

*Prosperity*

*Prosperity*

*Prosperity*

*November 2014*

# *Climbing the Credit Ladder:*

*Short-term loans as a path to long-term credit*

*John Gathergood,  
Adam Wildman and Lorena Papamanci*



**RESPUBLICA**  
society · prosperity · virtue



## About the Authors

*Professor John Gathergood is an Associate Professor in Economics at the University of Nottingham. John joined the University of Nottingham as a Lecturer in Economics in 2010 and was promoted to Associate Professor in 2013. His research focuses on household behaviour in financial markets and the impact of wealth shocks on consumption, labour supply and indebtedness. He has undertaken advisory work for the Financial Conduct Authority, the Bank of England, Her Majesty's Treasury, the Department for Business and various charities and private organisations.*

*Adam Wildman is a Research Manager at ResPublica. He co-ordinates ResPublica's research output through the three core workstreams, and is currently focused on ways in which to create moral markets, engender ethical corporate cultures and reform the banking sector. Adam's work focuses on ownership structures in banking, the role of technology in connecting to citizens and how ethical standards could make for better corporate cultures.*

*Lorena Papamanci is a Senior Researcher at ResPublica, co-ordinating events and research projects across all three of ResPublica's core workstreams. She focuses on labour market reform, including programmes and campaigns on education and skills.*

## ResPublica Acknowledgements

*The authors would like to thank Phillip Blond, Abigail Rees and Jessica Trelvellick for their assistance on this project. A special thanks is also due to the Consumer Finance Association, as without their support this independent project would not be possible. ResPublica would also like to thank the following members of the Project Advisory Group:*

- *Mark Garnier MP;*
- *Niall Alexander, Development and Communications Director, Moneyline;*
- *Hal Austin, Financial Adviser Editor, Financial Times;*
- *Tracey Bleakley, Chief Executive, Personal Finance Education Group;*
- *Anna Ellison, Research Director, Policis;*
- *Gareth Evans, Associate Research Manager, London Mutual Credit Union;*
- *Christine Farnish, Chair, Peer-to-Peer Finance Association;*
- *Jodi Gardner, Research Fellow, FinCris, University of Birmingham;*
- *Theodora Hadjimichael, Policy and Research Manager, Community Development Finance Association;*
- *Carole King, Head of Public Affairs, Provident Financial;*
- *Colin Kinloch, Debt Policy Manager, Money Advice Service;*
- *Sam Nurse, Company Secretary/Director, Institute of Money Advisers;*
- *Teresa Perchard, Chair, The Fairbanking Foundation;*
- *Jan Smith, External Affairs Director, Callcredit Group ;*
- *Adam Tyler, Chief Executive, National Association of Commercial Finance Brokers;*
- *Claire Whyley, Consultant, Financial Services Consumer Panel.*

## About ResPublica

*The ResPublica Trust is an independent, non-partisan think tank. We focus on developing practical solutions to enduring socio-economic and cultural problems in the UK. Our ideas are founded on the principles of a post-liberal vision of the future which moves beyond the traditional political dichotomies of left and right, and which prioritise the need to recover the language and practice of the common good.*

## Contents

---

Executive Summary	2
<hr/>	
1. Introduction	6
2. The new UK context for the short-term credit market	8
3. Barriers to credit enhancement and debt alleviation in the market	13
4. A new approach to transformative credit enhancement	18
5. A new paradigm for debt alleviation	23
6. Conclusions and recommendations	26
<hr/>	



# Executive Summary

*"The conclusion of all the recent controversies is relatively simple but ambitious: we need to develop a sustainable short-term credit industry shorn of its negative aspects that provides a bulwark against illegal lending and a social, economic and transformative service to its customers."*

After almost half a decade of economic gloom, it can now be said that the economy is on the mend. Employment is growing at the fastest rate for decades and unemployment is plummeting. However, this does not appear to have mitigated the difficulties many households across Britain face with regard to their living costs. Increases in part-time work, irregular working hours and stagnating wages have all put the squeeze on consumers, particularly those in low- to middle-income households.

The difficulties of static wage growth along with labour market and income insecurity have ensured that many consumers now regularly rely on personal credit to meet their household costs. One group of lenders has, more than any other, responded to this surge in credit demand. Payday lenders or, to phrase it accurately, high-cost, short-term finance providers, have quickly expanded into the marketplace since the start of the recession. Payday lending, the provision of small amounts of credit for short durations (often until payday), has increased dramatically over the last five years, both online and on the high street. For some, this form of credit is a lifeline or a means of maintaining a standard of living; for others, payday has been a deeply damaging experience with rapidly escalating costs and fees for failure to repay a small initial loan.

But dramatic new regulatory measures have fundamentally altered this sector. The most controversial aspects of the payday loan sector have now rightly been reformed. The Continuous Payment Authority (CPA) which allowed perpetual access to customers' bank accounts is now limited in use. Limits on repeated rollovers have also been introduced and, perhaps most radically of all, the interest rates that can be charged for such loans will be capped from early next year. During the past year, regulatory intervention has seen the introduction of affordability tests,

together with formal rules on CPA usage and 'rollover' lending. The Financial Conduct Authority (FCA) 'price-cap' will limit fees and charges, and make extortionary default fees unenforceable and limit the total cost of credit. Provisional remedies for market competition introduced by the Competition and Markets Authority (CMA) include the creation of accredited price comparison websites and the introduction of formal information disclosures for repeat borrowers.

Tougher regulation and sanctions have seen a marked reduction in the provision of credit to consumers served by this sector. Indeed, many of those at the bottom of the credit-worthiness curve have been excluded from finance almost entirely due to these changes. According to the FCA's estimate, the regulator's latest round of reforms, which include a cap on the total cost of credit, will cut out the provision of £420m from the personal finance sector and exclude one in five of those that were previously served by short-term finance providers.<sup>1</sup>

The justification for imposing such stringent regulation is that the actions of the payday lenders clearly required an aggressive and game-changing regulatory response. The cost of short-term loans, combined with certain allegations of misconduct and aggressive marketing behaviours on the behalf of a number of irresponsible lenders, rightly triggered the concern of the media, along with the action of regulators and policy makers.

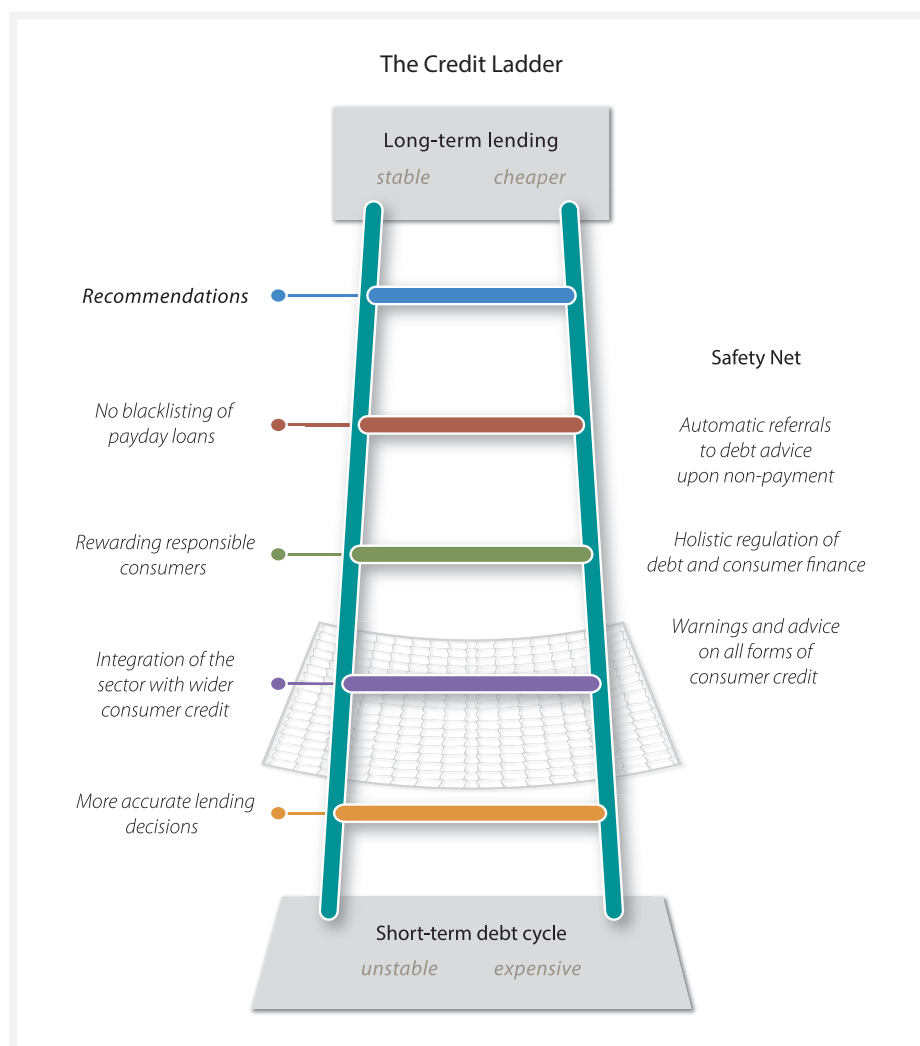
However, it is the contention of this report that a reformed short-term finance market should, in the future, be one that confers the greatest level of benefit to the greatest amount of consumers. Further measures that restrict low- or middle-income households accessing credit would, in our eyes, be detrimental to many of those struggling

with cost of living issues. As a result, the future of the short-term credit market should not be one in which it becomes increasingly difficult, if not impossible, to operate and provide consumers with the credit they need. This is not least because those denied the credit they need will turn to the illegal sector and put themselves at the mercy of the interest charges and collection methods of criminals.

The FCA recognises that it is in the interest of consumers that the payday lending market should continue to exist, albeit as a radically reformed market in light of regulatory intervention, since simply banning short-term credit will only benefit loan sharks, or push consumers towards the 'grey market' of unlicensed lending. The conclusion of all the recent controversies is relatively simple but ambitious: we need to develop a sustainable short-term credit industry shorn of its negative aspects that provides a bulwark against illegal lending and provides a social, economic and transformative service to its customers. We want the market provision to be such that consumers can obtain cheaper and more flexible forms of credit, which reflect the risk and loan performance of customers so that their credit position could improve over time. Similarly we want to prevent households from building up unsustainable credit and becoming trapped in a spiral of debt. We want the industry to be able to lend sustainably to those who need it, and to those who cannot be lent to responsibly and fairly, that they be referred to credit or debt advice agencies that alone can properly help them.

We build this transformation in the short-term finance sector on two key concepts.

The first we term 'credit enhancement'. This concept is based upon the idea that the consumer credit system should be geared towards improving the credit situation of consumers. Personal finance consumers who use the short-term credit market should over time have pathways to cheaper and more flexible (e.g. long-term) forms of credit, both from their current lender and from the market as a whole. The short-term lending sector, and indeed, the personal finance market overall, fails to provide sufficient opportunities for credit enhancement.



Achieving the right conditions for true credit enhancement requires reform of how credit risk is assessed, as well as developing pathways between different types of lenders, such as between payday lenders and banks, through which consumers can 'progress' and access more appropriate and longer-term forms of credit. This approach would tackle one of the still troubling aspects of the industry: that too many people become reliant on short-term credit as the only form that they can access, and that despite paying back on time and in full, little or no improvement in terms of rates or length of loan is offered to them.

Alongside credit enhancement, the second key component of the transformation needed in the personal finance sector is a new focus for debt advice and resolution. It

is an unfortunate consequence of personal credit that some of those who access the market will become trapped in debt. Some of this will be due to financial mismanagement, but most of the time this is due to unavoidable and unforeseen circumstances. For those who acquire unmanageable levels of debt, there must exist clear paths out of such debt. It is this subject, 'debt alleviation', which forms the second core principle pursued and promoted in this report.

These two concepts are discussed throughout the report, and the following eleven recommendations indicate how they could be made integral both to the short-term finance sector and the wider personal finance market, for the betterment of many households and individuals.

1 Financial Conduct Authority, *Press Release to CP14/10*. Available at: <http://www.fca.org.uk/news/fca-proposes-price-cap-for-payday-lenders> [Accessed 16 Oct 2014].

## Summary of Recommendations

### **1. The FCA and CMA should adopt a more holistic approach to consumer finance regulation**

Much of the consumer finance regulation imposed in recent years has been targeted at payday and short-term finance. However, this tends to ignore the fact that most personal debt derives from other sources of finance and that more obvious forms of short-term credit (e.g. unauthorised overdrafts) are actually more expensive than payday loans. For these reasons, we believe that the FCA and CMA should adopt a more holistic approach to personal finance regulation. Given this general principle, this new approach should not single out any form of finance as worthy of tougher regulation or harsher penalties. Instead regulators should realise that consumers are best served by measures that prevent consumers from creating unsustainable debt, regardless of the source of credit.

### **2. Lenders and money advice providers should put in place automatic referrals to debt advice charities upon non-payment**

Almost nine million people in the UK can be classified as being over-indebted, yet less than a quarter of this group are likely to receive any advice. In order to combat the high levels of indebtedness experienced by many in this country, we recommend that, in the case of a non-payment episode for any form of personal credit, including payday loans, that the consumer in question be referred automatically to a free debt advice provider. This could be either the Money Advice Service or an independent debt advice charity.

### **3. Payday lenders should create opportunity for credit enhancement among payday loan customers**

It is vital for the future stability and prosperity of consumers that, as they demonstrate and evidence a history of credit-worthiness, they ascend the 'credit ladder' and are able to access cheaper and more appropriate forms

of credit. Consumers who demonstrate that they are 'good risks' by consistently repaying on time should face reduced cost of credit in line with the reduced risk of lending. Payday lenders who currently reward consumers who earn their trust with larger loans (at the same interest rate) should also reward consumers with cheaper loans. Real-time scoring technology should be employed to capture loan repayment behaviour and allow payday lenders to more accurately price the risk of customers with improving credit histories. Providers who do this should have this aspect of their business model positively reflected in the loan comparison sites already recommended by the Competition and Markets Authority (CMA). A tailored response to individual borrowers could form part of the formal information disclosures already recommended by the CMA for repeat borrowers.

### **4. The credit industry, together with the FCA and CMA, should establish a credit market with enhanced consumer search for products**

Consumer search in the credit market is heavily curtailed by the perceived penalties arising from credit rejections. A well-functioning credit market should encourage, not disincentivise, consumer search and enable progression onto cheaper credit products. For such credit enhancement and progression to occur, options must exist for responsible customers of payday firms to access forms of finance normally offered by mainstream banks when this would be more appropriate. That a number of large banks have already suggested that they might move into the short-term finance sector indicates that the conditions for such co-operation exist. A hybrid system of referral fee rewards and incentives for achieving progression for consumers should be introduced to convince firms to follow this line. Credit Reference Agencies (CRAs) must work with regulators to create a reporting environment in which credit search rejections do not act to penalise consumers. We recommend that the trade bodies that represent these two markets, the Consumer Finance

Association (CFA) and the British Bankers' Association (BBA), establish a formal partnership that would allow for referrals between the two sectors to ensure that customers have a broad range of products open to them.

### **5. The Government should launch a consultation on the use of behavioural consumption data in credit scoring, and Credit Reference Agencies should release greater amounts of consumer data to better determine credit-worthiness**

One of the best means of assessing a customer's credit-worthiness is by assessing their consumption behaviour. If a consumer is likely to spend any borrowed monies on essential household goods and is not irresponsibly directing their finances towards non-essential goods, this could be an indication of a consumer in real and urgent need. Yet as it currently stands, there is little consumption data available to lenders when it comes to assessing good and bad credit risk. This means loans are often issued when they shouldn't be, and not issued when they should be. Because of this, we recommend that the Government conduct a consultation on this subject to determine how and what types of bank and transaction data could be utilised in this regard. This would be similar to a consultation that the Government recently conducted on SME data to increase business lending.

### **6. The CMA should introduce an industry-wide price comparison website to boost choice**

There exists a plethora of personal finance providers and a multitude of product offers in the UK credit market. But despite the apparent levels of competition in personal finance, consumers cannot adequately make use of or see the choices available to them. Unclear lending terms and a lack of product searching both ensure that there is very little comparison between providers. The CMA has asked for accredited comparison websites for the payday lending market to be established. We agree but we think by itself this is insufficient, we think it would be best for

there to be a price comparison website that compared all forms of personal finance of a similar type. This would be in keeping with our more holistic approach to regulation and would ensure that the consumer had all the relevant information, and as many choices as possible open to them, as well as the pathways to clear credit enhancement.

**7. The FCA should ensure all forms of consumer credit come with debt warnings and advice**

The recent raft of reforms on payday lending has required all firms in the market to display product warnings that detail the dangers of debt. While this will no doubt be helpful to many customers, we believe that such warnings should be displayed on all forms of personal finance, regardless of the type. We argue that debt is debt, and other forms of finance are more responsible for the accumulation of personal debt than short-term finance. As such, given our commitment in the report to developing better methods for debt alleviation, we believe that such a move should be pursued by regulators and embraced by the industry.

**8. The FCA should encourage further use of real-time data-sharing**

The credit risk systems that Credit Reference Agencies use to determine the credit-worthiness of certain consumers are vital to the proper functioning of the personal finance market. However, the current credit rating systems are not designed for those who access shorter forms of personal finance, who are also likely to be on the lower end of the income spectrum. For these customers, the sharing and revising of credit information needs to be updated on a much more regular basis. Without this, firms cannot conduct proper analysis of consumer affordability in light of recent events in a consumer's credit history. Daily credit analysis and sharing is something that a small number of lenders are trialling at the moment. We recommend that the entire short-term credit industry move to such a system, supported by the Business Information Providers' Association, which should insist that all of its members trial and roll out similar tools.

**9. The industry, together with Credit Reference Agencies, should encourage quotation searches in consumer finance to foster greater competition**

Competition and choice in the personal finance market are currently limited by the way credit rating operates, which means that loan applications, where credit searches leave a footprint on a consumer's credit record, can be interpreted negatively. This can act as a barrier to 'shopping around' and prevents many consumers from obtaining the best deal. Credit Reference Agencies (CRAs), together with the Standing Committee on Reciprocity and the Financial Conduct Authority, should explore means of facilitating comprehensive quotation searches which could enable genuine, effective and salient price comparison technology to be brought to bear on the consumer credit market. This is essential for creating an environment which encourages credit enhancement. We suggest the market move away from a model where credit providers individually pay CRAs for credit files towards a commission fee structure based upon loans written. We call upon the Financial Conduct Authority to undertake new research into the role of credit application histories and how their use within the industry discourages consumer search in the credit market.

**10. The Credit Referencing Agencies should, in collaboration with the short-term finance industry and the CFA, develop a clear method for positively referencing and capturing good loan repayment behaviour by payday customers**

Existing credit referencing technology does not adequately record payday loan repayment, nor is it clear that consumers have the possibility for building a good credit history via repayment of short-term loans. This form of alienation from mainstream credit can be a severe cause of detriment to consumers. It keeps them trapped where they are. 'Blacklisting' or other practices which preclude positive scoring the timely repayment of payday loans should be wholly abolished. Consumers must

have the ability to build their credit history through repayment behaviour irrespective of the form of credit concerned. Without this we create a captive credit market that offers no path for future advancement.

**11. The FCA should undertake research into what happens to those denied credit as a result of its interventions**

According to FCA figures, 11 per cent of those who currently utilise payday loans will be unable to do so as a result of the price cap. This equates to 176,000 people who will no longer, due to market restriction, be able to access short-term credit. The FCA has undertaken to review the impact of the market cap two years after its implementation. As part of that review process, and before that two year period, we think some analysis should be undertaken as to what has happened to these people who are no longer able to obtain short term credit. Have they turned to criminal or illegal lending, or have they simply not made the purchases they were hoping to make? Any proper regulation must look at the cost to those who are excluded from a service as a result of market intervention by the regulator. The consequences may be beneficial or harmful, but it would be good for the sake of those affected to have some objective knowledge of the situation.

We have made clear throughout this report that the consumer credit market as a whole, and not just the payday lending sector, conspires against the advancement and true flourishing of consumers. To reform the industry for the better, we must move from a system of personal credit that disenfranchises its customers into one that provides options to consumers for personal advancement. By adopting the above recommendations, we believe that the industry and the Government can transform the lives of many households and improve the economic circumstances of those currently struggling to stabilise their finances and build foundations for future prosperity.



# 1 Introduction

*"What sort of credit market should emerge from the payday lending sector, what do we as a society want from this market and, crucially, how best can it serve consumers?"*

After half a decade of economic gloom, the economy is on the mend. Economic growth in real terms is gradually increasing, employment is rising, and price inflation is stable. However, for many people this economic improvement is not reflected in improved living standards. Wage stagnation is a real and grave issue for many households. For most, increases in the cost of living have been outstripping wage gains in the period since the financial crisis of 2008.<sup>2</sup>

Over the years following the recession, working habits have also undergone a transformation. A greater proportion of the working population now work on zero-hour contracts and part-time work is becoming the norm for many. Many public sector workers have had little or no real wage growth. The enduring cost of living crisis, irregular payment patterns and the break on wages have all conspired to increase the average consumer's reliance on short-term credit – and this is particularly true for those on middle-to-low incomes with little or no liquid savings.

Does the credit market work well for these consumers? The answer in a UK context is no. There is a significant gap in the UK credit market. In this 'credit gap', consumers not served by the prime market face insufficient choice and flexibility in access to credit and limited opportunities to effectively search for credit products. There are few pathways open to those who cannot bridge this gap to enhance their credit score and get longer and cheaper loans. The fear is that many remain trapped in one credit market with few choices and few options even if they are good and responsible customers who repay their loans on time and without default. Current estimates suggest that as many as 300,000 individuals may be currently underserved by providers of credit, many of whom now rely on unlicensed or illegal forms of money lending.<sup>3</sup>

This 'credit gap' has developed alongside inexorable changes to consumer shopping habits. The rise of internet banking and the general digitisation of services have encouraged many customers to demand much more from their providers by way of access, flexibility, simplicity and immediacy. In light of these changing habits, over recent years a wide range of innovative consumer finance platforms have emerged. Crowdfunders, 'peer-to-peer' lenders, invoice financing firms and online payday lenders are the most prominent examples.

But one of these groups of lenders has, more than any other, undergone a revolution since the recession. Payday lending, the provision of relatively small amounts of money for short durations (normally until 'payday'), increased dramatically after the recession, both online and on the high street. Because of the cost of living crisis, with household budgets stretched to the limit, having access to almost immediate sources of finance has enabled many of those who struggle to pay bills and meet household costs due to irregular or uncertain income to have a source of readily available short-term finance.

But the payday lending market has grown beyond a market for credit to meet short-term emergency expenses and has become a regular form of consumption finance for many households. In fact, survey evidence shows approximately 55 per cent of payday loan customers use their loans for regular non-discretionary expenditure such as household bill payments, with 20 per cent using loans for discretionary spending such as consumer electronics or holiday expenditure. Moreover, the frequency of loan usage at the individual level also suggests these loans were not used only for occasional emergencies, as the average number of loans per year taken out by a customer is estimated to be six.<sup>4</sup>



The growth revolution of the payday lending market has now been superseded by a revolution of regulation. Dramatic new regulatory changes have fundamentally changed the payday lending market resulting in a smaller market in which less creditworthy consumers are now unable to access credit. More stringent obligatory affordability checks and a new maximum price cap set the parameters of this new market. But what sort of credit market should emerge from the payday lending sector, what do we as a society want from this market and, crucially, how best can it serve consumers?

Over recent years, a broadly negative view of the payday lending market has emerged. The cost of short-term loans, combined with certain allegations of misconduct and aggressive marketing behaviour on the part of a number of irresponsible lenders, has rightly raised the ire of regulators, policy makers and the media. Many of the problems associated with short-term finance derive from the high costs involved with accessing this type of credit. It is indeed unfortunate that those with poorer credit profiles are those that access this market, in which credit is particularly costly, but this is an essential and largely unavoidable characteristic of the supply of any form of consumer credit. Given that just to break even, let alone become sustainable, the rates charged to those who are less creditworthy will have to be several multiples higher than those offered to the more secure, society needs to ask more of these lenders such that they do all they reasonably can to advance the interests and well being of their customers and protect against loading more debt on those who cannot afford to sustain the payment of it. Regulatory measures already enacted will resolve certain aspects of market conduct and will create a new norm for assessment of creditworthiness and pricing loan products, but we believe that more can and should be done to create a short-term finance market that actually transforms the financial lives of its customers, creates

enough of a market return to enable the sector to be sustainable and provides a financial safety net against criminal lending and illegal collection practices.

We call for more radical innovation within the market for short-term credit which will yield better service for consumers in the market and allow firms to create value from the products they provide. The future of this market should not be one in which it becomes increasingly difficult for firms to operate and offer only a narrow range of products. That will only serve to decrease the supply of credit and widen the credit gap. Instead, we should look to a market in which consumers can obtain cheaper and more flexible forms of credit, the terms of which they can improve over time through enhancement of their credit profile and the brokering of customers of short-term finance into the stability of longer-term finance and greater security that may offer. This requires us to create an environment in which lenders can innovate to improve their product range and offer and can earn proper return from their innovations.

We build this revolution on two fundamental ideas of credit transformation. The first we term 'credit enhancement'. This concept has at its heart the idea that the consumer credit system should be geared towards improving credit offerings available for those who take out, and repay, credit. Consumers should have pathways to cheaper and more flexible forms of credit both within a credit relationship with a particular lender and from there to be able to access the broader market. We argue the current credit market offers insufficient opportunity for credit enhancement and does not sufficiently reward those who manage their debt responsibly.

Achieving credit enhancement means reforming how credit risk is assessed as well as developing pathways between different types of lenders, such as between banks and payday firms, through which consumers can progress and access cheaper or more

appropriate forms of credit, for instance longer-term loans at lower cost. This will require a proper system of incentives and rewards for referrals, and could lead to current short-term finance providers diversifying and enhancing their product offer so that they themselves could offer pathways to longer loans and or products like mortgages. For us, the idea of 'credit enhancement' is integral to this and should be pursued by policy makers, the industry and regulators.

The second key component of the credit transformation needed in the UK is a new paradigm for debt advice and debt resolution. Alongside 'credit enhancement', regulators should look to adopt a more holistic approach to reducing the prevalence of absorbing over-indebtedness in the UK. It is an unfortunate consequence of personal credit that some of those who access the market will become trapped in debt. Some of this will be due to financial mismanagement, but most often this is due to unavoidable and unforeseen circumstances, which could be better identified through improved methods of scoring creditworthiness using existing yet currently neglected data. For those who acquire unmanageable levels of debt, there must be clear paths out of debt. It is this subject, 'debt alleviation', which forms the second core idea and principle pursued and promoted in this report.

Combined, the two concepts of 'credit enhancement' and 'debt alleviation' form the basis of this report. It is our key aim to demonstrate that consumers will always require flexible and shorter forms of credit. It is much better, therefore, to make this form of credit as accessible as possible and provide options for personal betterment through improving credit opportunity and credit range, than it is to punitively exclude firms in this market to the detriment of consumers. The new market context is one in which firms can provide credit transformation to consumers who value their products and service, also serving a moral purpose. Pursuing the concepts of credit enhancement and debt alleviation is critical to achieving this vision.

2 Whittaker, M., and Hurrell, A. (2013) *Low Pay Britain 2013*, p.4. London: The Resolution Foundation. Available at: <http://www.resolutionfoundation.org/wp-content/uploads/2014/08/Low-Pay-Britain-2013.pdf> [Accessed 23 Oct 2014].

3 BIS, POLICIS, (2010) *Interim Evaluation Of The National Illegal Money Lending Projects*. Available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/31888/10-1186-interim-evaluation-illegal-money-lending.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31888/10-1186-interim-evaluation-illegal-money-lending.pdf) [Accessed 23 October 2014].

4 Financial Conduct Authority, *FCA CP14/10 Technical Annex consumer survey research* (2014). Available at: <http://www.fca.org.uk/static/documents/consultation-papers/cp-14-10-technical-annexes.pdf> [Accessed 9 Oct 2014].

# 2

## The new UK context for the short-term credit market

*"Access to credit is absolutely vital to a well-functioning consumer market, especially for those on lower incomes that can have cash-flow issues on a regular basis."*

### ***The dramatic development of payday lending in the UK***

The growth and evolution of the 'payday lending' credit market is the most significant development in consumer credit in the United Kingdom within the last ten years.<sup>5</sup> In 2013, the total value of loans in the market was approximately £2.5 billion.<sup>6</sup> While this is a relatively small proportion of total consumer credit in the UK (in total households owe approximately £160bn in unsecured debt at any one point in time, reflected in Fig. 1 - next page), payday loans are for small amounts, at high cost, and the significance of the market should not be measured in the total value of loans. Instead, the significance of the market is seen in the number of individual borrowers and the cost of loans. In 2012-2013 over 1.6 million customers received short-term credit, taking on average six loans per annum at an average value of £260 and paying over £200 in total interest and charges.

Growth in market size was extremely rapid between 2010 and early 2013. Estimates suggest total lending in the market was less than £750 million in 2010, with approximately 0.5 million consumers taking out a payday loan.<sup>7</sup> This threefold growth in market size and consumer volume over a three-year period is all the more remarkable within the context of overall, albeit moderate, decline in total consumer credit lending in the UK since the onset of the recession in 2008. Despite this, there is some evidence that the payday lending market reached a peak in customer volume and market size in early 2013 and that new rules

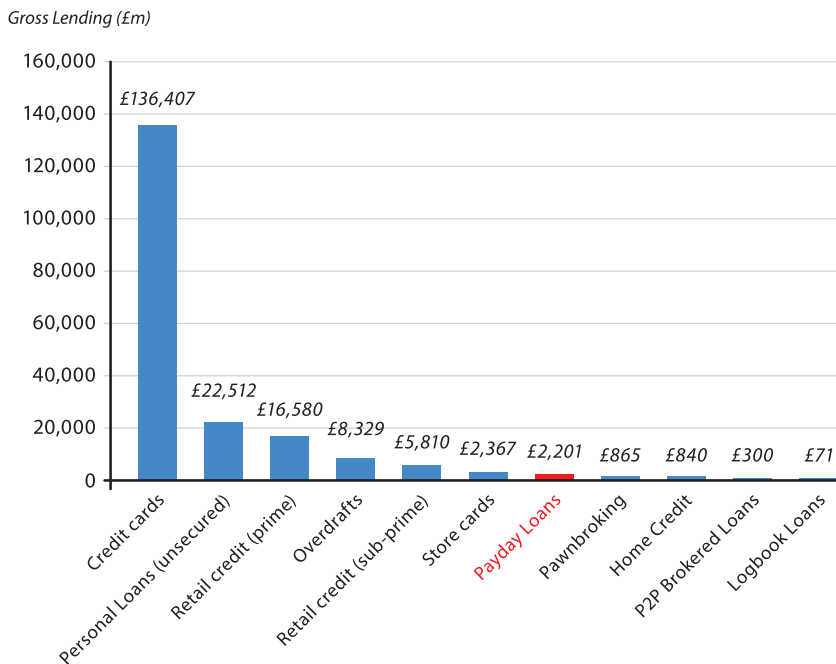
for consumer credit lending introduced in April and July 2014 have further shrunk the size of the market.

The rapid growth seen in the payday lending market has been largely attributable to developments in the wider UK economy and specific innovations within the consumer credit market, which have worked together to create the conditions for growth of payday lending. Not only did credit demand among middle-to-low income households increase, but the background causes of the recession – the perceived failure of traditional lending models – led to a tightening of mainstream credit supply in the market.<sup>8</sup> This created a 'credit gap' in the provision of personal finance to consumers, which payday lenders and other short-term finance providers then occupied swiftly and with much success.

The recession increased the demand for such forms of credit through higher levels of income volatility. It is inevitable that in periods of recession most individuals will experience an increased risk of unemployment and volatility in their earnings due to more uncertain hours of work coupled with a lack of wage growth. This increase in income volatility is particularly strong among working low-income households where many are commonly employed in manual or semi-skilled jobs, which are by nature more vulnerable to periods of recession. The number of zero-hours contracts in the UK, for example, has grown from around 150,000 in 2008 to just under 600,000 today.<sup>9</sup>

Fig. 1

Gross lending by credit type (2012 - 2013)



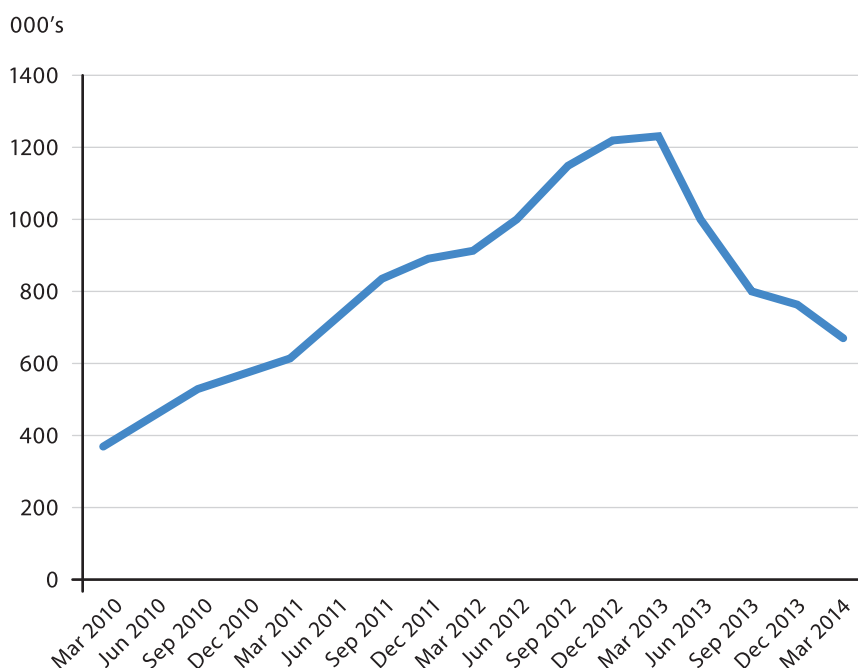
Source: FCA (April 2014) Research Paper: Consumer credit and consumers in vulnerable circumstances, p.14. Available at: <http://www.fca.org.uk/static/documents/research-papers/consumer-credit-customers-vulnerable-circumstances.pdf> [Accessed 23 Oct 2014]

On the supply side, the recession also resulted in a decline in the supply of mainstream consumer credit. During the 2008 recession most mainstream lenders reduced their willingness to lend, especially to sub-prime households due to perceived concerns over the risks of lending to these borrowers. The payday lending sector took full advantage of this period of retrenchment from mainstream providers and moved to occupy the gap in credit provision that emerged.

Faced with all this uncertainty and financial insecurity, many households need credit to fund their expenditure in periods of unemployment, low hours of work, or when their levels of pay are lower than expected. This is why, since the recession, demand for credit, and short-term credit in particular, has increased significantly. According to the sector's trade body, from 2010 to a peak in early 2013, providers in the market saw a surge in the number of new payday loans transactions from 372,000 in March 2010, to 1,235,000 in March 2013 – an increase of 232 per cent. There was also an increase of 178 per cent in the total value of new payday loans advanced in the same period. The value of new loans issued in March 2013 had more than doubled since March 2010, growing from £115 million to £320 million.<sup>10</sup> This is illustrated in Fig.2, which quantifies the evolution of the sector in terms of number of new loans issued. The data used for this graph relates to lenders which are members of the Consumer Finance Association.

Fig. 2

Number of new payday loans issued



Source: Industry data provided by the Consumer Finance Association

This growth in market share became possible because the leading payday lenders within the sector adopted new and sophisticated loan decision models based upon big data, machine learning and behavioural informatics. These models vastly outperformed the traditional approaches to lending utilised by the larger banks. These models do not rely on traditional credit scores and use technologies which allow firms to make better credit allocation decisions. The short-term and simple dimensions of payday loans mean that firms learn from consumer payment behaviour very quickly and can amend or adapt their decision models accordingly.

The growth of payday lending can also be explained by underlying trends in general consumer behaviour engendered by the growing digitisation of financial

markets. Payday lenders, especially online lenders, provide simple products with straightforward application processes that involve minimal paperwork and few administrative burdens on the applicant. It is typical of the short-term finance industry that monies are digitally transferred to consumers within a few minutes of a loan being approved. The whole process of application, approval and delivery of funds can be completed in one browsing session on a mobile phone or tablet, or in a single visit to a high-street store. In this way, payday lenders and other providers of short-term credit offer improvements in speed and convenience when compared to conventional credit providers.

Despite the rapid increase in the demand for short-term finance until 2013, as the UK economy improves further, it is likely that the recession-induced impetus in demand for payday lending will decline further. Improvements in earnings growth and reductions in earnings volatility will also lead to reductions in demand for short-term credit. These changes in market conditions are incremental to regulatory actions that have been applied to the sector over the last few years.<sup>11</sup>

### Market regulation and reshaping into 2015

The payday lending market developed within the context of a lightly regulated UK consumer credit market, at least compared with credit markets in most Western nations; one in which regulatory measures impinged very little on the market activity of most payday firms. Prior to 2013, short-term finance providers were free to adopt their own pricing structures and fee levels without limits beyond those imposed by market forces. Firms were also able to use new innovations in payments technology which facilitated speedy transfer of funds to consumers once loans had been approved, and privileged access to the smallest achievable payments from client bank accounts through the use of Continuous Payment Authorities (CPAs). Products developed by firms in the market could also come with a range of contingent charges relating to pre-payment, loan renewal (or 'rollover') and non-payment.

However, since the initial rapid growth of payday lending in the UK, there have been ever more vocal calls for the market to be more stringently regulated. Despite the clear market demand and need for short-term credit products, there are some strong objections to payday lending that have arisen over recent years and these have attracted significant media attention. The objections principally relate to the cost of payday loans, including interest and charges in default, firm affordability screening and the process for ensuring prudent lending, and firm conduct towards consumers.

The regulatory response from Government has, and continues to, fundamentally reshape the payday lending market. New requirements on firms around affordability screening and limitations on rollovers and CPAs have, when taken together, led to widespread changes in lending practice. A 'price cap' on the cost of credit is scheduled to come into effect in January 2015. The provisional remedies of the Competition and Markets Authority (CMA) investigation of the payday lending market see new measures on information disclosures, quotation searches and price comparison tools which will further change the market environment. To some extent, the price cap to be imposed by the Financial Conduct Authority (FCA) could be seen as a means of resolving the over-pricing of payday loans identified by the CMA. The CMA found that headline prices in this sector tended to cluster at approximately £30 to borrow £100 for a month. They estimated that "a more effective price competitive market would lead on average to a saving per loan between £5 and £10 on the headline price" and that the currently recommended cap should bring this headline price down by around £6.<sup>12</sup> We do not rehearse measures undertaken to date and those in prospect in detail here, but instead summarise their effects.

Since March 2013, there has been a 45 per cent drop in payday loan transactions,<sup>13</sup> principally due to the introduction of a tougher regulatory regime and the anticipation of such a regime, as reflected in Fig. 2, which marks March 2013 as the clear peak for sector growth. The implementation of a price cap is likely to cause further reduction in market size. Nevertheless, the payday lending market will remain an established component of the UK consumer credit market. The purpose of regulation is not to remove the market. This is reflected in

the sentiment of regulators as encapsulated in the recent reflection of the Chief Executive of the FCA:

*"We recognise that payday lending has a role in society, we know that last year 1.6m people took out payday loans, so we think we have calibrated it [the price cap] at a level where the efficient players will continue to operate."*  
- Martin Wheatley, Chief Executive, FCA.<sup>14</sup>

While the FCA determined that the current extent of lending causes unacceptable consumer detriment at the margin,<sup>15</sup> wholly driving out payday lending firms implies driving out the opportunity for consumers to borrow at all in this market, which would then perversely only encourage illegal lending at even more punitive rates and higher social cost. FCA analysis recognises that firms will respond to the cap of interest and charges by reducing their lending at the margin – firms will no longer expect some of their riskier customers to be profitable at the current margin of lending and decide not to lend to these customers. The FCA estimates that 11 per cent of consumers who currently receive loans will not be able to access this type of credit once the cap is introduced.<sup>16</sup> The industry suspects that the figure will be much higher, circa 50 per cent, and that the effect of this exclusion can lead to higher costs than the credit applied for: a YouGov survey of declined applicants showed large percentages incurring late payment fees and bank charges.<sup>17</sup> The precise impact of being denied access to credit, both in terms of costs to the consumer and their behaviour, for example, are purchases simply forgone, or will people turn to illegal lenders needs to be examined. This issue needs authoritative research to be commissioned by the FCA at a suitable point following the introduction of the cap in January 2015.

The FCA has, rightly in our opinion, judged it preferable for most customers to continue to be served in this new market context, where they would be more protected from high fees and charges, than for no customers to be served in this market at all. Recent FCA analysis recognises that, at a fundamental level, consumer benefits exist from being able to borrow via a payday loan even if the capped price is relatively high compared with the consumer credit market, should the consumption need for which the loan is

used be pressing.<sup>18</sup> This analysis recognises the fundamental economic insight that the availability of credit can benefit consumers when priced competitively.

New regulation of the payday lending market which will result, therefore, in a smaller, and perhaps less competitive market, should be seen as the driver of a new market context. This is a context in which, following the implementation of a price cap, fewer, more prudent firms in a smaller market operate under a 'price ceiling' leading to an average market price below the current market average. The market will be smaller, and serve a consumer segment with above average credit scores compared with the market of recent years. It is into this market that we make our recommendations.

### *The purpose of short-term credit*

In our view short-term credit can be welfare improving. Indeed, in general the ability to borrow so as to smooth consumption over time is good for consumers. It stands to reason that consumers can benefit from borrowing as much as they can from saving. Borrowing allows consumers to bring forward future income so that consumption can occur earlier than income is received. Without access to credit, consumers have to wait until income is received. As an example, without the availability of mortgage finance, consumers would have to wait until they had earned sufficient income to buy a house outright. This would be very costly to consumers, especially if they had no choice but to rent at cost in the meantime. Borrowing allows consumers to smooth their consumption over time. Access to credit is, therefore, absolutely vital to a well-functioning consumer market, especially those on lower incomes that can have cash-flow issues on a regular basis.

Payday customers overall are more likely to be in work than the population as a whole. In terms of income, 36 per cent of payday lending customers were classed as having a low income (less than £18,000 per year), and almost three in ten (28 per cent) had a relatively high income (£36,000 or more per year).<sup>19</sup> For those customers with a more restricted income, payday lending, unlike mortgage borrowing for example, is a means of short-term borrowing to

bring forward consumption by a small period, normally for a few weeks (the average loan duration for the industry is 26 days).<sup>20</sup> The term 'payday' refers to the notion that consumers might require funds to 'tide them over' until their next 'payday'. For many consumers, particularly those on lower incomes, bringing forward consumption by a short period of time can be absolutely vital. If the alternative is foregoing some essential consumption, such as food expenditure for their children or the replacement of an essential household item, perhaps made necessary by an unexpected expense earlier in the month, such as a child's school trip, then borrowing in the short-term is in many cases the best option. Indeed, evidence suggests that more than four out of every five payday loans are used for paying bills or household shopping.<sup>21</sup> So restrictions on short-term finance could significantly affect certain people's standards of living.

Even though in many cases short-term lending is expensive compared to other forms of credit (although unauthorised overdrafts and store credit are commonly more expensive forms of credit<sup>22</sup>), analysis shows that the majority of borrowers have few other options open to them. Payday borrowers have typically exhausted their existing lines of credit and have few options available other than borrowing from family and friends or illegal money-lenders. Research by the FCA revealed that 64 per cent of high-cost short-term credit (HCSTC) users had outstanding debt from other types of lender, mainly credit cards (20 per cent) and overdrafts (28 per cent) prior to their accessing a payday loan, while 36 per cent had already borrowed from family and 18 per cent from friends.<sup>23</sup>

Furthermore, typical consumers often have fragile finances due to income volatility and job uncertainty. Seven out of ten low-income households would find it difficult or impossible to raise £200-300 in the case of emergency.<sup>24</sup> For these people, access to credit is essential. Yet, such individuals also often have poor credit histories. The high cost of credit to these households in part reflects the risks associated with lending and the high default rates which occur among these consumers. If firms are to make profit through lending, and any sustainable market needs this, the fees and charges paid by consumers who repay must be sufficient to at least cover the monies lost to consumers

who do not repay. In credit markets where a large proportion of customers can be expected not to repay, these fees and charges are necessarily higher.

However, although a compelling case can be made in principle for the provision of payday lending, the UK's market experience has demonstrated that the mostly 'self-regulated' market has, in many cases, performed very poorly for consumers. Therefore, we adopt the position that this market can and should only exist within the new regulatory context of the proposed price cap and related measures, robust assessment of affordability and ongoing supervision and enforcement activities by the market regulator.

Taken together, this report welcomes the new short-term lending market context emerging in the UK following the regulatory actions proposed to date, although we believe an eye needs to be directed to the levels of competition within the sector and whether these will drop below acceptable levels. In the new regulatory context, the need for firms to be able to profit from lending to customers is balanced with the need to protect consumers from excessive fees and charges. Our recommendations are made within this new market context and seek to further improve market conditions for both lenders and consumers.

- 
- 5 The UK consumer credit market has seen other significant changes, including the introduction of 'balance transfer' deals on credit cards and introduction of other forms of credit such as pawnbroking loans. The US has also seen significant and rapid growth in its payday lending market.
- 6 Figures cited in the paragraph are drawn from *Consultation paper CP14/10\*\*\* 'Proposals for a price cap on high-cost short-term credit'*, Financial Conduct Authority (FCA) July 2014.
- 7 Author's calculations.
- 8 The decline in consumer credit lending seen during the recent recession could in principle be due to a fall in either credit supply or credit demand. However, Gathergood (2011), using Bank of England loan application data, demonstrates that credit applications increased during the recession but the proportion of credit rejections also increased sharply. Hence the decrease in overall lending was due to a tightening of credit supply. Gathergood (2011) also shows credit supply decreased disproportionately among racial minority households. Gathergood, J. (2011) 'Racial Disparities in Credit Constraints in the Great Recession: Evidence from the UK', *B.E. Journal of Economic Analysis and Policy* vol. 11 issue 1.
- 9 Alekson, V. and D'arcy, C., (2014) *Zeroing In: Balancing protection and flexibility in the reform of zero-hours contracts*, p.6. London: The Resolution Foundation. Available at: <http://www.resolutionfoundation.org/wp-content/uploads/2014/03/Zeroing-In.pdf> [Accessed 23 Oct 2014].
- 10 Private industry data provided by the Consumer Finance Association.
- 11 These effects are described in more detail below.
- 12 Financial Conduct Authority, July 2014, *Proposals for a price cap on high-cost short-term credit*, CP14/10, p.83. Available at <http://www.fca.org.uk/static/documents/consultation-papers/cp14-10.pdf> [Accessed 23 Oct 2014].
- 13 Private industry data provided by the Consumer Finance Association.
- 14 Interview with BBC Radio 4 'World at One' 15 July 2014. Available at: <http://www.bbc.co.uk/news/business-28305886> [Accessed 23 Oct 2014].
- 15 Financial Conduct Authority, July 2014, *Proposals for a price cap on high-cost short-term credit*, CP14/10, p.27. Available at <http://www.fca.org.uk/static/documents/consultation-papers/cp14-10.pdf> [Accessed 23 Oct 2014].
- 16 Idem, p.11
- 17 Consumer Finance Association, *Press Release: Out of Credit – survey reveals true cost for British borrowers who are denied credit*, 22 October 2014. Available at: <http://www.cfa-uk.co.uk/media-centre/press-releases/current-press-releases/out-of-credit-survey-reveals-cost-for-borrowers-who-are-denied-credit-under-new-lending-rules.html> [Accessed 24 Oct 2014].
- 18 Idem, p.92
- 19 [https://assets.digital.cabinet-office.gov.uk/media/5329df8aed915d0e5d000339/140131\\_payday\\_lending\\_tns\\_survey\\_report.pdf](https://assets.digital.cabinet-office.gov.uk/media/5329df8aed915d0e5d000339/140131_payday_lending_tns_survey_report.pdf) (p.25)
- 20 Private industry data provided by the Consumer Finance Association.
- 21 Which? (2014) *Credit Britain 2*, p.12. Available at <http://www.which.co.uk/documents/pdf/credit-britain-2---september-2014-378871.pdf> [Accessed 23 October 2014].
- 22 See for example, *Which? It's time to clean up credit*, 14 October 2013. Available at: <http://www.which.co.uk/news/2013/10/its-time-to-clean-up-credit-337066/> [Accessed 24 Oct 2014].
- 23 Financial Conduct Authority, July 2014, *Proposals for a price cap on high-cost short-term credit*, CP14/10, p.17. Available at <http://www.fca.org.uk/static/documents/consultation-papers/cp14-10.pdf>. [Accessed 23 Oct 2014].
- 24 Ellison A. et al (2011) *Credit and low-income consumers: A demand-side perspective on the issues for consumer protection*. Liverpool John Moores University.



# 3 Barriers to credit enhancement and debt alleviation in the market

*"A basic feature of a well-functioning credit market is that people with improving credit records should be offered lower-cost credit in line with a lower likelihood of default. If consumers with improving credit records are not rewarded in the form of access to cheaper credit, then firms will capture an undue surplus from these consumers, to the obvious detriment of the latter."*

In this section we argue that the new market context, though broadly welcome, will continue to present challenges and obstacles to consumers. We identify two specific problems. First, the lack of opportunity for consumers who establish good credit records to gain access to cheaper forms of credit, either with their current credit provider or with another. We term this a lack of opportunity for 'credit enhancement'.

The second problem is the absence of sufficient measures to prevent consumers from falling into the 'debt trap'. We see this as insufficient 'debt alleviation' within the market. Both problems share the common characteristic of preventing consumers from transforming their current financial position and improving their lot. We now explain these challenges and obstacles within the payday lending market in greater detail.

## ***Lack of opportunity for 'credit enhancement'***

It is clear that a key feature of payday loans valued by many consumers is the relative ease and simplicity of loan terms and the loan application process. One attractive feature of payday loan products is that upfront loan terms are both simple to understand and typically expressed as a value in pounds payable for a fixed period of time. Industry research demonstrates that almost three quarters of those who access short-term finance prefer costs of credit to be expressed in monetary terms, rather than from obscure or abstract APR representations, which can be mystifying.<sup>25</sup> The simplicity of up-front loan pricing

does not in all cases extend to contingent charges, or loans sourced via 'lead generators'. But, in general, the simplicity and salience of loan terms is a positive feature of this market.<sup>26</sup>

In addition to the benefits arising from the simplicity of the terms, the speed of the loan application process and speed of access are attractive features to many consumers. The rise of payday lending, especially online lending, has decreased application to decision times across the consumer credit market.<sup>27</sup> Improvements in payments technology and decreasing costs have allowed firms to issue loans speedily after the decision stage. Speed of loan decisions and transmission is needed by some consumers and desirable to many consumers. Payday lenders and other similar digital lenders have led on immediate and simple credit transactions over recent years. More traditional lenders have trailed their digital counterparts in this regard. The large banks have long, convoluted lending processes, and some credit unions, which are often suggested as alternatives to payday lenders, do offer short-term finance, but these products take days rather than hours, or even minutes, to clear.

However, despite these positive features of payday loan products, in many cases there exists an evident lack of opportunity for consumers to improve their access to credit or reduce the cost of obtaining credit in their relationship with a credit provider. This lack of opportunity exists both within the payday lending sector and within the consumer credit market in general. This situation ensures that consumers with improving credit performances are not rewarded for



that performance by way of cheaper credit. In this way consumers are not allowed to ascend the 'credit ladder' as they should under just or fair market conditions.

A basic feature of a well-functioning credit market is that consumers with improving credit records should be offered lower-cost credit in line with a lower likelihood of default. If people with improving credit records are not rewarded in the form of access to cheaper credit, then firms will capture an undue surplus from these consumers, to the obvious detriment of the latter. Such market behaviour could lead to accusations of rent-seeking on the part of the industry, and should be avoided by any responsible lender.

It is inevitable in any credit market that some misalignment of consumer risk and loan pricing will occur. While some consumers are aware of their other credit options and make an active and informed choice, some consumers undertake poor search activity in the market and apply for forms of credit which are inferior to those which they could obtain. However, this is often not the fault of consumers, and we will discuss how the credit market prevents optimal search behaviour by consumers below.

It is regularly the case that payday lenders do not 'risk price the loan' in their loan offering i.e. all consumers face the same price regardless of their ability to repay. In fact, in its earlier investigation in June 2014, the CMA had found that none of the payday lenders they interviewed within their market investigation charged different prices to borrowers of different risk, but that several major lenders indicated they either had considered or were considering some type of risk-based pricing.<sup>28</sup> Some lenders then cited the additional costs of risk-based pricing and the possibility that risk-based pricing decreases the simplicity of advertised loan terms. It is true that there are additional costs involved with pricing loans, but it is not overall beneficial for consumers to witness no improvement in the cost of credit from positive repayment behaviour.

However, as has often been the case with this fast-responsive sector, there has been innovation in this area, with different approaches including tiered pricing and using past repayment behaviour to determine loan pricing. For example,

Think Finance has entered the UK market with the 'Sunny' lending product which reduces interest rates to repeat consumers based on past borrowing behaviour.<sup>29</sup> However, these examples are isolated cases instead of the norm, which is what the market should be aiming for.

Loan re-pricing to lower costs is particularly relevant to the payday lending sector. It is well documented that there are high levels of repeat lending within the payday lending market. Many consumers demonstrate consistent repayment of loans without late payment or default events. In doing so, these consumers demonstrate themselves to be 'good risks' for the payday lender. However, the payday lender often does not respond to this demonstration of risk improvement by lowering the cost of the loan. In cases where firms operate some form of reward or trust benefit, this almost exclusively operates on the margin of lending amount only. Consumers who earn loyalty with the firm are able to borrow more, but not a lower price. This only serves to increase the surplus which firms obtain from these consumers, and in no way does it benefit the image of the short-term finance industry.

In addition to this, consumers who demonstrate that they are bad risks can be denied future credit by the payday lender through loan rejection. So the absence of meaningful credit progression for the consumers is a one-sided feature of the market which works only to the benefit of the lender. The extent of the surplus gained by firms may, as a result, be very large. And given that 64 per cent of loans were paid on time or early,<sup>30</sup> and nearly a quarter paid only a day late,<sup>31</sup> this situation seems particularly unfair.

As such, we call for more lenders to re-evaluate the business case for not undertaking risk-based pricing, at least for repeat customers with whom they have developed a lending relationship and a source of enhanced data on the customer's creditworthiness. We also encourage lenders to look towards models of risk-based pricing for all loan applications, include new customer applications.

### ***A lack of effective competition in consumer credit***

Alongside a lack of 'credit enhancement' opportunity within a customer's relationship with a lender, customers in the short-term market do not find it easy to search across the broader credit market and this limits overall consumer choice. This is particularly detrimental to low- and middle-income consumers who are often at the margins of mainstream credit. This is most likely to be due to an unfortunate feature of the consumer credit market: the convention of recording credit applications and interpreting large numbers of such applications as a sign of credit hungriness and potential financial difficulty. In this market, firms tend to view a large number of credit applications as indicative of lower likelihood of repayment. Firms use credit application information in this way because it is informative for their credit allocation decision models.

Credit Reference Agencies (CRAs) typically claim that rejected credit applications do not impact on the likelihood of a consumer being accepted in future as credit files contain information only on credit applications and not the results of those applications. However, this can be misleading, as a large number of applications over a short period of time may be taken as indication that the consumer is credit-hungry and therefore in financial difficulty. Most lenders would actually inform consumers of this before applying for a loan that would leave a footprint on their credit report.<sup>32</sup> While footprints themselves are not negative, other lenders may infer likely credit rejections or a sign of great financial need from a report showing many searches, which may, in turn, discourage customers from 'shopping around'.

Moreover, even though credit referencing agencies (CRAs) do not specifically record credit rejections, they do provide information on all credit applications, and lenders can match credit application records with credit holding records to infer instances where consumers are likely to have been rejected for a credit product. The impact of this convention of recording searches is that 'shopping around' for the best loan product is discouraged or prevented. Consumers can be reluctant to search for credit due to the risk of rejection and the impact this

would have on their chances of obtaining credit elsewhere. For many consumers, an application for a cheaper or more flexible form of credit would otherwise be worthwhile. However, recording of credit searches induces consumers to become risk averse and hold back from applying for better credit terms, which significantly reduces effective competition in the short-term finance sector.

In addition, the way in which credit searches are recorded and viewed has prohibited the introduction of meaningful price comparison tools and websites in the consumer credit market. In many markets online price comparison tools are a highly utilised and effective means of consumer search. For these tools to operate effectively, consumers need to be able to search between offers and prices for which they are eligible, not simply search between headline prices. Such price comparison tools are, for instance, ubiquitous in the insurance market.

The deterrent effect of current conventions of credit scoring are particularly damaging to consumers on the margin of mainstream credit, who may be discouraged from applying for prime credit and instead make use of a less appropriate source of finance. In the prime credit market, consumers may be more confident of acceptance on the most favourable product. However, for those who would access short-term finance, the costs of credit rise dramatically following loan application rejections. This deters active consumer behaviour and limits competition.

### **Registering payday loans negatively in credit referencing**

In reaction to the negative connotation commonly associated with shorter forms of finance, there is some evidence that payday loan use might result in 'blacklisting' or exclusion from the mainstream credit market. Payday lenders typically emphasise that payday loan use and repayment can result in better credit opportunities for customers – such as the extension of more credit and larger loans to individuals who repay on time. However, there is some evidence that non-payday lenders exclude customers on the basis of observing they have used a payday loan. There is much anecdotal evidence that credit card providers seek supplementary credit record information on payday loan use. In the mortgage market

there is publicly available lending criteria data which demonstrates that some mortgage lenders will reject mortgage applications if a consumer has a recognised payday loan on their credit record.

Mortgage providers GE Money and Kensington Mortgages have, for instance, both stated that they will reject applicants that have taken out short-term finance.<sup>33</sup> This is perhaps due to a bias that originates from a decision, taken in 2013, by the large Credit Reference Agencies (CRAs) to specifically detail whether a person has taken out a payday loan or other form of short-term credit. Prior to this, a short-term loan was listed as general debt without differentiating it from other types of credit.<sup>34</sup> It is since this decision to distinguish short-term finance from other types of finance that mortgage providers have started to discriminate against those who have taken out a payday loan. In our opinion, it is hard to see how a single, or small number, of payday loans for a small amount should preclude a consumer from taking out a mortgage or other long-term form of credit. Given this, it is difficult to justify a practice that penalises payday customers and poorer consumers in this way. Moreover, with existing CRA technology not adequately recording payday loan repayment is not clear that consumers have the possibility for building a credit history via repayment of short-term loans. This form of alienation from mainstream credit can be a severe cause of detriment to consumers. 'Blacklisting' or other practices which preclude positive scoring on the basis of timely repayment should be wholly abolished. Consumers must have the ability to build their credit history through repayment behaviour irrespective of the form of credit concerned.

Taken together, we observe three factors that prevent true credit enhancement: the failure of most firms to price loans in response to good repayment histories; the failure of credit search recording conventions to allow the development of effective price comparison tools; and the 'blacklisting' of customers on the basis of payday loan use. The impact of these is to inhibit 'credit enhancement' within the market. Consumers are excluded from more affordable credit on better terms and as a consequence this transfers surplus to firms within the market. We identify this as a major challenge to improving the life circumstances of consumers within the payday lending market.

### **Under-provision of debt alleviation**

The second key issue for the short-term finance market is the absence of sufficient measures for preventing consumers from falling into the trap of unpayable and irresolvable debt, as well as the absence of adequate solutions for consumers who become over-indebted. The measurement of over-indebtedness is inherently complicated, though a significant share of the UK population can be seen as being 'over-indebted' and the concentration of over-indebtedness is greater within the payday lending market than the consumer credit market as a whole.<sup>35</sup>

While the problem faced by consumers who consistently perform well on their payday loan repayments is lack of opportunity to progress onto better forms of credit, the problem for consumers who become over-indebted is either an inadequate means of preventing unpayable debt or ineffective procedures for the resolution of debt. A host of options do exist for debt resolution and alleviation, but many factors, such as poor marketing, shame and denial prevent consumers from making full use of these. So for our purposes, despite there being nominal options for resolution, we consider these to be ineffective.

### **Affordability and credit scoring**

The first component of the debt-related problem is a lack of prevention on the part of both consumers and firms. A subset of consumers who use payday loans do so at very high risk of default. In a competitive credit market we would expect some level of late-payment or default on the part of consumers. However, when running its market investigation, the regulator determined that the levels of default observed at that time were too high and some very risky consumers received loans when they should not have.<sup>36</sup>

Some consumers who use payday loans are typically at high risk of default and firms may misallocate loans. The popular conception that firms have an incentive to lend to individuals who cannot repay in order to profit from contingent charges is misleading. Firms earn a very small share of their revenue from contingent charges. In fact, in 2012, the CMA found that the

average lender gained less than 12 per cent of their revenue from contingency charges (roll-overs, late fees and extension fees). Since then the total value of roll-over transactions has decreased by 80 per cent (as of March 2014)<sup>37</sup>, and we expect the downward trend to continue. Equally, most contingent charges applied to customer loans following late or non-payment are not paid by consumers.

The perceived solution to the problem of excessive likelihood of default is either to insist upon more stringent affordability checks, or to price the cap of payday loans such that the riskiest customers are no longer profitable to firms and firms react by reducing the supply of credit to these customers. Both measures work to exclude from the market those consumers at high risk of over-indebtedness.

However, an approach based upon credit rationing risks excluding risk-worthy customers from the market. When making credit decisions, firms score customers according to their creditworthiness and make judgements based upon credit scores. Credit scores are imperfect predictors of credit risk: some customers with good credit scores are actually bad risks, some customers with poor credit scores are actually good risks. Tightening lending criteria increases the likelihood of excluding customers who are actually good risks and does not address the underlying problem of limited information within a credit score. This is an area in which innovation and improved data sharing can improve loan allocation decisions without resort to paternalistic measures.

### **Debt resolution**

The second component of this problem is the absence of clear and available means of resolving unpayable debt. Unpayable debts arise when consumers are unable to meet their debt obligations, either due to unforeseen financial developments or due to an unwillingness to meet their contractual obligations. In these circumstances, the personal insolvency regime should provide a means for debt resolution that balances the rights of creditors against any debtors. An insolvency

regime which unduly favours creditors results in consumers being unable to resolve their debts. The regime should balance the enforcement of contracts favourable to creditors with a debt alleviation route for over-indebted borrowers.

Once a consumer is in default, the credit market provides insufficient means of debt resolution. At present consumers do not have sufficient insurance options. As an unfortunate consequence, many consumers in default experience many forms of detriment, including rising penalties and charges, and the psychological and social impact of credit problems. Some personal insolvency options exist as means of debt resolution. Formal bankruptcy and Individual Voluntary Agreements (IVAs) are well established insolvency processes, but they are too expensive for most consumers, with consumers required to raise £750 in payment when petitioning for bankruptcy. Debt Relief Orders (DROs) are a more feasible option, but are only available in limited circumstances<sup>38</sup> and also attract fees. Moreover, most consumers require professional assistance in order to complete an application for a DRO.

In addition, in many cases where personal insolvency options would provide an effective means of debt resolution to consumers, these options are not taken up. Lack of engagement with money advice providers is a major barrier to debt resolution. Despite extensive advertising, the proportion of consumers with severe debt problems making use of these services remains low. As a consequence, many consumers find themselves in a perpetual cycle of over-indebtedness despite the existence of resolution options which could improve their financial position and yield financial and non-financial improvement to these consumers.



- 
- 25 Consumer Finance Association, *Press Release: Generation Y are more financially aware than baby boomers*, 18 September 2013. Available at: <http://www.cfa-uk.co.uk/media-centre/press-releases/press-releases-2013/generation-y-are-more-financially-aware-than-baby-boomers.html> [Accessed 23 Oct 2014].
- 26 See CMA, June 2014, *Provisional Findings Report* para. 4.8-4.10 for a description of loan pricing and advertising conventions in this market. Available at: [https://assets.digital.cabinet-office.gov.uk/media/539b1d16e5274a103100000a/Main\\_report.pdf](https://assets.digital.cabinet-office.gov.uk/media/539b1d16e5274a103100000a/Main_report.pdf). [Accessed 23 Oct 2014].
- 27 Competition Commission, *Payday Lending Market Investigation*, p.11 cites the pressure credit unions feel to compete on speed and p. 24 more general competition between consumer credit lenders and payday lenders. Available at: [https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131\\_competition\\_from\\_other\\_types\\_of\\_credit\\_working\\_paper.pdf](https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131_competition_from_other_types_of_credit_working_paper.pdf) [Accessed 15 Oct 2014]
- 28 CMA (2014) *Payday lending market investigations. Provisional Findings Report*, para 4.11, p.4-3. Available at: [https://assets.digital.cabinet-office.gov.uk/media/5397ef3c40f0b6101d000003/Summary\\_of\\_provisional\\_findings\\_report.pdf](https://assets.digital.cabinet-office.gov.uk/media/5397ef3c40f0b6101d000003/Summary_of_provisional_findings_report.pdf) [Accessed 23 Oct 2014].
- 29 For example, to determine your finance charge (between £20 to £29.50 per £100 borrowed) for first-time loan applicants, QuickQuid uses 3 rate tiers: Excellent, Good or Average, based on various factors including, but not limited to, the borrower's credit history, employment history and loan repayment history. More details available on the lender's website. at <https://www.quickquid.co.uk/rates-and-terms/short-term-loan.html> [Accessed 23 Oct 2014]. A separate case study on progressive interest rates under the 'Sunny' product is presented in the next section.
- 30 Competition & Markets Authority, *Payday lending market investigation – Provisional findings report*, p.4 Available at: [https://assets.digital.cabinet-office.gov.uk/media/539b1d16e5274a103100000a/Main\\_report.pdf](https://assets.digital.cabinet-office.gov.uk/media/539b1d16e5274a103100000a/Main_report.pdf). [Accessed 23 Oct 2014].
- 31 Industry data provided by the Consumer Finance Association.
- 32 Quick Quid Flex Credit: <https://www.quickquidflexcredit.co.uk/how-it-works> The lender's website has the following note: 'When you submit your loan application, a full application search record will be created. If a credit report shows that too many application searches have been done in a short period of time, it could be a sign of great financial need or identification fraud.'
- 33 Anker, G. 'Black mark for payday loans', *Mortgage Strategy*, 3 December 2012. Available at: <http://www.mortgagestrategy.co.uk/black-mark-for-payday-loans/1062225>. article [Accessed 23 Oct 2014].
- 34 Idem.
- 35 Citizen's Advice (2014) *Briefing: Funding for debt advice through the FCA levy*. Available at: [http://www.citizensadvice.org.uk/citizens\\_advice\\_briefing\\_onfunding\\_for\\_debt\\_advice\\_through\\_the\\_fca\\_levy\\_21\\_january\\_2014.pdf](http://www.citizensadvice.org.uk/citizens_advice_briefing_onfunding_for_debt_advice_through_the_fca_levy_21_january_2014.pdf) [Accessed 23 Oct 2014].
- 36 Office of Fair Trading, *Payday Lending Compliance Review, Annexe A, Quantitative Findings*. Point A.32 14 per cent of loans were never repaid. A.35 states that "a high default rate may therefore indicate that the affordability assessments that are being carried out are not capturing [...] all the factors that determine whether a customer will be able to repay the loan in a sustainable manner and within the loan period."
- 37 Author's calculations based on industry data provided by the CFA.
- 38 For example, they are only available for debts up to £15,000, for those on very limited incomes who are not homeowners. See more at: <http://webarchive.nationalarchives.gov.uk/+/http://www.insolvency.gov.uk/pdfs/guidanceleafletspdf/droguide.pdf> [Accessed 23 Oct 2014].

# 4 A new approach to transformative credit enhancement

*"It is a key proposition of this report that it is vital for the long-term prosperity of consumers that, as they demonstrate and evidence a history of credit-worthiness, they are permitted to ascend the 'credit ladder' in order to access cheaper and more appropriate forms of credit."*

This section presents a series of radical, but achievable, proposals to improve the functioning of the credit market, including specific proposals relating to the payday lending market. The section will outline how future regulatory reform should be structured; how consumers can be permitted to 'progress' through the consumer credit market; and what can be done to alleviate or prevent unmanageable levels of consumer debt.

## ***Introduce holistic regulation***

Before making our main recommendations, we first highlight the importance of market definition for effective regulation of this market, and the need for holistic regulation. When it comes to debt, the outcome of an inability to repay any borrowing is, from the consumer's perspective at least, exactly the same regardless of the form of the original loan. The debt could be owed to a high cost short-term credit (HCSTC) lender, a high street bank or a home-credit provider. It could be an outstanding sum on a credit card, a store card or a catalogue purchase. Money is fungible and so is debt. The outcome is the same: money is owed by the customer, it must be repaid and, if circumstances mean that it cannot be, the customer is likely to find themselves subject to considerable detriment, both financially and psychologically.

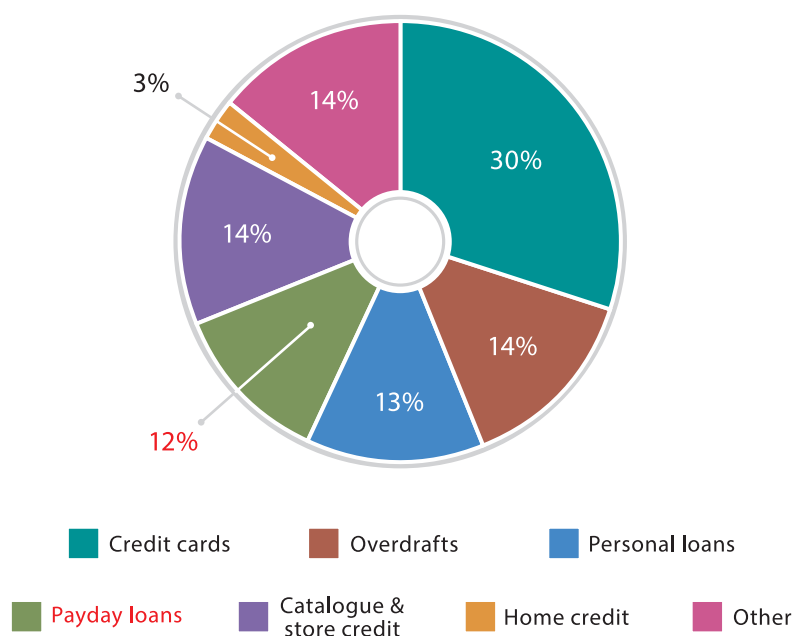
In their yearly market outlook report, debt charity StepChange analysed the different types of unmanageable debt that drove consumers to use their services. Their

findings support our view that borrowers and consumers in general find themselves indebted for a number of reasons and will therefore need debt advice and support. In fact, Fig. 3 shows that only 12 per cent of people seeking debt advice from StepChange were doing so because of difficulties paying back a payday loan, similar to the number of people struggling with their overdrafts (14 per cent) or their personal loans (13 per cent) whereas a much larger percentage (30 per cent) were experiencing credit card debt.

Moreover, the size of the problem cited by StepChange clients varied according to the type of credit or debt they had run and must be considered in regulation. As seen in Fig. 4, an average credit card or personal loan debt is higher than £9,000, whereas store credit, home credit, payday lending and other forms of HCSTC comprise significantly lower forms of debt.

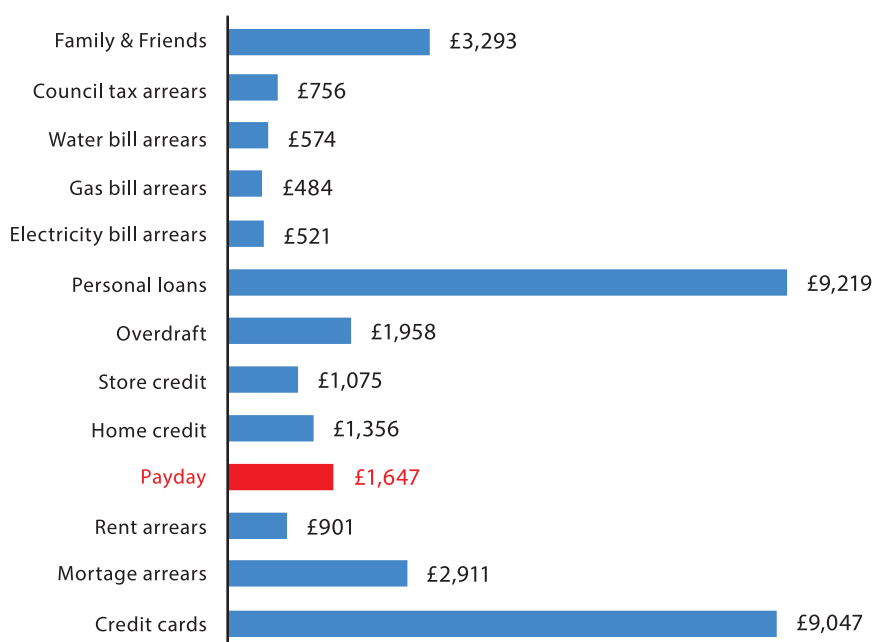
The definition of HCSTC lenders (which encompasses almost all payday and short-term lenders) and the way in which this classification separates out a small minority of lenders from the wider pool of consumer credit providers is, whilst perhaps politically advantageous, not pragmatically helpful for consumers, the industry or regulators. The creation of another category specifically for what are referred to in common parlance as 'payday lenders' adds an additional layer of complexity that is unnecessary and obstructive. For consumers who are not familiar with legal definitions, it makes it more difficult to understand what rules apply to the lender that they are currently

Fig. 3  
Types of unmanageable unsecured personal debt



Source: StepChange, Statistics Yearbook: Personal debt 2013. Available at: <http://www.stepchange.org/Portals/0/documents/media/PersonalStatsYearbook2013.pdf> [Accessed 23 Oct 2014]

Fig. 4  
Average size of debt (by debt type)



Source: StepChange, Statistics Yearbook: Personal debt 2013. Available at: <http://www.stepchange.org/Portals/0/documents/media/PersonalStatsYearbook2013.pdf> [Accessed 23 Oct 2014]

transacting with and creates uncertainty over the protections afforded to them. The definition is further confused by carve-outs for home-collected credit and other selected 'social' businesses.<sup>39</sup> For lenders, it creates an incentive to engage in 'regulatory arbitrage' and it may be that some HCSTC lenders have extended the repayment periods on their loans as a result. The argument for a more holistic approach that considers debt in the round is supported by the fact that someone in financial difficulty is likely to hold many forms of debt concurrently: 86 per cent of payday loan users have a credit card, and 31 per cent have 'maxed it out'.<sup>40</sup> To try to determine what particular form of borrowing initiated their debt problems is obviously difficult to do. Indeed, credit card providers, banks and payday lenders alike often sell their impaired loans onto debt collection agencies so, regardless of with whom the original credit was secured, consumers will often find themselves dealing with the same people when it comes to collection upon default. Furthermore, the end solutions in terms of debt advice and/or insolvency procedures are the same regardless of the form of the original debt.

Thus, debt should be viewed in a holistic manner. Drawing distinctions between different forms of debt simply creates artificial divides which may help politicians to garner votes by making them appear to be taking definitive action against a sector that, for many reasons, has become something of a public hate-figure, but does not help consumers who are struggling to manage debt problems or make the regulatory architecture any more effective. For this reason, we argue that the FCA should adopt for all future reforms a more holistic approach to personal finance regulation. This new approach should not single out any form of finance as worthy of tougher regulation or harsher penalties. Instead new regulators should realise that debt is debt, and that consumers are best served by receiving support and advice from all providers of personal credit.

Placing more stringent requirements on just one part of the consumer credit sector has the potential to simply displace consumers to another part without actually addressing the underlying issues. For example, unable



### Case Study 1: Sunny Rates™ - Repaying good borrowing behaviour with lower interest rates

Using a personalised scheme to judge credit-worthiness, Sunny awards points to existing clients according to repayment behaviour. By paying a loan or instalment on time and watching financial literacy videos, borrowers earn between 5 and 20 points, while late repayments are sanctioned by 10-40 points, the exact amount depending on the frequency of repayments. Consumers can also earn points by demonstrating good budgeting skills and financial knowledge. On the lender's website there are four videos on financial literacy, each paired up with a quiz that can earn the borrower up to 20 points. The videos explain budgeting techniques, debt management, saving as a way of avoiding future credit needs, as well as shopping around for the most suitable type of loan.

These points are then used to determine the interest rates customers pay. Starting out at 100 points, each new borrower will automatically qualify for a 29% interest loan. In time, these points can build up the borrower's score down to a 15% monthly interest rate, as explained in Fig. 5 below.

Compared to an average payday loan rate, responsible borrowers can save up to £43 for an average loan of £260 in 30 days. The difference is even bigger should the borrower run an unauthorised overdraft, incurring a minimum daily charge of £5.

to get a 'payday loan' due to tighter affordability criteria, a consumer might be forced to use an unauthorised overdraft facility which, as already highlighted, can be more costly as a result of charges imposed by the bank. Moving consumers from one form of borrowing to another does not do anything to address the underlying issues of why they are in such desperate need of credit in the first place or help them to ease any existing financial difficulties. In the worst cases, consumers might move from legal lenders to illegal ones.<sup>41</sup>

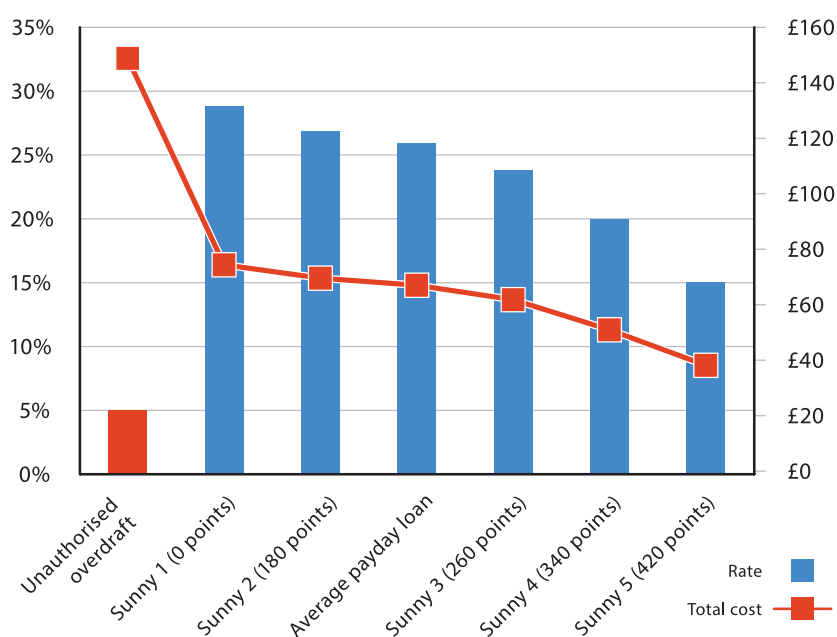
### Credit enhancement in a customer-firm relationship

This section presents measures that will enhance the opportunity for 'credit enhancement' and ensure that consumers receive those products that are of most benefit to them. We propose a solution which combines new opportunities for competitive market forces to enter the payday lending market with changes to credit reference agency conventions that would allow effective price comparison. In addition to this, we would also look to promote further innovation in product offerings within the payday lending market which facilitate consumer progression.

In a competitive credit market, consumers that show they are lower risk should see improved credit offers available to them. A consumer with an improving credit history should receive offers of more favourable credit from lenders. Where this does not occur, the existing lender is making abnormal profit. Market forces should eliminate this abnormal profit through similar lenders making better credit offers.

The payday loan market itself should respond to the lack of progress opportunities available to consumers by developing 'progress products'. Alternatively, lenders should diversify their product offerings to incorporate a broader price range. Progress products are products that reward consumer repayment behaviours with more favourable loan terms. The terms of such products are essentially simple 'rate changing' events which occur at points in time when the consumer has demonstrated competence in repayments. There are examples of progress products in the current credit market. The Capital One 'Progress Card' reduces the applicable interest rate on the credit card falls over time by 2 per cent every 6 months if the consumer meets all their contractual payments

Fig. 5  
Cost of short-term loan - £260 for 30 days



Source: Sunny, [www.sunny.co.uk](http://www.sunny.co.uk)



and stays within their credit limit.<sup>42</sup> Hence there is a clear link between current repayment and future credit terms which incentivises the customer to repay loans in the present.

In some cases a progress product could use the same 'trust ratings' as those currently used by firms in the market. However, instead of rewarding repayment behaviour by the offer of larger balances, firms should reward consumers with lower headline rates. At present, many market actors cite the inelasticity of price demand as a reason why price competition is not effective in the market. However, among the more prime consumers under consideration here, the elasticity of demand is likely to be higher. Hence these products will be attractive to this group of consumers, which is the group of consumers most likely to be eligible for and to benefit from the introduction of progress products.

Sunny's initiative goes a long way in combating the usual credit score bias associated with accessing short-term credit, and it may also encourage competition and consumers shopping around. While the CMA data suggests typical payday rates (pre-rate cap) averaged 37 per cent per month, Sunny began lower, at 29 per cent, and then allowed consumers to progress to lower rates. In addition to their internal progression Sunny makes this type of data available to CRAs. This allows customers that demonstrate good payment history to have it reflected on their credit reports. Sunny currently reports payment history to four of the primary CRAs in the UK market. As the average payday loan user takes out 6 or more loans during the course of a year, the responsible borrower has enough opportunities to build up a good score with Sunny and have it reflect in their credit report. We recommend that data on borrowing behaviour be made public by all lenders, like Sunny, and reflected on the person's credit history. True credit progression can only be achieved when all lenders will re-price their loans according to their borrowers' credit history and risk profile.

The introduction of progress products will also constitute a strategic reaction to the imposition of the price cap in this market. Lenders will most likely receive

criticism for 'pricing to the cap'. However, the introduction of progress products will allow lenders to present a customer journey in which price declines over time can bring down the cost of borrowing from the cap limit and deliver improved value for money to customers.

In addition, the introduction of the payday lending price cap will offer firms an incentive to offer more flexible, lower cost forms of credit. To some extent, the ability of firms to survive post-cap is dependent upon them expanding their current market into more-prime consumers. The price cap sets a limit of daily interest charges – the initial cap component is 0.8 per cent of principal per day. This is likely to bring an end to the very short-term lending market. Firms will not be able to charge their current levels of up-front fees for short loans and as a result these loans will become uncompetitive. The cap, however, does allow firms to earn considerable revenues on longer loans (up to 100 per cent of the total cost of credit). As firms seek to offer longer loans, such as instalment loans, they should also offer more flexible lines of credit. These could be in the form of credit cards with shadow limits whereby the card can be used to originate fixed-value transfers to the consumer.

There is scope for firms to integrate vertically and offer opportunities for progress within the market via sub-prime to prime products. For example, a short-term finance provider could combine product offerings with a sub-prime credit card company to offer progress products. Alternatively, vertical relationships could progress customers through referrals agreements. Payday lending firms could be rewarded for referring good-risk consumers to sub-prime credit providers within the market. Recently some well-known banking names in the UK have signalled their intent to offer short-duration, fixed-price loans (e.g. RBS). These firms would be prime candidates for referrals integration with existing firms within the market.

### **Credit enhancement within the broader credit market**

It is a key proposition of this report that it is vital for the long-term prosperity of consumers that, as they demonstrate and evidence a history of credit-worthiness, they are permitted to ascend the 'credit ladder' in order to access cheaper and more appropriate forms of credit. To not permit this would be grossly unjust and unfair to responsible consumers. For such 'credit enhancement' to occur, options must exist for responsible customers of payday firms to access forms of finance normally offered by mainstream banks, and for customers of high street banks to access shorter forms of finance.

In order to allow customer movement within the market, the market itself needs to provide accurate measures of risk and the consumer needs to be aware of the expected benefits from 'shopping around'. The CMA's recent report into the payday lending market found that consumers did not tend to shop around between providers in this sector and called for accredited price comparison websites on which all payday lenders would be listed.<sup>43</sup>

The CMA's proposed price comparison websites, however, will only tell users the costs of borrowing from a number of payday lenders; they will not allow borrowers to compare with other forms of credit. Indeed, especially as all payday lenders are likely to migrate towards the maximum charge allowed under the cap on the total cost of lending once it is introduced, the difference in prices will be minimal. An obligation to list on an accredited price comparison website should, therefore, be extended to all consumer credit providers in order to allow consumers to make a fully informed choice. Comparison websites should, therefore, present to consumers all forms of credit that would offer them the amount sought, for the term sought.

However, effective price comparison will only work if consumers can obtain bespoke information about credit offers available to them, not simply a list of headline rates. Price competition is currently severely limited by the conventions described earlier on the way in which credit searches are recorded and interpreted. The best means of improving credit offerings to consumers

should be the harnessing of natural market forces, but as has been mentioned, these are currently hindered by the CRA convention of recording credit applications in a manner which infers negative scoring for credit searches. This discourages consumers from 'shopping around' the credit market. This convention clearly needs to be reformed as it is strongly anti-competitive.

In order to create effective price comparison, we need to see a more widespread adoption of quotation searches, like those used in the mortgage market. Such a search is a credit check made by a firm which does not leave a footprint on a consumer's credit history. These do exist in the mortgage market, for lenders who seek to provide 'decisions in principle' to mortgage applicants at the mortgage application stage or to give an indication of the price at which they would be willing to offer credit.

The wider use of these quotation searches would facilitate the development of meaningful price comparison tools within the consumer credit sector. In many financial markets, price comparison websites have become the primary means of consumer shopping. In the insurance market, for example, consumers can receive agreements in principle from many insurers within seconds of application. Results from price comparison searches return indications that for example some insurers would not insure, some can provide an indicative price, and some can make an up-front price offer. The equivalent within the consumer credit market would be a set of offerings from credit card providers

which could take the form of in principle rejections, indicative offers (e.g. with a price range) and firm offers. As such, we recommend that FCA encourage greater use of quotation searches, as we believe this would dramatically increase competition in the consumer credit market to the benefit of many customers.

In our opinion, the price comparison market for consumer credit should function in a manner akin to the price comparison market for home insurance. On provision of personal information, customers should receive individual-specific quotes which provide terms and prices relevant to them. An insurance price comparison search returns a list of specific products and prices which the customer can choose. The same should be true of consumer credit price comparison. Comparison of a headline price is woefully inadequate.

Price comparison websites (PCWs) have a clear incentive to add 'credit comparisons' to their current portfolio of price comparison markets and some sites already provide this facility. Such websites earn commission through referral agreements and advertising revenues. The consumer credit market is an expansive market into which more PCWs could move. However, it is our opinion that there is no need for new PCWs which would only allow comparison of headline prices of the type the CMA suggest, but instead comparison sites should embody at least 'quotation searches'. We call upon the FCA to further investigate these options as it implements the CMA proposals. As argued above, PCWs that permit

only the comparison of headline prices would be ineffective, as they do not communicate meaningful information about the products for which a consumer is eligible, nor the relevant transaction price for any particular consumer. Instead of this type of comparison site, existing high-impact sites should be enabled to break into this market. Existing arrangements for referral fees, comparison metrics and technology could be swiftly deployed in the consumer credit market.

Instead of evaluating HCSTC in isolation, a more complete view would improve understanding of where the different forms of consumer credit providers sit in the market and assist in the creation of an overarching regulatory framework that facilitates consumers being matched with the most appropriate form of credit for their particular needs and wants.

---

39 For example, see the extended comparison between payday lenders and other forms of credit, finding numerous similarities, found in Competition Commission, *Payday lending market investigation: Competition between payday lenders and other credit providers*. Available at: [https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131\\_competition\\_from\\_other\\_types\\_of\\_credit\\_working\\_paper.pdf](https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131_competition_from_other_types_of_credit_working_paper.pdf) [Accessed 15 Oct 2014].

40 StepChange MoneyAware, 'Payday Loans: Help us keep up the pressure', July 18 2014. Available at: <http://moneyaware.co.uk/category/debt-2/payday-loans-debt-2/page/2/> [Accessed 23 Oct 2014].

41 BIS, POLICIS (2010) *Interim Evaluation of the National Illegal Money-lending Projects*. Available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/31888/10-1186-interim-evaluation-illegal-money-lending.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31888/10-1186-interim-evaluation-illegal-money-lending.pdf) [Accessed 23 Oct 2014].

42 Capital One, 'Capital One Progress Card Summary', <http://uk.creditcards.com/credit-cards/capital-one-progress.php> [Accessed 23 Oct 2014].

43 Competition & Markets Authority, October 2014 *Press Release: CMA sets out proposals to lower payday loan costs*. Available at: <https://www.gov.uk/government/news/cma-sets-out-proposals-to-lower-payday-loan-costs> [Accessed 23 Oct 2014].

# 5 A new paradigm for debt alleviation

*“The prevention and resolution of consumer over-indebtedness can be achieved through a series of measures which yield innovations in credit scoring and loan allocation technologies, as well as responsible intervention in debt resolution.”*

## **Real-time credit scoring**

The prevention and resolution of consumer over-indebtedness can be achieved through a series of measures which yield innovations in credit scoring and loan allocation technologies, as well as responsible intervention in debt resolution. To some extent the introduction of the price cap will reduce the riskiness of marginal consumers as firms move to new, lower risk, margins of lending. Further innovations at this margin of lending can improve firms' credit scoring performance. This will result in better loan allocation decisions and the opportunity for firms to extend market size while operating under the price cap.

A combination of credit scoring innovations can be brought to bear in the market to improve credit allocation decisions. Firstly, the move to 'real-time' data sharing will ensure more information is readily available in credit files. Real-time data sharing is a much overdue innovation in the credit market at large, and an essential component of affordable lending in the payday loan market. Real-time data sharing involves continuous (daily) updating of credit files in contrast to the existing convention of updating credit reports on a monthly basis. Following recommendations from the FCA and the Department for Business, Innovation and Skills, two of the major credit referencing agencies have announced the development of real-time data sharing services. Callcredit launched MODA in June 2014, while a similar scheme by Equifax is due to be launched later in 2014.

The low frequency of consumer credit record updating has in part emerged due to the historical needs of the credit market. Until recently there was little need for updating credit files any more frequently than once per month. However, in the short-term credit market, loan events can extend over only a matter of days, and multiple loan applications in a short period of time can result in consumers taking payday loans from a lender that does not realise that the consumer has existing loans outstanding with other lenders, a recent non-payment on a credit card or any other event on their credit file. Real-time credit scoring should eliminate these problems.

The industry debated the merits of upgrading from daily to real-time updates of borrowers' credit history. While the regulator favours the latter, research by MODA's developers revealed that less than 1 per cent of borrowers accessed more than one loan in the same day, therefore rendering it unnecessary for the CRA to increase the frequency of their updates.<sup>44</sup>

We therefore recommend that the whole short-term finance industry adopts similar services. Also, we recommend that other CRAs trial and roll out such data-sharing tools, possibly under the tutelage of the industry's trade body, the Business Information Providers' Association. Doing so would improve the credit data available to lenders and make for better, more efficient forms of credit that are more accessible and affordable.

## Case Study 2: Real-time data-sharing

### How it works

MODA allows for daily updating of a customer's credit file, including events such as overdue payments, rollovers and credit extensions, so that lenders have access to up-to-date information on the situations of those applying for a loan with them.

As of June 2014, all CFA members are early adopters of MODA, along with nine other lenders who used it at its launch. Moreover, the FCA expects 90 per cent of the sector to be participating in real-time data sharing by November 2014, leading to more than 90 per cent of short-term loans being reported in real-time.

### Benefits for consumers

The CMA's June 2014 provisional report found that 54 per cent of short-term borrowers took out another loan while their previous one was still outstanding. Given that credit files were usually updated monthly and the average payday loan is repayable within the month, this suggests that before the introduction of real-time data sharing, over half of customers borrowed without their lender being aware that they had another outstanding loan. This is particularly significant given that customers who experienced credit or debt problems were more likely than average to have used more than one payday lender.

The FCA argues that increased real-time data-sharing would support more effective affordability assessments, and thus allow lenders to make more accurate lending decisions. It could also help borrowers who are trying to improve their credit rating by providing more up-to-date information.

allocation decisions. Many firms within the payday lending market employ sophisticated state-of-the-art credit scoring models which use a wide range of behavioural data. Behavioural consumption data will be a valuable addition to these models. Yet as it currently stands, there is little consumption data available to lenders when it comes to assessing credit risk. Because of this, we recommend that the Government conduct a consultation on this subject to determine how and what types of bank and transaction data could be utilised in this regard. This would be similar to a consultation that the Government recently conducted on SME data to increase business lending.<sup>45</sup>

## Pathways out of indebtedness

Where consumers become over-indebted there is evident need for increased provision of advice and lower barriers to personal insolvency resolution actions. Take-up of advice by over-indebted consumers is low. Many remedies to low take-up have been trialled, including extensive advertising by money advice services in the general media; targeted advertising on lender marketing materials and websites; and referral to money advice services by lenders as part of their claims management strategies. These initiatives, although well-researched and well-intended, often disappoint. The consistent finding from extensive research is that the majority of consumers who enter default very quickly become disconnected from the credit market.

We suggest a more radical and incisive intervention: automatic referral of consumers in late-payment to money advice services where referral occurs at the point of first contact by the lender. There is much research on the delivery of advice provision to those in non-payment which shows consumers need to be contacted very early on following non-payment. Importantly, this research demonstrates that the specifics of the means and media of contact are very important. Many approaches result in low utilisation: pass-on of money advice contact details by the lender, cold-calling by money advice providers, 'call-you-back' services.

As a consequence, we recommend a specific form of automatic referral which has performed strongly in trials undertaken by the Money Advice Trust: automatic referral,

## New data, new methods, better credit scores

What is needed in the market extends beyond purely increasing the frequency of credit file updating. In addition to this, firms should have access to the vast array of consumer data returned to CRAs in order to improve their credit score affordability checks. In particular, one high value source of information on consumer risk and affordability not currently exploited by lenders is information contained in consumer consumption transactions histories.

Increasingly, current account providers and credit card providers share transactions histories data with credit reference agencies. These records provide the contents of a customer's bank statement – the history of transactions i.e. details of monies spent at retail and other outlets plus the time, date and value of transactions. These records contain information which is useful for credit scoring.

A new academic literature on 'behavioural credit scoring' has introduced the idea that creditors can learn useful information about the riskiness of consumers through analysis of their consumption behaviour. This has been shown using data in a developing country context and is most likely to be applicable in all economic settings. For example, the composition of transactions reveals information about consumer riskiness. A consumer with a large share of consumption transactions spent on, for example, consumer electronics and jewellery is typically a higher credit risk compared with a consumer who exhibits a large share of consumption spending on homewares and home refurbishment expenditures. Consumers who make high frequency purchases towards the end of the working week are typically riskier than consumers who exhibit steady recurrent pattern of purchasers form a stable set of vendors.

Firms should embrace this new data to improve credit score models and loan

via telephone, during the first contact call initiated by a lender following a customer non-payment event. The specific construct is important here: a consumer should be referred 'live' to a waiting advisor during the first contact by their creditor. The specifics of this design are important for its success, as demonstrated by recent trials.<sup>44</sup>

Financial and legal support should be extended to allow consumers to take advantage of Debt Relief Orders (DROs). DROs offer a simple and quick debt resolution vehicle under certain circumstances. However, they are under-utilised due to a lack of legal support. Recent history of DROs has shown that the withdrawal of legal aid resulted in a sharp decline in the volume of numbers issued, even during a period in which consumer debt problems were becoming more severe and widespread.<sup>45</sup>

A lack of awareness of sources of debt advice is but one barrier to those in financial difficulty seeking help. Another obstacle is the perceived social stigma, sense of personal failure and having let others down, and the misconception that the 'debt spiral' is one that can never be escaped, which means that many are reluctant to accept that they have a debt problem at all. Seeking advice requires acceptance of the problem and, to a certain extent, relinquishing confidentiality and independence over one's own financial affairs, at least momentarily. These psychological elements of debt cannot be easily explained, understood or solved. However, there are, perhaps, some potential measures that could be taken to mitigate at least some of the causes of these feelings.

Just as the form of the initial debt does not matter to a consumer requiring debt advice having fallen into financial difficulty, the form

does not matter to the consumer forced to turn to insolvency procedures. Improving awareness and understanding of insolvency procedures would go some way in reducing the reluctance of those in difficulty to seek debt advice and should, therefore, be promoted alongside debt advice services. Misconceptions about insolvency procedures make consumers think that they are a 'one-way street' from which a person can never come back, that one is forever marked as a debtor and play a major role in fuelling fears of exclusion, finality, and of being looked down on that are often associated with financial difficulty. These fears mean that many keep their problems to themselves, simply exacerbating the issues. In fact, insolvency options are by no means a 'death sentence': an Individual Voluntary Agreement (IVA) is added to the Individual Insolvency Register but removed just 3 months after it ends. Many also believe that insolvency procedures are expensive but a Debt Relief Order (DRO) costs just £90 and there are many charities which are willing to cover this sum if the applicant is unable to. Both IVAs and DROs can cover debt owed on bank and building society loans and overdrafts, credit cards, personal loans, store cards, catalogues and charge cards. DROs can also include hire purchase or conditional sale agreements and 'buy now - pay later' agreements.

As already highlighted, all forms of consumer debt have the potential to create similar consumer detriment. However, at present, only promotions for those lenders deemed HCSTC providers are required to bear a risk warning with a link to the Money Advice Service website.<sup>46</sup> The overarching outcome that should be being pursued is for consumers to have better awareness of the options for debt advice available to them such that they can make an informed choice as to the appropriateness of taking

on more debt rather than taking the loan out of desperation, regardless of where they are considering turning for credit. Placing more stringent requirements on just one small part of the consumer credit sector (and it is, indeed, just one small part; consumers owe a total of £158bn in credit debt but the CMA's estimate puts payday lending at around £2.8bn)<sup>47</sup> does little to contribute to this aim.

Consumers might find themselves in financial difficulty as a result of debt originating from a credit card, a home-collected loan or a HCSTC provider, so it follows that all forms of borrowing should be required to bear this risk warning. Indeed, we believe that such warnings should be displayed on all forms of personal credit, regardless of the source of that credit. We argue that debt is debt, and other forms of finance are just as responsible for the accumulation of personal debt.

It has also been suggested that a levy should be imposed on HCSTC providers to fund debt advice services. Again, for the same reasons, it makes sense for this levy to be imposed on all providers of consumer credit, regardless of the form that credit might take. Finally, the Money Advice Service is by no means the only provider of free debt advice. Increasing awareness of debt advice options should, therefore, not be limited to drawing consumer attention to the existence of the Money Advice Service.

44 Jan Smith – Callcredit, 27 Sept 2014, "How can payday lenders help borrowers climb the credit ladder", ResPublica fringe event at the Conservative Party Conference. Full debate available at: <https://twitter.com/search?q=creditladder&src=typd>

45 SME Credit Data Impact Assessment A. Available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/323255/FSTs\\_Office\\_Credit\\_Data\\_IA\\_Clean\\_Version\\_E-sig.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/323255/FSTs_Office_Credit_Data_IA_Clean_Version_E-sig.pdf) [Accessed 15 Oct 2014].

46 Money Advice Trust (2011) Understanding Financial Difficulty: Exploring the opportunities for early intervention. Available at: [http://www.infohub.moneyadvicetrust.org/content\\_files/files/understanding\\_financial\\_difficulty.pdf](http://www.infohub.moneyadvicetrust.org/content_files/files/understanding_financial_difficulty.pdf) [Accessed 23 Oct 2014].

47 SME Credit Impact Assessment A. Available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/323255/FSTs\\_Office\\_Credit\\_Data\\_IA\\_Clean\\_Version\\_E-sig.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/323255/FSTs_Office_Credit_Data_IA_Clean_Version_E-sig.pdf) [Accessed 15 Oct 2014].

48 <http://www.fca.org.uk/news/tougher-rules-for-payday-lenders-take-effect>

49 <http://www.ft.com/cms/s/0/84c43f0c-f130-11e3-9161-00144feabdc0.html>



# 6 Conclusions and recommendations

*“To truly transform the consumer credit market from one that disenfranchises its customers into one that provides opportunity for personal betterment, we believe the two concepts of ‘credit enhancement’ and ‘debt alleviation’ should be promoted.”*

Throughout this report we have demonstrated that the consumer credit market, as it currently exists, conspires against the advancement and true flourishing of consumers – especially those on lower incomes. To truly transform the consumer credit market from one that disenfranchises its customers into one that provides options to consumers for personal betterment, we believe the concept of ‘credit enhancement’ should be promoted. This would ensure that consumers can ascend the ‘credit ladder’ to obtain more affordable and appropriate forms of credit. For this, the credit-rating system will need to be overhauled and competition greatly promoted within the sector.

There must also exist options for debt alleviation. Over 9 million adults in the UK are currently over-indebted. This is not only damaging to those who suffer under such pressures, but presents a considerable danger to future national prosperity. Both policy makers and the industry must ensure that the right levels of debt advice exist to help cope with such high levels of personal debt. Those measures that help consumers relieve themselves of debt should also be better promoted and encouraged by Government.

The following eleven recommendations illustrate the level of reform needed in the sector if we are to have a consumer finance market that in truth works for the betterment of its customers.

## **1. The FCA and CMA should adopt a more holistic approach to consumer finance regulation**

Much of the consumer finance regulation imposed in recent years has been targeted at payday and short-term finance. However, this tends to ignore the fact that most personal debt derives from other sources of finance and that more obvious forms of short-term credit (e.g. unauthorised overdrafts) are actually more expensive than payday loans. For these reasons, we believe that the FCA and CMA should adopt a more holistic approach to personal finance regulation. Given this general principle, this new approach should not single out any form of finance as worthy of tougher regulation or harsher penalties. Instead regulators should realise that consumers are best served by measures that prevent consumers from creating unsustainable debt, regardless of the source of credit.

## **2. Lenders and money advice providers should put in place automatic referrals to debt advice charities upon non-payment**

Almost nine million people in the UK can be classified as being over-indebted, yet less than a quarter of this group are likely to receive any advice. In order to combat the high levels of indebtedness experienced by many in this country, we recommend that, in the case of a non-payment episode for any form of personal credit, including payday loans, that the consumer in question be referred automatically to a free debt advice provider. This could be either the Money Advice Service or an independent debt advice charity.

### **3. Payday lenders should create opportunity for credit enhancement among payday loan customers**

It is vital for the future stability and prosperity of consumers that, as they demonstrate and evidence a history of credit-worthiness, they ascend the 'credit ladder' and are able to access cheaper and more appropriate forms of credit. Consumers who demonstrate that they are 'good risks' by consistently repaying on time should face reduced cost of credit in line with the reduced risk of lending. Payday lenders who currently reward consumers who earn their trust with larger loans (at the same interest rate) should also reward consumers with cheaper loans. Real-time scoring technology should be employed to capture loan repayment behaviour and allow payday lenders to more accurately price the risk of customers with improving credit histories. Providers who do this should have this aspect of their business model positively reflected in the loan comparison sites already recommended by the Competition and Markets Authority (CMA). A tailored response to individual borrowers could form part of the formal information disclosures already recommended by the CMA for repeat borrowers.

### **4. The credit industry, together with the FCA and CMA, should establish a credit market with enhanced consumer search for products**

Consumer search in the credit market is heavily curtailed by the perceived penalties arising from credit rejections. A well-functioning credit market should encourage, not disincentivise, consumer search and enable progression onto cheaper credit products. For such credit enhancement and progression to occur, options must exist for responsible customers of payday firms to access forms of finance normally offered by mainstream banks when this would be more appropriate. That a number of large banks have already suggested that they might move into the short-term finance sector indicates that the conditions for such co-operation exist. A hybrid system of referral fee rewards and incentives for achieving progression for consumers should be introduced to convince firms to follow this line. Credit Reference Agencies (CRAs) must work with regulators to create a reporting environment in which credit search rejections do not act to penalise consumers. We recommend that the trade

bodies that represent these two markets, the Consumer Finance Association (CFA) and the British Bankers' Association (BBA), establish a formal partnership that would allow for referrals between the two sectors to ensure that customers have a broad range of products open to them.

### **5. The Government should launch a consultation on the use of behavioural consumption data in credit scoring, and Credit Reference Agencies should release greater amounts of consumer data to better determine credit-worthiness**

One of the best means of assessing a customer's credit-worthiness is by assessing their consumption behaviour. If a consumer is likely to spend any borrowed monies on essential household goods and is not irresponsibly directing their finances towards non-essential goods, this could be an indication of a consumer in real and urgent need. Yet as it currently stands, there is little consumption data available to lenders when it comes to assessing good and bad credit risk. This means loans are often issued when they shouldn't be, and not issued when they should be. Because of this, we recommend that the Government conduct a consultation on this subject to determine how and what types of bank and transaction data could be utilised in this regard. This would be similar to a consultation that the Government recently conducted on SME data to increase business lending.

### **6. The CMA should introduce an industry-wide price comparison website to boost choice**

There exists a plethora of personal finance providers and a multitude of product offers in the UK credit market. But despite the apparent levels of competition in personal finance, consumers cannot adequately make use of or see the choices available to them. Unclear lending terms and a lack of product searching both ensure that there is very little comparison between providers. The CMA has asked for accredited comparison websites for the payday lending market to be established. We agree but we think by itself this is insufficient, we think it would be best for there to be a price comparison website that compared all forms of personal finance of a similar type. This would be in keeping with our more holistic approach to regulation and would ensure that the consumer had

all the relevant information, and as many choices as possible open to them, as well as the pathways to clear credit enhancement.

### **7. The FCA should ensure all forms of consumer credit come with debt warnings and advice**

The recent raft of reforms on payday lending has required all firms in the market to display product warnings that detail the dangers of debt. While this will no doubt be helpful to many customers, we believe that such warnings should be displayed on all forms of personal finance, regardless of the type. We argue that debt is debt, and other forms of finance are more responsible for the accumulation of personal debt than short-term finance. As such, given our commitment in the report to developing better methods for debt alleviation, we believe that such a move should be pursued by regulators and embraced by the industry.

### **8. The FCA should encourage further use of real-time data-sharing**

The credit risk systems that Credit Reference Agencies use to determine the credit-worthiness of certain consumers are vital to the proper functioning of the personal finance market. However, the current credit rating systems are not designed for those who access shorter forms of personal finance, who are also likely to be on the lower end of the income spectrum. For these customers, the sharing and revising of credit information needs to be updated on a much more regular basis. Without this, firms cannot conduct proper analysis of consumer affordability in light of recent events in a consumer's credit history. Daily credit analysis and sharing is something that a small number of lenders are trialling at the moment. We recommend that the entire short-term credit industry move to such a system, supported by the Business Information Providers' Association, which should insist that all of its members trial and roll out similar tools.

### **9. The industry, together with Credit Reference Agencies, should encourage quotation searches in consumer finance to foster greater competition**

Competition and choice in the personal finance market are currently limited by the way credit rating operates, which means that loan applications, where credit searches leave a footprint on a consumer's credit record, can be interpreted negatively.



This can act as a barrier to 'shopping around' and prevents many consumers from obtaining the best deal. Credit Reference Agencies (CRAs), together with the Standing Committee on Reciprocity and the Financial Conduct Authority, should explore means of facilitating comprehensive quotation searches which could enable genuine, effective and salient price comparison technology to be brought to bear on the consumer credit market. This is essential for creating an environment which encourages credit enhancement. We suggest the market move away from a model where credit providers individually pay CRAs for credit files towards a commission fee structure based upon loans written. We call upon the Financial Conduct Authority to undertake new research into the role of credit application histories and how their use within the industry discourages consumer search in the credit market.

### **10. The Credit Referencing Agencies should, in collaboration with the short-term finance industry and the CFA, develop a clear method for positively referencing and capturing good loan repayment behaviour by payday customers**

Existing credit referencing technology does not adequately record payday loan repayment, nor is it clear that consumers have the possibility for building a good credit history via repayment of short-term loans. This form of alienation from mainstream credit can be a severe cause of detriment to consumers. It keeps them trapped where they are. 'Blacklisting' or other practices which preclude positive scoring the timely repayment of payday loans should be wholly abolished. Consumers must have the ability to build their credit history through repayment behaviour irrespective of the form of credit concerned. Without this we create a captive credit market that offers no path for future advancement.

### **11. The FCA should undertake research into what happens to those denied credit as a result of its interventions**

According to FCA figures, 11 per cent of those who currently utilise payday loans will be unable to do so as a result of the price cap. This equates to 176,000 people who will no longer, due to market restriction, be able to access short-term credit. The FCA has undertaken to review the impact of the market cap two years after its implementation. As part of that review process, and before that two year period, we think some analysis should be undertaken as to what has happened to these people who are no longer able to obtain short term credit. Have they turned to criminal or illegal lending, or have they simply not made the purchases they were hoping to make? Any proper regulation must look at the cost to those who are excluded from a service as a result of market intervention by the regulator. The consequences may be beneficial or harmful, but it would be good for the sake of those affected to have some objective knowledge of the situation.

We believe that if the industry and those in Government were to adopt these recommendations the market for consumer credit could be transformed into a sector that empowers and enriches citizens. The current failings of the consumer credit market are many. We therefore argue that an approach to reform must be adopted by Government that embraces the holistic and consumer-centric principles espoused throughout this report.

## Prosperity Workstream

*The UK has some of the highest levels of wealth concentration in the developed world. It has an economy where most mature markets are dominated by a small number of players and the barriers to entry are far too high. It is not an exaggeration to suggest that in many areas, from energy to banking to groceries, the UK has a monopolistic rentier rather than a market economy – a system in which certain individuals or small groups gain market dominance and excessive returns through anti-competitive practices. This conspires against innovation and is detrimental to the small and emergent businesses that generate growth and spread prosperity. Added to this, our education system, by specialising too early and often in the wrong areas, fails to produce students with fully rounded skill-sets. We are simply not equipping our future workforce with the means to safeguard our, and their, economic future. This is one reason why the real value of wages in proportion to growth in GDP continues to stagnate or fall. Our long-term productivity dilemma is a function of market capture and the effective de-skilling of the population.*

*We believe that shared prosperity cannot be achieved by simply tweaking the market. Britain needs significant demand and supply-side transformation, with new visionary institutions re-ordering our economy. We need long-term solutions that give power over wealth and assets, not simply handouts, to ordinary people. Central to this process of economic empowerment is an ethical, practical and adaptable education that gives people the skills to build their own businesses, or develop their own talents, rather than a conveyor belt to a service industry of low wage and less return.*

*New financial institutions to promote small business lending are required, and this involves smaller, more specialised and decentralised banks that can deliver advice as well as capital. We wish to explore ways in which all financial transactions can be linked to a wider social purpose and profit, which itself needs a transformation of the legal framework within which economic transactions take place. We believe that the future lies in the shaping of a genuinely social market which would be in consequence a genuinely free and open market. Internalising externalities and creating a level economic playing field in terms of tax paid and monopolies recognised and challenged, remains beyond the scope of contemporary governments to deliver. Such a vision requires new concepts. The viable transformative solutions lie beyond the purview of the current visions of both left and right in the UK.*

## About the CFA

*The CFA (Consumer Finance Association) is the principal trade association representing the interests of major online and store-based short-term lending businesses operating in the UK.*

Prosperity

Prosperity

Prosperity

In recent years, the payday lending industry has seen significant growth, followed by necessary regulatory reform. However, despite changes in both principles and lending practice, the market in its current form serves neither the interests of consumers nor of wider society.

The challenge we now face is that of creating a sustainable short-term credit industry shorn of its negative aspects; one which can protect people from illegal lending at a time when tightened household budgets continue to fuel the demand for credit.

*Climbing the Credit Ladder: Short-term loans as a path to long-term credit* argues that a reformed short-term credit industry has the potential to be both socially and economically transformative for those in need. In this report, we propose reforms to allow payday customers to 'climb the credit ladder' and progress into longer-term finance and the stability and prosperity it can engender. At the same time, the reforms we suggest will support those who fall into severe financial difficulty, making sure they do not enter a vicious circle of debt upon debt and are instead pointed towards the advice and resolution they need.

This report calls for a change of approach in the short-term finance market. A well-functioning short-term lending sector should be part of a wider consumer credit market, one which enables people to progress to cheaper and more affordable credit, and provides a safety net to those in need. The report sets out the necessary reforms to the sector to create a market that truly serves those who use it, and which can help create financial stability and prosperity at all levels of our society.



ISBN: 978-1-908027-20-7

Price: £19.95

*The ResPublica Trust is a company limited by guarantee registered in England and Wales, number 7081565, registered office 15 Newland, Lincoln, LN1 1XG.*