Consumer Focus
Campaigning for a fair deal

Keeping the plates spinning

Perceptions of payday loans in Great Britain

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About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland. We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice.

We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

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Concerns about payday lending

Concerns have been raised in the US and the UK over the level of consumer detriment caused by payday lending, which has led to interest rate caps in a number of US states, effectively banning the practice. There are concerns that the impact of the recession in the UK will drive greater numbers of consumers towards this form of lending and trade discussions have indicated an intention for further expansion in this market.

Key criticisms of payday lending

There are two main criticisms of payday lending, and our conclusions offer a balanced view of these.

- Loans are expensive in terms of APR, although high APR rates may be justified by the high cost of lending small sums of money
- Most borrowers are repeat borrowers. This is the prime criticism of payday lending in the UK

Our research into payday lending

As a result of these concerns and criticisms, Consumer Focus commissioned research to investigate payday lending in order to improve knowledge and understanding of this relatively new form of lending in the UK, and the benefits and risks associated with it for consumers, in general, and those on low incomes, in particular. IRN research looked into the payday lending market and Synovate conducted qualitative research, interviewing a sample of payday loan borrowers to ascertain their attitudes towards and experiences of taking out payday loans.

Payday lending: a definition

Payday lending is a form of credit whereby the borrower either gives the creditor a cheque or authorisation to make an automatic withdrawal from their bank account. This is used as security for a short-term loan to be repaid, typically, on their next payday. Payday lending is an established form of lending in the US, but is a relatively new entrant to the high-cost credit market in the UK.

UK payday loan borrowers

A central aim of our analysis is to understand who takes out payday loans in the UK. Are UK practices the same as those in the US, for example? It is also important to understand how payday loans fit into the market place alongside other forms of short-term borrowings such as overdrafts and credit cards.

The characteristics of UK payday loan borrowers

Our research has indicated that the profile of borrowers in the UK is significantly different to that of borrowers in the US. In the UK, borrowers tend to be young adults (under the age of 35), single and without children. In contrast, in the US, borrowers tend to be older and have young families.

In the US, adults without bank accounts are payday loan borrowers and those in the sub-prime category (consumers with impaired credit histories) make extensive use of payday loans, but this is not the case in the UK. While 67 per cent of payday loan borrowers in the UK have an income of below £25,000, this is a lower percentage than in the US, where it is closer to 75 per cent.

Most users of payday lending in the UK are based outside of the South East and London, with the North of England and Scotland being home to most borrowers.

The experiences of UK payday loan borrowers

Our qualitative research identified that payday loan users had had one of three types of experiences:

- long-term negative experience
- short-term mixed experience
- short-term positive experience

The evidence from our qualitative research shows some short-term borrowers can find using payday loans a positive experience, provided the loan is paid off in the short term. They are unlikely to suffer long-term difficulties, but some have mixed feelings about using payday lending. They are shocked at the cost, or feel ashamed or embarrassed at using this form of finance. This has led some people to seek ways of avoiding getting into a similar position in the future, such as informal savings groups. Nonetheless, others, generally those on lower incomes, have a long-term negative experience. This is usually if they are rolling over a single loan, taking out multiple loans over a period of months or juggling multiple loans from more than one lender at a time. This can result in significant financial problems and emotional stress.

Conclusions and recommendations

Controls on payday loans

We conclude that there is currently no clear evidence that banning payday loans necessarily helps consumers avoid financial difficulties. Indeed, the loans can have advantages over some other forms of credit. For example, they can be cheaper than unauthorised overdrafts (which are outside the consumer's control in terms of whether or not they are granted). It is also possible that, if they were to be removed from the market place, illegal lending could prosper.

Consumer Focus concludes that evidence from the US (which is reflected in the findings of our qualitative research) provides justification for limiting the number of loans an individual can take out at any one time or on a repeat or rollover basis. Evidence suggests UK borrowers are taking out an average of 3.5 loans a year. Trade discussions have indicated that the UK payday loan industry is looking to boost this average to five loans per person.

It is important that effective safeguards are put in place now to avoid UK payday loan borrowers experiencing the same detriment as those in the US, where it has been estimated that five million consumers in the US each year are caught in a 'cycle of debt', where they are dependent on repeat borrowing at high cost in order to meet basic living expenses[1].

Limiting the number of loans: Consumer Focus recommends that the number of loans or rollovers permitted per year should be limited to a maximum of five per household[2]. Research from the US[3],indicates this should prevent a potential debt trap scenario being established in the UK. This would be achieved by clarifying the Office of Fair Trading (OFT) Irresponsible lending guidance[4] so that the definition of 'unsustainable' lending includes borrowers taking out more than five payday loans or rollovers in one year.

Furthermore, where consumers have borrowed or 'rolled over' up to the maximum of five times in one year, this should be treated as an indicator of financial difficulty and lenders should be obliged to refer consumers to independent advice and support to deal with any financial problems.

Further research: Further work should be carried out by the OFT investigating the impact of banning payday loans within the context of the UK market.

1 Center for Responsible Lending, Ernst, K, Farris, J and King, U (2003, revised 2004), *Quantifying the Economic Cost of Predatory Payday Lending*

2 'household' is defined here as a family group (ie an adult, their spouse/partner – if applicable – and any dependent children living with them)

3 Wilson, B.J., Findlay, D.W., Meehan, Jr, J.W., Wellford, C.P. and Schurter, K. (2008). *An Experimental Analysis of the Demand for Payday Loans*. Unpublished Manuscript. Available at SSRN: **http://ssrn.com/abstract=1083796** (accessed 13 June 2010).

4 Office of Fair Trading (2010), Irresponsible lending - OFT guidance for creditors (para 6.25)

We support the OFT's recommendation in their review of high cost credit that it should collect essential information on the high-cost credit sector[5]. In the future, this will assist with better evidence in relation to the payday loans market, including in respect of the impact of interest rate caps or banning paying loans on the UK market.

Safeguarding payday loan users

The different experiences and needs of the three types of payday lending users identified in the research means that solutions will need to be tailored differently for each type of user.

In order to address some of the difficulties faced by consumers who suffer **long-term problems**, Consumer Focus recommends that the OFT (and the Consumer Protection and Market Authority (CPMA) when it is formed) requires lenders to:

- control the amount of money consumers can borrow by ensuring more thorough affordability checks when the first loan is taken out (including effective salary checks)
- ensure affordability checks are repeated when additional loans are taken out in case of change of circumstances
- limit the number of months that a loan can be deferred for (see above)
- limit the number of repeat loans (see above)
- limit the value of repeat loans
- share information to avoid people being able to take out payday loans from multiple lenders simultaneously

These measures should protect some of the more vulnerable consumers. However, they might slow down the application process, removing one of the reasons consumers find this type of borrowing helpful. These measures could also add to cost. Nonetheless, we are aware that some lenders are already carrying out checks, which suggests these protections could be introduced without significant additional delay or costs.

We recommend that an industry Code of Practice, as proposed by the OFT high cost credit review[6], should incorporate the above measures. It would be a positive step towards the protection of consumers in this area, although we remain doubtful whether a voluntary code would be sufficient to give the full level of protection needed.

Money guidance and money advice: For those who have a **short-term positive experience of payday lending** increased financial literacy may enable them to exercise choice more effectively between different payday loans or different financial products. We support the OFT review recommendation that consumers are helped to make informed decisions on high cost credit by current financial literacy initiatives[7] on this basis. However, for those who have a negative experience of payday lending (and some mixed experience consumers), money advice will be a more appropriate form of assistance.

[5] Office of Fair Trading (2010), Review of high cost credit: Final report (p52)

[6] Office of Fair Trading (2010), Review of high cost credit: Final report (p53)

[7] Office of Fair Trading (2010), Review of high cost credit: Final report (p47)

Provided financial education initiatives address the distinct needs of the different types of payday lending users, we support the OFT high cost credit review's recommendation that existing financial literacy programmes should help consumers make informed decisions on high cost credit.

Banking reform: Improving the alternatives for all consumers

Our research has shown that low income consumers choose payday lending in preference to more mainstream options, because of the problems they encounter when using traditional products such as overdrafts and credit cards. Consumer Focus recommends that the current programme of banking reforms should include measures that would reduce the need for low income consumers to resort to high cost borrowing options. These include:

- **Clear fee structures:** Across all types of borrower, consumers chose payday lending because they found it easy to understand how much they had to pay back and when. Presenting overdrafts and credit card charges in the same way as payday loan fees may help consumers to compare products more effectively. The importance of clarity for consumers to enable consumers to compare products is reinforced by the findings of the OFT high cost credit review
- **Emergency borrowing facility:** Many consumers turn to payday loans due to the speed of access. Banks should introduce an emergency borrowing facility that allows access at short notice to small amounts of money in the short term at reasonable rates of interest. This would be repaid as a first priority as soon as there were funds in the account, which would give banks the same level of security available to payday lenders. An emergency borrowing facility of this nature could act as a lower cost mainstream alternative to payday loans
- **Fair bank charges:** If banks were not able to impose penalty charges for unauthorised borrowing and their charges were related to actual cost, consumers might opt not to use payday lending and use their banking facilities instead
- **Social lending:** Continued investment in social lending through credit unions and community-based initiatives will provide an opportunity for consumers to save small sums of money against future financial difficulty and borrow at affordable rates in times of crisis. As a first step, we would strongly recommend the continuation of the DWP Growth Fund which is due to end in March 2011. Raising awareness of credit unions could also put some consumers in a better position to avoid using payday lending

Introduction

The research study

Given the background to payday loans in the US, Consumer Focus has identified a need for policy development and advocacy in this area to ensure a fair deal for consumers in the UK as the market grows in the coming years. However, there has been a lack of robust evidence on which to base policy proposals, particularly in terms of borrowers' perspectives on payday loans.

For this reason, Consumer Focus commissioned IRN Research to investigate the UK payday loan market to determine the prevalence of payday lending in the UK, and compare this to the situation in the US.

At the same time, Consumer Focus asked Synovate to conduct research to assess in detail the circumstances in which consumers take out payday loans and their experiences of doing so. The objective was to identify the types of people that take out payday loans, and to look specifically at their motivations, attitudes and experiences.

This chapter now presents:

- the research aims and objectives
- the research methods employed in the study

Aims and objectives of the research study

The research aimed to explore the motivations of those who borrow from payday lenders, including:

- their financial circumstances
- why they needed short term finance
- the key factors which influenced their decision-making

The research also aimed to come to an understanding of the experience of payday loan users in detail. This included looking at the emotional, attitudinal and practical factors that led to their use of payday loans (rather than other sources of finance). The research also investigated the emotional and practical impact on them of using payday loans.

With this information, Consumer Focus intends to identify both the benefits and risks associated with payday loans, and to make recommendations to reduce the risk of consumer detriment.

Methodology

IRN Research carried out a literature review evaluating research conducted in both the UK and the US.

Synovate conducted in-depth face-to-face interviews with 20 borrowers in London, Leeds and Glasgow (see Appendix A for details). They had all taken out a payday loan at least once in the previous 12 months. Interviews lasted for approximately 45 minutes and were held in central locations.

Next steps

Consumer Focus is using the findings and recommendations in this research as the basis for a consumer-focused policy aimed at improving the safety of payday loans and addressing the problems associated with payday lending.

Chapter 1: Overview of research findings – the payday loan industry

This chapter presents an overview of the findings from IRN Research's investigation of the UK and US markets in payday lending.

Market size and trends

The recession has led to a rapid growth in demand for payday loans due to lower income consumers being financially squeezed; the reduced availability of other unsecured loans; and consumers being reluctant to take out longer-term loans to finance short-term cash needs.

Based on an estimated average loan of £294. IRN Research estimates 1.2 million adults in the UK took out payday loans in 2009. It also estimates there were 4.1 million loans resulting in a total lending of £1.2 billion[8]. The payday loan industry generated a gross income of £242 million in 2009, equivalent to around 20 per cent of the total amount lent.

In recent years, the market for payday loans has experienced rapid growth with online loan providers, in particular, entering the market. The growth of the online segment has resulted in the average rate of charges per £100 of loan rising from around 15 per cent in 2006 to 20 per cent in 2009. Online providers work with high costs and tend to charge more on average than High Street providers.

Research by the Office for Fair Trading (OFT) suggests the demand for payday loans could rise steeply in the future[9]. Using the figures from this research, IRN Research predicts the number of borrowers could potentially rise by 40-45 per cent in the coming years[10].

Major players

Seven companies stand out as the largest market operators:

- Dollar Financial Corp (including The Money Shop and online provider Express Finance (Bromley) Ltd)
- Mem Consumer Finance (trading as Month End Money, Payday Now, PayDay UK, Payday Store, Quicksilver and Payday Loans)
- Cheque Centres
- CashEuronet UK LLC (trading as QuickQuid)
- Albemarle & Bond Holdings PLC (including Herbert Brown & Son)
- H & T Pawnbrokers
- National Cash Advances

8 Figures based on IRN Research's discussions with the trade and an analysis of the accounts of the largest payday loan providers in the UK. IRN Research estimates that this figure was approximately £0.33 billion in 2006.

9 Office for Fair Trading (2009). *High-cost Consumer Credit – Emerging Evidence From The Review.* London: Office for Fair Trading.

10 The OFT high-cost credit research asked consumers not currently using payday loans if they anticipated needing this type of credit in the future. 1 per cent said they could potentially need payday loans. This implies a demand for payday loans from another half a million adults. With 1.2 million borrowers in 2009, this suggests growth in borrower numbers of around 40-45 per cent.

Dollar Financial Corp is the market leader supplying around 25 per cent of all the payday loans originated in 2009. As well as being the largest High Street provider, it is also now operating online. Mem Consumer Finance is the second largest player and the largest internet provider. Cash Centres (High Street provider) and CashEuronet (online provider) are the number two players in their respective markets. Behind these two companies are the largest pawnbrokers in the UK, Albemarle & Bond Holdings PLC and H & T Pawnbrokers.

Business models

Payday lenders finance the main share of their business from internal resources. Even if they use bank finance, the banks usually stipulate that up to 20 per cent of loans must be financed from internal resources. This does not mean the capital for payday loans is generated 'free of charge'. Payday lenders still have to pay an implicit cost for their internal finance in the form of interest forgone on alternative loans or investments.

Payday lenders work with high fixed costs: the cost of underwriting a loan is the same irrespective of a loan's value, and most of the costs faced by providers are not dependent on the number of loans written. Key fixed costs are staff costs, rents, business overheads and, for online providers, investment in online application systems.

Many loan costs are incurred at the application stage and have to be incurred whenever an application is made, irrespective of whether a loan is approved or declined, and irrespective of the size of the loan. The costs associated with a £200 loan are largely the same as those for a £750 loan, making the profit margins on small loans very tight.

Because payday lenders tend to loan small amounts, their profit margins per loan are normally low. UK providers made this point in our discussions. The US market caters to a different type of borrower, but the models of operation in the US market are similar to the UK. Data from the US estimates profit margins of 9 per cent on the average loan amount.

Variable costs include credit checks obtained from specialist providers like Teletrack UK and Lend Protect. Credit reference agencies like Experian are more expensive and take longer to update their records. Other variable costs are default costs and the cost of capital.

High fixed costs mean that profits are largely driven by the number of loans made, given the significant economies of scale in the business. It is the number of loans granted that determines how profitable a business is: the higher the number of loans, the more profitable the business. Profits are generated mainly by the number of loans not the number of borrowers. A lender earns a similar amount from having 100 loans taken by 100 people as 100 loans taken by 10 people, although the latter will be marginally more profitable.

Online lenders face higher costs, compared with those on the High Street, because they reject a higher proportion of loan applications, and they face higher rates of fraud and default. Consequently, the cost of obtaining a loan online (often £25-£30 per £100) exceeds the costs of obtaining a loan on the High Street (often £13-£18 per £100).

Payday lenders require cheques and debit card details so they can ensure collection costs and default rates are minimised: if a borrower fails to pay off a loan, the lender has a relatively low-cost method of collection.

The high fixed costs of loans and the fixed price charged per £100 of a loan means borrowers of larger sums are effectively subsidising those borrowing relatively small amounts, given that a marginal cost approach to pricing would suggest much higher charges on smaller loans and lower charges on larger loans. However, without the fixed price method of pricing, many small value loans would be withdrawn from the market.

Multiple loan applications

It is the number of loans that is profitable for lenders rather than the number of borrowers. Even so, research in the US by Mark Flannery and Katherine Samolyk says borrowers taking out multiple loans are in the interest of the loan provider, because they contribute to loan volume[11]. Further research by the Center for Responsible Lending (CRL) shows there is evidence of payday lenders encouraging repeat borrowing, suggesting they depend on it for survival[12].

The CRL shows that in US states where a cap has been imposed on the number of loans a borrower can make in a year (between five and eight),[13] lenders have publicly stated this will put them out of business. Washington DC was the first to have a cap of eight loans per borrower a year, starting in January 2010. In response, some lenders in the state have already shut down. CRL data confirms that 90 per cent of all payday loan business in the US is generated by borrowers with five or more loans a year, which may explain why payday lenders are opposed to limiting the number of loans. The issue of a UK cap on loans or rollovers is discussed below.

[11] *Flannery, M. and Samolyk, K. (June 2005). Working Paper No. 2005-09, Payday Lending: Do the Costs Justify the Price.* Arlington, *VA: Center for Financial Research.*

[12] Center for Responsible Lending (2004).*The Debt Trap of Payday Lending*. Lending Issue Brief No. 19, September 16, 2004.

[13] It should be noted that US loans are fortnightly rather than monthly.

Potential pitfalls for borrowers

There are two main criticisms of payday lending:

- Loans are expensive in terms of APR, although high APR rates may be justified due to the high cost of lending small sums of money
- Most borrowers are repeat borrowers. This is the prime criticism of payday lending in the UK

Key differences between the UK and the US payday loan markets

US data indicates that many borrowers take out multiple loans each year and tend to take out new ones as soon as current loans finish their term. The extent of serial borrowing (known as 'rollovers') also appears to be high. However, the US experience does not translate simply into that of the UK:

- Households without bank accounts are largely absent from the UK lending market because it is a requirement in the UK for all borrowers to have one. US borrowers are much more likely to be on the poverty line than those in the UK, and are more likely to be in permanent need of borrowed funds. Also, those with young families are greater borrowers of loans in the US than the UK
- The US does not have a national law equivalent to the Consumer Credit Act 1974. Payday loans are still largely determined by the state law in the US. The exception is a federal law which became effective on 1 October 2007 that caps lending to military personnel at a maximum of 36 per cent APR. In contrast, borrowers in the UK are protected by the Consumer Credit Act 1974 and payday lenders are regulated by the Office of Fair Trading

Despite these differences, there are indications of difficulty for borrowers in the UK market. The evidence in the OFT High Cost Credit Review found that nearly 30 per cent of loans in the UK are not repaid on the initially agreed repayment date of within 30 days/next payday and 10 per cent of payday loans go beyond 90 days. Borrowers face significant additional costs when loans are extended[14].

Banning payday loans

Concern about the impact of payday loans has led to a number of US states banning them. However, there is a lack of conclusive evidence that doing this necessarily helps consumers.

In 2004 and 2005, the governments of Georgia and North Carolina permanently closed all the payday lenders operating in their states. A study by the Federal Reserve Bank of New York looked at the impact of these bans on households' financial problems[15]. Did the bans reduce financial problems or exacerbate them?

The bank's study concludes:

'Most of our findings contradict the debt trap hypothesis. Relative to other states, households in Georgia bounced more checks after the ban, complained more about lenders and debt collectors, and were more likely to file for bankruptcy […]. The changes are substantial […]. Preliminary results for North Carolina are very similar.'

[14] OFT (2010) High cost credit review: Final Report, Annexe C.

[15] Morgan, D.P. and Strain, M.R. (November 2007 and revised February 2008). *Payday Holiday: How Households Fare after Payday Credit Bans*, Staff Report no. 309. New York: Federal Reserve Bank of New York.

One of the main factors behind this conclusion is that in the US, while payday credit is expensive, it is still cheaper than a close substitute: bounced cheque protection sold by credit unions and banks[16]. This spares cheque writers the embarrassment of having a cheque returned from a merchant and incurring any associated merchant fees, but the protection can be quite expensive, estimated at an (implicit) APR of 2,400 per cent.

Interest rate caps are another method by which payday lenders can effectively be banned, as the cap is set at a level that makes it uneconomic for them to continue to operate. The issues for using rate caps to regulate payday loans are therefore similar to those of imposing an outright ban.

US research shows payday loans can increase a low-income household's chances of long-term financial survival. An experimental study by Wilson et al investigated how the availability of payday loans and overdraft protection affected ability to manage a hypothetical household budget over a 30-month interval[17]. Budgets were tight and the study found that the availability of payday loans increased the likelihood of survival by 31 per cent, but as a greater number of payday loans are used, the likelihood of survival reduces by about three per cent for each additional loan.

There are reasons why banning payday loans in the UK (either through an outright ban or by interest rate caps) may not help consumers:

- Payday loans may be cheaper than other short-term sources of finance, such as unauthorised overdrafts
- Payday loans ease financial problems and taking them away may deepen the financial problems of low-income borrowers
- There is a risk that loan sharks could prosper if payday loans were no longer available. Many borrowers do not have access to a full range of alternative forms of credit, and payday borrowing is often the only option. If payday lending is denied, illegal forms of credit may be the only alternative. Traditional banks are reluctant to offer competitive short-term access to credit products, especially overdrafts, for those with relatively low incomes. Payday borrowers are less likely to own their own homes than the general population and, accordingly, are ineligible for home equity credit. Moreover, many traditional banks do not offer local retail services in areas served by payday lenders. While credit unions and community lenders can provide more affordable credit for members, low awareness of these options among low income consumers has meant the take-up of these alternatives is very limited.

[16] Stegman, M. (2007). 'Payday Lending,' Journal of Economic Perspectives, Vol. 21, No.1, p.169-190.

[17] Wilson, B.J., Findlay, D.W., Meehan, Jr, J.W., Wellford, C.P. and Schurter, K. (2008). *An Experimental Analysis of the Demand for Payday Loans*. Unpublished Manuscript. Available at SSRN: **http://ssrn.com/abstract=1083796** (accessed 13 June 2010).

Limiting the number of loans taken out

Multiple use of payday lending cannot in itself be taken as evidence that these loans perpetuate consumer indebtedness. It could be that other causes of indebtedness are resulting in multiple loan use. It is conceivable that those with persistent financial problems synchronise loans with their income flows and rely on paydays loans throughout the year.

However, Wilson et al show that if payday loans are overused there comes a point (and that point is 11 loans per year in the US) where loans prove detrimental to households and actually reduce a household's chance of financial survival[18]. This suggests that, with survival falling by 3 per cent per loan and an overall gain from loans of 31 per cent, anyone taking out more than 11 loans loses as much as they gain. These findings suggest the availability of payday loans increases consumer ability to make ends meet but the gains diminish as use becomes more frequent.

Given that US loans are fortnightly rather than monthly, the US data suggests that a UK borrower should not take out more than five loans in a year. UK evidence suggests borrowers are currently taking out an average of 3.5 loans a year. Contacts made by IRN Research with the UK payday loan industry as part of this research have confirmed comments in the press that the industry is looking to boost this average to five loans per person. At this point, there would be concerns that the loans are detrimental to borrowers.

Based on the research in the US, limiting the number of loans or rollovers to a maximum of five per household[19] per year should prevent a potential debt trap scenario being established in the UK. This would be achieved by clarifying the Office of Fair Trading (OFT) Irresponsible lending guidance for creditors so that the definition of 'unsustainable' lending includes borrowers taking out more than five payday loans or rollovers in one year[20].

A limit of five loans per household should not significantly reduce the level of supply, as the market in the UK is currently operating at below this level of loans on average and the UK industry have thus far expressed their aim only to reach this level[21].

[18] Ibid.

[19] See note 2 for definition of 'household' (p7).

[20] Office of Fair Trading (2010), Irresponsible lending – OFT guidance for creditors (paragraph 6.25)

[21] A limit of five loans in the UK would be equivalent to 10 loans per household in the US and is therefore above the limit imposed in Washington DC in January 2010, which has led to a reduction in supply.

Thus, by limiting the number of loans or rollovers to a maximum of five, payday lending should still be available for consumers to use them, but not to the point where they become an unsustainable debt. The aim of limiting the number of loans or rollovers would be to prevent consumers getting into a debt spiral where they are borrowing in order to service the loan and it is increasing rather than relieving their burden of indebtedness. As our qualitative research (below) has found, it is consumers on lower incomes who take out repeat loans or rollover their loans who experience the greatest difficulty with this form of lending. In addition, it should be recognised that where a household has taken out five payday loans within a year, this is an indicator of possible financial difficulty and lenders should be obliged to refer consumers to independent money and debt advice for help with any financial problems.

In addition, further work should be carried out by the OFT investigating the impact of banning payday loans within the context of the UK market. To date, research in this area has largely focused on the experiences of other countries.

We support the OFT's recommendation in their review of high cost credit that it should collect essential information on the high-cost credit sector[22]. In the future, this will assist with better evidence in relation to the payday loans market, including judging the impact of interest rate caps or banning paying loans on the UK market.

Currently, a chief concern is that a complete ban on payday loans would increase illegal lending, but if a greater range of lower cost alternatives were available to low income consumers through banks and social lenders, this risk would significantly diminish. Later in the report, we make recommendations about improving the alternatives available to consumers (see below, Chapter 5).

[22] Office of Fair Trading (2010), Review of high cost credit: Final report (p52)

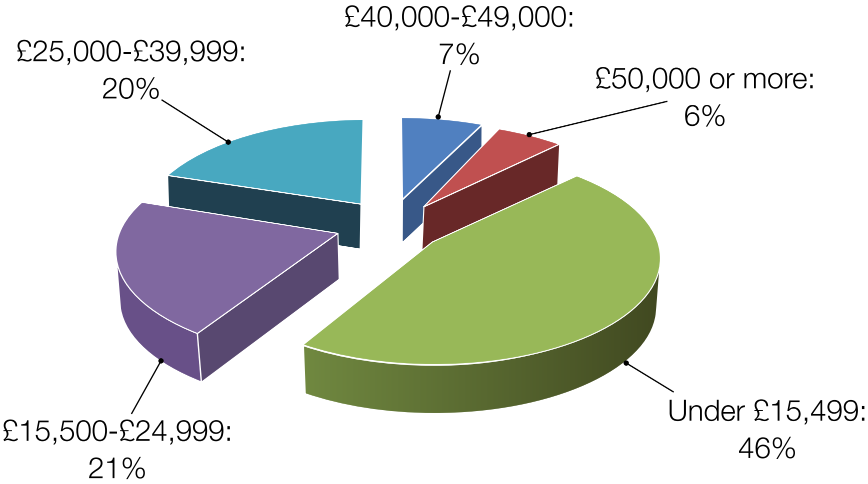
Chapter 2: Overview of research findings: the profile and experiences of borrowers

This chapter presents an overview of the consumer profile of payday loan borrowers from IRN Research's investigation of the UK and US markets, and Synovate's interviews with UK borrowers. It identifies the attitudes, decision-making processes and influencing factors common to the borrowers interviewed.

Consumer profile[23]

According to IRN Research estimates, UK payday loan borrowers tend to be young adults with below average incomes, although they are not sub-prime (consumers with impaired credit histories). In the UK, 67 per cent have an income of below £25,000 compared to the US where it is closer to 75 per cent. Moreover, while, in the US, adults without bank accounts are payday borrowers and those in the sub-prime category make extensive use of payday loans, this is not the case in the UK.

Figure 1: the estimated breakdown of payday loan users by household income, 2009



Almost 70 per cent of loan users have a household income below the mean UK average of £24,492[24]

The average household income of payday loan borrowers is around £24,000 – this is higher than the average borrower income as 40 per cent of payday loan borrower households may have more than one income earner. Also some of the youngest payday loan borrowers may be living at home with their parents.

Source: IRN estimates based on trade research

[23] The data in this section is based on IRN discussions with the trade and a review of data that exists in the public domain. Because of the small number of payday borrowers, it was not possible within reasonable cost, to undertake a consumer survey of borrowers. The data is, therefore, IRN's best estimates of the market structure.

[24] Office for National Statistics (2010). *Family Spending: A Report on the 2008 Living Costs and Food Survey*. Hampshire: Palgrave Macmillan.

Around 55 per cent of UK borrowers are under the age of 35, and 60 per cent are not married or cohabitating. Most do not have dependent children. This again contrasts to the US where borrowers tend to be older with young families.

This suggests that, compared to the US, lending in the UK is less focused on longer-term needs such as household investment, and more focused on immediate short-term needs.

UK borrowers tend to be based outside of the South East and London, with most in the North of England and Scotland. This closely matches the income and socio-economic profile of borrowers.

Based on data from trade discussions and figures that are in the public domain, IRN Research estimates the income structure of payday borrowers in the UK in terms of household income, and this is shown in Figure 1.

Borrowers' experiences: the research interviews

Payday loan borrowers' financial circumstances, their experiences with and attitudes towards payday loans varied substantially across the 20 interviews conducted by Synovate for this research study[25].

Despite these varied experiences, there are some common themes:

- attitudes towards personal finance
- key factors influencing the decision to take out a payday loan
- views on the clarity of payday loans

Attitudes towards personal finance

Many of the payday borrowers we interviewed are either currently or have been in substantial debt. As a result of the current recession and credit crisis, many are also suspicious about banks' motives, and believe banks actively encourage consumers into debt. In addition, many are wary of taking out a new or additional financial product, such as a credit card or overdraft, which might tempt them into long-term debt. As a result, payday loans are seen as a straightforward way of solving a temporary financial problem (assuming the loan is paid back immediately), without the temptation of taking out bigger loans.

The key factors influencing the decision to take out a payday loan

Many of these borrowers take pride in their ability to be financially self-sufficient, and feel payday loans offer them the chance to sort out their finances privately and independently, without having to ask for money from friends or family. As outlined above, many are also pleased to have found a solution that did not involve banks, given previous negative experiences.

Speed and convenience are also key reasons why these borrowers decide to take out a payday loan. There is only a small amount of paper work and the transfer of funds is near instant.

The borrowers appreciate the anonymity of the process, particularly online borrowing. For a variety of reasons, many are ashamed or embarrassed about taking out a loan. This may be due to being short of money or the purpose of the loan. Consequently, they like the 'no questions asked' approach of the lenders.

[25] *See Appendix A: the interviewees* for the breakdown of personal characteristics

The clarity of payday loan fees

These interviewees primarily talk about payday loans in terms of the actual value of the fees rather than the percentage rate of interest. They were told the amount they will have to repay for each £100 borrowed. Many say they find this easy to understand. As a result, payday loans are seen as being presented more clearly than products offered by High Street banks such as overdrafts and credit cards. However, although they understand the fees associated with payday loans, some are unaware of the rates of interest and how it compares to mainstream financial products such as credit cards and personal loans.

None of the interviewees said they were misled about the fees they would have to pay back, if they paid on the date agreed when they took out the loan. However, some thought lenders could be more upfront about explaining the scale of the repayments if they didn't repay the full amount on time, and others said lenders did not explain what would happen if they were unable to repay their loan on an agreed date.

Impact of taking out a payday loan

Many of the interviewees had only taken out a payday loan once and some said it had been a positive experience. These borrowers said it had helped them overcome a difficult and urgent financial need and, although they would hope not to use such loans regularly, they felt it was the best option for their particular circumstances at the time.

Others, already in financial difficulty, said the loans had become a substantial burden on their lives because the loans had become habitual. While some started by paying them off immediately, having access to progressively larger loans (if continually using the same lender), meant they were finding it more difficult to pay them off in full after the first month. This seemed to result from a combination of repeat borrowers becoming more accustomed to using this type of finance (and initial reservations they may have had wearing off) and the practice of some companies to offer larger loans to consumers who have repaid previous loans successfully. Some consumers, who were particularly indebted, seemed to have got into a cycle of having to borrow more and more in order to pay back their existing debt.

Some borrowers were accessing loans from several payday loan companies at the same time, and this added to an overall repayment problem.

Taking out a high cost loan had an emotional impact on some borrowers as they worried about how to pay it back. They felt ashamed that they had had to resort to a payday loan and said they were too embarrassed to discuss this with friends.

Notwithstanding the wish of several borrowers to avoid banks, a desire to see more short-term loan alternatives offered by major high-street banks was a common response. This was seen as a way to reduce the social stigma of short-term loans, and make borrowers feel less marginalised from the mainstream of personal finance.

One interviewee said:

'There's a wee bit of shadiness about it and people think you must be desperate to go to them. I think once they become a bit more mainstream you just think I can get one of them now and it doesn't seem as bad, like an overdraft which takes less time. I think once people start using it more they realise you don't need to be desperate to use it, it's just a handy thing.' Male, Glasgow

The application process

The consumers in our sample used a range of channels to purchase payday loans, including in store, online and by telephone.

Many of those we interviewed felt the application process for payday loans, on both the High Street and the internet, was extremely quick. Some were surprised by how few checks were made into whether they were going to be able to repay the loan, such as ringing an employer to verify the level of the borrower's salary and that therefore they will be able to pay back the loan on the agreed date. Some believed their lender would lend to almost anyone.

Some of those, who had taken out more than one loan, pointed out that the level of checks varied between lenders. Occasionally, lenders phoned their place of work to confirm their employment, but such examples are the exception. There was some ambivalence about a perceived lack of proper checks. While there was some concern and suspicion about how easy it was to get a payday loan, speed and convenience made such a loan an attractive option for many. However, it is evident that some payday lenders are already able to provide a service with a higher level of checks.

Chapter 3: Types of payday loan borrowers

It was possible to identify three types of borrower from the interviews, although it should be recognised that the sample was relatively small. This chapter looks in more detail at the attitudes and experiences of the three types of borrowers which emerged from the interviews.

Borrowers had one of three types of experiences:

- long-term negative experience
- short-term mixed experience
- short-term positive experience

The table in Appendix B summarises the different types of borrower and their experiences.

Long-term negative experience

These borrowers had either taken out one payday loan and deferred payments for a number of months, or taken out more than one loan, sometimes from more than one lender at a time. Payments were often deferred to extend the life of the loan.

Financial circumstances

Interviewees in our research who deferred repayment of their loans or took out multiple payday loans are from lower income brackets or have problems managing money. Many had incurred large debts in the past and had poor credit ratings. In some cases, these debts remain outstanding. Some also have irregular streams of income and struggled to make ends meet on a monthly or weekly basis.

Decision-making journey

Short-term finance solutions seemed to be the only way of getting the extra money this type of borrower needed to pay rent and bills from one week to the next, or to deal with a short-term need for cash. In most cases, these borrowers considered more mainstream solutions, such as overdrafts and credit cards, to be unavailable to them. This is either because they had already exhausted these products, and had credit cards and overdraft limits which were 'maxed out', or they had poor credit ratings as a result of past difficulties.

These borrowers often had negative feelings towards High Street banks. Because of accrued debts, they perceived banks as lacking sympathy or flexibility regarding repayments or access to other streams of finance. As a result, they preferred to source finance independently from their bank and through a payday lender.

Key factors influencing the decision to take out a payday loan

Simple application processes were a key factor in the decision to take out a payday loan for this type of borrower. They saw payday loans as 'no-questions-asked' with minimal and quick credit history checks, and relatively limited scrutiny of their ability to repay the loan. As a result, the experience was comfortable without judgement or embarrassment compared to their expectations or experiences of more stringent checks in a mainstream bank.

The speed of transaction was another key factor. These borrowers spoke of enjoying the emotional 'high' when receiving a payday loan and the financial buoyancy this ensured for the coming month. The finite loan period (usually one month) also appealed, particularly to repeat borrowers, because they believe committing to a repayment date helped them to efficiently manage their finances. Some repeat borrowers do not trust themselves to pay back more flexible loans from mainstream banks in good time, leading to debts that 'hang over' for long periods.

Usage and impact

Those we spoke to tended to only borrow what they thought they needed to plug the immediate shortfall in their finances. However, a small number increased the loan amount over time by, for example, taking out more than usual around Christmas. This had severe repercussions in the following months, when the extra fees accrued placed them under serious pressure.

Our research revealed that some lenders did not ask repeat borrowers about their employment situation when they applied for subsequent loans. Interviewees had changed jobs or been made redundant since taking out their first payday loan, but their salary was not checked when taking out subsequent loans.

Those experiencing a long-term negative effect tended to have taken out multiple loans often from more than one lender simultaneously. They said lenders did not ask if they had other outstanding loans.

For some borrowers, payday loans enable them to forget about their financial problems for another month, at which point they take out another loan. Some did not recognise this pattern in their own behaviour prior to taking part in our research. Others had only taken out one loan, but had struggled to pay back the loan in the first month, leading to longer-term problems and additional fees.

In terms of impact, borrowers said paying back the loans took precedence over paying off other debts. For some, this has substantial knock-on effects because, for example, they could not pay the minimum monthly repayment on a credit card or overdraft, resulting in additional charges. As well as causing financial problems, some also said the experience of trying to pay back payday loans, particularly after having let them roll over or taken out multiple loans, had caused them emotional stress and anxiety. Several also mentioned a feeling of shame or embarrassment, particularly if they had deferred payment or taken out repeat loans.

Case study: Katie, teaching assistant, London

Katie had got into a difficult situation with money and one month was unable to pay her rent.

She applied to extend her overdraft but was refused because she had gone over her limit a few times in the past. She was at the maximum on her credit cards, and didn't think she would get another one if she applied. She says, 'I was just really, really bad with money. I got two overdrafts and a credit card completely up to the limit so I couldn't use them anymore. I wasn't making enough money and I just kind of got into a really bad situation.'

She didn't want to ask her family or friends, and thought that a longer-term loan would take too long – her rent was due immediately. She went to a local pawnbrokers shop with the aim of pawning something to raise the money she needed, but this wasn't going to raise enough. In the shop, she saw a sign offering payday loans, and took one out there and then. She felt she had no other option and wasn't eligible for any other help.

She took out a £600 loan, but then was not able to pay it back the following month, or the month after. She thinks she had it for almost a year, and that she paid about 14 per cent interest,[26] and estimates she paid back double what she borrowed. She hasn't ever added up everything she paid, 'I don't want to think about it. I have never actually worked it out because I think I would feel a bit sick if I did.'

Having taken out the loan, she found it really difficult to get out of the situation. Taking out the loan had a significant impact on her, both financially and emotionally, 'I felt stressed out all the time. There would be a period of one or two weeks a month constantly thinking about money and how I was going to pay it off, and how am I going to pay for everything else as well as that. So I just felt really stressed out all the time and obviously didn't have any money to do anything either, so I didn't really go out much or buy myself anything, so [I was] unhappy and stressed mainly.'

She didn't speak to any of her friends or family about the loan because she was ashamed about the situation she had got herself into. In the end, she broke down and confessed to her new boyfriend, who paid the debt for her. She doesn't know how she would have paid it back if he had not helped.

[26] This is likely to be a substantial underestimate, as many payday loan companies quote APR rates of around 1,200 per cent (although this varies substantially between companies and depends on the amount borrowed). An APR of 1,200 per cent works out at about 23 per cent per month and Katie estimates a monthly interest rate of 14 per cent. However it is possible that Katie found a very good loan rate at 14 per cent per month.

Short-term mixed experience

Many of the borrowers we spoke to had only taken out one payday loan in the past 12 months, and many paid it back the next month without rolling over the payment and incurring additional charges. Some of these borrowers said they have mixed feelings about having taken out a payday loan.

Financial circumstances

Many of these borrowers had low household income and few savings. Some had existing debt, and all had to watch their expenditure very closely. Some were also working in temporary or shift-based positions, which meant their income was unreliable and might vary on a weekly or monthly basis, leading to shortfalls at certain times of the year. Some had also experienced a recent drop in income due to redundancy or moving jobs, meaning they needed to adjust to a different flow of income.

There were two reasons why these borrowers needed a payday loan: either to plug the gap due to a later-than-anticipated payday, or to finance expenses such as utility bills, maintenance work or a family emergency.

Decision-making journey

A payday loan was chosen rather than more mainstream credit services from banks for similar reasons to those who had had a long-term negative experience of payday loans. They either believed they were not eligible for a credit card, personal loan or overdraft extension, or they actively chose not to use these products because they worried about controlling their spending and getting into long-term debt. Many also did not want to deal with banks because of feeling poorly treated in the past.

A payday loan was seen as a 'one-off' solution that allowed a problem to be sorted without recourse to a bank. They did not feel comfortable about taking out a payday loan and were worried about the cost and potential consequences, but felt there was no other choice at the time.

Key factors influencing the decision to take out a payday loan

The short-term nature of payday loans was a key factor in these borrowers' decisions. They were looking for money to cover them for a short period of time. They needed help and didn't want to be paying off interest for several months afterwards. These borrowers tended to take out roughly the amount they thought they needed to cover a deficit, rather than taking as much as the lender would give them.

Many in our interviews commented on the extremely high fees, but felt that, on balance, this was offset by the speed and convenience of the payday loan, which they did not expect from their bank. Their need for extra funds was immediate but not something they expected to reoccur, so a short-term instant loan seemed like the most suitable option.

The relative anonymity of the transaction (particularly online) was a key consideration for some who take pride in their ability to manage their finances, despite their low income. These borrowers said they would rather take out a payday loan than ask a friend or family member for help.

Usage and impact

Those having a short-term mixed experience had both positive and negative feelings about payday loans. On the one hand, they said the loan helped them overcome a difficult financial situation, and described feelings of relief when they received the loan because it meant they were able to deal with a short-term financial problem. However, alongside this short-term relief, there was shock at having ended up in this situation and a feeling of vulnerability because of their reliance on a payday loan to resolve their problems, especially when considering the high fees. Consequently, some of these borrowers arranged a form of saving following their experience to ensure they did not have to resort to a payday loan again.

Case study: Somina, cleaner, Glasgow

Somina works full time as a cleaner. She lives with her two sons and struggles to make ends meet. She looked into getting a payday loan because she was having difficulty paying her bills, 'The main thing was my council tax: I hadn't paid for months and I was getting reminders and notices, and I knew I wasn't going to be getting paid for a while yet and I couldn't wait.'

Somina would not normally consider a payday loan because of the high interest, but she didn't feel like she had an option. She wanted to take out a bank loan but that would have taken too long. She has a few credit cards, but they were already maxed out and she had monthly interest to pay, and she didn't want to her overdraft to go further into debt. The situation was desperate and a payday loan seemed the only way to avoid having to ask friends or family for money.

She went to her local lending shop and was surprised at how quick the whole transaction was and how few questions she was asked about her finances, 'You know you go to some places and they know they're going to get business off you so they're really polite, there was nothing like that. I didn't feel welcomed. I thought, "I'm the needy one now, I don't care how you treat me".'

Somina was relieved to get her loan, 'I was pleased because I thought it was easy, they didn't ask me too much. You're nervous and so when I walked out my day was brilliant after that!'

Somina was able to pay back her loan on the agreed date using the wages she had received by that time. She does not rule out getting another payday loan, but only if things get desperate again. She is also on the lookout for cheaper ways to manage her finances in future. She is considering joining a committee of friends, all of whom give £50 to the 'pot' every month – then they decide together who is most in need of the lump sum each month.

Short-term positive experience

We interviewed borrowers who had only taken out one payday loan, and did not defer payment or incur additional charges. These borrowers said they had a positive experience of taking out the loan. They considered themselves unlikely to purchase a similar loan again in the near future.

Financial circumstances

These borrowers used a payday loan as a one-off for an out-of-the-ordinary purchase, such as a holiday or new furniture. Often the money was used for things they felt ashamed about or saw as frivolous. Although many are in relatively low-income brackets, they are mainly financially stable, with a secure monthly or weekly income. Some had a good credit rating and little or no outstanding debt, but limited or no savings to call upon.

Decision-making journey

A payday loan was a quick way of getting a little extra cash as a safety net prior to a specific event or purchase. These borrowers tended to take out higher value loans compared to others ‘to be on the safe side’ because they were more confident about being able to pay back the extra fees.

While many had the option of using bank finance, they were unwilling to do so for a variety of reasons. Firstly, they did not want to be tempted into debt by a long-term product such as a credit card or overdraft facility. Secondly, they wanted to avoid the hassle of potentially lengthy credit checks and application processing times, and thought the additional fees for payday loans were worth paying in order to get money quickly and easily. In some cases, these borrowers had not investigated what their bank could offer them or at what rate. They assumed it would be easier and quicker to get a payday loan.

Key factors influencing the decision to take out a payday loan

Payday loans were seen as a ‘luxury’ in that the borrowers were aware that the cost of the loan was high, but they believed they were getting value for money in other ways. The key factors in their decision were speed and convenience. The payday loan was issued virtually instantaneously, in contrast to the more lengthy credit checks required by banks.

They were comfortable with the fixed repayment date because they felt they knew exactly where they stood in terms of repayment arrangements and could avoid having to repay a longer-term loan over a number of months.

Some of these borrowers also said they would rather not go to their bank for a small loan, in case it has an impact on their ability to get a larger loan in the future.

The anonymity of the process also meant they were not judged about the use of the loan – particularly important for those borrowers embarrassed about what they were using the money for.

Usage and impact

These borrowers were generally positive about their experience. They said the loan gave them the reassurance to enjoy a short-term purchase, such as a holiday, without worrying about running out of money. However, they also said they would not take out payday loans regularly, because they usually have enough funds available to cover additional expenses, and there are other cheaper options available to them, such as overdraft or credit facilities.

Case study: James, retired, Glasgow

James is retired but works a couple of days a week as a driver, just for fun and to earn a little extra cash. Last year, he and his wife were going on a month-long holiday, and he thought it would be nice to have a bit more money in reserve, in case he wanted to be extravagant when they were out there. Unfortunately his pay cheque was being processed at the time they were departing so he needed to look at other options before he went away.

He did consider going to his bank to get a loan, but this wasn't appealing, 'I thought, I don't want a bank loan. I don't want a long-term thing and my overdraft was pretty high. I wasn't going into the bank to take out £1,000 for a holiday – I had the money and I didn't want to start getting into prolonged repayments. I had just bought a new car and I had some money tied up in a five-year ISA but I didn't want to touch that either.'

James decided to pay a visit to a lender he'd seen in his local town and to find out what they could do for him, 'It's the only time I have ever done anything like that, I normally look at things from a distance and I study the pros and cons […] but they said: "Aye, you can have up to £750 today", and I thought, that's just what I want!' As well as the speed, James was attracted to the finite term of the loan, which meant the debt would not be outstanding for several months.

James did not spend the money on holiday, and repaid nearly £200 in interest on his return. Even so, he thinks the peace of mind afforded by the payday loan made it the right decision at the time. However, he feels the interest rate was very high, and he would think twice before taking out a similar loan in future.

Improving the alternatives

It is evident from the above that there are consumers who are opting for payday lending because it meets their needs for short-term borrowing in a way that mainstream and/or lower cost options do not. If the banks and other financial institutions were able to meet the needs of consumers for quick access to short-term borrowing in an affordable way, it would reduce the need for consumers to rely on payday lending at high cost. For some consumers, particularly those who suffer long-term difficulties, it is essential that banking reforms ensure that mainstream financial services providers make more affordable alternatives available to lower income consumers.

Chapter 4:
The alternatives to payday loans

Credit cards, overdrafts and personal loans are the most well-known and widely used alternatives to payday loans. However, for many in our research, the mainstream finance alternatives to payday loans did not have the characteristics that they were looking for at the point at which they needed financial help. They were looking for a quick, convenient, 'no questions asked', easy to understand and helpful form of finance. For many, the price of a loan was a secondary consideration given the need for speed and easy access based on the situation they found themselves in.

A summary of views

Table 1 is a summary of the views of those we interviewed about a range of financial products. Each product is scored against a number of factors. As the table shows, payday loans have key advantages over most other mainstream finance options, in terms of being quick and easy to access, and borrowers feeling able to stay in control of their debt.

Table 1: a summary of research interviewees' views on a range of financial products

Key:

✓✓✓	✓✓	✓	✗	✗✗	✗✗✗
Strongly agree					Strongly disagree

Form of finance	Quick to get	Easy to access	Easy to understand	Cheap	Trust myself/gives me control	Want to help me
Payday loan	✓✓✓	✓✓✓	✓✓	✗	✓✓	✓✓
Credit card	✓	✓✓	✓✓	✗	✗✗✗	✓
Overdraft	✓	✓	✓✓	✓	✗✗	✗✗
Personal loan	✗	✗✗	✓✓✓	✓	✓	✗✗
Credit Union loan	✗	✓	✓✓✓	✓	✓	✓✓
Store cards	✓✓	✓✓	✓✓	✓	✓✓	✓
Car manufacturer finance	✗	✗	✓✓	✓✓	✓✓	✓
Pawnbrokers	✓✓✓	✓✓✓	✓✓	✗	✗	✓✓
Loan from friends or family	✓✓✓	✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓

Credit cards

For many of the borrowers we interviewed, credit cards were not seen as an option because they did not believe they would be able to take out new or additional cards due to poor credit ratings. Others did not have access to credit cards, viewed them with suspicion, or were wary about being tempted into further longer-term debt.

Some borrowers had actively considered taking out a credit card and some made attempts to do so before taking out a payday loan. However, many were ineligible because of a poor credit rating. Some felt their credit ratings were unfair because they are based on previous rather than current financial circumstances and behaviour, and they wanted the opportunity to demonstrate they were credit worthy.

It was clear from our research that credit cards are not seen as an alternative to payday loans. Many we spoke to had money problems in the past which had led to them accruing substantial debts. Consequently, they were wary of forms of finance that might tempt them into a similar situation again. Credit cards were seen as a 'tempting' form of finance and many were concerned about and even scared of taking out a credit card.

There was a clear view that credit cards were a long-term debt, compared to short-term payday loans. Many we spoke to had a credit card when they took out their payday loan or had previously had a credit card. They were unable to pay off the balance each month and consequently deferred the debt, often only paying the minimum monthly repayment. They felt that this both lengthened the period of the debt and made credit cards an expensive way of borrowing money.

A commonly held view was that credit card companies are too quick to give credit and increase credit amounts[27], and there was a belief that companies often offer credit disproportionate to a person's income. They also felt borrowers were encouraged to increase their credit limit through proactive offers and marketing.

[27] Research by USwitch suggests 5.7 million consumers have had their credit card limits increased without their consent. Uswitch.com (2009), available at: **http://bit.ly/bg9fRR** (accessed 22 June 2010)

Overdrafts

Many of those we spoke to were unable to access or extend overdrafts because of either their low monthly income or a poor credit history. Overdrafts were also seen as a means by which banks tempt customers into debt, although to a lesser extent than credit cards.

As with credit cards, many of our interviewees, particularly those who had had a long-term negative experience or a short-term mixed experience of payday loans, were already using their maximum overdraft facility. They were unable to extend it, or believed they would be refused if they tried to do so. Overdrafts were more likely to be an option for those we identified as having had short-term positive experiences with payday loans. However, these borrowers do not often consider them because of the time and administration required.

More broadly, some borrowers saw overdrafts as a tempting source of longer-term debt that they did not feel they would be able to resist. Even if they had started an overdraft with the intention of using it in the short term, their experience was that this turned into longer-term debt that they were then unable to pay off on a monthly basis. Although they were not viewed as negatively as credit cards, many interviewees still felt that overdrafts are offered by banks with the intention of getting consumers into debt, as the terms and conditions of repayment were not fully explained to them.

Some also mentioned bank charges made overdrafts an unviable alternative to payday loans. Those who had investigated the cost of going overdrawn discovered a payday loan would be cheaper, particularly if there were competitive low introductory rates. Some also mentioned banks charging £1 per day for the use of an overdraft facility, which they saw as comparatively expensive if they need to borrow a relatively small amount.

Some of those we interviewed wanted to have access to a short term, low-value ‘buffer’ amount that would allow them to go over their limit without any charges and without lengthy credit checks. They saw this as the most appropriate option for dealing with short term, low-value finance needs. Agreeing a formal overdraft extension was not seen as an appropriate solution given the time and potential inconvenience, such as needing to physically visit a bank, compared to the immediacy and convenience of a payday loan.

Personal loans

Personal loans were not seen as a viable alternative to payday loans because of the application process and size of loans offered.

A personal loan, although potentially accessible for those identified in our research as having had a short-term positive experience of a payday loan, was not a viable option for most of those we interviewed. Many believed they did not have the credit rating necessary to take out a personal loan. In addition to constraints due to personal circumstances, the application process was seen as too intrusive and slow (it was presumed a personal loan would take a least a week to secure); and the amounts usually lent were much larger than a typical payday loan.

Many were looking for a 'no questions asked' solution to their financial problem and saw personal loans as too intrusive, asking for detailed personal information and an explanation for the exact purpose of the loan. Many believed they would not be given a loan for a short-term bill, family emergency or holiday.

Those who had taken out personal loans in the past were generally positive about them. The fact that a personal loan was taken out for a large, single amount over a long period of time and paid back in exact monthly instalments until the entire loan was repaid meant they were able to keep the debt under control. To this extent, although personal loans were seen as a debt, they were not seen as being as dangerous a debt as credit cards and overdrafts.

Credit Union loans

Credit Union loans were less well known than overdrafts, credit cards and personal loans. Consumers with experience of Credit Union loans see them as a preferable, friendlier alternative to taking out a personal loan from a bank. These consumers feel that Credit Unions are more customer-focused and more likely to help in a crisis than banks. However, the length of time it takes to receive the loan means they are not seen as an alternative to payday loans for short-term financial problems.

Chapter 5: Conclusions and recommendations

Our research has highlighted that the payday lending market in the UK has grown considerably in recent years and seems likely to expand further, particularly online. At the moment, although low-income, the consumer profile in the UK is different to the US, as borrowers in the UK tend be younger and without dependent children.

Our research has identified both the benefits and risks associated with payday loans. In addition, although using a small sample, it has identified three types of borrowers based on their attitudes and experiences of payday loans.

While payday loans can cause substantial problems for some people and have a negative emotional impact, they can also play an important and useful role for others. Consideration needs to be taken to ensure those who are at the greatest risk are protected while those who derive real benefit from the loans with little negative impact continue to have reasonable access to them.

Key findings

Payday loan market:

- There is currently no clear evidence that banning payday loans necessarily helps consumers avoid financial difficulties
- Research from the US provides justification for limiting the number of loans a borrower can take out at any one time or on a repeat or rollover basis. Our own qualitative research supports this

Payday loan users:

- It is lower-income consumers with limited access to other forms of finance that have the most negative experience of using payday loans
- Some consumers have a more positive experience of using payday loans, although a proportion have mixed feelings about using them
- Some consumers are positively choosing this form of lending as a result of deficiencies in what is available to them in the mainstream:
- They see payday loan fees as clearer than the charging structures for other forms of finance
- They feel more able to ‘control’ their debt by taking out a short-term payday loan than by using other finance options
- Other forms of finance are often not considered or seen as an option because they were not available to these consumers (eg due to poor credit ratings) or negative associations, such as the potential for longer-term debt

Recommendations

Payday loan market:

Limiting the number of loans: Consumer Focus recommends that the number of loans or rollovers should be limited to a maximum of five per household per year. This should prevent a potential debt trap scenario being established in the UK. This would be done through clarifying the definition of 'unsustainable' lending in the OFT Irresponsible Lending guidance for creditors[29].

Where consumers have borrowed or 'rolled over' up to the maximum of five times in one year, this should be treated as an indicator of financial difficulty and lenders should be obliged to refer consumers to independent advice and support to deal with any financial problems.

Further research: We also recommend that further work should be carried out by the OFT investigating the impact of banning payday loans within the context of the UK market, as current research focuses on the experiences of other countries.

We support the OFT's recommendation in their review of high cost credit that it should collect essential information on the high-cost credit sector[30]. In the future, this will assist with better evidence in relation to the payday loans market, including judging the impact of interest rate caps or banning paying loans on the UK market.

Payday loan users:

The different experiences and needs of the three types of payday lending users identified in the research means that solutions will need to be tailored differently for each type of user.

Protecting long-term negative experience payday lending users:

The impact of payday loans on those identified as having long-term negative experiences could be addressed by the OFT (and, when it is formed, the Consumer Protection and Markets Authority) requiring lenders to:

- control the amount of money consumers can borrow by ensuring more thorough affordability checks when the first loan is taken out (including effective salary checks)
- ensure affordability checks are repeated when additional loans are taken out in case of change of circumstances
- limit the number of months that a loan can be deferred for (see above)
- limit the number of repeat loans (see above)
- limit the value of repeat loans
- share information to avoid people being able to take out payday loans from multiple lenders simultaneously

[28] See note 2 for definition of 'household' (p7).

[29] Office of Fair Trading (2010), Irresponsible lending – OFT guidance for creditors (paragraph 6.25)

[30] Office of Fair Trading (2010), Review of high cost credit: Final report (p52)

It could be argued that safeguarding payday loans will mean making them slower or harder to access or increasing the fees charged. While this might protect some borrowers, it could also remove one of the key reasons borrowers find payday loans helpful. However, according to our interviewees, some payday lenders are already operating with a higher level of checking, which indicates that it can be done without compromising speed and convenience. In addition, extending the amount of time it takes to receive the loan may give consumers time to reconsider whether they really need the loan or if an alternative source can be found.

The OFT review of high cost credit recommends that the trade associations of payday lenders establish a Code of Practice. The aim of this would be to promote best practice within the market in order to show the lenders are able to address concerns without the need for additional regulation[31]. We recommend that an industry Code of Practice, as proposed by the OFT high cost credit review should incorporate the above measures. It would be a positive step towards the protection of consumers in this area, although we remain doubtful whether a voluntary code would be sufficient to give the full level of protection needed.

Money guidance/money advice: Increased financial literacy may benefit those who have a **short-term positive experience** of using payday loans, as they are in a position to shop around, and money guidance may enable them to exercise choice more effectively between different payday loans or different types of financial products[32]. However, we consider it would have less relevance to those with few other options, who are resorting to a loan to deal with financial difficulty, whether it is long-term or on a one-off basis. Thus, for those who have a **negative experience** of payday lending (and for some of those with a **mixed experience**), money advice will be a more appropriate form of assistance.

On the basis that money guidance and money advice initiatives must be tailored to address the distinct needs of the different types of payday lending users, we support the OFT high cost credit review's recommendation that consumers are helped to make informed decisions on high cost credit by existing financial literacy programmes[33].

[31] OFT (2010) Review of high cost credit: Final Report (p53)

[32] The OFT high cost credit review found that consumers could potentially have saved about £21million if they had chosen the best priced product available on the market. OFT (2010) Review of high cost credit: Final Report

[33] Office of Fair Trading (2010), Review of high cost credit: Final report (p47)

Banking reform: Improving the alternatives for all payday loan users

As shown above, some consumers decide to use payday loans rather than overdrafts and credit cards as they see them as more manageable. As we have found in other research[34], low income consumers are very keen to maintain control of their finances and avoid the risk of debt and will often take a more expensive option in order to do so. In addition, speed of access is a key factor. Government and the industry must work together to provide a better service to low income consumers.

We recommend that the current programme of banking reforms includes measures to reduce the need for low income consumers to resort to high cost borrowing:

- **Clear fee structures:** Across all types of borrowers, the clarity of the payday loan fee is a reason why these loans are chosen over other forms of finance. Consumers are shown the fees in absolute terms, making it hard to compare to overdraft and credit card APR fees. As a result, their ability to assess the relative cost of products is reduced, and few were aware of the scale of the difference between the cost of payday loans and other forms of finance. Presenting overdrafts and credit card charges in the same way as payday loan fees may help consumers to compare products more effectively. All charges and fees for credit should be included in one headline figure to enable better comparison between products. The OFT review of high cost credit has shown how important clarity is for consumers to be able to compare different financial products[35].
- **Fair bank charges:** Some consumers take out payday loans rather than incur penalty charges for unauthorised overdrafts. Currently, unauthorised overdraft charges often exceed the cost to the lender of providing credit to the borrower. If banks' charges for unauthorised borrowing had to be related to actual cost, consumers might opt not to use payday lending, as the charges would be less punitive and more manageable.
- **An emergency borrowing facility:** Banks could improve the financial options available to many low-income consumers by offering an emergency borrowing facility to act as a lower cost mainstream alternative to payday loans. This could be in the form of a pre-approved drawdown facility on the consumer's account which could be activated by contacting the bank. It would differ from an overdraft in that it would be a short-term loan and only available a few times a year. It would be repaid as a first priority as soon as there were funds in the account, which would give banks the same level of security available to payday lenders. We recommend that banks make available a facility of this nature that allows access to relatively low value borrowing at short notice in the short term at reasonable rates of interest.
- **Social lending:** Continued investment in social lending will provide an opportunity for consumers to save small sums of money against future financial difficulty and borrow at affordable rates in times of crisis. As a first step, we would strongly recommend the continuation of the Growth Fund which is due to end in March 2011.

[34] Consumer Focus (2010) On the Margins: Society's most vulnerable people and banking exclusion; Consumer Focus (2010) Opportunity Knocks: Providing alternative banking solutions for low-income consumers at the Post Office.

[35] OFT (2010) High cost credit review: Final Report, Annexe A.

Credit unions provide a valuable source of affordable credit, but there are limits on their accessibility as they still operate on a relatively small scale in the UK. Nonetheless, credit union membership may be an option for consumers who are trying to avoid the possibility of future resort to payday lending by saving. They would also be better placed for access to lower cost borrowing if the need arose subsequently. As awareness of Credit Unions was low among those interviewed, we would recommend increased promotion of Credit Unions, through the industry and money guidance and money and debt advice services, so that these consumers will be fully aware of the options available to them.

Other forms of community-based lending initiatives, including more recent innovations such as peer-to-peer lending (eg Zopa and Grameen bank) may also provide viable alternatives to payday lending. In addition, Consumer Focus has recommended that significant expansion of credit union services could be achieved through the Post Office[36]. This could either be by Post Office Limited (POL) creating a credit union of its own or by a partnership between POL and existing credit unions.

Next steps

Consumer Focus will publicise the above findings and recommendations in order to campaign for the changes that are needed to protect consumers who use payday lending from over-indebtedness and unsustainable borrowing. We will press for mainstream providers to adapt their services to be more responsive to the needs of low income consumers.

We will engage in discussions with the Government and the industry, both payday lenders and mainstream financial services, to make them aware of this research and to persuade them to change their policies and practices for the benefit of consumers.

In the long-term, we aim to reduce the need for consumers to resort to high cost payday lending out of necessity rather than choice and to ensure that those who choose to use payday lending are making an informed decision and are protected from excessive costs or detrimental practices.

[36] Consumer Focus response to the BIS consultation on developing the banking and financial services available at the Post Office, February 2010

Appendix A: The interviewees

The sample in detail

Location	Glasgow	5
	Leeds	6
	London	9
Gender	Male	10
	Female	10
Age	Under 30	8
	30-49	8
	50+	4
Ethnicity	White	13
	African	2
	Pakistani	3
	Indian	2
Socio-economic group	B	1
	C1	8
	C2	5
	D	6
Borrowing channel	Face-to-face	5
	Telephone	5
	Online	10

Recruitment

Recruitment to the sample was achieved using specialist recruiters, contracted by Synovate, through a mixture of street recruitment, 'snowballing' techniques (asking if recruits have friends or family that may qualify for the study) and recruitment databases. The recruitment specification was to find interviewees from a range of working people in terms of age, sex, socio-economic group and family circumstances. It was intended that there should be a good mixture of consumers on low incomes in the sample. It was also considered important to ensure that we recruited a proportion of repeat borrowers to the study, in order to explore their experiences and the issues they faced.

Appendix B: Types of payday loan borrowers

The table below sets out the characteristics of the different types of payday loan borrowers, according to their experiences of using payday loans.

Consumer experience	Payment pattern	Financial circumstances	Reason for needing loan	Other options	Reason for using payday loan	Impact
Long-term negative experience	Deferred, repeat or multiple loans	Lower incomes (sometimes irregular), struggling to make ends meet Money management issues or past debt problems, poor credit ratings	Pay rent or bills, meet short-term need for cash	Rarely	Simple 'no-questions-asked' application processes Negative attitudes towards banks Speed of transaction Finite loan period	Struggled to repay loan, leading to repeat loan or loan 'rollover' with additional fees Financial knock-on effect of problems with other bills Emotional stress and anxiety, shame and embarrassment

continued over

Consumer experience	Payment pattern	Financial circumstances	Reason for needing loan	Other options	Reason for using payday loan	Impact
Short-term mixed experience	One-off loan repaid on time	Low, sometimes unreliable, household incomes and few savings Existing debts	Plug a gap between paydays One-off expenditure on household bills or emergency	Sometimes	Rejected mainstream options - believed not eligible or - wanted control over debt and to avoid being tempted into long-term debt Negative attitudes towards banks Finite loan period Speed and convenience Anonymity	Relief in overcoming a short-term financial problem Uncomfortable with taking the loan Worry about repayment and potential consequences
Short-term positive experience	One-off loan, repaid on time	Low, but stable incomes Good credit ratings Little or no debt Limited savings	Safety net for one-off 'luxury' purchase eg holiday or new furniture	Often	Rejected mainstream options – to avoid being tempted long-term debt Speed and convenience Finite loan period Avoid using bank (use bank for bigger loans) Anonymity	Reassurance Could enjoy a purchase without worrying about running out of money

About the project team

Project manager

Marie Burton, Senior Policy Advocate, Consumer Focus

Marie commissioned the research and managed the project, taking responsibility for combining both studies and their recommendations into a single report.

Peer reviewer

We would like to thank Catherine Wolthuizen of the Consumer Financial Education Body (CFEB) for peer reviewing this document. Please note that the contents of this report should not be seen as reflecting the views, attitudes or opinions of Catherine or CFEB.

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Synovate

Synovate is the market research arm of Aegis Group plc. Qualitative research and analysis was conducted in early 2010 by Hamish Kynoch and Tom Lilley of Synovate. Both Hamish and Tom are experienced qualitative specialists with expertise in both financial and public sector research.

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