A MODERN CREDIT REVOLUTION:

AN ANALYSIS OF THE SHORT-TERM CREDIT MARKET

Consumer Finance Association

Social Market Foundation

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This report was commissioned by the Consumer Finance Association and was produced independently by the Social Market Foundation.

Executive Summary

This report provides an up-to-date assessment of the short-term credit market and analyses how the market has changed since the introduction of the price cap regulation in 2015. It draws on new polling of consumers of short-term credit and on industry data collected for this study. Whilst we do not carry out a full-scale evaluation of the overall costs and benefits of the regulation, we seek to understand how changes in the market have affected consumers, in terms of both costs of loans and access to loans.

Costs of interest

- Industry data shows that the average daily costs of loans have fallen significantly from 1.3% in 2013 to 0.7% in 2015. On average, consumers now are paying less for a loan than in the past. These benefits have flowed to consumers who have stayed in the market who are on average on higher incomes than those who no-longer have access to the market.
- The average cost of a loan (as of December 2015) is below the Initial Cost Cap of 0.80% cap at 0.70%. In other words, rates are 12.5 per cent below where they could be under regulations. This may be a sign that price competition persists – in so far as providers are not simply setting all their rates at the regulated ceiling. This is supported by the fact that average daily interest rates are not uniform across providers. However, there has been a narrowing of choice as observed through less variation in daily interest rates.

Default fees

- Industry data shows that the proportion of loans on which consumers were charged additional fees (beyond contractual interest) halved from 16% in 2013 to 8% in 2015.
- Where loans are subject to such fees, industry data shows that average levels – including fees and interest charged post-default – have fallen from £45 in 2013 to £24 in 2015. Despite these reductions, there is an outstanding question as to whether such fees and charges are too high, representing as they do around 10% of the value of the average loan where they are levied.

Consumer perceptions and experiences of taking loans

- Our consumer survey suggests an improvement in perceptions of affordability among more recent borrowers: 56% of consumers who took out a loan since 2015 agreed that their most recent loan was 'an affordable way of borrowing', compared to 43% of those whose last loan was taken out before 2015. However, a quarter of consumers since 2015 (26%) disagreed that their last loan was affordable. Consumers may be referring to their views on how expensive the loan is and / or whether they are able to service the loan.
- Our consumer survey also revealed that a large proportion (nine in ten) of recent consumers considered using short-term credit to have been a convenient way to borrow money. At the same time, around one in five of recent borrowers cited issues around paying the loan back over a longer period than planned and a similar proportion cited fees for late payment.

Market size and consumer demographics

- The number of loans sold has fallen significantly according to our industry data. Across our industry sample, loans sold in the period January to April 2016 were 42% lower than in the period January to April 2013. This data is drawn from firms that operated through to 2016 and may underestimate the drop in loans – for instance, a large number of firms exited the market in this period, such as many cheque centres.
- Consumers buying loans in 2015 are on average coming from higher-income brackets than in 2013.

Access

Both the contraction of the short-term credit market in general and the change in demographics of borrowers are consistent with the FCA's prediction that a proportion of consumers would be excluded from the market and that these people would be lower-income individuals.

- Our consumer survey suggests that consumers perceive that the short-term credit market has become harder to access. More than half (57%) of consumers who had bought loans both before and after the price cap agreed with the statement: 'Short-term loans are more difficult to access than they used to be', with a quarter (24%) disagreeing.
- Of consumers in our survey who had bought a loan before 2015 but not afterwards 16% tried to get a loan but were not accepted, and 18% thought they would not qualify for credit so chose not to apply.
- When asked how they would have behaved had they not been able to purchase their loan, most consumers in our survey would either have gone without essentials (27%) or borrowed from friends or family (37%). Previous evidence suggests that borrowing from family and friends often cannot necessarily be repeated or be a sustainable option for many.
- Other consumers cited cutting back on other forms of spending (12%), not buying what the loan was used for (12%) and relying on mainstream or alternative credit.

- Our survey shows that 6% of short-term credit consumers report that they would have used an unlicensed lender who is not a family or friend if they had not been able to access a short-term loan. The implications of losing access to the market is hard to evidence definitively because it is not possible to track individual consumers longitudinally, though it is likely to vary significantly depending on the financial circumstances of the individual, other credit options available to them and demands on their expenditure.

Regulators in the past have identified significant harm caused to some low-income, high-risk borrowers by short-term credit, and the FCA concluded previously that the loss of access to credit is overall a good thing for such consumers. However, evidence also points to the importance of short-term credit for meeting the costs of essentials.

This report reinforces the fact that access remains an important trade-off for future regulation as well as a wider social policy challenge that the Government must address.

THE Results

6%

report they would use an unlicensed lender (not a family or friend) if they had not been able to access a short-term loan.

Of consumers in our survey who had bought a loan before 2015 but not afterwards

16%

tried to get a loan but were not accepted.

57%

of consumers who had bought loans both before and after the price cap

AGREED THAT:

'Short-term loans are more difficult to access than they used to be'

24%

DISAGREED

Loans sold in the period January to April 2016

↓ **42%**

than in the period January to April 2013

27%

Would have gone without essentials if not for access to a short-term loan

37%

Would have borrowed from family & friends

CONSUMERS BUYING LOANS

are on average coming from higher-income brackets than in 2013.

IMPROVEMENT IN PERCEPTIONS OF AFFORDABILITY

'A short-term loan is an affordable way of borrowing'

56%

of consumers who took out a loan since 2015 agreed

43%

whose last loan was before 2015 agreed

26%

disagreed that their last loan was affordable

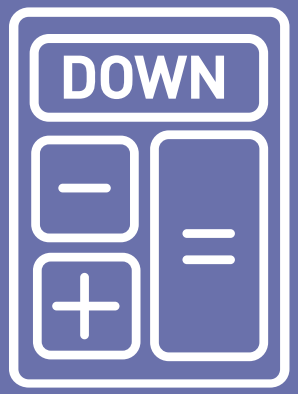
Recent consumers considered using short-term credit to have been a convenient way to borrow money

Proportion of loans on which consumers were charged additional fees

(beyond contractual interest)

From 16% in 2013 to 8% in 2015

AVERAGE DAILY COSTS OF LOANS



From 1.3% in 2013 to 0.7% in 2015

CHAPTER ONE

Introduction

Economic and financial context for UK households

The economic context for UK households remains difficult. Although unemployment levels are low, many families are still financially fragile. Following the downturn, real-terms wage growth was stagnant and negative for many years, and more recent increases since 2014 have been modest.[1] In 2015, the Joseph Rowntree Foundation estimated that 6.8 million people lived below the poverty line in a household in which someone is in employment.[2] Changes to the structure of work and employment patterns – including growth in self-employment, part-time employment and zero hours contracts, as well changes to state benefits – have also led to less stable and less predictable incomes.[3] While general inflation is low, housing costs have risen.

A large proportion of UK households remain poorly-placed to manage these risks or to cope with dips in income or with unexpected expenditure. Previous research by the SMF and by the Money Advice Service has shown that four in ten of individuals possess less than one week's worth of income in savings.[4]

Short-term credit – what it is and the role it plays

In this context, the ability for households to access a range of credit options that meet their immediate budgeting needs, and to smooth short-term variations in expenditure and income, is fundamentally important, including short-term credit. 'High Cost Short-Term Credit' is defined by the Financial Conduct Authority (FCA) as unsecured loans that last less than one year at an interest rate of over 100% APR.[5] It includes so-called 'payday loans' which are repayable in a single instalment within one month or less, as well as the increasingly-common instalment loans where repayments are spread over several months.[i] Products can be purchased online or via high street stores – the former being much more common than the latter. Loans are typically made for comparatively small sums (£100 to £1,000). Compared to other forms of borrowing, short-term credit is typically easy and quick to apply for, with money from the loan available to successful applicants promptly.

Previous research by SMF and Money Advice Service has shown that

4/10

of individuals possess less than one week's worth of income in savings.[4]

i The report refers to 'short-term credit'.

The market in short-term credit expanded markedly in the aftermath of the financial crisis, growing from £0.33bn worth of loans in 2006 to £2.5bn in 2013. The FCA estimated that in 2013, 400 firms served 1.6m customers, providing 10 million loans.[6] The Competition and Markets Authority (CMA) reported in 2014 that on average customers took out around six loans per year.[7]

The Government and regulators recognise the potential benefits of the short-term credit market, with the FCA arguing in November 2014 that the market 'can be beneficial to some borrowers to bring forward consumption – such as in emergencies and when they do not have access to other credit options – so we do not think it is desirable to leave consumers entirely without the option of using [short-term credit].'[8]

Despite this, consumer groups, regulators and the Government have criticised specific practices and identified various market failures. Principal concerns have centred on the fact that short-term credit could exacerbate the debt problems of some consumers because of high interest rates, roll-overs and charges if people were unable to pay back on time. A survey carried out in 2013 found that 38% of payday loan customers had experienced a bad credit rating and 10% had been visited by a bailiff or debt collector.[9] More broadly, survey research has shown that many users of short-term credit are likely to be financially constrained, with more than four in ten having missed payments on credit commitments or household bills in the last 12 months (as of 2012).[10]

In 2012, the Office for Fair Trading (OFT) launched a review into the short-term credit market, concluding that 'the payday loans market is not working well for many consumers', citing widespread non-compliance. It found evidence that around a third of loans were repaid late or not repaid at all; 28 per cent of loans were rolled over or refinanced at least once, providing 50 per cent of lenders' revenues; and, 19 per cent of revenue came from the five per cent of loans which were rolled over or refinanced four or more times.[11] The Department for Business, Innovation and Skills conducted a study in 2013 to assess whether firms were abiding by an industry good practice charter. It found evidence that compliance with the provisions was not good enough.[12] Other studies pointed to the potential for short-term credit to exacerbate the difficulties of some clients, who were sold loans they could not afford and subsequently became trapped into a cycle of borrowing.[13]

Regulatory interventions in the short-term credit market

1. A change in regulatory oversight from the OFT to the FCA from April 2014, bringing different licensing arrangements and a different culture of oversight and compliance.[14]
2. The FCA confirmed that new rules and guidance would be introduced in 2014 to address specific practices in the market and to protect vulnerable consumers. Measures included:
   a. Enforcing rules on affordability checks to ensure that firms 'assess the potential for a loan to adversely affect the customer's financial situation'.[15]
   b. Limiting to two the number of unsuccessful attempts firms can seek payment using a continuous payment authority.
   c. Limiting to two the number of times a loan can be 'rolled over' and introducing a provision that borrowers must be alerted to sources of debt advice.
   d. Putting risk warnings on loan adverts.

As will be described later, these are important regulatory interventions which have led to changes in the structure of the market, the volume of loans and the risks to which consumers are exposed.

3. The FCA introduced a price cap on the costs of short-term credit products effective from 2015.

The short-term credit market grew from

£0.33bn

worth of loans in 2006 to

£2.5bn

IN 2013

The price cap – the rules, the intentions and the implications

DETAILS OF THE CAP

Through the Financial Services (Banking Reform) Act 2013, Parliament gave the FCA a duty to introduce a price cap to secure an appropriate degree of protection from excessive charges for borrowers of high-cost short-term credit. The FCA published a consultation paper on their proposals in July 2014 and published its policy paper in November 2014, with the cap introduced from 2 January 2015.

The cap comprises three rules:[16]

INITIAL COST CAP

COSTS TO THE BORROWER MUST NOT EXCEED

0.8% PER DAY

SUCH COSTS TO INCLUDE INTEREST AND FEES

DEFAULT CAP

DEFAULT FEES ARE CAPPED AT **£15**

INTEREST CAN CONTINUE TO BE CHARGED BUT AT NO HIGHER RATE THAN THE INITIAL COST CAP

TOTAL COST CAP

THE TOTAL COSTS OF THE LOAN MUST NOT EXCEED

100%

OF THE AMOUNT BORROWED

The FCA intends to review the price cap in the first half of 2017.

POLICY INTENTION OF THE CAP AND POTENTIAL IMPLICATIONS

In proposing the cap, the FCA argued that it could achieve multiple benefits, including: safeguarding those whose financial position would become worse if they took out short-term credit; protecting those who struggle to repay loans because of escalating costs; reducing costs for most borrowers; whilst ensuring that nine in ten of consumers who would otherwise be served by the market could access credit.

In designing the cap, the FCA carried out extensive modelling and consultation, concluding that:

> "Excessive charges for high-cost short-term credit are harming significant numbers of consumers. Many borrowers pay a high price for a loan that is of limited net benefit, or makes their already difficult financial situation worse. Borrowers who have problems repaying can end up owing significantly more than they originally borrowed. For those who only just get loans, these make them worse off in the medium-term compared with those who fail to get loans.[17]"

The FCA argued that the cap could be welfare enhancing by lowering interest rates and by removing access to the market from some consumers, thus leading to reduced stress, mental health problems and less detriment induced by short-term credit. The FCA highlighted the risks to those consumers who only just qualified for short-term credit, with the likelihood of high default and the potential for short-term credit to lead to a worsening of their financial position.[18] It drew particular attention to large numbers of consumers who got into severe payment difficulty evidenced by high late and non-payment rates, many of whom would lose access to credit as a consequence of the price cap.[19]

Three elements to the price cap were intended to provide protection across different aspects of the loan:

- The Initial Cost Cap of 0.8% cap was intended to protect all borrowers and to discourage firms from lending to borrowers who are more likely to be harmed by short-term credit.
- The Default Cap was intended to protect borrowers who pay their loan back late. This would address the fact that charges 'exacerbate the difficult and deteriorating financial situation of many [short-term credit] users', and overturn a situation where 'current high charges facilitate lending to borrowers who are at high risk of detriment as a result of borrowing'.
- The Total Cost Cap was intended to limit escalating interest, fees and charges and to mitigate debt spirals. An additional goal was simplicity.

Taken together, the aim was to lower costs of borrowing, to reduce the level of punitive charges and to make it uneconomic for firms to offer loans to individuals who were unlikely to be able to repay their loans.

However, the FCA acknowledged that protecting consumers from high costs should be balanced against other objectives, such as whether and how a price cap would affect firms' lending decisions and market competitiveness, and the potential 'effect there would be on consumers who would no longer have access to high-cost short-term credit, and whether as a result consumers would be better or worse off'. Evidence from other countries suggests that the downside risks associated with price caps have the potential to be real and substantive, including: fewer firms competing in the market and higher barriers to entry for new firms; less

choice for consumers; and, consumers being refused credit they previously would have been able to access.[20] The structure of the cap may reduce the incentives for individuals to pay off their loan on time (by reducing default fees) or reduce the readiness of firms to exercise forbearance when consumers fail to pay back on time.

Research focus and questions

In this report, we examine the current state of the market and how it has adapted to recent regulation. Whilst we do not carry out a full-scale evaluation of the overall costs and benefits of the regulation, we seek to understand how the market has changed, and what this means for consumers. We look at how the costs consumers face have changed and whether access to the market has changed following the price cap regulation. In particular, this report looks at the following issues:

The size of the market and characteristics of consumers

- Has the size of the market changed in terms of loans sold and the value of loans?
- Who uses short-term credit?
- Has the profile of short-term credit customers changed since the introduction of the price cap? And if so, in what ways?

Costs, affordability and punitive charges

- Have consumers seen a reduction in the cost of credit? – And if so by how much?
- Which consumers have seen a reduction in the costs of credit?
- Do consumers perceive loans to be more or less affordable?
- Has the level of competition and the range of products changed?
- Has regulation affected the proportion of loans that are subject to default charges and interest? And has the size of these charges changed?

Access to the market

- Has credit become more or less accessible for consumers? Which consumers have been affected?
- What are the implications for these individuals when they find they are ineligible for short-term credit?

Methodology

This report draws on two new sources of data collected for this project.

Industry data

Data was collected from eight providers of short-term credit. All of the firms that provided data were members of the CFA, although requests were also made to major providers that are not members of the CFA. Our panel of providers sold 4.6 million loans in 2013, suggesting that they represented just under half of the market (by loan volumes) in that year.

The SMF requested data from providers covering the period 2013 through to April 2016, including: characteristics of borrowers, number of loans, loan values, average daily costs of borrowing, proportion of borrowers charged additional fees, average level of additional fees, average contract lengths and average actual length of contract, and proportion of loans paid off on time.

In reporting our findings on the market, unless otherwise stated, industry data has been weighted for each provider dependent on their share of the market (by volume of loans). We also comment on the general firm-level trends in the market.

Consumer polling

The report also draws on the findings of a new YouGov online survey of short-term credit consumers. There were 1,202 respondents. All respondents had been consumers of products between 2013 and 2016. The survey was carried out in July 2016. As with other nationally representative surveys, YouGov uses weighting to fine-tune the demographic balance of the sample. The paper reports the weighted results.

In addition, the research draws on market studies by the FCA, OFT and CMA, consumer surveys and academic and policy literature.

1,202

respondents to the CFA's YouGov survey into short-term credit consumers

CHAPTER TWO

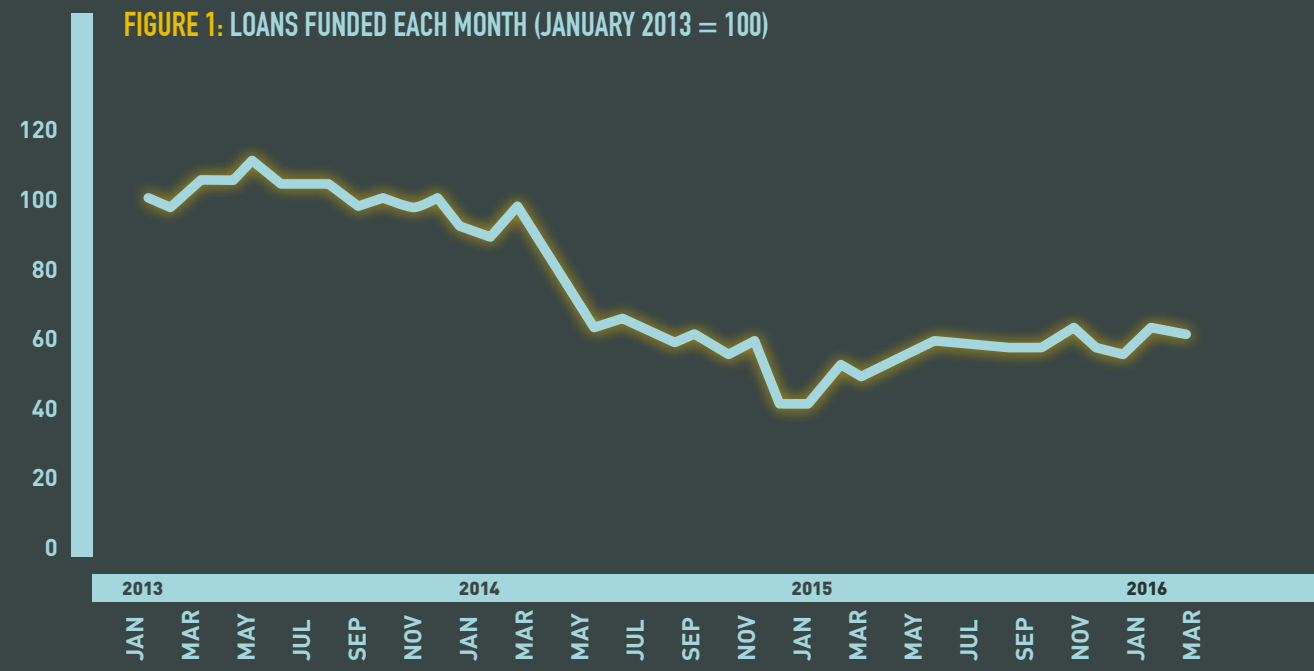
Changes in the short-term credit market

1. Size and shape of the market

NUMBER OF LOANS

As noted earlier, the short-term credit market expanded significantly between 2006 and 2013. However, FCA data modelling published in its November 2014 Policy paper found that the market had peaked and that the volume of loans had fallen from 2013, dropping by around 40% between March and August 2014. Our analysis of industry data (Figure 1) shows that the market in short-term credit continued to fall in the last part of 2014 and in the early part of 2015, before recovering slightly in spring 2015. The number of loans in the period January to April 2016 was 42% lower than it had been during the period January to April 2013. Loan volumes in our sample remain 2% lower as of April 2016 than in August 2014 (when the FCA benchmarked its analysis ahead of introducing the price cap).

FIGURE 1: LOANS FUNDED EACH MONTH (JANUARY 2013 = 100)



Source: SMF analysis of industry data.

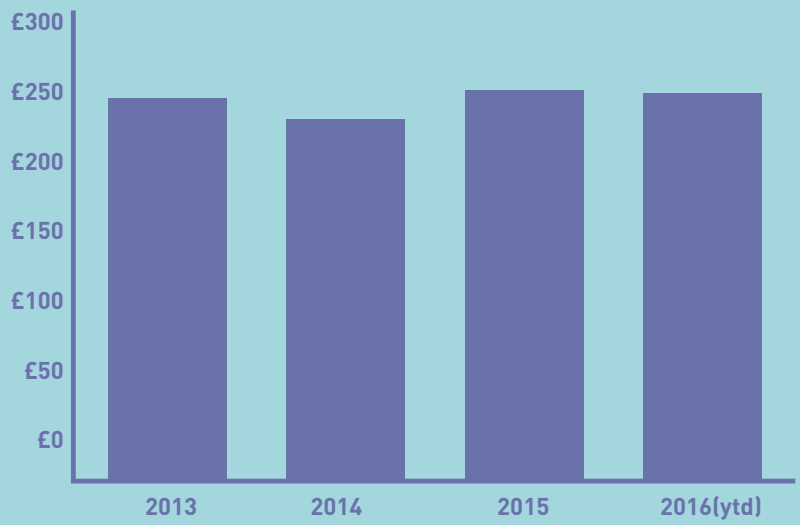
It is likely that a number of factors have affected the number of loans sold since 2013. In reporting on changes that occurred in the market up to August 2014, the FCA concluded that the decline did not appear to be the consequence of a reduction in demand from consumers. The FCA's analysis illustrated that the drop in volume of loans between September 2013 and August 2014 of approximately 40% coincided with an increase in overall applications for loans of 20%, reflecting a sharp reduction in firms' acceptance rates by 50% for the same period.[21] Instead, the significant reduction in loans from April 2014 corresponded with the introduction of new regulatory guidance that requires firms to make enhanced affordability assessments as well take other steps. Stricter affordability assessments could be expected to reduce the number of loans offered to higher-risk clients. The FCA concluded that the reduction in lending up to August 2014 largely affected borrowers that were the least creditworthy.[22]

In addition, the price cap is likely to have contributed to lower loan volumes, by reducing the number of loans granted to higher-risk clients as these customers became less profitable to serve under the conditions of the cap. Figure 1 shows that loan volumes continued to fall in autumn 2014 and during the first few months of 2015, suggesting that the market adapted ahead of the introduction of the price cap, as firms anticipated the regulation and its effects.[23] As will be discussed later, the change in the size of the market has important social implications.

SIZE OF LOANS

The average size of loans has been relatively steady – rising by £11 in nominal terms from the yearly average of 2013 (£245) to 2016 (£256). Theoretically, the regulations introduced in 2014 could have incentivised higher value loans – to the extent that the costs of providing a loan of any size increased as a consequence of more intense credit assessment procedures. Equally, both the 2014 regulations and the 2015 price cap may have removed consumers from the market who typically bought smaller loans, such as the unemployed and those on lower incomes.[24] It is noteworthy here that the price cap does not stipulate a maximum loan value.

FIGURE 2: AVERAGE SIZE OF LOANS SOLD EACH MONTH – IN NOMINAL (CASH) TERMS



Source: SMF analysis of industry data.

NUMBER AND TYPES OF FIRMS

Reports suggest that the number of credit providers has reduced significantly since the peak of the market.[25] Citizens Advice concluded in spring 2016 that, of a sample of 126 firms who were operating in the market in 2013, four in ten had exited.[26] The shape of the market has also changed significantly with a sharp decline in the number of high street lenders. In spring 2015, the CFA estimated that six in ten high street lenders had left the market.[27] Despite this attrition, it is not apparent that there is insufficient market participation to achieve effective competition in the market of online products – although the contraction among high street lenders may make competition more problematic in particular localities.

The products in the market have also evolved with a decline in the traditional month-long payday loan and an expansion in instalment loans which have longer contract periods and where consumers have greater flexibility as to when they pay back.

2. Characteristics of consumers

GENERAL CHARACTERISTICS OF SHORT-TERM CREDIT CONSUMERS

Past research by the CMA, the FCA and others has shown that the characteristics of consumers have many features in common with the general population, but that there are also some important differences. Data collected by the CMA during its recent market investigation (prior to the price cap) reveals that consumers are typically in employment, of younger age and on average incomes.[28]

CHARACTERISTICS OF SHORT-TERM CREDIT CONSUMERS AS OF 2013)

	CHARACTERISTICS OF SHORT-TERM CREDIT CONSUMERS
GENDER	Six in ten (59%) consumers are men and four in ten (41%) are women.[29]
EMPLOYMENT	The vast majority of short-term credit consumers are employed rather than unemployed; and they are more likely to be employed than the general population (although this is partly a function that more of them are working age).
AGE	Consumers are younger rather than older, with 71% of customers aged 18 to 44 compared with 46% of the population.[30]
HOUSEHOLD COMPOSITION	Short-term credit consumers are more likely to have children and live in larger households than the average UK individual. This may be a function of their younger age profile.[31]
INCOMES	Household incomes for consumers are slightly lower but broadly similar to the UK average. Drawing on industry data, the CMA revealed that the mean net income for a borrower was £15,600 (compared to the UK average of £17,100), the 25th percentile was £12,000 (compared to the UK average of £11,700) and the 75th percentile was £21,600 (compared to £26,300).32 High street customers typically have lower incomes than online customers.

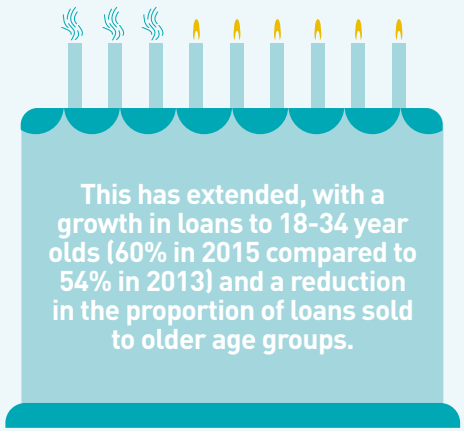
Source: TNS BMRB Survey and Appendix 2.3 'Demographics' – CMA Study33

HOW THE DEMOGRAPHICS OF CONSUMERS HAVE CHANGED OVER TIME

Below we describe how the demographics of consumers using short-term credit has evolved since the introduction of regulation in 2014 and 2015 drawing on data from our panel of providers.

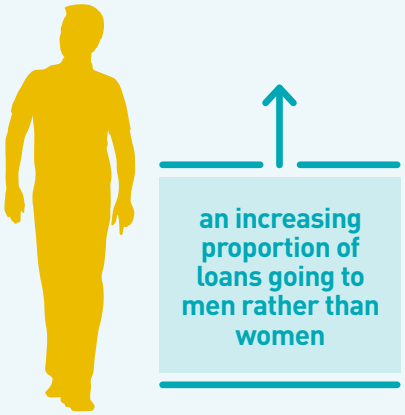
Age:

As of 2013, there was already a significant weighting towards younger consumers.



Gender:

There appears to have been some modest change in the gender demographics with an increasing proportion of loans going to men rather than women. This may in part be a product of a reduction in the market of high street lenders, a channel that historically sold more loans to women.



Employment:

Purchasers of loans in 2015 were more likely than those of 2013 to be in employment. In part, this reflects the UK's positive employment story in recent years – the employment rate of 16-64 year-olds grew from 71.5% in 2013 to 73.7% in 2015.[34]

However, the rise in loans sold to employed individuals appears to be stronger than the growth of employment in the wider economy, rising from

89% IN 2013 **96%** TO IN 2015

(INCLUDING EMPLOYEES AND THE SELF-EMPLOYED).

This may be for reasons described in the income section.

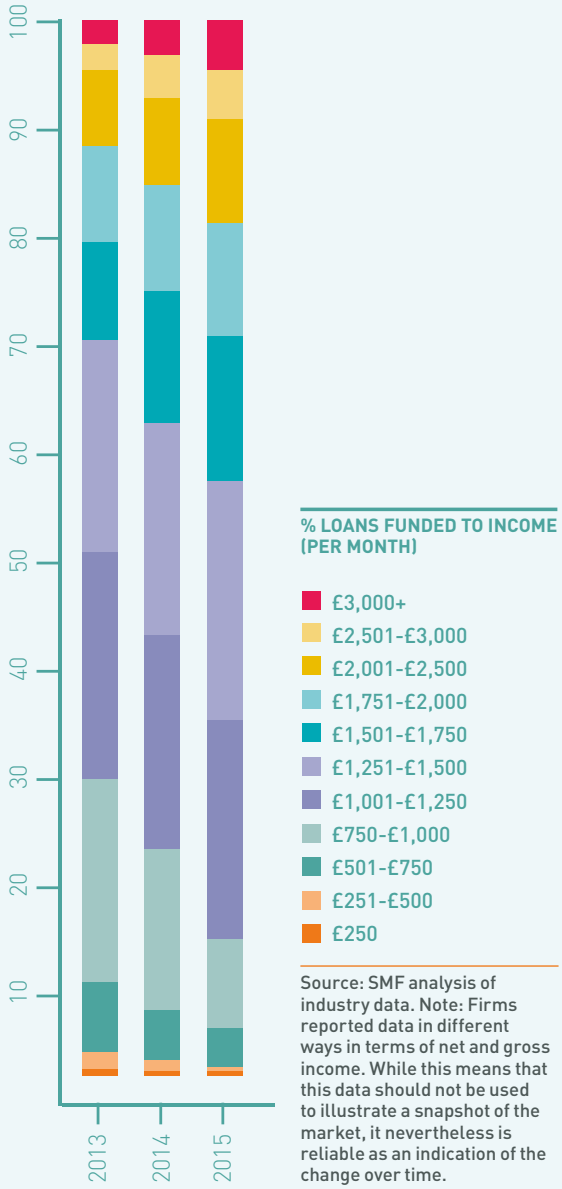
Incomes:

Loans have increasingly been granted to individuals higher up the income distribution. There has been a reduction in loans taken out by those on the lowest incomes and this is consistent with the intention and forecast effect of the cap, namely that it would remove from the market borrowers (typically on lower incomes) who are less able to service their loans and for whom the severity and likelihood of detriment is greatest. Figure 3 on the right illustrates the changes in the characteristics of borrowers by loans funded (by year). This data is not adjusted for earnings growth or inflation over these three years – and therefore we would expect to see some modest growth in these bands purely as a consequence of these economic factors.

However, these changes in borrower demographics are more dramatic than those in average weekly wages[35]

Our firm-level data reveals this trend occurring across all providers in our sample.

FIGURE 3: REPORTED MONTHLY AVERAGE INCOME OF BORROWERS OF EACH LOAN (BY YEAR WHEN LOAN WAS AGREED) – NOMINAL (CASH) TERMS



Source: SMF analysis of industry data. Note: Firms reported data in different ways in terms of net and gross income. While this means that this data should not be used to illustrate a snapshot of the market, it nevertheless is reliable as an indication of the change over time.

3. Costs of loans and affordability

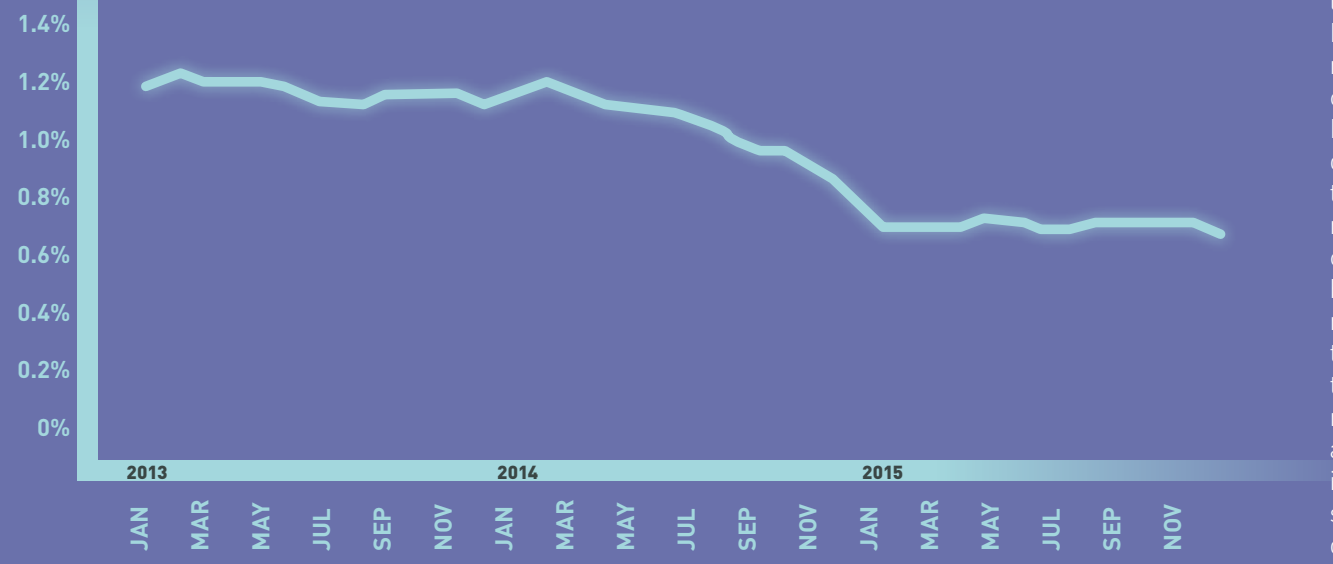
DAILY COSTS OF SERVICING A LOAN

Our industry data shows that the costs of loans have fallen significantly since 2013. In this period, the highest average daily interest charge was 1.3% in February 2013. The rate dropped markedly during 2014, especially in the six months from July 2014. By January 2015 the average rate fell below the Initial Cost Cap of 0.8%. Despite the significant reduction, interest rates in the short-term credit market continue to have high APRs (the FCA noted that at the initial cost cap of 0.8% interest per day, the APR is 1,270% for a 30-day £100 loan) – though this should be seen in the context of loan length and borrower risks.[36]

A fall in daily interest rates would be expected to occur as a direct result of the daily price cap. However, a number of factors may have combined to reduce the rates. Fees were starting to fall before the introduction of the rate cap in January 2015. This is likely to have been – in part – a consequence of firms anticipating the price cap regulation (observable July to December 2014). Overall, all borrowers who were previously lent money at rates in excess of the 0.8% daily cap have benefited assuming that they can continue to borrow. The scale of the reduction suggests that the gain to some consumers may have been significant. For instance, a consumer borrowing £200 for 30 days would pay £36 less under the current average market prices than in 2013.[37] In 2014, the FCA calculated the average annual savings as £180 per annum per consumer (on the bases that the average saving was £32 per consumer and the frequent repeat borrowing by consumers).[38] These benefits are going to consumers who on average have higher incomes than those who can no-longer access these products.

It is also notable that the average costs of loans are below the 0.8% cap at 0.70% (as of December 2015). The fact that all providers are not simply setting their rates at the regulated ceiling suggests that price competition persists. Regulation may have the unintended effect of reducing price competition either because the number of firms competing in the market reduces (as it did in this case) or indirectly as a consequence of how the regulation is perceived by consumers. In the latter case, consumers may interpret the regulation as a signal that they do not need to seek out the best deal in the market (because they assume that the regulation is ensuring that they are getting a low-cost product) thus allowing firms to implicitly collude on prices. For instance, the stakeholder pension product had a capped cost of 1% and providers typically set their fees at the maximum rate; a study of the effect of price restrictions in Colorado found that 'charges gravitated systematically toward the price ceiling over time'.[39]

FIGURE 4: AVERAGE DAILY COST OF INTEREST TO CUSTOMER (BY MONTH WHEN LOAN WAS AGREED)



Source: SMF analysis of industry data. The average daily cost of loan to customer was calculated as total cost of lending, including fees while in good standing, by effective term, for each monthly vintage. We report costs to the end of 2015 because some of the products in our sample would still be within contract when the data was collected in July to September 2016. Our data suggests that the average costs have remained the same in the four months to April 2016.

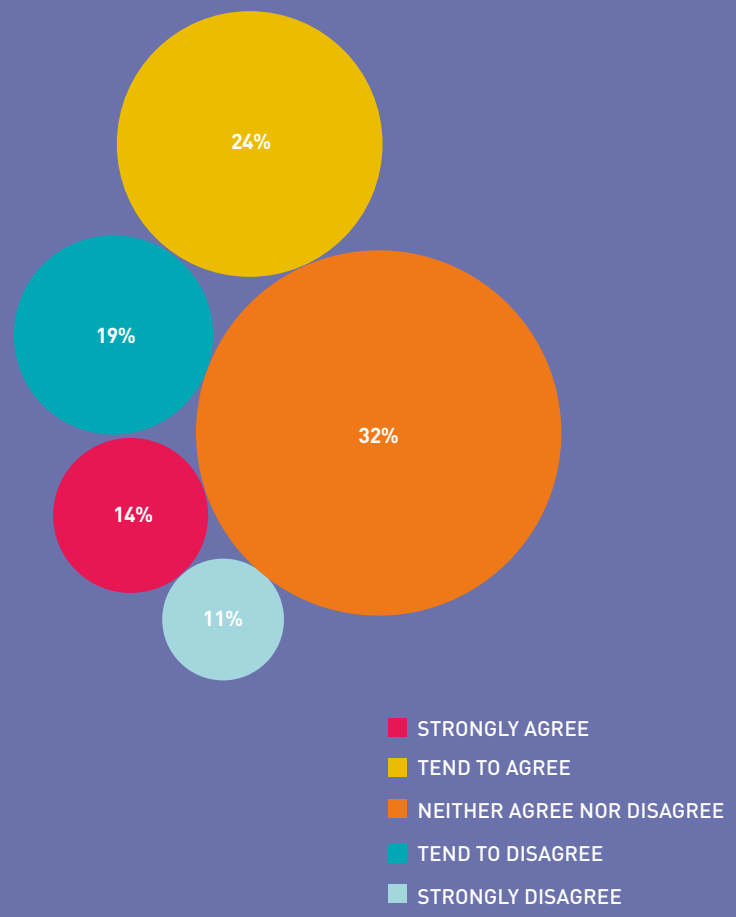
The range of interest rates charged by providers has narrowed significantly. Before the introduction of the cap, the FCA found that daily costs (when all costs and charges are considered) varied from 0.4% to above 4%, with most loans charging between 1% and 2% equivalent daily rate.[40] Under the cap such differential rates across products is not permissible. However, although the average daily rate for many firms is clustered around 0.7%, average rates vary by more than 0.2% across our sample of firms.

Daily rates may also be influenced by the structure of the cap: the Total Cost Cap may be biting – forcing firms to keep daily interest rates low on long-term products; some firms may desire to retain default fees as an incentive and therefore lower daily interest rates so as to remain under the Total Cost Cap. Finally, the nature of competition in the market may be driving competition on headline rates rather than other product costs. The CMA report of 2015 ordered that all online lenders should be prohibited from supplying payday loans to customers in the UK unless details of their loan products are published on at least one price comparison website.[41]

CONSUMER ATTITUDES TO COSTS AND AFFORDABILITY

Our consumer polling shows that reported attitudes to costs and affordability are more positive for loans taken out more recently. Among consumers who have experience of buying loans both before 2015 and after 2015, 38% reported that the loans bought in 2015 or 2016 were cheaper than before 2015; compared to 29% who thought the opposite and 32% who neither agreed nor disagreed. It should be noted that some users of short-term credit post-2015 may not have completed their contracts.

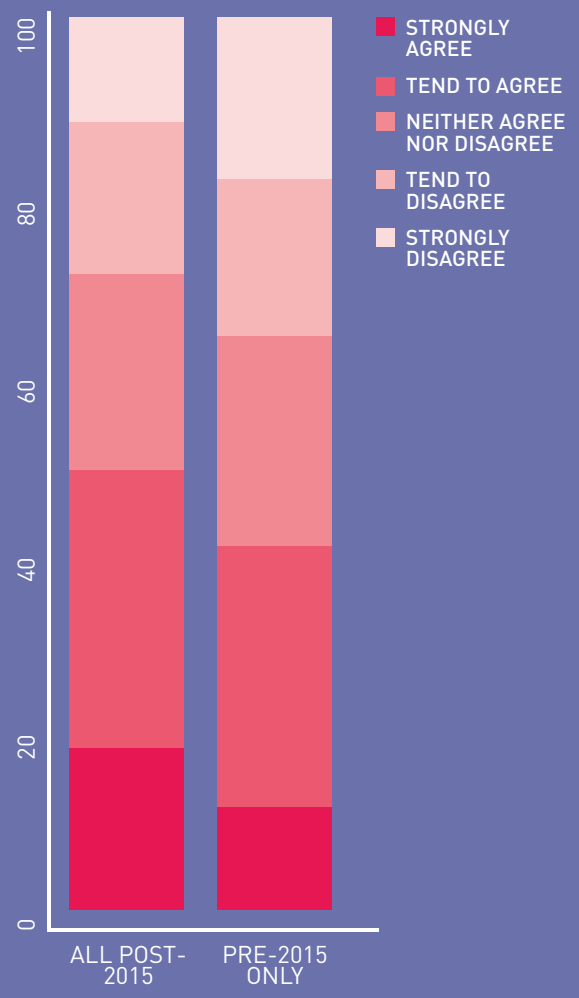
FIGURE 5: PERCENTAGE OF CONSUMERS AGREEING THAT 'SHORT-TERM LOANS ARE CHEAPER THAN THEY USED TO BE'



Source: YouGov poll of short-term credit consumers. Unweighted base: 213 respondents comprising consumers who bought a loan both before and after 2015. Percentages may not add to 100 due to rounding. Full question: 'Earlier in the survey you said that you have taken out short-term loans both before 2015 and during/after 2015. Thinking about your experience of short-term loans since the start of 2015, in contrast to your earlier experiences, to what extent do you agree or disagree with each of the following statements? (Please select one option per row)'

Our survey also asked about attitudes to affordability. Consumers whose last product was purchased after 1 January 2015 were more likely to agree with the statement that 'My short-term loan was an affordable way of borrowing' than those whose last loan was purchased before 2015. As Figure 6 shows, a majority of all recent borrowers agree that short-term credit is 'affordable'. Affordability relates to the ability of the borrower to service the loan. Thus views may be influenced by the income and circumstances of the borrower (which may have changed) as well as the costs and / or structure of the loan. Stricter affordability assessments may mean that more recent borrowers have had to demonstrate more clearly that they will be able to repay their debt. Attitudes may also more directly reflect the reduced daily interest rates and charges (see below for the latter). Against these positive trends, a significant minority (26%) of recent consumers disagree that their loan was affordable. These findings should also be seen in the context of wider discussion about affordability. A recent Citizens Advice report claimed that there had been some improvement in affordability assessments carried out by lenders but that there was 'still room for improvement'.[42] The report drew on a survey of 432 consumers in which three quarters answered 'Yes' and one in five answered 'No' to the question 'Did the lender ask questions about your situation and your ability to pay back the loan?' The industry contested how these results should be interpreted drawing attention to potential issues of recall among respondents and the use of credit reference checks by lenders.[43] Assessing affordability checks will continue to be an important role for the FCA.

FIGURE 6: PERCENTAGE OF CONSUMERS AGREEING THAT 'MY SHORT-TERM LOAN WAS AN AFFORDABLE WAY OF BORROWING'



Source: YouGov poll of short-term credit consumers. Split by date loan was purchased. Unweighted base: 433 respondents post-2015; 769 respondents pre-2015.

CHARGES, FEES AND PUNITIVE COSTS

To the extent that they offer an incentive to consumers to pay off their loans on time and act as a means of recovering costs, default fees set at a reasonable level may be an effective component of a loan. However, in its March 2013 study, the OFT noted that fees and charges for arrears and default could be 'very high', and could 'significantly exacerbate the consumer's financial situation'.[44] In particular, there was a concern that some firms had based their business models around making money from rollovers and default charges. The OFT study estimated that firms obtained half of their revenues from the 28% of people who were unable to repay their loans through a mixture of fees and rollovers.[45] Regression analysis carried out by academics at the University of Bristol found that the odds of consumers repaying more than they expected was six times higher among those whose lenders had added extra fees or charges (other than the interest charged on the loan).[46] Fees may also distort choice and competition. Borrowers may be particularly insensitive to costs associated with fees and charges and concentrate on headline rates when they compare products before buying; similarly they may also underestimate how likely they are to default.[47]

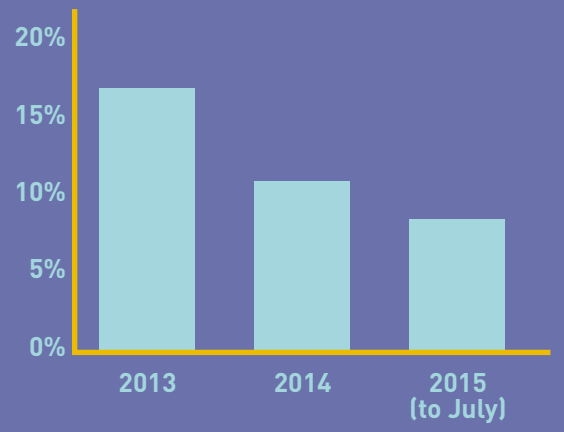
Proportion of consumers who face charges and fees (beyond contractual interest)

Since 2013, our industry data shows that the proportion of loans on which consumers face additional fees (beyond the contractual interest) has decreased significantly, halving from 16% in 2013 to 8% in 2015. This appears to have been driven by market share shifting to some firms that have never been in the habit of charging fees as well as a trend across all providers in our panel to charging fees on a lower proportion of loans. This in turn is likely to be in part at least a consequence of the growth of instalment loans, which are typically longer loans lasting three, six or even twelve months.

Scale of fees and punitive or unexpected charges

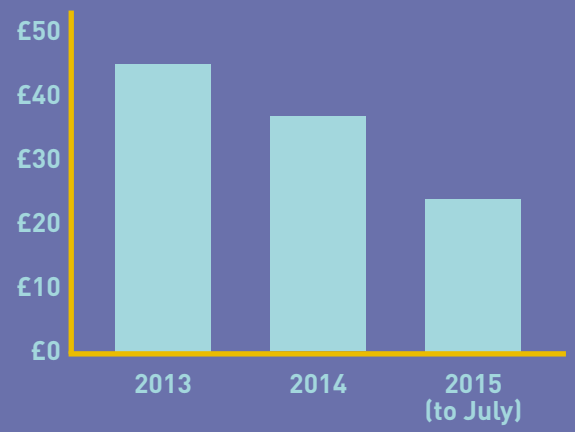
Alongside a significant reduction in the prevalence of loans on which consumers are charged additional fees (beyond the contractual interest), the average size of the fee has also fallen since 2013. As can be seen, when fees are levied they still represent a significant proportion of the average loan (which stands at approximately £256) – around one tenth. Our definition of fees contain both fixed charges (which cannot exceed £15) and interest rates post-default, which may or may not be higher than the contractual interest rate (but must be lower than 0.8% per day). As can be seen from Figure 8, the average charges are above the regulated cap of £15 fee because our measure includes interest as well.

FIGURE 7: PROPORTION OF LOANS WHERE CONSUMER WAS CHARGED ADDITIONAL FEE BEYOND CONTRACTUAL INTEREST (ALL CUSTOMERS WHO HAVE PAID A FEE FOR DEFAULTING LATE PAYMENT OR POST-DEFAULT ACCRUING INTEREST) – BY YEAR OF LOAN ORIGINATION



Source: SMF analysis of industry data. We report results to July 2015 because some of the loans in our sample sold after this date could still be live, and therefore charges could still theoretically be applied. Our data suggests that the proportions have remained similar in the period from August 2015 to April 2016.

FIGURE 8: AVERAGE LEVEL OF FEES CHARGED (INCLUDING ALL CUSTOMERS WHO HAVE PAID A FEE FOR DEFAULTING LATE PAYMENT OR POST-DEFAULT ACCRUING INTEREST – SEE FIGURE 7)



Source: SMF analysis of Industry data. This data covers all fees charged up to 60 days after contractual end date. We report results to July 2015 because some of the loans in our sample sold after July 2015 could still be live, and therefore charges could still theoretically be applied. The average level of fees has remained similar post-July 2015, averaging £24.75 since.

REPAYMENT TIMELINES

Failure to pay a loan off on time is both potentially an indicator and cause of financial distress. Our industry data shows that the average contractual loan period has got longer since 2013, extending from an average of 81 days to an average of 106 days in 2015. At the same time, the average actual loan length (i.e. the period of time from when the loan was agreed up to when the borrower paid off the loan) has fallen from 93 days (in 2013) to 69 days (in 2015). This may be symptomatic of borrowers taking advantage of longer loan periods and managing their repayments conservatively by repaying early. Qualitative research has found previously that borrowers are typically debt averse and wish to repay loans as quickly as they can.[48]

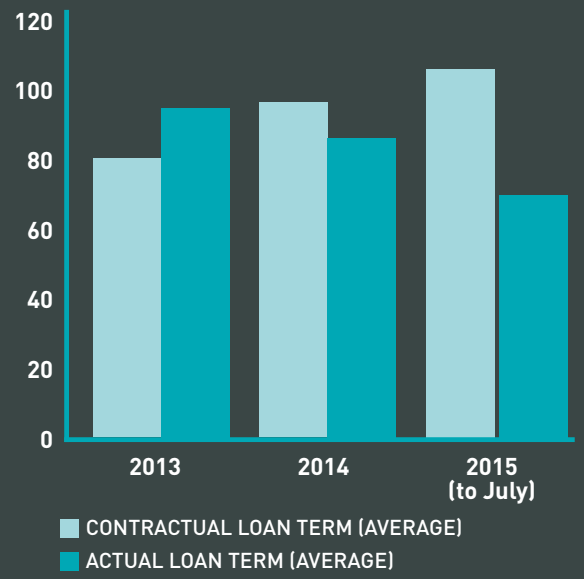
Average actual loan length

(i.e. the period of time from when the loan was agreed up to when the borrower paid off the loan)

IN 2013

IN 2015

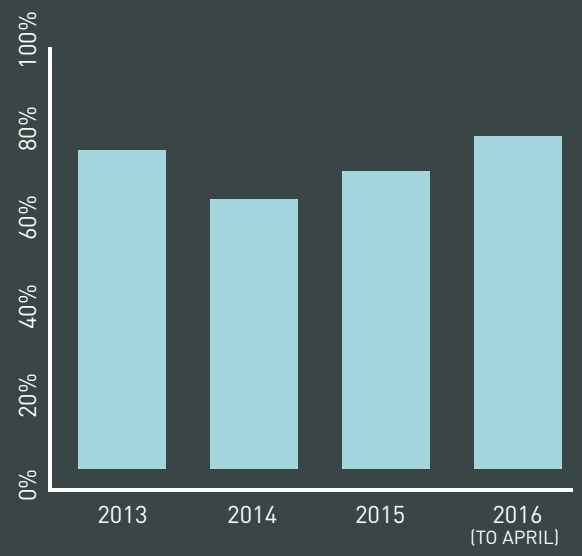
FIGURE 9: CONTRACTUAL AND EFFECTIVE LOAN PERIOD – AVERAGES IN DAYS (EXCLUDING DEFAULTS)



The picture above (in Figure 9) is however the average (mean) representation. It does not tell us about the distribution of this effect across borrowers. Figure 10 below shows that there has been only a very marginal increase in the proportion of loans that are paid off on time in the period 2013 to 2016 – although there has been more noticeable increase between 2014 and 2016.

Source: SMF analysis of Industry data. We report results to July 2015 because some of the loans in our sample were sold after July 2015 may not yet reached their contractual term. Our incomplete data since July 2015 shows an extension of the trend illustrated in this figure.

FIGURE 10: PROPORTION OF LOANS PAID OFF ON TIME ACCORDING TO CONTRACT AND WITH NO LATE PAYMENTS (ACCORDING TO MONTH WHEN CONTRACT ENDS)



Several factors may explain the findings on fees, loan lengths and loans being paid off on time. For instance it could be that some consumers with much longer contractual periods are paying off their loans very quickly, thus bringing down the mean actual loan length. Forbearance from providers may also partly explain the difference between the proportion of consumers who are charged default fees and the proportion paying off their loan on time. A Citizen's Advice report found that half of consumers who contacted their lender after entering difficulties paying off their loan had their charges and interest frozen.[49]

Source: SMF analysis of Industry data. The remaining loans entered default. 'Default' was defined as loans not paid off within 7 days of the contractual due date for traditional month-long payday loans and 60 days for fixed fee instalment loans.

4. Quality considerations

CONVENIENCE AND QUALITY

Theoretically, capping the costs of credit may have the effect of forcing firms to reduce the quality of the products they offer as profit margins drop. Other regulatory interventions such as the enhanced affordability assessments may also directly affect product features such as speed of approval.

Data from our survey of short-term credit consumers suggest that this has not occurred. Past research has shown that short-term credit loans are typically valued for their convenience and speed.[50] If anything, there has been a modest improvement in the positive attitudes towards the convenience of loans among consumers.

Among consumers who have bought products during or after 2015,

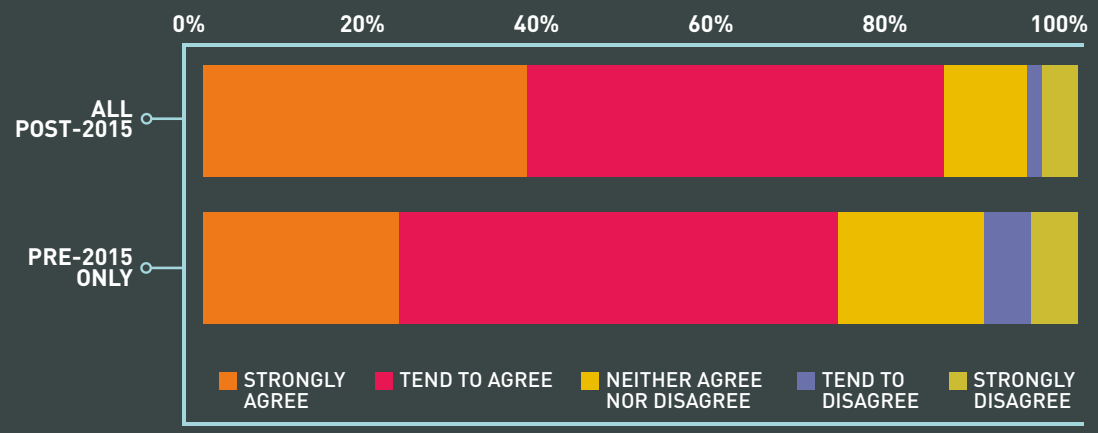
90% AGREED

that their short-term credit loan was 'a convenient way of borrowing'

COMPARED TO 77%

of consumers who bought before 2015.

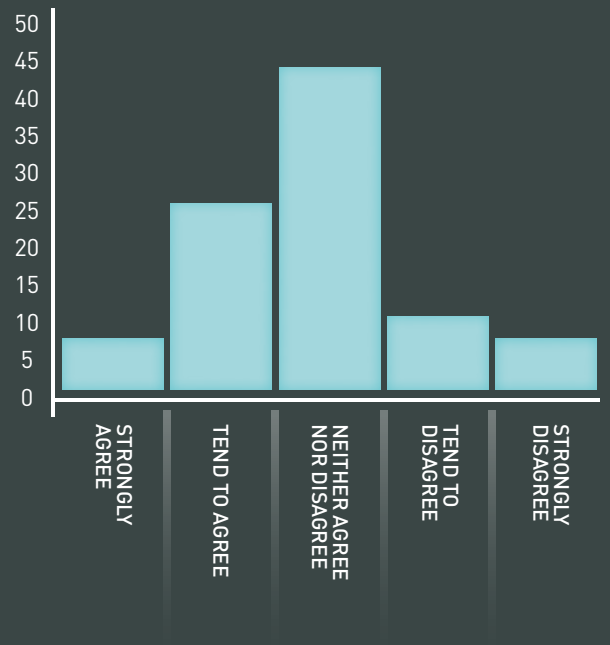
FIGURE 11: PROPORTION OF CONSUMERS AGREEING WITH THE STATEMENT: 'MY SHORT-TERM LOAN WAS A CONVENIENT WAY OF BORROWING'



Source: YouGov poll of short-term credit consumers. Split by date loan was purchased. Unweighted base: 433 respondents post-2015; 769 respondents pre-2015. Note, this is an online survey and may capture better the views on online users.

Answers to a second survey question also suggest that short-term credit products meet the needs of consumers. Consumers who used short-term credit before and after 2015 were likely to report no change (45%) or an improvement (36%) rather than the opposite (19%).

FIGURE 12: PERCENTAGE OF CONSUMERS WHO AGREE WITH THE STATEMENT THAT 'SHORT-TERM LOANS MEET MY NEEDS BETTER THAN THEY USED TO'



These findings may also reflect wider changes in the market. Firms may have innovated providing different forms of convenience through technology. Online lending – where convenience and speed have traditionally been viewed as important factors[51] – has taken greater market share.

Source: YouGov poll of short-term credit consumers. All consumers who had purchased loans both before and after 2015. Unweighted base: 213 respondents.

PROBLEMS AND COMPLAINTS

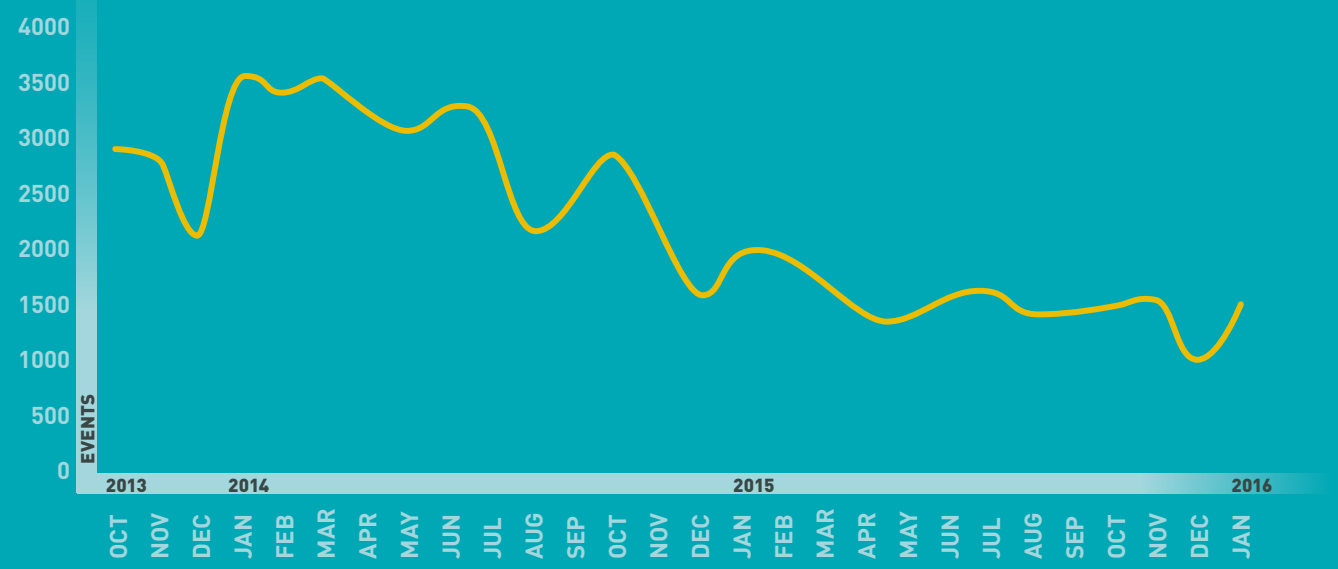
Previous research shows that the majority of short-term credit consumers report being satisfied with their experience. Polling by TNS BMRB carried out in 2013 found that 89% of retail payday consumers and 94% of online payday consumers were satisfied with their short-term lender. Three quarters reported that they would recommend the short-term lender they had used to someone else who needed to take out a loan.[52]

This broad picture of satisfaction among customers has been juxtaposed with some consumers requiring third party support and advice, and reporting complaints and problems. For instance, Citizens Advice reported in spring 2016 that an average of 806 consumers per month was seeking help from the charity.[53] Data from the Financial Ombudsman shows that there were 4,186 complaints in the first half of 2016 – although this represented a small proportion of the total number of loans sold in this period.[54] The FCA has continued to order providers who have not complied with their obligations as lenders to pay redress to their customers.[55]

Recent trends reported by other studies appear to be broadly positive in terms of the numbers of consumers requiring help. **A 2016 study by Citizens' Advice found that there had been a reduction in the number of problems reported by payday borrowers to its advice service. In particular, there was a noticeable drop off in the number of payday loan advice clients per month from November 2014 and a subsequent fall during 2015.[56] As of 2015, the monthly average was 804 clients per month compared with 1,491 before the cap.**

This is despite the fact that there has been a generally consistent volume of clients visiting the Citizens' Advice debt service generally. An even more dramatic fall occurred in the number of payday loan problems reported each month by Citizens' Advice clients. The volume more than halved between early 2014 and early 2016. The drop off in clients approaching Citizens Advice appears to have been even steeper that the fall in the number of loans across our industry sample. The report concluded that 'it appears that the stronger regulation of the market has led to a reduction in consumers suffering from sub-standard firm behaviour.'[57]

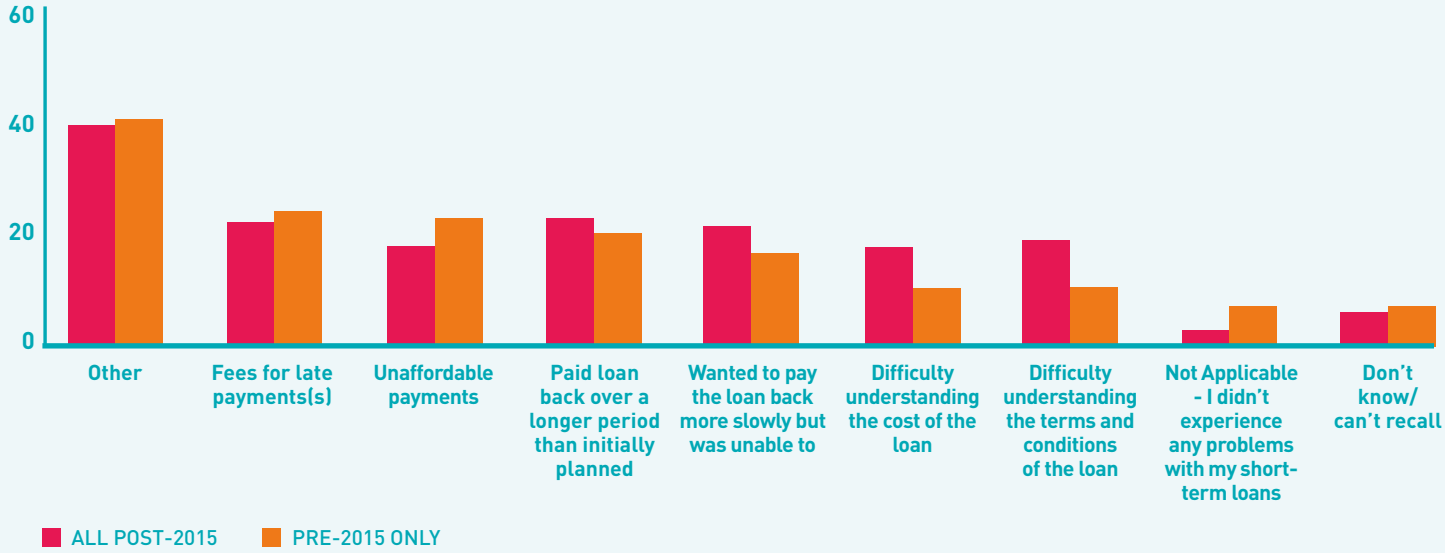
FIGURE 13: PAYDAY LOAN PROBLEMS BY MONTH REPORTED BY CLIENTS TO CITIZENS ADVICE – OCTOBER 2013 TO JANUARY 2016



Source: Citizens Advice, 'Payday loans: An improved market?'

Data from Citizens Advice clients show that where loan problems are taken to the charity most relate to dealing with debt problems (71%) or liability for debt (13%). Our survey analysis also reveals consumers' answers to the question 'Which, if any, of the following problems did you experience with your most recent short-term loan?' In response, around one in five recent borrowers cite paying the loan back over longer period than planned; and a similar proportion cite fees for late payments; and wanting to pay back the loan over a longer period but being unable to do so. A slightly lower proportion of recent borrowers reported unaffordable payments, difficulty understanding the cost of the loan and difficulty understanding the conditions of the loan. It is unclear why the proportion of borrowers citing fees for late payments has not fallen in line with the industry data on fees presented earlier. It should be noted that the data sources for the two are different and this may offer a potential explanation. For instance, it may be that some of the consumer respondents were referring to contractual interest after the initial loan period or referring to the fact that they were notified of charges which they may have subsequently been excused paying. However, we are not in a position to draw firm conclusions. In our survey, around four in ten of consumers cite 'Other' as a problem they have experienced but in the absence of further breakdown this remains difficult to interpret and requires further research.

FIGURE 14: PERCENTAGE OF CONSUMERS CITING ANSWERS TO THE QUESTION 'WHICH, IF ANY, OF THE FOLLOWING PROBLEMS DID YOU EXPERIENCE WITH YOUR MOST RECENT SHORT-TERM LOAN? (PLEASE SELECT ALL THAT APPLY. IF YOU DIDN'T EXPERIENCE ANY PROBLEMS, PLEASE SELECT THE "NOT APPLICABLE" OPTION)'



Source: YouGov poll of short-term credit consumers. Split by date loan was purchased. Unweighted base: 433 respondents post-2015; 769 respondents pre-2015.

5. Access to the credit people need

As the FCA acknowledged in its consultation and policy papers on the price cap, one of the potential effects of regulation may be to reduce access to credit for some individuals who otherwise would have been able to use the products. In the section below we describe what role short-term credit plays in the lives of those who buy the products and then assess what the early evidence suggests about outcomes for consumers who may not be able to access the market.

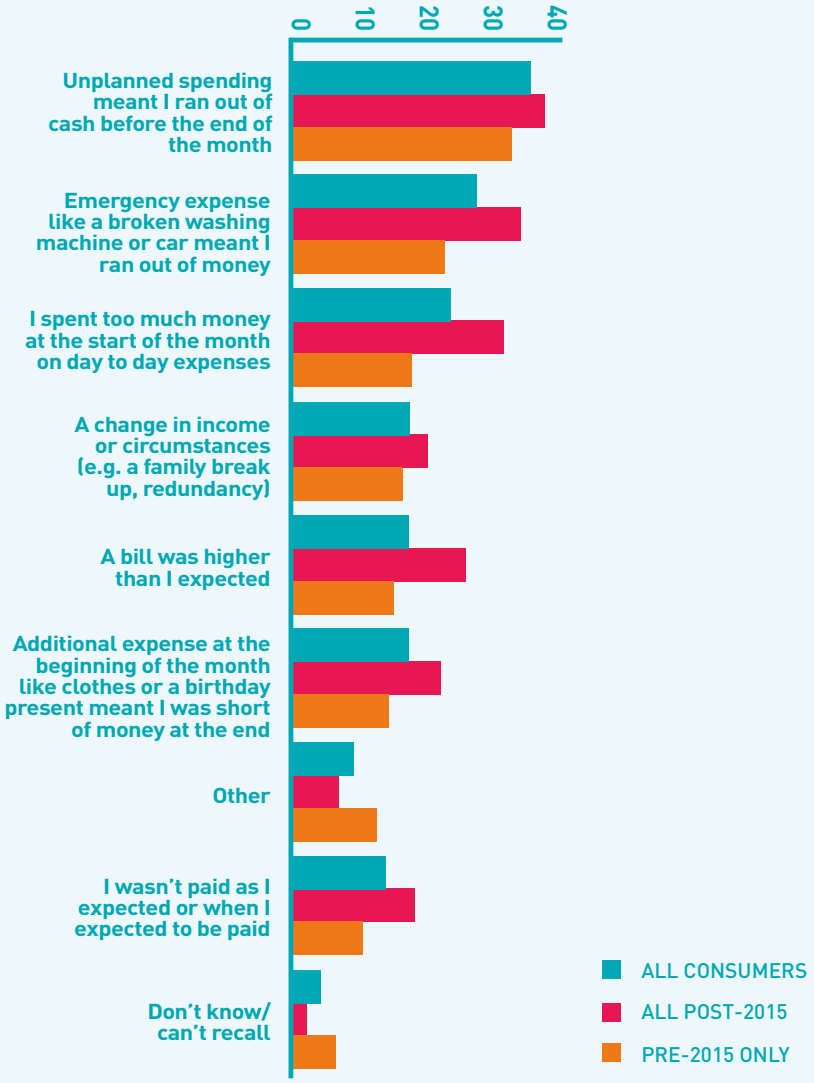
WHY ACCESS MATTERS

Why consumers take out loans

Our polling backs up past surveys and qualitative studies showing that short-term credit often fulfils an important role for borrowers. As can be seen from Figure 15, the need for a loan was typically associated with an unexpected change in income (triggered by a change in the family or a lower income from work) or with unexpected or unplanned spending, such as a bill or a one-off cost (such as a repair). Qualitative research by CHASM at the University of Birmingham has revealed the wide range of ways in which incomes can be jolted leaving a shortfall to be filled, including: job loss; variable wages; insecure work and self-employment; insufficient welfare benefits; loss of benefits or delays in receiving benefits.[58]

Our consumer survey reveals that a significant proportion took out a loan as a response to unplanned spending before the end of the month, or having spent too much at the beginning of the month on essential expenses or on additional expenses (e.g. a birthday present). While more recent consumers are more likely to cite more specific factors, the shape of the distribution is similar and differences are likely to be explained by better recall among more recent borrowers.

FIGURE 15: REASONS WHY BORROWERS TOOK OUT THEIR LAST LOAN: 'THINKING ABOUT YOUR MOST RECENT SHORT-TERM LOAN. WHICH, IF ANY, OF THE FOLLOWING ARE REASON(S) WHY YOU TOOK THIS LOAN OUT?'

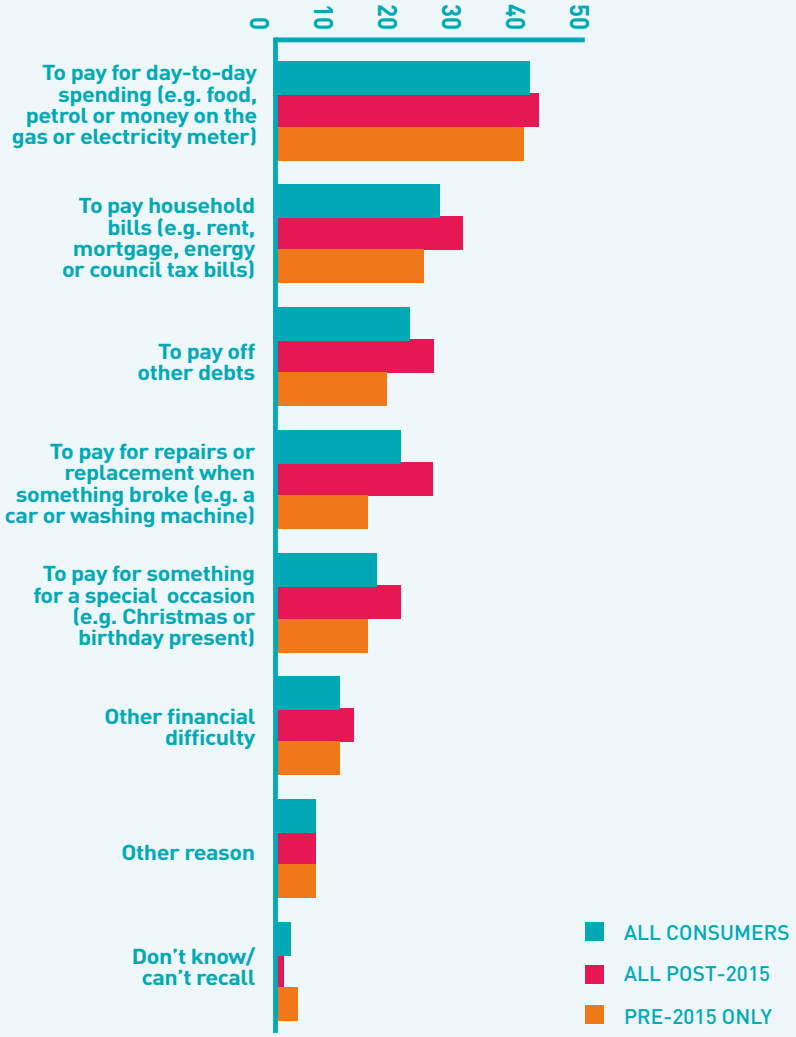


Source: YouGov poll of short-term credit consumers. Split by date loan was purchased. Unweighted base: 433 respondents post-2015; 769 respondents pre-2015.

What consumers spend the money on

As well as understanding why borrowers take out loans, it is important also to know about how they actually use the money. Our research shows that the most common destination for money from short-term credit loans was to pay for day-to-day-spending, such as food, petrol or for electricity meters (representing 43% of loans). The next most common uses were paying household bills (28%), paying for repairs or replacement when something broke (22%) or paying off other debts (22%). This bolsters existing research that shows that the majority of short-term credit consumers use their most recent loan for household bills or everyday spending.[59] It perhaps helps explain why in polling for the CMA a majority of consumers (59%) reported that they 'definitely' could not have gone without what they spent the loan money on.[60]

FIGURE 16: WHAT BORROWERS SPENT LOAN MONEY ON: 'STILL THINKING ABOUT YOUR MOST RECENT SHORT-TERM LOAN. WHEN YOU RECEIVED THE LOAN, WHAT DID YOU SPEND THE MONEY ON? (PLEASE SELECT ALL THAT APPLY)'



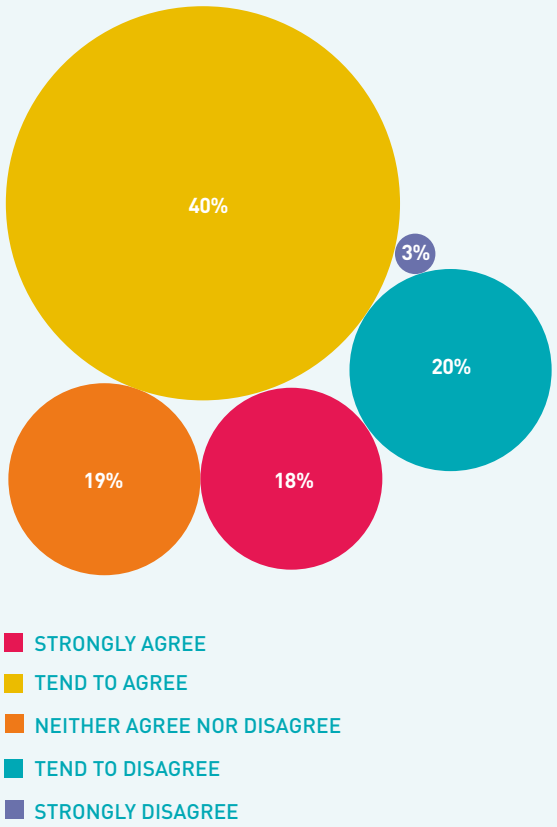
Source: YouGov poll of short-term credit consumers. Split by date loan was purchased. Unweighted base: 433 respondents post-2015; 769 respondents pre-2015.

EVIDENCE ON ACCESS TIGHTENING

From a baseline of autumn 2014, the FCA forecast that around 870,000 people a year would continue to use short-term credit representing around 93% of those who would be served in the absence of the cap.[61] The FCA estimated that 70,000 consumers who would otherwise have been served by the market would no-longer have access to short-term credit after the introduction of the price cap.[62] The changes in the market ahead of August 2014 had already meant that around 70,000 to 90,000 consumers who would otherwise have been denied by the cap had already stopped being served by the market. The FCA analysis of November 2014 found that the shrinking of the market during 2014 was likely to have been driven by fewer borrowers with lower credit scores accessing loans. The price cap was also predicted to exclude the least creditworthy customers.[63]

Our consumer polling suggests that tightening of access in the market has occurred, a conclusion supported by other studies – although the actual level of exclusion is hard to quantify.[64] For instance, among consumers who had bought a loan both before 2015 and after 2015, around half (57%) thought that loans had become harder to access since 2015, versus a quarter (24%) who thought the opposite. One in five (19%) said 'neither'. Clearly these respondents continued to use short-term credit in both periods.

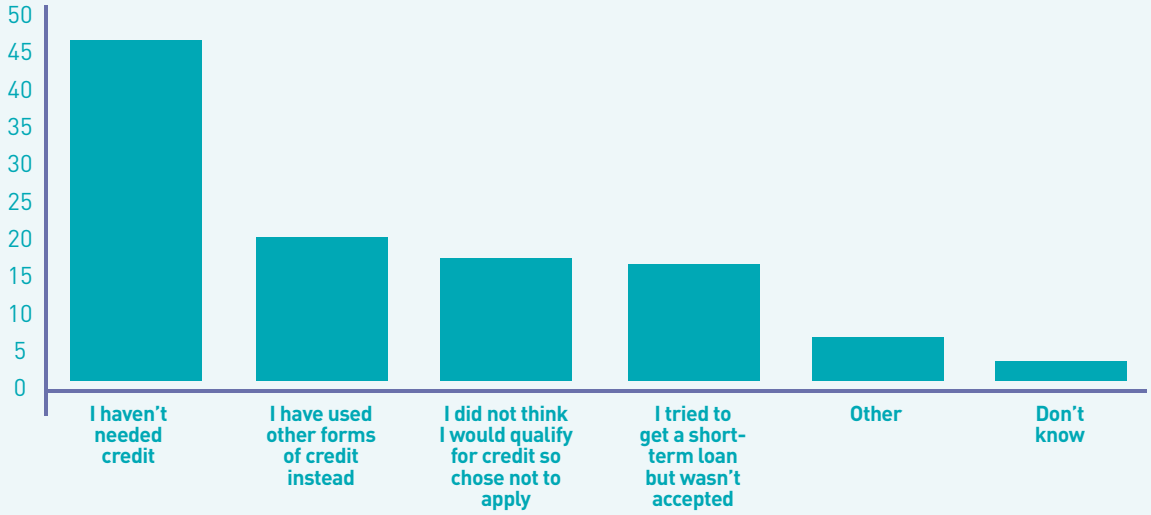
FIGURE 17: PERCENTAGE OF CONSUMERS WHO AGREE WITH THE STATEMENT THAT 'SHORT-TERM LOANS ARE MORE DIFFICULT TO ACCESS THAN THEY USED TO BE'



Source: YouGov poll of short-term credit consumers. Asked of consumers who had bought loans before and after 2015. Unweighted base: 213.

Our consumer polling also asked individuals who had bought a loan before 2014 but not in 2015 or 2016 why they had acted in this way. Most people (46%) who did not take a loan out after 2015, but had before, did so because they had not had a need for credit. However, 20% used other forms of credit, while 16% tried to get a loan but were not accepted and 18% thought they would not qualify for credit so chose not to apply. The latter two categories of responses imply that these consumers did not buy a loan because they were either refused, or thought they would be refused, credit. This may be a consequence of their personal financial conditions deteriorating and / or access tightening in the market.

FIGURE 18: PERCENTAGE OF CONSUMERS RESPONDING TO THE QUESTION: 'YOU SAID THAT YOU HAVE NOT TAKEN OUT A SHORT-TERM LOAN IN 2015 OR 2016. WHICH, IF ANY OF THE FOLLOWING, ARE REASONS FOR THIS? (PLEASE SELECT ALL THAT APPLY)'



Source: YouGov poll of short-term credit consumers. Asked of consumers of loans pre-2015 only. Unweighted base: 769.

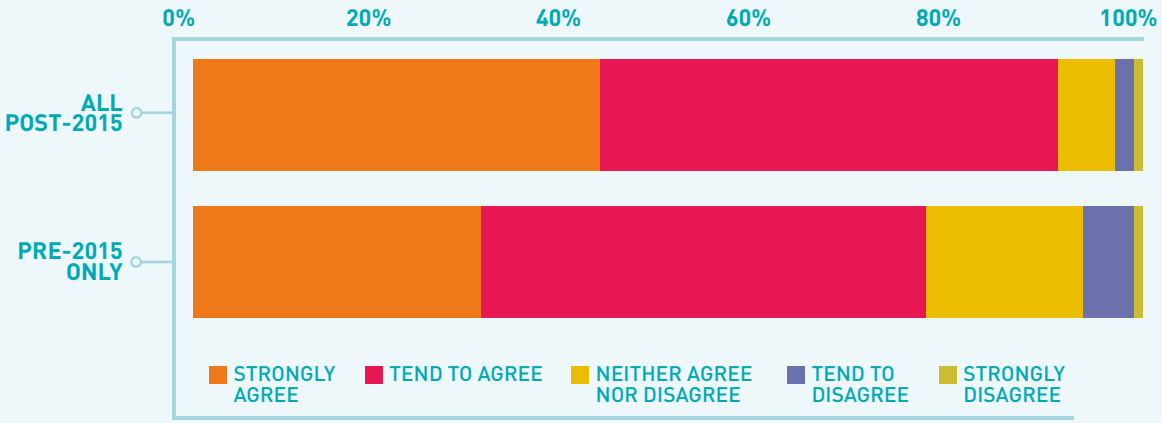
WHAT CONSUMERS WOULD DO IF THEY COULD NOT ACCESS LOANS

In the context of access tightening and the significant function that short-term credit can play, it is important to understand how consumers may behave if they are unable to access short-term credit.

Past research has shown that borrowing from mainstream lenders was not perceived as a realistic option for some sections of the population, especially those on low incomes.[65] In our consumer survey, more than eight in ten users agreed with the statement that 'a short-term loan was the only option available to me'. Past research has found similar estimates with mainstream credit only an option for 24% of online payday borrowers and 14% of retail customers.[66] When presented with potential alternative credit lines, CMA surveys have found that four in ten (39%) of consumers reported that they could not have used any alternative credit product to borrow the money.[67]

More than 8 in 10 AGREED that 'a short-term loan was the only option available to me'

FIGURE 19: PROPORTION OF CONSUMERS THAT AGREE WITH THE STATEMENT: 'A SHORT-TERM LOAN WAS THE ONLY OPTION AVAILABLE TO ME'

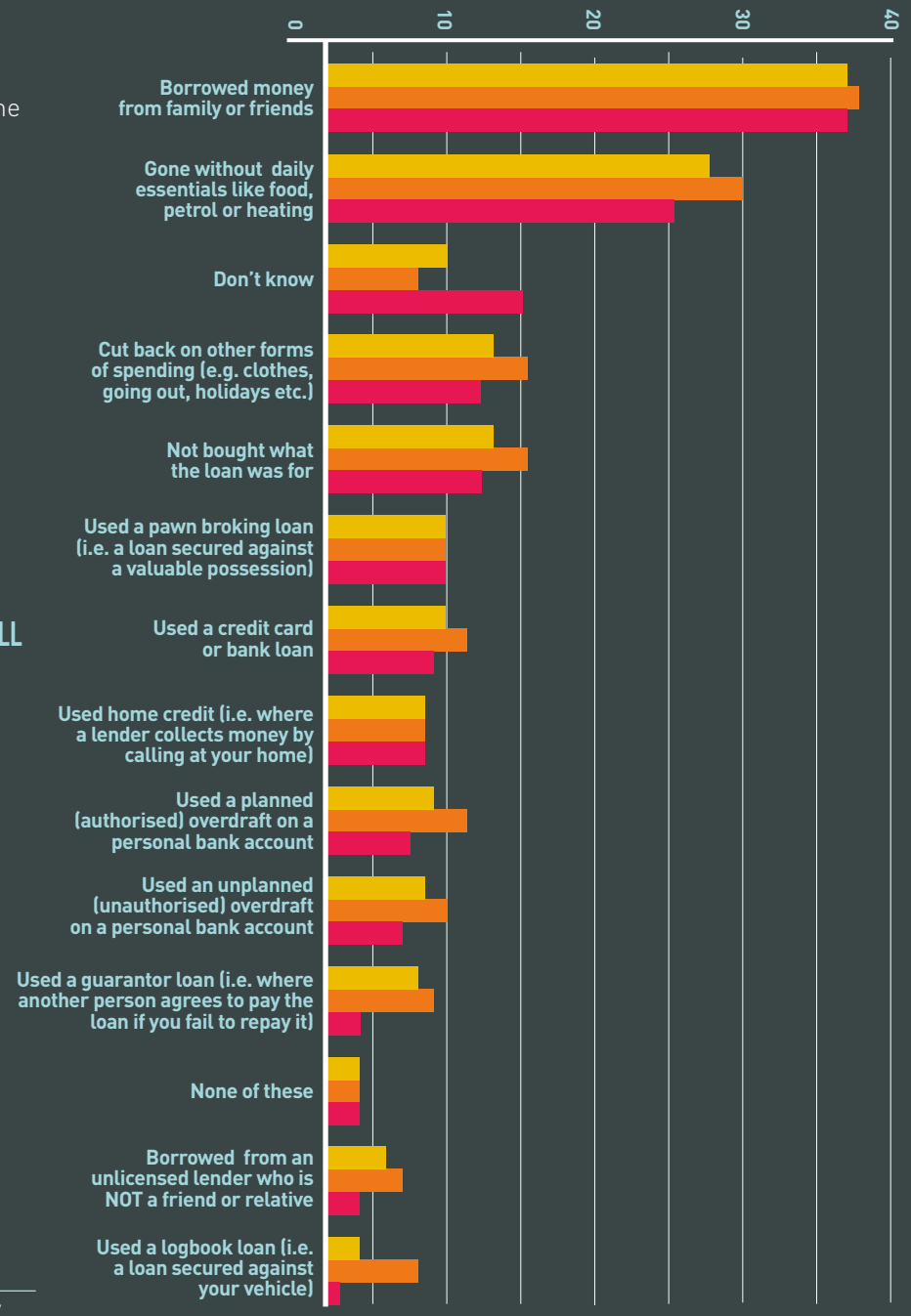


Source: YouGov poll of short-term credit consumers. Split by date loan was purchased. Unweighted base: 433 respondents post-2015; 769 respondents pre-2015.

Figure 20 provides more detail on what consumers would do in a hypothetical situation where they were unable to access their short-term loan. Around a third (37%) would have borrowed from family and friends instead. SMF research has shown that transfers within the family and between generations are common even among low income households.[68] However, it is also clear that access to informal credit from family and friends is not universal and that it can expose those who provide the help to financial strain themselves and even indebtedness.[69] YouGov polling of declined applicants in 2014 revealed that of those who could turn to family and friends seven in ten could only do so infrequently.[70] In our survey, nearly three in ten of consumers (27%) report that they would have gone without daily essentials; whilst 12% would have cut back on other forms of expenditure and 12% would not have bought what the loan was borrowed for.[71]

Some consumers reported that they would turn to alternative sources of credit in the market, such as pawn broking (10%) and home credit (8%); whilst some would turn to mainstream products such as a planned overdraft (9%), an unplanned overdraft (8%) or a credit card (10%). Here, it is important to note that the costs of other forms of credit vary significantly depending on products themselves, the terms on which they are secured and how the loan facility is used. Taking the example of credit cards and overdrafts: in some cases these loans are likely to be cheaper than short-term credit; in other cases more expensive (for example if the borrower makes prolonged minimum credit card repayments or makes use of an unauthorised overdraft).[72] Studies suggest that in US states with restrictions on interest rates, there are more incidents of late and missed payments on mainstream credit.[73] A 2014 survey of declined applicants for short-term credit revealed that a quarter of respondents had reported that they had incurred fees or fines that were more than the costs of the loan would have been had they been approved.[74]

FIGURE 20: PERCENTAGE OF CONSUMERS CITING ANSWERS TO THE QUESTION: 'THINKING ABOUT YOUR MOST RECENT SHORT-TERM LOAN. IF YOU HAD NOT BEEN ABLE TO ACCESS A SHORT-TERM LOAN ON THIS OCCASION, WHICH, IF ANY, OF THE FOLLOWING DESCRIBE WHAT YOU THINK YOU WOULD HAVE DONE INSTEAD? (PLEASE SELECT ALL THAT APPLY)'



Source: YouGov poll of short-term credit consumers. Split by date loan was purchased. Unweighted base: 433 respondents post-2015; 769 respondents pre-2015.

In this context, it is concerning that 6% of survey respondents report that they would have borrowed from an unlicensed lender instead. These figures are slightly higher than previous surveys, such as the 2013 survey for Bristol University which found that between 1% and 2% of payday consumers would consider borrowing from a loan shark (although the absolute numbers of respondents in the survey remain relatively small).[75] Past surveys have also sought to assess how many short-term credit consumers have actually used illegal lenders. Amongst these, in a 2014 YouGov survey of declined applicants, 4% of respondents reported having turned to an illegal lender;[76] a 2014 survey of 2,000 short-term credit consumers commissioned by the FCA found that less than 2% of respondents stated that they borrow from an illegal lender.[77] The potential risks around illegal money lending are also implied by the fact that 6% of Citizens Advice advisers reported in a survey that borrowers were turning to illegal lending or unauthorised credit as a consequence of being denied credit from the market (it should be noted that the study concluded that these advisers were unable to provide significant evidence that this was actually happening).[78] Frustratingly, there is little up-to-date public information on the prevalence of illegal money lending in the UK (the latest being 2010).[79] While we do not know whether use of illegal lenders is rising, we can observe that a proportion of consumers appear to be prepared to use illegal lending if unable to access the market.

Empirical studies have found that in countries where interest restrictions apply consumers may switch to other forms of lending, including illegal lending, although reviews of the evidence by Bristol University and the FCA have judged that the evidence is not conclusive that this would occur in the UK.[80] The FCA has argued that denying lower-income and more vulnerable consumers access to short-term credit is likely to be generally beneficial and unlikely to lead to significantly more consumers using illegal money lending as a direct result of a lack of access to short-term credit. [81] However, others have disputed this. Professor Rowlingson et al have argued that the effect is more likely to be harmful than positive unless alternatives are put in place because people may turn to other forms of high cost credit which less suit their needs, may use expensive forms of mainstream credit or turn to illegal lending. The report contended that the underlying causes of demand for short-term credit should be addressed including low levels of state benefits, insecure work and pay.[82] The Financial Inclusion Commission also cited a similar concern in its March 2015 report, noting of the cap introduced by the FCA that: 'while it has restricted supply, it has not restricted demand'.[83] Whilst not reflected in our survey, there are some indications that consumers may indeed be turning to other forms of high-cost credit, for instance, Citizens Advice has said that it is seeing increases in consumers approaching them about problems relating to guarantor loans and rent-to-own products, alongside a fall in problems related to payday loans.[84] Our research suggests that regulators and enforcers should be vigilant given the potential risks identified above.

CHAPTER 3

Policy considerations

The last chapter showed that there have been some significant changes in the market since 2013:

- The number of loans sold has reduced significantly.
- The industry data shows that the proportion of loans on which consumers are charged fees has halved in the period, and the average fee level has reduced. However, there is an outstanding question as to whether such fees and charges are too high and around a fifth of consumers cite fees for late payment as a problem.
- Average daily costs of loans have fallen from 1.3% in 2013 to 0.7% in 2015.
- Our consumer survey suggests an improvement in perceptions of affordability among more recent borrowers: 56% of consumers who took out a loan since 2015 agreed that their most recent loan was 'an affordable way of borrowing', compared to 43% of those whose last loan was taken out before 2015. However, a quarter (26%) of consumers since 2015 disagreed that their last loan was affordable. Consumers buying loans in 2015 are on average coming from higher-income brackets than in 2013, which is consistent with the FCA's prediction that the market would shrink and lower-income individuals would be excluded from the market.
- Our consumer survey suggests that consumers perceive that the short-term credit market has become harder to access and that some consumers have struggled to access it.
- If consumers had been unable to purchase their loan, 27% of consumers reported that they would have gone without essentials and 37% said that they would have borrowed from family and friends.
- Our survey shows that 6% of short-term credit consumers report that they would have used an unlicensed lender who is not a family or friend if they had not been able to access a short-term loan.

Below, looking ahead to the 2017 review of the cap and to wider social policy development, we draw conclusions on potential considerations for the future.

DESIGN OF THE CAP

International experience suggests that price caps may be susceptible to gaming with firms adjusting down their headline rates to fit under the cap only to expand charges and costs that sit outside the cap.[85] Such unintended consequences do not appear to be emerging in the UK market, and the three elements of the cap appear to function in a complementary fashion. For instance, our industry data shows the proportion of loans on which fees are charged has declined, as has the average size of fees. This is likely to be a consequence of all three elements of the cap, which function collectively to make it less profitable for firms to offer loans to those consumers who are more likely to fail to pay back their loans on time. One consequence has been the evolution of longer-term loan products, and the characteristics of these products should be monitored as the cap beds in.

COMPETITION AND PRICES

The regulation appears to have led to lower average interest rates on loans. At the same time, price differentiation has diminished in the market since the introduction of the regulation. This was an inevitable consequence of the regulation (given the scale of differentiation previously exceeded 0.8%). While there appears to have been some price convergence since the introduction of the cap, there remains some price variation between providers. It is also reassuring that lenders are not setting prices at the ceiling, implying some downward competitive pressure.

Regulators should keep a watching brief on how interest rates change in the future and ensure that lenders are competing on price. Indications of price convergence or of rates gravitating towards the initial price cap should be viewed as warning signs. This is particularly important given the CMA's conclusion in 2015 that 'customer demand responded weakly to prices', that the 'competitive constraints that lenders faced when setting their prices were weak' and that more than half of payday consumers do not shop around at all prior to taking out a loan.[86]

In addressing competition, the consumer-facing pro-competition initiatives of the CMA and FCA remain important policy tools for the future, offering the potential of lower prices for consumers without some of the trade-offs inherent in price setting (see below). This should include continuing to learn from behavioural economics as a route to drive consumer pressure on firms.[87]

AFFORDABILITY AND SUITABILITY

A number of charities and consumer bodies – for instance StepChange and Citizens Advice – continue to highlight the importance of credit products being suitable and affordable for the consumers who are sold them.[88] While there appears to have been some improvement in the market (in part at least as a result of regulatory intervention), a significant minority of consumers of short-term credit disagree that loans are affordable. Effective regulatory oversight here remains important.

ACCESS TO CREDIT

The significant reduction in the size of the market and the consumer attitudes revealed in our survey indicate that access to the market has tightened with potential consequences for some people who would have been able to access the market in the absence of the cap. The FCA was straightforward about the nature of the trade-off inherent in the price cap. When it reviews the price cap in 2017, the FCA will need to strike the balance between further lowering costs of short-term credit through price setting versus maintaining access to the market. It will be particularly important to consider which types of consumers may be excluded. In its 2014 Policy Paper, the FCA concluded that many of the people denied access to credit because of the price cap would benefit from the regulation – in other words they would be better off not having access to the market than being able to borrow because they would be worse-off in the medium term. The FCA noted that the benefits of denying consumers access to credit were strongest for those borrowers who could only just access the market before the cap was introduced. However, the regulator also acknowledged that denying access to short-term credit to more marginal consumers was less clearly beneficial. Any further tightening of the regulatory framework may lead to exclusion of consumers for whom the predicted benefits of losing access would be lower.

Aside from any future regulatory change, providing means of credit for those who cannot access the market remains a fundamental and growing social policy consideration. Access to the market is reducing at the same time as social credit – in the form of the Social Fund – is being cut back. Alternative forms of finance should continue to be promoted – both because they may be cheaper for some consumers and because diversity of provision can drive competition. Credit unions could potentially play a role here – although it is likely that they will only be an option for a comparatively small proportion of consumers. For instance, a consumer survey for the Competition Commission found that only 2% of consumers using payday products in the past 12 months had also used a credit union, although 15% of consumers reported that they could have used a credit union product instead of taking out a payday loan.[89]

The fact that many current and past consumers of short-term credit are in employment may mean there could be opportunities to provide credit via employers. For instance, loans provided via the workplace to employees may enable lenders (which may or not be employers themselves) to assess credit risks more thoroughly and, potentially, develop mechanisms to deduct money from wages before borrowers receive the money in their account.[90]

Many aspects of data collection and sharing have improved markedly in the market. However, there is insufficient tracking of individuals who are applying for loans and / or who are unable to access the market. The Government should seek to update its analysis of the incidence of illegal lending in the UK and assess thoroughly whether and how the inability to access different forms of mainstream and alternative credit contributes to it.

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The Social Market Foundation (SMF) is a non-partisan think tank. It believes that fair markets, complemented by open public services, increase prosperity and help people to live well. The SMF conducts research and runs events looking at a wide range of economic and social policy areas, focusing on economic prosperity, public services and consumer markets. The SMF is resolutely independent, and the range of backgrounds and opinions among our staff, trustees and advisory board reflects this.

ABOUT THE CONSUMER FINANCE ASSOCIATION

The CFA is the principal trade association representing the interests of some of the best known short-term lending businesses operating in the UK. Members include Lending Stream, Mr Lender, MyJar, Payday Express, Payday UK, Peachy, Quick Quid, Satsuma, Speedy Cash, Sunny, The Money Shop and WageDayAdvance.

Consumer Finance Association

T: +44 (0)203 178 7408
F: +44 (0)203 170 5909
E: enquiries@cfa-uk.co.uk
W: **www.cfa-uk.co.uk**

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