



## **Doorstep Robbery:**

why the UK needs a fair lending law

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# Executive summary

The UK has a major debt problem – one unnoticed by mainstream media and society. It affects the very poorest in our society. At least three million UK households pay hundreds of thousands of pounds to legal loan sharks who charge them over the odds for something that most of us can easily access from banks: credit.

Because income and benefits levels in the UK are too low to allow people to save, make ends meet, cope with an unforeseen emergency, or just afford rising living costs, people at the bottom of the income ladder are driven to use high cost credit.

Nine million people in the UK don't have access to credit from banks, so have no choice but to use rip-off lenders: The cost of a loan of £100 with a company such as Provident Financial can be £49.50 – nearly 50 per cent of the amount borrowed, or an APR of 545.2 per cent. A loan from a payday lender costs even more; to borrow £100, lenders charge £25 for one month – an annual percentage rate of nearly 1300 per cent. These lenders charge whatever they want – the sky is the limit.

The Office of Fair Trading estimates that high cost lending in the UK is worth £35bn a year. A huge amount squeezed from the budgets of the poorest in society. Unlike many European countries, the UK guarantees its citizens no legal access to affordable credit, or caps the cost of it; lenders can refuse to lend to anyone for any reason, and they can charge any price – be it 500 per cent or 5000 per cent. In other words, there is no fair lending ethos in this country.

Legislation that would stop these practices has been rejected by Government based on flawed evidence.

The Government argues that poor people in Germany and France – where the price of credit is capped – are worse off than poor people in the UK. But the 'evidence' for this claim is flawed and ignores the following key facts:

- Poor people in Germany and France have much greater access to mainstream credit than in the UK. Here, an estimated nine million people cannot access credit from banks. In Germany and France, this figure is far lower, both in numbers and in relation to their populations (2.5m and 3.5m respectively).
- There are far fewer adults without a bank account in Germany and France – approximately 500,000 (in Germany) and one million (in France), compared to 1.75m in the UK. Not having a bank account means paying much more for bill payments and other services, further increasing the need for credit. It is the UK in which the poor are excluded.

## Our solution

We call for an independent and wide-ranging review of the UK consumer credit market. We recommend to Government the following:

The introduction of a *community reinvestment act* that promotes transparency in the financial system, that applies to all lenders. Banks that do not invest

sufficiently in local communities should be forced to sponsor a local affordable lender. High-cost lenders (e.g., doorstep lenders) should be compelled to alert people to alternative, cheaper lenders operating in their area and co-operate with them.

The introduction of a *cap on the total cost of credit*. The exact level needs to be investigated as there is a need to establish the real risk of default and the cap to be set accordingly. In addition, there needs to be a discussion of where the cut-off point should be: if people have more than a 50 per cent risk of defaulting on their loans, is it wise for them to take out loans in the first place?

Abolishment of *credit dependency*. Independent research should establish the shortfalls in income and boost levels where necessary to maintain an accepted standard of living. Also, it should seek to promote savings programmes and support credit unions and CDFIs across the country to help them break the market dominance of payday and doorstep lenders.

The *evidence of the impact of interest rate caps* on poor households needs to be revisited. Current research seriously overstates the risk of credit exclusion and is confusing cause and effect. This does not allow for a balanced assessment of effects of price caps on poor households.

# Introduction

Late in 2008, there was an outcry over plans by the UK Government to introduce an interest charge on emergency loans available to people on benefits. The proposal would have meant that recipients would pay an annual interest rate of 27 per cent on the loans they take out to replace essential goods, such as a refrigerator.

The Government was accused of acting like a 'loan shark' by exploiting the plight of the poor. The Government quickly backed down and decided not to charge what *The Mail on Sunday* called 'punishingly high interest rates on vital loans to the poor.'<sup>1</sup>

The outcry was, of course, justified. It seems like a no-brainer that people already on low incomes and in need of financial support should not be charged an interest rate that many of us would find obscenely high.

This logic, however, does not apply to the commercial sub-prime credit industry. Companies operating in this sector provide small consumer loans to people on low incomes who cannot or do not want to use banks. Their prices exceed by far the 27 per cent APR suggested by the Government – annual percentage rates start at around 180 per cent, but are more often than not 600 per cent. In the case of payday lending, interest rates of several 1000 per cent are common. The public outcry over these charges is notably absent.

This is despite the fact that at least three million people<sup>2</sup> use sub-prime lenders, often to pay bills or for emergency expenditure. Payday lenders, home credit institutions and pawnshops make a tidy profit from the need of poor people to take out credit when their money doesn't stretch far enough. Companies operating in the sector claim to provide an essential social service by making small amounts of credit available to people in emergencies, thereby avoiding destitution or an increase in the number of illegal loan sharks.

**Unlike in many other countries in the world, there are no price controls on the cost of credit in the UK. Under the pretext of free market rhetoric and purported negative outcomes for people on low incomes should credit be restricted, there is no legislation in the UK that limits the price of credit.**

This means that lenders can set the level of interest rate as high as they want. The only constraint is the price that potential borrowers are willing to pay; otherwise the sky is the limit. The outcome is that many sub-prime clients are trapped in a continuous cycle of indebtedness as they pay disproportionate sums to borrow small amounts of money, with the interest payments often exceeding the original credit.

The underlying argument for this free market approach is that access to any form of credit at any time by everyone is a good thing and that restricting access to credit is detrimental to the poor. This belief is firmly entrenched in the minds of politicians, the industry, and many third sector organisations. This thinking is underpinned by structural changes that resulted in the increase of unsecured consumer credit as wages and incomes have not kept step with inflation rates; savings rates have dropped, and the use of credit to fund everyday expenses has increased. Credit use has become the norm rather than the exception. Instead of closing the gap

between income and basic expenditure, the Government has favoured a market-led solution to the problem, which in essence means that credit dependency has risen, and those who can least afford it pay the highest price. The sub-prime industry argues that it provides an essential service to people on low incomes to finance once-off expenditures. However, most of their clients are now continuously in debt, which is partially caused by the business models of sub-prime credit, and partially because of the decline in real incomes that creates a continuous need for credit to make ends meet.

The consequences are obvious, continuous debt means continuous repayment of capital and interest. Interest payments reduce disposable incomes, potentially increasing the need for credit and limiting the ability to save. People are quickly locked into a debt trap that can potentially lead to personal bankruptcy. High levels of debt create anxiety and health problems.<sup>3</sup>

Despite these clear problems, existing research on interest rate caps and credit exclusion does not question credit dependency. Based on a rather thin evidence base, it is argued that restricting access to credit to low-income households will increase credit exclusion and over-indebtedness, and drive people to illegal loan sharks. This view has taken hold in Government and to some extent in the third sector as well. The pervasiveness of this view is dangerous, as it cements the market dominance of high-cost lenders, and endemic poverty.

We therefore seek to revisit the evidence used to demonstrate the negative effects of interest rate caps. Are caps really bad for the poor? Is credit the only way out for people on low incomes? What other solutions are there?

First, we address pricing structures and risk models to explain the emergence of sub-prime lending and why different people pay different interest rates.

Next, we examine existing evidence on interest rate caps and analyse the implications of these findings

Finally, we propose potential alternatives to the current high-cost credit model.

# Of risk and knowledge: a short overview of consumer credit

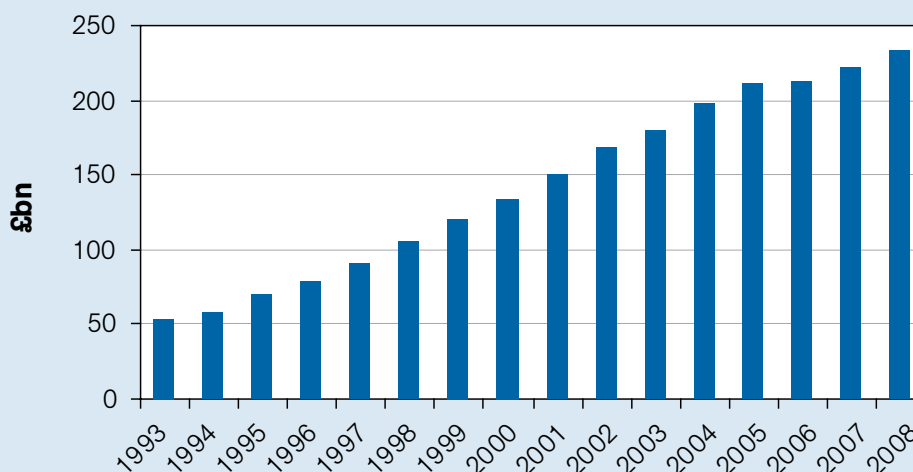
The use of consumer credit has exploded in the last 15 years. This increase in unsecured lending was accompanied by a shift in attitudes. Whilst in the past, credit was taken out to fund larger expenses or a certain project (e.g., a car, a home, or a new kitchen), it is now seen as part of everyday life.

Credit is frequently used to increase disposable income, and pay for goods such as clothes, food and utilities. New product forms, such as revolving credit – where debt on cards, overdrafts and similar is not paid off within a designated period, but rolled over through automatic renewal of available limits, and renewed draw-down of funds – have contributed to the growth of the credit card and sub-prime lending.

With the expansion of consumer credit, the lending industry has also developed new markets. It has created products that target people on low and very low incomes, the so-called 'sub-prime market'. This term is more familiar in relation to the mortgage sub-prime market, i.e., the mortgages provided by banks such as Northern Rock to people who were rejected by mainstream lenders. But the sub-prime market also includes consumer credit, such as credit cards with an APR of around 40 per cent, and much more expensive forms of credit such as payday lending, pawn-broking and home credit (see p.8 for an explanation of what these lenders are). Most mainstream clients would recoil from the type of interest rates charged in the sub-prime market. Interest rates of 40 per cent APR for a credit card seemed (at least until very recently) usurious and completely unjustifiable. Yet, in the sub-prime market, this is one of the cheaper options. Interest rates of over 250 per cent are the norm, and payday lending also frequently charges multiples of 1000 per cent.

But how is it that prices in the sub-prime market are 100 times those charged in the mainstream market? The answer is not simple, but in essence, it is about risk for the

**Figure 1: The use of consumer credit in the UK in the last 15 years.**  
**Total unsecured lending in the UK 1993–2008 (Bank of England)**





lender. The question that any lender will ask before providing credit is: how likely is it that the borrower will be able to repay the credit in full and on time? Depending on the answer the lender will decide whether or not to provide credit to the applicant. A second consideration is the cost of credit: lenders' prices will also be influenced by how much clients are willing to pay.

### **Risk and credit scoring**

The relationship between a potential borrower and a potential lender is marked by strong 'information asymmetries'. This means that potential borrowers know far more about their financial situation and their ability and willingness to repay the loan in full and on time than the lender. Lenders can only rely on the information given by the applicant, such as payslips, proof of permanent employment, and proof of assets, for example a house or savings – i.e., collateral. The ultimate risk of a client defaulting or paying back late can never be fully excluded and thus needs to be estimated. The cost of credit, usually expressed as interest rate payable on the outstanding loan amount (the principal), thus always includes a certain component that reflects the probability of the lender losing part or all of the money lent.

In the last couple of decades, lenders have tried to change this information imbalance by building databases containing information about borrowers beyond their repayment punctuality. This method is called 'credit scoring'.

Lenders or credit rating agencies, such as Experian, collect demographic information to build risk profiles of their clients, calculating the likelihood of default based on statistical formulae. These profiles are made up of payment records (e.g., the regularity of repayments made on previous loans, use of credit cards, etc.), but also of socio-demographic data, such as age, gender, occupation, post code, marital status, number of dependants, home ownership, and stability of life situation (e.g., frequency of job changes, house moves, etc.). The more detailed the credit history, the more a lender can find out about the borrower. Depending on the score, lenders decide if they will provide a loan, and at what price. Living in an affluent area (identified by the post code), with a stable well-paying job and an impeccable repayment record on previous loans, for example, results in a good credit score, indicating a high probability of repayment and hence a low risk. This low level of risk is typically reflected in a person's ability to easily access credit and at a low price.

On the other hand, if the credit history shows a bad repayment record (i.e., missed payments on previous loans, or repossession of goods bought on credit), and if the applicant lives in a poor area, and frequently changes jobs, this will lead to a poor credit score. Depending on the lender's policy, and on the severity of the repayment problems, credit may be denied completely, or a higher interest rate charged to cover the increased risk of default. The higher the risk, the higher the interest rate, and usually the lower the amount of credit an applicant can borrow.

At first sight, this appears to be a good system to streamline the credit application process and even out the information imbalance. However, these profiles are not a perfect predictor of risk, and they can be too schematic and omit alternative information, such as regularity of bill payments or savings.<sup>4</sup> By and large, applications for consumer credit are solely based on credit scoring. While this makes the process quick and efficient for most, those rejected because of some perceived or real flaw in their credit history will find themselves unable to access the cheap mainstream option, as appeals against rejection decisions are rarely granted.

An additional systemic problem with credit scoring is that a lack of credit history is interpreted as having a bad credit rating. This leads to the situation where someone who is prudent with money, manages on an existing budget and has had no previous need for credit can be denied a loan or credit card application (the latter is now often essential for paying for goods on the internet, for example). This is a catch 22 situation – without using credit, people cannot build a credit history and hence will be seen as high-risk clients, either refused credit or charged higher rates. This affects mostly poor households, as they tend to budget in cash rather than through bank accounts.<sup>5</sup>

In short, credit scoring relies too much on existing information and puts too strong an emphasis on statistical probability, marginalising people on low incomes.

The next question is: why do banks not simply increase the price for the high-risk groups to reflect the risk that they seemingly present to their lending operations? Why 'outsource' this group to the sub-prime market? After all, there is no price cap on the level of interest in the UK; hence they could charge what ever they deem fit to cover the high risk, making up for some of the lost capital should a borrower default before completely repaying the loan. Also, the return on a risky loan, if repaid completely, would be high, thus compensating for the risk of default. Following this logic, there appears to be no reason for the apparently systematic credit exclusion of people on low incomes.<sup>6</sup>

The reasons for banks' behaviour lies in cost/profit considerations and reputational risk.

First, the loans poor people require are frequently small, a few hundred pounds at the most. Banks make more profit from larger loans than from smaller ones. There is a fixed cost of processing a credit application that is independent of the loan size (the unit cost). Hence, the proportion of money that can be earned from small, short-term loan is lower than from a large loan that is paid off over several years. Banks thus have little incentive to provide small consumer loans when there is more money to be earned from higher value loans. The combination of this disincentive combined with the (perceived or real) higher risk means that banks often do not bother with loan applications for small amounts. If one of the credit-scoring markers indicates that the risk is high (e.g., the post code or occupation) and the amount applied for is low, then the bank might well reject an application because the profit margin would be insufficient.

Secondly, most mainstream banks (such as Barclays, HSBC, or First Direct) would recoil from charging high interest rates, as they fear repercussions from both customers and shareholders alike:

- Customers may find their practices distasteful as the interest rates appear extortionate.
- Shareholders may fear that customers will desert the bank because of their distaste, and may believe that despite the higher prices, lending to poor households is still too risky.<sup>7</sup>

The combination of the lower profit margins and the reputational risk of charging interest rates that would compensate for these lower profits thus create exclusion from mainstream credit.

Enter the sub-prime industry. Sub-prime lenders provide products that meet the needs of people on low incomes. Flexibility and affordability of instalments are the main criteria here. First, low-income households frequently budget in cash, as it suits their payment cycle better (benefits and low wages are often paid out weekly or fortnightly rather than monthly). Also, poor households have little leeway in their budget to pay for unforeseen expenses. Predictable, fixed-value instalments to repay credit are thus important, as is the flexibility to occasionally pay late or miss one repayment. Banks typically charge fees for late or only partial repayment of instalments, thereby increasing the cost of credit drastically and, above all, burdening already-stretched households with a further expense that usually needs to be paid immediately. There is hence little flexibility in repayment schedules. Sub-prime lenders provide the necessary requirements of predictability and flexibility that banks cannot or do not want to provide.

### **What are sub-prime lenders?**

Sub-prime lenders include a wide array of institutions that provide credit to those customers that mainstream lenders (such as the high street banks) would reject. Their lending criteria are more relaxed than those of mainstream lenders, but their prices mostly exceed those of the standard lenders.

As a rough guideline, sub-prime lenders and products can be separated into two groups. In the first group, we have those who cater to people with a bank account and jobs, offering interest rates of around 50 per cent APR, and give people the opportunity to build a credit history or improve an existing credit rating. Examples of

this include the now infamous Northern Rock mortgage lender. The second group of sub-prime lenders concentrates on those people without access to mainstream credit. Roughly speaking, these include people with basic bank accounts (these do not offer any credit facilities), the unbanked, and people with a strongly impaired credit history that do not qualify as 'average' clients. Our report concentrates on this group of people. For the remainder of this report, we will use the term 'sub-prime' to indicate both clients and companies in this market segment.<sup>8</sup>

As pointed out in the introduction, sub-prime lenders charge APRs of usually more than 180 per cent, with the highest to be found in the payday lending industry, with APRs of up to 1700 per cent.<sup>9</sup> This pricing structure can be partially explained by the high risk of default, but there are other reasons why lending to people on very low incomes costs more than to more 'mainstream' clients. More affluent people can reduce consumption, or sell smaller assets to ensure continuing repayment. The poor often have few ways of managing debt when presented with an income shortage. This adds another layer of risk to the lender, hence increasing the price charged to compensate for the potential default or late payment.

In addition, sub-prime lenders, particularly those operating in cash (home credit providers and the payday lending industry) use the flexibility they provide as an argument for very high interest rates as part of their service. Their business models fall into two categories: home credit and payday loans.

### Home credit

Home credit companies have a network of local agents that visit people in their homes to offer credit and collect weekly instalments. Credit amounts are typically around £200, but can be as low as £50 and as high as £500. Typical annual interest rates are upwards of 150 per cent for loans repaid over 30 or 50 weeks. Clients are often unemployed and many do not have a bank account, precluding collection by direct debit. According to the Competition Commission, 2.3 million people use this form of credit.<sup>10</sup> Home credit provides the flexibility in repayment that low-income households need. Instalments can be missed without incurring an extra fee or other form of penalty (i.e. restriction of credit availability). Home-credit providers use this flexibility to justify their high prices – the risk of late payment is built into the price. Whilst this flexibility is greatly appreciated by clients, it imposes a high cost on them – there are no rebates or changes in credit conditions when the client always repays on time. To a certain extent, 'good' clients subsidise those who pay late or miss payments.

### Payday loans

Users of this type of credit must be employed and have a bank account into which their wages are paid. There are no credit checks and little to no investigation into the ability of a client to service the loan. The lender accepts a post-dated cheque made out for the next payday, and pays out the sum on the cheque minus a fee for the service. The incoming salary serves as security that the lender will receive the money back. On the day that the client receives his or her salary, the payday lender then cashes the cheque. For a cheque of £100, payday lenders will typically keep between £15 and £20. APRs on these arrangements typically exceed 1000 per cent.<sup>11</sup> For this type of lending, it can be argued that the risk to the lender is actually very low. The lender holds the cheque as a security against the next incoming wage, and hence the risk is only that of an employee being made redundant before the next payday, or the company going into administration. Whilst it is a risk, this is something that all lenders have to deal with, so the excessive charge cannot be justified.

The real problems with payday lending start with the practice of rolling the loan over: if clients do not have sufficient funds in their account, they can pay a further fee to defer the cashing of the cheque. If this is done over several months, the fees can quickly surpass the actual amount owed (the principal). Most crucially, the original loan is not repaid through this rolling over. An example can illustrate this cost structure:

A customer gives the payday lender a cheque of £100, and receives £80. The fee of £20 goes directly to the lender. The client cannot cover the amount at the next

payday, and rolls the credit over against another fee of £15. If this is done over six months, the client has paid £95 in fees to obtain £80 as a cash advance and has yet to repay the original £80. Whilst some payday lenders restrict the number of times a loan can be rolled over, and require a partial repayment of the principal, there is no regulation that standardises this behaviour. According to *Debt on our Doorstep* (DOOD), a leading organisation in the campaign for responsible lending practices in the UK, there is no comprehensive overview of the payday lending market, and hence little information on the size of the problem. However, according to the research by DOOD, the number of payday outlets has grown substantially since 2007.<sup>12</sup>

Sub-prime credit providers often claim that they provide a socially beneficial service, as they offer short-term credit in times of emergency to a population group that cannot access finance from elsewhere. However, it appears that many sub-prime clients are perpetually in debt and never pay off the principal as they require the credit to make ends meet. This prompts the question – what is credit for?

### **The uses of credit**

To shed some light on this question, it is important to revisit the original purpose of credit, namely the extension of cash for an investment that will prove profitable in the long run, i.e., where returns exceed the cost of repaying the loan with interest. Lenders and borrowers expect a return on investment. In recent years, however, credit has not necessarily been tied to financing a specific 'investment' but used to finance consumption. In the case of much of sub-prime lending, credit has been extended to cover basic living expenses. For the purpose of this paper, we distinguish four types of situations where credit may be required:

#### **1 Emergencies**

Households who manage reasonably well on their budget, but cannot make substantial savings, are suddenly hit by an unexpected expenditure that cannot be deferred. This can be the cost of a funeral, a broken refrigerator, or car repairs. All emergency expenditure has a one-off character, i.e., credit for it has a limited time period and is paid off in full.

#### **2 Investment**

This category reflects expenditure made to improve a living situation. This can include, for example, the purchase of a car that enables someone to obtain a job, or fees for a training or university course. It can also include replacing a mattress to improve sleep, or redecorating a room. Again, these are frequently one-off expenditures and credit taken out to pay for these is clearly delineated in volume and length.

#### **3 Consumption**

Credit usage to pay for holidays or clothes has increased drastically. Many affluent households see their credit cards as a means to increase their disposable income. Similar to the fourth credit type, the principal is rarely paid off and debts can build up quickly.

#### **4 Daily expenditure**

Households on very low income often cannot make ends meet. There is little to no scope for making further savings in expenditure, and hence credit needs to be taken out to pay for food, clothes, utility bills, and other expenditures in everyday life. This need to take out high-cost credit puts an unnecessary pressure on low household budgets, and it also means that households are perpetually in debt. The situation is exacerbated when households need to borrow additional sums to service existing debt.

With the increase in consumer credit, products that provided finance for daily expenditure have increased dramatically. Increases in the cost of living were not matched by increases in wages and benefits, thus creating credit dependency among poorer households. This credit dependency can quickly lead to high levels of debt, and eventual over-indebtedness. Revolving credit and roll-over credit have greatly contributed to this development.

- **Revolving credit** describes the practice most associated with credit cards. Customers are given a monthly limit that they can use on their credit card. This limit is renewed monthly, giving the customer fresh access to credit. If this limit

## Box 1: Total cost of credit vs annual percentage rates (APRs)

There is justified criticism of the use of APR as a price measure of credit. We agree with these criticisms and explain in this box the shortcomings of APR and why using the total cost of credit to provide price comparisons would be better.

Discussions around interest rate caps often focus on the APR that is charged on the borrowed amount. Unfortunately, with the focus on APRs, the true cost of credit is obscured.

In the home credit industry, all fees associated with the loan are part of the cost of credit and included in the APR. At first sight, the APR would thus seem to adequately reflect the price of credit. However, APRs only reflect the *annual* cost, not the total cost over the length of the loan. In addition, the APR does change quite dramatically with the length of the loan: the longer it takes to repay the loan, the lower the APR becomes. At the same time, the total cost of credit rises with the length of the repayment period. The reason lies in the way repayment is adjusted for a shorter/longer repayment period: the shorter the repayment period, the higher the weekly instalment, and vice versa.

In other words: the longer it takes to repay a loan, the higher the total cost of credit, and the lower the APR – an example using the loan calculator on the website of Provident Financial, one of the largest home credit lenders, illustrates this.

For a loan of £200 over 31 weeks, the weekly instalment is £10, and the total amount payable £310. This is an APR of 365.1 per cent. The total cost of credit is £110 (£310–£200).

To repay the same £200 over 52 weeks results in a weekly instalment of £7, and an APR of 272.2 per cent. The total amount repayable is then £364, and the cost of credit is £164 (£364–£200). So, in spite of the lower APR, the second option is actually more expensive.<sup>13</sup>

The total cost of credit (TCC), in contrast, expresses the price of credit as a percentage of the amount borrowed. This gives a good indication of the proportions between amount borrowed and the price paid for it. Using the examples above, the first loan would result in a TCC percentage of 55 per cent ( $110/200 \times 100$ ). In the second example, it is 82 per cent ( $164/200 \times 100$ ). There is no confusion about which of the two is lower, and thus represents the better deal. It also underlines the high prices paid in both instances – the cost of credit is over half of the amount borrowed.

is for example £1,000, this means that the client has access to £12,000 of unsecured credit a year. Of course, clients need to make regular repayments that are agreed with the credit card company. There are usually mandatory minimum repayments to pay off the outstanding debt, on which interest is charged. If the client uses credit constantly, and makes only minimum repayments, the outstanding balance and the interest due can quickly rise to represent a substantial sum of annual income, resulting in over-indebtedness. As this product is not typically offered by doorstep and payday lenders, we will not concentrate on this type of credit.

- **Roll over** credit is the practice of deferring payment of an outstanding loan by continuing to pay interest, but leaving the capital unpaid. This is common in payday lending, and also reported in the home credit industry.
- **Renegotiated loans** are those loans where lender and borrower have agreed to change the terms of repayment. Repayment instalments are decreased to better suit the borrower's budget, which increases the length of the loan. Whilst it provides relief on the budget, it increases the total cost of credit (Box 1).
- **Credit reshuffling** is used when existing credit lines are fully exhausted. Borrowers obtain a new credit card with a higher limit or take out a new loan. The new credit is then used to pay off existing debt and the higher limit is used to continue to increase spending power. This tactic is often used by people struggling with repayment to appease lenders and maintain a clean credit history. In some cases, this type of credit consolidation can help to better deal with debt, but can also increase the risk of over-indebtedness, especially when the terms of the consolidation loan are worse than those of the existing loans. As people scramble for new lenders, these terms are not always fully read and understood. In the home credit industry, borrowers often take out a new and larger loan from the same lender to pay off the outstanding debt, with the terms of the new loan then leading to higher costs of credit, similar to credit renegotiation.

# The effects of interest rate caps – a comparison

Despite the evident burden on poor households from having to take out high-cost credit, the Government is opposed to the introduction of an interest rate cap. It argues that interest rate caps would reduce the availability of sub-prime credit, causing destitution and driving people into the arms of illegal loan sharks.

This is based on a set of arguments derived from research carried out in the UK, Germany and France. Germany and France have price controls and more restrictive consumer credit regulation and practice than the UK. The research argues that the situation for poor people in Germany and France is worse, as they are excluded from credit.

Research supporting these claims is driven by the assumption that access to credit is a necessity of modern life and does not question the fact that people on low incomes need credit to fund essentials, and that they have to pay the highest price for it. Following this line of argument, sub-prime lenders (such as doorstep lenders) are seen as a force for good, as they provide an essential service to a market that the mainstream does not, or cannot, serve. From this perspective, a price cap in consumer credit markets would mean that sub-prime lenders could not cover their costs anymore, and hence they would withdraw from this market segment, leaving the poor exposed to hardship and illegality.

This is only true, however, if pricing does accurately reflect risk. Pricing in the sub-prime industry is not transparent, and there is some evidence to suggest that prices in the sector are overinflated. When the Competition Commission investigated the home credit industry in 2003/2004, it found that one sub-prime lender operating in both the UK and in Ireland was cheaper in Ireland than in the UK. Overall, it concluded that the doorstep lending industry in the UK overcharges its clients by around £7 per £100 lent, a cautious estimate by the Competition Commission's own admission.<sup>14</sup>

In spite of these facts, the Government did not compel the industry to lower prices or to become more transparent. The discussion then and now is dominated by the assumption that prices accurately reflect risk, and that the sub-prime sector provides a vital service to those on low incomes. The question as to why those who can least afford it need to take out high-cost credit to afford basic everyday items was never asked. The narrow focus of the discussion detracts from the wider issue of credit dependency of the poor.

Instead, opponents of interest rate caps pointed to the research mentioned above.

This research demonstrated seemingly greater levels of credit exclusion in Germany and France, higher levels of over-indebtedness, and a greater incidence of illegal loan sharking. The price cap is seen as the singular explanatory factor for these circumstances. This is despite the fact that inter-country comparisons of consumer credit markets are very difficult to make, and that differences will have more complex roots than only interest rate caps. Research that provides arguments against interest rate caps overlooks this wider picture. A more nuanced analysis of credit regulation, income levels, social welfare provisions, and cultural attitudes to credit is missing from the discussion.

In the following section, we seek to introduce a more detailed picture and open a discussion on credit dependency in the UK.

In particular, we reassess the validity of the claims made by opponents of interest rate caps:

- Countries with interest rate caps have higher levels of credit exclusion.
- Countries with interest rate caps have higher levels of over-indebtedness.
- Countries with interest rate caps have higher incidence of illegal lending.
- Demand for credit among poor households is the same in countries with and without interest rate caps.

But first, let's briefly review the sources of these claims.

### The sources of evidence

The research that forms the basis of much of the UK's stance on price caps stems from reports prepared by the consultancy Policis on behalf of the Department for Trade and Industry (DTI), now the Department for Business, Skills and Innovation (BIS). When asked about their opinion on interest rate caps, policy-makers and practitioners in the field of debt advice frequently cite this research as the reason for their opposition. In our opinion, however, there are some question marks over this research; it does not appear to adhere to basic standards of social science research. We set out our concerns regarding the quality of the research in Appendix 1 while in the body of this report we focus on the arguments made. We concentrate on two reports prepared for the DTI (now BIS) and one presentation, all of which are in the public realm:

- *The effect of interest rate controls in other countries*<sup>15</sup>
- *Illegal lending in the UK* (together with the Personal Finance Research Centre, November 2006)<sup>16</sup>
- *Interest rate ceilings and responsible lending – an international perspective*, a presentation given at the Transact National Conference 21 November 2008<sup>17</sup>

There appear to be no other UK reports that empirically investigate the impact of interest rate ceilings on consumers.<sup>18</sup>

All three of these reports/presentations rely strongly on a survey among low-income households conducted in Germany, France and the UK in 2004. Hence,

## Box 2: The empirical data: a survey without basis?

The evidence base of the DTI report relies heavily on a market survey undertaken by TNS on behalf of Policis (the consultancy that carried out the report) in 2003. Against common practice, however, next to no information is available on how and with whom the survey was undertaken. Only in one report is mention made of the number of people who responded to the survey, and that these 2,717 respondents were chosen from among the 20 per cent of the poorest households in each country.<sup>19</sup> Beyond this statement, no information is available on:

- Selection methods: who was asked and how were they chosen?
- Number of respondents in each country: how many replied and from where?
- The questions asked: why was the questionnaire not included in the reports?
- Type of questioning techniques: how was information collected? Did people tick boxes, were answers prompted, or were they coded retrospectively?

Contrary to convention,<sup>20</sup> none of this information is provided; hence there is no way to assess the quality of the data, the wording of the questions and to establish whether or not keywords were defined. These are important issues in social science research as respondents tend to interpret questions in different ways – and without a unifying definition, results are difficult to compare (see Appendix 1 for a detailed explanation). Similarly, the analysis does not provide sufficient information to allow for an informed assessment of the research – no actual response figures are given for each question. Responses are frequently expressed in percentages, but without knowing how many people answered, the information is useless. Hence, the validity of answers for the whole of the database needs to be questioned.

by and large, they use the same database. Germany and France were chosen as comparison countries as they both have interest rate ceilings in place.

There are some serious question marks over the survey which forms the basis of the evidence and the conclusions drawn. We discuss the methodological shortcomings of this report in detail in Appendix 1, and limit our concerns regarding the customer survey to a few short points presented in Box 2 before we concentrate on the analysis of the data.

Leaving these methodological concerns aside for the moment, we now turn to assess the claims made by opponents of price caps on their effects on the poor.

### Credit exclusion: causes and extent

One argument against price caps is that they exclude poor people from credit: they present a higher risk, which lenders cannot cover adequately because the price of credit is capped. The evidence gathered by Policis on behalf of the DTI (now the BIS) is used to underline this point.<sup>21</sup> The report, *The effects of interest rate controls in other countries*, states that credit exclusion in Germany and France is higher than in the UK. Credit exclusion here is defined as not being able to access credit at all, be it from a sub-prime or from a mainstream lender. The price cap in both countries is given as explanation for this apparent widespread exclusion: because of the limits on prices, there would be no sub-prime lenders providing credit to the high-risk segment of the population.

From data on consumer credit market volumes, it becomes immediately clear that supply of credit in Germany and France is not as abundant as in the UK.

However, is the price cap the only reason for this situation? And does this mean that credit exclusion is widespread? Or do other factors play a role?

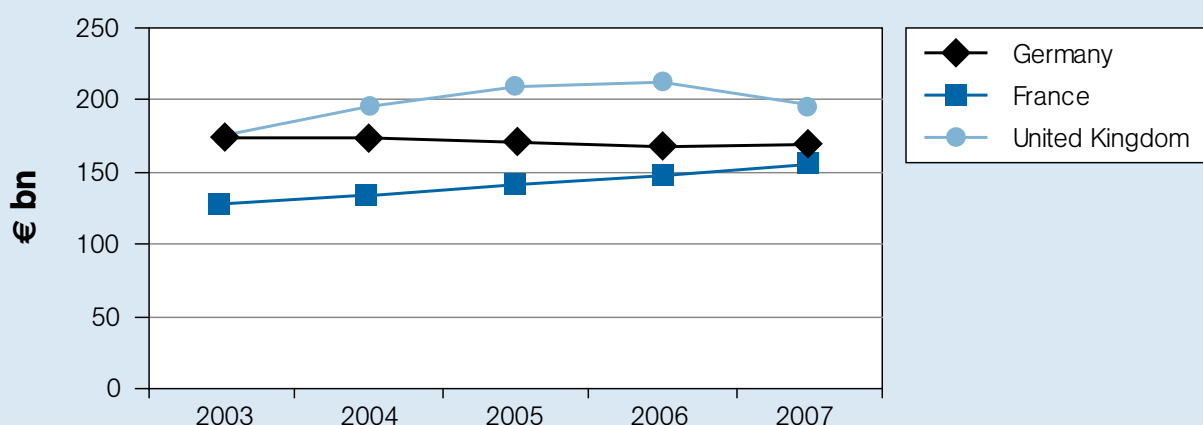
### Regulatory differences

The regulatory regimes for consumer credit vary greatly between France and Germany on the one hand, and the UK on the other. Broadly speaking, regulation in the UK is not very onerous on lenders, while rules and laws are much tighter in the other two countries.

### Price capping

As mentioned above, there are no price caps on the cost of credit in the UK. Both Germany and France, on the other hand, have price caps in place. In Germany, usury is defined as the interest rate being more than twice the market

Figure 2: Consumer credit lending (€bn)



Source: ECB 2008,<sup>22</sup> modified. Note that the comparisons are approximate as data collection varies between the three territories.



rate. Lending above this limit is considered predatory lending and constitutes a criminal offence. Credit agreements where this ceiling is exceeded are void and the client does not have to repay the interest. The level of the ceiling can float up and down. In practice, maximum APRs are usually around 28–30 per cent.<sup>23</sup>

In France, the cap is prescribed by law and is adjusted quarterly by the Banque de France. There are two ceilings: one for credit below €1500 at around 20–25 per cent and one for credit above €1500, at around 7–8 per cent APR.<sup>24</sup> The French Government is currently reviewing its consumer credit legislation, so this may change in the near future.

From our explanations of the differences in risk and pricing structures between the mainstream and the sub-prime market, it is reasonable to deduce that the price cap is responsible for the absence of a sub-prime market.

However, this is not the sole factor that restricts the development of a sub-prime market and the availability of consumer credit in general.

Current legislation in Germany, for example, allows only banks to provide credit. As a consequence, home credit companies and payday lenders cannot exist in Germany. In addition, credit card balances have to be paid off in full each month, unlike in the UK, where credit card debt can be paid off over several months. These factors already limit the availability of credit – but this has nothing to do with the usury ceiling.<sup>25</sup>

In France, there are financial institutions (some of which are at least part-owned by a bank) specialising on the provision of consumer credit of varying types. Credit can either be tied to the purchase of a good, or can be unsecured credit, such as revolving credit. Interest rates for credit are limited by the ceiling described earlier. However, this does apparently not restrain accessibility of credit for most people. Real credit cards are common, as is revolving credit in general (we will return to this later in more detail). Regulation of operations, however, is stricter than in the UK: all types of credit institutions are regulated by the Bank of France (or the Committee for Credit Institutions and Investment Institutions (CECEI) to be more precise) and have to fulfil certain licensing criteria, such as minimum capital requirements.<sup>26</sup> As a consequence of these regulatory requirements, certain sub-prime models such as cheque cashing services, payday loans or home credit companies do not exist. Again, the interest rate ceiling cannot be seen as the sole determining factor for the absence of a sub-prime market in France.

The reverse of this situation is also true: the absence of a price cap in the UK is not the sole reason why sub-prime lending is thriving here. Of all the three countries, consumer credit regulation is most relaxed in the UK. Companies providing consumer loans, but not taking consumer deposits, only need to obtain a license from the Office of Fair Trading. The conditions of obtaining this license concern themselves mostly with character fitness and professional competence of the applicant,<sup>27</sup> but do not require minimum capital holdings or other pre-conditions. Consumer credit companies are not regulated or supervised by the Financial Services Authority, the Treasury, or the Bank of England. Of course, the ability to charge very high prices will be conducive to the existence of a large sub-prime market. However, the relative simplicity with which lending operations can be established is also an important factor.

These differences in regulation make it difficult to compare countries based on the existence or absence of interest rate caps alone. Because of the tighter rules on suppliers of credit (stricter licensing and supervision regimes), there will be fewer organisations willing to enter the market in Germany and France in the first place. The lower barriers to entry into the personal consumer credit market in the UK result in a higher availability of credit in the UK compared to the other countries. Does this mean, however, that credit exclusion is more widespread in Germany and France? Given that there is no sub-prime lending industry in these two countries, we need to concentrate on the exclusion from mainstream banking. Not being banked in either France or Germany makes obtaining credit nigh on impossible, as opposed to the UK where doorstep lenders provide credit for the

unbanked. For credit exclusion to be *per se* higher in Germany and France, more people in these countries would have to be unbanked than in the UK.

### Financial exclusion levels

Looking at the numbers of unbanked people in all three countries, it quickly becomes clear that this number is far higher in the UK than the other countries. As a consequence, the levels of exclusion from the mainstream credit market are far higher: a conservatively estimated 1.75m adults in the UK do not have a transactional bank account.<sup>28</sup> In contrast, in Germany, there are only an estimated 500,000 adults.<sup>29</sup> The estimates of the number of unbanked people in France vary between 500,000 and 1 million adults.<sup>30</sup>

Of course, having a bank account is not the same as having access to credit. In all three countries, banks offer basic bank accounts (BBAs) without overdraft facilities or credit cards to certain client groups.

In the UK, there are 7.7 million accounts without credit facilities,<sup>31</sup> nearly 4 times the number of Germany (two million at the end of 2006<sup>32</sup>) and France (2.1 million in 2008<sup>33</sup>).

This puts the number of people excluded from mainstream credit in the UK well ahead of the other two countries: in total, at least 9 million people cannot access credit from mainstream banks here, as opposed to ca 2.5 million in Germany and between 2.5 million and 4.1 million in France.

These figures indicate that the banking systems in Germany and France are more inclusive than in the UK, reducing the potential market for sub-prime credit through specialised high-cost lenders. Again, different regulatory regimes contribute to these differences.

In the UK, there is no universal service obligation, i.e., banks are not compelled to open bank accounts for clients they do not approve of. The Government and the banks started a voluntary initiative in 2003 to halve the 2.8 million people that were then unbanked, with varying degrees of success.<sup>34</sup> The basic bank account (BBA) is recommended as a first account for people on benefits, and for people on low incomes. British banks may refuse people a BBA if they have an undischarged bankruptcy (i.e., they are in the process of insolvency procedures) or have a bad credit history.

In contrast, banks in France are obliged to open a bank account for everyone, and have to offer an overdraft of 50 per cent of a client's income on current accounts. This regulation was created to curb the penalty payments that clients incur when going accidentally overdrawn.<sup>35</sup> Accounts without credit facilities are specifically for those who have entered bankruptcy procedures and hence by law have lost their right to access credit for a certain period. Rather than being a specific bank account, current accounts have their credit facilities withdrawn (i.e., overdrafts are cancelled and credit and debit cards voided).

Similar to the UK, German banks have undersigned a voluntary commitment to open bank accounts for everyone. There is a legal quasi-obligation for savings banks to open bank accounts that is taken very seriously (the exact status of this obligation appears to be disputed and varies from state to state). BBAs are offered to those who have been declared bankrupt or are seen as over-indebted. Reasons

**Table 1: levels of credit exclusion in the UK, Germany and France**

	UK	Germany	France
Number of unbanked (in m)	1.75	0.5	0.5–2.0
People with basic bank accounts (in m)	7.70	2.0*	2.1
Total excluded from mainstream credit	9.45	2.5	2.6–4.1

Source: nef research; \*end of 2006

to refuse the opening of a BBA in Germany, for example, are limited to fraudulent behaviour or repeated breach of agreements.<sup>36</sup>

While there is no compulsion for banks to offer an overdraft, banks are less restrictive in their practices than in the UK. According to the German Federation of Savings Banks, the source and level of income does not automatically preclude the extension of an overdraft to a client. There is no precise data on the volume of overdraft lending to people on low incomes or benefits as there are no binding rules, and each of the ca 1500 banking institutions in Germany can decide on lending practices.

It is noteworthy that in the UK, bankruptcy and over-indebtedness are reasons to refuse the opening of a BBA, while in the other two countries they are specifically designed for this segment of the population.

As a consequence of UK banking policies, credit exclusion from the mainstream is far more pronounced here than in Germany and France – so even though there is no dedicated sub-prime market in the latter two countries, there is also much less need for it. Not only does this challenge the validity of claims that credit exclusion is worse in countries with interest rate caps, it is also a clear demonstration of the importance of an inclusive banking sector that provides bank accounts – and, where reasonable, credit – to people on low incomes.

### Over-indebtedness

Research into interest rate caps also claims that levels of over-indebtedness are higher in France and Germany than in the UK. Again, the existence of an interest rate cap is used to explain this phenomenon. As interest rate caps would suppress the development of a sub-prime credit market (and as we have explained earlier, this explanation is insufficient), people would have to take out loans that are not commensurate with their needs. The very small loans usually offered by sub-prime lenders in the UK (from £50 upwards) would not be available. Instead, the poor would have to borrow amounts that exceed their needs (and budgets) from mainstream lenders, thereby unnecessarily burdening them with a high debt load that causes over-indebtedness.

There are two problems with this argument. First, opponents to interest rate caps claim that these cause credit exclusion. At the same time, they claim that caps cause over-indebtedness. This appears to be a contradiction: if interest rate caps cause exclusion from credit, how can people become over-indebted in the first place?

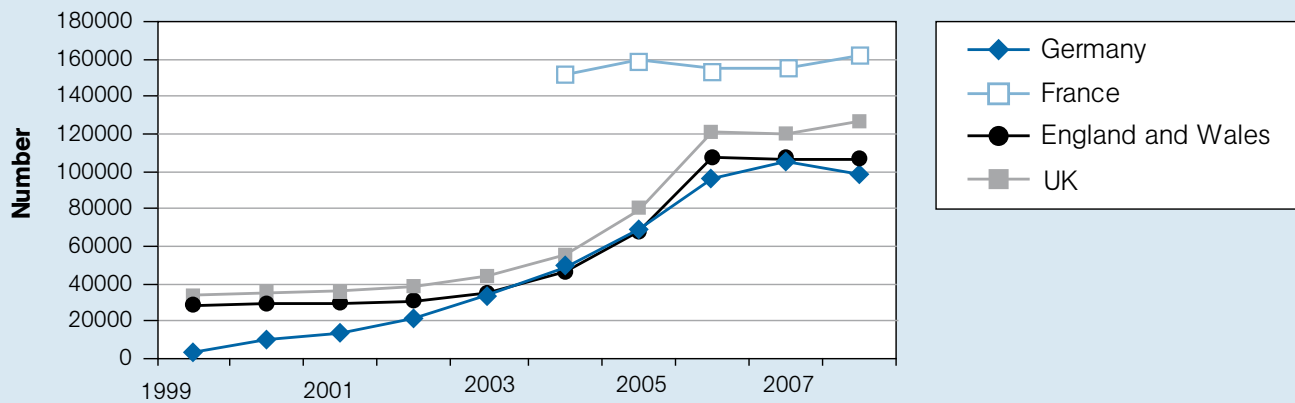
Secondly, comparing data on over-indebtedness between countries is difficult as there is no single definition of over-indebtedness in Europe. As a consequence, over-indebtedness is not a good indicator to compare levels of problem debt. Inter-country comparisons based on this indicator should thus be treated with caution.

Furthermore, research seeking to demonstrate that levels of over-indebtedness are higher in Germany than in the UK<sup>37</sup> compares two different indicators: namely estimated levels of over-indebted households in Germany with the number of personal insolvency proceedings in the UK (Appendix 1). These two indicators do not allow for a direct comparison as over-indebtedness is a *process* that does not necessarily lead to personal insolvency. Interventions by debt advisors and negotiations with creditors can achieve a sustainable repayment plan and help avoid bankruptcy. Personal insolvency, on the other hand, is an administrative procedure regulated by law, and once proceedings have started, they cannot be halted. In order to obtain a good comparison of problem debt between countries, personal insolvency figures are a far more suitable indicator.

As Figure 3 shows, personal insolvency figures in the UK have increased dramatically since 2006. This is despite the fact that this predates the credit crunch, i.e., in times where credit was freely available. Since 1999, UK figures have been consistently higher than in Germany, where the numbers have actually dropped in 2008. This is counter-evidence to the argument that interest rate caps cause over-indebtedness.

The sharp increase in the UK is all the more startling as it occurred during the 'good times'. A way to avoid insolvency (i.e., the inability to service debt) is to take out

**Figure 3: Insolvencies in the UK, France and Germany**



Sources: UK figures: The Insolvency Service; for Germany: Statistisches Bundesamt; France: Banque de France.

a new loan to pay off previous debt. The amounts that need to be paid are thus shuffled from credit card to credit card, without ever paying off the outstanding amount. In a situation where consumer credit is freely available (i.e., checks on ability to repay are based mostly on an applicant's credit score and annual income), this can be done several times before the credit burden becomes too high to manage. The increase in personal insolvencies in 2006 indicates that even without the credit crunch and subsequent reduction of availability of consumer credit, people found themselves unable to cope with their debt load.

However, as Figure 3 also reveals, personal insolvencies are much higher in France than in both Germany and the UK. Again, can this be attributed to the interest rate cap, or are other factors at play?

France, like many other countries, has seen a stark increase in consumer credit over the past 15 years. Revolving credit plays an important role in this market. This form of credit makes up 20 per cent of total consumer credit, the third-highest level in Western Europe. In terms of volume, France (€28.8m) ranks second behind the UK (€90m), (by contrast, the share of revolving credit of total consumer credit in Germany is only 7 per cent, and a volume of €15.7m<sup>38</sup>). This relatively new form of credit, and the selling practices associated with it, is seen by some as the main culprit for over-indebtedness.

Just as in the UK, the credit crunch has put an end to a way of budgeting which is entirely dependent on the continuous availability of fresh sources of credit. Short-term credit in general (e.g., renewable, unsecured credit without a repayment plan) now accounts for 70 per cent of debt of insolvency submissions,<sup>39</sup> a strong indicator of the problems associated with this form of credit.

Apparently, the regulation on sales and marketing practices has failed: a study by a consumer protection agency, 'UFC Que Choisir', (the French equivalent of Which?) suggests the credit is often pushed on to clients. Customers are sold revolving credit although they sought finance for a specific product, like an electronic good. According to the UFC Que Choisir, the revolving credit market in France would be characterised by 'absence of choice, systematic and hidden provision of credit (via store cards), granting of credit without in-depth investigation of the consumer's circumstances'.<sup>40</sup> Credit tied to the purchase of a certain good (with a payment plan) was replaced by revolving credit provided through store cards. While it seems that there is regulatory failure, the level of the interest rate does not appear to play a role here.

Again, by solely focusing on interest rate caps as the explanation for a certain societal phenomenon, the wider picture is missed. Over-indebtedness is a problem in both France and Germany, but the interest rate cap appears to be unrelated to this problem.

## Credit dependency and illegal lending

We have already shown that levels of credit exclusion are not necessarily higher in countries with interest rate caps provided they have banking regulation that promotes financial inclusion. Interest rate caps are also not responsible for over-indebtedness as the experience in Germany and France demonstrates. The discussion shows clearly that the focus on interest rate caps does not serve well as an explanation of the differences in consumer credit markets.

This also applies to a further claim made by opponents of interest rate caps, namely that demand for credit among poor households is similar across countries. Again, the consumer survey carried out by Policis<sup>41</sup> is cited as evidence to back up this argument. This suggests that there would be equal credit dependency of low-income households, i.e., the absolute need to take out a loan when an emergency arises. As we investigate in closer detail in Appendix 1, we have doubts about the conclusions drawn by the report's authors based on the survey. In addition, we are questioning the statement that credit demand is not specific to a country's regulatory and cultural environment.

There are two reasons why we doubt the validity of this statement:

- 1 Poverty and inequality levels are higher in the UK.
- 2 Disposable incomes are lower and prices higher in the UK.

## Equality of poverty?

The statement that the demand for credit is equal in all three countries compared can be interpreted in two ways:

- 1 The spread of poverty is similar, i.e., that there is a similar proportion of poor people in all three countries.
- 2 The depth of poverty is similar, i.e., that the gap between the households earning the least money and the national average is the same.

To assess the first possible interpretation of demand equality, it is necessary to establish if similar proportions of households in all three countries are poor. Of course, being poor does not mean that credit is absolutely necessary, i.e., that people are dependent on credit to make ends meet. However, the proportion of households in poverty is a good indicator to assess the potential size of the market.

As we have already demonstrated, exclusion from mainstream credit is far more widespread in the UK than in Germany and France; this casts doubt on the assertion that demand will be equal in all three countries. Secondly, the proportion of households at risk of poverty is also higher in the UK. Table 2 depicts the percentage of total households at risk of poverty after transfer of benefits in Germany, France and the UK. The definition for poverty used is that a household is poor if its income is less than 60 per cent of the median income in a given country.

As can be seen from Table 2, the percentage is highest in the UK. This suggests that the potential need for credit to make ends meet is more pronounced. If social transfers and income from work are not sufficient to make ends meet, credit may be considered as a way to increase disposable income.

This indicator is also a measure of inequality: the more people below the threshold of 60 per cent, the more unequal the society as the differences in income are starker. Data on income inequality confirms this.

Figure 4 shows the ratio between the income of the top 20 per cent earners in each country compared to the bottom 20 per cent (a so-called 'quintile'). For example, in 2007, the ratio in the UK was 5.5:1, meaning that the income of earnings in the highest quintile is 5.5 times more than that of the earnings in the lowest quintile. The ratios in France (3.8) and Germany (5 in 2007, 4.8 in 2008) are lower.

**Table 2. Percentage of households at risk of poverty**

Country/Year	2005	2006	2007
United Kingdom	19	19	19
France	13	13	13
Germany	12	13	15

The increase in percentage in Germany can be attributed to the reform of unemployment transfers that saw a steep decline in the provision of secondary unemployment money (see section below for further explanation). Data for 2008 was only available for Germany where the rate remained constant at 15 per cent.

The poverty definition used to produce this data is not fixed, i.e. the income level below which a household is considered to be poor can go up as well as down: if the majority of households earn £20,000 a year, the poverty threshold is £12,000 (60 per cent of £20,000). If the majority of households have an annual income of £17,000 a year, then the threshold sinks to £10,200 (60 per cent of £17,000).

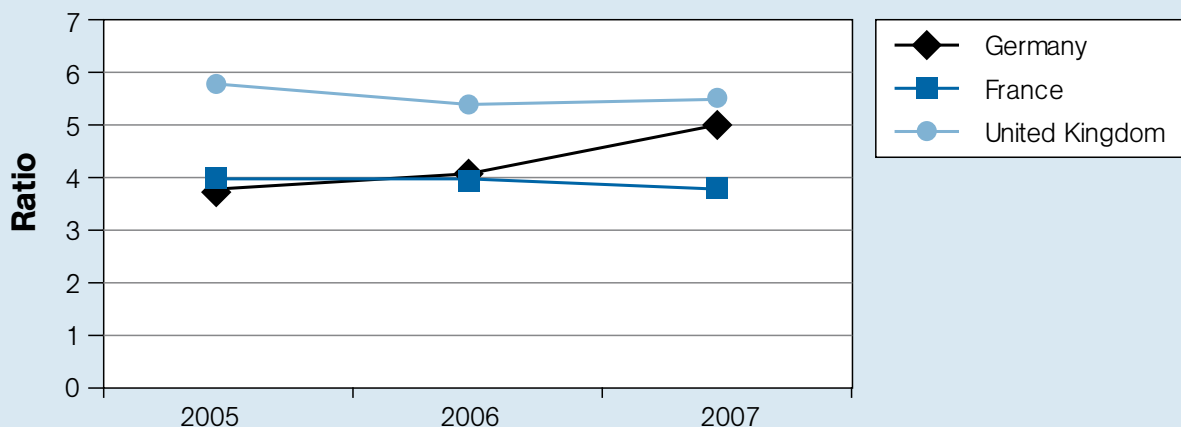
Source: EUROSTAT<sup>42</sup>

This indicates that relative poverty levels are higher in the UK than in the other two countries. Whilst this is not a clear indicator of credit dependency, it strongly suggests that there is greater demand for credit in the UK – hence, levels vary and are not equal as the Policis research suggests. However, it appears that Germany is approaching UK levels of inequality, so this may have to be revisited in the future.

#### **Coping mechanisms – credit is the only way out?**

The second interpretation of equality of demand suggests that people below a certain income will need credit to make ends meet. Although there may be fewer households in need of credit individually, all affected households would need the same amount of money to cover unexpected expenditure and/or pay for everyday goods and services. This money can only be obtained through credit, and not through other coping mechanisms. So the argument goes on: excluding people from credit will drive them into the arms of illegal loan sharks. Commonly, illegal lending in this context is defined as the provision of loans by individuals who charge extortionate fees and interest rates, and use threats to life and limb if repayments cannot be made.

**Figure 4: Income ratios in the UK, Germany and France in 2007.**



Source: Eurostat<sup>43</sup>

NB Data for 2008 was only available for Germany, where the ratio has gone down to 4.8.

Again, this argument overlooks the more varied reality of people on low incomes. The poor use a variety of coping strategies to overcome crises – none of them are ideal; the use of credit is only one of them, and one that does not seem to be used equally across all countries.

For example, the high levels of illegal lending that Policis suggests exist in Germany and France may be overstated by the survey.

Speaking to several experts in France and Germany to investigate the extent to which illegal lending is a problem, most respondents agreed that this phenomenon is much less pronounced in France, and is unlikely to exist at all in Germany.<sup>44</sup> The Institut für Finanzdienstleistungen (IFF, Institute for financial services) recently, in a submission to the Office of Fair Trading, highlighted the lack of evidence on loan sharks in Germany.<sup>45</sup> In addition, extensive internet and literature research did not reveal evidence of illegal lending in Germany and France.

Germany does have a problem with fraudulent credit brokers, who promise provision of money to applicants without any credit checks. As a research report with mystery shoppers carried out by SCHUFA (Germany's main credit rating agency) has demonstrated, credit is hardly ever forthcoming. Instead, applicants are persuaded or cajoled into paying upfront fees for budget checks and compulsory home visits, often resulting in the payment of several 100 euros before a decision on the credit is made. In the study, none of the attempts to secure credit in this way was successful.<sup>46</sup>

These fraudsters cause considerable damage to applicants and their families, not only financially but also psychologically. There is no question that this practice needs to be curbed. However, the existence of such fraudulent activity has nothing to do with the usury rate, and does not prove the existence of loan sharks as they are defined in the UK. According to the SCHUFA report, people turning to these credit brokers are already classed as over-indebted – i.e., a responsible lender would not extend any further credit to them, interest rate ceiling or not. Furthermore, it appears unlikely that the fraudsters target the poorest of households. The sums that need to be paid up front are quite considerable, and it is questionable if low-income households would have this kind of money to spare.

In France, experts agree that there may be some incidence of illegal lending similar to the UK (extortionate credit rates, threat and use of violence in case of non-payment) – however, as Mr Kiehl from Crésus states: the French Government does not investigate this problem and there are no official statistics that attempt to estimate the scale of the problem.

To assume that people on low incomes will inevitably turn to unlicensed extortionist lenders when refused mainstream credit is very restrictive. People devise a series of coping strategies to cope with emergencies. These include strategic default on bill payments, pawnbroking,<sup>47</sup> appeals to social services for a grant or a loan, charitable donations, borrowing from friends and family, or simply going without – the latter of course often under considerable distress. We do not argue that these strategies are without problems or should be seen as an ideal. As a simple calculation demonstrates, however, the link between credit exclusion and illegal lending is not as clear-cut as opponents of interest rate caps suggest. This can be demonstrated using figures from the UK.

In the UK, a substantial proportion of people excluded from mainstream credit do not use sub-prime credit. According to the Competition Commission, the home credit industry has 2.3 million clients.<sup>48</sup> Many of these have access to mainstream or other forms of sub-prime credit. The Competition Commission, for example, states that in 2004, 49 per cent of all customers of Provident Financial (the largest of all home credit providers with 1.5 million customers) had access to other forms of credit, all of which require a bank account.<sup>49</sup> If we assume that half of all home credit clients (1.15 million) have access to mainstream credit, this leaves 1.15 million people for whom sub-prime credit is their sole option.

However, there are ca 9 million adults without access to mainstream credit (1.75 million without a bank account and 7.7 million with an account that offers credit

facilities) for which sub-prime credit remains the sole legal option.<sup>50</sup> If we generously assume that of these 9 million, 1.15 million are home credit clients, and around 700,000 people use payday lenders (there is no data on the size of this market), this leaves 7.15 million adults without recourse to legal credit. Are these all going to illegal lenders, or do they use other coping strategies? Even Policis does not suggest the incidence of illegal lending to be this high.<sup>51</sup> Hence, the assumption that interest rate caps will inevitably drive people to illegal lenders cannot be upheld.

Without dedicated research into this, we simply cannot know how low-income households cope. To assume, however, that credit is the only option considered is to overlook other coping strategies and to detract again from the wider issue of insufficient incomes for people on low incomes.

### **Box 3: Interest rate caps in the USA – uncompetitive and reducing diversity?**

Research into interest rate caps also looks to the USA to assess the experience of different states there. Again, we seek to challenge the main points made in regards to the US sub-prime credit market. For reasons of space, we will only draw out the salient points.

The arguments against caps refer to payday lending, one of the main form of sub-prime lending. They can be summarised as follows:

- States without interest rate caps have a more competitive and diversified market.<sup>52,53</sup>
- Payday lending is short-term in nature, aimed at providing cash for emergencies, and hence serves a social purpose.

Based on these arguments, payday lending was frequently exempt from interest rate regulation. Some states allowed payday lenders to charge 10 times the official limit. In recent years, however, this perception seems to shift, as more and more states are introducing stricter regulation.

#### **Claim 1: Payday lending is competitive and diverse in states without caps**

In a study carried out by the Centre for Responsible Lending, prices and fees in payday lending in states without an interest rate cap do not fluctuate between different markets.<sup>54</sup> Rather than reflecting cost, fees are charged at the highest permissible levels because they are the primary source of revenue for the lenders. In Colorado, for example, where the Government imposes a maximum fee on payday lending, payday lenders charge this maximum in 93 per cent of cases. Advance America, a company operating across several states in the USA was found to charge a flat fee of 16 per cent of the amount lent in all states, regardless of the level of competition. Similarly, QC Holdings held its fee constant at 15 per cent in all states between 2003 and 2005.<sup>55</sup> This evidence clearly indicates that payday lenders do not compete in price, but charge what the market will bear or what is legally permissible.

#### **Claim 2: Payday loans are short-term and for emergencies only**

There is strong evidence to suggest that a large percentage of customers roll their loans over, or take out loans in quick succession, thereby landing frequently in a debt trap. According to regulatory filings, over 90 per cent of payday loans are offered to borrowers with five or more loans per year. Over 60 per cent of loans go to borrowers taking out 12 or more loans per year, which is a rate of at least once a month for loans that last typically two weeks. Researchers also argue that lenders are relying heavily on this roll-over debt to fund their operations,<sup>56</sup> thereby exploiting the debt trap and financial illiteracy of clients unable to access credit from mainstream banks.

The experience of North Carolina, where payday lenders ceased to operate after the introduction of strict payday legislation, serves as a good example to demonstrate that caps can actually increase competitiveness and diversity in the market. After the introduction of a cap:

- small consumer loans (less than \$600) increased by 37 per cent;
- affordable lenders could expand their market share as awareness of affordable lending increased and aggressive marketing by payday lenders disappeared; and
- there was an increase in savings brought about by switching to low-cost credit.<sup>57</sup>

In addition to challenging the arguments of opponents of price caps, the example of North Carolina also demonstrates the importance of building a strong affordable lending sector, which in the USA is nurtured by the Community Reinvestment Act (Box 4).



# Escaping the debt trap: increasing affordable lending and decreasing credit dependency

As we have shown, interest rate caps do not need to have a negative impact on poor households. They cannot be seen in isolation, but have to be part of a wider set of measures that will enable poor households to escape the debt trap and reduce credit dependency.

The scope of the reforms needed to create a transparent and just lending environment in the UK is large, but this should not deter policy-makers from embarking on this task. The current situation in which high-cost lenders can charge extortionate interest rates under the pretence of providing a social service is untenable. By having to pay the highest price for credit, the poor are unable to build any assets and are trapped in the cycle of low income and high-cost credit. There is therefore an urgent need for reform and bolster existing efforts to increase the income of the poor.

In the following section we outline the reforms we propose, focusing strongly on the introduction of price controls and universal banking services.

## **What price credit? Ensuring equity of access**

As a first step to developing our proposal for a fairer lending environment in the UK, we model the impact of a law that would set a price cap on the total cost of credit (Box 1) and impose a universal service obligation for credit on credit providers.

We aim to provide an alternative vision to the view that there is no alternative to the situation at hand (as witnessed in a recent research report on affordable home credit provision<sup>58</sup>). We propose a model in which a cap on the TCC is to be supported by additional regulatory and social measures to increase transparency, fairness and affordability, while decreasing the credit dependency of households on low income in the UK.

## **Modelling the impact of usury rates<sup>59</sup>**

As explained in the introduction, there are marked differences between sub-prime and mainstream credit markets. In the mainstream market, the price of credit is dependent on the risk that the borrower presents to the lender. In the sub-prime market, all borrowers are categorised as high-risk and charged the same uniform price. These differences in pricing structures are to some extent a reflection of differences in demand. The demand curves for both markets are depicted in Figure 1.

In the mainstream market, demand reacts heavily to price: the higher the price, the lower the demand. As this group is not highly dependent on credit, and has a low risk profile, it reacts strongly to price changes. Seeing as they are good clients (i.e., high likelihood that they will repay the credit), this group has a bargaining chip – lenders want to lend to them. Hence, there is competition, and many different companies from which members of this group can choose.

For the second group, demand is less sensitive to price and hence more inflexible for several reasons:

- Sub-prime clients' credit ratings usually prevent them from accessing credit from mainstream banks, meaning they have no or very little choice in lenders. As lending to this group is associated with higher risk, not many lenders want to enter this market. This is not only because of the increased risk of defaulting

(the high charge for credit would compensate for this to a certain extent), but also because of reputational risks.<sup>60</sup> In the classical market model, a limited number of competitors means limits on price competition, adding to the other factors that drive up the cost of credit (such as high risk, home collection, inclusion of penalty fees upfront in the price, etc).<sup>61</sup>

- Certain features of sub-prime credit, especially the home credit market, are indispensable for clients on low incomes: fast availability, flexibility in repayment, and low instalments. Clients are prepared to pay a higher price for these features, reducing their sensitivity to price levels. The strong relationship developed by home credit providers, such as Provident Financial, with their clients also creates barriers to entry for would-be competitors. This, too, keeps prices higher than would otherwise be the case.<sup>62</sup>
- In an emergency, or if credit is used to pay for basic expenditure, credit dependency is high – and so is the willingness to pay high prices for it.

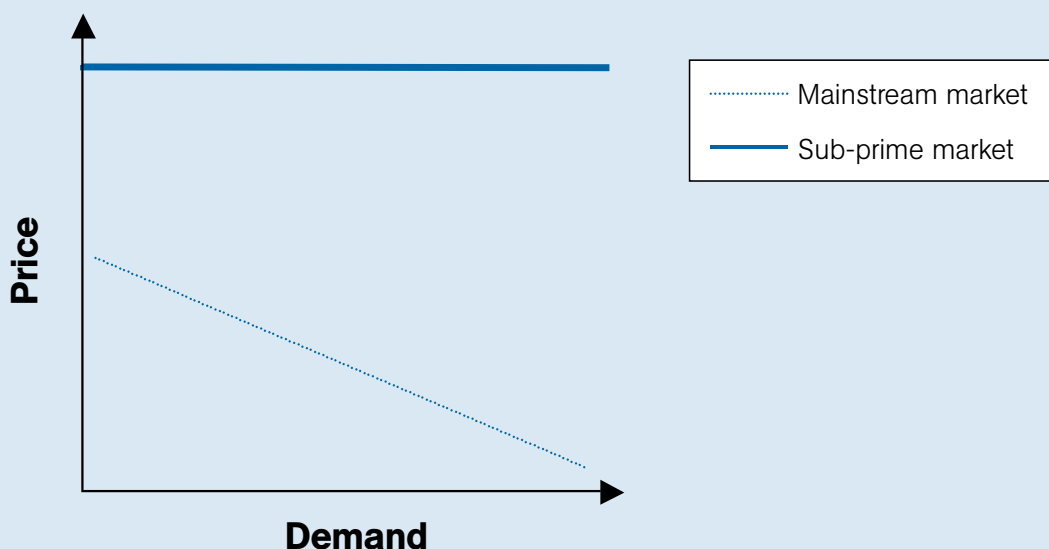
Hence, the price does not influence demand as much as it does for the other set of clients. Figure 5 schematically depicts these different demand levels.

As a consequence of the differences in demand (so-called differences in price elasticity between different market segments), pricing policies also vary between the two credit markets.

In the mainstream market, price is adjusted according to the risk profile: the lower the risk, the lower the price. In the sub-prime market, this risk-based pricing does not exist. All clients are charged a uniform rate. A good repayment history does not lead to price reduction. Not only does this uniformly high price create the operational profits for sub-prime lenders, it also means that good repayers subsidise losses for the company incurred by bad repayers. This is an unjust situation, where equally poor people have to pay high prices and cross-subsidise losses, whilst in the mainstream market, the richer section of the population can enjoy the benefits of price competition and good repayment behaviour.

As explained earlier, there is a large gap between maximum prices in the mainstream and the sub-prime market. The mainstream maximum price is, of course, much lower than for the high-risk group. This is evidenced in the UK where, in the absence of any restrictions on interest rate levels, the mainstream credit rates are between 5 per cent and 30 per cent (this is including some of the more

**Figure 5: Differences in demand levels: sub-prime and mainstream market**



expensive credit cards offered, for example, by Barclays to people with an impaired credit history), but the sub-prime interest rates can go up to over 1000 per cent APR for cash loans (e.g., Chase Finance Limited), and even higher for payday lenders. It has to be recalled at this stage that sub-prime lenders argue that lending to high-risk groups is costly and hence the prices are justified.

The argument against a cap is that the introduction of a price cap will reduce the availability of credit, as some sub-prime models may not be viable any more: if the price of the high risk cannot be covered, i.e., the likelihood of a client defaulting on repayment, then companies will stop lending to the high-risk segment of the population. For example, if the probability of a client defaulting is 60 per cent, and the cap is set at 50 per cent, then companies will not lend to this client anymore.

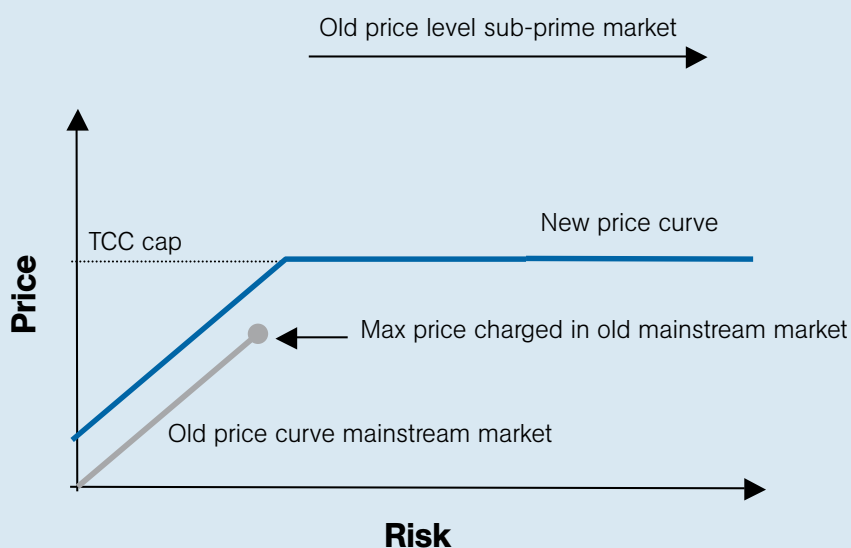
In our model, we propose to overcome this problem by removing the distinction between sub-prime and prime markets and introducing a universal service obligation. The introduction of a price cap could then lead to a reduction in price whilst credit supply will remain by and large stable.

If a price cap is set at a level that is higher than the maximum price currently charged in the mainstream sector (this will be called price P1), the supply of credit to the low-risk group remains unaffected. For example, if the maximum price paid by low-risk customers is 30 per cent APR, then a price cap of 50 per cent TCC will not reduce credit availability for this group.

However, as pointed out above, in the high-risk market, this could, theoretically, lead to a decline in supply if price caps do not reflect the risk of a client defaulting. If we introduce the price cap at 50 per cent, but the probability of default is 60 per cent, then these clients may be unable to obtain credit in the future. On the other hand, we have to ask if people whose probability of default is at such a high level should take out a loan in the first place? They may be better served by a grant or advice on how to increase their income.

For those where the probability is not exceedingly high, the introduction of a universal service obligation would overcome this problem. All lenders would be obliged to lend to all customers, regardless of their credit risk (of course, within limits of responsibility, e.g., if a customer is already over-indebted, no further debt should be added). This would force lenders to adjust their models – the cost of credit would have to be brought down to match or undercut the maximum price allowed.

**Figure 6: Theoretical changes to the credit market**



This change in credit markets would have a variety of impacts. Cross-subsidising from the 'good' sub-prime group to the 'bad' sub-prime group would in essence cease, as the good clients would benefit from price reductions due to their better credit history. This would mean that losses through defaults would increase, and profits would be reduced. To compensate for that, the price of credit for good customers would be increased to reinstate this cross-subsidy.

Figure 6 depicts the current situation and how it could be seen from a lender's perspective (we will consider the demand side, i.e., the customers in the next paragraph). The dashed line is the mainstream market before the price cap is introduced: people with a good credit history (low risk) pay low interest rates, but as their risk profile increases, so does the price. There is a cut-off point beyond which mainstream lenders are not prepared to go (marked by the black dot), both in terms of risk and price. The thin line at the top represents the current price levels in a sub-prime market. Here, lenders will extend credit to those groups the mainstream does not want to lend to; however, within that market, there is no risk-based price differentiation. The thick black line represents the situation after the introduction of a universal service obligation and an interest rate cap (marked by the dotted line). Prices for lower-risk clients will rise as lenders encounter higher default rates from the high-risk customers, but prices will drop for the higher-risk clients.

It is likely that when customers fall into a certain high-risk credit category, they will be charged the maximum allowable rate. However, through improving their credit score, they may be able to obtain cheaper interest rates in the future.

So, how are these changes going to impact on demand? Theoretically, the increase in prices for the low-risk group may reduce demand, as they are not as dependent on credit, hence lenders would have to rely more on the higher-risk group. However, the reduced price would lead to an increase in demand as credit would be more affordable, allowing people to finance purchases more frequently on credit – but crucially, contrary to the old system, they would be in a better position to pay off the outstanding amount as the price is vastly reduced. The changes may also attract a second group, namely those people on low incomes currently put off by the high prices charged in the sub-prime industry. The experience of North Carolina (Box 3) indicates that an increase in demand is realistic.

There are, of course, several obstacles in this model. The first set of obstacles relates to company strategies, and existing market conditions.

First, given the current market infrastructure in the UK, it would be unlikely that this model would be implemented even with great political will. A mainstream customer is unlikely to take out a loan from Provident Financial or another sub-prime lender for fear of being branded a poor customer. Likewise, mainstream banks would be very reluctant to accept high-risk clients, not only because of the high prices they would have to charge, but also for fear of being branded a bank for the poor.

To circumvent this, we thus propose the additional (and long overdue) introduction of a community reinvestment act that is adapted to the UK. This act should ensure that banks invest a share of their profits in those communities from which they generate profits, thereby contributing to the economic regeneration of areas from which banks have largely withdrawn in the UK.<sup>63,64</sup> Whilst a detailed description of what such an act should look like in the UK would go beyond the remit of this report, and is for Government to determine, we outline the basic tenets such an act would have to fulfil.

Similar to the USA, a community reinvestment act in the UK would require banks and other financial institutions licensed under the Financial Services Authority (FSA) to disclose how much, where and who they lend to. At the same time, they would be required to disclose the sums they earn from these locations, for example, from deposits made by individuals and small businesses. As part of their license requirements, these institutions would be compelled to reinvest a certain proportion of the money into the communities they lend to. If they fail to comply, they should be subject to financial sanctions. The investment by banks does not need to be undertaken by the banks directly. They could invest in affordable providers of credit, such as credit unions and CDFIs that are already undercutting the existing high-

## Box 4: Disclosure of lending in the USA: the Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act (CRA).

In essence, the CRA and the HMDA impose a universal service obligation for credit and investment on banks. Both acts were introduced in the 1970s in the USA to end the practice of 'red-lining', in essence racial discrimination based on zip codes (post code zones). If a person lived in an area with a predominantly African-American population, it would be impossible for them to obtain credit, no matter how high their income. This meant, for example, that home ownership levels among African-Americans were much lower compared to the national average. The fundamental tenet of both acts is that banks have to disclose the areas in which they take deposits (i.e., where they have branches and where their clients live) and that they have to demonstrate that they reinvest a certain proportion of these deposits into these communities. They could either do this directly (i.e., providing loans to clients living in these areas) or indirectly (i.e., channelling the funds through community finance organisations and credit unions, affordable lending institutions that seek to boost local economies and help alleviate poverty). In this latter option, the CRA has become one of the main tools to support affordable lending and community banking in the USA. Since 1994, money is distributed through the Community Development Finance Institution Fund (CDFI Fund). The CRA also provides the basis to ensure compliance with the Act and to impose penalties if a bank is found to act in contravention to the Act. Furthermore, the CRA limits the scope for mergers and acquisitions between banks, ensuring a continued diversity in local banking. Given the high concentration of banks in the UK, continued branch closures and disappearance of local banks and their brands, an Act that emulates the CRA is badly needed.

cost lenders by a large margin. However, they are woefully underfunded and hence cannot compete at sufficient scale with the commercial lenders. A reinvestment act, combined with a price cap on the cost of credit, would thus present this sector with the opportunity to grow to scale and get the opportunity of breaking the dominance of home credit and payday lenders in the UK.

The second set of obstacles relates again to market theory.

In our model, we assume an increase in lending to high-risk customers and a decrease in lending to low-risk consumers. Theoretically, this would mean that credit prices would be pushed up to the cap that is set on the total cost of credit – something that in economic theory is often referred to as a 'market for lemons'.<sup>65</sup> The information asymmetries mentioned earlier come into play here again. If borrowers who know that they have a higher risk of default are in urgent need of credit (e.g., because of irregular income patterns), they are prepared to pay higher prices. This then drives lenders to assume that someone who is prepared to pay high prices will inevitably default, reducing their incentive to lend to this client in the first place. Where they are forced to do so (as our model proposes), lenders will thus be tempted to lend to all clients, at the same high price, independent of credit risks to even out losses incurred from defaults. Hence, there is the likelihood of a drift towards the maximum ceiling. As a consequence, people less dependent on credit will take out less and less credit, leaving lenders with only high-risk clients – resulting in higher losses and decreased profitability that could eventually lead to the demise of the lender.

However, theory is contradicted here by empirical evidence and the adaptability of business models.

First, despite interest rate caps, there is still a large supply of consumer credit in France and Germany, as well as the USA. Banks compete for the business of low-risk clients on price, not only because it is a less risky business, but also because they tend to take out larger loans, increasing profits even if interest rates are lower.

Secondly, by channelling funds to not-for-profit lenders, these can then develop products that suit the needs of low-income households, especially low instalments and high flexibility (Box 3). In the UK, CDFIs and credit unions offer such products, but because of the lack of political and financial support have yet to realise their full potential.

Whilst these examples do not overcome all the problems associated with a reinvestment act and a cap on the total cost of credit, they do demonstrate that

there is an alternative to the current situation in which many of the most vulnerable people in society have to pay unsustainably high cost for accessing credit.

### **Is credit the solution?**

A market-based solution as set out earlier would be one of the solutions to address the problem of high-cost credit diverting much-needed money away from people's pockets. At the same time, however, we need to ask the question: should we accept that the poorest people are dependent on credit to make ends meet? Do we want to live in a society where contact with a debt collector is seen as important social service to combat the loneliness of elderly, and for which they pay a premium of about 200 per cent?<sup>66</sup> Do we really believe that the best way for poor people to make ends meet is to take out more and more credit, and above all credit for which they frequently don't repay the principal, but only the interest rates?

Not only is it a paradoxical situation where the poorest pay the highest prices for credit, it also seems perverse that in one of the richest countries in the world, incomes do not suffice to lead a decent life. We hence urgently call for an investigation into the cost of living and compare this with the average income of the lowest fifth of UK households. As a recent report by the Joseph Rowntree Foundation already demonstrates, current increase in prices does not match increases in incomes: there is a gap between what people consider necessary to lead an inclusive life and what the typical income of a poor household is in the UK.<sup>67</sup>

At the same time, it is necessary to increase financial literacy to enable people to make better spending decisions, and most importantly, to increase awareness of, and opportunities for saving. The Government's introduction of Child Trust Funds and the planned introduction of the Savings' Gateway (an account for people on lower incomes where every pound saved is matched by 50p from the Government) are steps in the right direction. However, to enable people to save, their reliance on high-cost lenders needs to be broken. The better people understand the high price they are paying compared to people borrowing from CDFIs and credit unions, the more conscious they will become about their choice of lender. Even though people appear to be aware of the high price they pay for home credit, they are not always aware of alternatives – or there may not yet be an affordable lender that serves their area. Every pound that is now being paid in interest to high-cost lenders is a pound that cannot be saved, or spent locally on goods and services, and is thus lost to the household and the local economy. Furthermore, households remain in the debt trap, continuously in need of credit to pay off other credit and to make ends meet. Retaining the current status quo will only reinforce this pattern, increase inequality and entrench poverty.

# Conclusions and recommendations

The current absence of price regulation for consumer credit in the UK has created a situation in which those who can least afford it pay the highest price for credit. Not only is this a gross social injustice, it also creates economic costs as the debt burden reduces the ability of people to save and make financial plans.

Ultimately, as a society, we should strive to reduce the credit burden of people on low incomes as it will help them to budget better on their existing income and build up savings. This means migrating people away from high-cost credit product to more affordable credit. Potential savings could be used to build savings cushions. This will not necessarily reduce the need for credit in an emergency, but it will lower the price they have to pay for it.

Changing the status quo is no doubt a challenge. At the moment, however, Britain seems to be curiously unentrepreneurial in finding a solution to this situation. Under the pretext of not wanting to interfere in a 'competitive' market, sub-prime credit is seen as the only way in which to provide sufficient funds to the poor in order for them to cover the cost of living. Explorations of alternatives, such as the research on not-for-profit lending cited above,<sup>68</sup> do not break with the assumptions that this report has sought to challenge – namely that access to credit is a necessity and restricting it is detrimental to the poor.

As we have sought to demonstrate, existing research is at best inconclusive and at worst misleading. There is an urgent need for stringent research into the risk models of sub-prime consumer lending. Assumptions about high default rates are refuted in practice by the success of CDFIs and credit unions in the UK and the USA that provide affordable credit and keep default rates down.

Introducing an interest rate cap may reduce the availability of credit if there are no flanking measures to improve provision of affordable credit. There is an urgent need to boost social lending, and to increase the number of banked people. As **nef** (the new economics foundation) has long argued, and is still arguing, the current banking system needs to be reformed to allow everyone access to a bank account with direct debit facilities that make collection of payment simpler and more efficient.<sup>69,70</sup> Furthermore, levels of income need to be addressed – have benefits and wages at the bottom of the income ladder increased in step with inflation to a sufficient level to make ends meet? Or is it simply not enough to maintain a minimum income level?

So it is not interest rates caps that are bad for the poor; it is inappropriate credit combined with the inability to make ends meet. It is reckless lending and profiteering, and belief in free markets rather than social credit and budget support that drive people into debt. The financial crisis has demonstrated the banking system is too far removed from the local economy, and that its remote credit-scoring models are unsuitable for a large part of the population which is then relegated to the high-cost market. The Government must use the opportunity it now has to reform the whole of the credit market. The current lack of ambition is a sad reflection on the UK Government's acceptance of the current situation as irrevocable. To challenge this attitude, we recommend the following:

Introduce *a community reinvestment act* that promotes transparency in the financial system. Not only should banks be compelled to disclose their lending patterns, but also sub-prime lenders and affordable lenders. Banks that do not invest sufficiently

in local communities should be forced to sponsor a local affordable lender. High-cost lenders (e.g., doorstep lenders) with a heavy concentration of activity in a geographic area and a large share of the market should have to cede part of their territory to an affordable lender and should be compelled to alert people to alternative, cheaper lenders operating in their area.

Introduce a *cap on the total cost of credit*. The exact level needs to be investigated as there is a need to establish the real risk of default and the cap to be set accordingly. In addition, there needs to be a discussion of where the cut-off point should be: if people have more than 50 per cent risk of defaulting on their loans, is it wise for them to take out loans in the first place?

In any event, there is the possibility of a reduction in affordable credit as some lenders might withdraw from the market. However, together with the introduction of a community reinvestment act, the boost that affordable lending will receive will make up the shortfall generated by any theoretical decline in availability of sub-prime credit.

Most importantly, the Government should seek to *abolish credit dependency*. Independent research should establish the shortfalls in income and boost levels where necessary to maintain an accepted standard of living. Also, it should seek to promote savings programmes and support credit unions and CDFIs across the country to help them break the market dominance of payday and doorstep lenders. Following the findings of the Competition Commission, policy-makers must realise that the sub-prime market has high barriers to entry and therefore needs to be tightly regulated. In addition, there should be an independent investigation into the risk models applied by high-cost lenders. Given that many affordable lenders have low levels of default and write-off, but offer a much cheaper service, it is possible that high-cost lenders overcharge their clients.

Financial literacy programmes and initiatives such as the community banking partnerships that seek to promote financial inclusion through a co-ordinated approach need to be rolled out. Debt and money advice agencies, CDFIs and credit unions are already helping people to better manage their money, and this work needs to be supported.

The *evidence of the impact of interest rate caps* on poor households needs to be revisited. Current research seriously overstates the risk of credit exclusion and is confusing cause and effect. The narrow focus on interest rate caps as the sole explanatory factor for differences in consumer credit markets is insufficient to take into account differences in banking markets, financial inclusion levels, and cultural attitudes towards savings and credit. This does not allow for a balanced assessment of effects of price caps on poor households.



# Appendix 1

As has been suggested throughout this report, we have serious concerns about the evidence on which the arguments against interest rate caps are based.

The consumer survey carried out by Policis on behalf of BIS (the former DTI) serves as the main source for opponents of interest rate caps. As already mentioned in Box 2, there are question marks about the way in which the results of this survey are presented. We will use the opportunity to present a more detailed analysis of our concerns. The examples given are not exhaustive; we limit our focus to some of the most apparent areas of concern.

Empirical social research has a few, very basic tenets that allow researchers to judge on what basis findings were arrived at: by revealing literature and data sources, methodology of surveys, and providing background information on organisations and individuals interviewed. These conventions of social research methods are, for example, stipulated by Becker and Bryman in their book *Social Research Methods*.<sup>71</sup>

Becker and Bryman argue that these factors are important as there 'is a need to contribute to knowledge in a reliable, trustworthy and transparent way'. The authors quote Denscombe, who emphasises the importance of using 'precise and valid data, collected and used in a justifiable way to produce findings from which generalisations can be made'.<sup>72</sup> These factors are paramount in producing research that is transparent and that can be reconstructed and retraced by readers.

The research reports under review here, however, do not fulfil these criteria in a number of important ways.

First, the survey that the two reports and the presentation cite as evidence for the impact on interest rates lacks transparency. One of the biggest difficulties when constructing surveys is to find wordings for questions that do not suggest a particular answer to the respondent. Hence, they should be as neutral as possible.

To show that every effort was undertaken to demonstrate the neutrality of the questions, the questionnaire should be included in the report so that the reader can get an overview of the wording of the questions. Without provision of the questionnaire, transparency is undermined.

Furthermore, to ensure reliability (i.e., that the survey can be repeated to investigate a different group), keywords within questionnaires need to be defined (or 'operationalised' to use the technical term) so that survey respondents understand what is meant by the words and readers can also see the reasoning behind the choice of word. What do the authors mean, for example, by the statement that respondents 'would find it quite difficult to raise £500 a special purchase'?<sup>73</sup> How does 'quite difficult' differ from 'very difficult'? Or was this deliberately left undefined as to obtain the most spontaneous answers possible from the respondents? This is unusual in closed questions (i.e., where the respondent can only choose from a set of given answers), and if used should have been explained in the report.

However, none of the terms used in the questionnaire are operationalised, and hence the reasoning behind the choice of words remains obscure. This impacts again on transparency, but also on reliability – if respondents are free to interpret the meaning of the statement 'quite difficult', do they all mean the same degree of difficulty? These qualitative differences represent a difficult choice for researchers, and it is an important issue which social scientists frequently grapple with.

Given this lack of transparency, it is difficult to assign a sufficient degree of rigor to the survey results and analysis.

Also, the authors of the research report do not provide sufficient information on the choice of the survey sample.

In order for a reader to assess if the sample for the survey was representative, the absolute minimum of information required would be:

- The method of choosing the survey participants.
- The number of individuals that replied to the survey.
- The questionnaire used in the survey.
- Demographic data about the sample, at least gender, occupational status and age, but ideally also information about income levels, home ownership, household size, and number of dependants.
- The time span in which the interviews were conducted.
- The method by which they were conducted (face-to-face, telephone, mail-based).

Of these minimum conditions, only two are fulfilled, one only partially: the authors state that the interviews were done face-to-face, and that the survey is based on the responses of a 'representative sample from 2,717 low income consumers falling into [sic] bottom 20 per cent of household incomes in each territory'.<sup>74</sup> There is no information, however, on what proportion of responses was generated in each of the three countries, and which database was used to select the bottom 20 per cent of household incomes.

All other minimum requirements are not fulfilled. Again, therefore, the survey responses cannot be assumed to represent solid evidence.<sup>75</sup>

Thus, the survey on which these Policis reports are based falls short of these basic tenets of social research. Other shortcomings compound the lack of rigor of the reports. There is no bibliography, and most data remains unsourced. Where they are attributed to a database, website, book, or article, there is not sufficient information in order to locate the source in question. For example, Figure 5 on p. 12 of the 2004 report states that the source of the data is TransUnion and Policis estimates.<sup>76</sup> There is a link to the TransUnion website, but no further information about this organisation or the methodology with which the data is compiled is forthcoming. The authors do not state the assumptions on which their estimates are based. Figure 7 on p.14 in the same report equally falls short of the need for research to be presented in such a way to allow readers to reconstruct the argument. The source for the data used in this graph is given as 'Stephens & Co, John Caskey, Policis estimates' without further information as to the nature of the organisations providing the data or details of how to access this data.

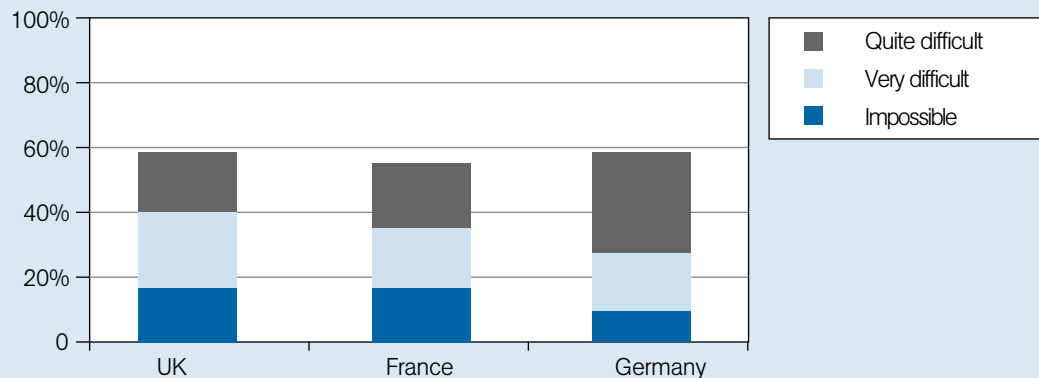
Furthermore, the depiction of data in graphs is misleading and does not adhere to agreed standards, such as providing a legend, and using appropriate scales. Base set numbers on which the graphs and subsequent assumptions are based are not provided. As the figures are often only presented in percentages, the reader cannot put these into context.

There are also analytical problems, partially due to the lack of operationalisation of keywords. For example, the report equates difficulties of making savings or raising cash in an emergency with demand for credit. This again overlooks different possibilities for people to compensate in emergencies without having access to credit. It will be difficult for any household in all three countries to raise the sums suggested (£200–300 for an emergency, and £500 to save for a major purchase) – but this does not mean that the only way to compensate for this lack of cash is through credit. Hire purchase, although more expensive, would be one such way to access goods, as would be charitable donations, borrowing from friends and family, or loans from the state (similar to the social fund in the UK).

Based on this flawed approach, Policis then makes the sweeping assertion that 'demand appears to be constant irrespective of the regulatory or cultural context, with low income households having an irreducible need for credit'.<sup>77</sup>

**Figure A1: Policis presentation of data on ability of low-income households to raise money without resorting to borrowing.<sup>78</sup>**

**Whether could raise £200-300 in emergency without borrowing**



This statement is backed up by analysing response rates. The three answers that apparently were offered to respondents are:

- 1 Impossible to raise £200–£300 in an emergency without borrowing.
- 2 Very difficult to raise £200–£300 in an emergency without borrowing.
- 3 Quite difficult to raise £200–£300 in an emergency without borrowing.

Figure A1 depicts the outcome of the question:

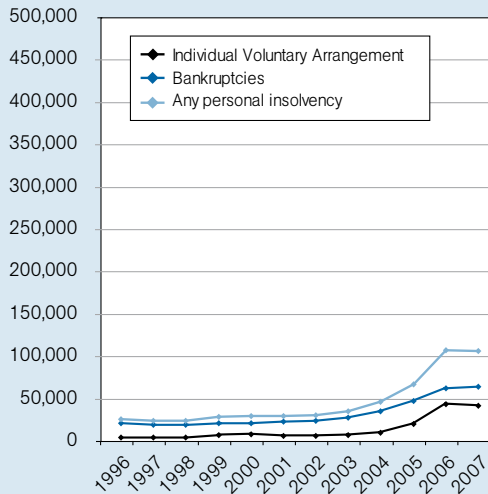
Figure A1 actually contradicts the Policis’s assumption that demand for credit is uniform. Leaving aside that the fact that difficulty of raising funds does not equate to demand for credit, Figure A1 does not reveal a similarity in the need for credit in all three countries. Because of the lack of data provided, it is difficult to ascertain the percentage differences in detail, but it is obvious that respondents in Germany answered far less frequently that it would be ‘impossible’ for them to raise the money, whereas a similar proportion of respondents in France and the UK appear to have chosen this option. Most survey respondents who would find it ‘impossible’ to raise £200–£300 without borrowing live in the UK (closely followed by France), whereas most respondents who would find it only ‘quite difficult’ live in Germany and France. Even on its own terms, this does not equate to a constant demand across all the three countries as Policis states.

Policis then equates those who would feel unable to raise the aforementioned sums with those who believe they would be unable to borrow. Again, this does not add up – not being able to raise money without borrowing does not equate to credit exclusion. Also, the answers appear to be self-assessed – i.e. there is no evidence that the respondents have actually been unable to obtain credit.

Not only does Policis argue that interest rate caps constrain credit, and do nothing to reduce the debt burden of people on low income, but it also seeks to show that over-indebtedness is higher in Germany and France than it is in the UK. This is a rather striking misinterpretation of data, made in the presentation at the Transact Conference in November 2008 in London. The authors of the presentation used estimates on over-indebted households for Germany and the number of personal bankruptcies and individual voluntary arrangements (IVAs) in the UK to compare the levels of over-indebtedness. As we have discussed earlier, comparing the estimated number of over-indebted households with the number of personal insolvencies is inadequate. However, in the presentation, Policis equates the two as being the same.

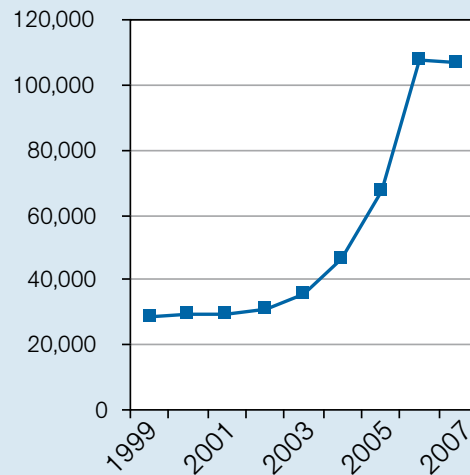
Not only do the authors compare two incomparable indicators, the graph presented by Policis in the 2008<sup>79</sup> presentation represent the data in an inappropriate way. First, the graph does not depict data for the whole of the UK but for England and

**Figure A2: UK over-indebtedness trends – Individual voluntary arrangements and personal bankruptcy**



Source: Policis<sup>80</sup>

**Figure A3: UK Individual voluntary arrangements and personal bankruptcy**



Source: The Insolvency Service (2009) <sup>81</sup>

Wales only. Secondly, as the graph copied from the presentation and displayed here as Figure A2 shows, the scale on the Y-axis is set very high, giving the immediate impression that insolvency is low.

Figure A3 uses the same data, but a more appropriate scale, highlighting the difference in perception.

There are many more examples of methodological and analytical problems to be found in the research reports. Others voiced these at the time the DTI-commissioned research was published; however, the Government has not reacted to these criticisms. We urge the Government to revisit this evidence and compare it with our findings that the discussion around interest rate caps needs to be set within a wider framework of income levels, financial inclusion and credit dependency.

# Endnotes

- 1 Carline B (2008) 'Labour MPs revolt over Brown's plan to charge 27 per cent interest on emergency loans to poor'; *Daily Mail*, 21/12/2008 <http://www.dailymail.co.uk/mailonsunday/article-1099183/Labour-MPs-revolt-Browns-plan-charge-27-emergency-loans-poor.html>
- 2 The figures are hard to estimate. The number of home credit clients is estimated at 2.3 million, but there is no information on the number of people using payday lenders and pawnbrokers.
- 3 Department for Trade and Industry (2003) *Fair, clear and competitive – the consumer credit market in the 21<sup>st</sup> century* (London: DTI).
- 4 BigInvest, for example, is seeking to create alternative credit histories that include bill payment records and similar – see the Alternative Credit Scoring Initiative, <http://www.biginvest.co.uk/partners.html>
- 5 National Consumer Council (2004) *Paying more, getting less* (London: NCC).
- 6 There is little evidence on who exactly is excluded, but there are ca 2.7 million adults without bank accounts in the UK, and ca 3.5 million people with basic bank accounts,- none of which can thus access mainstream credit from banks. <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=145&a=15542>
- 7 This last point may seem slightly contradictory given that the financial crisis was caused by investments in the sub-prime market. However, the deals were packaged in a way that seemingly ensured that risk was spread and hence low.
- 8 People frequently use a variety of lenders to cover their expenses. Some people with access to mainstream credit also use sub-prime credit and use different repayment strategies to retain a clean credit history. See the findings from: Competition Commission (2006) *Home credit market investigation* (London: Competition Commission).
- 9 Recently, one example was of a lender charging 2.6 million per cent APR. Joseph Rowntree Housing Trust Resident's Magazine (2009) *Trust News*, p.11 (York: JRHT).
- 10 Competition Commission (2006) *op. cit.* p.6
- 11 Debt on our Doorstep (2008) *Payday lending in the UK: Background Note* (London: DOOD).
- 12 Ibid.
- 13 Calculations made using the provident financial loan calculator on 23 October 2009 <http://www.providentpersonalcredit.com/products/LoanCalculator.aspx?&red=1> Prices for the loans have increased over the past 6 months.
- 14 Competition Commission (2006) *op. cit.* p.9.
- 15 Policis (2004) *The effect of interest rate controls in other countries* (London: DTI).
- 16 Policis/Personal Finance Research Centre (2006) *Illegal Lending in the UK* (London: DTI).
- 17 Policis (2008) *Interest rate ceilings and responsible lending – an international perspective* (London: Policis). Available at [http://www.transact.org.uk/core/core\\_picker/download.asp?id=554](http://www.transact.org.uk/core/core_picker/download.asp?id=554)
- 18 We are deliberately not taking into consideration theoretical econometric models as they usually make assumptions that are unrealistic in real life – e.g., Paxson C (1990) Borrowing constrains and portfolio choice. *Quarterly Journal of Economics*, **105**: 535-543. The author assumes that 1) lenders have full information about each borrower's income distribution and asset holdings, and 2) lenders are perfectly competitive. Both these conditions cannot be observed in the market place.
- 19 Policis (2004) *op. cit.*
- 20 Becker S and Bryman A (eds) (2004) *Understanding research for social policy and practice: themes, methods and approaches* (Bristol: Policy Press)
- 21 Policis (2004) *op. cit.*
- 22 European Central Bank (2008) EU Banking Structures, Table 5, p. 40 (Frankfurt: ECB).
- 23 Sanio, W, Decker E (no date): Study on financial services provision and prevention of financial exclusion – Germany, Country Report Stage 1 p.13; Study prepared for the financial inclusion observatory. Available at <http://www.ecosocdoc.be/static/module/bibliographyDocument/document/001/363.pdf>
- 24 Banque de France (2009): *Les seuils d'usure* (Paris: Banque de France). Available at: [http://www.banque-france.fr/fr/poli\\_mone/taux/credit/usure.htm](http://www.banque-france.fr/fr/poli_mone/taux/credit/usure.htm)
- 25 This limitation of the existence of 'real credit cards' may change in Germany in the near future. Parliament in Germany is currently debating the introduction of this form of credit card where debt can be paid of over several months. It is likely that there will be a time limit after which the credit has to be repaid, but it is not set yet. It is also not clear if this law will be implemented before the upcoming elections in September 2009 which is likely to see a change in Government.
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- 27 Office of Fair Trading (2008) *Consumer credit licensing – General guidance for licensees and applicants on fitness and requirements* (London: OFT).
- 28 HM Treasury (2009) *Progress towards the shared goal on access to bank accounts* (London: HM Treasury). Available at [http://www.hm-treasury.gov.uk/financial\\_inclusion\\_bankaccounts.htm](http://www.hm-treasury.gov.uk/financial_inclusion_bankaccounts.htm)  
We have strong reservations about the counting method, but have no choice to accept these estimates as the best available.
- 29 Sanio W and Decker E (no date) *Study on financial services provision and prevention of financial exclusion – Germany – Country report stage 1*. Available at <http://www.ecosocdoc.be/static/module/bibliographyDocument/document/001/363.pdf>
- 30 Financial Inclusion Observatory (2009): *Level of access to bank accounts from people who want it*. Available at <http://www.fininc.eu/countryreport,en,53,95,5,1.html>
- 31 British Banking Association (2008) *Basic bank accounts and financial inclusion – final quarter 2008* (London: BBA). Available at <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=145&a=15542>
- 32 Zentraler Kreditausschuss (2008): *Hohe Akzeptanz der ZKA-Empfehlung zum Giro-Konto fuer jedermann*. Available at [http://www.zka-online.de/zka/pressemitteilungen/volltext/backpid/0/article/hohe-akzeptanz-der-zka-empfehlung-zum-girokonto-fuer-jedermann.html?tx\\_ttnews\[arc\]=1&tx\\_ttnews\[pL\]=1262300399&tx\\_ttnews\[pS\]=1230764400&cHash=f7a3d70b04](http://www.zka-online.de/zka/pressemitteilungen/volltext/backpid/0/article/hohe-akzeptanz-der-zka-empfehlung-zum-girokonto-fuer-jedermann.html?tx_ttnews[arc]=1&tx_ttnews[pL]=1262300399&tx_ttnews[pS]=1230764400&cHash=f7a3d70b04), accessed on the 23<sup>rd</sup> of October 2009
- 33 Banque de France (2009) *Fichier central de chèques (FCC), Composition en fin d'année* (Paris: Banque de France).
- 34 We reject the definition of the Financial Inclusion Taskforce that includes savings accounts as 'being banked'. A savings account does not allow for the full participation in financial services and does not allow customers to realise savings associated with a transactional account.

- 35 Email correspondence with Fédération des Caisse d'Épargne, the French Savings Banks Association. This does not apply to people with the status 'interdit bancaire', i.e., those with a basic bank account.
- 36 Zentraler Kreditausschuss (2009) *ZKA Empfehlung – Empfehlung des Zentralen Kreditausschusses zum Girokonto für jedermann*. (Berlin: ZKA) Available at <http://www.zka-online.de/zka/zahlungsverkehr/girokonto-fuer-jedermann/zka-empfehlung.html>
- 37 Policis (2008) *op. cit.*
- 38 Athling Management (2008) *Pour un développement responsable du crédit renouvelable en France. Rapport réalisé par Athling Management pour le Comité Consultatif du Secteur Financier (CCSF), table page 12* (Paris: Banque de France).
- 39 Banque de France (2009) *Typologie des situations de surendettement, Bulletin de la Banque de France • N° 175 • 1er trimestre 2009* (Paris: Banque de France).
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- 43 Eurostat (2009b) *Inequality of income distribution, Income quintile share ratio* (Luxembourg: Eurostat).
- 44 I am grateful to the following people for their assessment and advice:  
In Germany: Michael Knobloch, Institut fuer Finanzdienstleistungen e.V., Nina Haut, Debt Advisor, Mainz.  
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- 45 Reifner U and Knobloch M (2009) *The German Credit Market: How it deals with usury and the credit needs of low income households*. Expert Opinion for DOOD (Debt on our Doorstep). Submission for the Office of Fair Trading High Cost Credit Review, September 2009
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- 47 Policis suggests in its 2005 report that there are no pawnbrokers in Germany. There are, however, municipal institutions across Germany, similar to those in France. These pawnbrokers are not-for-profit and state-run, thereby guaranteeing a safe option for those who do not have access to other forms of credit anymore.
- 48 Competition Commission (2006) *op. cit.* p.2–17.
- 49 Competition Commission (2006) *op. cit.* p.4–16.
- 50 We leave out pawn-broking for the moment as the sector is relatively small and presumes that people still have assets.
- 51 Policis/Personal Finance Research Centre (2006) *op. cit.*
- 52 Policis (2004) *op. cit.*
- 53 Morgan D (2007) *Defining and detecting predatory lending*; Federal Reserve Bank of New York Staff Reports. (New York: FRBNY).
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- 55 King U, Parrish L and Tank O (2006) *Financial quicksand: Payday lending sinks borrowers in debt with \$4.2 billion in predatory fees every year* (Durham: Center for Responsible Lending).
- 56 See U King 2006 and 2007, *op cit*
- 57 Data obtained by the Center for Responsible Lending via data provided via correspondence with Mark Pearce, Deputy Commissioner, North Carolina Office of the Commissioner of Banks, available on file.
- 58 Kempson E *et al.* (2009): *Is a not-for-profit home credit business feasible?* (York: Joseph Rowntree Foundation).
- 59 We are very grateful to Damon Gibbons from Inclusion for providing us with his idea and for discussing and adjusting it.
- 60 Banks nevertheless profit from the high-price lending in the sub-prime market, either through investing in the sub-prime companies, or through subsidiary companies that clients would not immediately linked to the high street brand. Charges in this latter instance are still much lower (e.g., the Barclays Initial credit card that charges around 28 per cent APR).
- 61 In fact, the market for home credit is heavily concentrated, with Provident Financial holding around 60 per cent of the market. With the recent demise of London Scottish Bank Plc the home credit market has lost another competitor. Another player, Cattles PLC, is in serious financial turmoil and may also cease trading.
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- 65 Akerlof G (1970) *The market for 'lemons': Quality uncertainty and market mechanism*. The Quarterly Journal of Economics **48**: 488–500.
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- 68 Kempson *et al* (2009) *op. cit.*
- 69 Thiel V (2008) *Keeping Britain posted*, (London: **nef**).
- 70 Spratt S *et al* (2009) *I.O.U.K.: Banking failure and how to build a fit financial sector* (London: **nef**).
- 71 Becker and Bryman (2004) *op. cit.*
- 72 *Ibid.* p. 17–18.
- 73 Policis (2004) *op. cit.* p. 9.
- 74 *Ibid.* p.5.
- 75 This and similar concerns were also aired at the time (2004) by the IFF in Germany. Their response to the Policis research can be found here: <http://www.money-advice.net/media.php?id=1633>
- 76 Policis (2004) *op. cit.*
- 77 Policis (2004) *op cit* p.9
- 78 *Policis (2004) op. cit. p.10*
- 79 Policis (2008) *op. cit.*
- 80 *Ibid.*
- 81 The Insolvency Service (2009) *Policy Directorate Statistics* (London: The Insolvency Service), available at: <http://www.insolvency.gov.uk/otherinformation/statistics/insolv.htm>



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