situation for most of these but instead added to their troubles. Many had since got into serious difficulty, or, due to other changes (such as recent job loss), were facing imminent and seemingly intractable difficulties.

In contrast, there were a small number of examples in the Depth Interviews where short-term credit had helped people stabilise their financial situations and juggle their commitments or even alleviate

[20] Money Advice Trust press release, 25.05.12, 'MAT comments on the Government's payday loans announcement'.
[21] Citizens Advice press release, 13.03.12, 'Citizens Advice welcomes report on payday lending regulation'.

the difficulties they had experienced. This included a home credit customer (described above) who had used a home credit loan to pay off her Council Tax arrears and avoid court action.

The Consumer Survey and Depth Interviews conducted for this research provide insight into patterns of borrowing and lending that previous research has indicated may increase the risk of consumer indebtedness. The following sections explore three issues: (1) customers who feel it is too easy to borrow; (2) taking out repeat or multiple loans; and (3) borrowing to repay debts.

10.4.1 Do customers feel it is too easy to borrow?

In the Consumer Survey, there was general consensus among customers across the four types of credit that '*it is too easy for me to borrow this way'.* Around six in ten customers agreed with this statement (Table 10.4).

Table 10.4: Whether customers agreed or disagreed that '*It is too easy for me to borrow this way*'

Column percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Agree	61	56	63	60
Disagree	35	41	35	37
Don't know/does not apply	5	3	2	3
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. The apparent variation across the groups for this measure is not statistically significant (p>.05)

Regression analysis showed that customers' spending orientation was highly predictive of whether or not they agreed with this statement. Customers with a neutral or non-spending orientation had lower odds of agreeing that it was too easy to borrow compared with customers who were more orientated towards spending. Similarly, customers on a higher income were less likely to agree, all other things being equal, than those on low incomes. Customers who had taken out a short-term loan more than a year ago had increased odds of agreeing it was too easy to borrow, compared with those who had taken out a loan in the last month (Appendix Table 26).

In the Depth Interviews, very few people said they had been encouraged to borrow more or extend their loan by the lender. Several had been informed that they could borrow more, but did not feel they had actively been encouraged to do so. The exception was one customer who had used the same online payday lender on two occasions. He described how he had received a lot of emails from the lender asking '*do you need it this month*?' He had not taken up the offer of further loans.

10.4.2 Do customers take out repeat or multiple loans?

Previous research indicates that the total number of unsecured credit commitments a consumer has at any one time is a significant factor in over-indebtedness (Kempson, 2002). Other indicators of financial stress identified in research include taking out repeat or multiple home credit or payday loans over the course of a year and borrowing from different lenders at the same (Burton, 2010; Kempson et al, 2009).

In relation to having multiple short-term loans at the same time, in the Consumer Survey most customers either had one short-term loan or they had none at all (because they had already repaid their most recent loan). Significant minorities of customers had two or more short-term loans, however.

Among retail payday loan customers, the proportion with two or more loans at the time of the Consumer Survey was 22 per cent, and for pawnbroking customers 25 per cent. At the upper end, the figure was nearly half for home credit customers (45 per cent). Online payday customers were at the lower end, with 10 per cent having two or more loans from an online payday lender at the time of the Consumer Survey (Table 10.5).

Regression analysis showed that, all other things being equal, pawnbroking and payday loan customers had lower odds of having multiple loans at the same time compared with their home credit counterparts. Not having a recent bad credit history and taking out the most recent loan more than a month ago also reduced customers' odds of having multiple loans (Appendix Table 27).

In contrast, customers who were overdue repaying their most recent short-term loan had four times higher odds of multiple loans than those who had repaid their loan when it first fell due. Customers' financial situation was also a significant predictor of multiple borrowing (Appendix Table 27).

Where customers had more than one short-term loan at the same time, these loans were generally with the same lender. Even so, the number of customers with multiple loans from more than one lender was considerable: 39 per cent of home credit customers with more than one loan and the same proportion of pawnbroking customers, rising to half of retail payday loan customers (Table 10.5).[22]

In relation to repeat borrowing, the Consumer Survey asked customers how many short-term loans of that type they had taken out in total in the last 12 months. The average (mean) ranged from 2.3 loans for home credit customers, 2.5 for pawnbroking customers, 3.0 for online payday loan customers and 5.1 for retail payday loan customers (Table 10.5).The variation between customers partly reflects the different loan terms and loan amounts for home credit, pawnbroking and payday loans.

While most customers had taken out no more than two loans in the last 12 months, sizeable numbers had borrowed on three or more occasions. As we might expect, these proportions were much higher for customers in the very short-term payday loan market. As a result, 46 per cent of online payday loan customers and 56 per cent of retail payday loan customers had taken out three or more loans in the last 12 months. The same was true of 30 per cent of home credit customers and 23 per cent of pawnbroking customers (Table 10.5).

Looked at another way, a minority of pawnbroking and payday loan customers had taken out the equivalent of at least one loan per month in the last 12 months. This was the case for two per cent of pawnbroking customers, and the same proportion of online payday loan customers. At 10 per cent, the proportion was considerably higher for retail payday loan customers – but a small minority nonetheless.

[22] The sample size for online payday loan customers was too small for analysis.

Table 10.5: The proportion of customers with more than one short-term loan

Column percentages		Home Credit	Pawn broker	Retail Payday	Online Payday
Number of loans of this type customers currently have*	0[1]	2	27	32	60
	1	52	47	45	30
	2	28	12	12	7
	3+	17	13	10	3
	Don't Know	1	1	1	<1
Base		*399*	*264*	*393*	*395*
Number of lenders of this type customers currently have loans from*	1	58	62	44	
	2	32	31	30	
	3+	7	8	20	
	Don't Know[2]	2	<1	6	
Base		*180*	*65*	*86*	*38*
Total number of loans of this type over the last 12 months*	0	3	11	3	3
	1	31	46	18	25
	2	35	20	19	25
	3	17	8	18	18
	4	7	6	9	10
	5-9	5	6	16	15
	10-19	1	2	9	3
	20+	-	1	4	-
	Don't Know	2	-	4	<1
	Mean (average)[3]	*2.3*	*2.5*	*5.1*	*3.0*
	Median (middle value)[3]	*2.0*	*1.0*	*3.0*	*2.0*
Base		*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents, except number of lenders where base is all those who have more than one loan. * Indicates that the variation across the groups for this measures is statistically significant (p<.05)
1. Customers could have no outstanding loans because they had already repaid their most recent loan at the time of the survey interview. 2. The 'don't knows' include those who reported that they had more than one loan, but reported having no lenders (clearly, this is not logical). This accounts for 11 cases. 3. Excludes 27 respondents who did not answer this question.

Several people in the Depth Interviews had used short-term loans on a number of occasions. For those who were in difficulty, regular use of these loans and in some cases dependency on them had contributed to their difficulties or escalated their existing financial problems.

For example, one online payday lending customer had originally taken out a payday loan to pay off arrears on household bills. He had since taken out a payday loan every month for the last seven months, with the loan amounts steadily increasing and new loans being used to cover the cost of previous ones.

Similarly, another payday loan customer had taken out a loan once every two to three weeks over the last 12 months, in each case repaying the previous loan in full before taking out the new one.

While this pattern of borrowing had helped him to pay his rent, the interest charged had added to his overall level of debt, perpetuating his need to borrow.

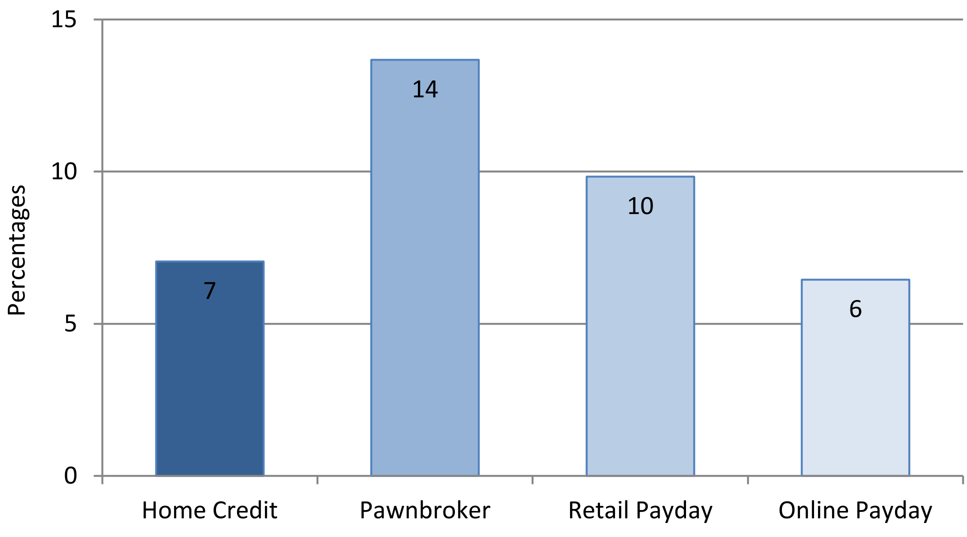
For home credit and pawnbroking customers in the Depth Interviews, repeat use of loans had been a routine way to fund lumpy expenditure, rather than to deal with difficulties. And they had not resulted in difficulties for these people.

10.4.3 Do customers borrow to repay non-mortgage debt?

Previous research identified borrowing to repay non-mortgage debt as an indicator of financial difficulty (see, for example, Burton, 2010). In the Consumer Survey for this research, between three and five per cent of customers across the four types of credit said they had taken out their most recent short-term loan in order to pay off another loan from the same lender or some other non-mortgage borrowing (which could include borrowing from friends or family) (see Table 4.1).

When it came to loan repayment, the majority of customers in the Consumer Survey had repaid or planned to repay their most recent short-term loan from earnings (especially in the case of payday loans) or other income. But a small number of customers said they intended to borrow the money in some way, ranging from three per cent of online payday loan customers, through to four per cent of home credit and four per cent of retail payday loan customers. In the case of pawnbroking customers, 10 per cent had borrowed or planned to borrow in order to repay their most recent loan. In most cases, this involved borrowing from a friend or family member (Appendix Table 28).

Figure 10.3 Borrowing to repay non-mortgage debt when taking out this loan or at repayment*



Source: Consumer Survey. Base is all respondents, excluding respondents to the pilot survey. * Indicates that the variation across the groups for this measures is statistically significant (p<.05). *Bases: Home credit, 369; Pawnbroker, 256; Retail payday, 366; Online payday, 372.*

When these two measures were brought together in the analysis, twice as many pawnbroking customers (14 per cent) as home credit (seven per cent) and online payday loan customers (six per cent) had either taken out their most recent short-term loan to repay other borrowing or had borrowed (or intended to borrow) money to repay their most recent short-term loan (Figure 10.3). Even after controlling for other factors in regression analysis, pawnbroking customers had more than twice the odds of borrowing to repay debts compared with home credit customers. In addition, credit history was highly predictive of borrowing for this purpose. All other things being equal, customers with a poor credit history had higher odds of borrowing to pay off debts compared to those who had not experienced recent adverse credit events. The odds were also higher for men and customers with mainstream credit, but lower for lone parents (Appendix Table 29).

In the Depth Interviews, despite several people being in serious difficulty (and receiving debt advice from the CAB), few had been in difficulty with other types of non-mortgage borrowing. Only one person had taken out online payday loans explicitly to repay other types of non-mortgage borrowing (a high cost credit card, overdraft, catalogues as well as telephone bills). The more typical picture among those in difficulty financially was of people having got into or facing arrears on other types of bills (e.g. Council Tax, utility bills and rent) and using short-term fixed-term credit to try and mitigate or avoid difficulties with these. However, isolated instances of repeat use of payday loans appeared to be indicative of a cycle of borrowing, in which a subsequent loan was used to repay another loan of the same type.

In their own words: Survey respondents' experiences of using short-term credit

Using a pawnbroker

Kirsty is 19 and lives with her parents. She is unemployed, having recently been made redundant from her job as a shop assistant. Last year, while she was still in work, she was invited to a big celebration at the last minute, which she didn't have the money for. She did however have a bracelet worth £200 and decided to pawn the bracelet to fund the night out.

Her intention was to redeem the bracelet from her next wage packet, but when the time came she did not have the money to do so. The lender offered to extend the agreement but Kirsty knew that, realistically, she could not afford the charges on top of the loan amount. She therefore decided not to redeem her bracelet. She would have regretted missing the social occasion, so feels overall that using a pawnbroker was a positive experience. Since then she has pawned a couple of small items with the same lender that she had no intention of redeeming.

Using an online payday lender

Jack lives with his wife and their young daughter. They both work full-time: he is a machinist and she is an assistant retail manager. Over the last few years, they have both had spells out of work. During these times, they regularly took out payday loans online. Sometimes they borrowed to pay a bill that they couldn't otherwise cover, and used a payday loan to avoid bank charges for a failed direct debit. On other occasions, it was '*silly spending...we we're down to our last £5 in the bank, we might fancy a curry tonight and with [payday lender] we could borrow £20 until Friday*'.

Online payday loans appealed to them as they wanted to borrow very small amounts (£20 - £100) for short periods of time. They liked the speed of being able to access the money, and the '*faceless environment*' as there would be no shame if they were rejected.

As Jack explained, they have gradually stopped using payday loans: '*it was a mixture of sort of being a bit more sensible and going back to work*. Although they found the loans convenient at the time, Jack could see that in the long run '*you borrow £100 this month it means you're £100 down next month and it's a continuous loop until you just bite the bullet and go without'*. He feels he would be more inclined to go without nowadays.

Using home credit

Jean is retired, and for the last eight years has been caring for Kieran, her teenage grandson. Her income comprises state pension and pension credit, supplemented by tax credits and money from social services for looking after her grandson. Jean is anxious to make sure that Kieran doesn't miss out on anything, but struggles to pay for things for him like music lessons and holidays.

Up to five years ago, Jean never used consumer credit ('*I don't want a credit card, thank you*!') and wasn't sure she would qualify, as she rents her home. One of her friends mentioned a home credit lender to her, and over the last few years she has taken out several loans with them to fund 'extras' for Kieran, on average one loan of around £500 every year. This year she has borrowed £1,000, however.

She likes the fact that an agent comes to her home to collect the money '*It just makes you pay it...I haven't got to go toddling off paying it in somewhere else'*. The agent has also been flexible on the rare occasions Jean hasn't been able to pay the full weekly amount: '*I've always caught up again afterwards'*.

Jean was well aware of the downsides of using home credit. She was not happy about the cost of her home credit loans and appreciated that '*I'm worse off because I'm paying out more than if I'd saved up'*. But on the whole, her experience was positive: '*they've been fair with me...It has helped me out'*. Jean's income will fall once Kieran goes off to college, and she then intends to clear her home credit loan and stop borrowing.

Source: Depth Interviews with customers who took part in the Consumer Survey. Names and some personal details have been changed.

11 Are there detriments associated with short-term credit?

Summary

A minority of customers overall said the loan had (so far) cost them more than they had expected. This was higher, all other things being equal, among those who had not repaid according to the agreement, and users of pawnbroking compared with payday loan customers.

The Wealth and Assets Survey showed that the use of short-term credit was not predictive of asset or wealth holding. However, a significant minority in the Consumer Survey considered they were worse off as a result of taking out their most recent loan.

Controlling for other factors, retail payday loan customers in the Consumer Survey had increased odds of feeling worse off compared to other customers. In the Depth Interviews, this was either because they had become trapped in a cycle of dependency on credit, or because use of short-term credit had exacerbated existing financial difficulties.

Upwards of four in ten customers in the Consumer Survey agreed that this type of credit trapped them in a cycle of borrowing. Retail payday loan customers and those whose financial situations had deteriorated in the last five years had higher odds of agreeing with this statement than other customers.

Around one in ten pawnbroking customers in the Consumer Survey had relinquished (or looked set to relinquish) the items they had pledged. The Depth Interviewees who were in this position were not necessarily uncomfortable with this prospect.

Had Consumer Survey respondents been unable to take out a short-term loan on this occasion, a large minority would either have gone without the things they wanted the money for or sold something they owned to raise the cash. For pawnbroking and payday loan customers, this would have meant being unable to pay bills or other essentials for many of them, with potentially serious financial consequences. Many others would have borrowed from friends or family.

Previous research identifies the types of detriments that consumers who use home credit, pawnbroking or payday lending may experience. These include the possible loss of valuables by pawnbroking customers (Collard and Hayes, 2010); shortage of money following the repayment of loans which is often timed to coincide with the receipt of wages or benefits (Kempson and Collard, 2005); and a reported dependence on high-cost credit among the consumers who use it (OFT, 2010). Some of these detriments are not necessarily limited to short-term credit.

The Consumer Survey provides evidence about consumers’ experience of using short-term credit, which mainly draw on consumer’s subjective views of their situation. These are (1) cost of borrowing compared with customers’ expectations; (2) customers’ financial situation; (3) patterns of borrowing; and (4) in the case of consumers who use a pawnbroker, unredeemed property.

11.1 Cost of borrowing compared with customers' expectations

In the Consumer Survey for this research, the majority of customers reported that the total amount they had to repay (at least so far) was about what they expected (Table 11.1). Pawnbroking customers were more likely than other customers to say they had to repay *more* than expected. But as noted in section 5.3, pawnbroking customers were also more likely than other customers not to have considered any cost information before they pledged their valuables.

Table 11.1: Was the total amount that customers had to repay about what they expected?*

Column percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
More than expected	23	28	18	12
Less than expected	5	6	4	6
About as expected	69	60	75	82
Didn't know what it would cost	1	3	1	-
Don't know/refused to answer	2	3	3	-
Base	*399*	*264*	*393*	*395*

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05)

Regression analysis showed that, even controlling for other factors, pawnbroking customers were more likely to be repaying more than they expected. But it showed no relationship between customers repaying more than they expected and whether or not they had considered any cost information when they took out the loan.

Loan status was, however, highly predictive. All other things being equal, customers who had not repaid their loan according to the loan agreement had increased odds of repaying more than they expected, in comparison with those who had repaid their loan when it first fell due. The odds were six times higher for customers who had not kept to the credit agreement but eventually repaid their loan, and nearly three times higher for those who were still repaying what they owed. Other factors associated with customers repaying more than they expected included ethnicity and their financial situation (Appendix Table 30).

When incurring extra fees was included in the regression, this was also strongly predictive of customers repaying more than they expected (table not shown). The odds of repaying more were nearly six times higher among those whose lenders had added any extra fees or charges (other than the interest charged on the loan), compared with those who had not incurred extra fees. The other factors, describe above, remained predictive.

There was little evidence in the Depth Interviews that the loans people had taken had cost them more than they expected. On the contrary, some payday loan and pawnbroking customers felt the costs of borrowing were small and manageable. However, as reported above in section 5.3, while the people in this sample were very often aware of the general cost of the loan they had taken out, they were not necessarily familiar with the detail of the terms and conditions of the loan and the implications of them. For example, one online payday loan customer was aware of the £5 transfer fee, the cost of the credit and the potential for default charges. But he had not thought through the consequences of these charges on his ability to meet the full cost of the loan and the effect it would have on his available income in subsequent weeks or months.

11.2 Impact of short-term credit on customers' financial situation

The Consumer Survey asked customers if they were better off financially, worse off or about the same as a result of taking out their most recent short-term loan.

Across the four credit types, the majority of customers felt their situation was about the same. But a significant minority considered they were worse off. At the lower end, 11 per cent of online payday loan customers felt worse off, rising to 19 per cent of pawnbroking customers and 20 per cent of home credit customers. At the top end, a quarter of customers who had taken out a retail payday loan (24 per cent) said they were financially worse off as a result (Table 11.2).

Table 11.2: Whether customers felt better off, worse off or about the same financially *

Column percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Better off financially	14	15	18	17
Worse off financially	20	19	24	11
About the same	66	66	58	71
Don't know/ Too early to say	1	1	1	1
Base	***399***	***264***	***393***	***395***

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measures is statistically significant (p<.05)

Regression analysis showed that, even controlling for other factors, retail payday loan customers had increased odds of feeling worse off compared to other customers. Customers whose general financial situation had deteriorated in the last five years and those with an outstanding short-term loan that they had not repaid to term also had much higher odds of feeling worse off, all other things being equal (Appendix Table 31).

A number of the people in the Depth Interviews recognised the negative financial impact of using these types of credit in the short-term. This was the case across the loan types and was described in two main ways, either in relation to the total cost (in interest and any other charges) of taking on the loan, or – for home credit customers, who were making regular instalments – a reduction in their disposable income each week for the duration of the loan. A few interviewees, all of them recruited via the CAB, described feeling that taking out the loan had caused, contributed to or added to their financial difficulties in the short term.

Others, in contrast, reporting feeling that the loan they had taken out had not impacted them negatively at all in the short term, because they considered that their repayment amounts were affordable. These included a home credit customer and someone who had used an online payday lender. One person who used a pawnbroker felt that there were no costs to her at all in the short-term because she had been able to raise more money from an item than it had originally cost her and she did not need to redeem it. None of these interviewees were in difficulty financially.

Looking at the longer-term picture, several of the people interviewed in depth felt they were neither better nor worse off. Two of those who had used a pawnbroker, for example, felt reassured that they were not obliged to redeem the item they had pledged, and had essentially 'sold' the item pledged, while another felt (at £60) that her loan was too small a loan to have had any long-term negative consequences. One online payday loan customer similarly reported experiencing no problems as he had paid the loan off on time. None of these individuals were in unmanageable debt situations when interviewed.

However, it was not uncommon for others in the Depth Interviews to report that they were worse off financially in the long-term as a result of their borrowing. This was either because they had become trapped into a cycle of dependency on credit (with the short-term fixed-term loan they had taken out playing at least some part in this), or because the loan they had taken out had exacerbated existing financial difficulties rather than easing them as they had hoped. In our sample, these were exclusively people who had borrowed from a payday lender (retail or online) and they were also exclusively debt advice clients. Two interviewees, both of them payday loan customers, also noted that these loans (or the financial problems they had exacerbated) would impact on their credit worthiness in the longer-term.

Finally, one home credit user, while not in financial difficulty, noted that she was worse off in the long-term as a result of having taken out the loan. This was because, had the loan not been so readily available, she would have avoided the extra cost of borrowing incurred through interest charges by saving up for the (discretionary) items she had bought.

Analysis of the Wealth and Assets Survey also provides insight into the relationship between short-term credit and asset or wealth holding. This showed that short-term credit use was not predictive of asset or wealth holding, once other characteristics were controlled. So although short-term credit was independently related to current and recent difficulties it did not impact, positively or negatively, on measures of well-being that might indicate or reflect the longer-term situations of individuals and households. This is in contrast to the use of mainstream credit, which was independently associated with a reduction in both the levels of assets and total wealth.

11.3 Patterns of borrowing

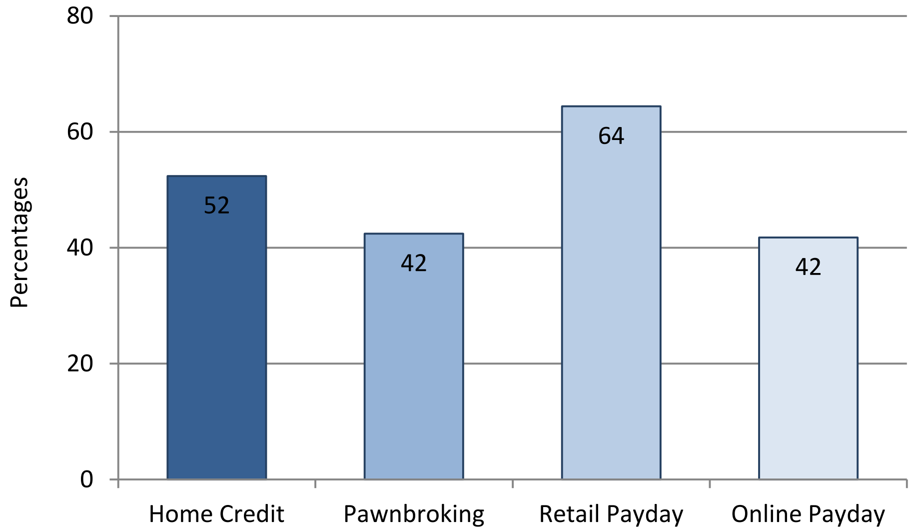
Earlier sections looked at patterns of lending and borrowing that could increase the risk of consumer indebtedness. Customers in the Consumer Survey were also asked whether they agreed or disagreed that the type of short-term credit they used '*trapped me into a cycle of borrowing'.*

Although only a minority of customers felt they were worse off as a result of their most recent short-term loan, upwards of four in ten customers nonetheless agreed that this type of credit trapped them into a cycle of borrowing. This ranged from 42 per cent of pawnbroking and online payday loan customers, rising to 52 per cent of home credit and 64 per cent of retail payday loan customers. Even after controlling for other factors in regression analysis, retail payday loan customers had higher odds of agreeing with this statement than other customers (Figure 11.1; Appendix Table 32).

Two other factors were highly correlated with feeling trapped in a cycle of borrowing, independently of other characteristics: ethnicity and customers' financial situation in the past five years. Non-White customers had more than twice the odds of expressing this view, compared with their White counterparts. And customers whose financial situation had got worse in the last five years similarly had nearly twice the odds of feeling trapped by their borrowing, compared with those whose situation had improved.

Additional variables were included in a second regression model: (1) whether the total repayment was more, less or about what customers expected; (2) whether the customer incurred extra fees; and (3) customer satisfaction with the service from the lender. Of these, only customer satisfaction was correlated with customers feeling trapped in a cycle of borrowing. Customers who were very disappointed with their lender had almost five times higher odds of feeling trapped in a cycle of borrowing compared with those who were very satisfied. Loan type, ethnicity and customers' financial situation remained significant (Appendix Table 32a).

Figure 11.1 Customers who agreed that the type of short-term credit they used '*trapped me into a cycle of borrowing.*



Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this measure is statistically significant (p<.05). *Base: Home Credit, 399; Pawnbroker: 264; Retail Payday, 393; Online Payday, 395.*

Other factors that increased the odds of customers agreeing with this statement were having a strong spending orientation and having an outstanding loan that had not been paid when it fell due (Appendix Table 32).

Some people in the Depth Interviews felt there was a risk of getting trapped into a cycle of using short-term fixed-term credit, even if they did not feel themselves to be in such a trap. In their view, it was more of a risk for users who lacked self-control or who desperately needed the money.

In fact, nearly all of the people in the Depth Interviews were repeat users of the type of credit they were interviewed about. This ranged from those who had taken out a total of one or two payday or pawnbroking loans in recent times (e.g. over the last year), to others who had taken out 15 to 20 payday loans over the course of the last year. One retail payday loan customer, a CAB client, had borrowed repeatedly for a mixture of essential bills and discretionary spending. He talked about getting into a '*continuous loop until you bite the bullet and go without*'. Another, who had taken multiple loans of increasing amounts from different lender, felt that each new loan contributed to a *'vicious circle'*.

Except for one person who had only taken out one loan, all the home credit customers in the Depth Interviews had had more than one loan in the last few years. Some routinely took on a new loan as soon as the previous one was repaid. And there were examples of home credit users using the new loan to repay part of the previously one off or otherwise 'topping up' the existing loan. Despite this, the loans remained manageable for these customers. The repayments were fixed and as such formed a part of their routine expenditure. They also considered the purposes they used them for as 'nice to haves', suggesting that their (repeat) use of home credit was more-or-less an active lifestyle choice that they made.

11.4 Unredeemed property

If a pawnbroking customer does not redeem or renew an agreement at the end of the loan term, the pawnbroker is entitled to use the property to recoup the loan, the interest and any associated costs. In this event, the customer loses the items they have pledged.

In the Consumer Survey, among pawnbroking customers whose loans had already fallen due, one in ten (12 per cent) had lost the valuables they pledged because they had not redeemed or renewed their loan agreement.

In addition, three per cent of customers said they did not intend to repay their outstanding loan from a pawnbroker when it fell due. This meant they would very likely lose the items they had pledged.

Although they were not necessarily representative of all pawnbroking customers, some of those who took part in the Depth Interviews were comfortable about potentially losing the items they had pledged, because they were things they did not want or use.

11.5 In the absence of short-term credit, what actions would consumers take?

There is some evidence from qualitative research that considers how people in the UK manage without access to mainstream credit. In such circumstances people often report that they rely on friends or family, or a pawnbroker. As a very last resort, low-income borrowers may turn to an illegal lender. Other alternative actions may be to try to save up, or apply to a not-for-profit lender such as a credit union (where available) or the Social Fund. DWP Growth Fund applicants who were turned down for a loan had mainly gone without the items or services they wanted the loan for (Collard et al 2010).

In the Consumer Survey for this research, customers were asked the most likely course of action they would have taken, had they not been able to borrow from a short-term lender at all. The two main alternatives mentioned by customers were (1) to forgo something or (2) to borrow from a friend or relative.

Upwards of three in ten customers said they would most likely have forgone something, had they been unable to take out a short-term loan on the most recent occasion. This generally meant going without the things they wanted to borrow the money for. It also included customers who said they would have sold something in order to get the money they wanted. Customers who used a pawnbroker or a retail payday lender were more likely to say they would have sold something (Table 11.3). This is probably because the lender they used also retailed jewellery and/or other second-hand goods.

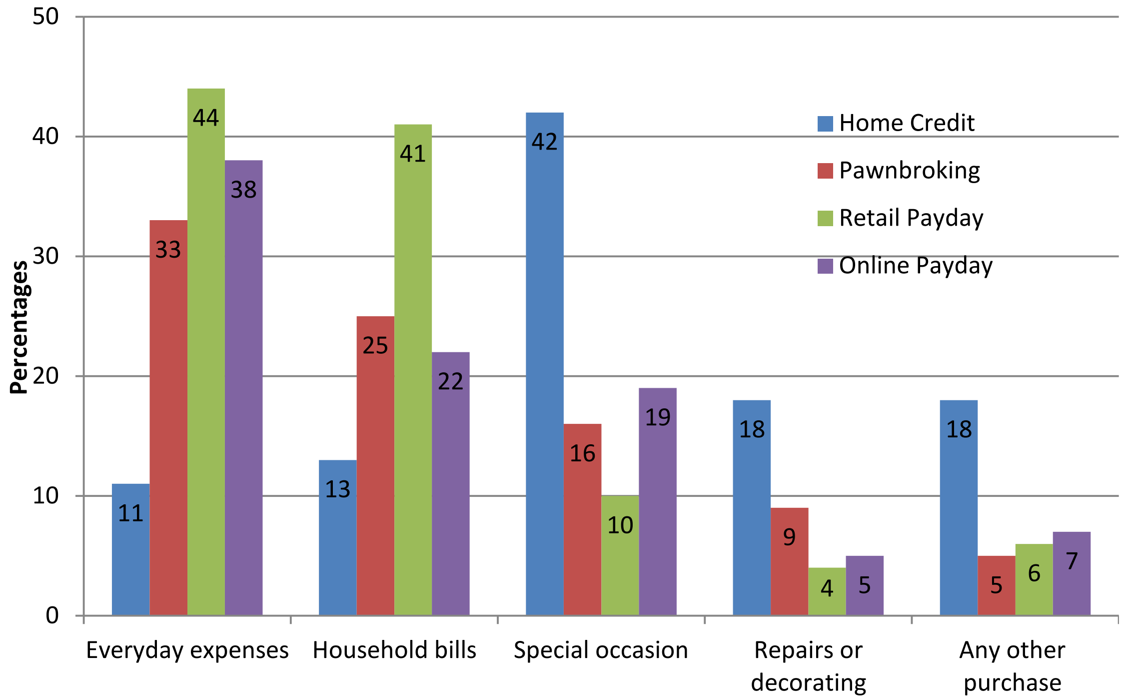
Table 11.3: Most likely actions if customers had not taken out a short-term loan

Column percentages	Home Credit	Pawnbroker	Retail Payday	Online Payday
Forgone something	48	34	37	35
Gone without the things they wanted the money for	*42*	*22*	*29*	*29*
Sold something	*5*	*12*	*8*	*6*
Used savings	2	3	3	1
Saved up	16	3	4	4
Borrowed from a friend or relative	23	41	39	44
Asked a friend or relative for the money or to buy things for them	2	4	4	3
Borrowed in some other way	8	11	8	9
Something else	1	3	2	3
Don't know/too hard to say	1	3	2	2
Refused to answer	-	-	1	0
Base	***399***	***264***	***393***	***395***

Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups for this question is statistically significant (p<.05)

Regression analysis showed no independent relationship between customers' saying they would forgo something and the type of short-term credit they used. Age, ethnicity and credit history were predictive, however. All other things being equal, older customers aged 50 or over had higher odds of saying they would go without or sell something. Non-White customers and those who had not experienced a recent adverse credit event had lower odds (Figure 11.2; Appendix Table 33).

Figure 11.2: The most common things customers said they would have forgone if they were unable to take out a short-term loan and did without the money*



Source: Consumer Survey. Base is all respondents. * Indicates that the variation across the groups on each of these measures is statistically significant (p<.05). *Base: Home Credit, 159; Pawnbroker: 59 (treat with caution); Retail Payday, 108; Online Payday, 104.*

The consequences of going without the things they wanted a loan for were potentially more serious for pawnbroking and payday loan customers than for their home credit counterparts. While home credit customers would mainly have been unable to pay for a special occasion, or to pay for some larger household purchase, customers who used a pawnbroker or a payday lender would potentially have been unable to pay for everyday expenses or other household bills (Appendix Table 34).

Borrowing the money from a friend or relative was the other option that customers considered a viable alternative if they were unable to take a short-term loan. This ranged from 23 per cent of home credit customers (who typically borrowed larger sums of money), up to around four in ten of pawnbroking and payday loan customers, who generally borrowed smaller amounts (Table 11.3).

Other options were not considered viable by many customers. Saving up was not generally felt to be an alternative, except for around two in ten home credit customers (16 per cent). Around one in ten customers across the four credit types said they would most likely have borrowed the money from another source, typically a different short-term lender. Regression analysis showed no relationship between customers' socio-demographic characteristics and the likelihood of borrowing the money from somewhere else (other than a friend or relative) (Appendix Table 35).

The findings from the Depth Interviews corroborate those from the Consumer Survey. Borrowing from friends and family, saving up for the purchase they made with the loan, and going without a 'nice-to-have' were all mentioned by people we interviewed. Others, however, would have fallen into arrears on bill payments, had to face court proceedings, lost their home or used a bank account that would have levied a charge. And some pawnbroking customers would have considered using a payday loan.

12 The impact of price restrictions on short-term credit

Summary

A previous review of high cost credit sectors concluded that the introduction of any price cap would be complex, expensive and difficult to administer. A range of other options have been mooted in the UK to address the issues said to be associated with short-term credit. This includes the introduction of a cap on the total cost of credit including interest, fees and auxiliary costs, proposed in the Consumer Credit (Regulation and Advice) Private Members' Bill. Some action has already been taken to address the issues said to be associated with short-term credit and payday lending, including strengthened enforcement powers and new provisions to tighten up payday loan refinancing.

Several other countries already regulate (or propose to regulate) credit charges other than interest, albeit not in the specific way proposed in the Consumer Credit (Regulation and Advice) Private Members' Bill.

In the absence of any examples of caps on the total cost of credit, the Evidence Review related to price restrictions of any type, mainly interest rate caps. Experiential evidence from other countries indicated three responses by lenders to price restrictions (in the form of interest rate restrictions), depending on the level at which restrictions are set: lenders cease to operate in the market; they restructure the products they offer; and they serve a narrower range of customers. The experiences of lenders in the Business Survey corroborated this picture.

In turn, empirical evidence indicates a range of impacts on credit markets where price restrictions exist, including more risk averse lending; fewer short-term loans; less product diversity; and reduced competitiveness. Experiential evidence points to avoidance or circumvention activities by lenders. One way that lenders may circumvent restrictions is to charge fees that are not covered by an interest rate cap, something that a cap on the total cost of credit is designed to overcome. There is evidence that price restrictions lead to a convergence of credit prices at the price ceiling, although this seems to depend on the market and the nature of the cap.

There is strong evidence that interest rate restrictions reduce access to credit for consumers, particularly for low-income borrowers. The evidence is less clear about displacement to other credit products and the impact of price restrictions on debt and financial difficulty. Depending on how price restrictions are structured, there is evidence that they may lead to increased costs of credit for consumers, for example if lenders apply extra charges that fall outside the price cap. Again, a cap on the total cost of credit would, in theory, overcome this problem.

The case for the introduction of a cap on the cost of credit in the UK was explored by the OFT in its review of high-cost credit, published in 2010. A cap on the annualised total cost of credit per £100 borrowed was one of the controls considered. The case for such a cap was that it offered the best means of comparison for consumers, particularly if short-term loans were rolled over. The argument against was that it still had the potential to confuse consumers given the short-term nature of many such loans. Other types of caps the OFT looked at were floating caps (to keep pace with the market), which seem to be effective in some US states (discussed below) but may be complex to set and monitor. Overall, the OFT concluded that the introduction of any price cap would be complex, expensive, and difficult to administer. The OFT's findings in relation to price controls are described on the following page.

The OFT review of high-cost credit: Price controls

In 2010 the Office of Fair Trading (OFT) published the final report from its review of high-cost credit. As part of this review, the OFT considered the case for price controls for home credit, pawnbroking and payday loans (and also rent-to-buy credit) as potential remedies for the concerns it identified within these markets, particularly the limited competition it found in these markets. They examined the evidence for and against the adoption of price controls, mostly in relation to interest rate caps.

Based on its review, the OFT concluded that introducing price controls would not be an appropriate solution to these concerns (OFT, 2010).

While recognising that price controls could address concerns around high profits and initially limit the headline prices consumers pay, the OFT was concerned that responses by lenders may lead to outcomes that would not benefit consumers. The following lender responses were identified:

- Tighter lending criteria that restricted the types of consumers they served
- Withdrawing particular products
- Exiting the market completely.

The potential for these responses to result in reduced access to high-cost credit for consumers concerned the OFT for two reasons:

- High-cost credit was already constrained and many consumers had few practical alternatives to high cost credit in the short term;
- The use of high-cost credit for non-discretionary spending by many consumers meant that reduced access '*would have a significant impact'* on consumers' ability to manage their finances effectively (OFT, 2010: p9).

The OFT also concluded from its review that the introduction of price controls would require '*the development of a system that would be complex, expensive and difficult to administer*' (OFT, 2010: p10). This reflected the complexity of the market, requiring that investigations of pricing and profit be undertaken on a product-by-product basis. It also reflected the possibility that lenders might impose more stringent late payment and default regimes that might be less transparent and could impact adversely on vulnerable borrowers. And it related to concerns about the difficulty of managing the scope for circumvention given the multiplicity of price controls required.

While the OFT acknowledged that a price cap could be set at such a high level at to avoid some of the difficulties associated with the implementation of price controls, still it regarded that such intervention was not necessarily justifiable. They noted that the UK already has provisions for controlling credit prices or charges that might be deemed unfair through the Consumer Credit Act (CCA) 2006.

The Consumer Credit (Regulation and Advice) Private Members' Bill proposed (among other things) a maximum charge for credit per £100 advanced, calculated on an annualised basis, but which may reflect the different duration of credit agreements. In her submission to the BIS Consumer Credit and Personal Insolvency Review, Stella Creasy MP (who introduced the Bill) indicated that late payment fees and auxiliary costs should be included in the maximum charge for credit.[23]

12.1 Actions underway to address issues associated with short-term credit in the UK

Various actions are already underway in the UK to address issues associated with short-term lending, and payday lending in particular. BIS has announced a commitment to strengthen enforcement powers across the consumer credit market as a whole by giving the OFT the authority to suspend a consumer credit licence with immediate effect where there is an urgent need to do so to protect the interest of consumers.

In addition, a customer charter for payday and short-term lenders came into effect in November 2012. Drawn up by four trade associations, the charter includes provisions on extending loan terms, credit assessment, increased transparency around loan repayments and help for customers in financial difficulty.[24] Alongside the charter is an addendum to existing trade association codes of practice which sets out new standards of consumer protection for consumers who take out payday or other short-term loans from members of these trade associations. Once implemented, the charter and addendum will sit within or alongside their existing codes of practice.

Government also expects the payday loan industry to respond effectively to recommendations from the OFT's investigations into the misuse of continuous payment authority and compliance with the law and regulatory guidance.

12.2 Other proposals to address issues said to be associated with short-term credit

Consumer Focus has proposed restrictions on the number of payday loans an individual can have (as happens in some US states) to help prevent unsustainable lending and the referral of repeat borrowers for advice (Burton, 2010). Alongside these proposals, Consumer Focus called for fairer and clearer bank charges and emergency borrowing facilities to provide viable alternatives to payday lending.

Another proposal, in the UK and elsewhere, to tackle the problems associated with short-term lending is the increased provision of affordable loans through not-for-profit lenders such as credit unions and community finance organisations. The UK government financially supported the provision of affordable loans through the DWP Growth Fund. It has since committed further

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[23] The consumer credit regulations implementing the Consumer Credit Directive state that the Total Charge for Credit (as expressed in the APR) must include charges for any ancillary service relating to the agreement such as PPI or other insurance if that service is compulsory in order to obtain the credit or to do so on the terms and conditions marketed. The TCC does not include charges payable for non-compliance with the agreement such as late payment charges or default charges. It also does not include charges relating to the purchase of goods or services which would have to be paid whether the goods or services were paid for with credit or cash (BIS, 2010, Guidance on the regulations implementing the Consumer Credit Directive).

[24] The four trade associations are the Consumer Finance Association, the BCCA, the Consumer Credit Trade Association and the Finance and Leasing Association. The customer charter and addendum are available from www.cfa-uk.co.uk/codeofpractice.asp [accessed 27.07.12] and other trade association websites.

investment in the expansion and modernisation of credit unions to provide services for up to one million more consumers on lower incomes over the five years from 2012.[25]

In Australia, major banks have teamed up with leading charities, and with the help of government funding they have been able to offer affordable credit loans to low income families in Australia (Deeming et al, 2011). In the UK, the HM Treasury-led Financial Inclusion Taskforce expressed disappointment in the level of engagement of the UK banking sector in supporting credit unions and other not-for-profit lenders (Kempson and Collard, 2012).

The remainder of this section focuses on price restrictions that exist elsewhere and the evidence of the impact of price restrictions on the financial services industry and consumers.

12.3 The types of price restrictions that exist elsewhere

Overall, there seem to be six main reasons why restrictions on cost have been introduced:

- To prevent/control over-indebtedness
- To prevent excessive/unreasonable rates (including for reasons of ethics and usury)
- To prevent unfair practices/abuse of poorly informed or over-indebted consumers
- To decrease risk-taking by lenders
- To prevent predatory/aggressive lending
- To overcome the ineffectiveness of supervisory bodies (iff/ZEW, 2010).

Price restrictions in the form of a cap on the interest rate or APR are relatively common. For example, 17 EU member states have some form of price restriction and countries may have several different price caps. The nature and level of these restrictions varies markedly from country to country (iff/ZEW, 2010). In addition, in response to concerns about short-term small-sum SMS and online lending, Finland is in the process of introducing a cap on the APR that can be charged on loans below €2,000.

In terms of its specific provisions, the type of regulation proposed by the Consumer Credit (Regulation and Advice) Private Members' Bill does not seem to exist anywhere else. Some countries do, however, regulate (or propose to regulate) credit charges other than interest and these are briefly described below. Evidence related to the impact of price restrictions in these countries and elsewhere is discussed in section 12.4.

Poland has a maximum APR on all consumer credit agreements that are taken out (mortgage and non-mortgage). This maximum APR is equal to four times the Central Bank Lombard Rate, which is reset monthly (iff/ZEW 2010). In 2006, this rate was 5.75%, meaning that the maximum was 23%; in March 2010, it was 5%, giving a maximum of 20%. No distinction is made by category or size of credit. In addition, Poland has a direct floating ceiling on fees and additional charges (not included in the APR), which may not exceed 5% of the amount of the loan. The cost of Payment Protection Insurance is included within this regulation.

In **Australia**, New South Wales, the Australian Capital Territory and Queensland currently operate a 48% cap on interest charges plus other fees and charges. New legislation on small amount credit

[25] ww.dwp.gov.uk/other-specialists/the-growth-fund/latest-news [accessed 27.07.12].

contracts (contracts of one year or less for AUD 2,000 or less) is to be implemented in 2013. This will create a new tiered cap on costs which:

- Caps costs for loans under AUD 2,000 so that the maximum any lender can charge for a small amount credit contract is 20% of the amount of credit up-front and 4% for each month of the loan.
- Prohibits lenders offering small amount credit contracts with a term of 15 days or less.
- Introduces an interest rate cap of 48% plus an additional AUD 400 to cover establishment costs for mid-range loans between AUD 2,000 and AUD 5,000 with a maximum term of two years.[26]

The level of the cap on small amount credit contracts to be introduced throughout Australia in 2013 was increased following scrutiny of the proposals by two government committees. The original proposals were for a maximum up-front charge of 10% of the total amount borrowed and 2% per month. The government considered that the new proposals for a tiered cap balanced '*the interests of consumers with the viability of the industry'.*[27]

In **Canada**, in federal legislation there is a 60% per annum cap across the credit sector, which includes all charges and expenses (such as fees, fines, penalties and commissions) with a few exceptions such as insurance charges, official fees, overdraft charges. Some provinces also specifically regulate payday lending, under the Payday Lending Exemption. The caps operated by these provinces on payday loans range from CAD 21 to 31 per $100 borrowed.

Correspondence with the Debt Advisory Center in the **Czech Republic** indicates that there was a proposed amendment to the country's consumer credit legislation to limit penalty charges to 1.5 times the total loan and to limit the APR to three times the average bank consumer credit APR. This amendment does not appear to have been implemented.

Studies carried out in the **US** imply that States only operate interest rate restrictions, not caps on the total cost of credit (iff/ZEW 2010). Some States regulate the fees that payday lenders can charge as well as the interest charges they can make, but these fees are prescribed separately rather than expressed as a cap on the total cost of credit.

12.4 The impacts of price restrictions

The following sections summarise the evidence in relation to the impacts of price restrictions on lenders, credit markets, consumers and regulators in the countries where they are in operation. In the absence of any examples of caps on the total cost of credit, as proposed in the UK, the evidence described relates to price restrictions of any type.

The evidence presented here draws mainly on other reviews that have been carried out, supplemented with findings from studies not included in those reviews. It distinguishes between expected or theoretical outcomes, experiential evidence (such as market evidence, expert or stakeholder opinion which may be anecdotal and unsubstantiated) and empirical evidence (research

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[26] Amendments to Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011.
[27] Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011, Supplementary Explanatory Memorandum.
http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fbillhome%2Fr4682%22 [accessed 27.07.12].

studies, comparative studies or experiments). The conclusions drawn from empirical evidence have been included, although these are clearly open to interpretation.

12.4.1 Impacts on lenders

The Evidence Review undertaken for this study found relatively little empirical evidence related to the impact of price restrictions on lenders; the available evidence is instead experiential in nature. Some of the lenders in the Business Survey had direct experience of operating in countries that had price restrictions. Their experiences and views corroborate the picture that emerged from the Evidence Review, which indicates three responses by lenders, depending on the level of the cap that is introduced:

- Lenders cease to operate in the market
- Lenders restructure the products that they offer
- Lenders serve a narrower range of borrowers.

The Evidence Review found no evidence to suggest that price restrictions lead lenders to develop more efficient business practices, although this was expected to be a consequence of proposals for price restrictions put forward in Australia (Australian Government, 2011).

Lenders cease to operate in the market

The level at which price restrictions are set will affect the viability of continuing to operate and therefore the number of lenders that exit the market. Experiential evidence, reported by lenders and third parties in Australia, indicated that more than 27 lenders ceased trading over two years in Queensland and New South Wales as a result of introducing the 48% cap on interest and other fees and charges. There were no details about the proportion of lenders that these 27 or so represented. A report by the Australian Government concluded that lenders that had ceased trading were most likely to be smaller lenders or those operating '*an inefficient business model*' (Australian Government, 2011: p45).

In addition to existing interest rate restrictions, Slovenia relatively recently introduced a cap on the APR that non-bank lenders can charge, which cannot be higher than 200% of the average charged by banks. According to one consumer organisation, this has resulted in the exit from the credit market of online lenders that provided loans by SMS.

In the Business Survey for this research, one small online lender that had previously operated in Australia ceased to do so as a result of the introduction of the price cap in New South Wales, the Australian Capital Territory and Queensland. In addition, several lenders in the Business Survey believed that price restrictions of the type originally proposed in the Australian Consumer Credit and Corporations Legislation Amendment (Enhancement) Bill 2011 (of a flat-rate 'establishment' fee of 10% of the total amount borrowed and 2% per month) would result in the cessation of payday and other short-term lending if introduced in the UK.[28]

Two payday lenders (a large retail and online lender and a small online lender) in the Business Survey for this research had experience of operating in the US and Canada. The small online lender only operated in US states without interest rate caps; it had stopped lending in states such as

[28] The amended proposals had not yet been announced at the time of the Business Survey.

California which introduced price caps. It had also stopped lending in Canada. The large lender operated in some states of the US that had higher price caps (e.g. Florida) but not in others with low price caps (e.g. Ohio).[29] It also operated in Canada.[30]

Lenders restructure the products they offer

In the Business Survey for this research, one large home credit lender described how it had operated in other countries which have price restrictions (including countries where restrictions on charges other than interest had been introduced). Along with other lenders in those markets, it continued to operate by restructuring its home loan products. Put simply, the loan product was divided into the elements that were covered by the legislation (e.g. interest, up-front fees) and the elements that were not (e.g. home collection, insurance). Separate charges were made for these different elements. In the lender's view, this resulted in a less transparent product for the consumer, who also did not pay any less as a result. In addition, in one country the lender ceased to offer the shorter-term home credit loans that are available in the UK, because the price restriction meant it was not viable to do so.

In Australia, a pilot scheme run by National Australia Bank (NAB) found that the cost of providing credit depended on loan amount, term and size of loan portfolio. A flat rate interest rate restriction of 48% was not profitable for loans of AUD 1,700 or smaller, for a term of one year or shorter, or with a portfolio of 3,000 loans or fewer (Australian Government, 2011).

Lenders serve a narrower range of borrowers

A large home credit lender in the Business Survey for this research described differences in its customer base in a country that had price restrictions compared with the UK. In the country with price restrictions, its customers were rather better-off than their UK counterparts, because the price restrictions meant it was not viable to lend to lower-income consumers. A large online payday lender in the Business Survey had stopped lending to the armed forces in the US when lenders were banned from making payday loans and car title or logbook loans to military personnel.

Like credit unions worldwide, credit unions in the UK have always operated with an interest rate cap.[31] In June 2006 the interest rate cap was doubled from 1% to 2% a month (equivalent to 26.8% APR). The argument for this change was that by raising the amount that credit unions could charge, it enabled them to lend to a broader range of borrowers, including those with a poor credit history who might otherwise have to borrow from other non-mainstream sources at much higher rates of

[29] According to the website www.credit.com, Florida permits maximum payday loans of $500 exclusive of fees, over seven to 31 days. There is a maximum 10% interest rate and maximum $5 fee. The APR for a 14-day $100 loan is 390%. Ohio permits loan terms up to six months and maximum loans of $800. The maximum interest charges are 5% per month on unpaid balances plus $5 fee, plus $3.75 fee for every $50 about $500. The APR for a 14-day $100 loan is 390%. California permits loans up to 31 days to a maximum value of $300. The maximum charge is 15% of the amount loaned.

[30] In Canada, in federal legislation there is a 60% per annum cap across the credit sector, which includes all charges and expenses (such as fees, fines, penalties and commissions) with a few exceptions such as insurance charges, official fees, overdraft charges. Some provinces also specifically regulate payday lending, under the Payday Lending Exemption. The caps operated by these provinces on payday loans range from CAD 21 to CAD 31 per CAD 100 borrowed.

[31] The credit union interest rate cap exempts credit union loans from consumer credit regulation on the basis that they are not-for-profit, ethical lenders that can be trusted to treat borrowers fairly. (DWP Credit Union Expansion Project, Stakeholder Update July 2012).

interest (the riskier is the borrower the higher the rate of interest must be to compensate).[32] A further increase in the cap has been mooted.[33]

The Financial Inclusion Taskforce noted that the 2% per month interest rate cap on credit union lending, plus the limited resources for administrative subsidy, heavily constrained the proportion of the credit excluded population that could be served by this means. An evaluation of the DWP Growth Fund (which provided instant access loans to financially excluded households) estimated that higher interest rates than 26.8% would be needed to put Growth Fund lending on a more stable commercial platform. It was estimated that an APR of 71.2% would be required to cover operational costs and financial risks associated with lending. An APR of 108.2% would be needed to reach a commercial rate of profit of 12.7% on loan capital (Collard et al, 2010).

12.4.2 Impacts on markets

The impacts of price restrictions on short-term lenders described above help shape the credit markets in which they operate.

Empirical research indicates a range of impacts on credit markets where restrictions exist. These include an increase in risk averse lending; fewer short-term loans; higher volumes of mainstream lending; reduced diversity of credit products; displacement to rent-to-own credit; and reduced competitiveness (iff/ZEW, 2010; OFT, 2010; Policis, 2004). There is also experiential evidence of avoidance and circumvention activities in markets where restrictions exist, including offering types of loans or charging fees that do not fall under the legislation, or requiring customers to purchase other goods or services (Australian Government, 2011; iff/ZEW, 2010; OFT, 2010). In the US, the pawnbroking market thrived in Michigan State in the context of harsh restrictions on payday lending (OFT, 2009).

Price restrictions have been shown to affect the price of credit too. Evidence from the US shows that, in Colorado, retail payday loan prices gravitated systematically toward the price ceiling after it was introduced in 2000.[34] Variation in charges across retail payday loans also diminished (DeYoung and Phillips, 2009). In the Business Survey for this research, the experience of one home credit lender was that lenders' prices tended to gravitate to the level of the price cap; and the market remained static as a result. If the price cap is set low, arguably price convergence is not necessarily problematic. It does mean, however, that some borrowers who might have benefitted from even lower prices are not able to do so.

Another study for the European Commission found inconclusive evidence of a convergence of consumer credit interest rates, based on the literature and the experience in the Netherlands and Poland. Rather, convergence depended on the market structure and the way in which interest rate restrictions were implemented (iff/ZEW, 2010).

The same European Commission study concluded that it was unlikely for interest rate restrictions to result in a decline in the *overall* volumes of consumer credit (iff/ZEW, 2010). In Florida, which has

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[32] House of Commons Standard Note: Credit Unions, version dated 16 November 2011.
[33] www.dwp.gov.uk/docs/credit-union-feasibility-study-report.pdf [accessed 27.07.12].
[34] In Colorado, payday loan charges are capped at 20% of the loan principal up to USD 300 and 7.5% of the principal amount between USD 300 and USD 500. The maximum loan amount is USD 500 and the maximum loan term is 40 days.

restrictions on payday lending, loan data for the period 2005-2009 indicated a steady growth in the aggregate number of payday loans and the dollar value of loans. There was also a decline in default rates (Anderson and Jackson, 2010).

Experiential evidence from developing countries found that interest rate ceilings made it difficult for micro-finance institutions to operate (Duval, 2004). More recent experiential evidence from South Africa indicated that micro-lending activities continue to grow following the introduction of a tiered cap, with lenders using technology to keep costs to a minimum (Whittaker, 2008, cited in Australian Government, 2011).

12.4.3 Impacts on regulators

There appears to be very little evidence on the impact of price restrictions on regulators. In the experience of consumer representatives in Australia, the introduction of restrictions had made enforcement more straightforward and therefore cheaper (Deeming, 2011). The Australian Treasury also expects that their proposed tiered cap on costs will reduce the risk of lender avoidance. Other experiential evidence points to the difficulties of regulating off-shore payday lending (OFT, 2010).

12.4.4 Impacts on consumers

The evidence indicates four main impacts of price restrictions on consumers, which relate to:

- Access to credit
- Cost of credit
- Displacement to other types of credit or other lenders
- Levels of debt and financial difficulty.

There is strong evidence that interest rate restrictions reduce access to credit, particularly for low-income borrowers. Depending on how price restrictions are configured, there is evidence that they may lead to increased rather than reduced costs of credit; in theory, a cap on the total cost of credit would overcome this problem by prohibiting lenders from making any additional charges. The evidence is less clear about whether or not price restrictions lead to displacement and the impact they have on levels of debt and financial difficulty.

Access to credit

The impact of interest rate restrictions on access to credit has been explored in several research studies carried out in the US from the 1960s onwards as well as studies conducted in South Africa, France, Germany and Poland. The findings from these studies, plus stakeholder interviews conducted in EU member states, showed that the existence of interest rate restrictions reduced credit access, particularly for low-income borrowers (iff/ZEW, 2010). A national online survey conducted in the US in 2009 found that moving from no price cap on pawnbroker loans to a monthly interest rate cap of three per cent (roughly a 40 per cent APR) was associated with a 25 per cent decline in these loans. A similar picture was seen in relation to auto title (log book) loans (McKernan et al, 2010).

Cost of credit

The introduction of price restrictions is expected to reduce the price that consumers pay for short-term credit. The data is not available, however, to examine the cost of credit to individuals before and after the introduction of price restrictions (iff/ZEW, 2010). Without this information, it is not possible to say what proportion of consumers experience lower cost credit (in monetary terms) as a result of price restrictions.

Based on analysis of *average* credit interest rates from a number of EU member states and stakeholder interviews, research for the European Commission was not able to identify any unambiguous evidence that average interest rates declined in countries that had interest rate restrictions (iff/ZEW, 2010).

Drawing on historical data from the UK and US, data collected in the US in the 1970s and 1980s, and examples from several EU member states, the same study found evidence that interest rate restrictions led to increased charges for consumers as lenders tried to compensate for reduced interest revenues by raising charges not covered by the price restriction (iff/ZEW, 2010). For this reason, campaigners in the UK argue for price restrictions that encompass the total cost of credit, not just the interest charge.

Similarly, as reported above, one large home credit lender in the Business Survey for this research had restructured its loan products in order to comply with price restrictions in other countries. In their view, this resulted in the costs of credit being less transparent to consumers. They also considered that customers did not pay any less for home credit as a result of the price restriction.

Displacement to other types of credit or other lenders

Reductions in short-term credit supply as a result of price restrictions may result in consumers using other types of credit or other lenders instead, such as illegal lenders, informal borrowing from friends and family, or mainstream credit. Several studies have examined these patterns of borrowing in countries with and without interest rate restrictions, which are reported below. There does not seem to have been any research to track the patterns of borrowing of short-term credit users before and after the introduction of price restrictions.

Only one research study has compared the levels of illegal money lending in countries with and without interest rate restrictions (Policis, 2004). It found higher levels of illegal lending in France and Germany (which both have interest rate restrictions) than in the UK (which does not have an interest rate cap). Taking into account this research and stakeholder interviews conducted in EU members states, a study for the European Commission found inconclusive evidence that interest rate restrictions led to a substantial illegal market in credit (iff/ZEW, 2010).

Experiential evidence from the US indicated that that a clamp down on (licensed) online payday lenders in one US state (Pennsylvania) led to a proliferation of unlicensed online lending. There is also anecdotal evidence that, following a clamp down on payday lenders in Pennsylvania, consumers crossed state borders to obtain payday loans (OFT, 2009).

Consumer survey data indicated that higher-risk borrowers in France (which restricts interest rates) borrow larger sums over a longer period of time from mainstream lenders than their UK counterparts who had access to short-term credit. The same study found that mainstream credit volumes were higher in US states with interest rate restrictions but credit scores were lower, suggesting that in the absence of short-term credit a higher proportion of mainstream credit was sold to high-risk borrowers (Policis, 2004). In the US, there were also more rent-to-own stores in states with interest rate restrictions than in those without (Policis, 2004). This suggests that, if they cannot access cash loans, consumers may use rent-to-own products, the costs of which can be misleading (and high; OFT, 2010).

Stakeholder interviews in EU member states indicated that there were no significant differences in levels of informal borrowing (e.g. from friends and family) in countries with interest rate restrictions compared with countries that had no restrictions (iff/ZEW, 2010).

Levels of debt and financial difficulties

There is mixed evidence from existing studies about the impact of interest rate restrictions on levels of debt and financial difficulties.

Evidence from the US indicated that sub-prime loan volumes and average debt per person were lower in states with interest rate restrictions and/or no specific legislation that allowed payday lending than those states that did not have these restrictions (Policis, 2004).

Based on stakeholder interviews and a comparison of evidence from EU member states, a study for the European Commission concluded that interest rate restrictions were unlikely to directly influence levels of over-indebtedness (iff/ZEW, 2010).

Several other studies, however, have linked restrictions on short-term credit with financial difficulty. Linked to the issue of credit displacement, US states with interest rate restrictions were found to have a higher incidence of late and missed payments on mainstream credit than those without restrictions. This difference was especially marked for non-bank revolving credit and sub-prime credit cards that were most likely to be sold to low-income and high-risk borrowers (Policis, 2004).

Another two studies in the US suggest that tighter restrictions on payday loans are associated with a higher incidence of financial difficulty. In one, financial difficulty took the form of bounced cheques and bankruptcy filings (Morgan and Strain, 2008). In the other, it related to households' subjective assessment of their financial situation and their employment status (Zinman, 2008). It has been noted that, in both studies, these outcomes could have been the result of unobserved factors rather than restrictions on payday lending (Caskey, 2010).

In Australia, there were anecdotal reports from consumer advocates that the number of debt advice cases fell as a result of the introduction of price restrictions (Deeming, 2011).

Patterns of borrowing

In Australia, it is expected that restrictions on the cost of short-term credit will also reduce repeat payday borrowing (Australian Government, 2011). Evidence from the US suggests that this may not be the case. Florida has a range of restrictions on payday lending including a limit on interest and fees; a limit of one outstanding payday loan at a time; and a 24-hour cooling off period between loans. However, in the absence of a specific prohibition on repeat borrowing, a proportion of borrowers continue to use payday loans as an ongoing line-of-credit (Anderson and Jackson, 2010).

13 How might short-term lenders respond to price restrictions in the UK?

The Business Survey found very little support among lenders or their trade associations for the imposition of a cap on the total charge for credit in the UK credit market. They were unclear how a cap on the total charge for credit would be calculated and were concerned about the inclusion of default charges that the majority of customers did not pay. The variation between and within the different sectors meant that the cap or caps would be challenging to set, monitor and review.

There was nonetheless support among some lenders for more effective controls on default charges. One already operated a policy whereby customers of instalment loans were never charged more than double the loan principal.

All but one of the firms in the Business Survey was making a profit. A few had only recently moved into profit. Lenders were confident that their accounts and management information would demonstrate they were not making excess profit.

If caps were introduced at around the level of their current price structure, most lenders considered they would continue lending. Some would adapt by tightening their lending criteria. Caps set at any industry or product average would risk eliminating short-term home credit loans.

If a cap was introduced below the level of their current price structure, lenders reported that they would respond by tightening their lending criteria, reducing costs or exiting the market. Some lenders mentioned levels at which they felt they would be unable to continue lending.

The possible unintended consequences of introducing a price cap or caps in the UK mentioned in the Business Survey included the development of new products that fall outside consumer credit law; an increase in credit linked to the purchase of retail (which could result in consumers paying heavily-inflated prices for goods); and the addition of extra charges that were not included in any legislation (although a cap on the total cost of credit is intended to overcome this problem).

For home credit one possibility would be the introduction of default charges which would undermine the traditional lending model and result in less transparency for consumers. For online lenders, cross-border or offshore lending was mentioned. For retail lenders already offering buyback on retail goods, increasing this side of their business was a real possibility.

The main impacts of any price cap for consumers were felt to be reduced credit supply by regulated lenders, with some consumers potentially using unregulated lenders instead; less choice of credit products for those consumers that still had access; and the risk of less transparent pricing structures that in turn threatened to undermine competition.

Not surprisingly, the Business Survey for this research found very little support among lenders or their trade associations for the imposition of price restrictions in the UK credit market. The introduction of price restrictions would, in their view, impact negatively on lenders and consumers by distorting the credit market; reducing competition and consumer choice; and reducing credit supply as lenders restricted their lending activities or exited the market altogether. Only one lender (a medium-size retail lender) offered any support for the introduction of a price cap, on the basis that it could bring down the high costs of online lending and result in some online lenders exiting the market completely, which they felt would be a positive outcome.

If price restrictions were introduced, there were concerns generally among the lenders and trade associations about issues such as the uncertainty this would create for lenders which may in turn affect business development and investment; downward pressure on any price cap over time; and how compliance would be monitored and reviewed. They felt strongly that any price restrictions should apply to the wider credit market, not just short-term credit, in order to create a 'level playing field'. The inclusion of overdrafts and credit cards received particular mention.

In contrast, there was support among some lenders (including lenders of different types and sizes) for more effective controls on default fees (such as a cap). Lenders, including payday lenders, also talked about potential consumer detriment, particularly in parts of the online payday lending market, which could not be addressed by a price cap. As a relatively new industry, some payday lenders were felt to be 'testing the limits' of the market. There was also concern about unsustainable and irresponsible lending (and borrowing) such as borrowers using one payday loan to pay off another, which was likened by one lender to '*a pyramid selling scheme'*. Poor risk assessment and inadequate credit checking by online lenders were mentioned by other lenders, such as not checking bank statements or payslips. Rollover loans and ineffective regulation and enforcement against online lenders (for example, with regard to non-compliant websites) were also causes for concern. None of these would be directly resolved by the introduction of price restrictions.

The following sections report in more detail lenders' and trade associations' views about price caps.

13.1 Profitability and excess profits

One argument for introducing price restrictions in a market is where excess profit is made due to weak competition.

Previous work carried out by the OFT and Competition Commission considered the relationship between return on capital employed (ROCE) and weighted average cost of capital (WACC). In its home credit inquiry, the Competition Commission saw calculated ROCEs of 15.5% and higher as being indicative of excessive profit, or else 'substantially in excess' of the WACC, for a large lender. It concluded that profits in excess of the typical cost of capital for a large home credit lender were earned over the period 2000 to 2005 by a small number of firms that represented a substantial part of the market. This conclusion was challenged vigorously by lenders (Competition Commission, 2006).

The OFT's 2010 review of the high-cost credit sector looked at home credit, pawnbroking and payday lending. It was only able to draw limited conclusions because of data issues, including lenders operating in more than one product market (OFT, 2010). With this caveat in mind, it concluded that a number of pawnbrokers and home credit lenders earned profits in excess of their cost of capital. In contrast, the majority of rent-to-buy retail credit providers appeared to be making losses or profits below their cost of capital (OFT, 2010). Therefore, there is little robust evidence about excess profitability with the exception of home credit.

As part of this research project, BIS was interested to understand how lenders might demonstrate that they were not making excess profits from short-term credit products. It was not in the remit of the research to analyse the profits made by lenders or to assess whether or not these profits were excessive.

> *So what is a way of showing that we're not too profitable? Shutting shop?* (Small retail lender)

All but one of the firms in the Business Survey was making a profit. A few had only recently moved into profit. The one lender that was not making a profit was a small specialist online payday lender, which had recently started lending in the UK.

Lenders in the Business Survey did not consider their firms to be making 'excessive' profits, and argued that it was not possible to make excess profits in the sorts of competitive markets in which they operated. The idea that lenders should be penalised in some way for making profits was, in their view, counter-intuitive and counter-productive. And, if lenders were penalised for making profits, what about corporations such as Google, Amazon, Barclays and Tesco that made very large profits indeed?

In order for it to be measured, the concept of excess profits would have to be defined. Return on capital employed seemed to be the common measure for assessing profit levels, and lenders already produced accounts and management information that showed the profits they made and could be used to assess whether or not these were in some way excessive. For retail lenders, the task would be more challenging because they had a number of separate income streams that comprised their business (including non-credit product lines), and they did not always account for these separately.

13.2 The structure of a price cap

Business Survey respondents were generally against any form of price restriction, however it might be structured. A price cap based on the annualised percentage rate (APR) was considered by respondents to be wholly inappropriate for short-term loan products. In an alternative approach, the Consumer Credit (Regulation and Advice) Private Members' Bill proposed a maximum total charge for credit which:

1. Must reflect the cost of providing credit in a properly functioning competitive credit market or be designed to eliminate excessive risk taking by consumer credit lenders and borrowers,
2. Must be expressed as the maximum total charge for credit permissible per £100 advanced, calculated on an annualised basis, and
3. May reflect the different duration of credit agreements.

The Business Survey responses highlighted two issues in relation to the Bill. First, respondents were unclear about how the total charge for credit envisaged in the Bill would be calculated and how it related to the total charge for credit set out in the Consumer Credit Directive, on which the APR is predicated.[35]

Second, there were concerns about the inclusion of late payment or default charges in the total charge for credit, because the majority of borrowers do not incur these charges. As noted in section

[35] The Total Charge for Credit Regulations in the Consumer Credit Directive set out what must be included in the TCC to the consumer and how this must be expressed as an APR.

9.3, lenders that provide home credit or pawnbroking often do not make any charges other than interest. Respondents also questioned how default charges would be calculated for inclusion in the total charge for credit, and how it could be explained to borrowers without creating confusion.

In addition, the Bill raised the concept of a price cap that varies by credit product. The lenders who took part in the Business Survey generally acknowledged that, in theory, a variable price cap would be appropriate in the UK's complex credit market. But again lenders raised questions about how a variable cap would operate in practice, particularly how it would be monitored and reviewed. For example, the nine home credit lenders in the Business Survey offered a total of 27 different loan terms between them. Many of these 27 loan terms were only offered by one company, and none of the loan terms was offered by more than three firms. so presumably each loan term would be subject to a different cap. And to ensure a level playing field, lenders felt strongly that any price cap should apply equally to other credit products, such as overdrafts.

13.3 The level of a price cap

No proposals have been mooted in the UK about the potential level of a price cap in the credit market. At present, there is a cap on the level of interest that credit unions can charge on loans, set at 2% per month or 26.8% per year (as mentioned in section 12.4, discussions are ongoing about the possibility of raising this cap). Following the Competition Commission's 2006 report on their market investigation into store card credit services, store card statements for cards charging more than 25% APR must remind the customer that they may be able to access cheaper credit elsewhere, but there is no price restriction.

> *If [bank name] can argue that just going overdrawn by £10.00 unauthorised means it warrants them a cost of, what is it £5.00 a day or £6.00 a day on £10.00, just crunch the numbers on APR on that, if they can argue that's necessary, sustainable and defendable then it just makes a mockery.* (Large retail lender)

The Business Survey highlighted the wide range of prices charged by lenders for different credit products, with notable differentials between store-based and online loans. Lenders in the Business Survey were asked about the potential impact on their activities of (a) a price cap based on their current price structure, and (b) a price cap that was set below their current price structure.

13.3.1 Home credit

The variety of home credit loan terms makes it difficult to compare the costs of loans from different home credit companies on an exact like-for-like basis. Generally speaking loans from medium-sized companies in the Business Survey tended to be the most expensive and the lowest rates were offered by some of the small companies. The idea of a variable cap implies that a different cap would be set for loans of different loan terms, which are considered by the home credit industry to constitute distinctive loan products.

If a price cap was set at their current rates, most home credit lenders in the Business Survey considered that they would probably continue to lend. Depending on how the price cap was set (e.g. whether or not it was a cross-product average), home credit lenders might cease to offer very short term loans (e.g. 14-16 week loans) because they would not be profitable. This was counter-intuitive to lenders, however, because these loans tended to be popular with customers, had lower default rates than longer-term loans, and were integral to lenders 'low and grow' model of new customer acquisition. A move to longer-term loans (e.g. more than 52 weeks) was rejected by some lenders on this basis; others said they might consider it. Other responses mentioned by lenders included focusing more on existing customers, and reducing collection costs e.g. by increasing the size of agents' rounds.

> *In practice the rounds will get smaller, it's just the way that it happens, so initially the customers would stop being served, certain agents would lose their jobs and in the medium term we wouldn't end up collecting the same money every week and doing the same issue every week, it would be less and it would spiral down... It becomes untenable.* (Medium-size home credit lender)

Most home credit lenders were doubtful they would continue lending if a price cap was set *below* their current rates. This was true of large, medium and small lenders. Again, responses such as ceasing to offer short-term loans, tightening lending criteria and efforts to reduce costs were discussed. But while these were possible in theory, in practice lenders considered that the home credit business model would be undermined and become unsustainable if a low price cap was introduced.

Only one (medium-sized) home credit lender mentioned the possibility of diversifying into other credit products (payday loans).

13.3.2 Pawnbroking and retail payday lenders

For some store-based lenders in the Business Survey, payday lending was the major part of their business; a few focused much more heavily on pawnbroking; while non-credit activities such as retailing second-hand goods and buyback were the main income streams for a few of them. Depending on their product mix, therefore, retail lenders could potentially shift to other business activities if a price cap was introduced that made some or all of their lending activities less attractive or unsustainable.

Pawnbroking

Most lenders in the Business Survey charged between 7-8% per month for pawnbroking, although it could be as low as 5% per month (offered by a small lender on some items) or 2.9% per month (offered by a large lender on high-value loans). Lenders generally considered that they would continue pawnbroking if a price cap based around their current rates were introduced. Where pawnbroking was a small part of their business, lenders would be likely to focus more on alternative income streams.

For at least some lenders, a cap set *below* their current price structure would make pawnbroking unsustainable, particularly for very small-value loans. A few small lenders in the Business Survey went as far as to indicate the levels at which they believed this would occur, which ranged between 2% and 4% per month.

Payday loans

The charges for in-store payday loans varied widely, depending on whether the customer paid by cheque or by debit card using a continuous payment authority. Among the lenders in the Business Survey, the charges for payday loans were typically expressed as a percentage per month. Rates for cheque-based payday loans ranged from 10% charged by a small lender to 17.99% charged by a large lender; most charged somewhere between 13% and 15%. For payday loans repaid by continuous payment authority, the rates ranged from 15% to 30%, but with most between 20-25%.

If a price cap was introduced at the sorts of rates they currently charged for payday loans, a few lenders (both large and small) considered that they would be able to continue lending much as they were now. Other lenders were less sure. One concern was the impact of a price cap based on some industry average, given the variation in charges described above. This would, in the lenders' opinion, reduce pricing flexibility and therefore their ability to compete, with the possibility that some borrowers might end up paying more than they do now. One small lender had already started to move away from payday lending due to the difficulty of finding a profitable business model in the face of online competition; a price cap would probably hasten this process, and result in the lender focusing more on its buyback activities, which are not covered by consumer credit legislation.

Most lenders in the Business Survey expressed uncertainty or considered it unlikely that they would continue to offer payday loans if a price cap was set *below* their current charges. For the most part, payday lending was not in any case their core business activity. In the face of a low cap for payday lending, they would probably switch away from payday lending to concentrate on other activities, notably buyback or pawnbroking. Where mentioned, the rates at which lenders considered payday lending to be unsustainable ranged from £10 to £12 per £100 (mentioned by one small and one large lender), to £7 or £8 per £100 (mentioned by a small lender). It is important to note that these lenders mainly operated cheque-based payday lending. Payday loans repaid by continuous payment authority were higher cost than those repaid by cheque.

For large lenders whose primary business was retail payday lending, a price cap below their current rates would either result in efforts to reduce costs, tighten lending criteria, or exit from the payday market (or in one case the credit market) altogether.

13.3.3 Online payday lenders

The interest rates charged by online lenders in the Business Survey for payday loans ranged from 1% per day to 25% (i.e. £25 for every £100 lent) for a 28 day loan and 36% for a 30 day loan. If a cap (or caps) were introduced at these sorts of rates, online lenders generally considered that they would be able to continue lending. They felt that some adaptation of their business models would still be required, however, such as diversifying into other products such as instalment loans or goods sold on credit; tightening their lending criteria so that they stopped serving some customers; or reducing the scale of the business (or at least not continuing to invest in it).

If a price cap was introduced *below* their current rates, one large online lender considered that it would be able to continue lending only by further tightening its lending criteria. Given the proportion of loan applicants that online lenders already refuse, this implies that considerably fewer than 10 per cent of online applicants would be successful.

One small online payday lender (that charged £36 per £100 on a 30 day loan) considered that its business would probably not be viable if a price cap was set below its current charges, and certainly not if a cap were set around £27 per £100 (or three-quarters of its current rate). Similarly, the online lender that offered instalment loans regarded £30 per £100 as the point at which its business would become unsustainable.

13.4 Other possible consequences of introducing a price cap

The report from the OFT's review of high-cost credit identified a number of unintended consequences said to result from price controls (which in most cases referred specifically to interest rate ceilings; OFT, 2010). These include reduced choice and access for consumers who are not vulnerable to detriment; reduced diversity and competition within the market; the possibility that prices gravitate up towards the ceiling; less transparent pricing; displacement to less desirable types of credit; and for online lending, the potential for this to continue from locations beyond the reach of UK legislation.

Lenders and trade associations in the Business Survey were asked about the possible (unintended) consequences of introducing a price cap or caps in the UK. These were discussed in relation to a price cap, however structured, although the extent of the impact may differ depending on the nature and level of the cap.

Many of the issues they raised echo the arguments raised in the OFT report (OFT, 2010). As noted above, for retail lenders that already offered buyback on retail goods, increasing this side of their business was a real possibility because it falls outside consumer credit legislation. As described in section 6.2, buyback was often more expensive than pawnbroking.

One trade association representative described the risk of creating a 'culture of avoidance', with lenders devising ways of working around a price cap. Some of the possible work-rounds mentioned in the Business Survey included:

- the development of new products that fall outside consumer credit law
- an increase in credit linked to the purchase of retail, which could result in consumers paying heavily-inflated prices for goods (unless the price of goods were also closely controlled)
- the addition of extra charges that were not included in any legislation e.g. application fees, dormancy fees
- for home credit, the introduction of default charges which would result in less transparency for consumers and undermine the home credit model
- for online lenders, cross-border or offshore lending would be an option.

The main impacts of any price cap for consumers were felt to be reduced credit supply by regulated lenders, with some consumers potentially using unregulated lenders instead; less choice of credit products for those consumers that still had access; and the risk of less transparent pricing structures that in turn threatened to undermine competition.

13.5 Default charges

Although lenders in the Business Survey were concerned about the idea of default charges being included in a cap on the total charge for credit, there was nonetheless some support for more effective controls on default charges. Several lenders (notably retail lenders) were aware of examples of borrowers being charged '*dodgy fees and extras'*, with non-trade association members and online payday lenders thought to be the main culprits.

> *I think there's too many excuses, there's too many ways to apply fees... there's just not enough transparency around when and how these fees are applied and it's too easy to manipulate the customer...*(Online instalment lender)

Views were mixed, however. Some lenders considered that default charges were already covered adequately in existing legislation and regulations. As home credit lenders did not generally levy default charges, this was something they felt applied to other lenders rather than them. There were, though, several lenders from different sectors who did feel there was possibly merit in limiting or capping default charges where these were applied.

One large retail lender already operated a policy whereby borrowers who took out an instalment loan were never charged more than double the amount they had originally borrowed.

14 Evaluating the evidence: the potential role for a cap on the total cost of credit

A price restriction, in the form of a cap on the total cost of credit, has been proposed in the UK to reduce the cost of short-term credit to consumers. The remit of this research was to provide an up-to-date evidence base on the pros and cons for business and consumers of introducing such a cap to help inform policy decision-making in this area. It was not within the scope of the study to make recommendations about whether or not such a cap should be introduced.

This final section draws together the evidence from the study to examine:

- The extent to which cost is an issue for consumers who use the short-term credit market.
- Competition and profit in the short-term credit market.
- The likely impact of a price cap on the cost that consumers pay for short-term credit.

It also considers other issues for consumers in the short-term credit market and how these might be addressed.

14.1 To what extent is cost an issue for consumers who borrow in the short-term credit market?

This study considered the cost of short-term credit in relation to two main components of cost: the total charge for credit; and default charges.

14.1.1 Total charge for credit

The costs associated with lending small sums of money over short periods of time to people on low incomes or with a poor credit history are high (Collard et al, 2010; Kempson and Collard, 2005), and this is the case even on a not-for-profit basis (Kempson et al, 2009). In line with previous studies, the Business Survey for this research indicated that this is due to:

- High refusal rates (also driven by fraudulent applications for online loans);
- Bad debt;
- For large lenders, the cost of wholesale borrowing.

These costs are reflected in the price paid by consumers. The Business Survey indicated that pawnbroking is the least costly of these types of credit in terms of interest charges, because it is secured. Online borrowing is by far the most costly and online lenders were also more likely to charge additional fees, such as optional charges for faster payment. Analysis carried out by the OFT and Which? indicated that payday loans may, in some circumstances, be cheaper than an unauthorised overdraft.

In the Consumer Survey for this research, customers recognised that short-term credit was an expensive form of borrowing and that there were cheaper types of credit, although they might not have access to them and in some cases were concerned about the dangers of using revolving credit such as credit cards and overdrafts. Customers were generally aware of the cost of borrowing when they took their loan out, the majority having considered some form of cost information. Upwards of six in ten customers said that the total amount they had to repay was about what they had expected; for up to three in ten, however, the total cost was reportedly more than they had expected.

14.1.2 Default charges

In the Business Survey, lenders' approaches to default charges varied by credit type. Home credit lenders and pawnbrokers generally reported that they did not charge their customers default fees. In contrast, penalty charges for missed payments were common among retail and online payday lenders. The level and structure of default charges made by payday lenders varied widely and in some cases seemed high relative to loan size.

The majority of customers in the Consumer Survey said they had not incurred extra fees such as a penalty charge or a default letter fee. Between one per cent and 10 per cent of customers in the Consumer Survey had incurred extra charges, depending on the type of short-term credit they had used. All other things being equal, customers who had used a pawnbroker or a payday lender had higher odds of incurring extra charges than home credit customers. This is partly because home credit customers who miss payments are not considered by lenders to be in default, as long as they arrange to make up what they owe, for which there is no additional cost. This means that home credit customers can end up repaying their loan over a much longer period than they expected. Even so, the built-in flexibility of home credit loans is one of their main attractions for low-income borrowers.

14.2 Competition and profit

One argument for introducing price restrictions (such as a cap on the total cost of credit) is where weak competition in a market results in high prices and excess profits. The Competition Commission and the OFT both previously identified a lack of price competition in the home credit, pawnbroking and payday lending markets, explained by evidence that showed consumers in these markets valued other factors above price.

In the Consumer Survey for this research, customers generally placed greater emphasis on convenience and access to credit than the cost of credit when taking out a short-term loan. As a result, most customers did not compare the cost of loans from different lenders of the same type, much less other types of lenders. Online payday loan customers were more likely to find out the cost of loans from other payday lenders than their counterparts, however.

Lenders in the Business Survey reported their respective markets to be competitive both on price and other factors. There appeared to be greater variation in the prices charged by payday lenders than among home credit lenders and pawnbrokers. Across the board, smaller lenders in the Business Survey tended to charge less than larger ones. Based on previous studies carried out by the Competition Commission and OFT, there is limited evidence of short-term lenders making excess profits. In the Business Survey for this research, most lenders were making a profit, although for some this was relatively recent.

14.3 What impact would a cap be likely to have on the cost that consumers pay for short-term credit?

The international evidence considered for this research related to price restrictions of any type, not specifically a cap on the total cost of credit. In the absence of firm proposals for the level and structure of a cap (or caps) on the total cost of credit in the UK, lenders in the Business Survey for this research also talked more generally about the likely impact of a price cap.

14.3.1 Total charge for credit

The evidence indicates that price restrictions (typically in the form of interest rate restrictions) do not necessarily reduce the cost of credit paid by borrowers. In some countries, credit price re-structuring in response to a price cap resulted in customers paying more than they did before. This is potentially less of an issue if legislation prohibits any and all forms of additional charges or fees that could be levied. Even so, there is a risk that the cost of borrowing becomes less transparent to consumers and that lenders would find innovative ways of adding charges.

There is some evidence (from one state in the US) that credit prices gravitated over time to the level of the price cap. As a result, consumers would on average end up paying more for their borrowing. This depends on whether or not the cap is set at a level above the price that lenders typically charge.

Smaller lenders in the Business Survey for this research tended to charge less than their larger counterparts, so in theory they may be expected to stay in the market if a cap was introduced. In fact, the Business Survey and international evidence suggested that smaller lenders were more likely than larger ones to exit the market if a price cap was introduced. This was because small lenders' business models would no longer be viable if a price restriction was set below their current charges and any costs to business associated with the introduction of price restrictions would be likely to have a disproportionate effect on small businesses.

14.3.2 Default charges

The proposal for a cap on the total cost of credit in the UK includes restricting extra fees and default charges. In the Business Survey for this research, some short-term lenders (of different types and sizes) felt there was potentially a case for curbing default charges. They were unclear, though, how default charges could be included in a cap on the total cost of credit, given that most customers did not default on their loans. That said, one lender in the Business Survey already operated a policy whereby its instalment loan customers were never charged more than double the loan principal in default charges. Another approach (which was not raised in the Business Survey) might be to limit the number of times default charges could be levied on a loan, thereby indirectly placing a limit on the total that is charged.

One or two respondents in the Business Survey raised the possibility that restrictions on default charges would result in short-term lenders exercising less forbearance than they currently do. In order to recover the costs of lending, there would be a greater incentive for lenders to pursue non-payers more rigorously.

In addition, the introduction of any price restriction may result in lenders starting to charge default fees where currently they do not make any additional charges. This would particularly affect home credit, where default charges are rarely applied. At the time of the Consumer Survey, around a third of home credit customers had missed at least one loan repayment.

14.4 Other possible impacts of a price cap

Aside from the potential impact on the cost of credit for consumers, international evidence and the evidence from this research indicated that a price cap may impact on access to credit and the types of credit products offered by lenders. There exists relatively little empirical evidence about the impact on enforcement and regulation of introducing a price cap.

14.4.1 Access to credit

International evidence and the Business Survey for this research indicated that smaller lenders (which also tended to be cheaper) would be likely to exit the short-term credit market, reducing the overall supply of credit in local communities. This would in turn potentially reduce competition at the local level. In terms of specific credit products, evidence from one US state indicated that payday lending would continue to grow if a relatively high price cap were introduced. The Business Survey showed that a price cap may reduce the availability of short-term home credit loans. Pawnbroking would probably continue broadly as now, unless a very low cap was introduced.

International evidence and the Business Survey indicated that the introduction of a price cap would result in lenders tightening their lending criteria. This provides a strong incentive for lenders to improve their risk assessment methods, including the way in which they assess affordability. It would arguably highlight the value of better data-sharing and credit referencing systems, particularly in the payday lending industry. This in turn may help prevent customers taking out loans they cannot afford to repay or taking out multiple loans from different lenders at the same time.

On the other hand, if lenders tighten their lending criteria as the result of a price cap, this would restrict access to credit for certain types of consumers; opinion is likely to be divided on whether this is a positive or negative outcome for a cap. Lenders would focus on existing good-paying customers more than new customers. And they would retreat from serving low-income borrowers and those excluded from mainstream markets. They would stop lending to higher-risk consumers including those who have a propensity not to repay their short-term loans on time. These include lone parents and people with larger value loans. Another high-risk group are consumers who are in difficulties on other bills and commitments. The Consumer Survey showed that between 26 per cent and 46 per cent of customers had experienced difficulties paying household bills or other commitments in the past 12 months. These were disproportionately customers with a bad credit history, customers who had experienced a general decline in their financial situation in the last five years and non-White customers.

The Consumer Survey for this research also showed that if customers could not access short-term loans, most would either go without or turn to a friend or relative for help. A small number would try and borrow from somewhere else, including from another short-term lender. Using an illegal lender was something that the vast majority of customers would not currently consider. Proposals for the expansion and modernisation of credit unions and other community finance lenders in the UK might help off-set any reduced access to short-term credit that resulted from the introduction of a price cap.

As evidenced elsewhere and in this research, if customers went without the money, a proportion of them would default on other commitments (notably household bills) or reduce their basic standard of living. This was more likely to be the case among pawnbroking and payday loan customers who depended heavily on short-term credit to make ends meet. For others (notably home credit customers), going without the money more often meant forgoing more-or-less discretionary items that nonetheless enhanced their quality of life in the short to medium term.

14.4.2 Types of products

While there is a possibility of new credit products being developed, the evidence points to reduced rather than increased diversity following the introduction of a price cap.

The Business Survey for this research indicated that home credit lenders were likely to withdraw very short-term (14-16 week) loans if a price cap was introduced. The high fixed costs of providing these loans would make them unprofitable. At the same time, these loans were popular with customers, they carried lower default rates and they were a means for lenders to manage risk for new customers through a strategy of 'low and grow'. The scope for home credit lenders to diversify into other credit products was not viable because of the particular model they operated.

Other evidence showed that, if cash loans were less readily available because of a price cap, consumers might instead use rent-to-own companies such as BrightHouse. There was also the possibility that short-term lenders might diversify into credit linked to the purchase of goods, with the risk that consumers pay inflated prices for these goods (unless prices are also controlled). Diversifying into credit linked to the purchase of goods was not generally considered to be a viable option by the lenders in the Business Survey for this research.

The Business Survey indicated that retail lenders currently offering payday loans would be likely to shift to other activities, and in particular pawnbroking, sale and buy-back of goods (which is not covered by consumer credit legislation) and the purchase of second-hand goods for resale. Some had already started to move away from payday lending and increased their other areas of business. In the Consumer Survey, selling goods to raise money was seen as an acceptable alternative by consumers who currently used short-term lenders. Online payday lenders would potentially move to longer-term instalment loan products that were not subject to a price cap.

It also seems likely that the scope for lenders to allow customers to roll over or extend their payday loan would be reduced if a cap on the total cost of credit was introduced. This is because lenders would be less able to levy multiple interest charges on the same loan and still comply with a cap.

14.4.3 Regulation and enforcement

There exists little empirical evidence about the impact of price restrictions on regulators or the costs of enforcement. The OFT previously concluded that the introduction of any price cap would be complex, expensive and difficult to administer (at least under the extant regulatory regime). In the Business Survey for this research, lenders considered that a variable cap on the total cost of credit (including default charges) would add to the complexity of setting, monitoring and reviewing such a policy. The costs of implementing new regulation would be likely to have the biggest effect on small lenders.

By contrast, consumer representatives in Australia considered the introduction of a price cap to have made enforcement more straightforward and, by extension, cheaper. It was also thought to have led to a reduction in the number of debt advice cases.

One possible unintended consequence of a price cap is that lenders move their businesses out of the UK, and operate from another jurisdiction that does not have any price restrictions. This is particularly relevant to online lending and it could create regulatory arbitrage whereby identical-looking online lenders are subject to different rules.

In the Business Survey for this research, lenders and trade association representatives felt strongly that, were price caps to be introduced, they should apply across the credit market, not just to the short-term lenders that were the focus of this research. Any caps should, in their view, cover other products such as credit cards and overdrafts, auto title (logbook) loans, and rent-to-own credit.

The key findings from sections 14.1 to 14.4 about the cost of credit and the possible impact of introducing price restrictions are summarised in the box below.

Key findings on the cost of credit and the possible impacts of price restrictions in the short-term lending market (sections 14.1 to 14.4)

- The headline costs of home credit, pawnbroking, retail and payday loans are high relative to other forms of credit. Although they were aware of the (high) cost of their loans, customers of short-term credit were generally price insensitive. They valued other factors above price and would still borrow if the cost was higher.
- For a minority of customers, particularly of *pawnbroking* (28 per cent), the credit they used cost them more than they expected.
- Default charges made by some *payday lenders* seemed high relative to loan size.
- Default charges were rarely levied by the *home credit* companies and only one per cent of customers had incurred any extra fees.

Possible impacts of price restrictions on lenders and markets

- The headline prices charged by lenders may tend to migrate towards the level of the cap.
- Some lenders, particularly the smaller ones (which tend to have lower charges), may exit the market. Their business model would no longer be viable if a price restriction was set below their current charges. Any costs to business associated with the introduction of a price restriction would also be likely to have a disproportionate effect on small businesses.
- The supply of credit by regulated lenders would reduce and competition within the sectors could be weakened.
- Lenders may tighten their lending criteria, restricting access for some types of consumers.
- Risk assessment practices – particularly in the *payday lending* industry – may improve, reducing the proportion of customers who are unable to repay their loan as they should.
- The scope for lenders across the markets to allow consumers to extend their loans would reduce.
- Restrictions on default charges could result in short-term lenders exercising less forbearance than they currently do. For *home credit* in particular, the introduction of a price cap could lead lenders to start levying default charges where they currently do not.

- *Online lenders* may move off-shore which could create regulatory challenges.
- *Home credit* lenders are likely to withdraw very short-term loans, which are popular with consumers and are integral to lenders 'low and grow' model of new customer acquisition.
- Lenders would be likely to focus on other areas of their business, particularly sale and buy-back of goods and the purchase of second-hand goods for re-sale among *retail lenders*, and longer-term instalment loans among *online lenders*.

Possible impacts of price restrictions on consumers

- Some consumers may find that they pay less for their loans (or their equivalent) than they previously did; others will find they pay more. There is no evidence about the proportion of customers who pay or more or less for short-term credit after a price restriction is introduced.
- Access to credit may reduce, particularly for low income or other vulnerable consumers.
- If consumers could not borrow from a short-term lender, a large minority (upwards of one in three) would go without the money. For many *pawnbroking* and *payday loan* customers this would mean that they would be unable to meet household bills or other essentials.
- If it caused lenders to tighten their lending criteria, a price restriction may reduce the detriment experienced by customers, especially of *payday loans*, who are able to take out loans they cannot afford or multiple loans from different lenders at the same time.
- Customers, of *home credit* in particular, may incur default charges where they did not do so previously; non-payers in other markets may also be shown less forbearance.
- Pricing structures may become less transparent for consumers, making it more difficult for consumers to compare products and lenders based on price.
- The diversity of the products that are available may reduce, resulting in less choice for consumers. In particular, the availability of short-term *home credit* loans is likely to reduce.
- Consumers may be more likely to turn to alternative forms of borrowing, particularly from friends or family, using rent-to-own companies, or – among current customers of *pawnbroking* in particular – selling goods to raise cash.
- 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 the option of using 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).

14.5 Other issues for people who use short-term loans

In the Consumer Survey for this research, the majority of customers reported high levels of satisfaction with the short-term lenders they had used. Across the credit sectors, the main reason for satisfaction was customer service. Among payday loan customers, satisfaction also reflected the convenience of borrowing and the speed of the loan decision. The Depth Interviews with customers and debt advice clients indicated that the ability to access short-term credit in the absence of other options was a source of satisfaction as well. Most customers in the Consumer Survey reported that they would either borrow from the same type of short-term lender again if they needed to borrow a similar amount, or they would borrow from friends or family.

Nonetheless, there are other issues in the short-term credit market, apart from cost, that are of potential concern. These relate to (1) consumer vulnerability and affordability; (2) financial difficulty; and (3) multiple and repeat borrowing. These issues are considered sector-by-sector in the following sections.

14.5.1 Home credit

Although a high proportion of home credit customers were classified as vulnerable consumers (following the OFT's definition; Burden, 1998), in fact there was relatively little evidence to suggest that customers could not afford their loans or were borrowing to make ends meet. An apparent dependency on home credit did not seem to reflect financial difficulty but rather long-term poverty.

Consumer vulnerability and affordability

Following the OFT's definition of vulnerable consumers (Burden, 1998), a high proportion of home credit customers in the Consumer Survey (77 per cent) were classified as vulnerable based on a measure that comprised age, employment status, income and ethnicity. This reflected that a high proportion of home credit customers were on low incomes (72 per cent) and that a large minority were over State Pension Age (23 per cent). Customers of home credit were the least likely to have access to mainstream credit (10 per cent).

Most home credit customers (94 per cent) were asked for information about their income and outgoings before taking out a loan, as evidence of their ability to afford the loan.

Financial difficulty

Compared with other short-term credit users, home credit customers were least likely to have financial difficulties on other commitments (26 per cent).

The home credit loans they took out were generally used to spread the cost of larger, one-off discretionary expenses. Compared with customers of other short-term credit, a relatively small proportion of home credit customers used their most recent loan to pay for day-to-day essentials or household bills (22 per cent).

A third of home credit customers had missed at least one loan repayment on their most recent home credit loan; most of them had arranged with their lender to repay what they owed, and would not have incurred default charges

Multiple and repeat borrowing

Most home credit customers (57 per cent) already had a loan with the same lender at the time they took out their most recent home credit loan. The new loan was generally used (at least in part) to pay off their existing loan. Almost a half of home credit customers (45 per cent) had at least one other home credit agreement at the time of the Consumer Survey. This may explain why more than half of them (52 per cent) agreed that home credit *'trapped me into a cycle of borrowing'.*

14.5.2 Pawnbroking

Based on the OFT's definition, the majority of customers who borrowed from a pawnbroker were vulnerable consumers. They showed signs of financial difficulty and generally used short-term credit to make ends meet. That said, most pawnbroking customers were able to repay what they owed and redeem their goods.

Consumer vulnerability and affordability

The majority of pawnbroking customers in the Consumer Survey were classified as vulnerable consumers (77 per cent) according to the OFT's definition. This reflected the fact that seven in ten had low household incomes and a comparatively high proportion of them were non-White (22 per cent). A minority (18 per cent) had mainstream credit options that they could potentially have used. They also had the option of selling the goods they had pledged.

Unlike home credit and payday lending, loans from a pawnbroker are secured against the goods pledged by the customer. Because of this, risk assessment is mainly about assessing the value of the goods

Financial difficulty

Pawnbrokers were generally used to bridge an acute gap between household income and pressing expenditures. The majority of customers in the Consumer Survey borrowed from a pawnbroker to pay for everyday expenses or household bills (52 per cent).

A relatively high proportion of pawnbroking customers had been unable to pay household bills or missed payments on credit commitments in the last 12 months (45 per cent), suggesting that they found it difficult to make ends meet.

For customers whose most recent pawnbroker loan had already fallen due at the time of the survey interview, a significant proportion (38 per cent) had been unable to repay as they should. One in seven of these customers (14 per cent) had renewed their loan. The rest had come to an arrangement with the lender, taken some other action, or (in 12 per cent of cases) forfeited their items.

One in ten pawnbroking customers (10 per cent) had borrowed or planned to borrow in order to repay their most recent loan, which was slightly higher than home credit and payday loan customers.

Multiple and repeat borrowing

On average, customers had taken out 2.5 loans from a pawnbroker in the last 12 months (bearing in mind that the average pawnbroking agreement is for six or seven months, although borrowers can repay early). A relatively small proportion had two or more loans from a pawnbroker at the time of the survey (25 per cent). Most pawnbroking customers did not agree that this type of credit *'trapped me into a cycle of borrowing'* (58 per cent did not agree).

14.5.3 Retail payday lending

Compared to home credit and pawnbroking, a lower proportion of retail payday loan customers were vulnerable consumers according to the OFT's definition. While most were able to repay their loans on time, significant numbers of retail payday loan customers showed signs of financial difficulty and relied on short-term payday loans to make ends meet.

Consumer vulnerability and affordability

Six in ten retail payday loan customers in the Consumer Survey were classified as vulnerable consumers according to the OFT's definition. This was lower than home credit and pawnbroking, mainly because those using retail payday loans were much more likely to be in work and had higher household incomes as a result. A significant minority of retail payday loan customers were non-

White (18 per cent), the second highest proportion after pawnbroking customers. Only a small proportion of retail payday loan customers (14 per cent) had mainstream credit options they could have used.

Almost all retail payday loan customers (97 per cent) said they were asked for information about their income and outgoings before taking out a loan, as evidence of their ability to afford the loan.

Financial difficulty

Two-thirds of retail payday loan customers in the Consumer Survey borrowed to pay bills or for everyday expenses (66 per cent), the highest proportion across the four types of short-term credit.

And of all customers in the Consumer Survey, those who used retail payday loans were most likely to have missed consumer credit repayments or been unable to pay household bills in the last 12 months. Almost half of customers (46 per cent) had missed payments, indicating that their household finances were tight.

For the most part, where customers' most recent retail payday loan had already fallen due, they had paid it to term. A quarter (26 per cent) had not paid their loan as they should, however. One in seven (14 per cent) had renewed their loan; the rest had made an arrangement with the lender or taken some other action. A small number of customers had renewed their loan three or more times (seven per cent).

Multiple and repeat borrowing

Although most did not have multiple retail payday loans at the time of the survey, 22 per cent of customers in the Consumer Survey did have two or more loans. This was more than twice the number of online payday loan customers with multiple loans (10 per cent). With an average of 5.1, the number of retail payday loans in the past 12 months was also high compared with online payday loans (average 3.0). This may help explain why 64 per cent of customers (the highest proportion across all four sectors) agreed that retail payday loans *'trapped me into a cycle of borrowing'*.

14.5.4 Online payday lending

Online payday loan customers were rather better off than other short-term credit users and somewhat more likely to have the option of using mainstream credit. Although most were asked to provide information about their income and outgoings, the proportion was lower than among other short-term credit users.

Consumer vulnerability and affordability

Online payday loan customers were much less likely to be classified as vulnerable consumers based on the OFT's definition than other short-term credit users (37 per cent). Nine in ten were in work, and the majority were not on a low income (69 per cent). Compared with other short-term credit customers, more online payday loan customers had mainstream credit options available to them, although this remained low at 24 per cent.

Most online payday loan customers had been asked to provide information about their income and outgoings when they took out their most recent loan or on a previous occasion (87 per cent). But 11 per cent said they had never been asked, a much higher proportion compared with the three other types of short-term credit. Only a small proportion of online payday loan customers had been asked to provide proof of income (six per cent) or copies of bank statements (three per cent) when they applied for their most recent loan.

Financial difficulty

The most common reason for taking out an online payday loan was to pay for everyday expenses or household bills (54 per cent). Compared with their retail counterparts, online customers were twice as likely to borrow to pay for special occasions (15 per cent compared with seven per cent of retail payday loan customers).

The majority of online payday loan customers (59 per cent) had not experienced difficulties with consumer credit or household bills in the last 12 months. The fact that 41 per cent had experienced difficulties nonetheless seems relatively high, given their higher incomes and the fact that 14 per cent lived with their parents.

Among customers whose most recent online payday loan had already fallen due, only a small proportion had not repaid it to term (13 per cent). Ten per cent had renewed their loan; the rest had come to an arrangement with the lender or taken some other action. A few had renewed their most recent loan three or more times (three per cent).

Multiple and repeat borrowing

The incidence of multiple online payday loans was lower than among retail payday loan customers (10 per cent) as was the average number of loans in the past 12 months (3.0). As a consequence, most online payday loan customers did not agree that that this type of borrowing *'trapped me into a cycle of borrowing'* (58 per cent).

The key findings from section 14.5 about the other issues for people who use short-term loans are summarised in the box below.

Key findings on the other issues for people who use short-term loans

Vulnerability and affordability

- Many customers, particularly of *home credit* (72 per cent) and *pawnbroking* (70 per cent), were on low incomes.
- Mainstream credit was a feasible alternative for only a minority of customers, particularly *home credit* users (10 per cent).
- Only a small proportion of *online payday* loan customers said they were asked to provide proof of income (six per cent) or copies of bank statements (three per cent) when applying for loans.

Financial difficulty

- Large numbers of *pawnbroking* and *retail and online payday loan* customers used short-term credit to pay for everyday expenses or household bills.
- Large minorities of customers were in difficulty with other financial commitments, ranging from a quarter of *home credit* customers to more than four in ten of *pawnbroking* and *payday loan* customers.
- Significant numbers of *pawnbroking* (38 per cent) and *retail payday loan* customers (26 per cent) were unable to repay their most recent loan when it became due. Not repaying to term was an important factor in explaining why some customers had to repay more than they expected.
- A small proportion of customers had renewed their most recent loan (14 per cent in the case of

pawnbroking and *retail payday loan* customers, and 10 per cent of *online payday loan* customers). The rest had mainly come to an arrangement with the lender or taken some other action. Around one in eight *pawnbroking* customers (12 per cent) had forfeited the items they had pledged.

- In a small number of cases, *payday loan* customers had rolled over their most recent loan three or more times (seven per cent in the case of *retail payday loan* customers whose loans had already fallen due, and three per cent of *online payday loan* customers).
- A third of *home credit* customers had missed payments on their most recent loan. Most had come to an arrangement to repay what they owed, and did not incur any default charges.
- In some cases in the Depth Interviews, the use of short-term credit compounded or worsened existing financial difficulties.

Multiple and repeat borrowing

- Significant minorities of customers (up to 45 per cent of *home credit* customers) had two or more short-term loans when interviewed, in some cases from the same lender.
- While most customers had taken out no more than two loans in the last year, 56 per cent of *retail payday loan* customers *had* taken out more than two; and one in ten had taken out the equivalent of at least one loan per month.
- Significant proportions of customers, particularly of *retail payday loans* (64 per cent), felt that using this type of credit trapped them in a cycle of borrowing.

14.5.5 How might other issues in the short-term credit market be addressed?

Bringing together the evidence from each of the four credit sectors, the following sections examine how other issues in the short-term credit market might be addressed, including the potential impact of a cap on the total cost of credit.

Consumer vulnerability and affordability

The Consumer Survey showed that customers of short-term lenders, particularly those who used a pawnbroker or a retail payday lender, could be classed as vulnerable consumers (following the OFT's definition), and a high proportion had been unable to pay household bills or other commitments in the last 12 months. Most, however, had not renewed or extended their loans or defaulted on loan repayments.

Tightened lending criteria and improved checks on affordability at the point of sale of short-term loans would potentially reduce the proportion of vulnerable consumers who had access to short-term credit. These steps might also limit borrowing from short-term lenders among customers who had experienced financial difficulties in the past 12 months. The Consumer Survey showed that customers whose financial situation had deteriorated in the past five years and non-White customers had increased odds of experiencing financial difficulties in the past 12 months, regardless of the type of short-term credit they had used.

As noted earlier, the introduction of a cap on the total cost of credit could potentially result in short-term lenders tightening their lending criteria and risk assessment processes. Other drivers for change might include enforcement of the OFT's Irresponsible Lending Guidance, the development of better credit data sharing systems, and the implementation of the Good Practice Customer Charter for payday and other short-term loans.

Financial difficulty

In the Consumer Survey, a high proportion of customers used a pawnbroker or a payday lender to pay for everyday expenses or household bills. Regardless of credit type, customers whose financial situation had deteriorated in the past five years had higher odds of borrowing for these reasons. Factors such as low income, the cost of living and poor money management may all help explain why people borrow to pay for essential expenditure. It seems unlikely that a cap on the cost of credit would directly address this issue. Measures to help consumers in this situation might include encouraging them to contact their creditors or seek independent advice if they cannot afford to pay bills and commitments, and at the same time ensuring that creditors provide appropriate advice and support to customers in financial difficulty in line with regulatory and industry guidelines, including the Good Practice Customer Charter for payday and other short-term loans.

Most customers in the Consumer Survey were able to repay their short-term loan when it fell due. But significant proportions of pawnbroking and retail payday loan customers had not repaid their most recent loan as they should. This resulted in them either renewing the loan, coming to some other arrangement with the lender or taking some other action. Around one in eight pawnbroking customers who found themselves in this situation had forfeited the items they had pledged. Only a small proportion of customers overall had incurred default charges.

It was common for home credit customers to refinance their loans; if they refinanced to repay an existing loan, they may have been eligible for an early settlement rebate. Between 10 per cent and 14 per cent of pawnbroking and payday loan customers extended their loans; most did so once or twice. Previous authors have proposed restrictions on the number of times a payday loan can be extended (Burton, 2010). Two trade associations that represent payday lenders already stipulate a limit on the number of payday loan rollovers their members should permit. This also happens in some US states.

Multiple and repeat borrowing

Almost half of home credit customers had more than one home credit loan at the time of the Consumer Survey. The same was true of more than two in ten pawnbroking and retail payday loan customers. Regardless of credit type, customers were more likely to have two or more short-term loans of the same type if their financial situation had deteriorated in the past five years or if they had been unable to repay their most recent short-term loan when it fell due.

A cap on the cost of credit would not directly address this issue. Better data sharing systems, including real-time data sharing for payday loans, and the use of credit reference agency data at the point of sale might reduce the number of customers who had several short-term loans at the same time. In the US, some states limit the number of payday loans that customers can have, either at the same time and/or over a specific period of time.

14.6 Summary: What are the main issues in the short-term credit market and how might they be addressed?

BIS commissioned this research to better understand the impact on lenders and consumers of introducing a variable cap on the total cost of credit that can be charged in four short-term credit sectors: home credit, pawnbroking, retail payday lending and online payday lending. The remit of the research was not to make recommendations to Government on whether or not a cap on the total cost of credit should be introduced. Instead it has considered, in depth, the context of short-term credit use and examined new and existing evidence on the likely impact of introducing a price cap to help inform policy decision-making in this area.

The following sections summarise six main areas of concern indicated by this research and identify the short-term credit markets to which these concerns mostly relate. Other concerns related to the payday loan industry are the use of lead generators and brokers of online payday loans; and problems with the use of continuous payment authority to collect payday loan payments. In the Consumer Survey for this research, four per cent of online payday loan customers said they had applied for their most recent loan through a credit broker or other intermediary. Other online borrowers may not have been aware of using a broker or intermediary, however. The Consumer Survey included customers whose most recent payday loan was not yet due for repayment, as well as those who had repaid their most recent loan. Of the 1,451 short-term credit customers that participated in the Consumer Survey, four payday loan customers reported dissatisfaction with the lender they had used due to payment problems.

14.6.1 The total charge for credit

The Consumer Survey showed that potentially lower cost mainstream credit was not a viable alternative for the majority of short-term credit customers. People who use short-term loans pay a high charge for credit. The highest charges are made by online payday lenders, which is the most rapidly growing of the markets considered by this research.

Like previous research, the Consumer Survey showed that most borrowers do not conduct any form of price comparison before taking out a short-term loan. The exception was online payday lending, where 46 per cent of customers had compared costs before taking out their most recent loan.

Reducing the cost of credit would benefit short-term credit users by lowering credit repayments and increasing the amount of disposable income available to them. In theory, a cap on the total cost of credit would reduce the cost of short-term borrowing. The available evidence about the impact of price restrictions on the cost that consumers pay for credit relates to interest rate restrictions, however, not the total charge for credit. The evidence reviewed for this research does not show unequivocally that interest rate restrictions reduce the cost of borrowing to consumers, particularly those on low incomes. There is no evidence about the proportion of customers who pay less for short-term credit after interest rate restrictions are introduced than they did before.

14.6.2 Default charges

Home credit lenders and pawnbrokers do not generally charge for default. Retail and online payday lenders do, and the charges can be high relative to loan size. A small proportion of payday loan customers in the Consumer Survey were potentially affected by this issue: 10 per cent of retail and six per cent of online payday loan customers had incurred extra charges such as default fees.

Some lenders in the Business Survey felt there might be a case for curbing default charges. Others were concerned that restricting default charges to address poor practice might result in lenders showing less forbearance more generally. If price restrictions were introduced, home credit lenders that currently do not charge for late or missed payments might start to do so.

14.6.3 Affordability assessment

A major element of credit risk assessment is whether or not the loan or advance is affordable for the consumer. Poor practice in assessing affordability can result in consumers getting into (worse) financial difficulty because they are able to borrow from lenders even though they may not be able to repay what they owe. The OFT is responsible for compliance monitoring and enforcement action in the case of non-compliance to ensure that consumers can afford to repay what they are able to borrow.

In the Consumer Survey, the majority of short-term credit users said they had been asked by their lender for information that could be used to assess affordability, either when they took out their most recent loan or on a previous occasion. The proportion was lower among online payday loan customers (87 per cent, compared with 94 per cent of home credit and 97 per cent of retail payday loan customers). And only a small number of online customers had been asked for proof of income or bank statements when they applied for their most recent loan (although they may have provided them on a previous occasion).

The online lenders covered by the Consumer Survey may have used other ways of assessing affordability as substitutes for proof of income or bank statements. Even so, it remains a concern that so many borrowers could not recall being asked for this information.

14.6.4 Financial difficulty

The Wealth and Assets Survey finds a strong link between short-term credit use and measures of financial difficulty. In the Depth Interviews for this research, where people took out short-term credit to mitigate lost income or to avert existing financial difficulties, it generally compounded the problems that they faced rather than resolved them.

The Consumer Survey showed financial difficulty to be a widespread issue for people who used pawnbrokers, retail payday lenders and online payday lenders.

- Large proportions of customers used their most recent pawnbroker or payday loan to pay for everyday expenses or household bills (66 per cent in the case of retail payday loan users, 52 per cent of pawnbroking customers and 54 per cent of online payday loan customers).
- Significant numbers of these customers had missed payments on credit commitments or household bills in the past 12 months (46 per cent of retail payday loan customers, 45 per cent of pawnbroking customers and 41 per cent of online payday loan customers).

For customers who had already paid off their most recent short-term loan, most had repaid it in full when it became due. Significant minorities of pawnbroking and retail payday loan customers had not repaid their most recent loan as they should, however, leading them renew their loan (see below) or take some other action. For 12 per cent of pawnbroking customers in this situation, they had lost the items they had pledged. There was also evidence of customers borrowing to repay borrowing (either at the time of taking out a short-term loan or repaying it), particularly among pawnbroking customers (14 per cent) and retail payday loan customers (10 per cent).

If they were unable to access short-term credit as a result of the introduction of price restrictions, some of these customers would be likely to default on household bills or other payments, or default on them sooner. To prevent this happening, any reduction in access to credit would have to be offset in other ways, for example through the expansion of credit unions or by increased welfare benefits and wages. Other measures to help people who are unable to pay their bills include debt advice provided by creditors or independent advice agencies.

14.6.5 Multiple and repeat borrowing from short-term lenders

Previous research finds that any consumer credit increases people's risk of financial difficulties; the more credit commitments someone has, the higher the risk of difficulties.

Multiple borrowing was particularly evident among home credit customers in the Consumer Survey. Around half (45 per cent) had two or more home credit loans at the time of the survey interview, bearing in mind that home credit loans tend to be repaid over a longer term than payday or pawnbroker loans. Multiple borrowing was also notable among pawnbroking and retail payday loan customers in the Consumer Survey. Two in ten retail payday loan customers (22 per cent) and 25 per cent of pawnbroking customers had two or more of these types of loan at the time of the survey interview.

In terms of repeat borrowing, among retail payday loan customers the average (mean) number of loans in past 12 months was 5.1 loans. For pawnbroking customers it was 2.5 loans (bearing in mind that a standard pawnbroking agreement is six to seven months). Combined with the fact that these customers tended to borrow for everyday expenses or to pay household bills, this indicates that they used short-term credit to bridge recurrent shortfalls between their income and outgoings. The average for home credit customers was 2.3 loans in the past 12 months.

A cap on the cost of credit would not directly reduce the numbers of customers who take out multiple loans at the same time or borrow repeatedly from short-term lenders. This would require better data sharing systems and the use of credit reference agency data at the point of sale or a limit on the number of short-term loans that people can have, either at the same time and/or over a specific period of time. The measures outlined above to help people at risk or in financial difficulty would equally apply to in the case of multiple or repeat borrowers. They are in any case likely to be the same people.

14.6.6 Loan renewal

Loan renewal is possible for payday loans and pawnbroker loans. In the Consumer Survey, among the customers whose most recent loans had already fallen due, the numbers who had renewed their loan were small: 14 per cent in the case of both pawnbroking and retail payday loan customers and 10 per cent in the case of online payday loan customers. Repeated loan renewals can be a sign of financial difficulty. Rolling over loans three or more times was fairly uncommon in the Consumer

Survey: seven per cent of retail payday loan customers had rolled over their most recent loan three or more times, as had three per cent of online payday loan customers.

Two UK trade associations that represent payday lenders stipulate a limit on the number of payday loan rollovers their members should permit. The Good Practice Customer Charter for payday and other short-term loans has provisions related to loan renewal, although it does not set a limit on the number of renewals. The introduction of price restrictions would be likely to reduce the scope for lenders to roll over loans, because they would not be able to levy multiple interest charges on the same loan and still comply with a price cap.

14.6.7 Concluding comments

In theory, a cap on the total cost of credit would reduce the cost of short-term borrowing. The available evidence about the impact of price restrictions on the cost that consumers pay for credit relates to interest rate restrictions, however, not the total charge for credit. The evidence reviewed for this research does not show unequivocally that price restrictions (in the form of interest rate restrictions) reduce the cost of borrowing to consumers, particularly those on low incomes. There is no evidence about the proportion of customers who pay less for short-term credit after interest rate restrictions are introduced than they did before.

If price restrictions were introduced in the UK, the evidence points strongly to a reduction in access to short-term credit. Views will vary on whether this is a positive or negative outcome. Regardless, the large number of customers who use short-term loans to meet essential expenditure underlines the need for any reduction in access to credit arising from intervention to be offset in other ways, for example through credit union expansion or by increased welfare benefits and wages. Even in the absence of price restrictions, these measures could benefit short-term credit users.

It seems unlikely that a price cap, however constructed, would directly address many of the other issues experienced by people who use short-term credit. Other potential changes that might help improve outcomes for consumers who use short-term credit include the development of better data sharing systems (particularly for payday loans), and implementation of the Good Practice Customer Charter for payday and other short-term credit. They also include potential limits on the amount that can be applied in default charges or restrictions on the number of times a loan can be extended. While these measures may address some of the consumer detriments identified in this research, they are not directly aimed at reducing the headline cost of short-term credit.

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