Consultation Response

StepChange Debt Charity response to the Financial Conduct Authority consultation:

CP10/14: Proposals for a price cap on high-cost short-term credit

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We are an independent charity dedicated to overcoming problem debt. Our advice and solutions are effective, tailored and importantly, free. Foundation for Credit Counselling. Wade House, Merrion Centre, Leeds LS2 8NG. Company No 2757055. Charity No 1016630. www.stepchange.org

Introduction and key point summary

StepChange Debt Charity is the largest specialist provider of free, independent debt advice operating across the UK. In 2013 over 500,000 people contacted our free helpline or online debt remedy tool for advice, support and solutions to serious debt problems. We expect this number to grow to 600,000 in 2014.

StepChange Debt Charity believes that high-cost short-term credit (HCSTC) is a broken market. We have seen a rapidly increasing number of people coming to StepChange Debt Charity for help with payday loans in the last four years, and their average debt has increased substantially too.

Fixing the HCSTC market requires strong action to address consumer detriment, by reducing incentives for poor lending and business conduct, as well as protecting people from unsustainable distress purchases. In the medium term, a range of policy measures are needed to reduce the demand for HCSTC and bring forward the supply of more sustainable alternatives.

Consumers will continue to need access to short term credit and FCA action should also be aimed at stimulating market reform. This entails the FCA addressing problems in adjacent credit markets where consumers also suffer detriment. The goal of an affordable lending market treating consumers fairly will involve others but the FCA has a critical role to play in creating the right environment.

As such, we welcome this important step from the Financial Conduct Authority (FCA) in setting out a cap for the total cost of credit, based on rigorous analysis of the payday lending market.

The price cap represents an opportunity to reduce the level of consumer detriment experienced by HCSTC borrowers. Yet, we are not convinced that the proposals set out in this paper are clear enough on the policy outcomes that the proposed price cap is seeking to achieve. The FCA has set out to achieve a seemingly impossible balance between contradictory objectives, particularly its statutory competition and consumer protection objectives.

We consider that the scale of detriment associated with HCSTC, and the speed with which HCSTC borrowers can get into entrenched difficulty with multiple expensive loans, means that policy-makers and regulators should prioritise consumer protection as the key objective in developing the cap.

We want to see a HCSTC market where borrowers pay a fair price for their loan, and can pay it back at a rate they can afford without facing excessive penalties and charges, so that they do not become dependent on more HCSTC to keep up with existing borrowing. This means ensuring that people do not rely on HCSTC to cope with longer term financial difficulties where they are unlikely to see their income increase to repay the loan.

Our response argues that the FCA can and should go further in protecting consumers, by tightening the proposed regulations on price caps for HCSTC. In summary, we would urge the FCA to consider:

- A lower overall cap on higher value loans to prevent excessive debt inflation.
- Differentiated caps after an initial period in the loan to account for lower lending costs and prevent excessive debt inflation.
- Separate caps on the initial and default interest so that 'over-confident' consumers would not be misled by seemingly attractive initial costs, and to disincentivise lenders from profiting from default interest.
- Lower, more proportionate levels of default fees to reflect default administration costs, in parity with other credit markets.

Even with these amendments, further action will be needed from the FCA to ensure that the cap is truly effective at reducing consumer detriment – whether through further regulation, supervisory activities, or pre-emptive action to prevent arbitrage in adjacent markets. We highlight where we believe further action is needed under each specific question.

Detailed responses

Q1 Do you have any comments on our general approach to developing our proposals for the price cap?

The proposal to cap prices and default charges is a significant step forward in protecting people from some of the deeply entrenched financial difficulty that high cost short term credit products can cause.

We welcome the rigour of the analysis that the FCA has conducted, which provides a clearer sense of how a price cap on HCSTC would impact on business models, lending decisions and borrowers' outcomes than looking only at international evidence would enable.

We understand that the FCA had to meet competing and conflicting objectives. However, we believe the analysis should have led to a greater weighting for consumer protection objectives.

In particular, the analysis points to the need for stronger consumer protection against debt inflation than a 100% cap on the total cost of credit entails, and a more

significant reduction in the proportion of consumers who would face detriment after using HCSTC.

The FCA's analysis find that 50% of HCSTC experienced financial detriment as a result of taking out a payday loan, yet just 11% of people would be prevented from getting a loan as a result of these proposals. That means that more than 4 in 10 HCSTC borrowers in the price-capped market would remain at risk of real financial detriment as a result of taking out a loan. This is considerably short of the level of consumer protection that we believe is necessary.

We do not believe that excluding people from HCSTC when it leads to detriment is a negative outcome. This is reinforced by the FCA's analysis, which suggests that negative outcomes associated with exclusion from HCSTC are significantly more limited than industry groups have warned. Only 5% of those who had been refused a loan would consider using an illegal money lender, and just 2% had used (or attempted to use) an illegal money lender. A significant 60% of people who faced exclusion would not borrow at all. This should provide reassurance to the FCA and government on the case for taking a strong approach to consumer protection.

As such, we believe that the FCA has given too much weight to competition concerns. This seems particularly disproportionate when both the FCA's and the CMA's analysis finds limited effective competition in the market - price competition among lenders is weak, and consumers lack market power due to 'a perceived urgency and uncertainty about eligibility for credit products'.

Measures stated to boost competition typically focus on keeping a larger number of lenders in the market, and come at the expense of protecting consumers with more stringent caps on the daily cost of credit and the total price cap. Yet, the paper makes no indication of how the increased number of firms would lead to more effective price competition.

This overlooks evidence from Florida, where tighter caps have still seen the market grow. In any case, we believe – without intervention – the factors that make competition weak in this market will continue regardless of the proposals. We believe this gives the FCA a mandate to be bolder in prioritising consumer protection, while also necessitating more concrete proposals to stimulate price competition in this market to ensure that the cap does not become a target for lenders to structure their products in order to reach the 100% cap, e.g. by offering longer term high cost products.

Finally, the analysis makes it clear to us that the price cap is not – and cannot – be a silver bullet. The FCA's analysis concurs with our own client data that the vast majority of HCSTC borrowers also have debts on a range of credit products, and that the drivers for people to use HCSTC are complex and driven by a number of social policy factors.

We believe the FCA must also set out how it will deal with the regulation of adjacent consumer credit markets which vulnerable borrowers could turn to and HCSTC firms could move into. The FCA must also set out more concrete proposals for the wider regulations needed to ensure that the price cap is effective and complemented by robust conduct rules.

As we have argued above, we are not overly concerned about the effects of a lower number of firms operating in the market. Nevertheless, we would welcome more clarity from the FCA on some of the practical implications of the price cap being rolled out. We would be keen to know what provisions will be in place for customers with debts owed to firms that cease to offer loans, look to sell loan books, or go into administration.

Q2: Do you have any comments on the proposed price cap structure?

We are concerned that the overall structure of the cap will still allow circumstances in which people end up paying a very significant and disproportionate amount of money for their loans.

As the proposals stand, we are concerned that a total price cap of 100% remains a very high amount, particularly on larger loans – and could easily see people getting into longer term difficulty.

Making no distinction between initial cost caps and default interest cost caps could see firms advertising shorter loans to ‘over-confident’ and optimistic consumers, who then find their debts grow with default interest added on to the debt each day.

We believe the FCA’s proposals at 5.45 merit further consideration. A separate default cost cap of, for example, 20% would provide stronger incentives for firms to lend responsibly in the first place and not profit excessively on people defaulting on the loan. We see that HCSTC lenders typically price for the increased risk of default in their initial lending rate, and we believe that the high level of normal interest is a strong incentive for people to pay back their loan.

We are unconvinced by the FCA’s argument that this fee structure would be too complicated for people to understand if the information was set out clearly. There are precedents of splitting caps in other financial services products, such as NEST pensions, where there is a two part cap, based on a charge per contribution and a charge on the fund. This cap has now been applied to other auto-enrolment pension products.

On balance, we think it is more important to protect consumers from their debts inflating quickly - particularly in ways they don’t expect due to the optimism people

experience at the time of taking out a loan. We would therefore urge the FCA to give further consideration to a split cap applying different limits to the principal loan cost and default costs.

Q3: Do you have any comments on the price cap levels?

Total cost cap

We are concerned that a cap of 100% for higher value loans in particular will still lead to significant levels of detriment for consumers. Paying back twice the value of a loan could still see many borrowers falling into difficulty that necessitates further HCSTC borrowing.

While the FCA's approach of presenting the impact of percentage caps on £100 loans helps to explain how the cap works in simple terms, it can skew the perception of how loans work from the reality.

The reality that we see at StepChange Debt Charity is people with significantly higher payday loan debts. When percentages translate to pounds, and relative to the average income of people with payday loan debts, it is clear that the proposed level of caps would still translate to entrenched difficulty for many customers.

The CMA finds that the average initial loan is £260, but that people have an average of 6 loans. Someone with just one payday loan could find themselves £520 in debt under the cap, while the average HCSTC borrower could find themselves £3,120 in debt.

Our clients with payday loan debt have an average monthly net income of £1,305, meaning that just one loan which reached the 100% cap would still see them owing a significant proportion of their income – which would quite conceivably lead to the need for further borrowing to meet their credit commitments.

The FCA argues that a 100% cap is a clear concept for consumers to understand, but we do not believe that simplicity is a strong enough reason to propose a level of price cap that will still see more than 4 in 10 borrowers facing difficulty as a result of the loans. As above, we are not convinced by the competition arguments for setting it at 100% - especially if there is little effective competition already, and both the FCA and CMA find that consumers are generally insensitive to prices.

We believe the FCA should give further consideration to a number of measures to limit the amount that debts can escalate. In particular, we think it is worth considering separate caps for initial interest and default costs/interest, and whether there should be lower overall caps for loans above a certain value.

We also think the effects of this could be mitigated by tighter application of CONC7 rules on interest and charges, and would be keen to have a stronger statement from the FCA on how they will use these rules to bolster the price cap.

Initial cost cap

We appreciate that an initial cap of 0.8% could be seen as a reasonable balance of lender and consumer interests for a short term, low value loan. However, we question whether it is still a reasonable reflection of costs for a longer or higher value loan.

At present many two month loans in the market are charged at a rate of around 0.5% a day, but we consider there to be a real risk that the market could move to offering primarily longer term loans at around 0.8% a day - which more quickly escalates the cost to 100% of the amount borrowed.

We believe this flat rate also creates incentives for lenders to plan on re-negotiating or postponing the payment date, allowing default interest to accrue or simply offering significantly longer loans from the outset – in order to maximise profitability, which is higher the longer the loan lasts, once set-up and acquisition costs have been accounted for.

This could see lenders move from a model of being very quick to collect debts to one where they are motivated to allow the loan to extend as long as possible – and making the 100% cap on the total cost of credit the norm rather than the maximum. This would see consumers continue to pay high amounts of interest on their debts and face further financial difficulty.

It also risks creating a ‘balloon’ payment problem – where longer, larger loans are expected to be paid off in one big lump sum at the end - we can only see that this would lead to more HCSTC dependency, as people need to borrow more to pay off inflated HCSTC debts.

Crucially, the FCA’s analysis suggests that there would still be a default rate of 35% under this price cap scenario - which still seems an unacceptably high level of detriment, and that only a fifth of those experiencing detriment in the current market will have been excluded from HCSTC.

We believe there is a strong case for the FCA to regulate for lower default interest rates, and lower daily rates on loans offered over a longer timeframe - for example, after an initial period of two months - and that regulatory measures should be put in place to strongly incentivise instalment payments on longer time frames, using a declining principle, to ensure that borrowers are not faced with a large, unaffordable bill at the end of the term. There is a precedent for different levels of charges in other sectors; for example, after the Sandler Review in 2003 stakeholder products were

capped at a lower level (1%, down from 1.5%) after a certain time-frame (10 years) to acknowledge the lower business costs at that point in the product cycle.

Default costs

The FCA states that the cap for default costs should be based on reasonable costs, but the analysis does not cover what reasonable costs might be based on. As it stands, £15 seems high cost for fixed charges, relative to the total cost of some smaller loans - 30% of loans were for £100 or less. It is worth noting that the current cap on credit card defaults is £12.

As we highlighted above, we are very concerned about firms allowing loans to continue charging default interest up until the 100% total cost of credit cap is reached, which – especially for larger loans – could see people needing to borrow more in order to pay off significantly inflated debts.

Q4: Do you agree with our proposals on repeat borrowing?

We are concerned that the current proposals do not do enough to limit the scope of repeat or concurrent HCSTC borrowing, which is a key way in which HCSTC debts can inflate quickly, become unmanageable and prompt further borrowing that leads to a cycle of HCSTC dependency.

The need for repeat and concurrent borrowing is driven by loans being unaffordable in the first place, which a significant number of loans would be under the proposed cap.

Without a limit on repeat and concurrent borrowing, it will be relatively easy – as the FCA suggests – for firms to issue new loans within minutes of the initial payday loan being paid off. This could still see a high incidence of consumers taking out new payday loans to keep up with their first payday loan, getting many into deeper debt spirals.

The proposals to limit the harm that repeat borrowing would then be reliant on effective data-sharing, supervision and enforcement of responsible lending, alongside action to limit the costs expensive credit options in adjacent markets, such as unauthorised overdrafts, home-collected credit, and in log-book lending.

As proposals stand, we are not convinced that the FCA has provided sufficient clarity and assurance that people won't be able to turn to a range of lenders and products that would cause their financial difficulties to spiral quickly.

A purely supervisory approach does not seem consistent with the pre-emptive approach that the FCA stated it would take to regulation. There is a risk, even with a strong supervisory regime, that the FCA will be 'playing catch-up' with the dynamic, responsive HCSTC industry - meaning borrowers may fall into difficulty in the meantime.

On that basis, we can see a case for upfront rules on repeat borrowing, such as restrictions on number of loans within given timeframes. We are surprised that the FCA has dismissed these as 'too stringent'. We believe the FCA should actively commit to considering these further if there is a sustained level of detriment due to unaffordable lending once the cap has been implemented.

Irrespective of stronger rules on repeat borrowing, we believe the FCA will need to take the following actions to bolster its supervision of repeat-borrowing to ensure the effectiveness of the rules:

- 100% of HCSTC providers signed up to real-time data sharing, so that all lenders have full information on which to make an affordability assessment.
- Strong new guidance for responsible lending, with a focus on assessing affordability of loans – particularly repeat loans, will be needed to ensure that debt repayments do not take up an unsustainable amount of their take-home pay.
- A clear indication of how frequently the FCA will be supervising the lending decisions of HCSTC providers, particularly affordability tests.
- A commitment from FCA to produce rulebook guidance to dissuade firms from marketing 'near HCSTC' products and to encourage more reasonable charges in adjacent markets – to prevent people building up further unmanageable debts if they are unable to access loans that fall within scope of HCSTC regulations.

Q5: Do you have any comments on the scope of the price cap?

We appreciate the practical reasons for defining HCTSC as loans less than 12 months, and why more continuous forms of high cost borrowing, such as home-collected credit, overdrafts and logbook loans need separate rules.

Nevertheless, we are concerned that credit options that fall outside the scope of the price cap can exceed the cap and cause consumers similar levels of financial detriment:

- An unauthorised overdraft of £200 from a major high street bank would attract £300 of charges in just 60 days, equating to 150% of the total cost of the credit, and a daily cost of 5%.

- A home-collected loan of £500 with a weekly repayment of £32.50 over a period of 23 weeks would attract £247.50 in interest, equating to 50% of the total cost of credit, but a daily cost of 1.5%.

- A logbook loan of £1000 from an online lender, with 15 monthly payments of £142 would attract an additional £1130 in interest, equating to 113% of the total cost of the credit but a daily cost of 0.4%

In order to prevent spillover to these adjacent markets – whether firms moving into these product types or consumers taking out equally expensive and unsustainable forms of credit – we would urge the FCA in the first instance to develop rulebook guidance, which indicates that the FCA has identified a tolerance for the kinds of charges that they consider reasonable, and that all firms who provide short term credit, even outside the handbook definition of HCSTC, should take account of their rules for total and daily cost of HCSTC in their pricing. Firms should be able to explain how prices materially higher than those indicated as the limit for HCSTC are consistent with treating their customers fairly, and how pricing structures reflect responsible provision of credit in the expectation that customers will repay on time.

We would also urge the FCA to pay particular attention to firms narrowly circumventing the rules with their products, e.g. offering high cost loans for a period of 12 months and 1 day. They should make clear that attempts to circumvent the cap will be treated as a breach of the FCA Principles.

Q6: Do you have any comments on our proposed Handbook rules?

Where we suggest amendments to the policy in response to other questions in the consultation, we believe the rules should be amended accordingly.

We are pleased to see re-financing explicitly included within the cap. As highlighted above, we continue to have concerns about the 100% cap on the total cost of credit becoming the norm rather than the maximum, and would urge the FCA to consider measures to prevent loans quickly escalating to 100% of their original value.

We are pleased that credit brokerage charges will be included under the total cost of credit cap, as part of a connected agreement. Our advisers see a significant degree of consumer detriment associated with credit brokering and we consider that this business area deserves its own regulatory review.

Q7: Do you agree with our proposals on unenforceability?

We welcome the proposals on the unenforceability of loans that breach the total cost of credit cap. In order to make these rules effective, we believe that HCSTC lenders should be required to provide key information with each loan that informs people, in clear language, of their rights under the loan and how to go about enforcing those rights. Otherwise, we fear that borrowers will not feel empowered to challenge poor practice.

We welcome the fact that some CPAs will be unenforceable, but would seek clarity from the FCA about how this will work in practice, e.g. if the unenforceable payment has already been taken, how will the borrower go about getting the unenforceable portion refunded.

Q8: Do you agree that we should prevent UK-based debt administrators from enforcing HCSTC agreements on behalf of ECD lenders which include charges in excess of the price cap?

Yes, we support the FCA's proposals to prevent debt administrators enforcing agreements in excess of the cap. We are supportive of the FCA's case to HM Treasury for more powers in this regard. We would also welcome clarity on how the FCA will police the usage of continuous payment authority by ECD lenders.

Q9: Do you have any comments on the proposed approach to data sharing?

As we argued above, we have significant reservations about accepting 90% of providers (by market share) voluntarily signing up to real-time data sharing as sufficient to avoid mandating it. Real-time data sharing is essential to ensuring that that loans are leant responsibility, based on full information about a customer's financial commitments.

Anything other than full participation in real-time data sharing, using an effective database, undermines these efforts, and will allow loans to be made which are unaffordable for consumers and likely to lead to more entrenched financial difficulty. Without real-time data sharing, the FCA will not be able to give the frequent and

intensive level of supervision to lending decisions that will be needed in the HCSTC market, and ensure that providers adhere to the new rules.

We consider that the industry has been given sufficient notice to voluntarily sign up to real-time data sharing, and we would urge the FCA to act quickly if it finds that 100% of lenders are not signed up by November 2014.

Q10: Do you agree with the costs and benefits identified?

We have set out our thoughts on the proposals under the specific questions.

Q11: Do you agree with our assessment of the impacts of our proposals on the protected groups? Are there any others we should consider?

The FCA has identified the disproportionate usage of high street payday loans by women and black and minority ethnic borrowers as justification for keeping the cap at a higher level. As a consequence of keeping the cap at a higher level, more people from a broader group of borrowers, including many from these groups with protected characteristics, will experience detriment. We would urge the FCA to state what actions it will take to counteract the additional detriment that many borrowers will face.