



Regulating Payday Lending:

Are we being ambitious enough, are we asking the right questions?

**Damon Gibbons, CfRC
Gavin Hayes, Compass**

September 2010

Introduction

In August, Consumer Focus published research into the use of payday lending¹ which estimates the market to be worth over £1.2 billion per year, and which indicates this form of borrowing was used by some 1.2 million people in 2009. The report also goes on to forecast a significant growth in payday lending in the coming years, and examines criticism of the industry that loans are expensive and trap people in a pattern of repeat borrowing.

The report finds that although some groups of borrowers use payday loans as a short term solution to temporary cash flow difficulties and do not get into difficulties, others, particularly lower income borrowers do often find themselves 'rolling over' loans or taking out multiple loans from a number of different lenders, resulting in 'significant financial problems and emotional stress'.

The Consumer Focus research, which follows an examination of the payday lending industry as part of the Office of Fair Trading High Cost Credit Review published earlier this year, makes a number of policy recommendations, notably:

- The number of rollovers or loans per year should be restricted to a maximum of five per household
- Households reaching this level of usage should be referred by lenders for advice and support with their financial problems
- That the OFT should place controls on the amount of money that can be borrowed by ensuring lenders conduct thorough affordability assessments prior to granting a loan
- That lenders should share information concerning payday borrowers to prevent consumers from taking out multiple loans from different lenders at the same time

¹ 'Keeping the plates spinning', Marie Burton, Consumer Focus is available from <http://www.consumerfocus.org.uk/assets/1/files/2010/02/Keeping-the-plates-spinning.PDF>

Consumer Focus also calls for the industry to respond to the recommendations of the OFT's High Cost Credit Review, which included the development of an approved industry code of practice covering these issues.

Finally, it is important to note that Consumer Focus recognise the need for greater transparency and fairness in bank charges, as payday loans are often presented as a cheaper alternative to these:

“If banks were not able to impose penalty charges for unauthorised borrowing and their charges were related to actual cost, consumers might opt not to use payday lending and use their banking facilities instead.”

However, regulatory action in many areas of the US, where the payday lending industry originated, and Canada, which has also experienced a significant growth in payday lending in recent years, go much further than the measures proposed by Consumer Focus. For example, some US states restrict the amount of payday loans to no more than 25% of the borrower's income, and lenders are compelled as a condition of their licence to share information about outstanding debts in order to prevent a borrower from obtaining multiple loans. In addition, a code of practice adopted by some payday lenders in Canada entirely prohibits roll over lending.

This brief paper reviews these approaches and argues for UK regulation to be based on the best practice that has been developed in the US and Canada. It then proceeds to look at the 'supply side' push towards payday lending, including the explicit involvement of banks in funding and supporting payday expansion and urges Government and the FSA to conduct an investigation into British bank investments in payday lending operations.

Background to the UK payday lending industry

The payday lending industry originated in the US in the 1980's where it has primarily been focused on disadvantaged, low income, communities (Flannery & Samolyk, 2005). In the early 1990's, the business model was effectively exported to the UK, with US based lenders establishing new brand names for their UK payday lending operations and creating payday lending stores. A good example of this 'export model' is Dollar Financial, a US based lender which operates under the trading name of The Moneyshop in the UK. The Money Shop has expanded from one store in 1992 dealing primarily with cheque cashing to 273 stores and 64 franchises across the UK in 2009 (Dollar Financial Corp, 2009, p. 8).

There may be some differences between the two industries, with the emergence of on-line payday lending companies in the UK in recent years ostensibly focused on a relatively higher income group and different demographic (more single people than families) than the US store based operations. For example, the Consumer Finance Association, which represents payday lenders in the UK, estimates that payday loan customers have annual gross incomes of between £12,500 and £30,000, with £18,000 the 'approximate average', and the OFT reports that 'typical' UK customers are single men in rented accommodation with incomes in excess of £1,000 per month.

However, there is no doubt that some UK payday borrowers are on low incomes. Research conducted by Policis for the Friends Provident Foundation, and cited by the OFT High Cost Credit Review, finds that one in ten UK payday customers have incomes of less than £11,100 per year.

Concerns have therefore been raised by politicians and in the media that these lower income customers may be borrowing on a regular basis as a result of shortfalls between their incomes

and the cost of essential expenditures, and that the price of payday lending, which can cost as much as £35 in interest and fees for every £100 borrowed, simply drives people further into debt and forces them to become reliant on repeat borrowing. These concerns have now been supported by the Consumer Focus research.

Learning from regulatory action in the US and Canada

Recognition of these problems in the US and Canada has led to a lengthy battle between consumer groups and the payday lending industry concerning appropriate regulation, including research into the links between the growth in payday lending and insolvency levels (Berry & Duncan, 2007).

These campaigns have had considerable success, resulting in:

- Fifteen states in the US eliminating payday lending altogether either by introducing a ban or capping the maximum charge for credit at a low level, driving lenders out of business
- A federal cap on payday lending rates to the US military set at 36%, following concern that military personnel were being targeted by payday lending companies
- Thirty five states in the US and eight provinces in Canada introducing higher caps on the price of payday loans which allow them to operate but which nevertheless protect consumers from extortionate lending, for example caps have been set between \$21 and \$23 per \$100 lent in a number of Canadian provinces.

Payday lending laws in the US and Canada also incorporate measures to ensure responsible lending, by placing restrictions on:

- The amount of loan relative to the borrower's income. For example both Illinois and Nevada have put in place a clear requirement that loans should not exceed 25% of the borrower's income

- The number of loans that can be provided in any given period. For example, Arizona, California, Colorado, and Florida restrict the number of loans that can be provided to just one at a time, and Indiana prohibits more than one loan from a single lender and limits the total number of loans to two.
- The number of times a loan can be 'rolled over'. Alabama restricts the number of times a loan can be rolled over to just one; Alaska allows just two; and Illinois, Kentucky, and Louisiana prohibit this practice entirely.
- The level of fees that can be charged for overdue loans, with limits ranging from \$15 to \$30 for failure to pay on time.

In Canada, the Payday Lending Association, which represents approximately 37% of all payday lending companies operating in that country, has also introduced a code of practice that completely prohibits the rolling over of loans and the issuing of multiple loans at the same time, and which places limits on default charges of just \$0.90 per week for a \$100 loan for the first thirteen weeks, reducing to \$0.50 per week thereafter.

We consider that these examples from the US and Canada should therefore also form the basis for any future UK regulation of the payday lending industry and that responsible payday lenders in the UK should demonstrate, through a code of practice, their desire to match the best practice of lenders in these countries. In so far that the UK payday lending customer base is genuinely different to the US, then regulatory or self regulatory action along the above lines will need to target lending practice as it takes place with lower income payday lending customers, leaving the industry with greater freedom in its lending policy towards high income, single, households who have fewer difficulties using the product.

However, whilst these measures should help to address concerns that payday lending traps people in debt, they will not reduce the cost of loans.

The Office of Fair Trading's High Cost Credit Review notes that there may be limited price competition in the UK payday lending market. We therefore support the recommendation from Consumer Focus that more needs to be done to reduce levels of bank charges. However, we also consider that banks need to be pro-active and identify people in financial difficulties, including by offering access to mainstream small sum credit provision to replace ongoing overdraft and credit card debts for people on low to middle incomes as part of a structured programme to help get their finances back on an even keel.

Best practice from the US can be found in the 'Small Dollar Loan Pilot', organised by the Federal Deposit Insurance Corporation (see box on the next page), and we recommend the creation of a similar pilot in the UK as a matter of urgency.

The FDIC's Small-Dollar Loan Pilot

In December 2007, the Federal Deposit Insurance Corporation established a small dollar loan pilot with 28 participating banks to test out whether offering affordable alternatives to payday lending and 'fee based overdrafts' was commercially viable.

The pilot resulted in the making of 34,400 small-dollar loans worth \$40.2 million and ran to December 2009. In its evaluation, the FDIC reports the pilot as a success and that the loans were a viable commercial product to low income households with default risks similar to other types of unsecured credit. The pilot demonstrates that small sum credit products can be used to build and retain long-term banking relationships with people on low incomes and that there are also advantages in offering small loans alongside simple savings products and financial education.

A template has now been developed by the FDIC, which sets out the elements required for mainstream small sum credit products to be offered on a successful basis, as set out below.

A Safe, Affordable, and Feasible Template for Small-Dollar Loans	
Product Element	Parameters
Amount	\$2,500 or less
Term	90 days or more
Annual Percentage Rate (APR)	36 percent or less
Fees	Low or none; origination and other upfront fees plus interest charged equate to APR of 36 percent or less
Underwriting	Streamlined with proof of identity, address, and income, and a credit report to determine loan amount and repayment ability; loan decision within 24 hours
Optional Features	Mandatory savings and financial education

Asking the big question

However, bigger questions concerning the relationship between our banks and the payday lending industry also now need to be asked. A recent report from the US based consumer group, 'National People's Action', tracks the links between investment banks and payday lenders. The report makes alarming reading, finding that, through a network of funding relationships, and 'personal interlocks', the major US banks have deliberately supported the expansion of payday lending in recent years:

"The payday loan industry's easy access to financing would not have come without strong ties to Wall Street banks. Though payday lenders are often portrayed as occupying a separate sphere from the world of high finance, many current and former Wall Street bankers have led payday lenders either as executives or board members.

Big banks have also brought major payday lenders public, and continue to own substantial stakes in payday loan companies.

Ultimately, the big banks that borrow at near-zero interest rates from the Federal Reserve are not far removed from the payday companies that lend money at 500%."

The report indicates that major US banks, some of which have benefitted from US Government bailouts, such as Bank of America, Goldman Sachs, and Wells Fargo, own significant stakes in some of the top payday lenders, some of which also trade in the UK:

This close relationship between big banks and payday lenders is unlikely to be restricted to the US. In the UK, a former Barclays Bank Director of Consumer Finance is now a Director for Oakham Finance, a payday lender targeting migrant communities across London, which is bankrolled by a private equity firm based in the City of London.

This raises the serious question as to whether banks are *simultaneously* creating demand for payday loans by charging high default fees, and by tightening access to mainstream credit more generally, *and also* making money from this market growth through their investments in the expansion of payday lending operations.

We therefore urge Government and the FSA to launch an investigation into this issue and report publicly on its findings. As part of this investigation the FSA should also consider banning banks that provide retail financial services from making investments, whether directly or indirectly, in payday lending in order to remove any potential conflict of interest in this area.

References

Berry, R. E., & Duncan, K. A. (2007). *The importance of Payday Loans in Canadian Consumer Insolvency*. University of Manitoba.

Burton, M (2010). Keeping the plates spinning. Consumer Focus

Connor, K. & Skomarovsky, M (2010). The Predators' Creditors: How the Biggest Banks are Bankrolling the Payday Loan Industry. National People's Action, available from:

<http://showdowninamerica.org/node/826>

Federal Deposit Insurance Corporation (2010). A Template for Success: The FDIC's Small-Dollar Loan Pilot Program. Available from:

http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf

Flannery, M., & Samolyk, K. (2005). *Payday lending: do the costs justify the price?* Washington DC: Federal Deposit Insurance Corporation Center for Financial Research.