The New Regulatory Regime for Payday Loans in the UK: Making Consumer Credit Safer and Affordable

In the aftermath of the global financial crisis financial regulation and supervision has been significantly reformed in the UK. As a final peace of this reform, consumer credit, including payday loans, has been transferred to the new conduct of business regulator, the Financial Conduct Authority. The paper shows that payday loans are inherently detrimental financial products to all consumers that use them irrespective of which of the various traditional consumer sub-populations the payday customer belongs. Thus the paper focuses on the new regime's approach that intends to prevent consumer detriment in payday lending, on rules on responsible lending and product regulation. It shows the rules on responsible lending are likely to ensure only those consumers will be given loans that can afford them. Product regulation (in the form of rollover limits and price caps) will make payday loans safer and affordable. Nevertheless, there are certain conditions required in order to maximize the effectiveness of the regime. First, in designing the price cap, the annual percentage rate of charge and not the interest should be taken as a benchmark. Next, it the new regime is likely to deny access to credit for some consumers, this should be addressed by adequate social lending measures. Finally, the overall key to success of the new responsible lending and product regulation measures is effective enforcement.

Key words: consumer credit, payday loans, Financial Conduct Authority, responsible lending, product regulation

Introduction

One of the themes of this special issue is 'specific regulatory approaches to consumer sub-populations, according to product type.' This paper considers a specific regulatory approach to payday loans and to the 'payday loans consumers' consumer sub-population. The paper shows that payday loans are inherently detrimental financial products to all consumers that use them irrespective of which of the various 'traditional' consumer sub-populations the payday customer belongs. Thus the paper focuses on the new regime's approach that intends to prevent consumer detriment in payday lending, on responsible lending and product regulation.

Payday loans are a very topical regulatory issue at present in the UK. These are very high cost loans for a small amount of cash that are repayable at the customers' next payday. The loans are obtained within minutes or hours from placing the application and the procedure itself is simple and easy. Although marketed on a short term and speed oriented basis, because of the inbuilt feature of extension (rollover) subject to additional fees and charges, these loans have a potential to turn into a long term and very expensive commitment, a cycle of debt that ultimately leads to a debt trap. Consumers trapped in debt are subject to unfair and aggressive debt collection often being left without essential funds to live on. Because of how they work and how they were sold, payday loans caused significant detriment for a large number of UK consumers, and attracted the highest level of public anger from all consumer credits.[1] Ed Miliband, the Labour leader characterised payday lenders as 'modern' predators,[2] and noted; payday loans are 'one of the worst symbols of this cost of living crisis.'[3] However, so far, there is no publicly available academic writing addressing the problem of payday loans in the UK and the current measures being introduced to regulate them.

In the aftermath of the global financial crisis, financial supervision was subject to significant reforms in the UK. The process started last year, with the establishment of the new conduct of business authority, the Financial Conduct Authority (FCA), and was completed on 1 April 2014 when this authority overtook the regulation and supervision of consumer credit from the Office of Fair Trading (OFT).[4] One major benefit of the new regime is much stronger regulatory and supervisory powers of the FCA compared to the OFT. In terms of regulation, the FCA can make binding rules. It has included a new Specialist Sourcebook (the Consumer Credit Sourcebook (CONC)) in its Handbook that contains two kinds of rules: Rules (R) are binding on regulated firms, whereas Guidance (G) are non-binding rules and contain the FCA's expectations and help firms in compliance. In contrast, the OFT could only issue non-biding guidance. Regarding supervision, the FCA has a 'pro-active', forward looking and targeted approach, devoting more resources to supervising high risk firms. Firms have regular reporting requirements and the FCA conducts thematic work in response to systemic issues. To compare, the OFT could review compliance but conducted no ongoing supervision and relied on third party information and data. The FCA has extensive enforcement and redress powers. It can bring criminal, civil and disciplinary proceedings, withdraw authorisation, suspend operation, and issue unlimited fines, and require consumer redress and restitution. The OFT could bring civil and criminal proceedings, revoke licenses, issue non binding rules and limited fines for their breach and had no power to require redress and restitution (HM Treasury and BIS 2013,

[1] Moore, E. (2014, March 12), Payday sector is a lightning rod for FCA, *Financial Times*. Retrieved from http://www.ft.com/cms/s/0/3111911a-a9d3-11e3-8bd6-00144feab7de.html

[2] McDermott, J. (2013, November 5), We are now all part of the Wonga Economy, *Financial Times*. Retrieved from http://www.ft.com/cms/s/0/c80def50-4646-11e3-a0c0-00144feabdc0.html#axzz2vNjGyxQ7

[3] Ed Miliband Takes On The 'Wonga Economy', *Sky News* (2013, November 5). Retrieved from http://www.webcitation.org/6KwJOvDfX

[4] References in this paper use the materials published by the OFT and the CC. However, the reader should be reminded the OFT and the Competition Authority (CC) ceased to exist. From 1 April 2014 the OFT's competence was partially transferred to the FCA and partially to the Competition and Markets Authority, that merged the OFT and the CC.

table 1.A). One of the most significant powers of the FCA that is now applicable to consumer credit is its product intervention power. Under Section 137D Financial Services Act 2012 the FCA has a mandate and power to scrutinize and regulate products. This means, the FCA can mandate, restrict or ban certain features of a product or ban a product outright. The power includes capping the cost of credit and limiting the duration of the credit agreement in order to restrict roll-overs (HM Treasury and BIS 2013, para. 2.22-2.23).

The Government recognized that the high cost credit market, in particular in the payday lending sector, required urgent intervention (HM Treasury and BIS 2013, pp.3). Accordingly, the FCA made the regulation of these credits its top priority. However, it did not create a special regulatory regime for payday loans per se, rather a regime for short term, high cost credit more generally. This approach was taken so as to take into account the diversity of the UK consumer credit market and financial innovation, to capture the fundamental business models currently on the market and to prevent regulatory arbitrage (FCA 2014b, para. 5.3). Nevertheless, the paper shows, that although the regime does extend beyond payday lending, the measures do adequately address the needs of this (payday lending) consumer sub-population. In summary, the FCA requires responsible lending, obliges firms to place a risk warning in advertisements, imposes disclosure obligations, limited rollovers and debt collection attempts to two, and provided numerous obligations for fair treatment of customers in default. In the near future, the FCA will also cap the price of the loan.

The paper explores two aspects of the new regime that are intended to effectively prevent detriment to the ‘payday loans consumers’ sub-population and provide consumers with appropriate products: the new responsible lending rules and the new product regulation rules (limits on roll-overs and price caps). Now, one may argue that responsible lending goes hand in hand with responsible borrowing, consumers bearing their own responsibility to make an informed decision (e.g. Fejős 2009). However, as the prevailing view is that consumers are not rational decisions makes because they will tend not to read information (e.g. Ben-Shahar 2009, Willett 2011), are cognitively weak (e.g. Howells 2005) and/or behaviourally biased (e.g. Faure and Luth 2011) the paper does not discuss the new rules on information disclosure. It proceeds on the basis that responsible lending and product regulation are likely to be more important in preventing consumer detriment. Neither does the paper discuss the new rules on debt collection practices and more generally on treating defaulting customers fairly.

The focus is squarely on the new responsible lending rules and the new product regulation rules. It is shown that tighter affordability checks, roll-over limitations and price caps will make payday products safer and more affordable to use. There are, nevertheless, certain caveats. First, it is argued that, in designing the price cap, the annual percentage rate of charge (APR) and not the interest should be taken as a benchmark. Next, it is pointed out that the new regime will deny access to credit for certain members of the indentified sub-population, and that this should be addressed by adequate social lending measures. Finally, the paper highlights the importance of supervision and enforcement as a necessary complement to the responsible lending and product regulation measures.

Product Definition and Market Characteristics

There is no single definition of payday loans. Perhaps the most comprehensive is the definition given by the OFT, according to which, payday lending is 'the provision of small-sum cash loans marketed on a short-term basis, not secured against collateral, including (but not limited to) loans repayable on the customer's next payday or at the end of the month and specifically excluding home credit loan agreements, credit cards, credit unions and overdrafts' (OFT 2013a, para. 1.2). As said above, the FCA included payday loans in the 'high-cost-short-term' credit definition that is: 'a regulated credit agreement : (a) which is a borrower-lender agreement or a P2P agreement; (b) in relation to which the APR is equal to or exceeds 100%; (c) either: (i) in relation to which a financial promotion indicates (by express words or otherwise) that the credit is to be provided for any period up to a maximum of 12 months or otherwise indicates (by express words or otherwise) that the credit is to be provided for a short term; or (ii) under which the credit is due to be repaid or substantially repaid within a maximum of 12 months of the date on which the credit is advanced; (d) which is not secured by a mortgage, charge or pledge; and (e) which is not: (i) a credit agreement in relation to which the lender is a community finance organization; or (ii) a home credit loan agreement, a bill of sale loan agreement or a borrower-lender agreement enabling a borrower to overdraw on a current account or arising where the holder of a current account overdraws on the account without a pre-arranged overdraft or exceeds a pre-arranged overdraft limit.' (FCA Handbook, Glossary).

If the two definitions are compared, it can be seen that the latter is more detailed, but captures the same elements. A payday loan is a high cost short term loan. The duration of the loan is a month or less, though some products last longer to a maximum of 12 months. If repaid on time, the loan on average cost 25 per cent per month of the borrowed capital. The amount of the loan is typically less than £1,000 and the average amount loaned is around £270. Payday loans are unsecured loans (Europe Economics 2013, pp. 125; OFT 2013a, para. 1.2).[5]

However, payday loans have other features not reflected in the definition. These are fast loans in terms of application, approval and transfer. Successful applications normally receive funds the same day, often within minutes. Loans are, normally repaid by continuous payment authorities, but in retail stores repayment is also made in cash and by a post-dated cheque (Rowe et al. 2014, pp. 14).[6] Perhaps the most significant feature of payday loans, offered by most lenders, is the rolling-over facility. Rolling-over means the consumer pays of the interest and charges but the loan 'rolls-over' beyond the original repayment that continues for a subsequent month under the same terms and conditions (Rowe et al. 2014, pp. 14). Rollovers are technically different from 'refinancing' when the loan refinanced on different terms and conditions, the outstanding loan amount is repackaged into a new loan, possibly with additional borrowing and/or over a longer term' (OFT 2013a, pp. 6). Although not part of the definition, the FCA's did take into account the above characteristics in tailoring its regulatory approach to payday loans.

Payday loans are provided by non-bank entities, specialized consumer credit firms that vary in size and business models. Some are small, family run, single shops others are part of large multinational corporations (Europe Economics 2013, pp. 125). Some firms exclusively operate through retail premises (high-street shops), others use means of distance communication (online, phone SMS or mobile application), or rely on both channels (Competition Commission 2013, para. 33). Some firms specialize in payday loans, others are also engaged in other activities like pawnbroking and foreign currency exchange (OFT 2013b, para. 1.2). According to the OFT, the number of these firms in 2012 was 240 (OFT 2013c, pp. 28) the three largest firms being Wonga (wonga.com), Cash America (Pounds to Pocket and Quickquid) and Dollar Financial Corporations (Paydayuk and The Money Shop) (Competition Commission 2013, para. 32). The new regime made many players to exist the market, leaving around 100 firms.[7]

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[5] Competition Commission, Payday Lending Investigation, Competition between payday lenders and other credit providers. Retrieved from https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131_competition_from_other_types_of_credit_working_paper.pdf

[6] Competition Commission, Payday Lending Investigation, Competition between payday lenders and other credit providers. Retrieved from https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131_competition_from_other_types_of_credit_working_paper.pdf

[7] cf Goff, S. (2014, May 20). Tougher UK rules drive payday lenders away. *Financial Times*. Retrieved from http://www.ft.com/intl/cms/s/0/141899d6-dcf6-11e3-ba13-00144feabdc0.html#axzz34QZh3InG

A key trend in the industry (since its emergence in the USA in the 1990's) is its rapid growth (e.g. Shaaf 2010, p. 339). In the UK, the industry grew from £900 million in the financial year of 2008/09 to between £2-2.2 billion in 2011/12 (OFT 2013c, pp. 9). In 2012, 7.4-8.2 million new loans were issued to around 1.2 million customers (OFT 2013c, pp. 34).

The Payday Loans Consumers Sub-Population

Payday customers have several characteristics compared to the general consumer population. They tend to be men rather than women, in the age range of 26-45 years, living alone or with their partner, in a rented accommodation, shared house or with parents, and are in full time employment (OFT 2010, figure 4.1, table 4.1; figure 4.2; Personal Finance Research Centre 2013, para. 3.2.3, 3.2.4, Ellison et al. 2011, pp. 14). This is however only a simplified picture of an average payday consumer. A recent research placed UK payday consumers into five out of the total of ten segments.

The 'Living for Now' segment is a relatively low income group, more often younger and male. The majority work and regularly pay off bills, but tend to be less organised with money and prone to risk taking. The 'Striving and Supporting' group is also a low income segment, mostly working female with dependent children. Although risk averse, money management is a struggle, often fall behind on payments and find difficult to meet unexpected expenses. The 'Starting Out' segment is a young segment of men and women, often from minority ethnic groups. Despite having higher level qualifications with some still studying, incomes are relatively low. They struggle to make ends meet and often rely on credit to get by. The 'Hard Pressed' is also a low income segment of men and women, most single living with dependent children. The majority is out of work. This group has low financial confidence, limited access to mainstream credit, and struggle with keeping up with bills and to make ends meet. Finally, the 'Stretched but Resourceful' is a family segment of men and women in work with children. Their incomes are relatively high and often have their own home with a mortgage. Although generally able to keep up with bills, credit use is high. Many would struggle to cope with an income or expense shock (Rowe et al. 2014, pp. 57).

It is important to say that there is a high demand for payday loans within the identified sub-population. Payday loans are broadly used for two reasons (OFT 2010, para. 4.20). One category, around 30 per cent, has no access to other types of credit (Ellison et al. 2011, pp. 46, Personal Finance Research Centre 2013, para 4.3.2, see also OFT 2010, para. 4.31); the other, prefers payday loans and would not switch to similar products (Personal Finance Research

Centre 2013, table 20).[8] The most common reasons for this preference is convenience and speed of obtaining funds, and the suitability of the product, that is, short term borrowing of small amounts of cash (OFT 2010, figure 4.11). This demand is likely to increase in the future due to arrival of the 'new generation of debtors' those that are unable to pay off their household bills as opposed to traditional problems with credit products. The Money Advice Trust charity reported a record raise of 140 per cent in 2013 of people it helped with debt problems on household bills.[9] These are the 'ideal candidates' for payday loans.

Thus, although members of the identified sub-population show some common features, the reality is, consumers using payday loans are different in terms of their personal characteristics, individual life circumstances and attitudes to borrowing. Therefore, they belong to different categories of 'traditional' consumer sub-populations that are differentiated by age, education, income level, etc. Albeit different, the common bond between payday loans consumers is the use of payday loans. Since payday loans are inherently detrimental financial products to all consumers that use them, irrespective of which of the various traditional consumer sub-populations they belong, this paper considers justified to consider all payday loans consumers a special sub-population that needs protection.

The Vulnerability of Payday Loans Consumers: The Debt Trap

The vulnerability of payday customers stems from the very design of the payday loan product that is capable to create a cycle of debt and lead to a debt trap. Namely, payday loans are extremely expensive credits and this is exacerbated by the inbuilt feature of the loan to rollover. The product as it is designed is alone capable to cause vulnerability, but vulnerability is even more likely in combination with other factors like poverty, indebtedness and how the loan is used.

All consumers may be vulnerable to payday loans because of their cost. Taking the representative example of Wonga.com, if a £150 loan is taken out for 18 days with the fixed interest rate of 365 per cent per annum or 1 per cent per day calculated on the interest bearing balance, the interest will amount to £27.99. The loan will trigger a lump sum transmission fee of £5.50 added to the principal. The total repayment owed will be £183.49, and the APR an

[8] Competition Commission, Payday Lending Investigation, Competition between payday lenders and other credit providers. Retrieved from https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131_competition_from_other_types_of_credit_working_paper.pdf

[9] Osborne H. (2014, June 10). Serous debt crisis rise as families struggle with household bills. *The Guardian*, Retrieved from http://www.theguardian.com/money/2014/jun/10/serious-debt-cases-household-bills

amazing 5853%![10] Although, economists argue, the high price is justified by the risk of placement and high operating costs (Flannery and Samolyk 2005); and research shows, payday loans are not the most expensive from in the high cost short term credit sector (Ellision et al. 2011, pp. 9), neither argument seems to be a valid for the outrageous price.

Nevertheless, even if the upfront price is justified, the extremely expensive nature of these loans after default is not. Namely, if the loans are not repaid on time, they can roll-over. For example, if a £100 is borrowed for 30 days for £30. After 30 days the consumer pays the outstanding interest, the principal renews (rolls-over) and accrues another £30 interest. Thus after two rollovers the amount due will be £190 instead of £130. In addition, the default triggers additional fees and charges that can also accrue interest (OFT 2013c, pp. 11). For example, one lender charged on average £179 in fees during the 35 day period of default. This included an initial missed payment fee, a further non-payment fee after 7 days, a default fee after 35 days and additional charges for issuing debt collection letters (OFT 2013c, pp. 24). Thus in the above example, the consumer may be liable to pay much more than initially anticipated. Without limiting the number of roll-overs, the loan can in theory be extended forever. For example, the OFT found an example of rolling over 36 times! (OFT 2013c, pp. 23).

Empirical data shows the majority of loans get repaid on time, but a significant number does roll-over. In the financial year of 2011/12, for example, 28 per cent of loans rolled over or got refinanced at least once (OFT 2013a, para. A.20); 5 per cent of loans rolled-over more than 4 times (OFT 2013c, pp. 14). Roll-overs were significant source of profit. 36-41 per cent of the aggregate profit comes from roll-overs, refinancing, administration fees, default charges or late payment charges (OFT 2013a, para. A.17). This explains why some lenders advertised rollovers as a favourable feature of payday loans, and why actively encouraged consumers in payment difficulties to take advantage of this option.

The other characteristic of payday loans is repeat borrowing, or multiple loans. In the financial year of 2011/12, on average 58 per cent of customers took out more than one new payday loan, excluding roll-overs and re-financing. These customers accounted for around 81 per cent of total profit (OFT 2013a, para. A.27).

Thus no wonder critiques refer to payday lending as the credit markets equivalent of 'crack cocaine' that is a highly addictive source of easy money that hooks the unwary into a cycle of debt (Stegman 2007). The product characteristics of high price and rollovers are exacerbated by how the product is used, or by other personal circumstances of consumers like

[10] Wonga. Representative example. Retrieved from: https://www.wonga.com/

low income and high levels of accumulated debt. Under these conditions, consumers pushed into the cycle of debt find uneasy to get out of it and are likely to remain trapped in debt.

The debt trap is likely to be caused if payday loans are used for supporting unaffordable or excessive lifestyles. Morse's economic research reveals payday loans mitigate financial distress in extraordinary circumstances, and increase individual and community resiliency to financial downturns. However, his results prove the suitability of payday loans in financial emergency and are no evidence on their positive impact under ordinary circumstances (Morse 2009). Thus while payday loans may be useful for bridging temporary illiquidity problems caused by extraordinary circumstances, used as a sort of lender of last resort, they are arguably very dangerous products for no such situations. In the UK, payday loans are primarily used for covering everyday expected or unexpected household expenses and household bills; secondarily, on one time expenses like Christmas and birthdays and repairs; and thirdly for paying rent or mortgage or for refinancing another loan (Personal Finance Research Centre 2013, table 4.1; also OFT 2010, figure 4.9). The data suggest payday loans are normally used for bringing temporary household illiquidity and not financing excessive lifestyles and to live beyond their means (OFT 2010, para 4.25). However, there are cases when payday loans are used to finance problematic behaviour like gambling and drinking (Rowe et al. 2014, pp. 14) or living beyond means together with other forms of credit (Rowe et al. 2014, para. 5.2.2).

The other factors likely to lead to a debt trap are low income and high levels of accumulated debt that makes consumers less resilient to income or expenditure shocks (FCA 2014a, pp. 9, 30).

Many payday members of the indentified sub-population are on lower income consumers. In 2010, 13.3 per cent had an annual income between £11,100-15,000; 25.4 per cent between £15,000-19,200; 22.0 per cent between £19,200-24,300 and 28.9 per cent £24.300 and above. This data shows payday consumers generally had less income than the average consumer credit population, where 48.7 per cent of customers earn £25,000 and above (OFT 2010, table 4.2). However, it is difficult to say if they would fall under the low income category due to different definitions of low income. It has been said low income households are those with an annual income of between £11,000-19,000 or less (Worton et al. 2014, pp. 56); or those on the lowest 50 per cent of household income in the UK (Ellison et al. 2011, pp. 14). It seems the FCA considers low income households those living on annual income of £13,500-25,000 and very low income those having under £13,500 per annum (FCA 2014a, figure 10). Thus payday loans are mostly used by the better off section of low income consumers i.e. the richest of the poor. A smaller number of consumers is very poor or has an average income and above (OFT

2010, para. 4.11, figure 4.4; Personal Finance Research Centre 2013, para. 3.2.3, 3.2.4; Rowe et al. 2014, pp. 14).

Some payday loan consumers have high levels of debt. This is a result of past reckless behaviour, present over-borrowing and/or bad money management and financial prioritization (Rowe et al. 2014, para. 5.22, see also Ellison et al. 2011, pp. 10), low income and/or low levels of savings (OFT 2010, 4.5). Around a half of consumers whose only credit option are payday loans has been earlier refused by other creditors and has bad credit history (OFT 2010, pp. 4, 14). Many combine this product with other, particularly mainstream, products (OFT 2010, figure 4.17).[11]

Thus, the product design alone, but particularly together with other factors, is capable of causing significant detriment for consumers and leading to a debt trap. There are two ways to stop the debt trap happening. One is to place the responsibility on the consumer for the taken loan. This is achieved by disclosure regulation combined with financial education. However, as the value of both information disclosure and financial education is questionable (Willis 2008-2009) it should be the primary responsibility of the lender to provide, and the regulator to ensure, consumers are given suitable and affordable products. One way of achieving this is by mandating responsible lending, and the other, by product regulation.

Responsible Lending

In its broad sense, responsible lending includes general principles for credit-related activities: pre-contractual disclosure and adequate explanations, creditworthiness and affordability assessment and post-contract business practices including debt collection (see FCA 2014b, para. 4.13). Here, as already indicated, we are focused on responsible lending in its narrow sense, i.e. in terms of the lender only providing credit, based on background checks and professional judgment to consumers who can accommodate regular repayments without getting into financial difficulties.

Responsible lending obligations in the UK were introduced as a result of implementing the 2008/48/EC Consumer Credit Directive[12] (Ramsay 2012, pp. 382). The CCA requires a

[11] Competition Commission, Payday Lending Investigation, Competition between payday lenders and other credit providers. Retrieved from https://assets.digital.cabinet-office.gov.uk/media/5329df7b40f0b60a76000326/140131_competition_from_other_types_of_credit_working_paper.pdf

[12] Directive 2008/48/EC of the European Parliament and of the Council on credit agreements for consumers and repealing Council Directive 87/102/EEC, OJ L 133, 22.5.2008

creditworthiness assessment any time a new loan is issued and before the loan would be increased. The assessment should be done primarily based on information obtained from the consumer and where appropriate, by consulting a credit reference agency (s 55B CCA). More detailed rules were laid down in the OFT's soft-law document, the Irresponsible Lending Guidance (2011), including an obligation to assess affordability. Affordability does not solely mean being able to repay the loan at any cost, but only in a sustainable manner. Assessing affordability was seen by the OFT as a 'borrower-focussed test' that involves the creditor assessing the borrower's ability to undertake a specific credit commitment, or specific additional commitments in a sustainable manner, without the borrower incurring financial difficulty and/or experiencing other adverse consequences (see in Ramsay 2012, pp. 427).

Despite these rules being in place the OFT discovered that only 74 per cent of lenders conducted affordability assessments for all new customers; 67 per cent did for every new loan; and only 23 per cent for each roll-over (OFT 2013c, pp. 12). The OFT's mystery-shopping revealed that 6 per cent of lenders offered loans immediately, without asking any questions (OFT 2013c, pp. 13). Finally, even when information was solicited, it was usually the minimal e.g. one bank statement, that cast doubt on the extent to which lenders could assess affordability. Another research revealed, consumers felt assessments were easy to manipulate, especially in online applications, where consumers could 'test' loan levels and 'tweak' their income and outgoings, thereby increasing the amount they were eligible to borrow. Some consumers were even actively in encouraged to borrow more, particularly in applications placed over the phone. Other consumers were surprised there were minimal safeguards around taking out loans when they had been drinking or not of sound mind, especially when loans were applied though mobile apps (Rowe et al. 2014, para. 5.22). Thus payday loans were not only advertised as 'No credit checks' or 'Loan guaranteed' but were in practice given without any or very limited affordability assessment. This practice was probably induced by the above mentioned large percentage of the overall profit that lenders derived from extended loans and charges imposed on consumers. For many consumers payday loans were unaffordable at the moment of loan application and consumer detriment could have been easily avoided.

In the new regime, the FCA devotes considerable attention to the issue of responsible lending, and has significantly raised compliance standards for firms. The general rules on pre- and post-contractual creditworthiness assessment laid down in s55B CCA are now also confirmed in CONC. The FCA overtook OFT guidance into FCA and incorporated it into its Handbook with some modifications.

Thus, before making an agreement (CONC 5.2.1R) or before significantly increasing the amount of credit (CONC 6.2.1R) firms must estimate the particular consumers' creditworthiness and make sure borrowing is sustainable. As under the OFT regime, sustainability means affordability, that is, being able to repay the loan without getting into a financial difficulty (CONC 5.3.1G). Firms must not actively encourage consumers to borrow more if the assessment shows that borrowing would be unsustainable (CONC 5.3.5R).

The problem with responsible lending is that it relies on information. Yet, information available from consumers may be subjective, and consumers in financial difficulty are likely to hide their real financial situation (see also Rowe 2014, para. 5.2). The new rules mandate firms to carry out the assessment based on the information firms are aware at the time the agreement, it being incumbent on firms to make sure that they have sufficient information to make the assessment (CONC 5.2.2R). The FCA suggests that information could be derived from previous dealings, evidence of income and expenditure, credit score, credit reference agency report and information provided by the customer (CONC 5.2.3G). Thus in collecting information, firms should not only rely on information obtained from the consumer but use all information they have at the time of making the assessment. Moreover, firms must refuse to lend to a consumer where they know, ought to know or reasonably suspect, that the consumer was not truthful in disclosing relevant information (CONC 5.3.7R). An example where the firm ought to reasonably suspect the consumer was not telling the truth is when information supplied by the consumer is inconsistent with other available information (CONC 5.3.8G). Thus, the FCA encourages firms to pro-actively search for information using other sources, primarily credit registers and their own records.

The issue with credit registers is what kind of information they contain and whether the information therein is correct and up to date. Credit registers in the UK contain both information on current credit obligations and information on credit default. The problem with credit registers used by credit reference agencies has been that they were designed for traditional mainstream lending which occur on less frequent basis and allowed for information upload on monthly basis.[13] This was not sufficient for payday loans that often lasted for a shorter period of time. Although some registers like Experian maintained a separated database on payday loans, not all lenders uploaded their information.[14] Thus effectively, credit registers were not a reliable source of information, and were not sufficient to ensure responsible lending. In order to remedy

[13] Moore E. (2014, January 15). Payday lenders club together to create loans database. Financial Times, January 15, 2014. Retrieved from http://www.ft.com/cms/s/0/7f8e7bd8-7de0-11e3-b409-00144feabdc0.html
[14] http://www.experian.co.uk/assets/consumer-information/case-studies/Payday%20loan%20data%202.pdf

the situation, and possibly fearing the new regulator, the largest UK payday lenders come together to set up a database under the auspice of the existing credit registers. The special database is in operation from May 2014.[15] The FCA encourages this initiative (CONC 5.3.1 G), and wants to make sure, information in the registers is correct and up to date (CONC 9.2R). Thus in the future credit registers should be a reliable source of information.

Besides information obtained from the registers, firms must establish internal policies and procedures that allow for a reasonable assessment (CONC 5.3.2 R). This arguably means keeping own records. In order to the data stored to be reliable, the FCA suggests, firms should take adequate steps to ensure information on the credit application including that supplied by the consumer, is complete and correct (CONC 5.3.3G). For example, Wonga developed the system of ‘trust rating’. To first time customers Wonga will lend a maximum of £400. This maximum amount can gradually increase up to £1000 with the increase of the consumers’ trust that is gained timely repayments. Wonga has an internal automated system that considers thousands of objective data that includes previous Wonga loans and other information on the consumers overall financial health. Dependent on this the consumers trust rate can raise, freeze or reduce.[16]

Thus, firms should consider a number of data in their assessment. The FCA also believes the assessment should be proportionate given the circumstances of the particular case. Particularly given the amount, type and cost of credit, the consumers’ credit rating and existing financial commitments (including outstanding credit commitments, rent, council tax, and utility bills) and any special vulnerability like disability (CONC 5.2.3G).

Based on the above, it is expected lenders will lend more responsibly and provide loans only to those consumers that can afford it. Many of the earlier soft law rules now become binding, and the FCA also made sure firms understand how the rules should be applied. In the new regime, firms should have more sources of objective information. To this effect, it is crucial firms create their own databases, perhaps even a ‘trust rating’ system. More importantly, firms must share data between themselves. This seems to be the only way to prevent repeat borrowing, a common problem of the indentified sub-population. Given that a certain part of this sub-population is ‘loyal’ to payday loans and has no other forms of credit, it is plausible, these consumers were entirely absent from credit registers, where in fact, they had multiple outstanding debts and possibly a number of defaults. This should not happen in the future.

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[15] Moore E. (2014, January 15). Payday lenders club together to create loans database. Financial Times, January 15, 2014. Retrieved from http://www.ft.com/cms/s/0/7f8e7bd8-7de0-11e3-b409-00144feabdc0.html
[16] https://www.wonga.com/money/about-trust/

Product Regulation

It has been shown above that all 'payday loan consumers' are susceptible to detriment because the very feature of the inherently flawed nature of the product (Kenneth 2007-2008). These inherently flawed features (the high price and roll-over features) can only be corrected by product intervention.

There are numerous options to regulate the price. The interest or the APR can be capped. The method of interest rate calculation can be regulated by imposing restrictions on the variability of the interest rate or on the compounding of interest or by banning the imposition of interest on interest. The default interest or default charges can be capped. The instalments, the duration of credit, total amount of credit or net amount of credit can be restricted. Finally, the contractual interest rate can be controlled by open-textured tests (see Reifner et al. 2010, pp. 34)

Price regulation is connected to the concept of usury, and has a long history. In England, the history of price regulation is subject to the dynamics of regulation and deregulation, depending on what aims the regulations envisaged to achieve (see Goode 1982, Ramsay 2012, pp. 382). Before the new regime, the price was only subject to judicial scrutiny by reliance on the open-textured 'unfair relationship' test in s140A CCA (Ramsay 2012, pp. 440). Open-textured tests are flexible and thus suitable to determine the 'fair' price, but they require judicial enforcement with all the known disadvantages of a court action.

The 'unfair relationship' test was not a suitable instrument to prevent consumer detriment in the identified sub-population. Thus the FCA opted for a more direct intervention, and decided to restrict the feature of loans that were the most detrimental to consumers. First of all, it limited the number of rollovers to two (CONC 6.7.23R). This restriction is applicable from 1 July 2014 (FCA 2014b, pp. 13). The FCA considered two rollovers optimal because it delivers a certain degree of flexibility for consumers, that may need to delay repayment due to unforeseen circumstances like late pay, but prevents the creation of a debt cycle and being caught in a debt trap (FCA 2014b, para. 5.13-5.20). The FCA rightly held that if consumers are unable to repay the loan after two rollovers due to unforeseen or changed circumstances than rollovers are no solution but the best way to address the problem is forbearance and the agreement on affordable repayment plan (FCA 2014b, para. 5.20).

Limiting the number of roll-overs is one price regulatory technique suitable to prevent consumer detriment in payday lending. Although product intervention may be opposed in free market economies, given the above description of the debt trap and the role of rollovers in their emergence, this intervention was justified. Before the limit, loans could theoretically last forever, and make the loan extremely expensive and subject consumers to expenses that they did not reasonably anticipate. Thus the new regime will make payday loans safer to use.

On the negative side, limiting rollovers may decrease the number of loans granted and raise the cost of borrowing. Lenders will pass on to consumers some compliance costs by imposing additional fess and charges on consumers (Europe Economics 2013, pp. 100). Nevertheless, this may be prevented by the other product regulatory power of the FCA, price regulation.

Although the FCA did not originally intend to cap the price of payday loans, this obligation has been established by the Financial Services (Banking Reform) Act 2013. Section 131 mandates the FCA to cap high cost short term credit. The new rules will apply for agreements entered into on or after 2 January 2015.

Price caps have many advantages. As Ramsay (2010) summarizes, price caps respond to behavioural mistakes of consumers that underestimate the risk of high-cost credits; reduce the cost of proving usury; address failures of competition that leads to high prices on the market; prevent externalities from high-cost credit, such as state support of over-indebted individuals; and aim to ensure a 'fair' price (Ramsay 2010).

Price caps seem particularly justified by competition considerations. Namely, the OFT considered the payday lending sector concentrated. The 3 largest firms represented about 55 per cent of the market by turnover and 57 per cent of the value of loans. The top 21 firms accounted for 85 per cent of the payday market by turnover (OFT 2013c, pp. 5). This concentration is likely to be higher now that the largest market players remained but many others exited the market. Besides market concentration, the OFT also found low ability of consumers to drive competition due lack of financial literacy and lenders focusing on other factors than price like speed and convenience in financial promotions that determine the driving factors of competition (OFT 2013c, pp.3). Thus competition does not have the desired effect on price formation. The economic theory, according to which in a well working market competition between suppliers should drive down prices, is not applicable for the UK payday lending sector. This weak (price) competition arguably justifies price intervention (Personal Finance Research Centre 2013, pp. 27).

Overall, the new regulatory intervention of price caps is welcomed. It will address on feature of payday loans, the extremely high price that is capable to cause consumer detriment. It is expected, price caps will make products cheaper to use (Personal Finance Research Centre

2013, pp. 92). The most significant questions in determining the price cap is what will be its benchmark (the interest or the APR) and what will be its numerical limit.

At the time of finalizing the paper, no details are known how the cap will be designed, but policy direction seems to suggest it will involve capping the APR. George Osborne, the chancellor has said that he is inclined towards capping ‘the overall cost of credit’, not just interest rates.[17] Stella Creasy, a Labour MP who has been campaigning against payday lenders said it is vital the cap is set ‘holistically’ set to catch ‘every single charge’.[18] This seems to be the right direction. The paper below argues it is crucial the FCA takes the APR as benchmark for the future price cap in order to ensure a ‘fair’ price.

The Consequences of the New Regime and the Way Forward

The new regime is expected to have an overall positive impact on the ‘payday loans consumers’ sub-population. Responsible lending is likely to ensure only those consumers will be given loans that can afford them, and prevent unsustainable borrowing. Limiting rollovers to two will make credit safer to use, as the duration of the loan and the accrued payment obligations will stop after two extensions. Price caps are likely to reduce the cost of borrowing and make payday loans cheaper to use. Thus payday loans will be more affordable and safer products.

Nevertheless, there are certain conditions required in order to maximize the effectiveness of the regime. First, in designing the price cap, APR and not the interest should be taken as a benchmark. Next, it the new regime is likely to deny access to credit for certain members of the indentified sub-population, and that this should be addressed by adequate social lending measures. Finally, the overall key to success of the new responsible lending and product regulation measures is effective enforcement.

The first caveat is that in designing the price cap, the APR should be considered the price of the loan and not the interest. This is primarily because the APR represents the borrowers’ true cost for the taken loan, capping the interest will lead to circumvention by adding fees and charges, and the APR is more transparent and thus comparable than the interest.

This paper asserts, the APR is the ‘true’ price the consumer pays for the taken loan and not the interest (see Reifner et al. 2010, pp. 94). Interest is the charge for the money borrowed.[19]

[17] Sharman, A. Parker G. (2013, November 25). George Osborne moves to impose cap on cost of payday loans. Financial Times. Retrieved from http://www.ft.com/cms/s/0/3c3bab76-55a4-11e3-96f5-00144feabdc0.html#axzz369UA1w1t

[18] Goff. S. (2014, May 20). Tougher UK rules drive payday lenders away. *Financial Times.* Retrieved from http://www.ft.com/intl/cms/s/0/141899d6-dcf6-11e3-ba13-00144feabdc0.html#axzz34QZh3InG

[19] Interest, Collins Dictionary of Business, Collins, Glasgow (2002) pp. 224.

From a contractual perspective, interest is the price that the borrower pays for the borrowed money. It is the profit of the lender adjusted to inflation. The rate of interest includes a portion of the capital borrowed, added with the lender's profit and adjusted to the inflation.[20] Thus interest is the price of the credit as it is directly linked to the amount borrowed. Other charges like administration fee are 'ancillary' and only indirectly linked to the loan. On the contrary, APR is the rate of the total charge for credit, expressed as an annual percentage of the total amount of credit provided to the borrower (FCA Handbook, Glossary). The total charge for credit represents the borrowers' true cost of the credit (FCA Handbook, Glossary). The APR includes the interest and other fees and charges that the consumer incurs in performing the contract. It only excludes charges payable upon the consumers' non-compliance e.g. default charges (CONC App 1.2.3). Thus the notion of APR is much broader than the interest. It takes the entirety of the credit transaction, not only the contractual counter-obligation of the consumer for the taken amount of loan. It expresses the true cost the borrower pays for the loan, its true price.

Taking the APR as the benchmark will avoid regulatory arbitrage. If only the interest is capped, firms are likely to impose fees and charges and fees to gain profits, a trend that is particularly expected in the light of limiting rollovers. Ramsay 2012's illustration is useful in this respect. The USA credit card companies made enormous profits because competition focused on a wrong pricing element. As consumers tended to overestimate their future borrowing on the credit card they failed to concentrate on the high interest rate and instead focused on immediate costs of the annual fee. Thus the annual fee was subject to competition. The competitive pressure to reduce the annul fee resulted in maintaining high interest rates, increasing late payment charges and fees (Ramsay 2012, pp. 64). Because consumers tend to focus on the core of their obligation, the total amount they would have to repay, and are less attentive to the APR (Rowe et al. 2014, pp.4, Personal Finance Research Centre 2013, pp. 32), the right benchmark for imposing a price cap should be the APR to combat behavioural biases.

Finally, transparency considerations are strong arguments in favour of taking the APR as the price. Transparency is crucial in comparing offers on the market. However, the complexity of the (contractual) interest raises the question if interest can even be transparent. The interest will depend on a type of interest, i.e. on the variability of interest rate (fixed and variable interest) and on its method of calculation and capitalization (simple and compound interest). Any particular interest is also dependent on: the lender's cost of obtaining funds; the

[20] *Cf* interest and interest rate, Collins Dictionary of Business (2002) pp. 224-225.

cost of administering the loan; the risk of inflation; and the risk of default (Bender 1994). On the other hand, the elements included into the APR and its method of calculation is harmonized on European level though the Consumer Credit Directive and uniformly implemented by Members States (see CONC App 1.2). Although at first sight interest seems easier to understand and the APR confusing, taking into account the above considerations, the ability to understand interest for an average person is an illusion.

Thus, in designing the price cap, the FCA should consider the APR and not the interest the price. This approach will ensure the payday credit customers' upfront cost is limited, focus market competition on the price, and enable the comparability of payday loans on the market.

One of the consequences of the new regime is that some members of the indentified sub-population will stay without access to credit. It is estimated this will be the situation of 18-30 per cent of current payday customers (Europe Economics 2013, pp. 100). However, access to credit is of a paramount importance. Academics argue credit is a 'service of general economic interest,' like water and electricity supply, a service that is indispensible to fully participate in the contemporary society and its economic life (Ramsay 2010a, pp.383-384). The World Bank considers access to credit as a method of reducing income inequality and poverty (World Bank 2008, pp. 138). The problem could be addressed by structural reforms that would increase the number of suppliers of payday loans. It has been argued these reforms could be achieved by encouraging banks (Kenneth 2007-2008) and/or social lending entities (Pierce 2008) to provide payday loan alternatives. Given the importance of social lending in preventing financial inclusion (Wilson 2012), this paper sees a great potential of embracing those without access to other types of credit by credit unions.

Credit unions are not-for-profit financial institutions based on co-operative values (House of Commons 2013, pp.2), regulated by the Credit Unions Act 1979. As the co-operative means, membership is essential for getting access to services offered by credit unions. This is offered based on a 'common bond' that is of non-financial character e.g. geographic location, occupation (House of Common 2013, pp.3). In recent years, credit unions expanded in role and size in the UK. The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 loosened the strictness of the 'common bond' requirement (Ramsay 2012, pp. 499) thus making these institutions more accessible. Lately, credit unions started to offer payday loan alternatives, i.e. short term cash loans approved within 1-2 days, for a much cheaper price. For example, at My Community Bank, a new credit union, borrowing £255 for 30 days would cost £5.62, while at Wonga it would be £83.65.[21] However, credit unions are not as widespread as it would be desirable (see House of Commons 2013. pp. 6) not all consumers have access to these institutions and not all offer payday loans alternatives.[22] Hence, policy direction should go towards developing this alternative for the most marginal consumers.

Finally, because the success of regulation depends on its effective enforcement (Lastra 2006 p. 89; also Fejős 2013) it is important the new rules are properly enforced. Earlier, the under the OFT's regime the rules were in place but their effective enforcement was frequently absent. For example, the OFT's Irresponsible Lending Guidance set out the unacceptable behaviour of a licence holder. As shown, the OFT was aware of at least some irresponsible lending practices, and although it could call into question fitness to hold licence and withdraw it accordingly, it failed to do so (see OFT 2013c, pp. 24, HM Treasury and BIS 2013, table 1.A; also Rowe et al. 2014, pp. 56). As the rules discussed in this paper set considerably high standards for protecting the payday lending consumers' sub-population, it is imperative the rules are applied in practice. To this effect, the FCA should use its wide supervisory powers and rely on its pro-active and forward looking approach in supervision. It is should carefully monitor payday credit firms, and probably consider the largest entities high risk firms. For any breach impose robust fines and if appropriate, make sure, consumers are compensated. Only this enforcement practice will induce compliance and protect consumers. As Which?, the largest consumer protection organization advocated, consumers need a 'Watchdog and not Lapdog'.[23] It is now up to the FCA to fulfil this expectation in protecting the 'payday loans consumers' sub-population.

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[22] For example the Oxford Credit Union does not offer a financial product that could be a payday loan alternative. See http://www.oxfordcreditunion.co.uk/cp2.php

[23] http://johnleechmp.wordpress.com/2012/06/13/watchdog-not-lapdog-campaign/

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