

REPORT

JUMPING THE SHARK

BUILDING INSTITUTIONS TO SPREAD
ACCESS TO AFFORDABLE CREDIT



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ABOUT IPPR

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EXECUTIVE SUMMARY

Before the banking crisis, a combination of state redistribution and consumer debt maintained the living standards of many low- and middle-income households. However, in its aftermath – with incomes squeezed, credit tightened and welfare payments reduced – finances have got tough for millions. Payday lenders have stepped into the gap, providing short-term unsecured loans that may be flexible, but which also come at a very high cost, with many now facing an expensive ‘poverty premium’ simply to get by.

Ending this poverty premium is the ambition of this report. A return to rising living standards will reduce households’ reliance on debt, but it will not eliminate their need for it. For a substantial minority, the mainstream credit market will not meet this need, while state-delivered alternatives such as the Social Fund are unlikely to return and were imperfect in any case. Regulation can reduce the harm done by providers of consumer credit, but it alone cannot ensure that the public interest is properly served in the provision of affordable credit.

Instead, we argue that a new institutional settlement is required, one that sustains a form of credit based on rooted, democratic finance that serves the needs of low- and middle-income households. As we will describe, this would take the form of a national institution with the remit of mobilising and capitalising a diverse range of local not-for-profit lenders. It should be capitalised in the first instance by a one-off levy on the consumer credit market, to provide compensation for the direct financial harm it has caused. We also set out steps by which this institutional reform could incentivise saving among low-income families, and restructure the toxic payday loan debt that is stuck on so many household balance sheets.

The payday loan industry has grown rapidly in recent years because it has met a demonstrable need and provided access to credit quickly and easily to a group of people that is often excluded by mainstream lenders. Payday loan firms have made effective use of technology and advertising, as well as developing a visible high street presence. In the context of median incomes for non-retired households falling by 6.4 per cent between 2007/08 and 2011/12, the payday lending industry now supplies over 8 million loans annually, expanding from an estimated £100 million worth of loans in 2004 to over £2.2 billion in 2012/13.

However, the service offered by payday lenders comes at a usurious cost, with £100 lent typically costing between £25 and £35 over 30 days, and sometimes more. It is estimated that two-thirds of those who take out a payday loan have a household income of less than £25,000, and, contrary to some stereotypes, the vast majority take out these loans in order to pay for basic, everyday necessities. Moreover, high costs are often combined with predatory lending practices and poor affordability assessments, which can lead to escalating costs and personal debt problems. These flaws are deep-rooted in the way this sub-market operates, to the extent that the Office of Fair Trading recently referred the entire sector to the Competition Commission.

Of course the payday lending industry is only a small part of a much wider consumer credit market worth £180 billion. According to the National Audit Office, bad practices and uncompetitive prices across this industry caused £450 million of direct consumer harm in 2011/12 alone. For example, one study found that 3.6 million low-income consumers experience financial penalties each year while using mainstream credit and financial services equivalent to £174 per person. Individuals with precarious financial

circumstances lack dependable alternatives in the short-term credit market, leaving them vulnerable to exploitation by unscrupulous firms.

As the economy recovers, rising household income and low inflation will be essential for reducing people's reliance on debt to support their living standards. This is an urgent need given that UK households collectively owe nearly £160 billion in unsecured consumer credit. However, even if real household incomes grow strongly in the coming years, there will continue to be a need for short-term affordable credit in small amounts to enable families to cope with unexpected or 'lumpy' costs.

At present, payday loans are the only viable, legal option for those who do not have savings or family and friends to fall back on. We therefore support overdue efforts to clamp down on the worst practices in the payday lending sector, which exploit those who have nowhere else to turn and forces them into a deeply unequal economic relationship. It is right to place a legal cap on the total cost of credit, which has been found to work effectively in other countries, and to limit the number of so-called 'rollovers', which can lead to a toxic spiral of high-cost debt.

In addition, we believe further steps should be taken to protect consumers, including the following.

- Requiring lenders to provide a clear 'pounds and pence' cost for any potential loan, plus the payment rate and term length.
- Including bank overdraft charges within the planned cap on the total cost of credit.
- Making affordability checks mandatory before a payday loan can be agreed.
- Enforcing a 24-hour 'cooling off' period between a loan request and that cash being paid, giving borrowers the chance to think again and firms the chance to conduct proper affordability checks.

We also think that the Financial Conduct Authority (FCA), which has now assumed responsibility for the regulation of the payday lending industry, must be given the necessary resources to do the job.

While these changes would help to prevent *bad* things from happening to consumers, regulation is a poor strategy for promoting *good* things. Building a systemic alternative to high-cost, short-term loans will not be achieved by regulation alone, or by simply looking to the market for a solution given the costs of servicing short-term loans to often financially risky individuals. Since this need is not going to go away, public action is required in the form of institutional innovation and the redistribution of capital.

As such, we recommend establishing an Affordable Credit Trust (ACT) – a democratic, non-state body with the purpose of capitalising and mobilising a diverse range of local not-for-profit institutions that lend small amounts at affordable rates to ordinary people. This institution should be established by law, with its purpose, functions and governance set out in statute. It should operate independently from government, with the core duties of spreading access to affordable short-term credit and protecting people from unsustainable personal debt. A board comprising independent experts, government appointees, representatives of 'chartered' institutions (see below) and individual members should govern the ACT, which should have five main roles.

- First, it should be responsible for issuing ‘charters’ to local not-for-profit institutions that want to offer affordable credit and that meet a set of basic conditions.
- Second, it should endow such ‘chartered’ institutions with capital to lend to local people according to a set of broad criteria (it would not issue loans directly).
- Third, it should aim for the broadest possible spread of ‘chartered’ institutions across the country, seeking to stimulate and mobilise new entrants to the affordable credit market. This would include developing and providing technological and administrative capacity to local institutions, learning from the work of similar national bodies in the US, South Korea and Canada.
- Fourth, it should monitor and support ‘chartered’ institutions to promote transparency, share best practice and take action against the misuse of capital or examples of consumer detriment.
- Finally, it should help to reduce the level of high-cost, unaffordable debt on households’ balance sheets, while working to prevent people from falling into problematic debt.

The goal of this reform would be to mobilise the energy, capacity and resources in both existing and potential institutions that have roots and relationships in their community. In the first instance, credit unions and community development finance initiatives (CDFIs) would be prime candidates for gaining an ACT ‘charter’ and the benefits it would bring. However, in time, other not-for-profit institutions could enter this sector, such as housing associations, trade unions or social enterprises. Local authorities and mainstream banks could play an important role in helping such organisations by giving them technical and practical support.

Gaining an ACT ‘charter’ – and drawing down capital from the ACT – would involve meeting a minimal set of conditions, that give institutions latitude to innovate and adapt to meet local circumstances. These conditions should be as follows.

- Local lending institutions would need to stipulate the geographic ‘patch’ they planned to serve, and local people living within that area would have to be members of the institution to access affordable credit from it. This would ensure that individuals enter into a relationship with the institution and that, as members, they have a democratic voice in its operation (and by extension, that of the ACT).
- Lending should be responsible, with affordability checks conducted, yet rapid, with loans issued quickly after the 24-hour ‘cooling off’ period. To begin with, loans should be limited to £250, with members limited to one ACT-backed loan at a time. This is similar to the level of the average payday loan, and would ensure that as many people as possible benefit from subsidised lending.
- There should be a cap set on the lending rate operated by ‘chartered’ institutions, but it should not be standardised. The maximum should initially be set at 3 per cent a month (or 42.6 per cent APR), making £100 borrowed for one month cost £3. This cap is equivalent to the new legal limit for credit unions, which government analysis suggests will boost their viability, while maintaining sub-market rates, even without the reforms proposed in this report.¹

¹ By way of comparison, an ACT-backed loan of £250 over one month would cost £258.87; if repaid over six months it would cost £281.96, with monthly payments of £46.99. By contrast, a typical month-long £250 payday loan would cost £334.71.

- To reduce the default rate – and hence their operating costs – ‘chartered’ institutions should be given access to a backstop reclaim mechanism through the benefits system.² A system of this kind has generated a 94 per cent repayment rate for budgeting loans in recent years. This mechanism should only be triggered as a last resort, and even then used only to recover money in small amounts.

The goal of establishing the ACT would thus be to support a network of locally rooted and democratically governed lending institutions, with upfront capital and ongoing technological and administrative support. It would require local people to commit to becoming members of their local lending institution, with membership open to anyone living in the area (and conferring a voice in the governance of the institution). Decisions about lending would be a matter for each institution, provided that they serve the objective of spreading access to affordable credit to those who would otherwise be denied it, and follow strict requirements about operating in a transparent and non-discriminatory way.

To provide an initial capitalisation for the ACT, we recommend a one-off £450 million levy on the consumer credit industry, which is currently worth an estimated £180 billion in total. This would be equivalent to the level of direct ‘consumer harm’ that the National Audit Office has identified as having been caused by the sector in 2011/12 alone. A levy on this scale would redistribute some of the profits unjustifiably made at consumers’ expense towards providing practical alternatives to high-cost credit providers.

The precise distribution of this capital sum to local institutions would depend on the demand demonstrated by those bidding for a ‘charter’, with the ACT responsible for ensuring wide geographic coverage and ensuring financial probity. As an illustration of its potential impact, an initial capital injection of £450 million would support over one-and-a-half million loans of £250 at any one time across a network of ‘chartered’ ACT institutions, with the intention being to build up further capacity in time.

This would be achieved through ‘chartered’ institutions taking in deposits from its members, as well as issuing loans. In fact, a crucial element of this reform would be to support asset-building, boosted by an incentive for those on low incomes to save small amounts into ACT-backed institutions. For example, 20p could be ‘matched’ by the government for every £1 saved up to the first £20 deposited each month. In practice, this could be paid on the basis of the average balance held in an account over the previous year, deferred for a further period subject to the balance being maintained. This would provide a positive ‘carrot’, rewarding those who put some money aside, while ensuring that the subsidy could not be immediately withdrawn.

By way of example, if such a saving incentive were targeted at those in receipt of benefits or tax credits, and a third of them were to take maximum advantage of it (in which case 3.5 million people would gain £48 a year) it would cost just under £170 million.³ Such an ongoing subsidy would give ‘chartered’ institutions an incentive to grow their membership among the target population, and provide an ongoing subsidy to the ACT to help expand its loan book. The changes to defined contribution pensions announced at the March

² The government has recently introduced the Eligible Loan Deduction Scheme, under which the DWP will make deductions from benefits, in certain circumstances, on behalf of not-for-profit lenders. It should extend this facility to ACT-backed institutions.

³ According to the Family Resources Survey, there are 10.5 million adults claiming at least one of jobseeker’s allowance, employment and support allowance (or incapacity benefit), income support, child tax credit or working tax credit (based on 2011/12 figures).

2014 budget have opened up the space for a fundamental re-think of public subsidy for savings. As part of any such redesign, we propose that a very limited proportion of the £38 billion currently foregone in regressive and poorly targeted tax-relief on pension savings is transferred to supporting asset-building among those on low incomes.

Stronger regulation of high-cost credit and the introduction of the ACT would help to prevent the further escalation of personal debt. However, these steps would not reduce the stock of high-cost debt already on the balance sheets of low-income households. This issue has received far less attention than either banking debt or sovereign debt in recent years, despite arguably being just as damaging to our economic recovery, never mind its toxic social consequences.

Therefore, those servicing relatively small amounts of high-cost debt, who can demonstrate that they have repaid the initial amount borrowed, should be able to exchange that debt for an ACT-backed loan (up to the £250 cap at any one time), subject to the standard conditions. For members with a larger or more problematic high-cost debt burden, the ACT should seek to negotiate a collective debt restructure on their behalf. This should involve the payday lending firms taking a 'haircut' on their loans, individuals agreeing new repayment schedules, and the ACT buying up bundles of this re-profiled payday loan debt, using the government's balance sheet to keep borrowing costs down.

The explosion of high-cost payday lending in recent years has been one of the most pernicious consequences of the economic turmoil of the last few years. Our analysis finds that it is the result of a combination of market excesses and state failure, with individuals, families and civil society not powerful enough to resist and respond. The proposals set out in this paper aim to rebalance the fight, empowering individuals and institutions to help each other, and help themselves.

From a broader perspective, these reforms speak to a wider argument for a renewed social democracy: more assertive in standing up to markets where they dominate or humiliate people; less reliant on cash transfers and the central state that fails to ask people to play a part in solving their problems; and more attentive to the difficult – but altogether more transformative – task of building institutions and redistributing power that can create the conditions for people to come together and build better lives together.

1. INTRODUCTION

In the aftermath of the financial crisis, a great variety of morbid social and economic symptoms have appeared (Gramsci 1971). One of the most visible manifestations of these has been the rise of the payday lending industry, which charges eye-watering fees for access to short-term credit. While the speed and accessibility of payday lending works for some, the recent referral of the entire sector to the Competition Commission for endemic bad practice suggests that a better, more affordable alternative is desperately needed (OFT 2013a).

In that light, the plan to introduce a legal cap on the total cost of credit is a step in the right direction. However, the argument presented in this paper is that while they have an important role, regulatory solutions to the problems associated with high-cost credit and personal debt are inherently limited. Regulation can prevent the worst excesses, but it is less effective at promoting better alternatives. As such, we believe that bolder efforts are required to increase the supply of affordable credit and rebuild financial security among hard-pressed households.

The rise of the payday lending sector in recent years cannot be attributed to a lack of financial literacy. Rather, its root cause is a fundamental imbalance of economic power, with many people who are facing falling incomes and rising prices having few or no alternatives to turning to high-cost credit providers, because they lack savings or cannot access credit from mainstream lenders.

Moreover, even if irresponsible lending practices⁴ were stopped, there will remain a significant number of people who have no assets to fall back on but who need access to short-term credit in the event of an unexpected cash-flow problem or a 'lumpy' cost. At present, many are turning to expensive forms of debt to pay for everyday living costs as well as to fund short-term emergencies – and they are paying an expensive premium to do so, one that can often escalate rapidly and damagingly out of control. Clearly payday lending does not cause a problem for every user, and we have no intention of stopping their operation where they do no harm to consumers. However, for many others, a more affordable and sustainable alternative is required.

Therefore, in addition to proposing a series of practical steps to rein in the worst aspects of the wider high-cost credit market, this report's central proposal is for a substantial institutional and financial intervention in the short-term credit market. At its heart would be the creation of an Affordable Credit Trust (ACT) – an independent institution with the remit of capitalising and mobilising alternative providers of affordable credit. Its initial capital injection would come from a £450 million levy on the consumer credit industry,⁵ which, according to the Office of Fair Trading, would be equivalent to the level of consumer financial harm caused by that sector in 2011/12 alone (NAO 2012).

This would enable more locally rooted, democratically governed lending institutions – including but not limited to credit unions – to extend affordable credit to local people. These local institutions – 'chartered' and supported by the ACT – would also offer a savings facility, with an element of public subsidy for those on low incomes to help them build assets of their own.

Combined with strategies aimed at restructuring existing high-cost debt stuck on household balance sheets, this reform plan would aim to substantially alter the market for short-term credit across the country and – in time – improve the economic security and financial resilience of ordinary families.

4 See OFT 2013b

5 Defined to include payday loans, home credit, credit cards, store cards, personal loans and mortgages.

6 IPPR | Jumping the shark: Building institutions to spread access to affordable credit

2. THE DRIVERS AND DIMENSIONS OF THE RISE IN PAYDAY LENDING

Before turning to potential solutions, it is first necessary to clarify the nature of the 'problem' with the current payday lending industry and its relationship with the wider consumer credit market. This chapter explores these issues, and includes a new analysis of the typical users of payday loans.

Payday lenders provide small, unsecured cash loans at short notice on a short-term basis, typically for up to 31 days. They are usually lent to those on lower incomes, with no previous relationship normally required between the lender and the borrower. Part of the attraction of payday lenders to their target market is that they operate from accessible high-street locations and/or provide rapid access to cash through online technology. They also benefit from wider mistrust of mainstream banks, particularly among low-income households.⁶

In fact, payday lenders are often filling a gap in the market that mainstream banks and other lenders do not serve, either because the amounts lent are too small, or because the borrower is (perceived as being) too risky, or both. Given this fact, and the relatively fixed costs involved in a lending business, payday lenders seek to make profits by charging very high interest rates⁷ and levying high fees. Some also adopt poor or unethical business practices, such as relying on the 'rolling over'⁸ of loans to generate extra revenue.

Despite their high cost to the consumer, payday loans have been one of the few sub-sectors of the consumer credit market to experience significant growth since the recession. It grew from an estimated £100 million worth of loans made in 2004 to over £2.2 billion in 2012/13. The number of loans almost doubled between 2009 and 2012 to reach approximately 8 million in total (OFT 2013b). As table 2.1 shows, this growth has been combined with exceptionally high profit rates for many payday lenders.

This growth in profits has come at a significant cost to the consumer. According to the Office of Fair Trading (OFT), the average payday loan taken out is around £260 for a month, but they typically cost £25 for every £100 borrowed (rising in some cases to as much as £51 per £100 borrowed) (OFT 2013b: 9). On top of this, lenders routinely charge high fees for any repayment transgression. For example, Which? found that 17 of the biggest operators in the short-term lending market had default fees of £20 or more.⁹

Furthermore, the combination of high costs, short timescales and often inadequate affordability assessments mean that payday loan debt can rapidly escalate out of control. An examination of data from StepChange, one of the largest debt charities in the country, illustrates how quickly people can become trapped in a debt cycle. StepChange clients are not representative of all borrowers, but over a third of their clients with payday loans have three or more loans outstanding, with one-fifth having more than five loans out at

6 For example, eight in 10 low-income Londoners believe that they would find it difficult or impossible to borrow £200–£500 from a mainstream financial institution. Source: [https://www.ljmu.ac.uk/Faculties/HEA/HEA_docs/COMMUNITY_FINANCE_FOR_LONDON_\(SANTANDER\).pdf](https://www.ljmu.ac.uk/Faculties/HEA/HEA_docs/COMMUNITY_FINANCE_FOR_LONDON_(SANTANDER).pdf)

7 Given the short-term nature of most payday loans, the APR figure can be a misleading indication of the cost of a loan. Nonetheless, they are indicative of the very expensive nature of the product.

8 According to the OFT definition, 'rollover' loans are those on which customers repay the interest charges owed but postpone the repayment of the remainder of the outstanding debt for another loan period (typically a month). The experience of 'refinancing' is the same as far as the borrower is concerned, but refers to cases in which a new loan is issued to repay the outstanding balance on an existing loan. See page 13 of http://www.offt.gov.uk/shared_offt/Credit/oft1482.pdf

9 <http://www.theguardian.com/money/2014/jan/13/which-challenges-payday-lenders-missed-payment-fees>

once.¹⁰ In such circumstances it can be almost impossible for the borrower to escape their debt, even if they have paid off the original loan many times over.

Table 2.1
Top 10 largest payday
loan companies in the
UK (as of September
2013)

Rank	Company	Trades as	Most recent turnover	3-year turnover growth	Most recent pre-tax profit	Representative APR
1	Wonga	Wonga	£309,290,000	5.4	£84,476,000	5,853%
2	CashEuroNet UK LLC	Quick Quid, Pounds to Pocket	£198,101,370	3.2	N/A	1,734%
3	Instant Cash Loans Ltd	The Money Shop, AdvanceBritain.com	£172,315,000	1.8	£34,608,000	2,961%
4	MEM Consumer Finance Ltd	Payday UK, Month End Money	£123,112,910	2.0	£38,713,149	2,160%
5	Express Finance (Bromley) Ltd	Payday Manager, Payday Express	£51,763,131	2.4	£16,641,763	2,371%
6	WageDayAdvance Ltd	Wageday Advance	£39,518,114	2.5	£19,805,832	7,069%
7	Lending Stream Ltd	Lending Stream, Zebit	£32,743,910	42	£4,315,739	1,562%
8	TxtLoan Ltd	MyJar	£22,419,439	20.5	£470,655	3,943%
9	CFO Lending Ltd	Capital Finance One, CFO Lending	£19,635,755	24.9	£76,235	6,759%
10	PDL Finance Ltd	Mr Lender	£17,491,214	3.3	£3,243,555	4,849%

Source: Warren 2013

Moreover, what makes these high costs – and escalating debts – particularly worrying is the fact that they are borne mainly by the most financially vulnerable. It is estimated that two-thirds of those who take out payday loans have a household income of less than £25,000 (Burton 2010). Research suggests that, consequently, the majority of payday loans are used to pay for basic necessities like food, fuel or housing.¹¹ For example, a recent Christians Against Poverty survey found that among those seeking debt advice, 80 per cent had taken out a payday loan to pay for food, while a third (32 per cent) did so to cover mortgage repayments.¹²

To put the cost of payday lending in context, table 2.2 compares the cost of a loan from leading firms in the payday loan sub-sector relative to other providers of consumer credit.

To deepen the comparison, £400 borrowed from Provident Personal Credit (a home credit provider)¹³ would cost £26.00 a week over 23 weeks, and so would cost £598.00 in total. On the other hand, £400 worth of shopping put on a Dorothy Perkins store card,¹⁴ with 29.9 per cent APR, would (if a customer were to pay off only the minimum amount each month) incur interest of £67.70 in a single year, and would cost £467.70 in total.

As the payday lending industry rightly points out, their astronomical headline APR rates – which can be as high as 5,853 per cent – are misleading given the short-term nature of the loans. Moreover, the cost of credit (without public subsidy) inevitably reflects in part

10 See StepChange for further details: <http://www.stepchange.org/Paydayloans.aspx>

11 <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9663656/Almost-40pc-of-payday-loans-used-to-buy-food.html> and <http://www.bbc.co.uk/news/uk-25733830>

12 <https://capuk.org/connect/latest-news/four-out-of-five-use-payday-loans-for-food>

13 <http://www.providentpersonalcredit.com/current-customers/cash-loans/>

14 <http://www.moneywise.co.uk/news/2013-05-02/shoppers-warned-over-using-expensive-store-cards>

the price of risk, which is higher among the typical users of payday loans. Yet the cost of credit in this sub-market remains exceptionally high, and is often being borne by those with the very least.

Table 2.2
The relative cost of borrowing £400 borrowed over one month

Lender	Total cost	Total to pay
Payday UK	£116	£516
Peachy	£125	£525
Wonga	£131.21	£531.15
Quick Quid	£88.29	£488.29
London Mutual Credit Union*	£19	£419
Salford Credit Union	£31.84 over 6 months (cannot currently be paid off over only one month)	£431.84
Barclaycard	Zero if paid off when due; otherwise, £12 late payment fee plus interest.	Dependent on payment, but APR rate of 34.9 per cent

Note: Rounding reflects the available data from different sources.

*These figures are similar to those of other credit unions that offer payday loans.

Data sources, respectively: <https://www.paydayuk.co.uk/>; <https://www.peachy.co.uk/compare-peachy-loans>; <https://www.wonga.com/>; <https://www.quickquid.co.uk/fee-schedule.html>; <http://www.creditunion.co.uk/Loans.htm>; https://www.salfordcreditunion.com/eWEB_LoanCalc2.asp?contenttype=LoanCalculator#calc; and <http://www.barclaycard.co.uk/personal>

Credit unions

Credit unions are financial cooperatives that offer savings and loans to their members. They are democratically owned and governed, and exist for the benefit of members rather than to maximise profits for external shareholders. Combined with an interest rate cap of 3 per cent per month (from April 2014; equivalent to 42.6 per cent APR), this means that they can offer loans on a much more affordable basis than payday lenders. They also offer provide financial advice to members.

The total number of credit union members in Great Britain doubled from 563,000 in 2004 to almost 1.04 million in 2012, with 390 credit unions operating nationwide (Bank of England 2013). The recent decision to increase the interest rate cap to 3 per cent had the aim of ensuring that professionally run, well-capitalised credit unions can sustainably offer short-term, affordable credit (ABCUL 2013). With the support of the Department for Work and Pensions' (DWP's) Credit Union Expansion Project, the sector's goal is to increase access to financial services to a million more people on low incomes by March 2019.

Nevertheless, a recent DWP feasibility study into the credit union sector made clear that a number of weaknesses must be overcome before its potential can be fully realised. These include dealing with instances of weak governance, a lack of professionalism, concerns about financial sustainability, sector fragmentation, and low levels of awareness about the services on offer (DWP-CUEP 2012).

Any strategy for expanding the role of credit unions must involve promoting greater professionalism by bringing in outside expertise, improving financial sustainability through extra capital, an improved offer of competitive financial services, and building credit unions' membership bases through better marketing.

Despite its high costs to consumers, the payday lending industry has grown in large part because of a gap in the credit market that mainstream banks are unwilling (or unable) to fill. However, it is important to note that banks are also often either inaccessible to or expensive for low-income households. For example, to get approval for an unsecured personal loan from a bank, a borrower must typically have no history of adverse credit. If this means that they instead have to rely on an overdraft facility they can often face high costs for doing so, especially if it is unauthorised. For example, an estimated 6.6 million people incurred more than £100 in overdraft and penalty fees in 2011 (BIS 2012). Similarly, Ellison et al (2011) found that 3.6 million low-income consumers experienced financial penalties each year while using mainstream credit and financial services which amounted to approximately £630 million in total – an average of £174 per person. An OFT report into current accounts found that banks made nearly £2 billion from customers who used unauthorised overdrafts in 2011/12 (BIS 2012: 22–23). Even if mainstream banks did provide short-term credit to households, there is every risk that, without further reform, the costs – and penalties – would be extremely high for borrowers.

To return to the payday lending market, the scale of its problems was underlined by the referral of the entire sector to the Competition Commission by the OFT in June 2013. This followed systematic non-compliance with existing regulation by many firms in the market (regulation that was already weak by international comparison). Bad practice was found to stem from the design of the market and the business models of many lenders. Opaque pricing structures, a lack of price competition, reliance on income from rollovers, poor affordability assessments, and predatory lending and collection practices have all interacted to raise the cost of credit to consumers.

To give a sense of these problems, the following points were among the findings of the OFT's recent compliance review of the industry (OFT 2013b).

- Fifty leading payday lenders, which account for 90 per cent of the market, were found to be non-compliant with OFT guidelines.
- Over a quarter of lenders were found not to conduct affordability checks for new customers, while a third did not conduct checks for each loan.
- Too many lenders make it difficult for consumers to identify or compare the full costs of a loan.
- Nearly three in 10 loans were found to have been 'rolled over' or refinanced, accounting for nearly half of all revenues.
- Lenders were found to have promoted rollovers in order to maximise profits, when customers should instead have been declined rollovers due to their inability to pay (one lender even included this practice in its training manual).

Emblematic of the flaws in the payday lending market is the fact that 19 of the 50 companies that were given 12 weeks by the OFT to address areas of non-compliance chose to exit the market rather than attempt to comply with regulation.¹⁵ Why, then – given the potentially damaging nature of payday loans – has the use of them soared in recent years?

¹⁵ <http://www.credittoday.co.uk/article/15780/online-news/more-payday-lenders-leave-market-after-oft-action>

2.1 Rising demand, as incomes fall and prices rise

Despite their cost, payday loans have been servicing a clear demand for short-term credit. A fundamental driver of this demand has been falling real household income. The median income for non-retired households fell by 6.4 per cent between 2007/08 and 2011/12, with falling real wages exacerbated by the erosion in the value of benefits and tax credits (ONS 2013).

The rise of payday lending can also be partly attributed to longer-standing structural flaws in the UK economy. Nearly one-fifth of workers earn less than the Living Wage (Hurrell and Whittaker 2013), and analysis by the Trades Union Congress suggests that 80 per cent of the jobs created between June 2010 and December 2012 were in sectors in which the average wage is less than the Living Wage (TUC 2013). Reducing reliance on high-cost credit and lowering levels of personal debt will therefore require sustained growth in real incomes. This, in turn, will require higher employment and rising wages.

Meanwhile, the proportion of average household disposable income accounted for by expenditure on 'essential' household goods rose from 19.9 per cent in 2003 to 27.3 per cent in 2013 (Wales 2013). This change has been driven by falling incomes, but also by an increase in the cost of housing, as well as of gas and electricity bills, which rose by 119 per cent and 47 per cent between 2000 and 2012 respectively (Bolton 2014). Consequently, an increasing number of households have less financial 'slack' with which to deal with short-term cash flow problems or large or unexpected costs.

This situation is compounded by inequalities in savings and assets which mean many households have few reserves to fall back on: two-thirds of low-income households have less than one month's salary in savings at any one time, and 3.9 million families have insufficient savings to cover their rent or mortgage for a month should their income disappear (CSJ Working Group 2013). Furthermore, 8.8 million people already consider themselves to have 'serious' financial issues, with half of the 'over-indebted' population living in families on incomes under £20,000 (MAS 2013).

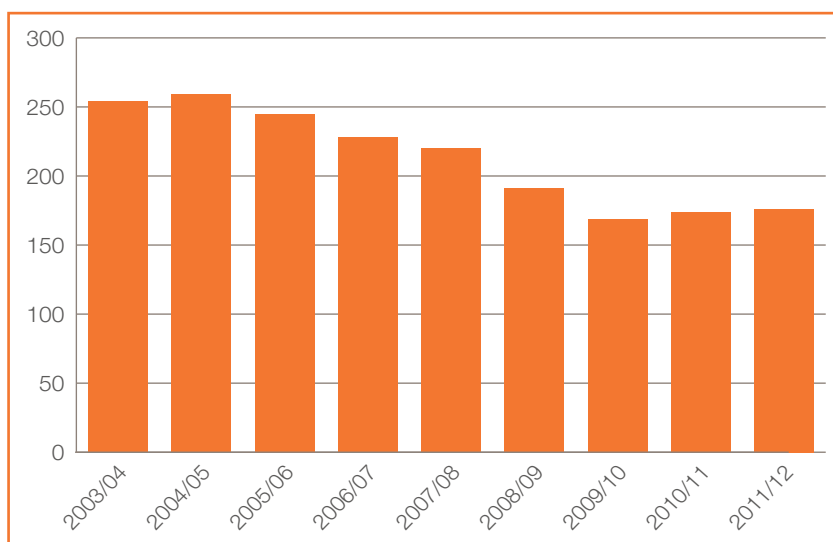
In this context, payday lenders have thrived in recent years by providing expensive temporary relief to people caught between the dual vices of declining wages and rising costs, who have little if any savings and assets, and who have few alternatives.

2.2 Fewer alternatives, as access to mainstream consumer credit tightens

The tightening of the broader consumer credit market is also likely to have driven growth in the payday lending industry in recent years. As figure 2.1 illustrates, gross lending to individuals has fallen significantly over the last five years, after it had previously risen to historically high levels before the financial crisis (NAO 2012).

The consumer credit market was worth 33 per cent less as a proportion of GDP in real terms in 2012 than it was in 2008, a fall driven in part by tighter credit conditions and households' desire to pay down their debts. This trend stands in stark contrast to the rise of payday lending. In 2006, it accounted for a mere 0.147 per cent of the £245 billion worth of the consumer lending market, but by 2012 it constituted 1.25 per cent of a market worth £180 billion.

Figure 2.1
Gross lending to
individuals (£bn),
2003/04–2011/12



Source: Adapted from NAO 2012: 32
Note: Figures adjusted for inflation.

Nearly half of all payday loan users report that they took out that loan because they could not access other forms of credit (BIS 2012). This finding is supported by the ‘debt cocktail’ measure compiled by the debt charity StepChange (see table 2.3). Since 2009, the use of other forms of lending among those who use payday loans has decreased. For example, the share of payday loan users who also hold credit card debt has decreased from 73 per cent in 2009 to 60 per cent in 2012. The proportion of people with both a payday loan and a personal loan has also dropped from 78 per cent in 2009 to 49 per cent in 2012.¹⁶ This suggests that it has become more difficult for those using payday loans to access other forms of consumer credit, increasing their reliance on the most expensive forms of credit.

Table 2.3
‘Debt cocktail’ of those
with payday loan debt in
the UK, 2009 and 2012

	Credit card	Overdraft	Personal loan	Payday loan	Family or friend
2009					
Proportion with other types of debt	73.1%	69.7%	78.2%	N/A	37.5%
Average number of debts per client who have a ‘debt cocktail’	2.4	1.4	2.2	1.6	1.0
Average size of debt	£4,095.23	£1,805.51	£8,251.16	£1,187.60	£2,727.92
2012					
Proportion with other types of debt	60.1%	62.8%	49.3%	N/A	34.2%
Average number of debts per client who have a ‘debt cocktail’	2.2	1.4	1.9	3.0	1.0
Average size of debt	£3,509.03	£1,532.96	£6,215.35	£1,657.19	£2,552.07

Source: IPPR analysis of original StepChange data, 2014.

¹⁶ IPPR analysis of original data from StepChange, 2014.

The payday lending industry should nonetheless be kept in perspective. Despite its recent growth, it remains smaller than the home credit industry, which was worth £3.5 billion in 2012,¹⁷ and it lends only slightly more than the £1.83 billion loaned out through (very expensive) store cards (NAO 2012). Payday lending is only a small part of the £180 billion consumer credit market, which is not without high costs or bad practices. In fact, the National Audit Office recently found that the consumer credit sector as a whole caused at least £450 million of direct consumer detriment in 2011/12 alone (NAO 2012). 'Consumer detriment' refers here to deliberate consumer harm inflicted by lenders through to poor practice, irresponsible lending, mistreatment or mis-selling.¹⁸

The home credit industry

Home credit (or 'doorstep lending') is the provision of low-value, unsecured cash loans that are repaid in fixed installments, usually over a period of around a year, to an agent that visits the borrower's home.

In 2006, a review by the Competition Commission found that 430 home credit lenders lent about £1.3 billion to around 2.3 million customers, and collected around £1.8 billion in repayments. The mean value of a loan issued was around £335, while the mean repayment term was 43 weeks. Home credit customers were more likely than the population as a whole to be female, under 35, have young families, live in a low-income household and live in rented social housing (Competition Commission 2006).

The Commission also found that the total cost of credit varied from around £30 per £100 borrowed for the shortest loans, to over £100 per £100 borrowed for some of the longest-term loans. The price of an average loan was approximately £20 higher than could have been expected in a market in which competition ensured prices reflected only the costs of provision (which equated to £7 per £100 of loans issued – significantly higher than other forms of lending, such as those provided by credit unions or online lenders, which do not require home visits) (Competition Commission 2006).

In February 2013 a Competition Commission evaluation¹⁹ of its own 2006 report found that many of the same problems found in that original study persisted, confirming that home credit providers target a similar market as payday lenders do, and that home credit is still very costly for the typical user.

2.3 Shrinking state support, as the holes in the safety net grow

In the past, when household budgets were under pressure and credit from mainstream lenders was not available, families could turn to forms of state support to tide them over. However, a series of changes in recent years have seen these options cut back, increasing households' exposure to financial insecurity and personal debt. This, in turn, has contributed to rising demand for payday lending.

17 <http://www.ccauk.org/information-for-businesses/home-credit-industry/> and http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/remedies/130228_home_credit_evaluation.pdf

18 <https://www.nao.org.uk/press-releases/office-of-fair-trading-regulating-consumer-credit-2/>

19 http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/remedies/130228_home_credit_evaluation.pdf

Arguably the most important change has been the dismantling of the Social Fund, which provided emergency interest-free loans and grants to low-income households. Until April 2013 this fund made three kinds of payments to people in receipt of benefits with an urgent need: community care grants, budgeting loans and crisis loans (see footnote for an explanation of each).²⁰ However, community care grants and crisis loans have been scrapped, with local authorities instead given money to provide local assistance as they see fit.

Budgeting loans continue for now, but will be replaced by ‘budgeting advances’ after the full implementation of universal credit (which will now not occur until long into the next parliament at the earliest). There is little clarity over how these will work, but crucially they will be an ‘advance’ on benefit payments rather than a loan. In contrast to budgeting loans, applicants for the advance will need to have been in receipt of an out-of-work benefit for at least six months, thereby excluding working households. Furthermore, while budgeting loans could be repaid over 104 weeks, the advance will have to be repaid within a year.²¹

Funding for what used to be the Social Fund has also fallen significantly: the £178 million that has been allocated to local authorities for spending on emergency local assistance in 2013/14 represents a cut of £151 million (46 per cent) compared to the funding available for the equivalent community care grants and crisis loans in 2010/11. In the latter year, total gross expenditure on these two elements of the Social Fund was £367 million, while total net expenditure was £243.6 million (after taking repayments on loans into account) (Royston and Rodrigues 2013).²²

Meanwhile gross expenditure on budgeting loans fell from £590 million in 2006/07 to £455 million in 2012/13. There have been no guarantees about how much will be available for budgeting advances, although given the fact that these are only bringing forward payment of benefits to which people are anyway entitled there are likely to be little if any direct additional cash outlays (Royston and Rodrigues 2013).

Future public support for meeting emergency needs is even more uncertain. The government has decided to end the dedicated funding stream provided to local authorities by the DWP for the provision of emergency local assistance from April 2015. Instead, it will be for local authorities to decide what support they want to provide, using their block grant from the Department for Communities and Local Government.²³ At a time of significant pressure on local budgets and services – and without a statutory requirement to provide emergency assistance – there is a very real prospect that no provision equivalent to the old Social Fund will be available in many parts of the country.

20 A budgeting loan helps pay for essentials like rent, furniture, clothes and hire purchase debts. The smallest amount that can be borrowed is £100. Budgeting loans are interest-free, and normally have to be repaid within 104 weeks. The community care grant was a payment made to people on certain benefits to help them meet costs that would enable them to remain in the community. A crisis loans was a payment intended to cover essential costs following an emergency or disaster. It was smaller than both budgeting loans and community care grants, and it was a loan: claimants were expected to pay it back. See <http://www.parliament.uk/business/publications/research/briefing-papers/SN06413/localisation-of-the-social-fund>

21 See <http://www.parliament.uk/business/publications/research/briefing-papers/SN06683/short-term-benefit-advances-and-budgeting-advances>

22 Of this, the gross expenditure of the crisis loan programme was £228.3 million, with £123.7 million recovered and a net expenditure of £104.7 million. It is worth noting that, because of the loan-based nature of the scheme, it generated a surplus of £50 million in both 2011/12 and 2012/13. By contrast, gross (and net) expenditure on community care grants in 2010/11 was £138.9 million, as these were grants rather than loans (Royston and Rodrigues 2013).

23 For further details see <https://www.gov.uk/government/publications/change-in-spending-power>

In the meantime, the shift in responsibility to local authorities has also changed the way in which emergency financial support is delivered. Only 23 per cent of councils offer loans as part of their local assistance scheme, while 62 per cent offer only grants (Royston and Rodrigues 2013). Greater use of grants will reduce the level of support available overall, as funding will be run down rather than replenished. It also represents an extension of the ‘hand-out’ model of often stigmatising support, rather than one that helps build independence and self-reliance.

Local schemes also have much tighter access criteria. Previously, crisis loans were available to anyone with a demonstrable need. By contrast, a quarter of local schemes are restricted to those on out-of-work benefits, with over half of them requiring applicants to be claiming some benefit or tax credit (in or out of work). Finally, whereas payments under the old system were in cash, only 11 per cent of local authorities have confirmed that they solely provide cash payments. Instead, 64 per cent say they only provide in-kind support, and 17 per cent say they provide a mixture of the two (Royston and Rodrigues 2013).²⁴

The exposure of UK households’ to financial insecurity has also been increased by a significant rise in the use of benefit sanctions. For example, between September 2012 and September 2013, 874,850 sanctions were applied to jobseeker’s allowance (JSA) claimants, up from 751,943 in the previous year – an increase of 16 per cent – while low-level sanctions (which account for 54 per cent of total sanctions) now automatically entail the loss of JSA for four weeks for a ‘first breach’ (Pearce 2014). These can often result from petty or arbitrary decisions, but mean that vital financial support is cut off at little or no notice, often leaving people at the mercy of a complex and inhumane bureaucracy. A minority of households have also had to cope with substantial absolute cuts in their income as a result of the household benefit cap, the so-called ‘bedroom tax’,²⁵ and cuts to council tax benefit.²⁶

One of the starkest manifestations of increased financial insecurity – and straightforward poverty – is the rise in the use of food banks, including by people in work, which has been anecdotally linked to benefit changes. Recent figures from the Trussell Trust show that over 350,000 people received three days’ worth of emergency food from one of their food banks between April and September 2013 – triple the number of people that received this help during the same period of the previous year. Moreover, 65,177 people (19 per cent of all Trussell Trust food bank users) were referred due to benefit changes between April and September 2013, compared to 14,897 (14 per cent) in same period in 2012, while 117,442 people (35 per cent) were referred due to a delayed benefit payment, compared to 35,597 (33 per cent) between April and September 2012 (Trussell Trust 2013).

2.4 The users of payday loans and their experiences

Having set out the main factors behind the recent rise in payday lending, we turn next to analysing the users of this form of short-term, high-cost credit. This analysis is based on data provided to IPPR by the debt advice charity StepChange,²⁷ Citizens’ Advice Bureau data,²⁸ and a poll commissioned by IPPR and conducted by Opinium.

24 A bizarre example of the effects that an in-kind system can produce is a case that occurred on the Isle of Wight, where the council offered a homeless pensioner a voucher for a tent. <http://www.theguardian.com/society/patrick-butler-cuts-blog/2013/jun/03/homeless-pensioner-offered-tent-by-council>

25 <http://www.housing.org.uk/policy/welfare-reform/bedroom-tax#sthash.BhFDr3Vd.dpuf>

26 <http://www.jrf.org.uk/publications/impact-localising-council-tax-benefit>

27 The data provided is related to socio-demographic and other financial indicators provided by clients who hold at least one payday loan debt, and who sought advice from StepChange during the years 2009–2012.

28 Unpublished Citizens’ Advice Bureau data released to IPPR privately.

Our analysis focuses on London which, due to a number of factors, is particularly vulnerable to the growth of payday lending. Great wealth sits alongside acute poverty: over 26 per cent of London falls within the most deprived 20 per cent of wards in the UK (Leeser 2011). Three-quarters (74 per cent) of Londoners say they would find it difficult or impossible to raise £200–£300 in an emergency without borrowing, while 83 per cent say they would find it difficult or impossible to save £500 towards a special purchase. Furthermore, eight in 10 low-income Londoners believe that they would find it difficult or impossible to borrow £200–£500 from a mainstream financial institution (Jones and Ellison 2011). The main findings from our analysis are as follows.

- People under the age of 40 are disproportionately heavy users of payday loans. Nearly 75 per cent of StepChange’s clientele who have a payday loan debt fall into this age category, though this proportion is slightly lower in London. Over a quarter (26 per cent) of the people who engage with StepChange are under 25; only 1.3 per cent are over the age of 60.
- The largest category of people seeking payday loan debt advice from the Citizens Advice Bureau (CAB) are single men without children, who comprise almost a third (31 per cent) of this group. The second largest group is single women without children (21 per cent). By contrast, couples with children make up a little over one in 10 (12 per cent) of those seeking advice.
- In 2009, the average number of outstanding payday loans held by each StepChange client was 1.6 (both nationally and in London), but by 2012 this figure had risen rising to 3.0 (and 3.3 in London). In 2012, 6,322 homeowners approached StepChange for advice with payday loan debt (467 of whom were in London). By contrast, almost five times that number of renters (30,091 nationally and 3,064 in London) sought advice.

As shown in table 2.4, according to our poll of people who had used a payday loan within the last two–three years, the most common factor that motivated take-up of payday loans was the need to pay for everyday living expenses (41 per cent), followed by household emergencies (35 per cent) and utility bills (32 per cent). A significant minority also cited the need to pay rent or a mortgage.

These results did not vary substantially across age groups, although those aged 30–39 were more likely to say that they used a payday loan for rent, a mobile phone bill and to pay off other debt. Younger people were also more likely to say that they used a payday loan for entertainment, including a holiday or a night out.

Overall, two important conclusions can be drawn from our survey of the users of payday loans. First, payday loans are often part of a wider web of personal debt. Many borrowers have at least one other form of debt – whether credit card, overdraft or personal loan – which potentially leads to an inescapable ‘debt cocktail’. Second, there is evidence that loans are largely used for basic essentials like utility or housing bills, and for seasonal costs. This suggests that – without a major and sustained upswing in living standards – there will remain a strong demand for lower-cost credit alternatives to support low- and middle-income households and prevent further build-up of personal debt.

Table 2.4
Uses for payday loans among UK correspondents who had used a payday loan within the last 2–3 years (both high street and online lenders)

Loan use	% of respondents that used money from a payday loan for each use
Everyday expenses (e.g. groceries)	41%
An emergency (e.g. to fix a boiler, repair a car)	35%
To pay off utility bills	32%
A holiday/weekend away	26%
Rent/mortgage payment	25%
To pay off a credit card bill	21%
Clothes	16%
A special event (e.g. birthday/wedding)	15%
A night out	13%
To top up or pay a mobile phone bill	9%
Other form of entertainment	3%
Other	6%
Don't know/not sure	5%

Source: Opinium polling conducted 3–6 September 2013; total respondents: 121.²⁹

Note: Percentages add up to more than 100 per cent because respondents were able to specify multiple uses.

The continued escalation of consumer debt underscores the importance of action to prevent it from ballooning further. By August 2013, outstanding unsecured (consumer credit) lending stood at £158.7 billion, and the average consumer borrowing level per UK adult was £3,183.³⁰ Recent analysis suggests that as many as 2 million people ‘could be spending more than half their disposable income on loan repayments by 2018’.³¹ Perhaps more worryingly, lower income households have far higher levels of debt leverage. For example, at the end of 2009 households on incomes of £13,500 or less had total debts worth 6.4 times their income, while households with incomes between £30,000 and £50,000 had total debts worth just under twice their income (Financial Inclusion Centre 2011).

29 From 2,003 people who answered ‘yes’ in an online survey to the question, ‘Have you used or are seriously considering any of the following methods of borrowing money?: a payday loan from an online provider, or a payday loan from a high street or door-to-door lender.’ These 121 respondents were then asked, ‘What did you use, or what are you considering using, your loan(s) for? If you have taken out or are considering taking out more than one loan, please select all the options you used or are planning to use the money for.’

30 <http://themoneycharity.org.uk/media/Debt-Stats-Summary-October-2013.pdf>

31 <http://www.resolutionfoundation.org/press/debt2018/>

3. STRATEGIES TO PROTECT AGAINST PREDATORY LENDING AND SPREAD ACCESS TO AFFORDABLE CREDIT

Our analysis of recent dynamics in the payday lending sector, in the context of the wider consumer credit market, indicates a clear need for major reforms to protect people from the worst lending practices, expand access to affordable credit, and restructure the bad debts that are stuck on household balance sheets. This chapter sets out concrete, practical proposals in this area, informed by the following arguments and principles.

In his classic book, *The Great Transformation* (1944), Karl Polanyi (1944) argued that the notion of a truly 'free market' is always an illusion. From state regulation to social pressures and the actions of powerful actors, markets that apparently arise through *laissez faire* interactions are in fact the result of human actions, institutions and purposeful inaction, often reflective of organised economic interests. This is true of how the payday lending market has developed. Moreover, at their best, markets are competitive and creative. However, where there are deep asymmetries of power, they can be inefficient and lead to rent-seeking, the costs of which are typically borne by the weaker participants.

This is important because in the payday lending market there are deep power imbalances between creditor and debtor. Most obviously, consumers combine a desperate need for credit with a lack of plausible alternative sources of it other than high-cost providers. This can lead to usurious costs and irresponsible lending practices. By contrast, wealthier households have benefited from substantial state-backed largesse in recent years, particularly as a result of historically low interest rates that have benefited mortgage holders, and quantitative easing that has inflated asset values. Power imbalances reflect wider institutional conditions. We should therefore think more seriously about how to correct the imbalances in the payday lending market, rather than simply accepting that the market has naturally arisen this way.

The problems in the payday lending market are also illustrative of wider flaws in the British economic model: finance divorced from the 'real' economy, too many rent-seeking practices, and an over-reliance on debt-fuelled consumption. Such problems cannot be resolved through tax and transfer strategies, nor through the actions of the centralised state acting alone. Instead, we need a strategy for spreading capital, building the assets of communities, and engaging citizens in forms of local democratic finance in which power and control resides with them, rather than with government agencies or unaccountable financial institutions.

In the long run we want to reduce the demand for short-term, high-cost credit, which is a result of the prices of household essentials rising faster than incomes. The goal should be for people not to need credit for day-to-day living. This will require a period of strong growth in incomes, combined with an easing of expenditure pressures in key household expenses.³² However, action is needed now in the following three areas.

1. Strengthening regulation of the high-cost credit market, to protect against the worst payday lending practices.
2. Creating an Affordable Credit Trust to capitalise and mobilise a network of local not-for-profit lending and saving institutions.
3. Restructuring existing high-cost payday loans, to ease the burden of unsustainable personal debt on the balance sheets of low-income households.

³² See de Santos 2012, Hull and Cooke 2012, Platt and Rowney 2013 and Platt et al 2013.

3.1. Strengthening regulation of the high-cost credit market, to protect against the worst payday lending practices

In recent months the government has taken a number of welcome steps to better regulate the payday lending industry. A cap on the total cost of credit, along with other powers granted to the Financial Conduct Authority (FCA)³³ to limit rollovers and reform the use of continuous payment authorities,³⁴ are all positive developments. For too long the payday lending industry in this country has been under-regulated in comparison with similar markets in other industrialised countries (CfRC 2011). However, further reforms are needed to improve transparency, end predatory practices and empower local communities to take control their local credit market.

Drawing on the analysis and arguments presented above, we therefore make the following recommendations.

- As part of the cap on the total cost of credit, lenders should be required to provide a clear ‘pounds and pence’ cost of any potential loan. This should take the form of a total cost of credit (‘TCC’) per £100 borrowed, plus the payment rate and the term length. This should become the common measure of cost and comparison, though the APR interest rate should also be displayed.
- The planned cap on the total cost of credit should include bank overdraft charges. These currently cost households around £2 billion a year, often for very minor infractions.³⁵ This measure would reduce the costs that households face for banking, while also dampening one of the drivers of payday-loan-use.³⁶ As our analysis has shown, the cost of borrowing via a bank overdraft can be higher than for a payday loan.
- A ‘cooling off’ period should be introduced before loans are processed and cash is received. A gap of 24 hours between application and payment would allow customers to withdraw at no cost if they changed their mind. This would encourage firms to properly assess loans, and stop them competing on speed.
- The FCA should set out guidelines for robust affordability checks that should be required before a loan can be agreed. At present there are only voluntary guidelines based on the OFT’s ‘responsible lending’ principles, and such checks are often skipped (BIS 2013: 11). The regulator, consumer groups and the industry should come together to design and agree these mandatory affordability assessment processes.
- To allow communities to shape their local credit markets, payday lenders should have to apply to the local authority for a change of use licence when they set up a new store. This requirement currently applies to other lending institutions like banks and credit unions. Councils should have the power to reject the application for a change of use if they feel it would be detrimental to social or economic wellbeing. This would build on the powers granted in the Localism Act (2011) that allow councils to refuse

33 The FCA regulates all providers of financial services in the UK, and maintains the integrity of the UK’s financial market, which now includes the payday lending industry.

34 A continuous payment authority or recurring payment is an arrangement under which you give a vendor permission to regularly take cash from your debit or credit card – whenever it feels that it is owed money. For more detail see <http://www.moneysavingexpert.com/banking/recurring-payments#three>

35 For example, borrowing £100 for 31 days from an authorised Halifax overdraft costs up to £30, and is higher for unauthorised use. See http://www.of.gov.uk/shared_of/reports/financial_products/OFT1005rev.

36 In 2009 a case on the cost of overdrafts was brought before the supreme court that argued that the amount banks charge for overdrafts is ‘not assessable for fairness’. Any cap on the total cost of credit of an overdraft enforced by the FCA should therefore have the necessary legislative support to make it constitutional.

planning permission to shops if they are thought to constitute an unsustainable development or pose a risk to the wellbeing of an area.

- The payday lending industry should agree a code of practice for advertisements. This could be modelled on the Gambling Commission's (2010) 'Guide to gambling advertising codes'. It should ensure payday loan adverts include messages about socially responsible use, display contact details for debt advice services, and avoid broadcasting times or sponsorship deals aimed at under-18s.³⁷
- The FCA should ban 'unsolicited real-time promotion' of high-risk credit products, such as 'cold calling' on a Friday night. The unauthorised trading of consumers' details should also be banned, as is currently the case for other financial services providers.

Backing the regulator

The Financial Conduct Authority (FCA) has now assumed responsibility for regulating the consumer credit market. However, it is not clear that it will have sufficient capacity to reduce consumer detriment and enhance competition.

In 2011/12, the Office of Fair Trading – the market's current regulator – received £11.5 million in licence fees from firms in the consumer credit market, of which £4.5 million was spent on enforcement. This equates to just £1 spent on enforcement for every £15,300 lent by the consumer credit market (HC-CPA 2013); by contrast, Ofcom spent £1 on regulation and enforcement for every £517 spent in the UK communications market. The FCA should therefore assess the adequacy of its funding and consider whether it should use its powers to raise licence fees.³⁸

Furthermore, a nationwide live database of payday lending data should be established to make it easier for the FCA to monitor lending and assess whether firms are extending loans to those already in clear financial distress. This would also make it easier for firms to conduct affordability tests and help to prevent the multiple lending that leads to spiralling debt. Encouragingly, there have been moves from some firms in the sector to establish a database voluntarily: a system run by the FCA which encompasses all firms in the market is the next logical step.³⁹

As in countries where such a live database already exists – for example, in Japan (Gibbons 2012), or in 14 American states (Pew Charitable Trusts 2013) – it should be jointly run by the regulator and the industry, with the system either owned or commissioned by the FCA. Payday lending firms should have an obligation to share data on credit references with both the regulator and one of the three main credit-checking companies, which many lenders do not currently do.

A system of robust rules is an essential part of ensuring responsible lending and limiting consumer detriment. We believe these measures, in addition to those already being implemented, would further strengthen consumer protection. However, regulation is more effective at stopping economic 'bads' than promoting economic 'goods'.

37 Ofcom has found that the number of payday loan advertisements on TV rose from 17,000 in 2009 to 397,000 in 2012, and that the average child aged 4–15 saw 70 such adverts in 2012. See <http://media.ofcom.org.uk/2013/12/10/ofcom-publishes-research-on-payday-loan-tv-adverts/> and <http://stakeholders.ofcom.org.uk/binaries/research/tv-research/Trends-advertising-activity.pdf>

38 <http://www.fca.org.uk/your-fca/documents/how-we-raise-our-fees>

39 <http://www.ft.com/cms/s/0/7f8e7bd8-7de0-11e3-b409-00144feabdc0.html#axzz2trQWttXV>

Indeed, as Andrew Haldane and Vasileios Madouros (2012) argued in their essay ‘The dog and the frisbee,’ the most effective regulatory systems are often those based around a small set of simple rules. The attempt to match complex systems (like the payday lending market) with complex regulation is likely to fail, as regulators will never be able to keep up with innovations and attempts to circumvent the rules. The result would be opaque regulatory structures that give informational – and power – advantages to firms over both consumers and regulators.

Ultimately, regulation alone cannot shape a flourishing affordable credit market. This requires institutional innovation and the redistribution of capital, so it is to the task of providing these that we now turn.

3.2 Creating an Affordable Credit Trust to capitalise and mobilise a network of local not-for-profit lending and saving institutions

Even if incomes begin to rise faster than prices, there will continue to be a need for short-term credit, especially for those without savings of their own to fall back on. As our analysis has shown, the current mix of short-term credit providers is filling this gap at too high a price and with too much consumer detriment. This is partly a result of bad practices, but it also reflects the fact that lending small amounts over short periods to risky borrowers at reasonable rates is not a profitable business. Meanwhile, existing public alternatives – such as the Social Fund – have been scaled back.

Therefore – in addition to further regulatory changes – a major institutional intervention is needed.

3.2.1 Establishing the Affordable Credit Trust as an independent national institution

We therefore propose creating an Affordable Credit Trust (ACT) – a national body with the remit of capitalising and mobilising local institutions that can lend small amounts at affordable rates to local people. This national institution should be established by law, with its purpose, functions and governance set out in statute. However, it should operate independently from government, and have spreading access to affordable short-term credit and protecting people from unsustainable personal debt as its core duties.

The Affordable Credit Trust should have five main roles, which are explained in more detail in section 3.2.2 of this report.

- First, it would be responsible for issuing ‘charters’ to local not-for-profit institutions that want to offer affordable credit and which meet a basic set of conditions.
- Second, it would endow such ‘chartered’ institutions with capital to lend to local people, according to set of broad criteria (it would not issue loans directly).
- Third, it would aim for the broadest possible spread of ‘chartered’ institutions across the country, seeking to stimulate and mobilise new entrants to the affordable credit market.
- Fourth, it would monitor and support ‘chartered’ institutions to promote transparency, share best practice and act against the misuse of capital or examples of consumer detriment.
- Finally, it should help to reduce the level of high-cost, unaffordable debt on households’ balance sheets, while working to prevent people from falling into problematic debt.

The monitoring and support role would involve collecting data on the lending and balance sheets of chartered institutions, which would be essential in detecting whether any local lender has gotten into financial difficulty. The ACT would also have the power to revoke a charter and transfer a chartered institution's capital, and loan book, to an alternative provider if there was evidence of inappropriate or irresponsible use. Membership of the Financial Services Compensation Scheme should be a condition of gaining an ACT charter – this would ensure that individuals are provided with protection (including deposit insurance for those saving as well as borrowing).⁴⁰

A board comprising independent experts, government appointees and representatives of chartered institutions and individual members should govern the ACT; independent expertise has proven invaluable to the Low Pay Commission. Representation of the broader public interest, via the government, would be essential given the taxpayer support that the ACT would receive,⁴¹ and there should be elections among both chartered institutions and individual members to determine their representation on the ACT board.

The goal would be for the ACT to play a significant role in the short-term credit market, introducing a 'public option' to compete with payday lenders. A partial analogy can be drawn with the National Employment Savings Trust (NEST), which has been created to support the introduction of auto-enrolment into workplace pensions. The arrival of a low-cost competitor has brought downward pressure to bear on pension fees and charges across the market, as well as providing institutional ballast to a set of regulatory changes.

In designing this new institution, there are a number of international models that could also be drawn upon. For example, in the US, the National Credit Union Administration (NCUA), created in the 1970s, plays an important role in supporting a large and vibrant credit union network. The NCUA is an independent federal agency tasked with chartering and supervising credit unions. It also manages the National Credit Union Share Insurance Fund (NCUSIF), which insures the deposits of more than 90 million account holders in all federally chartered credit unions, and the overwhelming majority of state-chartered credit unions.⁴²

The roots of the expansion of the American credit union movement date back to the 1930s, when President Franklin D. Roosevelt signed the Federal Credit Union Act into law. This established a system for federally 'chartering' not-for-profit, member-run credit unions.⁴³ These chartered credit unions are free to develop according to local circumstances and decision-making, while drawing on the support of national infrastructure and expertise. In 2013 there were 96 million credit union members in the US, and over \$632 billion dollars were lent at affordable rates. The average credit union in the US has assets of \$160 million.⁴⁴

Examples from other countries also highlight the benefits of a national network of cooperative, affordable credit providers, not least in reducing local providers' operation costs. In South Korea, over 900 credit unions are organised through the National Credit

40 <http://www.fscs.org.uk/>

41 It would be for the Office for National Statistics to determine how to classify the ACT, including its assets and liabilities, but in reality it would benefit from an implicit public underwriting, as is the case for the retail banking sector.

42 <http://www.ncua.gov/Pages/default.aspx>

43 <http://www.ncua.gov/about/Pages/default.aspx>

44 As at September 2013. Source: <http://www.ncua.gov/Legal/Documents/Reports/IAG201309.pdf>. For further details of the affordable short-term loans offered by the credit union movement in the US as an alternative to payday loans, see <http://www.ncua.gov/News/Press/NW20100916MatzPaydayLoan.pdf>. The US credit union sector experienced a turbulent financial crisis in 2008/09, in part because it engaged in risky lending that represented a departure from its original purpose. However, it has since rebounded strongly.

Union Federation of Korea (NACUFOK). This trade association runs a single IT system that allows all local credit unions to use shared software and data-management tools while maintaining their operational independence.⁴⁵ By operating a central infrastructure on which chartered institutions could draw, the ACT could drive savings in functions like legal advice, data management and IT systems.

3.2.2 Imposing a £450 million levy on the consumer credit industry to endow local institutions with capital to lend to local people at affordable rates

Having established the Affordable Credit Trust (ACT), the next step would be to provide it with an initial capitalisation capable of making a substantial intervention in the short-term credit market. This should come from a one-off £450 million levy on the consumer credit industry. This would be equivalent to the level of direct 'consumer detriment' that the National Audit Office found the sector to have caused in 2011/12 alone (NAO 2012). A levy on this scale would take the profits unjustifiably made at consumers' expense (albeit in just one year) and redistribute those resources towards providing practical alternatives to high-cost credit providers.

As of March 2013, there were 19,207 firms that held an OFT consumer credit licence and which operated as a consumer credit business (Leston and Watmough 2013: 56).⁴⁶ By way of illustration, if £450 million were raised through a flat-rate levy on all consumer credit businesses with an active consumer credit licence, it would equate to just under £23,500 per firm. However, in practice, the levy should not operate on this basis. Rather, it should target those firms that have done the most harm – according to the 'polluter pays' principle – and those that are most able to pay. The FCA is introducing a new regime that will distinguish between higher- and lower-risk consumer credit activities (FCA 2013: 18–23).⁴⁷ This will build on the OFT's existing 'high-risk credit' categories.⁴⁸

One obvious step would be for the Treasury to work with the FCA to identify firms in the higher-risk category who are active in the consumer credit lending market and apply a higher levy to such firms, rising progressively relative to their turnover. For instance, the collective turnover of the largest 10 payday lending firms – who typically pose the greatest risk to consumers compared to other consumer credit lenders – was nearly £990 million in 2012/13 (Warren 2013). Under the terms of the proposed levy they would pay more than a firm with a far smaller turnover.

However, at present not enough public information is available to sensibly allow such a system to be designed to an exact level of detail. Therefore, we propose that the government – working closely with the regulator – consider options for how to impose a levy on the consumer credit market in order to raise the desired

45 See <http://eng.cu.co.kr/pr/credit.html>. In Canada a similar role is also played by Credit Union Central of Canada ('Canadian Central'), for more on which see <http://www.cucentral.ca/SitePages/About%20Us/CorporateInformation.aspx>

46 Other firms that held a consumer credit license operated in other parts of the consumer market – for example, providing debt adjusting or debt counselling services.

47 Higher-risk activities liable for the levy would include providers of personal loans, such as payday loans or home loans, credit card lending, overdrafts, pawnbroking and hire purchases (but would exclude lending by sellers of goods and non-financial services where there is no interest or charges).

48 The following risk categories are designated by the OFT. 'A – consumer credit (if secured/sub-prime and/or in the home and/or short-term, high-cost payday type loans); C – credit brokerage (if secured/sub-prime and/or in the home); D – debt adjusting (if you or an associate charge for any credit activities); E – debt counselling (if you or an associate charge for any credit activities); F – debt collection; G – debt administration (if secured/sub-prime); H1 – credit information services (including credit repair); I – credit reference agency.' Source: http://www.offt.gov.uk/OFTwork/credit-licensing/high-risk/#.UvIoVfl_saE

amount. The structure of this levy should be guided by two principles.⁴⁹ First, it should be weighted towards firms in the higher risk categories, to target those that have generated consumer detriment in the past. Second, it should be progressively levied, by taking firms' level of turnover into account.

The ACT should use as little of this money as possible to pay for initial set-up costs and to establish a central infrastructure. The vast bulk of the fund should be used to endow local lending institutions that have received a charter, and then be lent to local people at affordable rates. This should be sufficient to maintain the value of the capital endowment (taking account of inflation and default rates) and meet operating costs (including a small fee to the ACT to cover its ongoing costs). All the administrative and operating costs incurred by the ACT and its chartered institutions should be made fully transparent.

Chartered institutions should operate a maximum – but not standardised – lending rate. Subject to an evaluation of its impact, this maximum should initially be set at 3 per cent a month (or 42.6 per cent APR), which will become the new legal limit for credit unions from April 2014. This would mean that the cost of borrowing £100 for a month would be around £3. The raising of this legal limit for credit unions is predicted to save low-income consumers £1 billion in loan interest repayments by March 2019 (HM Treasury 2012: 3).

It would be for the ACT to determine the amount of capital initially endowed to local institutions, but this should reflect their geographic reach, likely demand (based on actual or projected membership) and financial robustness. As an illustration, an initial capital injection of £450 million would support over one-and-a-half million loans of £250 at any one time across the network of chartered ACT institutions.

This would constitute a substantial intervention in the short-term credit market, relative to the £2 billion currently lent annually by payday lenders. There are currently between 7 and 8 million payday loans issued a year (at an average of slightly above £250 per loan). Table 3.1 below illustrates the maximum costs of an ACT-backed loan of varying durations. By way of comparison, the cost of £250 borrowed for a month from a typical payday loan firm is around £340.

Table 3.1
Cost of a £250
ACT-backed loan with
an interest rate of
3 per cent a month
(42.6 per cent APR)

Loan duration	Monthly repayment rate	Cost of credit	Total repayment
One month	£258.87	£8.87	£258.87
Two months	£131.69	£13.39	£263.39
Three months	£89.32	£17.96	£267.96
Four months	£68.14	£22.57	£272.57
Five months	£55.45	£27.24	£277.24
Six months	£46.99	£31.96	£281.96
One year	£25.95	£61.37	£311.37

The savings that ACT-backed loans would represent relative to their monthly payday loan equivalent would therefore be up to £80. Even if the payment schedule was extended over an entire year, making monthly repayment rates much more manageable, an ACT loan would still be roughly £25 cheaper than even a month-long payday loan.

49 As the regulation of the consumer credit market is undergoing significant change, it would make sense to wait for the FCA to assign its licensed categories once it begins its operation in April 2014 before setting this levy.

To gain an ACT charter, local lending institutions would have to be constituted on a not-for-profit basis, meaning that they would not need to generate a return for shareholders. As we go on to explain, they would also benefit from access to a backstop recovery mechanism through the tax credit and benefit system which, evidence suggests, would deliver a very low default rate and so would help significantly with the cost of servicing small loans. Furthermore, the capital of local lending institutions would be supplemented by deposits sought from their members, which for those on low incomes would be boosted by a modest public subsidy for saving among low-income households (this is also explored in greater detail below).

One issue in need of further consideration is whether individual chartered institutions – or indeed the central ACT – should invest capital on behalf of their members, in order to grow their endowment and deliver a return for savers. This has clear benefits, but also entails risks, especially when control of endowed capital by local institutions is a core element of the model. However, by way of comparison, the NACUFOK in South Korea invests surplus funds on behalf of its members, operates a lending service between members, and provides a central financing facility. Canadian Central plays a similar role in Canada.

The overall ambition would be to use the initial injection of capital from the consumer credit industry, via the Affordable Credit Trust, to build and sustain a democratic, not-for-profit, alternative source of affordable credit for low-to-middle-income households across the country. It should be combined with a local government funding settlement that would enable councils to offer emergency (non-repayable) grants to individuals or families in urgent and extreme need.

Learning from the DWP Growth Fund

The reforms proposed here build on previous attempts to support the growth of not-for-profit providers of affordable credit to low-income households.

For example, between 2006 and 2011 the DWP operated a Growth Fund that provided capital to third-sector lenders – mainly credit unions and community development finance institutions (CDFIs) – to lend to financially excluded households (as well as providing revenue to support the delivery of loans – administrative and staff costs, for example) (see Collard et al 2010).

Research has found that this initiative had a positive impact on access to affordable credit among those on low incomes (Deeming et al 2011). Over its lifetime, the Growth Fund supported 317,798 loans with a total value of over £137 million. Survey data indicates that 79 per cent of Growth Fund borrowers fell into the two lowest income quintiles, and that one in five did not previously have a basic bank account (Collard et al 2010).

However, there are important differences between the proposals set out in this report and the Growth Fund. The ACT would be an intervention on a substantially larger scale. Furthermore, its chartered institutions would be endowed with capital, rather than having it loaned to them, while their target market would be broader than only the very poorest.

Perhaps most importantly, the ACT would aim to deliver lasting institutional change, and would be independent of government – unlike the Growth Fund, which was a micro-spending initiative that did not drive wider or lasting change (and was scrapped by the Coalition government with few outside the sector noticing).

3.2.3 Setting the framework for ‘chartering’ local institutions as affordable credit providers

Having established itself and received its capital injection from the levy, the first main function of the ACT would be to issue – and then maintain – ‘charters’ to local institutions that wanted to join the Trust and access its capital and support.

In the first instance, the ACT should seek to engage with established not-for-profit lenders, such as credit unions and CDFIs. However, it should also aim to encourage existing organisations to enter the affordable credit (and savings) market, and to stimulate the creation of entirely new institutions. This would be a vital aspect of the ACT’s duty to ensure the broadest possible coverage of affordable credit across the country.

Within its statutory remit, the ACT would be responsible for setting out the conditions that institutions would have to meet in order to gain a ‘charter’, and the rules that govern how they should operate. These should be kept to an essential minimum, so as to bring a diverse range of institutions into the ACT and to leave space for innovation and experimentation with it.⁵⁰ As we discuss later, the ACT should engage with local authorities to help it identify – and generate – potential lending institutions in areas without a provider.

The fundamental condition for gaining a charter from the ACT should be that an institution is able to demonstrate its ability to operate effective credit and deposit facilities, and to responsibly manage the assets and liabilities that flow from this. This should be set out in a comprehensive business plan. Organisations with a track record in financial services, especially in the short-term credit market, will clearly be best placed to do this.

New entrants should be expected to use their business plans to show their potential to operate effectively in this market, particularly by setting out demonstrable demand for membership in their local areas, a clear lending strategy, and strong governance arrangements. Ideally they would also have some capital in place, though this should not be an absolute requirement.

Institutions would have to be non-profit-making, member-owned and democratically run to gain a charter. This would ensure that they are run in the interests of members and for the benefit of their local communities. Trustee boards overseeing day-to-day

⁵⁰ Potential applicants for charters that already operate financial services will already be registered with, and regulated by, the FCA. An issue that would need to be resolved is whether registration with the FCA should be a condition of receiving a charter, or whether (to reduce barriers to entry) the ACT could act as an umbrella regulated body on behalf of all chartered institutions.

management should comprise democratically accountable members of the institution, and representatives of any partnership organisations, such as the local authority.

Institutions would also need to stipulate the geography within which they would lend and seek members. This would ensure that capital remains locally rooted, and that the ACT can monitor the coverage of its chartered institutions. These geographies would not need to match any existing administrative boundaries, and there should be no bar on overlap between the spatial ‘footprints’ of chartered institutions. However, there should be some minimum and maximum scale requirements to ensure viability on the one hand and to prevent local roots and connections being lost on the other.

Subject to those criteria, applicants for a charter would need to commit to operating according to the following basic conditions (at least when they discharge their duties with respect to the ACT).

- Only members of the local lending institutions should be able to access affordable credit. Membership should be free and open to anyone living in the geographic area covered by the institution, on a strictly non-discriminatory basis.⁵¹ This would ensure that chartered institutions are democratically run in the interests of local people, who have a direct personal stake in its success. The only condition of membership would be that individuals have an active deposit or savings account with the institution, as well as a credit account for loans. This would support self-reliance, reciprocity and asset-building, which are the core objectives of this reform.

Within this regime, local institutions would be free to determine their lending strategies, while staying true to the objective of spreading access to affordable credit to those who would otherwise struggle to obtain it from mainstream providers. This should mean prioritising those in receipt of tax credits and benefits – a group that currently encompasses around 9.6 million households,⁵² and spans those in and out-of-work, from those on the lowest incomes up to those earning around £35,000 (DWP 2012). There would be major advantages in mobilising a broad base of membership: it would avoid the perverse incentives and sharp ‘cliff-edges’ of a tightly targeted system, while also drawing in higher deposits, avoiding stigmatisation effects, and building strong alliances in support of local lending institutions.

- Lending should be responsible yet rapid, and limited to £250 per member at any one time. Speed of access is one of the major attractions of the payday lending firms, who can provide credit at very short notice and with few checks. The ACT should not ape these practices, which have caused significant consumer harm. However, it would be vital for chartered institutions to offer a quick and effective service for those who want a more affordable alternative. Affordability checks should be carried out, although as relationships between members and institutions deepen (and track records develop) these should become more straightforward.

Credit should not be extended on the spot, but should be made available to people soon after the 24-hour ‘cooling off’ period that we recommend for the payday loans market as a whole.⁵³ Setting the maximum loan at £250 would mirror the average size of a payday loan,

51 The ACT should collect data on membership and lending across ‘chartered’ institutions to assess the profile and reach of those engaging with it.

52 This figure includes jobseeker’s allowance, employment support allowance, incapacity benefit, income support and working tax credit but excludes pension credit and child tax credit.

53 Under the old crisis loan element of the Social Fund, the average clearance time for a request was less than two working days, with only 0.2 per cent of applications missing that target.

while allowing as large a number of members to benefit from the affordable rates as possible. A sustainable repayment plan should be attached to each loan, with rapid repayment incurring the lowest cost. Members should not be able to take out more than one loan at any one time.

- A backstop reclaim mechanism through the benefits system should be available to lenders. In addition to not needing to make a profit, and accepting deposits as well as issuing loans, maintaining a very low default rate would be a vital part of enabling local ACT-chartered institutions to lend at affordable rates without running down their capital endowment. Chartered institutions should therefore have access to a mechanism for recovering outstanding debt in a sustainable way, through automatic deductions from member's tax credit and/or benefit payments.⁵⁴

A system of this kind generated a 94 per cent repayment rate for budgeting loans under the old Social Fund, at a cost of less than one penny per £1 recovered. Between 2005/06 and 2012/13, the average Budgeting Loan ranged between £394 and £451 a year⁵⁵ – slightly higher than the average payday loan – with an average of over a million loans made each year. Over this period, £3.9 billion was loaned out in total, and £3.7 billion was recovered. By contrast, Wonga wrote off £76.8 million's worth of 'uncollectable' loans in 2011, relative to revenue that year of £185 million (Wonga 2013 and Bowers 2013).

The government has recently introduced the 'Eligible Loan Deduction Scheme', under which the DWP will make deductions from benefits, in certain circumstances, on behalf of third-sector, not-for-profit lenders. This mechanism should be extended to ACT-chartered institutions, though it should be used very sensitively, with money reclaimed on a moderate basis which takes account of their financial circumstances. In some cases, members may decide to use the automatic reclaim from day one, in order to help them stick to a planned repayment schedule. The right of institutions to enforce this mechanism should be limited to instances in which a loan has not been repaid after a fixed period (say, one year).

These conditions set out the basic framework within which institutions chartered by the ACT would be expected to operate. The precise design of the details should be subject to further analysis and a period of detailed consultation. Furthermore, the specific figures suggested above – the minimum deposit level, the target lending group, the maximum loan level, the speed of loan delivery, the duration of loans, and the point at which the automatic reclaim mechanism should kick in – should be tested, evaluated and adapted as experience is gained of how this reform works in practice.

Potential applicants for an Affordable Credit Trust charter

The objective of this reform would be to both expand existing providers of affordable credit and mobilise new entrants into the market.

This may start with credit unions and community development finance institutions (CDFIs),⁵⁶ but it would also involve engaging with housing associations, trade unions, community banks (such as the proposed Bank of Salford), social enterprises and other

54 A similar mechanism should be considered for those who are not in receipt of tax credits or benefits, perhaps through PAYE or the self-assessment system.

55 Figures from IPPR analysis of data from the *Annual Report by the Secretary of State for Work and Pensions on the Social Fund* for the financial years 2005/06–2012/13.

56 In 2012, CDFIs lent £11.4 million in short-term loans to 28,992 people at an APR of 39 per cent. The peer-to-peer market, meanwhile, has doubled in the space of two years, and now lends up to £1 billion, though this is not primarily targeted at those seeking short-term credit.

innovative organisations. As an illustration, the following institutions give a flavour of the kind of actors which might become involved with the Affordable Credit Trust.

Five Lamps delivers an integrated range of social, economic and financial inclusion services to disadvantaged communities in the north-east of England. They have a dedicated financial inclusion team who, in 2011/12, helped over 15,800 people by providing personal loans and debt advice.⁵⁷

Lancashire Community Finance (LCF) is a 'not for profit' CDFI. As well as offering personal loans, business loans, start-up loans and home improvement loans, they also provide personal loans of between £400 and £5,000 over periods of between six months and five years, with flexible repayment plans at rates of interest considerably lower than those charged by doorstep and payday lenders. LCF also provides financial education and money management services.⁵⁸

Unite the union has recently set up a credit union service that aims to provide its members and their families with access to affordable finance and competitive savings products. Operated on a regional basis, almost all credit unions within the Unite service have committed to offering a payday loan equivalent at affordable rates.⁵⁹

My Home Finance is a not-for-profit CDFI, set up by (though separate from) the National Housing Federation. It provides credit at more affordable rates than payday lenders, while also offering basic current and savings account facilities.⁶⁰

The Post Office network has the potential to support or provide affordable credit. In fact it has made clear its desire to see local branches engage more in community finance, for example through its Community Enterprise Fund.⁶¹ One role it could play would be to support ACT-chartered institutions either directly with administrative support or by providing them with physical locations. It might also be possible for local Post Offices to apply for charters themselves.

The Church of England has publicly committed to using its churches to support credit unions, a goal that could be advanced through the ACT. As Sir Hector Sants, who is leading the process, has argued, 'There are around 12,000 parishes; contrast that with an ordinary banking network of just over 1,000 branches or so. The church has a tremendous network on the ground, in the community.'⁶² Moreover, there is potential for other major faith groups to work with the ACT in a similarly proactive manner (with the obvious proviso that institutions operate in a non-discriminatory fashion).

57 <http://www.fivelamps.org.uk/>

58 <http://www.lancashirecommunityfinance.co.uk/>

59 <http://www.unitetheunion.org/how-we-help/memberoffers/memberbenefits/unite-credit-union/>

60 <http://myhomefinance.org.uk/>

61 http://www.postoffice.co.uk/sites/default/files/Community_Enterprise_Fund_Leaflet.pdf

62 <http://www.theguardian.com/world/2014/feb/23/church-credit-unions-parishes>

3.2.4 Promoting a culture of asset-building by providing incentives to save to low-income members

One reason why so many low-income households are turning to high-cost lenders is that they lack savings that they can fall back on when times get tough. As such, building assets is an important part of increasing households' economic security. Therefore, the creation of the Affordable Credit Trust should also play a role in bolstering financial resilience, as well as expanding access to affordable credit.

The introduction of auto-enrolment has the potential to substantially expand workplace pension saving, though this investment is (rightly) inaccessible to people during their working life. Moreover, public subsidies for saving – in the form of tax-reliefs on pension saving and on capital gains in ISA accounts – disproportionately benefit the better-off (Adam et al 2012). Previous policies to support asset-building among low-income households – the Child Trust Fund and Savings Gateway pilots⁶³ – have both been scrapped.

The establishment of the ACT provides an opportunity to change this situation. As a start, access to affordable loans from a chartered institution should require an individual to become an active member of that institution, including holding a deposit or savings account. This would generate active engagement with a basic financial services product and open up the potential for a savings habit to take root. It would also ensure personal responsibility was at the heart of the ACT model, with members' own deposits being part of the capital that is lent out to other members.

However, this deposit account requirement should be matched by a financial incentive for those on low incomes to save. The design of this incentive should be subject to detailed modeling, and should be set at an initially moderate rate to enable an assessment of its impact.⁶⁴ An analysis of the Savings Gateway pilots by Ipsos MORI and the Institute for Fiscal Studies suggested that a ratio of 20p matched for every £1 saved is effective at boosting savings among low- and middle-income households (Harvey et al 2007).

While membership of an ACT-chartered institution should be available to everyone living in the institution's local area, the savings incentive should only be available to those in receipt of tax credits or benefits (and, in time, universal credit). This would ensure that the subsidy did not benefit those on high incomes, but was not so tightly targeted that it created perverse incentives. By structuring the subsidy on a 'matched' basis, the benefits would not accrue disproportionately to those able to save a significant amount.

One option would be for 20p to be 'matched' by the government for every £1 saved with a chartered lending institution up to the first £20 deposited each month. This would mean a maximum £4 boost each month to the savings of low-income households, or nearly £50 a year (if a member were to save around £240 in total). If a third of the 10.5 million households currently in receipt of at least one of JSA, employment and support allowance (or incapacity benefit), income support, child tax credit or working tax credit were to take

63 The Savings Gateway was an initiative aimed at encouraging savings among those on low incomes by 'matching' deposits with a public subsidy. In pilots of the scheme, over 70 per cent of participants continued contributing for 16–18 months after the subsidy ended, suggesting that it had been effective at developing a savings habit. See Ben-Galim 2011.

64 This would need to involve consideration of how the subsidy should be administered – for instance, through local institutions paying extra money into their member's accounts and then claiming back the expense incurred from the government via the ACT.

maximum advantage of a subsidy of this kind (that is, 3.5 million people gaining £48 a year), this initiative would cost just under £170 million.

The goal of such a policy would be to offer a tangible asset-building boost to people on low incomes, and to provide an ongoing injection of funding into ACT-chartered institutions (giving them, in turn, a strong incentive to engage local people as members and depositors). However, a direct 'match' on a monthly basis would run the risk that savers would withdraw the subsidy immediately, draining deposits and effectively turning a saving incentive into a cash payment. It would also be complex to administer.

A better approach might therefore be to provide a subsidy to eligible individuals on the basis of the average balance held in their account over the previous year, deferred for a further period subject to the balance being maintained. This would mean that the subsidy operated as a positive 'carrot', rewarding those who put some money aside. Under this model, it could still be paid on a 'matched' basis, topping up the balance of the first portion of savings held by eligible individuals.⁶⁵ Research into the Savings Gateway pilots found that people were encouraged into building up additional savings when there was a clear and simple 'match' attached to their deposits, even at small amounts (Ben-Galim 2011).

In practice, the design and level of the subsidy should be subject to experimentation and evaluation, with the aim of increasing the level of savings among low-income households in the most cost-efficient manner. That said, any such incentive would impose a cost on the government. To finance this move, a moderate amount of public funding should be shifted from subsidising pension saving among those on high incomes, and instead put towards promoting saving among those with few or no assets.

In 2011/12, over £38 billion was foregone in tax revenue as a result of relief provided for pension saving, the majority of which benefited higher-rate tax-payers (Emmerson 2014). In recent years the generosity of this relief has been moderately reduced through changes to the lifetime and annual allowances (which increased revenues by £4 billion a year) (HMRC 2011). The debate about the future of tax-relief on pension contributions has been blown open by the changes to defined contributions announced in the March 2014 budget. The justification for such a large subsidy, which is regressive and poorly targeted, is now even harder to sustain given the greater freedom that people now have with regard to their pension pots.

As such, we propose that, as part of any future re-think of public subsidy for saving, a small proportion of that £38 billion in foregone revenue – in the first instance less than £200 million – should be set aside for boosting asset-building and self-reliance among those on low incomes. This would in turn expand the amount of money that could be lent through ACT-chartered institutions.

3.2.5 Encouraging local authorities and banks to support ACT-chartered institutions

The purpose of the reforms proposed in this report is to capitalise and mobilise non-state, not-for-profit providers of affordable credit. However, both local authorities and mainstream banks could play decisive roles in ensuring the success of the ACT and its chartered institutions.

⁶⁵ A further issue for the ACT and its chartered institutions to resolve would be the interest rate paid to savers. This would need to be set at a competitive rate in order to attract deposits, but it would also need to be consistent with maintaining financial sustainability in the context of the cap on the interest rate on loans issued.

Crucially, local authorities could work with the ACT to identify local institutions that could apply for a charter, and to stimulate the creation of new lending institutions (either from scratch or by helping existing organisations to enter the market). An example of local authorities taking up this role is the creation of the Bank of Salford, an emerging community bank based on collaboration between the council, the trade union movement, civil society and local credit unions. Local authorities could also help chartered lending institutions in their area to broaden their membership by marketing their services to local people who engage with the council.

As an example of the contribution local authorities could make, it is also worth reflecting on recent steps taken by the London Borough of Islington, which has done the following.

- Provided a £250,000 grant to its local credit union, London Capital Credit Union, and offered a £40 incentive for new council tenants to join it. It has also provided financial assistance to people in crisis through its Resident Support Scheme.
- Blocked over 100 payday loan websites from the council's public computers, and banned payday lenders from council advertising hoardings. It is also using its trading standards team to 'mystery shop' payday lenders to ensure that they comply with existing regulations.
- Provided financial literacy education to under-25s through their Fit Money scheme, as well as supporting third-sector organisations such as the local Citizens Advice Bureau and the Islington Law Centre.

Part of the rationale for a major intervention in the short-term credit market is that mainstream banks have demonstrated their unwillingness to meet this need. However, they too could play an important role in supporting local lending institutions, particularly by helping them to professionalise their systems and operations. Providing support of this kind would be a way of demonstrating that banks can play a positive role in society, as part of efforts to win back the public's trust.

As an example of what is possible, the Progress Loans programme is a partnership between the Brotherhood of St Laurence charity⁶⁶ and the Australia and New Zealand Banking Group (ANZ). The programme's aim is to provide small personal loans of between A\$500 and \$5,000 to low-income households. Its target market is people who are managing their limited income well and can afford a loan, yet are excluded from mainstream finance. By June 2011, 1,259 loans had been drawn down by 1,254 individuals, with an average loan value of A\$2,952 and a default rate of only 2 per cent. The support of ANZ has been crucial in enabling the programme to offer an efficient service and maintain a high recovery rate (Vawser and Associates 2011).

A similar example has emerged in this country as a result of a major pilot partnership between the London Mutual Credit Union (LMCU), the Friends Provident Foundation and the Barclays Community Finance Fund. Its aim was to test whether the speed of a payday loan product could be delivered within the credit union interest rate cap (prior to it being raised to 3 per cent a month). During the pilot, 1,219 people received a loan of an average size of £238. The collective saving for this group was £144,966 based on the savings made from equivalent payday loan interest charges alone (excluding possible fees or penalty charges) – equivalent to almost £119 per borrower (Evans and McAteer 2013).

66 The Brotherhood of St Laurence is a not-for-profit organisation that works toward a vision of an Australia free of poverty through research, advocacy and delivering services for people suffering disadvantage. See <http://www.bsl.org.au/>.

To put that figure in context, if the 8.2 million payday loans taken out in 2011/12 from high-cost lenders had been accessed through a credit union alternative such as this, it is estimated that the collective saving would have been £749 million. This would equate to an average saving of at least £91.43 for every payday loan that was taken out (Evans and McAteer 2013). Interestingly, while a small average loss of £2.03 was made on each loan, in the medium term it was a profit-making loss leader: the projected additional income generated by those new members helped generate a small profit from the credit union's overall dealings with those people who took out a 'payday loan', 'making the model financially sustainable' (ibid: 5).

Moreover, unlike the LMCU pilot project, chartered institutions under our proposed reforms would have access to capital and administrative support from the national ACT, as well as a more secure revenue stream through the use of a system for reclaiming money through the benefits and tax-credit system. Also, unlike this pilot, ACT-backed loans would not typically be repaid over a month, which is more expensive to service. Consequently, chartered institutions would be able to deliver affordable loans in a more sustainable manner.

3.3 Restructuring existing high-cost payday loans to ease the burden of unsustainable personal debt among low-income household

The reforms set out above would help to prevent the build-up of further problematic debt from high-cost lenders by regulating-out the worst practices of the payday industry, capitalising and mobilising alternative providers of affordable credit, and helping low-income households to build up assets of their own.

However, even if all these measures were implemented, many people would still find themselves saddled with high-cost legacy debt on their household balance sheet from which they could not escape – even though they may have paid off the original amount they borrowed. This constitutes a major drag on people's ability to achieve sustainable personal finances and a basic measure of economic security.

The final essential element of reform is therefore to restructure this outstanding high-cost payday loan debt. Efforts to do so should focus in particular on those who have paid off the original amount that they borrowed but are still servicing interest payments and fees (which can escalate rapidly). There is no good data available on the number of households that are in this position, or their level of debt, but there is a strong justification for acting to help those who have become trapped with unaffordable debt which has arisen as a result of bad lending practices and inadequate regulation.

Since the financial crisis there has been considerable focus on the toxic debt held by banks, leading to a substantial restructuring and de-leveraging process in the financial sector, with implicit and explicit support from the taxpayer. Similar attention has been paid to rising levels of sovereign debt, with all the main political parties committed to reducing public debt over the medium term.

However, the issue of household debt has been far less prominent, despite it reaching record levels prior to 2008, and the fact that it is beginning to rise again. Outstanding personal debt reached £1.4 trillion in November 2013. By far the largest portion of this total was held in mortgages, the costs of which have been held down in recent years by extraordinarily low interest rates.⁶⁷ Wider personal debt also remains very

67 Including mortgage debt, the average household debt was £54,197 in November 2013; excluding mortgage debt it was £6,016. Source: <http://themoneycharity.org.uk/debt-statistics/>.

high, at £159 billion of outstanding unsecured consumer credit lending at the end of November 2013 (Money Charity 2014). While figures on outstanding payday lending debt specifically are not available, it is likely to impose a particular burden given its high cost and the relatively low incomes of those who tend to hold it.

For those servicing relatively small amounts of high-cost debt, the extension of affordable alternatives through the ACT provides a potential route of escape. Under these reforms, anyone holding an outstanding debt from a high-cost lender, who can demonstrate that they have repaid the initial amount borrowed, should be able to exchange that debt for an ACT-backed loan (up to the £250 cap at any one time), subject to the standard affordability checks and an agreed repayment plan.

There will, however, be some people who have outstanding high-cost debt that is substantially greater than this, or who cannot meet these criteria (they have not repaid the initial amount borrowed, for instance). It would not be reasonable to expect individual chartered institutions to restructure debt to the significant extent required in these situations, as this would reduce the amount of capital available for new lending. Similarly, any solution should not involve an effective taxpayer bailout of payday lending firms.

While more detailed work needs to be done to develop policy in this area, we suggest that individuals should be given a reasonable opportunity to alert the ACT, via their local institution, of their problematic debt, and that the ACT should then seek to negotiate a debt restructure, collectively, on that member's behalf. This should involve the payday lending firms taking a 'haircut' on their loans, and individuals agreeing new schedules to repay the initial amount that they borrowed, over a longer period of time in some cases. As well as brokering these deals, the ACT should also pursue a strategy of buying up bundles of re-profiled payday loan debt, thereby using the government's balance sheet to keep borrowing costs down.

A substantial debt restructuring of this kind would inevitably run the risk of generating moral hazard. If people are told that bad debts will be restructured then they will be more likely to engage in risky borrowing. It should therefore be made clear that the arrival of the ACT marks the moment at which predatory lending practices must end, and the legacy debt accumulated (in part) as a consequence of them must be dealt with. Leaving low-income households crippled by high-cost debt simply to make an example of them would be a cruel application of the principle of avoiding moral hazard.

Finally, while the rise of personal debt problems is not the result of poor financial planning, more effective debt and money advice would be beneficial. In 2013, the Money Advice Service committed to providing over £30 million in funding to support the delivery of free debt advice across the UK in 2013/14 (with a large share going to the Citizens Advice Bureau).⁶⁸ Key providers of advice – including the Money Advice Service, CAB and StepChange – should work with the ACT, as well as with local chartered institutions, to ensure that free debt advice is available to people who want or need it.

68 <https://www.moneyadvice.service.org.uk/en/static/money-advice-service-commits-over-gbp30-million-to-fund-delivery-of-free-debt-advice>

3.4 Conclusion: Building a virtuous circle

Deep long-term structural trends have put middle- and low-income households under sustained financial pressure. One manifestation of this has been the rapid rise of the payday lending sector, which provides short-term credit but at a cost that can be economically and socially damaging. In response, we need a sustained rise in employment and living standards to reduce people's reliance on credit for everyday essentials. However, even then, there will remain a widespread need for affordable credit to help deal with inevitable financial ups and downs.

In response to the problems within the payday lending sector that have been exposed in recent years, there is a need for better regulation to root out the worst practices and protect consumers. Creative solutions are also needed for restructuring the high-cost debt that is suffocating people's ability to improve their situations.

Our argument is that, in addition to such measures, institutional innovation and the redistribution of capital is also required in order to spread access to affordable credit and 'compete' with the payday lenders. The ambition set out in this report is for the establishment of an Affordable Credit Trust – and a network of local, chartered lending institutions – to make a substantial and lasting impact on the financial resilience and economic security of ordinary households.

This would involve shifting capital away from the consumer credit industry, which has caused substantial consumer detriment in recent years, and into not-for-profit lending institutions that can extend credit at affordable rates. It would also require individuals themselves to take a stake – as members and depositors – in the success of these institutions, supported by a shift in subsidies for saving to better target those who need help to build assets. It would ask local authorities and mainstream banks to play their part in making this reform a success.

The ultimate goal of the Affordable Credit Trust is to kick-start a 'virtuous circle': an initial capital injection to expand the provision of affordable credit, drawing in new members and increased deposits and boosted by a well-targeted saving incentives for people on low incomes, will enable those people to build up a stronger asset base of their own, which will in turn increase the amount of lending capital overall while reducing their reliance on credit to cope with unexpected costs or losses of income.

Overcoming the deep and complex problems identified in this report will not be achieved overnight. Given the scale of the problem, emergency action is necessary to curb high-cost credit and restructure bad legacy debt. However, it is also vital that the foundations are laid for a systematic, durable and sustainable alternative. We hope that this report contributes to that task.

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