Responsible lending and high-cost credit - does the cost-cap on payday loans really protect consumers?

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In 2015 the Financial Conduct Authority (FCA) introduced a price cap on payday loans.⁴ The success of the cap has been heralded in the sense that the number payday loan customers who have experienced difficulty appear to have reduced substantially. Commentators have suggested that the hard-line taken by the FCA has improved consumer protection, in addition to significantly curtailing the ability of unscrupulous lenders to lend money to the financially vulnerable.¹ Indeed Arora notes, albeit more generally, that ‘[t]he FCA’s approach to the regulation and supervision of [payday lenders] has created better borrowing conditions and terms for protecting the payday customer’.² Moreover, the Citizens’ Advice Bureau noted that 38% of firms that existed in the market in 2013, had exited by March 2016, a fact which it argues, may have reduced irresponsible lending practices. The article examines whether the price cap goes far enough to ensure that payday lenders are lending responsibly, in addition to impact of the price cap on the consumer protection environment of the consumer credit market.

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² See generally: Financial Conduct Authority FCA Handbook (Financial Conduct Authority: London 2013) CONC 5A.
³ For example see Gillian Guy ‘Payday loans are capped. Now let’s tackle other high-cost credit’ The Guardian (London, 2 January 2017)
Payday Loans - the cost cap

A payday loan is a convenient loan, short-term credit product, which can be used to meet the emergency funding requirements of a consumer. However, it soon became clear that payday loans became a source of funding that was used to meet the everyday living costs of low-income and high-risk consumers. These loans were provided to consumers who could not afford to meet the redemption requirements at the end of their loan term; leading to late repayment penalties, rollover charges and a dramatic increase in the interest payable on a loan.5 The regulation of payday lending was entrusted to the FCA on 1st April 2014.6 The FCA immediately placed a greater emphasis on the cost of loans being causative of issues faced by consumers of the market, focussing on the high compound interest rates and default charges that were prominent in the payday lending market, a matter evidenced by the fact that the first non-firm specific regulatory action specific to the payday lending market by the FCA, being the introduction of a product price cap.

The cap imposed by the FCA consists of three key component parts:

(a) The total amount a borrower could be required to repay in respect of interest and charges/fees shall not exceed or be capable of exceeding the amount borrowed;7

(b) The daily interest charged on a payday loan should not be more than 0.8% of the amount borrowed;8 and

(c) default fees should not exceed £15.9

It is of no doubt that some consumers who continue to avail themselves of the payday loan offering will be noticeably better protected, not least due the fact that the risk of their exposure to a debt

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5 The issues surrounding this are well documented. See for example: Office of Fair Trading, Payday Lending Compliance Review - Final Report (OFT 1481, March 2013), 13-16.
7 Financial Conduct Authority FCA Handbook (Financial Conduct Authority: London 2013) CONC 5A.2.2
8 CONC 5A.2.3.
9 CONC 5A.2.14(1)
product with the potential to spiral of control being reduced. That said it is clear that, in the context of affordability, capping the cost of payday loan simply provides an objective line in the sand, as opposed to a mechanism for ensuring that money is responsibly lent to vulnerable consumer in an affordable manner. Therefore, this article will now consider responsible lending in the context of the price cap on payday loans.

Payday loans and responsible lending - a paradoxical proposition?

Whilst the Office of Fair Trading (OFT) has been heavily criticised for the effectiveness of its regulation of the consumer credit market,10 credit should be afforded to its recognition of the systemic failure of payday loan providers to adhere to responsible lending practices.11 Indeed, as noted above, a key characteristic of payday lending is convenience - the ability to obtain funds quickly and easily in order to deal with emergencies. Thus, it is often the case that only limited information is requested from borrowers in order to ascertain the affordability of a payday loan. As a result, the price cap does little to prevent payday loans being granted to consumers who cannot afford to repay them, even where this affordability gap is clear at the application stage. Indeed, the Financial Ombudsman Service cites a case whereby the amount advanced to a borrower exceeded their monthly earnings,12 a matter which arguably undermines the very nature of a payday loan. Moreover, in the aforementioned case, the creditor presented the debtor with the opportunity to declare their monthly earnings, and the debtor did so accurately - yet the creditor still proceeded to lend the debtor more than their monthly earnings.13

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12 See Case Comment 119/10 - Financial Ombudsman Service 'Ombudsman News - Issue 119 - Short Term Credit'.
13 Ibid.
This is clear evidence that, even in an environment where a credit product is heavily regulated, the absence of a stringent responsible lending regime based on thorough affordability assessments, will not prevent unaffordable loans being granted. In fact, it is noteworthy that the OFT identified that proper consideration of a borrower's financial circumstances would impede a creditor's ability to compete in the fact-paced, convenience-focused payday loans market.\(^{14}\) This highlights that the existence of a payday lending market gives rise to a need for the Regulator to acquiesce to the fact that some aspects of the market will be lacking in the context of responsible lending. That being said, the FCA will shortly issue a Policy Statement on assessing creditworthiness in consumer credit, which may have a significant impact on the future of the payday lending market and access to credit for the quintessential payday loan borrower. Therefore, the impact of the cost cap and the reduced availability of payday loans will now be considered in the context of access to credit.

**Sub-prime borrowing and payday loans - the lesser evil?**

A noted above, the payday loans market provides low-income, high-risk consumers with access to credit in situations of emergency, or indeed to meet the needs of their necessary spending. Therefore, payday loans are aimed at borrowers characteristically defined as 'sub-prime'. As noted above, the FCA's price cap has seemingly reduced the number of active payday lenders.

Furthermore, there is clear evidence that the number of payday loans granted to consumers has reduced. Indeed, according to the Consumer Finance Association (CFA), the number of loans shrinking by 42\% in the period January to April 2016, when compared to January to April 2013. The CFA also suggested that the cost cap may have acted as a barrier to the market for those on lower incomes, who would typically borrow smaller amounts.\(^{15}\) Mindful of the fact that these borrowers would be considered sub-prime, the question remains as to where these sub-prime borrowers were

now obtaining funds to deal with emergencies and purchase the necessities for which the once relied on payday loans?

Overdrafts have been recognised as alternatives to payday loans, which could arguably be used deal with emergencies or finance everyday necessities. However, they can be considerably more expensive than payday loans, particularly where the overdraft facility is unplanned. Further, considering that payday loans have been specifically marketed as a way of dealing with broken household appliances, it is arguable that the hire-purchase providers may be a viable alternative in order to finance the purchase of new goods, rather than repairing existing appliances. Both forms of credit are notoriously expensive and can lead to borrowers finding themselves in dire financial situations, although notably, hire-purchase agreements are not subject to price regulation.

Furthermore Brown has expressed concern that the absence of a payday loan may lead to borrowers seeking funds from illegal sources of credit,\(^\text{16}\) where lenders use 'strong arm' tactics to secure repayment of debt.\(^\text{17}\) Indeed, the FCA may inadvertently and unintentionally subprime consumers more harm through the imposition of a cost cap, a risk the Regulator was swift to assert as being minimal, although the FCA does recognise the potential issues linked to ascertaining the true scale of consumers using illegal moneylenders.

Therefore, whilst alternatives are available, the fact that low-income, vulnerable consumers have arguably been priced out of the payday loans market by virtue of the price cap, it could lead to them using more expensive, less-regulated and, at worst, illegal sources of credit.

Conclusion

This article has set out the key aspects of the price cap on payday loans, and to ascertain whether consumers are better protected following its introduction. A price cap can only go some way towards ensuring that payday lenders provide high-cost credit, only to those who can afford to repay their loans. It is noteworthy that the prevalence of convenience over affordability does well to undermine the function of a cost cap in protecting consumers of the payday loans market. The number of borrowers obtaining payday loans has greatly reduced. Further, the potential impact of the FCA’s imminent review of creditworthiness assessments in the context of consumer credit, cannot be underestimated. Indeed, the cost cap, in conjunction with more stringent affordability assessments may exacerbate the decline of the payday loans market, causing consumers to turn to more expensive or even illegal sources of credit, thus generally undermining the protection of consumers in the wider market.