

# IMPACT OF WELFARE REFORMS

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## High-cost credit and welfare reform

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### Introduction

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High-cost credit, in particular payday lending, has recently received unprecedented levels of academic and media interest. In the last five years from 2009 to 2014, the market for these products has grown significantly – from around £800 million to £2.8-£3.5 billion, depending on the definition used. This growth has occurred for a variety of reasons, many of which are intrinsically linked with welfare reform. Whilst the current government is spending a considerable amount of time and effort addressing the regulatory aspects associated with the supply of high-cost credit, it is doing little to tackle the underlying reasons why increasing numbers of people are turning to such expensive, and potentially harmful, financial products. Until these issues are addressed, we will only be dealing with the symptoms and not the root causes behind these issues. This article analyses the impact that recent welfare reform has had, and could have, on high-cost credit. There are three parts. Part I briefly analyses political and economic reasons behind the rise of high-cost credit in the UK. Part II highlights how the government has dealt with the problems created by this explosion, including the increased regulatory requirements on credit providers. Finally, Part III suggests a range of reforms which will help to provide a safer credit market for low-income borrowers in the UK.

### Part I: The rise of high-cost credit

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During the recent period of international financial turbulence, growing numbers of UK borrowers accessed short-term finance to close the increasing gap between their income and the cost of living. Due to a range of economic and political factors, there has been a consequent

upsurge in the use of high-cost credit to 'make ends meet' – a form of credit which, as outlined above, has increased approximately fourfold in the last five years. The UK recently experienced the longest economic depression in over 100 years and a double-dip recession, wages stagnated or lowered, unemployment rose dramatically and the cost of living skyrocketed (Packman, 2014). Whilst the economy is beginning to show signs of improvement, these are being felt largely by the most well-off in our society, with little evidence of a 'trickle down' to those who need it the most.

Politically, a Conservative-led Coalition Government has enacted reforms that, when combined with the economic conditions discussed above, have resulted in an unprecedented increase in need for short-term credit. These include decreased access to welfare, the creation a universal benefits cap, dismantling the Social Fund (which was widely considered the 'lender of last resort' for vulnerable consumers in desperate need of funds) and the reduction in funding to a range of organisations designed to assist people who have fallen on hard times. The government also instigated a number of reforms which increased income insecurity, especially for low-income families, further contributing to people's need to rely on credit for many day-to-day expenses. It is therefore no surprise that in 2013 over two million people turned to payday lenders and other high-cost credit providers for short-term injections of much-needed cash.

## Part II: The Government's response to high-cost credit

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The increased attention paid to high-cost credit eventually led the government to review the legal regulation that previously existed in this field. For example, the government referred the industry to the Competition and Markets Authority for review (CMA) to determine what, if any, issues exist that may impact the competitiveness of the market. A new regulator for consumer credit, the Financial Conduct Authority (FCA), has also been created and replaces the Office of Fair Trading. The FCA has received increased funding and enforcement powers, and the impact of this is already evident with a number of firms having their licences revoked and actions taken against Wonga (UK's leading payday lender) for both unfair debt collection practices and irresponsible lending.

In conjunction with the transfer to the new regulator, the legislative and regulatory regime associated with high-cost credit has undergone significant reform, including:

- Enhanced affordability assessments, including a consideration of the borrowers' other financial commitments;
- Borrowers can 'rollover' (i.e. renew the loan for a further term without making any repayments) a maximum of two times;
- A maximum of two unsuccessful attempts at continuous payment authorities (CPAs) to pay off the loan in full allowed;
- Prohibition on the use of CPAs for part payments of outstanding loans;<sup>1</sup>
- Provision of a financial warning to be included in payday advertisements; and
- Provision of an information sheet, including how to access free debt advice, for borrowers who rollover a loan.

Whilst these go a considerable way to addressing some of the harm caused by high-cost credit, many in the consumer lobby, such as Stella

Creasy MP and Unite, saw this as 'too little, too late'. One of the biggest concerns voiced by a number of consumer advocates and politicians was the lack of any cap on the cost of credit, which meant that payday loans of 3,000% APR were commonplace and loans of up to 16,000% APR were available on the market. These organisations believed that, despite the increased regulation, a cap was still necessary and in November 2013, an amendment to the Banking Reform Bill was passed which required the FCA to implement a cap on the total cost of credit by 2 January 2015. This cap involves:

- 1 The initial cost of credit limited to 0.8% per day, with an annualised percentage rate of 1,270%;
- 2 Default fees limited to £15 and default interest must not exceed 0.8% per day; and
- 3 A 100% repayment cap, meaning that the borrowers will never have to repay more than double the amount they borrowed (see FCA, 2014).

Whilst both the enhanced lending requirements and the newly established cap will help address some of the most heinous lender activities, they do not address the underlying causes of the high-cost credit crisis – the fact that large numbers of people in the UK do not have access to affordable and appropriate financial products in times of need (French et al., 2012; Rowlingson and McKay, 2014).

## Part III: Looking beyond regulation – what more can be done?

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The third and final part of this paper will consider, in light of the issues discussed above, what future reforms are needed to combat the problems associated with high-cost credit. The CMA has outlined that approximately 70% of all payday loans are obtained for 'everyday expenses', including groceries, bills and costs associated with car ownership (CMA, 2014: 68). This is in sharp contrast to how high-cost credit is often marketed, as a once-off loan for unexpected expenses or luxury items, such as a holiday. Unfortunately, using expensive, short-term

credit for everyday expenses can easily result in the creation of credit dependency and a debt spiral, often with harmful consequences. It is therefore important to address the underlying needs behind the demand for high-cost credit in an attempt to decrease the number of people using this financial product in an inappropriate manner.

Lending to people on low incomes for short-term credit needs will always be relatively expensive, given the high cost of making such loans and the high risk of default. One way of making it more affordable is to subsidise it by assisting the non-profit sector. Demand for short-term credit will never cease completely and it is important that people, especially those on a low income, have access to appropriate and affordable credit. The government can assist this endeavour by increasing funding for Credit Unions and Community Development Finance Institutions (CDFIs), both of which provide affordable credit products. The banking sector also needs reform. The current vague and complicated fee structure of banks, including the high costs associated with unauthorised overdrafts, is one of the key reasons why many people turn to high-cost credit facilities. Pressure should therefore be put on mainstream banks to deliver increased short-term and affordable credit options to all customers. Unfortunately, for some of the poorest in our society, even low-cost loans from mainstream or not-for-profit institutions will have a detrimental impact on their financial position. Because of this, it is critical that the Social Fund is reinstated nation-wide, as this will ensure that people who are financially struggling do not exacerbate their situation by burdening themselves with problem debt.

It is an unhappy reality that many people turn to high-cost credit because their incomes are insufficient to cover their day-to-day expenses. Obviously further welfare reform is required to address this issue and ensure that all people have access to sufficient resources for a basic standard of living without having to resort to expensive and often harmful credit, including the promotion of a 'living wage' (see Davis et al., 2014). A wide range of further initiatives should also be implemented, including increased

financial grants to low income families during times of need and enhanced funding for support organisations, such as money advice charities and, potentially, food banks. These reforms will, especially when complemented with the increased regulation discussed in Part II, address the underlying causes fuelling the explosion in demand for high-cost credit, as opposed to just managing the symptoms.

### **Conclusion – High-cost credit in the UK, more than just a regulatory issue**

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It is clear that we cannot deal with high-cost credit, in particular payday lending, without recognising the intimate and interconnected relationship it has with the welfare system. On one hand, the Coalition's agenda has allowed demand for expensive, short-term credit to flourish, thereby creating the high-cost credit crisis currently being experienced by many, largely low-income, people in our society. On the other hand, the underlying issues behind high-cost credit will not be adequately resolved without addressing fundamental problems of low and insecure income, whether sourced from the labour market or from social security benefits. Whilst the government has made great inroads into the regulation of high-cost credit products, it has largely ignored the broader issues – why and how we have created a society where so many people need to access expensive and often harmful credit just to 'get by'. Until this is addressed, the currently regulatory endeavours are unlikely to do anything more than merely push these problems onto a new area.

### **Notes**

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- <sup>1</sup> An automatic payment of outstanding debts through a debit or credit card, linked either to a bank account or credit card. Once a borrower agrees to a CPA, the lender will be able to obtain payment without any further action from the individual.
- <sup>2</sup> We would like to thank the AHRC for supporting the work on which this paper is based, through the FINCRIS project: Responsibilities, Ethics and the Financial Crisis.

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