

# **Protecting Low Income Borrowers in the Credit Crisis**

A report by

**Rt. Hon. Ian McCartney MP  
& Damon Gibbons**

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## About the Authors

***The Right Honourable Ian McCartney*** is the Member of Parliament for Makerfield. He served under the former Prime Minister Tony Blair as Minister of State at the Department of Trade and Industry from 1997-1999; Minister of State for the Cabinet Office from 1999-2001; Minister of State for Pensions at the Department for Work and Pensions from 2001-2003; Minister Without Portfolio and Labour Party Chair from 2003-2006; and, Minister of State for Trade, Investment and Foreign Affairs from 2006-2007. Prior to that he held a number of positions in Opposition, including Health, Employment, Education and Social Services. Following his decision to step down from frontbench politics, he has taken on a number of unremunerated positions, becoming the President of the Money Advice Trust, the UK Commissioner General for the Shanghai World Expo 2010 and the President of the National Consumer Fireworks Association.

***Damon Gibbons*** is a co-founder and Chair of Debt on our Doorstep, an umbrella campaign established in 1999 to highlight problems of extortionate credit and to widen access to fair financial services. The campaign network comprises local community and faith groups, local authorities, debt advice agencies, credit unions, and national agencies including the National Housing Federation, Citizens Advice Scotland, Church Action on Poverty, and Oxfam. Damon is also a Board member of the European Coalition for Responsible Credit. He is employed as the Head of Policy and Partnership at the Centre for Economic & Social Inclusion.

# 1. Introduction & Summary of Recommendations

- 1.1 The unprecedented global credit and economic crisis that we are currently facing requires us to radically rethink the way that we regulate our credit markets.
- 1.2 A lengthy period of easy access to credit that gave rise to an extended boom in consumer spending and in housing markets around the globe has now resulted in a worldwide banking crisis that has constrained lending – even to households and businesses that remain ‘good risks’ – and tipped the major economies of the world into recession<sup>1</sup>.
- 1.3 The inability of households and businesses to obtain credit to reschedule existing commitments is pushing an increasing number towards default, repossession, and insolvency<sup>2</sup>. Credit markets, previously viewed as primarily a matter of freedom of contract between lender and borrower, are now recognised as having wider economic consequences, requiring regulation in the public interest. Quite rightly, government is pressing hard for banks and mainstream lenders to re-capitalise households and businesses following the use of tax revenues to re-capitalise the banks themselves.
- 1.4 However, more action is required if we are to prevent the crisis from adding further to the considerable number of households that have been excluded from mainstream financial services in recent years. Despite the significant success of government in reducing benefit dependency amongst low income households, we now find that low paid workers and families are faced with ‘credit dependency’ on high cost and predatory lenders.

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<sup>1</sup> Financial Stability Report (October 2008) HM Treasury, pg. 5

<sup>2</sup> Consumer County Court Judgments rose by 17.4% year on year in the third quarter of 2008 to 223,519 (Registry Trust Limited); Council of Mortgage Lenders estimates that 45,000 homes will be repossessed this year, with a possible rise to 75,000 in 2009; Company liquidations are up by 26.3% on a year ago, and individual insolvencies are up by 8.8% in the third quarter of this year (Insolvency Service).

1.5 This poses a considerable risk not only for the individual households concerned but for the wider communities in which low income borrowers are concentrated. Credit dependent households are the most reluctant to risk losing their remaining sources of credit, no matter the high costs that are being charged. This results in arrears being built up in other areas of the household budget, including on rent, council tax, and fuel and utility bills and a long term overall reduction in the amount of money available to be spent locally. This can have severe implications for the funding of public services in these areas, dampens the local economic growth rates, and exacerbates the problem of child poverty.

1.6 We must therefore re-double our efforts to address the damage that is being caused by these types of lending, particularly given the significant risk that the current crisis will result in a growth of these problems.

**1.7 We believe that two key principles need to be adopted**

- (i) Access to responsible credit products, provided or supported by mainstream financial institutions, needs to be widened in order to allow households to restructure their current liabilities and avoid becoming trapped in credit dependency
- (ii) Firmer action needs to be taken to prevent harmful forms of lending, unfair pricing, and predatory practices

1.8 **We recommend that government draw up a strategy to embed these principles in a new regulatory framework for credit.** We consider that they would not only prove to be effective in helping individual households from avoiding the worst effects of the current crisis, but would assist more generally in helping the UK to emerge from recession<sup>3</sup>.

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<sup>3</sup> In particular, ensuring that lower income households pay fairer prices for credit and reduce the proportion of their incomes spent on debt servicing is likely to lead to increased expenditure for consumption purposes and boost local economic growth (see, for example the successful approach taken by Leeds City Council which places action on debt and financial inclusion within the economy and enterprise strand of their regeneration strategy)

## **1.9 More specifically, we recommend that**

- Government, led by the Department of Business, Enterprise and Regulatory Reform ('DBERR') and HM Treasury, commit itself to placing banks under a clear obligation to consider the needs of lower income households and small businesses for access to mainstream financial products, including responsible credit, and to placing a requirement on banks to report on their actions to meet these needs.
- That DBERR and HM Treasury jointly establish a working group, including representatives from the Financial Services Authority, Office of Fair Trading, banks, and consumer agencies to bring forward workable proposals to realise this ambition within the next three months.
- That DBERR commit itself to placing a limit on the cost of credit that can be charged by lenders operating in non-competitive sectors of the market. We recommend that the time between now and the next budget should be spent preparing the ground for this policy to be brought into effect and to determine the most effective means by which this could be achieved.
- That DBERR commit resources to ensure that the illegal lending units are independently evaluated in 2010/11 to inform a decision on future funding, and that this evaluation also consider whether or not a new criminal offence of 'illegal lending' should be introduced.

## 2. The credit crisis for low income households

- 2.1 Credit can be extremely beneficial to households and the economy but it can also be extremely harmful. It can provide the means by which families purchase their homes, build their savings, and manage fluctuations in income and expenditure in the short term and over their lifecycle, boosting economic growth and smoothing out the business cycle. Yet it can also facilitate excessive risk-taking by both lenders and borrowers ('gambling' on asset appreciation or on unrealistic levels of income growth), resulting in the loss of homes, entanglement in debt, and loss of confidence in households, businesses, and banks.
- 2.2 Credit is not wealth itself, but only holds the potential to create wealth. Access to it is therefore important, but so too is the way it is provided. The *quality of credit* - that is the terms and conditions on which it is lent including its price - as well as the *purpose* to which it is put, are critical considerations. As this crisis demonstrates, these are issues that are too important to be left purely to borrowers and lenders to resolve within the marketplace – there is a wider public interest in the decisions that they make. Rash lending and borrowing decisions affect more than those who lend and borrow.
- 2.3 Dealing with the current crisis is therefore about reasserting the need for public interest regulation as the foundation of a future framework for the governance of credit markets. It is implausible for private financial institutions to be rescued by government and also argue that they should not be subject to greater regulation. Public opinion is rightly incensed that this is what some have attempted to do.
- 2.4 Government has struck a chord with people by putting pressure on the financial services industry to justify the prices that they are charging in the mortgage and credit card markets, and by pressing for lenders to make credit available to households in need of restructuring their commitments (for example by providing greater scrutiny through the Lending Panel) and to viable businesses.

- 2.5 These two issues – of fair prices and access to credit – remain the key concerns for households on lower incomes too. Whilst government pressure on the credit industry has necessarily been focused on mortgages, credit cards, and business lending, it is important that iniquities in other aspects of the credit market are not overlooked.
- 2.6 The economic downturn is already feeding through into rising unemployment and a sharp increase in credit defaults and debt problems. The announcements in the Pre-Budget Report of additional investment for Jobcentre Plus and of a further £15 million of funding for money advice provision were particularly welcome in this respect. However, as unemployment increases households will experience defaulting on credit agreements. Even with the significant fiscal stimulus package announced in the PBR, government is still forecasting increased unemployment through to 2010/11. Households experiencing these problems will inevitably find it harder to obtain credit from mainstream lenders in the future.
- 2.7 The cost of being outside of the financial mainstream is significant and has been recognised as such by government since the publication of the Social Exclusion Unit's Policy Action Team report on this matter in 1999. Analysis of the data from the Bank of England's 2006 NMG survey indicates that those households in the lowest income quartile spend an average of 12% of their disposable income repaying unsecured loans. This is four times as high as the ratio of repayments to disposable income for households in the top income quartile<sup>4</sup>.

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<sup>4</sup> Taxing Times for the Poor: the implications of increasing indebtedness for poverty in the UK, D. Gibbons, Debt on our Doorstep, May 2006

2.8 The cost of credit options available to lower income households is a significant factor. Recent years have seen a growth in extremely high cost credit products targeted at low income groups. These include

- Payday lending, which takes post dated cheques as security for loans of up to a month in duration and routinely charges in excess of 1,000% APR. One internet based payday lender advertises loans at over 9,000% APR
- Auto-title loans, which take car log books as security and typically charge between 370% and 430% APR for loans over a period of a year to 18 months
- Home Credit, or door to door collected loans, which charge anywhere between 180% to over 1500% APR depending on the length of the loan
- Rent to Own Stores, for example Brighthouse, which advertise goods for rent with a final purchase option. Typical APR's are 29.2% but insurances and other fees make these extremely expensive<sup>5</sup>. In addition, as with mail order, goods are artificially 'marked up' from the cash price in order to bring down the APR figure.

2.9 Whilst the vagaries of the APR calculation can sometimes make the cost of short term loans appear unduly high, it is clear that the actual amounts being paid by people on low incomes for these types of credit are extremely high when compared to more mainstream forms of borrowing. The best means of comparison is to annualise the Total Charge for Credit ('TCC') per £100 borrowed. As the table below indicates, the price difference between mainstream and other forms of borrowing is significant.

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<sup>5</sup> The cash price of a Hotpoint Washing Machine from Brighthouse is advertised as £527.74. It's rent to own schemes extend over 156 weeks, bringing the total amount payable to £759.72, excluding service cover – a total charge for credit of £231.98. Once service cover is included this increases the total amount repayable to £1168.44 – a total charge for credit of £640.70. Further additional insurance ('damage limitation cover') is often sold with the agreement to increase this further still.



Type of credit	Payday	Home Credit	Mainstream loan
<b>Typical terms</b>	£500 loan repaid after 26 weeks <sup>6</sup>	£500 loan repaid over 52 weeks	£1000 loan repayable over 12 monthly instalments from HBOS
<b>Total Charge for Credit ('TCC')</b>	Between £400 and £900	£366.65	£155.55
<b>Annualised TCC per £100 borrowed</b>	<b>Between £160 and £380</b>	<b>£73.33</b>	<b>£15.55</b>

2.10 All of the higher cost forms of lending appear to be expanding in the UK, and are set to grow further as credit becomes harder to access from mainstream lenders and more people experience repayment problems that affect access to affordable credit.

2.11 For example, the Payday lender, Dollar Financial, has recently opened its 250<sup>th</sup> store in the UK, and the largest home credit provider, Provident Financial is forecasting growth of 7% this year

*“The company is seeking to capture borrowers from mainstream British lenders, including Barclays Plc and Lloyds TSB Group Plc. Demand for credit has risen as larger lenders cut back on loans. The company expects customers to increase by about 7 percent this year, Chief Executive Officer Peter Crook said today”*  
 Provident Financial Reiterates Outlook on Customers, Bloomberg, 22/10/08<sup>7</sup>

<sup>6</sup> Payday loans are advertised as a means of short term borrowing (up to the next pay day of the borrower), however many allow loans to be ‘rolled over’ on an ongoing basis from one month to the next. For example, we found have found lenders explicitly stating that “We will automatically keep extending your loan until we receive instructions to take full repayment from you (Uncle Buck, a London based operation offering payday loans over the internet, see <https://www.uncle-buck.co.uk/charges.htm>)

<sup>7</sup> See <http://www.bloomberg.com/apps/news?pid=20601102&sid=aPuXjp7Bqx14&refer=uk>

- 2.12 One of the dangers of the current recession is that it will result in a significant growth in the number of people ejected from the financial services mainstream who are then forced to turn to extremely expensive products to meet their need for credit. This is what happened following the last recession in 1990/91 and which gave rise to a significant 'sub-prime' market both for mortgages and unsecured credit products.
- 2.13 Those households forced into these markets are not only disadvantaged because they must pay a higher price for credit, but are placed at real risk of becoming 'credit dependent'. By this we mean that they will be using credit to plug the gap between household expenditure and income on an ongoing and recurring basis.
- 2.14 Credit will often be used as a means by which households, particularly those reliant upon income related benefits to 'make ends meet' from one week to the next. This may start as way of paying for a large one-off bill, and spreading the costs for example of Christmas, but too often results in households rolling over loans to pay off previous loans, trapped in a cycle of increasing indebtedness and reliant upon a continued source of credit to pay for essential expenditure including food and heating<sup>8</sup>. Within the last two weeks GMTV reported from an estate in Bradford where lone parents were paying as much as £90 per week from their Income Support to door to door lenders.
- 2.15 There is growing evidence from the government's illegal moneylending units that an alarming number of households are also subjected to exploitation by illegal loan sharks. Research for the Department of Business, Enterprise, and Regulatory Reform indicates that there are approximately 165,000 users of illegal money lenders in the UK. These constitute approximately 6% of households in the most deprived areas and about 3% of low income households overall.

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<sup>8</sup> For a recent review of the relationship between fuel poverty and debt see Cold Comfort: A review of coping strategies employed by households in fuel poverty, (August 2008) D. Gibbons & R. Singler, Energywatch ([http://www.cesi.org.uk/Resources/CESI/8079\\_Energywatch\\_Cold%20Comfort.pdf](http://www.cesi.org.uk/Resources/CESI/8079_Energywatch_Cold%20Comfort.pdf))

- 2.16 Whilst one-third of these users of illegal moneylenders appear to do so due to their association with other social problems, including drug use and alcohol addiction, two-thirds are using illegal sources of credit due to a lack of other credit options.
- 2.17 However, the existence of legal high cost credit does not appear to prevent people from borrowing from loan sharks. In fact, around half of people using loan sharks, have borrowed from home credit lenders within the previous twelve months<sup>9</sup>.
- 2.18 The consequences of borrowing from illegal lenders can be severe. The initial evaluation of the illegal moneylending pilots in Birmingham and Glasgow highlighted the close links that exist between illegal lending, violence, intimidation and extortion.
- 2.19 Government action to increase affordable credit provision has not kept pace with these developments and the current crisis is likely to mean that significant levels of investment will be needed if lower income households are to be provided with access to better credit options.
- 2.20 To illustrate the scale of the problem, the size of the home credit market alone exceeds the scale of affordable credit made available through credit unions and the Social Fund. Home credit lenders put out over £1.5 billion of new loans in 2005, credit unions were lending only £353 million in the same year.
- 2.21 Whilst government's Growth Fund has added an additional £30-£40 million of lending capacity since that time, a recent report from the Third Sector Working Group established by the Financial Inclusion Taskforce makes a 'conservative estimate' of the need for the sector to make £1.2 billion per year in affordable loans if they are to provide a genuine challenge to the high cost credit market. On current levels of growth, the Working Group estimates that this would take a decade or more to be achieved.

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<sup>9</sup> Consumer research undertaken to support 'Illegal Lending in the UK', Ellison, Forster and Collard, PFRC and Policis for the then DTI, 2006 and cited in 'Transitioning high risk low income borrowers to affordable credit', BERR, August 2008

- 2.22 In the meantime, many of our poorest households are paying an unfair price for credit. In November 2006 the Competition Commission concluded its inquiry into the Home Credit market by announcing a set of remedies designed to redress the finding that excess profits of at least £75 million per year were being made as a result of lack of effective price competition. Those remedies concentrated on facilitating an increase in price competition through, for example, ensuring that borrowers in the market were provided with greater levels of information concerning the price of home credit and by facilitating borrowers movement towards cheaper forms of credit through the increased use of data sharing – allowing them to build up credit histories which could then be used to access other forms of credit, including credit cards.
- 2.23 It is now clear that the credit crisis has rendered these remedies ineffective. Credit options are becoming more constrained. Even those households with relatively good credit histories are finding it more difficult to obtain access to credit. Within the Home Credit industry – as is the case more generally, for example within banking following the take-over of Alliance & Leicester by Banco Santander and the merger of Lloyds TSB and HBOS – we are also seeing a reduction in the numbers of firms. Only this week, the third largest home credit lender, London Scottish Bank, has gone into administration. Competition, be it in the home credit market or in more mainstream banking and credit markets, is weakening, with inevitable consequences for consumers.
- 2.24 This begs the very urgent question as to how exactly we will ensure that consumers do not pay excessive prices for credit throughout the duration of this crisis. Government has rightly started to exert pressure as regards mortgage and credit card pricing, but there has so far been no action proposed as regards the prices for credit that lower income borrowers pay.

2.25 The current situation is now desperate. In some instances, legal lenders are now charging more than illegal loan sharks. In their report on Illegal Lending in the UK, published in 2006 for the DTI, Policis and the Personal Finance Research Centre note that

*“On average, at the outset of the relationship [with the illegal lender] the amount that it was anticipated would be repayable to the lender on an advance of £100 was £183, i.e. a total cost of credit (TCC) of £83, with little or no clarity on the term over which the loan would be repaid. **In practice, actual total cost of credit was on average £185 per £100 advanced.**”* (Page 8, our emphasis)

As indicated in our previous table, see para 2.9, above, this is easily exceeded by legal payday lenders in the UK, which are currently charging the equivalent of between £160 and £380 per £100 borrowed depending on the number of months the loan is rolled over.

2.26 In addition, observations that have been made concerning the way in which Illegal lenders “seek to control their victims primarily in order to create an ongoing income stream over a continually extended term, essentially for as long as it can be sustained” apply equally well to the relationships of ‘credit dependency’ that have been observed between low income borrowers and legal lenders, especially where the agents acting on behalf of legal loan companies are paid on a commission basis regarding amounts being collected. This encourages them to roll over, or re-loan, credit on a regular basis.

2.27 A series of interviews with Home Credit agents, commissioned as part of the Competition Commission inquiry confirmed this problem, although not all agents were happy with the way that that they were prompted by their companies to act in this way<sup>10</sup>

*“Ideally I would like them to take it [the reloan] as early as possible so they are paying back more, so for that week it gives me more collections, as unscrupulous as it is ... you know it's not fair, it's taking advantage of people who can't get loans elsewhere.”*

*“So say they've had a £200 loan and they pay back [over £300]. When they get to [half way] they [managers] will push them to have another £200. The customer will only get [less than £50] because they pay off the [money] they owe so they've put interest on from the first loan. So they are paying interest on interest and I have to go and ask them to renew this loan!”*

2.28 The fact that costs of credit in the legal market can be higher than the average cost from a loan shark makes a mockery of initiatives designed to clamp down on illegal lenders, and of the claim that allowing high cost legal lending will somehow prevent a growth in illegal lending.

2.29 In fact the relationship between the regulation of legal products and the development of illegal markets is far from straightforward, bearing in mind that decisions to operate illegally are not purely determined by the presence of demand but also by consideration of the penalties, and likely chances of being caught, for breaking the law.

2.30 We urge government to address both sides of that equation, by strengthening access to credit at a fair price for people on low incomes and also by clamping down further on those that would exploit vulnerable households by charging excessive prices and/or by operating illegally.

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<sup>10</sup> Research report for the Competition Commission provided by Andrew Irving Associates, April 2005, pg. 57

- 2.31 In addition, it is not the case that interest rate ceilings *necessarily* result in restrictions in the availability of credit, although they can do so if inappropriately applied. Evidence indicates not that interest rate ceilings are problematic in themselves, but that they become so where the level of the ceiling is introduced below the price that would be set through effective price competition and under properly functioning market conditions<sup>11</sup>. In non-price competitive markets, such as the UK's Home Credit market and increasingly in the mortgage and credit card markets, they can have a valid role to play in securing a fair deal for consumers that would otherwise be at a disadvantage in the market place.
- 2.32 Faced with a lack of price competition in the credit markets which is resulting in excess profits being made and exacerbating the hardship faced by many households, we consider that there are three main options
- Take action to increase price competition in order to bring down overall prices
  - Reduce prices directly through the use of ceilings to a level that would be charged if competition was taking place effectively on prices
  - Combine the two – for example introduce a price cap pending other actions to increase competition becoming effective
- 2.33 In the current climate it is difficult to see how the first of these options will be effective in delivering a fair deal for credit consumers in the immediate future.
- 2.34 Combining rate caps with measures to ensure the return of effective competition to the markets therefore appears to us to be the logical policy response, provided that measures are also taken to scrutinise the degree to which access continues to be offered.

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<sup>11</sup> See for example, 'Do consumers really want credit card reform', Kathryn Combs & Stacey Shreff, Federal Reserve Bank of Kansas City, Economic Review, Q3, 1999, which found that lenders "...with market power mark up the price above the cost of additional lending, creating a range within which an APR cap can fall without inducing rationing. If the cap is set in that range, consumers are willing to borrow more because the APR cap is lower than the current price. And assuming they can earn an adequate rate of return under the cap, [lenders] are willing make the additional loans because the cap is at least as high as the extra cost of making them. Customers benefit as a result. They all continue to obtain credit, and they obtain it at a lower effective price."

- 2.35 The current crisis has highlighted the fact that our credit markets have not been operating effectively. They have not been delivering fair and responsible products to people on low incomes for many years, and there is a real danger that if improved regulation is not put in place now that the economic downturn will result in many more households from being forced out from mainstream financial services provision.
- 2.36 In the next section we set out further detail of three steps that government could now take to address this problem – an obligation to provide access, an interest rate ceiling for non competitive credit markets, and further strengthening of the law with regard to illegal lending.



### **3. Measures to Protect Low Income Households**

- 3.1 We believe that government should build further on its actions to secure a fair deal for consumers by putting in progress the development of a strategy capable of protecting low income borrowers from the worst impacts of the credit crisis. In particular, we recommend that further steps are taken to ensure that they have access to financial services and affordable sources of credit; that limits on the total costs of credit are introduced into non-price competitive sectors of the credit market; and that action against illegal lenders is maintained.

#### ***Widen access to financial services and affordable credit***

- 3.2 Government has already made clear its intentions to introduce a statutory code of practice for banks in order to build on the previously voluntary Banking Code, and to ensure that small businesses are given appropriate information and notices of changes to the terms and conditions of their accounts. We support these moves, but note that the FSA's proposals for a new Banking Conduct of Business Sourcebook ('BCOBS') do not include any requirements for banks to demonstrate that they offer fair access to their products.
- 3.3 We believe that an additional requirement should be placed on banks. That they should be required to demonstrate how they have considered the needs of lower income households and small businesses when developing and promoting their range of services. In order to satisfy this requirement banks should be required to provide, in a standard format, details of the demographic characteristics of their customers and a self assessment of measures taken to facilitate access to their services, including relevant decisions over pricing policy.

- 3.4 Importantly, this requirement is limited to requiring banks to demonstrate that they have *considered* the needs of lower income groups. It does not force banks to make access available to products that would be inappropriate and it does not remove discretion from banks to refuse access based on wider commercial concerns. It does, however, seek to make those decisions more transparent and would open them up to greater scrutiny. The intention is to promote best practice in widening access. Banks may of course do this directly, by providing products themselves, or indirectly - for example by funding credit union and other third parties to provide services on their behalf.
- 3.5 In order to maintain effective scrutiny of bank performance in this respect, we recommend that these reports be made public and submitted to the recently announced Lending Panel for consideration and comment.
- 3.6 We accept that the detail concerning possible means of implementation for this proposal will need to be worked through. As the FSA is not responsible for consumer credit, it is not clear how they would be able to place banks under an obligation of this sort with regard to lending practice as part of the current move to introduce a statutory code – although they would appear to be able to ensure that the code included stronger obligations to provide bank accounts and savings facilities through that means.
- 3.7 To bring in an obligation to consider the needs of low income customers when developing and marketing credit products would require a joint effort from the FSA and OFT, informed by discussions with the banks themselves and with consumer agencies. We therefore recommend that DBERR commit itself to bringing in this obligation and jointly establish, with HM Treasury, a working group, including representatives from the Financial Services Authority, Office of Fair Trading, banks, and consumer agencies, to bring forward workable proposals to realise this ambition within the next three months.

## ***Limit the cost of credit in non-competitive sectors of the credit market***

- 3.8 Government is rightly acting to ensure that mortgage borrowers are charged a fair price following reductions in Bank of England base rates, and within the credit card market. We believe that there is an urgent need for action to ensure that lower income borrowers also obtain credit at fair prices.
- 3.9 As we set out in the previous section to this report, there has been an expansion of high cost legal lending in the U.K and in some instances the cost of credit from legal lenders is higher than that offered by illegal ones. In addition, it is clear from the Competition Commission inquiry into the Home Credit industry that credit in these sub-prime sectors of the market is not subject to normal competitive pressures.
- 3.10 We also know that it is possible to lend effectively at fair prices to people on low incomes. Credit Unions and Community Development Finance Institutions across the country have been doing just that for many years, and have not experienced high default rates. For example, the community based lender Fair Finance, based in Tower Hamlets, reported in 2006 that despite lending to some of the very poorest households, its bad debt ratio was just 1.2%<sup>12</sup>.
- 3.11 Charging people on the lowest incomes the highest prices only increases the risk of default, and requires all sorts of other mechanisms have to be put in place in order to reduce this. These include expensive home collection services, or the requiring of securities – in the form of cars, post-dated cheques, or in the case of pawnbroking, other goods. At the end of the day, low income borrowers are providing the greatest levels of security to consumer credit lenders and yet also paying the highest prices.

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<sup>12</sup> 'Fair Finance takes leaf out of bank book to give credit where it is due', Your Business, Financial Times, 2/12/2006

- 3.12 The current mechanisms for addressing the problem are too limited. The main market regulator, the OFT, does not have the power itself to impose a ceiling of this sort but can refer the matter to the Competition Commission which is capable of introducing such a cap if it judges that a lack of competition is causing consumer detriment and a ceiling would be an appropriate and proportionate response.
- 3.13 However, as the case of Home Credit indicates, the process can take several years to complete. The initial super-complaint against the Home Credit Industry was submitted by the National Consumer Council in June 2004, resulting in a referral from the OFT to the Competition Commission in December of that year. The final Competition Commission report was published two and a half years after the initial super-complaint on 30<sup>th</sup> November 2006. According to the Competition Commission's findings, in that time approximately £225 million in excess profits had been made by the industry at the expense of some of the poorest borrowers.
- 3.14 Two further years on from the conclusion of the inquiry, prices in the Home Credit market have risen further and competition is weakening. Excess profits made by the industry since the submission of the super-complaint now exceed at least £500 million, the equivalent of the current year's expenditure on Social Fund Budgeting Loans.
- 3.15 Other European countries have adopted much more effective approaches, and do not have our problems with high cost lending to people on lower incomes. In part this is due to greater investment in social alternatives, for example in Holland and France, but it is also due to clear legal intervention, in the form of price caps or 'usury' laws.
- 3.16 In Germany legal precedent from the late 1970's and early 1980's has established that lenders should not, as a 'rule of thumb' charge more than double the average market rate for consumer loans and overdraft credit. Details of the market averages are published monthly by the Bundesbank, and default charges are also restricted (as they are now also restricted in the U.K following OFT action on this issue).

- 3.17 A more structured approach is taken in France, where the Banque de France sets out three ceilings for different types of loans and sets a ceiling for each at 33% above the market average.
- 3.18 Clearly a range of potential options and mechanisms are available, and there will need to be debate concerning the level of the limit on credit charges as well as the best mechanisms to be put in place to monitor its operation and enforce it.
- 3.19 During the passage of the Consumer Credit Act 2006, Ministers in the then DTI pledged to review the case for interest rate ceilings within a reasonable period and debate has continued on the issue in Parliament since, including through the use of adjournment debates by back bench Labour members. Most recently, Jim Devine M.P has a current ten minute rule bill on this issue.
- 3.20 We therefore recommend that DBERR commit itself to placing limits on the cost of credit that can be charged by lenders operating in non-competitive sectors of the market, and that the time between now and the next budget should be spent preparing the ground for this policy to be brought into effect and to determine the most effective means by which this could be achieved.

***Maintain action against illegal lenders and consider strengthening enforcement powers***

- 3.21 DBERR is currently funding the provision of regional teams across Great Britain, which are targeting illegal money lending operations and which are now bringing forward prosecutions of loan sharks. An evaluation of the initial pilots found that these had been successful in conducting 111 investigations and have helped 1765 loan shark victims. They have recovered £1m in assets, with a further £1m likely to be collected pending court cases.
- 3.22 However, funding for this provision is currently due to expire in March 2011 and we believe that further evaluation of the projects is required in order to inform the future development of these services and to assist the Department in making a decision concerning future funding levels.
- 3.23 In particular, we recommend that an independent evaluation of the projects is needed to determine how improved links can be made between the illegal lending units, debt advice provision, and sources of affordable credit in order to help people make the transition away from illegal lending. We are particularly conscious of the need to help people move away from loan sharks without forcing them to fall back on very high cost legal sources of credit as an alternative.
- 3.24 We are also concerned that the current processes by which prosecutions can be brought against illegal lenders are overly complex and prevent swift prosecutions from being brought forward. As earlier evaluation has shown, there is a need to send a clear message to low income communities that the relevant authorities are in a position to help and protect the victims of loan sharks in order to ensure that they feel confident enough to come forwards. As part of a future evaluation, we therefore recommend that DBERR also consider whether or not a new criminal offence of 'illegal lending' should be introduced.

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