THE Joseph Rowntree REFORM TRUST LTD

Could you imagine an ethical Wonga?

Alternatives to payday lending

David Boyle

New Weather Institute

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Foreword

The months I spent on the Commission for Banking Standards convinced me that more debate is needed, and much more widely in society, about how the banking needs of poorer families are going to be met in the future.

This report is intended to be a contribution to this debate, and especially about the question of whether it might be possible to organise short-term credit on an ethical basis in the UK, and how in practice that might work.

This is a discussion document, to aid what I hope will be a much wider debate. It was begun in my office, before I became a government minister, and I am enormously grateful – both to David Boyle for the work he has done and to the Joseph Rowntree Reform Trust Ltd for making it possible, through their support under their Liberal Voices project.

Whatever the future of payday lending in the UK, and my views are well-known on that subject, it is not yet clear what kind of institutions we need to develop which can provide people with the credit they need – at the same time as setting them free from the need for continuous credit.

I hope this paper will help steer a debate which is important and urgent.

Baroness Kramer
House of Lords

Introduction

In July 2013, Archbishop Justin Welby promised that he would "compete Wonga out of existence".[1]

He was articulating a hope shared by many in the world of credit unions, community finance, social enterprise and politics. But this time, it was an ambition coming from an institution large and powerful enough, and with a prominent enough brand, to offer a serious challenge.

This promise was greeted with some cynicism but mainly with excitement. It was not just the tone of voice; it was also an ambitious objective with a broad agenda for achieving it. The Archbishop vowed to create the institutions that could take on the activities of the payday lenders – the high cost, short term loan providers – and beat them by charging less.

This led to another public argument about the sums that the new church lenders would have to charge, which were less than 20 per cent of some of the interest rates charged by the main payday loan companies, but still considered to be usurious by some commentators.

Welby was responding to the core problem of payday lenders, the huge sums they charge and the resulting destruction of the financial stability of the poorest. He was also recognising that closing them down would threaten to drive high cost lending into the hands of the underworld, yet – as things stand – the legal trade is also highly damaging to people and communities.

There is a widespread belief among policy-makers that payday lending ought to be – as Bill Clinton once said of abortion –

legal, safe and rare. This approach has been captured in legislation in 2012 and 2013, giving the regulator, the Financial Conduct Authority, the power to clamp down on interest rates, fees and rollovers – and an instruction to do so from April 2014.

But is clamping down sufficient? Certainly in the USA and Australia, similar measures have tamed the worst excesses of the industry. But does that eliminate the rationale for Archbishop Welby's ambition? Or, in practice, might we create an alternative to short-term, high-cost credit so that a better alternative, which offers better outcomes, can be put in its place?

This is a report about payday lending. Not so much about the economic and social impact, which is covered elsewhere, but about the practicalities – not just of regulating the industry – but of competing it out of existence.

It is based on a series of interviews with social entrepreneurs and others who have been wrestling with this issue, and in particular how you might create a social enterprise that could crowdfund an alternative to conventional payday lending, which at least might be less damaging – and, at best, might set out to improve people's lives and get them out of debt.

Section 1: The problem

Usury has a long history. Most of the world's great religions condemn it on the grounds that it is unnatural to make money out of money. The Reformation reformed, among other things, the Christian approach to charging interest, allowing reasonable interest to be paid. The Islamic banks still maintain the traditional refusal to countenance interest, charging fees for loans instead.

The pawnbroking industry virtually disappeared in the UK after the Second World War, and its place was taken in some neighbourhoods by a less than respectable doorstep lending style, charging interest of anything up to 5,000 per cent APR. The 1990s saw the emergence of a respectable high-cost loan industry, led in the UK by HSBC – which bought into the American payday loan market – aware that there was a gap in the market. Now the loans charged by the respectable end of the market are back up to 5,000 per cent again, and there have been reports of higher.[2]

The problem about the payday loan market is that there is that it is so lucrative. People need loans to tide them over, particularly when their credit record would rule out a conventional bank loan or credit card. The credit union sector operates in this market, just as the building societies traditionally did, linking loans to a successful saving record. But this did not plug the gap.

In recent years, during the recession – and supported by successful television advertising campaigns – the payday market has grown. According to a recent survey, about a million UK households take out a payday loan each month, often just to make ends meet:38 per cent of loans are used to pay for food or fuel, and 24 per cent are used to repay existing payday loans.[3]

That is why the market has grown so much during the recent downturn. There are no official statistics on the payday sector in the UK but it seems to have grown significantly since 2008, when it was estimated to be worth around £900 million. The following year, Consumer Focus estimated the total value of loans at £1.2 billion.[4] More recently, estimates have suggested it is in the range £1.7 to £1.9 billion, with about 240 companies involved.[5]

The Office of Fair Trading (OFT) reported that they were worried about:[6]

- The adequacy of the checks made by lenders on whether loans will be affordable for borrowers.
- The proportion of loans that are not repaid on time.
- The frequency with which loans are rolled over or refinanced and the circumstances in which this occurs.
- The lack of forbearance shown by some lenders when borrowers get into financial difficulty.
- Some aggressive debt collection practices.

The OFT was told by payday lender staff that rollovers were regarded as key 'profit drivers' and that staff were encouraged to promote them. "In extreme cases, our inspectors found examples of customers having 12 or more consecutive rollovers," they wrote.

The survey by *Which?* found that half their borrowers are unable to repay their payday loans and that 70 per cent regret taking out the loans.[7] This was confirmed in a poll from ComRes which showed that 48 per cent believed the loans had made their financial position worse.[8]

Effects on social exclusion

This amounts to a serious social problem, and the OFT study found dramatic confirmation that growing the market was happening at the expense of the customers. They found that nearly a third of loans are repaid late or not at all, and almost half the sector's revenue comes from loans that are rolled over at least once.

From the point of view of the households they target, involvement with payday loan companies in these circumstances may be disastrous, and will often be corrosive. One study suggests that any household would be extremely unwise to go further into debt than 45 per cent of household annual income and that a major factor in allowing this to happen was making loans too easy to take out.[9] Yet the advertising campaigns seem to be detoxifying the idea.

Martin Lewis, founder of Moneysavingexpert, told MPs that one in three people with children under 10 years old say their children can already repeat payday advertising slogans – and nearly 15 per cent claim their children urge them to get a payday loan when they refuse to buy them something. The rules on payday loan advertising risked "inuring a new generation to the dangers of these loans of last resort", he said.[10]

Effects on local economies

The profits of the top ten payday loan companies in the UK were about £194million, according to the Bureau of Investigative Journalism.[11] It is not clear how much the profits of the other 230 or so payday loan companies are, but the same report suggests that the turnover of the top ten is about 55 per cent of the total, which suggests that about £400 million a year is being extracted from the some of the poorest areas of the nation.

This will be an under-estimate because it excludes the money extracted to cover basic costs.

This is a serious problem, given that the way that money stays circulating in the most impoverished areas, from local business to local business, is a vital element in their economic resilience.[12] If there is an economic vacuum cleaner on the high street, it means that what enterprises survive locally will be that much less viable, and the neighbourhood that much more dependent on benefits and grants.

The loan companies point to the amount of money they are funnelling into the poorest economies. But more research is needed about the long-term impact on the poorest local economies when the borrowers are expected to pay back the loan, but find the equivalent of 5,000 per cent annual interest as well.

The central conundrum is that payday loan companies are designed to help people through what are intended to be unusual and temporary periods of financial difficulty. Long-term and repeated use of payday loans is seriously expensive.

Yet the business plans of most payday loan companies envisage growth. Their business purpose, and the purpose of their investors, is to maximise their profits – and this is bound to be at the expense of some of the poorest families and the most vulnerable places.

Section 3: Practical solutions

If the main consequences of this style of credit is for vulnerable families and local economies, the reason for this is in the structure of the payday loan companies, and their narrow focus on profits. Ethical considerations demand that there should be some limit to the money they can extract from their customers, when they are vulnerable and desperate, but – if the credit operation is required to expand – it is not clear how restraints are applied, except through regulation.

Payday lenders have no incentive to reduce their profits, or to reduce their market, when the overwhelming need for society as a whole is to reduce the need for them. There are no built-in incentives for the lenders to encourage people to save or be careful with money – quite the reverse – and no duty of care over their clients.

Regulation can certainly help and the proposals from the Financial Conduct Authority may move towards this.[13] So will the government's proposed cap on what lenders can extract from clients. But the central conundrum is that the structure and purpose of the payday lenders sets them at odds with the real needs of their clients.

The following are options to tackle the consequences of this mismatch:

Abolition

It is generally agreed that abolishing payday lenders will drive payday lending underground without actually tackling the basic problem.

Regulation

The FCA has proposed a series of regulations (see above). The Treasury's intervention, proposing a cap on total charges, is also important. The difficulty here is that payday lenders are potentially able to interpret roll-overs in any way they choose, often failing to count the first default. There is also nothing in practice to stop clients taking out more than one loan almost simultaneously.

The solution to this conundrum is to copy the model used in most US states, where payday lenders operate using a real-time database system that regulates these issues on their behalf. The system used by Veritec, for example, interprets roll-overs in a set way and also prevents clients taking out more than one loan. A similar system is required here, as Lord Sharkey urged in the House of Lords debate on the Financial Services Bill in 2013.[14]

In fact, most US states employ real-time databases, like the one provided by the US company Veritec, to provide the platform for payday lenders.[15]Then it is simply impossible to take out two payday loans at the same time from different companies, and it is impossible for the loan companies to 'interpret' rollovers in any lax way they can think of.It is also still quite possible for them to make a profit, as they do in New York, where the loan rate is capped at 25 per cent (plus charges).[16]

Regulation can certainly help with the problem of payday lending to the most vulnerable, but it simply tames the fundamental problem, which is that the lenders are not structured to provide what their clients most need. It does not remove it.

Gear up the credit unions

Archbishop Welby's solution is to gear up the credit union sector, or to build a parallel credit union sector accessible through churches. About a million people are currently credit union members, and the Department for Work and Pensions is aiming to double this within five years, and they are helping the sector be more professional and with their back office systems.

Some credit unions have been able to offer short-term loans. London Mutual has now reached a size when it can do so, and Central Liverpool Credit Union is also now competing with the payday lenders direct, but they are not competing in precisely the same market and they are not necessarily making a profit either.[17]

Nor do they have access to the sophisticated risk software that the big payday lenders have. Most credit unions will not be able to do this for some time, but it would be possible to imagine a credit union payday loans gateway which took customers automatically to their local credit union, if they were able to help – and took them elsewhere if not. That begs the question about what form the 'elsewhere' should take.

The difficulty is that, for most credit unions, this is not their original purpose. It also means a paradoxical shift in their core membership. To have the size and confidence to take on payday lenders, credit unions need to attract a broader range of members, including people on middle and higher incomes who can save and borrow larger amounts, and help balance out the riskier loans.

Some of the infrastructure that the credit unions would need would be available through the crowdfunding site LendLocal, which is now taking over the risk of the loans by credit unions and CDFIs (Community Development Finance Institutions), which looks set to be a model for the future.[18]

The expansion of credit unions, committed to encouraging thrift and providing the means for easy saving, does mean that some of the support necessary will be available for those who need short-term loans. But a number of problems will need to be solved before credit unions can take on the payday lenders; they will need:

- Much more sophisticated online systems and risk algorithms.
- The resources to lend to this new risky clientele.
- Different regulations to allow them to charge the much larger sums that would make high-cost loans break even or make a profit.
- Proper debt collection systems.
- An internet gateway covering the UK.
- Some alternative ethical lender if the local credit union is not able to help.

Existing state or state-funded institutions

There are two possibilities here. One is that some kind of alternative might be developed by housing associations, which are in the front line in the battle against payday lenders. Many are directing tenants to local credit unions. Coast and Country Housing, in the north east, is among those which have set up their own lending facility, offering loans at an APR of 22,89 per cent, by teaming up with the social enterprise My Home Finance.[19]

The other option is that some kind of loans might be made available through the welfare system, as they used to be, with re-payments taken directly out of benefits so that rollovers are not necessary. Given the right safeguards, an alternative to the old Social Fund could be highly effective, given that the infrastructure already exists to deliver it.

Crowdfunding

These drawbacks with other solutions has led to some debate about whether crowdfunding platforms might provide the basis for some kind of alternative to conventional payday lenders, capable of setting out an offer of ethical short-term lending.

The idea of crowdfunding an alternative covers two connected possibilities – that the crowdfunding platform might be used to deliver the investment required, and that the platform might be used to provide the loans (especially if it was structured as a social enterprise, like Buzzbnk). This could be done either indirectly like most payday lenders or, potentially, directly by brokering agreements between lenders and borrowers. The emergence of LendLocal as a crowdfunded secondary lender to credit unions and CDFIs is a sign that this can work (see above).

This is important because, to tackle the fundamental problem at the heart of conventional payday lending – the capture and imprisonment of vulnerable clients to grow profits – any ethical alternative would require a range of different kinds of funding.

The social enterprise structure is important because it may not be possible to finance ethical payday lending at a profit, because the small profits made would have to be funnelled back into helping clients escape from debt, by reinvesting in debt advice or financial education, or by creating a pool for writing off destructive debts. If the central purpose needs to be different – to help borrowers out of long-term debt – then the profits will have to be used to make that possible, and this may be inadequate for the task.

Section 4: What next?

If an ethical alternative to payday lending was to emerge, it would need multiple sources of funding to achieve its overall objective – to get people out of long-term debt – because that objective requires very different short and long-term interventions, and these need different kinds of investment.

There are five possible sources for this:

- The government, central or local: the basic institutions may need state funding for some aspects of their work which is most difficult to fund in other ways, or through the welfare system.

- Social bonds, or some other financial mechanism that is able to draw down the results of an effective institution of this kind in lower government spending later. Proving the causality may be difficult here.

- Philanthropic grants to cover the costs of diversionary services for clients who are already heavily in debt.

- Investment, either social investment or normal for-profit investment.

- Deposits funding short-term loans, and again this will depend on effective risk algorithms, and on some kind of regulatory framework – banking or credit union.

- Direct from customers, via a P2P crowdfunding platform, though operating in the short-term loan market will probably require risk to be pooled – which will rule out this form of P2P lending for at least some of the potential market.

These different forms of funding allow various possible models to emerge. The key point is that, in some cases, lending in this market means that the money will never be recoverable. Either way, it will require an effective online lending infrastructure, and it will need a credit scoring system that is as effective as those in the payday loan business.

It will also, as discussed above, require some kind of support infrastructure to support people who need to find their way out of debt, either through advice or other kinds of support or potentially by paying off the debt on their behalf.

This also looks more like a social enterprise investment than a more conventional option for an angel investor which would require the debt market to grow. It requires an investor with an enlightened understanding of what profit might be and what profits could be used for.

It also suggests four possible experiments.

Model 1

P2P lending: there is definitely space to segment the non-bank personal loans market so that some of it could be carried out peer-to-peer, if such a platform was made available. But this would be the part of the market that is served well neither by the banks nor the conventional payday lenders – it would be semi-informal loans, of the kind that would happen more between family and friends if there was a way in which they could be semi-formalised in this way. There may be huge potential here, but it would be hard to carry out short-term loans to people anonymously in this way because of the risk of default.

Model 2

Crowdfunding: this solution would need to find ways of sharing the risk by segmenting loans between a number of different borrowers, but given that there are profits to be made at the right price – and the profits are considerably higher than conventional investment options – this could be made possible, given the right risk assessment tools. To be ethical, it would need to cream off profits to pay for diversionary schemes to support clients rather than rolling over loans, and it would need to forego the 19 per cent of profits that the big payday lenders make from rolling over loans four times.[20]

Model 3

Combining credit unions: short-term lending is not the core business of credit unions, and the risk would need to be shared between them. There would also need to be a common platform, or at least a common internet gateway. It would need specialist support and software, but it would mean that the ethical payday loans would be embedded in an infrastructure that is already geared to helping people save and teaching people financial skills.

Model 4

Social enterprise: this could be managed by a new or existing crowdfunding platform, providing short-term loans on a reasonable profit-making business but using systems to support clients if the short-term loan failed to make the change that was required, or helping people with long-term budgeting problems make better use of their money.

Model 5

Housing association/Social Fund solution: this would mean that the government organised a new Social Fund lending infrastructure, given certain safeguards, so that re-payments could be taken automatically out of benefits, which would allow housing associations to lend money in this sector at considerably lower risk – and therefore lower cost.

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None of these issues can be tackled entirely in isolation, especially if people are living on low-pay or on the minimum wage or below, but they might be able to support people better than encouraging te repeated corrosive use of payday loans.

The key question is whether, by foregoing the profits from rollovers (50%), and by limiting profits on the first loan – as regulators will insist on in the future or the whole industry – there will be enough profit to satisfy investors and to feed back into support for vulnerable clients.

Further information

Association of British Credit Unions **www.abcul.org**
Buzzbnk**www.buzzbnk.org**
Church of England
www.churchofengland.org/media/1876410/credit%20unions%204%20pager%20final.pdf
Community Development Finance Association**www.cdfa.org.uk**
Community Investment Coalition
www.communityinvestment.org.uk
Move YourMoney **www.moveyourmoney.org.uk**
New Economics Foundation **www.neweconomics.org**
Office of Fair Trading
www.oft.gov.uk/shared_oft/Credit/oft1481.pdf
Social Foundation **www.socialfoundation.org.uk**

Notes

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[15] www.**veritecs.com/**

[16] **www.ncsl.org/research/financial-services-and-commerce/payday-lending-state-statutes.aspx**

[17] **www.centralliverpoolcu.co.uk/content.asp?section=18**

[18] **www.lendlocal.org.uk**

[19] **www.24dash.com/news/housing/2013-07-16-housing-association-battling-to-keep-tenants-away-from-payday-loan-sharks**

[20] OFT (2013).