The case for capping the cost of credit

End the Debt Trap Campaign briefing

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The End the Debt Trap coalition is a group of six organisations: Centre for Responsible Credit; Fair By Design; Jubilee Debt Campaign; New Economics Foundation; Research For Action; Toynbee Hall. Our goal is to tackle the build-up of unjust and unfair household debt in the UK economy and to prevent it from accumulating again.

Executive summary

Approximately **eight million people are caught in a debt trap**[1]: paying out an average of a quarter of their incomes each month to their lenders.

This high level of repayments, which will typically need to be maintained for a period of about five years, is unsustainable[2]. It is placing household budgets under extreme pressure and inevitably leads to more borrowing to pay off previous debt, and often simply to make ends meet[3].

The debt trap is not the fault of a few 'rotten apples' – lenders operating at the margins of regulation. It results from a system of 'risk-based pricing'[4]. This incentivises lenders to target people *who they know will struggle to repay with high cost credit*. The high cost of credit covers the high default rates. It is profitable, and even more so when lenders structure their products in ways which levy high default fees or encourage continual refinancing.

The total cost cap imposed on payday loans shows the way forward. The cap, which was introduced in 2015, has been highly successful. It covers all interest, fees and charges, and prevents these from ever amounting to more than the amount originally borrowed. Although the cap is, in our view, still too high and lenders are still incentivised to target people who will struggle to repay, its introduction has cut the cost of loans by one-third and has led to more responsible lending.

But payday lending constitutes a tiny fraction of the overall consumer credit market. Action is now needed to help the many millions of credit card and overdraft borrowers which the FCA has identified as paying back more than £2 for every £1 they borrow. We also need to ensure that other high cost credit including catalogues, door-to-door moneylenders, and rent-to-own stores are covered by the total cost cap. People use these products in combination and it makes no sense for total costs to be capped for some but not for others.

Extending the total cost cap across the consumer credit market would significantly boost household disposable incomes. We estimate that this would result in savings for households of at least £6 billion per year. These savings would enable people to build up their financial resilience against future income and expenditure shocks, and, because many indebted households are geographically concentrated, also provide a boost to economies in deprived areas.

A cap is also better than other possible measures that could be taken to address irresponsible lending. FCA rules, such as those concerning persistent credit card debt, and those requiring lenders to conduct 'affordability assessments', provide far too much discretion for lenders and don't address the underlying incentive for them to 'game the system'. They are also costly to enforce: requiring intense supervision of firms. Even if better written, there isn't any guarantee the FCA will get their enforcement right. For example, the FCA was too lenient when establishing a 'redress scheme' for Wonga's borrowers in October 2014[5].

It's time for politicians from all parties to act. The debt trap is a product of the risk-based pricing system and capping the total cost of all types of consumer credit is the best way to tackle it.

Introduction

Consumer credit is intended to help people spread the cost of living, and generates demand for goods and services, encouraging economic growth. But today, Britain's consumer credit system is failing far too many people and jeopardising our economy. This briefing explains why it is time to introduce a cap on the total cost of all consumer credit, as we did with payday loans.

The briefing has been produced by the End the Debt Trap Coalition. We are a group of six organisations: Centre for Responsible Credit; Fair by Design; Jubilee Debt Campaign; New Economics Foundation; Research for Action; and Toynbee Hall. We have come together in response to the growing household debt crisis in the UK. Our overall goal is to tackle the build-up of unjust and unfair household debt in the UK economy and to prevent it from accumulating again in future.

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What's the problem?

Personal debt is sky-rocketing, just as it did prior to the 2008 crash and subsequent economic crisis. Although most of the £1.3 trillion of personal debt in the UK is comprised of mortgages, there has been an alarming increase in the amount of consumer credit debt held by households in recent years. This now stands above £200 billion, and the interest payments on this amount to at least £20 billion per year.

Approximately eight million people are currently paying out more than one quarter of their income in repayments to their consumer credit lenders[6]. Even though they are making such a high level of repayments, the size of their debt is such that it will take them, on average, over five years to become debt-free.

This is clearly unsustainable. Being required to pay out such a high proportion of income for such a long time is placing budgets under extreme pressure and making it virtually inevitable that people will need to borrow again before their debts are cleared. These borrowers are caught in a debt trap: forced to take on more and more loans to pay off previous borrowing and simply to make ends meet.

This isn't the fault of a few 'rotten apples': a few unscrupulous lenders operating at the margins of regulation. It is the result of a system of 'risk-based pricing' which, unless it is constrained by a cap on the total cost of credit, will continually encourage lenders to act irresponsibly.

Without any cap on the total costs that they can charge, lenders use credit reference and other data to identify people who they know will struggle to repay. They do so in the knowledge that the high cost of credit paid by those who keep to the terms of the agreements, or repay at least partially, will cover the overall cost of those who default and still deliver a profit.

Without a cap on the total costs that they can charge, lenders are also incentivised to structure products in ways which take advantage of people who will struggle with repayments: for example, by charging very high default fees; or by encouraging people to refinance or 'roll over' debts which allows them to compound interest.

The human, social and economic costs of this system are huge. For individuals whose income is flowing to high-cost credit lenders, the debt trap means increased stress, worry and mental health problems[7]. It can also contribute to relationship breakdown[8], and makes it more difficult for people to obtain and sustain employment[9]. For communities where these borrowers are concentrated, reduced spending power means money is being sucked out of local businesses and high streets[10]. At the national level, debt repayments hold back economic growth by reducing aggregate consumption[11].

The total cost cap on payday loans

The danger of irresponsible, high-cost lending was recognised by Parliament in 2013, when it forced the Financial Conduct Authority to impose a cap on the total cost of credit that payday lenders can charge. That total cost cap came into force in January 2015. It ensures that people will never pay back more than twice the amount they have borrowed. This includes all interest, fees and charges – including when people cannot repay.

The total cost cap on payday loans has been highly successful. The Financial Conduct Authority itself has noted that the cost of a typical payday loan has been cut by nearly one-third (from over £100 to around £60), saving 760,000 people a total of £150 million per year.

Importantly, the Financial Conduct Authority's impact assessment also highlighted that the total cost cap has reduced the incentive for lenders to target people in financial difficulty, with "default rates on payday loans in 2016 around one-third of what they were in 2014". As the Financial Conduct Authority puts it[12]:

> *"This significant fall [in default rates] indicates that firms are increasingly lending to individuals able to repay the loan. This is in marked difference to the situation before to the price cap where firms were generating around half of their revenues from charges for late payment and default."*

And the payday cap also forced lenders to restructure their products. Prior to the cap, payday lenders offered very short-term loans, typically repayable in full within one month. This was designed to make it difficult for people to repay on time, and a large part of payday lender revenues was formed of default charges. But following the cap there was no incentive for lenders to structure products in this way: default charges were included in the total cost cap. As a result, most lenders have now introduced products which provide people with between three and six months to repay their loans.

Why the payday lending cap should be extended

Payday loans constitute a tiny fraction of Britain's overall consumer credit debt. The total amount of outstanding payday loan debt in 2016 was around £1.72 billion, but the overall level of consumer credit debt is around £200 billion[13]. Risk-based pricing operates throughout this wider consumer credit market, incentivising all types of lenders to act irresponsibly and target those who will struggle to repay with exploitative products.

Although the total cost of payday loans is capped, people can easily end up paying more than the twice the amount they borrowed on their credit cards and overdrafts. According to the Financial Conduct Authority:

- Four million people are in 'persistent' credit card debt[14]: paying more in interest fees and charges than they have paid off the principal (the amount originally borrowed) over an 18-month period. These are typically being charged £2.50 for every £1 that they borrow[15]; and
- Nearly seven and a half million people use *both* arranged and unarranged overdraft borrowing each year. Unarranged overdraft borrowing alone typically attracts costs of £2.50 for every £1 borrowed[16], so the total cost for people using both arranged and unarranged borrowing will be significantly higher.

Other forms of high-cost lending such as catalogues, store cards, door-to-door lending and rent-to-own also specifically target people who are struggling with money *and overlap with* credit cards and overdrafts to create a debt trap. For example, the Financial Conduct Authority reports that the typical payday loan borrower owes a total of £3,600. However, payday loans themselves make up only one tenth of this amount. Most of the debt is made up of personal loans, credit cards and car loans (averaging £800 each); borrowing on overdrafts (£360) and from other types of high cost lenders, including catalogue companies (£220).

Placing a total cost cap on just one of the elements of peoples' overall borrowing makes no sense. It allows lenders outside the cap to continue to trap people in long-term debt. This is true even for credit card lenders, despite the introduction of new rules designed to help people in persistent credit card debt in September this year (see box, below).

The cost of sub-prime credit cards

The Financial Conduct Authority's new rules for credit card lenders require that these identify people who have paid more in interest and fees than they have paid towards their principal borrowing after 18 months. At that stage, lenders need to write to these borrowers and that encourage them to pay more each month.

However, if someone is still in the position of having paid more in interest and fees than they have repaid on their balance after 36 months, then the lender needs to put in place a repayment plan to clear the debt within a 'reasonable period'. The Financial Conduct Authority defines a 'reasonable period' as between a further three to four years.

In reality, this doesn't stop sub-prime credit card lenders from charging more than payday lenders. For example, carrying a balance of £2,000 on an Aqua sub-prime credit card can attract an interest rate of up to 3.992% per month. If only minimum payments are made, the card accrues interest of about £2,000 over 36 months. At that point, the customer would have made payments totalling about £3,000 but only reduced the outstanding balance by about £1000. There would still be a debt of around £1,000 remaining.

The Financial Conduct Authority's rules provide for this to be paid back over a *further* three to four years. If any interest is charged during this time, then the borrower will be paying more than double the amount of the principal in interest charges. Because the Financial Conduct Authority's rules *do not require* interest to be frozen after 36 months, lenders are unlikely to do so, although they may reduce the interest rate being charged and/or put up the level of minimum payments required from the borrower to ensure the debt is repaid within the Financial Conduct Authority's recommended timeframe.

Why a total cost cap is the single most effective measure that can be taken

Expanding the total cost cap across the consumer credit market is the single most effective measure that can be taken to alleviate the debt burden on households and control the level of risk that lenders are taking.

Although it is difficult to be certain at this stage about the total savings that could be delivered to households by extending the payday lending cap, we estimate that around four million people in persistent credit card debt would save between £1,000 and £2,000 each. Some 7.5 million people who are currently using their overdrafts on a repeated and/or unarranged basis would typically save between £300 and £500. Some people will fall into both categories. The total savings resulting from a cap in these sectors alone are therefore likely to be between £6 billion and £12 billion.

Applying a total cost cap across the entire consumer credit market would particularly benefit lower income households. For example, 40 percent of all catalogue customers (3 million people) also have outstanding credit card debts but have average incomes of only £17,700 per year. A total cost cap which delivered a saving of £1,000 for these households would be equivalent to a pay rise of over five percent.

Capping the cost of credit paid by households would help them become more financially resilient by providing them with the opportunity to build up savings, but it could also boost economic growth. This is particularly likely in those areas where high cost lending is concentrated. For example, the Financial

Conduct Authority has noted that[17] "...on average, consumers in more deprived areas pay twice as much in charges for unarranged overdrafts than consumers living in less deprived areas".

Finally, capping the cost of credit has significant advantages over other, possible measures, intended to tackle Britain's debt trap.

Rules such as those introduced by the Financial Conduct Authority to address the problem of persistent credit card debt are extremely costly to enforce. To assess whether credit card lenders are complying with the rules requires intense supervision of each individual firm. This is also the case in respect of the FCA's more general requirements that all consumer credit lenders should conduct effective 'creditworthiness' assessments, including by undertaking 'appropriate' assessments of affordability prior to granting credit.

As well as being costly to supervise, these rules provide lenders with far too much discretion. For example, lenders are required to ensure that people taking out credit can afford to pay for their borrowing and maintain a 'basic quality of life'. This term is not defined, and the system of risk-based pricing incentivises lenders to 'game the rules' and interpret this in ways which suit their business models rather than the needs of households.

Even if the rules were better written, the Financial Conduct Authority does not always get the enforcement of its own rules right. The recent collapse of payday lender Wonga indicates that the Financial Conduct Authority was far too lenient when establishing a 'redress scheme' for borrowers in October 2014. That scheme was intended to provide redress for people who Wonga lent money to without properly assessing whether they could afford to repay. However, only 360,000 people received help from the scheme, and the level of compensation was unduly restricted[18]. As a result, many went on to apply for help from the Financial Ombudsman Scheme and the weight of these claims has since forced Wonga into administration.

Extending the total cost cap across the consumer credit market would therefore likely reduce the supervision and enforcement costs for both the Financial Conduct Authority itself and for other agencies including the Financial Ombudsman Service. It would also result in a reduction in the number of people becoming over-indebted and requiring help from our already over-stretched debt advice agencies. As debt advice is partly funded by a levy on the financial sector, there should also be a reduction in ongoing costs for lenders arising from the more responsible behaviours that a cap would force them to adopt.

Conclusions

Without a cap on the total cost of credit, lenders remain incentivised to target people who are likely to struggle to repay. This is creating misery for millions of people who have now become caught in a debt trap: borrowing more to repay earlier loans and simply to make ends meet. It is also resulting in huge social and economic costs.

The total cost cap on the payday lending sector has worked well: not only by reducing the cost that people pay, but by reducing the level of risk that lenders can take and by forcing them to restructure products in ways which better suit the needs of borrowers.

However, payday lending constitutes a tiny fraction of the consumer credit market. And people use multiple sources of credit. It makes no sense for one form of credit to be subject to a total cost cap, and for other forms which are used alongside this to remain outside of that cap.

A total cost cap is the single most effective measure that we can take to boost household disposable incomes and would result in savings for households of at least £6 billion per year. These savings would enable people to build up their financial resilience against future income and expenditure shocks, and because many indebted households are geographically concentrated also provide a boost to local economic growth in deprived areas.

A total cost cap is also much more effective and cheaper to implement and enforce than other possible alternatives. High prices in consumer credit markets arise due to the nature of the risk-based pricing system. They are not the result of failed competition, and remedies which may be more appropriate to price-capping in other markets (such as encouraging consumers to switch providers) are not effective.

Other regulatory measures are also failing. The recent Financial Conduct Authority rules intended to address persistent credit card debt do not address the high costs of sub-prime credit card lending and require intense supervision of firms. Its rules concerning creditworthiness and affordability assessments are also costly to enforce and do not address the incentive for lenders to 'game the system'.

It is now time for politicians to intervene, and act to End the Debt Trap by extending a total cost of credit cap across the consumer credit market. We call on politicians of all parties to come together and place the Financial Conduct Authority under a statutory duty to impose a cap within the next 12 months.

Endnotes

1 These borrowers are paying out more than a quarter of their income in debt repayments and will need to do for an average of five years before they can become 'debt-free'. This is unsustainable because high repayments over extended periods place budgets under ongoing pressure making it inevitable that they will need to refinance or borrow from additional sources simply to make ends meet. Analysis of the Bank of England's Household Debt Survey 2017 by the Centre for Responsible Credit.

2 Centre for Responsible Credit analysis of Bank of England NMG survey of household finances

3 For example, the debt advice charity StepChange has estimated that nearly four million people on lower incomes resorted to using high cost credit to meet day to day living costs last year.

4 Risk-based pricing in the credit market refers to the offering of different interest rates and loan terms to different consumers based on their financial circumstances and past credit behaviours. This typically involves an assessment of the consumer's credit score, adverse credit history (if any), employment status and income. People who have struggled to make payments on time in the past and/or who have low incomes are therefore charged higher prices than those in better financial situations.

5 For further details see https://www.responsible-credit.org.uk/wonga-collapse-cfrc-calls-for-treasury-committee-to-launch-an-inquiry/

6 Analysis of the Bank of England's Household Debt Survey 2017 by the Centre for Responsible Credit.

7 Fitch, C., Hamilton, S., Basset, P., & Davey, R. (2010). *Debt and Mental Health: What do we know? What should we do?*. London, Royal College of Psychiatrists.

8 Bradley, A., & Banks, D. (2017). 'In too deep: an investigation into debt and relationships'. London, Relate.

9 Gibbons, D. (2010). 'Out of money and out of work'. Manchester City Council.

10 Many studies have confirmed the geographical concentration of high cost borrowing and the impacts of this. These include research conducted by the University of Salford for Leeds City Council.

11 High levels of household debt have been confirmed by the Bank of England as a factor in explaining a fall in consumption spending following the 2008 financial crisis. See chapter four in 'Household debt: statistics and impact on the economy'. House of Commons Briefing Paper, Number 7584, May 2018.

12 Para 2.26, 'High cost credit: including review of the high-cost short term credit price cap'. Feedback Statement 17/2. Financial Conduct Authority, July 2017.

13 'Making ends meet: are households living beyond their means?', Office for National Statistics, July 2018.

14 'Credit card market study: persistent debt and earlier intervention – feedback to CP 17/43 and final rules', Financial Conduct Authority, February 2018

15 'New credit card rules introduced by the FCA', Press Release, 27th February 2018, available at https://www.fca.org.uk/news/press-releases/new-credit-card-rules-introduced-fca

16 'High-cost Credit Review: overdrafts', Financial Conduct Authority Consultation Paper 18/13, May 2018.

17 'High-cost Credit Review: overdrafts', Financial Conduct Authority Consultation Paper 18/13, May 2018.

18 For further details see https://www.responsible-credit.org.uk/wonga-collapse-cfrc-calls-for-treasury-committee-to-launch-an-inquiry/

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