The effect of interest rate controls in other countries

[July 2004]
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1.0 Introduction

1.1 Background to the research

(i) Consultation with a wide range of stakeholders, including representatives of the credit industry, local government and consumer groups was undertaken over 2003. In responding to the consultation exercise, the view was put forward by some consumer representatives that the introduction of an interest rate ceiling in the UK would be an effective means of addressing exploitative lending, enhancing consumer protection and tackling poverty.

(ii) The UK has not had interest rate ceilings since the 1974 Consumer Credit Act. Ceilings are however used as a regulatory device in much of the continental EU and in some US states. The DTI therefore commissioned research into how interest rate controls have worked in other countries, with a view to understanding the likely impact of any introduction of rate ceilings in the UK.

(iii) The research was designed to ascertain:

- How rate ceilings are applied within the wider regulatory framework in other countries
- How rate ceilings have impacted on credit markets overall (as distinct from that part of the market focused on high risk lending).
- How rate ceilings have impacted on the availability of credit for those on low incomes, the non-status borrower and the credit impaired.
- How rate ceilings have impacted on the cost of credit to low income and high risk borrowers.

(iv) The research was undertaken at a time of intense debate in the UK about the role of credit within the wider drive to tackle poverty and social inclusion and how most effectively to deliver to the government vision of affordable credit for all. It is intended as a major evidence-based contribution to this important wider debate and to the development of thinking in this key public policy area.
1.2 The evidence base

(i) The research was undertaken in the USA, the UK and in France and Germany. The USA, the largest and most developed credit market in the world, offers a number of advantages in seeking to understand the likely impact of rate ceilings in the UK. The US experience facilitates comparison of the credit markets in states which have no rate ceilings with those that do and provides the opportunity to examine the impact of the imposition or removal of ceilings. Equally, given the tendency of developments in the UK credit market to follow those of the US, the US experience of some of the high rate credit models that have been introduced into the UK in recent years may hold lessons for the future of the UK market. The credit markets of our EU neighbours in France and Germany, on the other hand, both of which have long had rate ceilings in place, provide useful European points of reference and enable comparison with the UK, where no statutory ceilings are in place.

(ii) The evidence base underpinning this project is a substantial one. Extensive primary and secondary research was undertaken in all four markets, with our observations resting on the following evidence components.

1.2.1 The USA evidence base

- A review of relevant literature
- Interrogation of (unpublished) state level consumer credit database from “TransUnion”, the national credit reference bureau. Analysis was based on a sample extract of 380,000 US consumers.
- A survey of the regulatory authorities and legislatures undertaken with the state banks in each of the US states to establish the details of the regulatory framework operating in each state.
- A survey of mainstream lenders in every state to establish rates for test examples of credit pricing on auto loan (1646 rates checked) and personal loan (591 rates checked)
- A review of non standard lending operators and markets
- Interviews with the non standard lending trade associations (Pay-day Loans, Rent-to-Own, Check cashing, Pawn-broking).
- Review of state level trade association data
- Various industry and broker reports, published research
- Public source data including The US Economic Census, Federal Reserve consumer credit data
- Net based survey of lenders and products to establish detail of pricing on the full range of sub prime credit products available in US.
- Review of telephone directories – the Yellow Pages equivalent – in each of the US states to establish numbers of lenders offering different types of credit services in each state.

1.2.2 The evidence base in the UK, France and Germany

- Original consumer research undertaken in each of the three territories
- Face to face interviews undertaken in-home, Oct - Nov 2003
- Representative sample of 2717 low income consumers falling into bottom 20% of household incomes in each territory\(^1\)
- Review of the regulatory frame-work in France and Germany
- Detail of legislation
- Interpretation by the courts
- Literature review
- Review of products and associated pricing
- Net and telephone based lender survey
- Mystery shop to obtain detail of product terms and conditions
- Various industry and broker reports, published research

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\(^1\) In the event sample in Germany, although falling within the bottom 20% of household incomes, had a bias towards the more affluent end of low income spectrum than that in France and UK
1.3 Summary of the regulatory framework in the various markets

1.3.1 The regulatory framework in the USA

(i) The USA has seen the once universal usury framework gradually dismantled on a state by state basis over the past 30 years. Formal usury rates are still very common, however, with formal ceilings having tended to drift upwards over time. Rates are now mainly stepped, with higher rates for smaller loans (defined as circa $2000 in most cases). Some states have chosen to dispense with their ceilings altogether. In 1974, at the point where the UK removed ceilings, only Massachusetts and New Hampshire had no usury ceiling in place. In 2004, 10 states had no ceiling. Rate ceilings are sometimes written into state constitutions but mostly are set by the state legislatures and reviewed occasionally. Ceilings specify maximum rates of interest which lenders can charge for different types of loans (loan size is usually the main determinant, but whether a lender is regulated by the state also accounts for many differences in allowable rates). Ceilings are sometimes set as flat rate ceilings which only specify maximum allowable interest rates, with maximum charges for other elements such as account set up or maintenance charges sometimes specified separately. In other cases, ceilings are specified in terms of a maximum finance charge, either over a month or a year, which would equate to an APR on the European model.

(ii) Special exemptions for small-scale loans and for particular lending models have however been created in many states. Special small loan ceilings had already started in 1974, being present in six Western states, but have been gaining popularity progressively, being present in 27 states in 2004. In recognition of the potential for credit exclusion and the need of the un-banked and non status borrowers for credit, exemptions to the usury ceilings have long been in place for pawn broking, a big business in the US, and now permitted in all of the US states except Vermont. As a new generation of sub prime credit models has developed over the last decade, the broad trend has been towards regulatory acceptance and control. Sector specific enabling legislation has been put in place for Payday lending in 28 states, with a further seven states allowing Payday under small loan exemptions. Specific legislation favourable to RTO (Rent To Own) was in place in all states but three in 2004. Auto Title loans are for the most part covered under the pawn-broking exemptions.

(iii) In recent years the regulatory focus has in fact been on facilitating inter-state lending. A landmark US Supreme Court case (Marquette vs. First of Omaha Service Corporation 1978) allowed national banks to charge credit card holders “out of state” rates (i.e. rate in place where national bank chartered). This decision provided the impetus for the growth of inter-state banking, led by the national banks. The Financial Modernization Act of 1999, section 731 then followed, being effectively a federal imposition of a level playing field, enabling in-state institutions to charge inter-state prices. In 2004, the full implications of this decision are still to be worked out by the courts.

(iv) The Truth in Lending Act passed in 1968 ensures that all charges, including penalties and ancillary charges are available at point of sale.
1.3.2 The regulatory framework in France

(i) The French approach is to specify tightly the components of the APR and to allow only limited flexibility setting rates, with the Banque de France having direct control of, and responsibility for, the management of default and over-indebtedness. The current usury framework dates back to 1966, with both usury and consumer protection frameworks subsumed in the Code de la Consommation. Usury rates are set every quarter at one third above the average market rates as assessed by the Banque de France. There are three different rates in place: the highest rate (20.85% in the first quarter of 2004) for all consumer loans under €1,524, the next rate (16.52%) for instalment loans, revolving loans and overdrafts above €1,524 and the third rate (9.6%) for personal and other loans above €1,524.

(ii) The broad rule is that everything that is a compulsory charge must be included in the APR. Thus items such as insurance which is not compulsory, but which is routinely added automatically to accounts, is not included in the APR and calculation of price. Items which relate to the conduct of the account are not included in the APR but there are set formulae2 for how charges and interest can be applied to missed payments. Items which are “taxable expenses” are not covered within the APR calculation or the statutory formula and can be charged to the consumer. Administration charges relating to missed payments fall into this category.

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2 The statutory charging formula is dependent on how the lender behaves after the borrower has defaulted. If he chooses to rescind the contract he is entitled to ask for 8% of the outstanding balance; if he continues the existing contract the charge is 8% of overdue amounts; if he agrees to reschedule this falls to 4% of overdue amounts.
(iii) Sanctions for default are harsh and rapidly and comprehensively applied. The Banque de France administers both the Fichier des Incidents de Crédits aux Particuliers (FICP), the main negative credit reference database and the Interdit Bancaire (IB) regime. An automatic statutory process leading to FICP or IB registration is set in chain at a relatively early stage of default unless the breach is made good within a short period. Interdit Bancaire acts as a barrier to all but the most basic money transmission facilities and in many cases to a range of wider services. The term has recently been reduced from ten to five years. Registration with FICP additionally precludes access to commercial credit. The Banque de France also administers the over-indebtedness regime and oversees arrangements made with creditors. There is a legal requirement to make good payments missed on debt service and commitments made but not met in the form of direct debits or cheques written. There are standard fiscal penalties also specifically for bounced cheques and unmet direct debits, which are applied in addition to the bank charges and merchant fees which the consumer will incur in any case. Forthcoming changes to the personal insolvency laws will render the process more flexible.

1.3.3 The regulatory framework in Germany

(i) In Germany there is a long tradition of self-regulation of financial services. The regulatory approach is to focus on transparency at point of sale and the avoidance of default. The main consumer protection framework is provided by the 1990 Verbraucher-Kreditgesetz (Law on Consumer Credit). Current usury ceilings are the result of key judicial decisions in 1978 and the 1980s. A “rule of thumb” applied by the courts sets the ceiling at a level twice the average rate for a given loan type, which are published every month by the Bundesbank. There are two average rates tracked for loans to households, being consumer loans and overdrafts. In 2003, the rates varied on a month to month basis from 6.90% to 7.90% for consumer loans and from 10.27% to 10.84% for overdrafts.

(ii) The major legally binding quantitative guidelines relate to two ceilings, the maximum interest rates on consumer credit and the default interest rate. The latter is set lower than most rates (5% above the base / discount rate) as an incentive for lenders to avoid default. The main requirement is for transparency of charges with all charges clearly stated in agreements. Insurance costs must be included in the APR only if they are compulsory. Standing and membership charges are not included in the APR, even if membership is a condition of the loan. Transaction costs for purchases are included in the APR but a range of other routine costs, including those for cash withdrawals, statement fees, and correspondence fees are not included in the APR. None of the costs of delinquency have to be included in the APR.

(iii) The risk to the lender is routinely substantially moderated by the use of guarantees and the contractual right of lenders to have direct access to salaries and social benefits in the event of non payment, a right which is automatically applied after three months of non payment.

(iv) Beyond this lenders are charged with a general duty of care not to create charges which would put the over-indebted borrower deeper in debt. The presumption is that the consequences of default are so drastic as to be avoided at
all costs. There is therefore a constraint on restructuring that does not afford real relief and a prohibition on associated fees. Lenders are broadly prohibited from making financial demands on the debtor that would drive him or her further “into ruin”.

(v) The long tradition of self-regulation in financial services has broken down in the credit broker arena and is currently being addressed with new regulation.
2.0 **Context**

2.1 **Demand – evidence on levels of need and the dynamics of consumer choice in markets with and without ceilings**

(i) One of the most striking features of the research undertaken to support this project was the absolute consistency of demand across territories. This was true both for overall levels of need for credit and for the dynamics of decision making.

*Demand appears to be constant irrespective of the regulatory or cultural context, with low income households having an irreducible need for credit*

(ii) Lower levels of recorded credit use among low-income households in the markets with ceilings that we studied appear to be a function of constrained credit options not lack of demand. Indeed it would appear that households on very tight budgets are among those most likely to need to borrow, being less likely to have savings safety nets in a cash emergency or to be in a position to save towards essential purchases.

(iii) The consumer research in Europe indicates that potential demand for credit – as measured by the need to borrow – is remarkably constant across territories. Around six out of ten households in the bottom 20% of household incomes in each country claimed to have a need to borrow at least occasionally. In the UK this translates into 3.7 million low-income households with a need for credit. Three quarters of these households felt that it would be difficult or impossible to save the equivalent of £500 for a special purchase. Among households dependent on state benefit nine out of ten in all three territories said that they would find it difficult or impossible to raise the equivalent of £200 – 300 in an emergency, without borrowing. The low levels of commercial credit use among the poorest German households would seem therefore to be a function of lack of supply rather than any cultural resistance to borrowing or lower incidence of need.
**Fig. 2  Need for credit to meet emergencies or fund major purchases is constant in all territories**

Those who feel they are unable to get credit have few means of managing cash flow crises or of acquiring items that they need but are unable to afford

(iv) As we shall show in 2.2 following, the availability of commercial credit varies considerably between territories. Wherever credit exclusion arises, however, those who find themselves without credit options have a common view on its effects. The most deeply felt impact is the inability to fund major purchases, with excluded individuals also conscious that they are exposed in a cash crisis.
Credit exclusion creates pervasive anxiety over the potential impact of cash crises and makes acquisition of high cost items very difficult.

Feelings on impact of credit exclusion

Base: Those who believe it would be difficult or impossible to obtain commercial credit

(v) The proportion of income devoted to debt service is strikingly similar across territories, regardless of products used or amount borrowed. The importance of affordability and the consistency of judgments on what constitutes a manageable repayment schedule is equally striking. Despite the fact that borrowers in the UK, France and Germany were using very different products and had borrowed significantly different amounts over widely varying terms, the value of monthly payments were very similar in each country, as can be seen from Fig. 4 below. These payments on debt service (i.e payments to commercial lenders) also represented a similar proportion of monthly income in each case.

Fig. 4 Payments on debt service are consistent across territories

The dynamic underlying choice of different credit models is also consistent and appears rational on both cost and utility grounds

(vi) The dynamic of sub prime consumer choices, and the way that trade-offs are made in the choice of lending model also appear consistent across territories,

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3 The income profile of the German borrowers in the sample was higher than was the case with either the British or French borrowers both because of the lenders require borrowers to be in secure employment.
reflecting the universality of the experience of coping on tight budgets. Where low-income borrowers have more than one credit option, consumer choices in relation to lending models appears rational on both cost and utility grounds.

(vii) Broadly speaking, borrowers on tight budgets prefer credit options offering readily accessible cash and ideally not requiring surrender of title to assets. In the US, figure 5 shows that, wherever cash loans are available, these are more successful than pawn-broking, which requires surrender of title to assets, and figure 7 shows that payday lending has grown much faster than both pawnbroking and Rent To Own credit. Similarly, figure 11 demonstrates that in the UK, home credit is taken out by more households than obtain credit via shopping vouchers or pawnbroking. Borrowers also seek to minimise the transaction costs, effort and risk involved in obtaining credit. Preference is often for models creating least potential exposure to the damage to personal and financial well being which may arise from payment delinquency and default. Other things being equal, cost is assessed in terms of both the likely total cost of borrowing (as distinct from interest rates alone) and affordability. Beyond this borrowers appear to be willing to pay a premium for convenience, for avoidance of harsh sanctions for default and for availability, where there are no other credit options.

In US states with liberal regulatory regimes borrowers choose new sub prime models over old and use less mainstream credit

(viii) The balance of importance of the various lending models in the US states without rate ceilings are consistent with the dynamics of sub prime consumer choice just described. Where a free choice between the full range of credit models is available (i.e. in states without ceilings and in those with specific Payday enabling exemptions) the pattern of consumer choice is consistent across states and is different to that pertaining in states with ceilings. In states without ceilings banked borrowers appear to use sub prime models along-side mainstream finances. For short-term loans, sub prime models, notably Payday, appear to be being chosen in preference to mainstream credit. Consumers appear to be moving away from traditional pawn-broking, largely favoured by regulators, towards Title Loans (the un-banked) and Payday (the banked).
**Fig. 5** Consumer choices in states with liberal regulatory regimes reflect consumer preference for new sub prime models over mainstream credit

Credit product use by product type in states without ceilings and/or Payday legislation compared to credit product use in all states

<table>
<thead>
<tr>
<th>Pawn brokers</th>
<th>Title loans</th>
<th>Payday</th>
<th>Sub prime revolving credit</th>
<th>Retail Debt</th>
<th>Revolving Debt</th>
<th>All mainstream credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
</tr>
</tbody>
</table>

1.0 = average credit use for each credit product category for all states


(ix) RTO is stronger in the states with ceilings, where, in the absence of credit options, it enables un-banked consumers particularly to acquire major items such as furniture, white goods and consumer electronics by means of rental contracts. In the states without ceilings, by contrast, purchase is the preferred route to acquisition, reflecting the wider choice and better value available to consumers able to finance purchases with retail or other credit options. As was shown in Figure 3 earlier, barriers to acquiring items which cannot be afforded out of income is one of the key difficulties arising from not being able to access credit.

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*Based average dollar debt per head of population for each product category*
Consumers in both the UK and US are actively choosing a new generation of sub prime models over mainstream credit and traditional products

(x) There is a clear trend at the top end of the sub prime market in both the US and UK towards a new generation of modern sub prime products. Banked borrowers are choosing sub prime products which are scaled to fit need, readily accessible, facilitated by electronic channels and supplied by large, national and international suppliers. Mainstream and sub prime credit cards are being used alongside dedicated high rate sub prime models, such as Payday loans, typically for different reasons. The same trends are evident but in a more muted form for the un-banked, who have fewer credit choices. In the US Title Loans and RTO are gaining ground at the expense of pawn-broking while home credit companies are losing customers to sub prime credit cards in the UK.

(xi) The operation of these consumer preferences is exemplified in the relative growth and decline of the Payday lending, RTO (Rent to Own) and Pawnbroking sectors in the US over the course of the past five years.
Fig. 7 Growth of Payday lending, RTO stores and pawnshops 1983 - 2003

Source Stephens & Co, John Caskey, Policis estimates

Fig. 8 Dedicated sub prime models are taking share from both card based credit and pawn-broking in the US
2.2 Supply: evidence on lender response to ceilings

There is less product diversity in markets with ceilings

(i) The markets studied with rate ceilings exhibit less diversity in the credit products available in the market and the range of credit models offered to low income households is sharply narrower. This is particularly marked for those dependent on state benefits, the un-banked (a significant minority in both the UK and US) and for the credit impaired. Sub prime credit models, which tend to feature high rates, are either unable to develop, in the case of established ceilings, or forced out of the market, where ceilings are imposed.

(ii) The effects can be seen in the far wider diversity of credit models available in the UK and US in comparison to either the French or German market. As discussed earlier, both the UK and US have a clearly identifiable, and increasingly segmented, sub prime market while neither France nor Germany has a distinct sub prime sector, as can be seen in the table in Figure 9.

Fig. 9 Credit product diversity in US, UK, France and Germany

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>UK</th>
<th>France</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mainstream</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ Prime cards and loans</td>
<td>■ Store cards</td>
<td>■ Retailer revolving credit</td>
<td>■ Mail order</td>
<td>■ Term loans from banks</td>
</tr>
<tr>
<td>■ Store cards</td>
<td>■ Mail order</td>
<td></td>
<td>■ Mail order</td>
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<tr>
<td>■ Retailer revolving credit</td>
<td></td>
<td>■ Mail order</td>
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<tr>
<td>■ Mail order</td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sub prime</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ “Step” credit cards</td>
<td>■ Low value starter cards</td>
<td>■ Remote revolving credit cards with cash drawdown facilities</td>
<td>■ Remote revolving credit cards with more limited cash facility</td>
<td></td>
</tr>
<tr>
<td>■ Secured credit cards</td>
<td>■ Rehabilitation cards</td>
<td>■ Retailer revolving credit cards with more limited cash facility</td>
<td>■ Mail order</td>
<td>■ Limited retailer credit</td>
</tr>
<tr>
<td>(fully secured by cash deposits)</td>
<td></td>
<td>■ Mail order</td>
<td>■ Limited retailer credit</td>
<td></td>
</tr>
<tr>
<td>■ Payday loans (secured by post-dated cheque)</td>
<td>■ Mail order</td>
<td>■ Mail order</td>
<td>■ Limited retailer credit</td>
<td></td>
</tr>
<tr>
<td>■ “Bounce protection”</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sub sub prime</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ Stored value cards</td>
<td>■ Home credit</td>
<td>■ Crédits Municipaux (State owned pawn-broking)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(facilities &amp; fees secured by cash deposit)</td>
<td>■ Rent to Own</td>
<td>■ Rent to Own</td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ Pawn-broking</td>
<td>■ Cash converters</td>
<td>■ Cash converters</td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ Rent to Own</td>
<td>■ Pawn-broking</td>
<td>■ Pawn-broking</td>
<td></td>
<td></td>
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<tr>
<td>■ Auto Title loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(secured on vehicle)</td>
<td></td>
<td></td>
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</tbody>
</table>
Lenders may respond to ceilings by raising access hurdles to high risk borrowers

(iii) Germany provides a good example of how a rate ceiling, particularly when combined with disincentives to default, can result in a highly risk averse lender set. Credit scoring thresholds and lending criteria in Germany have been set at a level which would tend to exclude higher risk groups. Low-income borrowers are generally able to obtain credit only if in secure long-term employment. Minimum loan values are set at a level significantly above that likely to be sought by those on the lowest incomes. Minimum loan values from the German Sparkassen\(^5\) (the primary source of credit for those low incomes) are set at €2,500, or in many cases €5,000, and are extended only to those with at least six months employment on a permanent contract. Side agreements signed alongside credit contracts give the lender the right to take payments directly from earnings (or benefits if the debtor subsequently becomes unemployed), thereby further moderating the risk to the lender. Accounts must be maintained with the bank, with the bank debiting repayments on receipt of salary, which must be paid into the account. Borrowers not meeting these conditions must find guarantors who do. Comprehensive documentary evidence, including signed statements by employers, is required to support credit applications, with this condition rigorously enforced.

**Fig. 10** The Sparkassen are reluctant to lend to those on the lowest incomes

Income of the low-income consumers surveyed who had a Sparkassen loan

- Income less than 700 euros per month: 9%
- Income 700 - 975 euros per month: 26%
- Income 975 - 1250 euros per month: 65%

Lenders withdraw from the market where ceilings are newly imposed

(iv) In markets where rate ceilings are introduced, on the other hand, if the business model and pricing structures cannot be adapted to fit within the new framework, lenders tend to withdraw from the market. This occurred in Florida, where rate ceilings for Auto Title lenders were imposed at the end of 2000. The number of Auto Title Lenders operating in the state, providing high cost short term cash credit to largely un-banked car owners, dropped from 600 pre legislation to 58 in the year following (Auto Title lenders are so called because advances are secured by the deposit of title to a car, together with a set of keys).

(v) Large sub prime lenders operating chains of outlets in many states also respond rapidly to changes in the regulatory environment. When the Office of the Comptroller of the Currency (OCC) issued advice in late 2001 for national banks to carefully review their activities in the payday market, ACE Cash Express, a major

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\(^5\) The German Sparkassen historically had a social remit but have diversified aggressively upmarket in recent years and from a consumer perspective are now indistinguishable from other commercial banks
check-cashing chain with substantial payday lending activities, discontinued offering loans in Alabama, Georgia and North Dakota within a matter of months because of the rate ceilings present in those states (which the national banks were able to circumvent).

Alternatively, lenders may adapt pricing structures so that less of the ultimate cost of credit to the consumer is captured within the usury cap

(vi) The main way in which the ceilings are accommodated is that interest rates become less important as a component of the total price of credit. This appears to be what has happened both in the US states with ceilings and in France. The US provides the most complete example of product and pricing innovation to accommodate ceilings and may be the most instructive for the future of the UK market. This is discussed in more detail in section 3.0 following on the cost of credit.

In both the UK and US the major development in sub prime markets has been the extension of credit cards to high risk borrowers

(vii) In both the US and UK sub prime credit markets, and indeed in France, the key development in sub prime markets in recent years has been the use of card based credit to extend the risk pool (the overall risk of a portfolio of loans) to ever lower income and higher risk borrowers. This development has been facilitated by advances in data technology, credit scoring and automated customer management, which enables differential risk based pricing. The expansion of the risk pool has rested on a move away from rates towards behaviour driven pricing as the key component of credit cost. In the US, where the key regulatory developments of recent years have focused on enabling inter-state lending, card products have been structured to facilitate sale across state boundaries, to nationally applicable pricing structures. Pricing features low APRs allied to behaviour driven pricing, a model also adopted in France, albeit in moderated form.

Fig. 11 Card based credit is increasingly extended to high risk groups in the UK

Commercial credit product use in last 12 months, working and benefit dependent households
Fig. 12  Product accommodation has enabled French lenders to extend card based credit to even the lowest income groups

The card market is increasingly segmented with the UK following US trends

(viii) Card based credit is now the most important credit vehicle for banked sub prime borrowers in the US. The card market is an increasingly finely segmented one with a range of propositions closely aligned with different risk segments. Credit is extended even to the highest risk borrowers, in the latter case through the provision of fully secured credit cards, a development which has yet to reach the UK. In the UK sub prime cards have been pioneered by the US lenders and have enjoyed rapid growth. The range of card propositions in the UK is not yet as wide as in the US. However, credit cards on offer to a new generation of UK low income card users now include those specifically targeting not only non status borrowers and “starter” cards (for low income borrowers who have not previously been offered cards) but also cards for the credit impaired.

The global trend is increasingly towards behaviour-driven pricing, with this at its most explicit in the case of sub prime cards

(ix) In pricing terms, the increasing segmentation of the US card market has been achieved by offering rates tiered for different levels of risk, with multiple APRs even on the same product, depending on channel of application and usage patterns. Crucially however, more of the cost to the consumer is behaviourally driven, and triggered by “charging events”, such as late payment or over limit balances. Pricing on sub prime cards is increasingly designed to drive revenue from the payment patterns of higher risk borrowers, with the real cost of penalty charges doubling in a decade. Products designed for higher risk borrowers frequently feature prime rates combined with ancillary charges, which tend to be high relative to balance values. At the highest end of the risk spectrum, risk to the lender is increasingly moderated by up-front fees and deposits, often in full, to secure credit lines, with fees also often paid in advance.

New high rate dedicated sub prime models have emerged to challenge sub prime card issuers & pawn-brokers in US and home credit in UK

(x) The other key development on the supply side in the US, and one which may also be instructive for considering the future of the UK market, has been the emergence of new high rate dedicated sub prime models, such as Payday lending,
RTO and Auto Title loans. Indeed Payday lenders and RTO are already established in the UK, albeit on a small scale. Payday loans (the target market for which is banked workers) and AutoTitle (serving the un-banked) share the key features of successful non card sub prime models around the world. Both feature high APRs, simple pricing structures, are focused on short term credit and have pro-active customer collection management programmes, the latter tending to be labour intensive and relationship based as distinct from automated and remote as in the case of card based models. As was discussed in the demand section 2.1 preceding, consumer preference for these new credit models over pawn-broking, traditionally the key source of cash credit for those on low incomes and the un-banked, has resulted in their rapid growth. Payday, the fastest growing of the new credit models, has grown from a virtually standing start to some 15,000 stores in less than a decade, which together lent some $25bn in 100m transactions in 2003. The historically fragmented nature of the US sub prime sector is changing as a result, with suppliers increasingly large national, near national and regional chains, the largest of which are listed. These new sectors are now consolidating and maturing. Regulatory response to these developments have been mixed, but the broad trends is towards acceptance and control. Further detail can be found in section 1.1 which discusses how the regulatory framework in the various US states has been adapted to these developments.

As a result sub prime markets are becoming increasingly diverse and competitive exerting downward pressure on price

(xi) The part of the market targeting low income banked borrowers has thus become increasingly competitive over the last five years in the US, as mainstream lenders and card issuers have vied with the new sub prime lenders for high risk lending business. This effect is most visible in the states without ceilings. Mainstream lenders in the US responded to the new models initially by developing partnerships with the Payday lenders. More latterly, faced with the threat to NSF fees – levied on bounced cheques and unmet direct debits and representing an $11.2 billion revenue stream in 2003, the US banks have developed competitive product concepts. Low income customers on tight budgets are now offered so called “Bounce Protection” products. These are essentially low value short term account based credit lines (which stop customers’ cheques from bouncing), and are designed as an alternative to short term pay day loans. Credit Unions (which in the US are a major force in the credit market but overwhelmingly serve middle income workers in large companies), are also developing a range of Payday-like and secured card products aimed specifically at low income groups. As a result of these competitive developments, prices in the sector, and of Payday in particular, have declined steadily over a five year period.

In the UK these developments are at an early stage

(xii) In the UK these developments are also visible but are at a less advanced stage, with the sub prime credit sector in process of transformation to a more diversified and competitive market than it has been historically. Over the past five years, traditional UK sub prime suppliers, such as the door step lenders have come under pressure from new credit models, for the most part from international suppliers, including the leading French lenders and US card issuers, the Australian Cash Converters (a variation on pawn-broking), Payday lenders and RTO operators.
3.0 The cost of credit to the consumer – evidence from markets with and without ceilings

3.1 Mainstream credit markets

Rate ceilings appear to have no impact on the price of credit for low risk borrowers which is determined by competition

(i) One of the questions posed by regulators in the UK, has been whether prices on mainstream loans would exhibit a tendency to drift towards ceilings, in order to facilitate lenders operating a cross subsidy between more and less high risk groups. However, a check on the prices of 2,240 mainstream personal and auto loans in fifty states revealed near identical prices on a $3,000 personal loan and a $12,000 auto loan, regardless of the rate ceiling operating in each state. A similar exercise undertaken for the US National Commission on Consumer Finance in 1971 produced very similar results, with the Commission then drawing the same conclusion as we have done in 2004, that rate ceilings do not influence the price of credit for low risk borrowers. The consistency of the result over a more than thirty year period in which credit markets have evolved substantially would appear to indicate that there is little scope for lenders to operate cross subsidy in highly competitive markets, and that this is particularly unlikely in modern, technology-driven, finely segmented credit markets

Fig. 13 The evidence over a 30 year period suggests that competition rather than rate ceilings determine price for mainstream credit

US states with more or less strict rate ceilings

<table>
<thead>
<tr>
<th>Average APR pertaining in states</th>
<th>Average Ceiling in states</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest 10</td>
<td>5.5%</td>
</tr>
<tr>
<td>11 to 20</td>
<td>12.0%</td>
</tr>
<tr>
<td>21 to 30</td>
<td>22.0%</td>
</tr>
<tr>
<td>31 to 40</td>
<td>36.0%</td>
</tr>
<tr>
<td>Highest</td>
<td>21.9%</td>
</tr>
<tr>
<td>No ceiling</td>
<td>19.0%</td>
</tr>
</tbody>
</table>
3.2 The sub prime market

The consumers most likely to be affected by rate ceilings are those operating outside the financial mainstream

(i) Given the constant nature of demand for credit and the alternative effects of product adaptation and market withdrawal described in the previous sections, the consumers most likely to be impacted by rate ceilings are thus those operating outside the financial mainstream, either un-banked or, having run into problems with debt, the credit impaired. The former are primarily the poorest citizens, often dependent on state benefits and thus among the most disadvantaged and vulnerable of all borrowers. The credit impaired, although biased towards those on lower incomes, will include a wider socio-economic mix.

Un-banked consumers represent a significant minority of both the UK and US populations and are among those with the greatest need to borrow

(ii) Such consumers represent a significant sub set of the various national populations, particularly in the UK and US, where banking penetration is low by European standards. Some 10% of all US households are un-banked. These are mainly the least affluent households and are particularly likely to be ethnic minority households, among whom 25% are un-banked. In the UK, 85% of all households are banked, with banking near universal among professional and managerial groups and younger non manual workers. The un-banked are concentrated in older age ranges and in unskilled manual workers and those on benefits. Overall 15% of all C1C2DE households are un-banked, rising to a quarter (25%) of those in the bottom 20% of household incomes and a little over half (51%) of those entirely dependent on state benefits. Banking in France and Germany is theoretically universal (though in France a proportion of those with accounts, primarily those on low incomes, will be barred from using their account through the Interdit Bancaire mechanism).

3.2.1 The role of behavioural pricing in shaping the cost of credit

Mainstream market expansion to low income borrowers has occurred using behaviour-driven pricing

(i) Behaviour driven pricing and product adaptation is not simply a feature of products clearly positioned as sub prime. Non rate charges have become central to mainstream card pricing, enabling lenders both to drive additional revenues from a product category in which margins are under pressure and to facilitate the extension of the risk pool. Borrowers across a spectrum of risk can be issued the same or similar cards, with the additional cost to the higher risk borrower determined, on the one hand by their greater tolerance of ancillary charges, where these are allowed, and, on the other, by repayment behaviour.

The price of credit is effectively transferred from front end rates to back end penalty and ancillary charges

(ii) The price of credit is effectively transferred from front end rates to back end charges. For borrowers who slip into delinquency or with irregular repayment
patterns, the primary determinant of the cost of credit is not the interest rate attached to the product but rather their own repayment record. It is not only by payment delinquency that the cost of credit is increased but also by patterns of behaviour (such as extended period of payment of minimum balances) which would indicate that card holders are at the margins of coping with the credit they have taken on. This latter effect is exacerbated with VISA type cards where minimum repayments are a percentage of the outstanding balance.

For sub prime cards and mainstream cards used by high risk borrowers, charges are more frequent and are high relative to balance values

(iii) In the case of sub prime borrowers, these effects are writ large, with charges not only more frequently levied, as a result of the greater incidence of delinquency, but also much more likely to be disproportionate to the balance owed. Data drawn from transactional records of card issuers across the US states shows clearly that outstanding balances on the cards sold to the highest risk borrowers are very markedly lower than for all other cards, averaging less than $200, compared to an average balance across all revolving debt in the US of $2,400. As can be seen in Fig. 14 following, the incidence of delinquency on these very low balance sub prime cards is two and a half times that for all other forms of debt.

Fig. 14 Pricing on sub prime cards is driven by high rates of delinquency triggering penalty charges which are high relative to small balances

Unless borrowers maintain a perfect payment record, the cost of credit to the consumer will be significantly higher than the APR would suggest

(iv) The same pattern can be discerned in France, where high risk borrowers are essentially using credit products designed for low risk credit users. Examination of patterns of repayment among low income borrowers in France indicates that use of such mainstream credit vehicles does not necessarily lower the cost of credit for high risk borrowers, indeed potentially quite the reverse. The cost of credit will be contained only if higher risk borrowers are able to maintain the perfect payment record typical of the lower risk borrower.
3.3 Patterns of repayment behaviour among low income borrowers

Regular late and missed payments are a feature of credit account management for a significant minority of low-income borrowers

(i) The consumer research in the UK, France and Germany, and the evidence from the US, suggests that late and missed payments are a common feature of the account management of a significant minority of low-income borrowers. It is indeed striking that patterns of late payment in the UK, France and Germany are very similar in each of the territories even though French and German credit models are more likely to penalise such behaviour. Given that the level of monthly repayments is strikingly similar across territories despite significant differences in sums borrowed overall, this would tend to suggest that the driver of missed payments is competing pressures on tight budgets rather than any overall affordability factor. Borrowers find themselves simply unable to avoid irregular payment patterns.

Payment irregularities that follow in the wake of personal crisis escalate debt and compound the effects of misfortune

(ii) Payment irregularities are often likely to arise in the wake of major adverse life events (i.e. divorce, unemployment). The tendency is therefore for escalating debt to add to the already difficult financial circumstances that tend to arise at such times. This type of borrower, as we have seen earlier, is unlikely to have savings safety nets to ameliorate these effects, as might be the case with a middle income credit user. The timescale for rectification of default (at most three months and as little as thirty days) is typically insufficient for individuals to recover from the financial consequences of whatever life event has precipitated the crisis (which indeed may still be ongoing within this period). As a result, individuals then tend to face sanctions for default, which will only add to the impact of crisis.

Households with children and those on benefits are more likely to exhibit account irregularity and to get more seriously behind on payments

(iii) The scale of late and missed payments among low-income borrowers is substantial. Some 22% of borrowers in the UK, 29% of borrowers in France and 34% of borrowers in Germany admitted to having made late or missed payments on personal loans in the last twelve months. Those who do miss payments tend to miss several, with those who had missed payments having averaged three late payments in the course of the last twelve months in all three territories. Households with children and those on benefits are more likely than other borrowers to miss payments, reflecting the greater pressure on budgets in these households. In many credit models, particularly card based credit, three consecutive missed payments tends to be the trigger for rescinding contracts and demanding full repayment of outstanding balances. Given the severity of sanctions for default in both France and Germany, this must be an important measure of the success of the lending model in meeting the needs of low-income borrowers.
Some 18% of low-income borrowers in the UK and Germany and 16% of those in France admitted to having been three or more payments behind on loans or credit cards, with this rising to 20% in households on benefits.

High risk borrowers using mainstream credit in France borrow larger sums over a longer term than those using sub prime models in the UK and US

(iv) The evidence from France suggests that where high risk borrowers use credit vehicles designed for lower risk borrowers there is a tendency for a number of syndromes to arise, which can further increase the cost of credit to the consumer. Firstly, the likelihood is that minimum loan values will be set high and thus out of scale to the funds that low-income households require. Credit limits will tend also to be set high, and higher as a multiple of income than dedicated high-risk lenders would allow. As a result, amounts advanced tend to be larger, in the case of personal loans, with balances on credit cards tending to rise towards a level that becomes very difficult to pay down. The revolving credit card holders in the French research had an average outstanding balance of €1400 and an average credit limit of some €2400, strikingly similar to the average for all revolving debt in the US but significantly above the average US sub prime card balance of $200, the £500 credit limit offered to new borrowers on the leading UK sub prime card or the slightly less than £300 borrowed by the average home credit borrower.

Fig. 15 Sub-prime models in UK are scaled to fit the borrowing needs and risk attached to their target market

<table>
<thead>
<tr>
<th>Value of most recent personal loan in UK</th>
<th>Value of most recent revolving credit in France</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard lending</td>
<td>Current credit limit</td>
</tr>
<tr>
<td>Non standard lending</td>
<td>Current balance outstanding</td>
</tr>
<tr>
<td>Home credit loan</td>
<td>Original credit limit</td>
</tr>
</tbody>
</table>

High-risk borrowers can find themselves unable to pay down balances and thus become trapped in a long term cycle of debt

(v) Those on tight budgets with few other means of financing the acquisition of major items can be tempted to allow balances to creep up. Small amounts of credit are withdrawn over time, so that balances either stay stable or continue to rise, with the term for repayment continually extended. More than four out of ten (44%) of the sample of low income revolving credit users in France claimed that their balances either stayed broadly stable or were rising. Even for those whose...

Likewise, home credit providers often roll over loans.
balances are reducing, this can be less a matter of account discipline than lender enforcement. A significant proportion of accounts appear to be judged sufficiently out of control to be frozen. Three in ten of all card holders claimed that they could not currently use their cards to withdraw cash or buy goods because their card was blocked by the card issuer, either as a result of payment irregularities or over-limit balances. Taken together, these patterns have significant implications both for the overall cost of credit and for levels of over-indebtedness.

**Price transparency would appear to be compromised where the cost of credit depends on ancillary and behaviour-driven pricing**

(vi) Significantly where price is shifted from rates to back end charges, price transparency would appear to be compromised. This appears to be especially true where cost to the consumer depends on penalty pricing and if consumers find themselves facing an escalating spiral of debt. Price transparency appears greater in the UK than in either France or Germany, with French borrowers running into problems with repayment being particularly likely to feel that the full potential cost of irregular payments had not been made clear at point of sale. Fig 16 following shows that those running into credit problems in France particularly tended to be aware at point of sale that credit irregularity would increase the total cost of credit but not to have appreciated the extent to which cost would rise.

**Fig. 16** UK consumers are more likely to believe that they understood the terms of credit agreement at point of sale than are their French and German counterparts

3.3.1 Comparison of the cost of credit using different credit models

(i) This section seeks to illustrate the effects of behaviour driven pricing. It takes the pricing structures of various products, both mainstream and dedicated sub prime models, and applies a number of behavioural scenarios in each case. Repayment behaviours have been selected to illustrate behaviours typical of low income borrowers of different types, with assumptions underlying the different scenarios informed by the research. The structure of different credit products tends to shape both take up and patterns of credit use, so it is not possible to construct directly comparable scenarios in each case. Different products offer advances on different scales, repayable over different time periods, allow more or less flexibility in patterns of repayment and are tolerant of, or penalise, payment...
irregularity to different degrees. All of these factors influence consumer use of the product, repayment patterns and, ultimately, in the case of behaviour driven pricing, the cost of credit to the borrower. The various scenarios chosen to illustrate the cost of credit are based in each case on typical consumer behaviours for the product concerned.

**Dedicated sub prime models are often cheaper than the mainstream alternatives under uneven repayment conditions**

(ii) It is striking that under uneven repayment conditions, sub prime models can be cheaper than mainstream models, confirming the rationality of consumer choices.

(iii) Low rate products designed for low rate mainstream borrowers appear to be an appropriate and safe choice for low income borrowers able to mimic the repayment behaviour of low risk borrowers. For those liable to make late or missed payments, particularly if the situation cannot be rectified quickly, a high rate product may ultimately cost less overall and be more likely to contain debt at a manageable level.

3.3.2 The real cost of credit in the US

(i) We compare the real cost of Payday Lending, “Bounce protection” a short term credit line available from the US banks, developed as a response to Payday, and sub prime credit cards.

(ii) The reason behind much of the popularity of payday lending in recent years in the US is that it is undoubtedly cheaper for banked customers with marginal balances to take on payday loans than it is to incur penalty charges on their accounts. Avoiding such charges will have the further advantage of keeping their mainstream credit record mainly intact (although it should be pointed out that payday lenders are increasingly using proprietary forms of credit scoring themselves, but the information is not yet being passed back into the mainstream).

(iii) Payday loans are taken out for small sums, typically $200 – $300, over a very short term, usually 14 days. Security is a cheque for the amount of the loan plus the fee due, dated for the next Payday, or electronic access to the borrowers account for direct debit on Payday. Loans are offered to banked workers only, with proof of regular income and permanent address required. Loans are typically rolled over, several times, with the industry average being 3.5 times, and the CSFA (Trade Association) best practice guidelines indicating a ceiling of four times. Typically therefore the loan is for a six to eight week period. Fees vary considerably between outlets, largely determined by the degree of local competition. The average finance fee on Payday loans has been falling as competition has intensified, with the industry average now 16%, rising to 25% on loans taken out remotely on an inter-state basis, reflecting a higher level of write offs on these loans. There are two methods of calculating fees, reflecting different

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7 According to survey of firms financing payday loan companies

8 Rates vary on Payday loans. Analysis by Stephens Inc of Payday trade data as part of their advisory role in both merger and acquisition activity in the sector and in raising capital for the Payday lenders suggests both that rates are falling and that the 16% is average across the industry. We have taken the view that this is likely the most accurate and up to date basis for the calculations on price.
regulatory approaches in framing Payday enabling legislation in different states. Cost of bounce protection fees or bank NSF fees can quickly outstrip the cost of a Payday loan.

**US Payday loans – the real cost of credit to the consumer**

<table>
<thead>
<tr>
<th>Loan repaid in 2 weeks</th>
<th>Charging model 1</th>
<th>Charging model 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of loan</td>
<td>200.00</td>
<td>200.00</td>
</tr>
<tr>
<td>Loan period of two weeks</td>
<td>32.00</td>
<td>Loan period of two weeks, extended to 6 weeks</td>
</tr>
<tr>
<td>Loan fee</td>
<td>16 dollars per one hundred advanced (avg. across branch based loans)</td>
<td></td>
</tr>
<tr>
<td>TAP</td>
<td>232.00</td>
<td>232.00</td>
</tr>
<tr>
<td>Cost of credit</td>
<td>32.00</td>
<td>32.00</td>
</tr>
</tbody>
</table>

| Loan fee              | 20 dollars per 100 advanced |
| TAP                   | 297.00                       |
| Cost of credit        | 97.00                        |

| Cost of credit for £200 borrowed | £32 |
| Observed APR               | 4641% |

| Amount of loan        | 200.00           |
| Loan fee              | 20 dollars per 100 advanced |
| TAP                   | 232.00           |
| Cost of credit        | 32.00            |

| Loan fee              | 32.00            |
| TAP                   | 328.00           |
| Cost of credit        | 128.00           |

| Cost of credit for £200 borrowed | £128 |
| Observed APR               | 4641% |

| Loan fee              | 40.00            |
| First rollover fee    | 32.00            |
| Second rollover fee   | 25.00            |
| TAP                   | 297.00           |
| Cost of credit        | 97.00            |

| Loan fee              | 32.00            |
| Rollover              | 32.00            |
| Rollover              | 32.00            |
| Rollover              | 32.00            |
| TAP                   | 328.00           |
| Cost of credit        | 128.00           |

| Cost of credit for £200 borrowed | £128 |
| Observed APR               | 4641% |

(iv) Borrowers tend to be on tight budgets and loans are frequently taken out to cover short term cash shortfalls on bank accounts relating to standing orders or outstanding cheques. The alternative way of financing the shortfall might be to pay the bank’s insufficient fund charge for paying out on the commitment or to arrange a short-term “bounce protection” credit line with the bank. NSF fees are typically in the $25 - $28 range, with the average bounce value covered being $70. So-called “bounce protection” products work differently, being short term high cost credit products developed by the banks as a competitive response to Payday loans, with fees typically in the range $2 – $3 per day per $100 covered. The example shown below shows the cost of borrowing the same $200 from the bank over the same period.

**Short term credit line from US banks – the real cost of credit to the consumer**

<table>
<thead>
<tr>
<th>Bounce protection credit line</th>
<th>NSF fees (non sufficient funds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 standing orders due out of account at $70 each (average value) $210 p.m.</td>
<td>3 standing orders due out of account at $70 each (average value) $210 p.m.</td>
</tr>
<tr>
<td>Bounce protection credit line @ $2.50 per day = $220.50 for 6 weeks, $294 for 8 weeks</td>
<td>Bank NSF fees = month 1 $75, month 2 $150, plus any merchant fees due for missed payments</td>
</tr>
</tbody>
</table>

| Cost of credit for £200 borrowed 6 weeks £210, 8 weeks £280 | Cost of credit for £200 borrowed 6 weeks £98.91, 8 weeks £138.47 |

(v) Payday loans and bounce protection tend to be used to alleviate short term cash flow pressures while spending on credit cards is more likely to facilitate consumption or investment spending, with purchases typically paid for over an
extended period. Penalty charges are applicable to Payday loans in the event of bounced cheques, but are less important as a component of cost, partly because loans are so short term. Behaviour driven pricing is more important as a component of cost for card based credit, where contracts can run for many years.

(vi) Pricing on sub prime cards varies significantly in the US, reflecting the more developed and segmented nature of the market, as do terms and conditions and the flexibility allowed to the borrower. All sub prime cards will feature behaviour driven pricing in the form of penalty charges. The higher the risk of the borrower, however, the more likely it is that ancillary standing charges will also be a feature of pricing structures and that credit limits will be tightly circumscribed and penalties for infringement of terms and conditions harsh. APRs are in fact frequently lowest on the cards designed for the highest risk borrowers. The two examples following illustrate this point and the way in which the combination of card limits and the operation of charges work to shape patterns of credit use. The key features of these US cards illustrate how behavioural pricing has been incorporated into pricing structures. It is worth bearing in mind that such cards are sold on an inter-state basis in what is a national market for credit cards generally, with pricing identical in states both with and without ceilings.

**Key features of US medium risk sub prime credit card pricing**

*Example is SKYPASS Visa Secured Card from US Bank*

- APR 13.9%
- $55 Annual fee
- Cash advances: APR 15.99% and greater of 3% or $5 per transaction
- Penalty charges $29 late payment fee (or $38 depending on number of occurrences):
  - $35 over limit fee (chargeable every month)
  - Penalty APR 23.9% if account delinquent twice in any 6 month period

(vii) The scenarios which follow illustrate how different behavioural patterns will influence the cost of credit to the consumer. The scenarios, particularly the second and third, have been chosen to reflect payment behaviours for low income borrowers revealed in the research underpinning this study. In the first instance the borrower is assumed to make purchases on a one off basis, and then to pay down the balance in an orderly fashion, without making further purchases. In the second, the borrower is assumed to make purchases on a regular basis, keeping the outstanding balance on the card close to $250 and to make only the minimum payment required each month. (viii) In the third scenario, the borrower behaves exactly the same as in the second scenario but makes three late payments each year, all of which are made good.
#### US medium risk sub-prime credit card – the real cost of credit to the consumer

<table>
<thead>
<tr>
<th>£</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Make purchases within limit and then paid down in orderly repayments</td>
<td>Keep balance close to $250 and make minimum payment each month</td>
<td>As scenario 2, 3 charging events per year (over limit / late payment) but make good payments</td>
</tr>
<tr>
<td>Credit Limit</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Purchases</td>
<td>330</td>
<td>330</td>
<td>330</td>
</tr>
<tr>
<td>Quoted APR</td>
<td>13.9%</td>
<td>13.9%</td>
<td>13.9%</td>
</tr>
<tr>
<td>Monthly payment</td>
<td>15</td>
<td>5% of balance</td>
<td>5% of balance</td>
</tr>
<tr>
<td>Components of cost of credit (% of total credit cost)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>0 (0.0%)</td>
<td>0 (0.0%)</td>
<td>0 (0.0%)</td>
</tr>
<tr>
<td>Interest</td>
<td>71 (24.5%)</td>
<td>134 (32.8%)</td>
<td>336 (31.3%)</td>
</tr>
<tr>
<td>Fees</td>
<td>220 (75.5%)</td>
<td>275 (67.2%)</td>
<td>275 (25.6%)</td>
</tr>
<tr>
<td>Penalty charges + interest</td>
<td>0 (0.0%)</td>
<td>0 (0.0%)</td>
<td>464 (43.1%)</td>
</tr>
<tr>
<td>Over number of months</td>
<td>42</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>Balance after 5 years</td>
<td>0</td>
<td>124</td>
<td>322</td>
</tr>
<tr>
<td>Cost per £200 borrowed</td>
<td>177</td>
<td>248</td>
<td>652</td>
</tr>
<tr>
<td>Observed APR</td>
<td>67.0%</td>
<td>52.1%</td>
<td>98.7%</td>
</tr>
</tbody>
</table>

(ix) The US sub prime card providers have pushed out the boundaries of behaviour driven pricing. The example that follows is not intended to illustrate typical pricing on US cards sold to low income borrowers as much as to illustrate the extent to which the behaviour driven pricing approach has been taken.

**Key features of US high risk sub prime credit card pricing**

*Example is Centennial Visa card from First Premier Bank*

- APR 9.9%:
  - $29 Account set-up fee
  - $95 Program fee
- $48 Annual fee
- $72 participation fee (charged at $6 per month)
- Advertised initial credit limit $250 but after initial charges effective credit only $72
- Cash advances: APR 23.9% and greater of 3% or $5 per transaction
- Penalty charges $25 late payment fee (chargeable every occurrence):
  - $25 over limit fee (chargeable every month)
  - Penalty APR 23.9% if account delinquent twice in any 6 month period

(x) Based on the card just described, the calculation following also takes three scenarios, similar to those described for the first example given. The differences in the resulting price of credit, the value of the credit that the borrower is able to obtain and the monthly payments that must be made to keep the card within limit are dictated by the product structure. In this instance the mechanism keeping the borrower’s credit facility in check and inflating the cost of credit is the low credit
limit allied to the various ancillary charges, both free-standing and in combination with penalty charges.

(xi) In the first scenario, the borrower is assumed to be able to maintain a pattern of regular repayment in order to re-establish his/her credit record over time (the card is marketed as a rehabilitation card). In the second scenario, the borrower makes higher payments and continues to make occasional small purchases, keeping within the card limit but makes three late payments each year (the average for the European consumers who missed payments) which are all made good. In the third scenario, the borrower still keeps within the card conditions, missing no payments but makes only the minimum payment on the balance outstanding each month. As can be seen, the cost of credit to the borrower varies considerably with the different behavioural patterns.

**US high risk sub-prime card – the real cost of credit to the consumer**

<table>
<thead>
<tr>
<th>$</th>
<th>Scenario 1 Make purchases within limit and then paid down in orderly repayments</th>
<th>Scenario 2 Make regular purchases, 3 charging events per year (over limit/late payments) but make good payments</th>
<th>Scenario 3 Keep balance close to $250 and make minimum payment each month in orderly payment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Credit Limit</td>
<td>250</td>
<td>650</td>
<td>250</td>
</tr>
<tr>
<td>Monthly payment</td>
<td>30</td>
<td>30</td>
<td>15</td>
</tr>
<tr>
<td>Purchases</td>
<td>9.9%</td>
<td>9.9%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Quoted APR</td>
<td>9.9%</td>
<td>9.9%</td>
<td>9.9%</td>
</tr>
</tbody>
</table>

**Components of cost of credit (% of total credit cost)**

<table>
<thead>
<tr>
<th></th>
<th>Insurance</th>
<th>Interest</th>
<th>Fees</th>
<th>Penalty charges + interest</th>
<th>Over number of months</th>
<th>Balance after 5 years</th>
<th>Cost per £200 borrowed</th>
<th>Observed APR</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>17 (4.4%)</td>
<td>27 (6.9%)</td>
<td>346 (88.7%)</td>
<td>0 (0.0%)</td>
<td>22</td>
<td>0</td>
<td>312</td>
<td>1333.8%</td>
</tr>
<tr>
<td></td>
<td>56 (4.1%)</td>
<td>163 (11.9%)</td>
<td>724 (52.9%)</td>
<td>425 (31.1%)</td>
<td>60</td>
<td>219</td>
<td>421</td>
<td>15880.4%</td>
</tr>
<tr>
<td></td>
<td>66 (7.4%)</td>
<td>104 (11.6%)</td>
<td>724 (81.0%)</td>
<td>0 (0.0%)</td>
<td></td>
<td></td>
<td></td>
<td>816.7%</td>
</tr>
</tbody>
</table>

3.3.3 The real cost of credit in the UK

**Cost of credit on new sub prime credit models imported into UK from US can be more than home credit model if payment patterns are uneven**

(i) In comparing the pricing on the two key UK sub prime credit models, the long established home credit, and the new card based sub prime cards, the rationality of consumer choices again becomes clear. In this instance the two pricing examples are drawn from the market leaders in each case, Provident Financial in the case of home credit, and the Capital One Classic Visa card in the case of the credit card.
(ii) The more affluent end of the home credit spectrum has been migrating with some enthusiasm to the new sub prime cards marketed by the US card companies who have entered the UK market and are targeting low income, non status and credit impaired workers, effectively the top end of the home credit customer base. Around a third of home credit customers, primarily those at the more affluent end of the customer spectrum, now have credit cards, with this proportion having grown rapidly over a five-year period. It is likely therefore that a substantial proportion of home credit users able to maintain a regular repayment record have already made the transition to card based credit. The consumer research suggests that an estimated 0.5 million low income households have used a credit card in the last twelve months.

(iii) The home credit borrower will pay the same price for their credit irrespective of whether their account management features late or missed payments or of the time ultimately taken to repay the loan. There is also a service element in the pricing in that both cash advances and repayments are collected in home weekly by an agent. Both these factors will feature in consumer product choices and judgements on cost, the ability of the borrower to manage their loan and the potential down-side risk attached to taking on debt. As an indicator of the importance of this flexibility to borrowers, around one in three payments on home credit loans are missed each week.

**UK Home credit loan**  
*Example from Provident Financial*

<table>
<thead>
<tr>
<th>£100 loan over 23 weeks</th>
<th>£200 loan over 55 weeks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weekly payment £6.40</td>
<td>Weekly payment £6</td>
</tr>
<tr>
<td>Credit charge £47.20</td>
<td>Credit charge £130</td>
</tr>
<tr>
<td>Cost of credit for £200 borrowed £94.40</td>
<td>Cost of credit for £200 borrowed £130</td>
</tr>
<tr>
<td>Observed APR 497.4%</td>
<td>Observed APR 177%</td>
</tr>
</tbody>
</table>

(iv) The pricing structure on the UK card which forms the basis of the scenarios below is closer to the medium risk US sub prime card illustrated earlier. It is targeted at low income borrowers in work, including those who have not previously had cards or who have experienced minor credit irregularities. The card offers credit limits in the range £250 - £2000, with borrowers on low incomes and little credit history typically having limits in the £250 – 500 range. It does not feature the disproportionate up-front fees of the US rehabilitation card just described but does feature administration charges for delinquency.
Key features of UK sub prime credit card pricing

- High standard APR 29.9% :
- No set up fees or annual maintenance fees
- Insurance 0.79% of balance
- Cash advances: APR 31.1% and greater of 1.5% or $2 per transaction
- Penalty charges:
  - £20 late payment fee
  - £20 over limit fee (chargeable every month)
- No penalty APR

(v) For those able to maintain an orderly repayment record, and pay off balances, the sub prime credit card is clearly a cheaper option than home credit, as can be seen in the first scenario. Where minimum payments are made on balances or an irregular payment pattern arises, home credit can be both the significantly cheaper option and the one least likely to result in the borrower paying down debt over a very long period or facing sanctions for default.

UK sub-prime credit card – the real cost of credit to the consumer

<table>
<thead>
<tr>
<th>£</th>
<th>Scenario 1 Make purchases within limit and then paid down in orderly repayments</th>
<th>Scenario 2 Keep balance close to £250 and make minimum payment each month</th>
<th>Scenario 3 As scenario 2, 3 charging events per year (over limit / late payment) but make good payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Limit</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Monthly payment</td>
<td>£15</td>
<td>5% of balance</td>
<td>5% of balance</td>
</tr>
<tr>
<td>Purchases</td>
<td>330</td>
<td>330</td>
<td>330</td>
</tr>
<tr>
<td>Quoted APR</td>
<td>29.9%</td>
<td>29.9%</td>
<td>29.9%</td>
</tr>
<tr>
<td>Components of cost of credit (% of total credit cost)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>34 (26.4%)</td>
<td>87 (26.4%)</td>
<td>144 (16.6%)</td>
</tr>
<tr>
<td>Interest</td>
<td>94 (73.6%)</td>
<td>242 (73.6%)</td>
<td>401 (46.4%)</td>
</tr>
<tr>
<td>Fees</td>
<td>0 (0.0%)</td>
<td>0 (0.0%)</td>
<td>0 (0.0%)</td>
</tr>
<tr>
<td>Penalty charges + interest</td>
<td>0 (0.0%)</td>
<td>0 (0.0%)</td>
<td>320 (37.0%)</td>
</tr>
<tr>
<td>Over number of months</td>
<td>32</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>Balance after 5 years</td>
<td>0</td>
<td>110</td>
<td>285</td>
</tr>
<tr>
<td>Cost per £200 borrowed</td>
<td>77</td>
<td>199</td>
<td>524</td>
</tr>
<tr>
<td>Observed APR</td>
<td>42.5%</td>
<td>42.3%</td>
<td>79.3%</td>
</tr>
</tbody>
</table>

3.3.4 The real cost of credit in France

(i) The pricing structure on the French revolving credit cards which have expanded credit to low income borrowers in France are a far cry from that employed in the explicitly positioned sub prime card earlier described, but nonetheless represent a form of moderated behaviour driven pricing. French revolving credit cards targeting low income borrowers feature APRs typically close to the prevailing usury ceilings but no higher. As is common practice with card
based credit in most countries, insurances tend to be added routinely to accounts, but are not strictly compulsory (though mystery shopping suggests that this distinction is not always made clear to the consumer). The small print of credit agreements indicate a degree of penalty charging (to a moderate statutory formula). On the face of it would appear therefore that French lenders, operating in a market with rate ceilings, have succeeded in extending credit to relatively high risk borrowers at a price lenders elsewhere would have difficulty in accommodating. Behaviour driven price enhancements for high risk borrowers arise however from the administration charges attached to account delinquency, which as taxable expenses are not featured in the APR, and from long repayment terms arising from continued payment of no more than the required minimum.

**Key features of French revolving credit card**

*Example is Cofinoga Card*

<table>
<thead>
<tr>
<th>APR</th>
<th>20.84% under €1524, 16.51% above</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable usury ceiling</td>
<td>20.85% under €1524, 16.52% above</td>
</tr>
<tr>
<td>Optional insurance 0.5% of outstanding balance (industry standard)</td>
<td>Annual fees 8€, 12€ with credit option</td>
</tr>
<tr>
<td>All inclusive monthly payments</td>
<td>up to 800€, 30€ p.m., 800 - 1524€, 60€ p.m., 1524 - 2,300€, 90€ p.m., 2300 – 3000€, 120€ p.m.</td>
</tr>
<tr>
<td>Bounced charges on purchases not met</td>
<td>up to 70€, 10€, to 120€ - 16€, More than 120€, 23€</td>
</tr>
<tr>
<td>Penalties for late missed monthly payments</td>
<td>If contract rescinded, 8% of outstanding balance plus unpaid interest plus late interest at contract rate, calculated daily</td>
</tr>
<tr>
<td></td>
<td>If not rescinded, 8% of unpaid amounts plus interest calculated daily</td>
</tr>
<tr>
<td>Late payment administrative charge</td>
<td>Between 10 and 20€, Late payment letter 5€</td>
</tr>
</tbody>
</table>

(ii) A similar pattern to that just described in the UK for the sub prime credit card can be observed in France, for borrowers using a revolving credit card. Where the borrower uses the card to make a single purchase of 1400 euros (the average outstanding balance for low income card holders) and then pays this amount down in an orderly fashion over a little short of three years, with a monthly payment dictated by the average credit line, the cost of credit is significantly less than it would be using sub prime credit models in the UK and US. Where the balance is simply maintained at the level of the average balance, the cost of credit rapidly approaches that of sub prime credit models in the UK, with the borrower still significantly in debt after a five year period. Where the borrower makes three late payments over the course of each year (average for those French card holders who had made late payments), the cost of credit is higher than home credit in the UK, though significantly lower than would be the case on sub prime credit cards in either the UK or US.
French revolving credit – the real cost of credit to the consumer

€ Average balance low income revolving credit = €1400
Average credit limit low income revolving credit=€2400

<table>
<thead>
<tr>
<th>Credit Limit</th>
<th>2400</th>
<th>2400</th>
<th>2400</th>
<th>2400</th>
<th>2400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly payment</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>50</td>
</tr>
<tr>
<td>Purchases</td>
<td>1400</td>
<td>1400</td>
<td>1400</td>
<td>3170</td>
<td>2650</td>
</tr>
<tr>
<td>Quoted APR</td>
<td>20.8%</td>
<td>20.8%</td>
<td>20.8%</td>
<td>20.8%</td>
<td>20.8%</td>
</tr>
</tbody>
</table>

Components of cost of credit (% of total credit cost)

<table>
<thead>
<tr>
<th></th>
<th>Insurance</th>
<th>Interest</th>
<th>Fees</th>
<th>Penalty charges + interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 1</td>
<td>132 (23.0%)</td>
<td>420 (73.3%)</td>
<td>21 (3.7%)</td>
<td>0 (0.0%)</td>
</tr>
<tr>
<td>Scenario 2</td>
<td>183 (14.3%)</td>
<td>584 (45.4%)</td>
<td>28 (2.2%)</td>
<td>492 (38.2%)</td>
</tr>
<tr>
<td>Scenario 3</td>
<td>207 (19.1%)</td>
<td>660 (60.7%)</td>
<td>28 (2.6%)</td>
<td>192 (17.6%)</td>
</tr>
<tr>
<td>Scenario 4</td>
<td>429 (23.5%)</td>
<td>1363 (74.6%)</td>
<td>35 (1.9%)</td>
<td>0 (0.0%)</td>
</tr>
<tr>
<td>Scenario 5</td>
<td>417 (18.0%)</td>
<td>1327 (57.4%)</td>
<td>35 (1.5%)</td>
<td>533 (23.0%)</td>
</tr>
</tbody>
</table>

Over number of months | 33 | 48 | 45 | 60 | 60 |
Balance after 5 years | 0 | 0 | 0 | 1397 | 1362 |
Cost per £200 borrowed | 82 | 184 | 155 | 115 | 174 |
Observed APR | 29.4% | 47.9% | 36.9% | 28.6% | 38.7% |

(iii) The significant difference between this model and that of the sub prime cards in the US and the UK is that it is designed for low risk borrowers who may be better able to pay down their balances as well as to maintain a regular repayment record. For many of the high risk French borrowers using this kind of product, the key issue can be not so much the cost of credit but the difficulty in being able to pay down large balances.
4.0 Non cost impacts of rate ceilings – evidence from markets with and without ceilings

4.1 Credit exclusion

*Rate ceilings affect the availability of dedicated sub prime models and create credit exclusion for those who cannot access the credit mainstream*

(i) The primary effect of the rate ceilings we studied is to restrict product diversity, as earlier discussed, and, where lenders cannot accommodate ceilings with product innovation, to create credit exclusion. This effect can be seen clearly by comparing the US states with and without ceilings. In the US states where rate ceilings preclude the operation of high rate lenders, the primary effect is that the range of credit options for high risk borrowers is much reduced. Sub prime lending volumes (see Fig 17), particularly in those categories most likely to be used by the un-banked, are significantly reduced. Given the striking evidence of the consistency of demand earlier discussed in section 2.1, this would seem to indicate a restriction on the availability of credit and thus a degree of credit exclusion for those on the lowest incomes.

*Fig. 17 Credit use falls significantly across all sub prime product categories in states with ceilings; banked diverted to mainstream, un-banked to pawn-broking*

Average debt per head of population by product category, regulatory framework and relative rigour of enforcement

1 = average debt per head of population for all states
Source TransUnion https://products.trendatatu.com, Policis estimates

*Credit exclusion is concentrated in the un-banked*

(ii) For those low income households who can borrow, primarily the banked, total debt per head remains constant across states regardless of the regulatory regime pertaining in the state. The lower lending volumes in states without ceilings thus indicate that credit exclusion in these states is concentrated in the un-banked, primarily those on the lowest incomes, minorities and the unemployed.
In states with ceilings borrowers are diverted to second choice products, such as pawn-broking, and to the credit mainstream

(iii) Those borrowers who are not excluded by access hurdles are diverted to credit models which can operate within the regulatory framework, but which would not necessarily have been first choice for the consumer, nor indeed the most advantageous option. Banked borrowers who might otherwise have borrowed from Payday lenders are diverted to the credit mainstream. Borrowers who cannot access the credit mainstream are diverted towards second choice vehicles, such as pawn-broking, a sector which is in decline in states without ceilings. Those either unable or unwilling to raise cash from pawnbrokers will do without cash credit or fall back on informal borrowing in cash crises.

In states with rate ceilings and / or no specific Payday enabling legislation

- Loan volumes and average debt per head in all sub prime categories are lower than in states without ceilings
- Mainstream credit volumes are higher but credit scores are lower (indicating that a higher proportion of mainstream credit is sold to high risk borrowers)
- There is significantly more low payment, late payment and default on sub prime cards (indicating that high risk consumers are on the margins of coping)
- Pawn-broking is only slightly more successful than in Payday enabled states
- Title loans are significantly reduced or eliminated
- There are significantly more RTO stores (used by those without access to cash credit)
The distortion of the natural patterns of consumer choice can expose borrowers to delinquency charging & increase default

(iv) The rationality of consumer choices in states without ceilings is demonstrated by the increased exposure of high risk borrowers to penalty charging in states where rate ceilings are in place. As was described previously, a significant minority of low income borrowers in all the markets examined find it difficult to avoid making late payments, a repayment pattern which tends to increase the cost of card based credit in particular. For high risk borrowers, as was seen in section 3.3.3, dedicated sub prime models can be cheaper than card based for those with uneven payment records. High risk borrowers diverted to mainstream credit in states with ceilings who cannot keep up an even payment pattern will potentially not only pay more for their credit but will also be exposed to a greater risk of sanctions for non payment and default.

The incidence of delinquency, and thus penalty charging, on mainstream cards is consistently higher in states with ceilings

(v) The US evidence shows that states with rate ceilings exhibit a consistently higher incidence of late and missed payments on mainstream credit than those without ceilings, across all mainstream product categories and across all measures of more or less serious delinquency and ability to cope. This is particularly marked for the non-bank revolving finance and sub prime credit cards most likely to be sold to low income and high-risk borrowers. The trend is consistent across 30, 60, 90 and 120 days late payment ratios and over a period of more than a decade. Borrowers who might otherwise use sub prime models and who are diverted to mainstream low rate credit are thus significantly exposed to penalty charging. There is also a greater tendency to make the minimum payment on balances over an extended period in states with ceilings, a pattern typical of those on the margins of coping and one likely also to increase the cost of credit. See Fig 19 below.
(vi) As can be observed, the sharp upturn in delinquency coincides with the down turn in the economic cycle, indicating that low income borrowers diverted to mainstream credit are particularly exposed to the risk of default in the event of an adverse change in the cycle or their employment circumstances.

**In states without ceilings, borrowers with a tendency to irregular payment choose models where pricing is predictable & borrowing is short term**

(vii) It is this syndrome that explains consumer preference for sub prime models in states without ceilings. Borrowers prone to irregular payments and who find it difficult to pay down debt tend to prefer shorter term borrowing and relatively predictable pricing and are reluctant to expose themselves to the risk of punitive sanctions or damage to their credit standing. This does not indicate of course that borrowers in states without ceilings or using dedicated sub prime models are any less prone to irregular payment behaviour. Indeed the consumer research made clear that an uneven repayment pattern is endemic among households on tight budgets, regardless of the regulatory environment. It is rather that in states without ceilings, borrowers are more likely to use high rate credit models repayable over the short term so that penalty and ancillary charges are less likely to be the major component of the cost of credit. Borrowers using such high rate models are also less likely to postpone repayment of their borrowing for very extended periods, so that they are less likely to become trapped in a long term cycle of debt. This latter effect is partly because high rate sub prime credit models are shorter term and structured to effect rapid repayment. Lender practice also plays a part in that these lenders are more likely than card based lenders both to actively manage customer
repayment and to have built a degree of flexibility into their customer management practices.

*The broad pattern of the impact of rate ceilings on low income consumers’ credit use is repeated in the rate capped markets of France and Germany*

(viii) As previously discussed the effects described in the US states with rate ceilings are broadly mirrored in the continental EU, with high risk borrowers in France using mainstream credit vehicles and suffering a high incidence of default and with the German market exhibiting a high degree of credit exclusion. As in the US, borrowers are diverted to second best choices where they cannot obtain cash credit. Those who cannot obtain cash credit, (the benefit dependent in Germany, and the credit impaired, in both France and Germany) will finance major acquisitions through mail order, with credit taking the form of coloured pricing, where this is available. Adverse credit registration in either France or Germany will preclude even this option.
4.2 The consequences of default

Those experiencing credit difficulties in France and Germany appear more likely to suffer significant detriment than their counterparts in the UK

(i) The automatic nature and rigid application of sanctions following default in France and Germany, and the greater range of recovery mechanisms available to creditors (automatic right of direct access to accounts, wages and benefits, for example) make it much more likely that defaulters will be pursued. The higher value of debt outstanding at the point of default in both countries also means that the lenders’ cost of recovery is less likely to be out of scale to funds owed, as is often the case with credit advanced through dedicated sub prime models in the UK. As a result, French and German borrowers in difficulties are more likely to lose some control over their accounts or to have employers made aware of their problems. Some 14% of those on low incomes with credit problems in Germany had funds taken directly from their accounts by creditors, as had 16% of those in France. A further 9% of German borrowers with problems had their salary garnished to effect repayment.

French and German borrowers with credit problems are much more likely to face complete financial breakdown than borrowers in the UK

(ii) Most striking of all are the differences between the UK and France and Germany in the incidence of total financial breakdown among those with credit problems. In the consumer research, 4% of those with credit problems in the UK had declared bankruptcy. Among their counterparts in France, 25% claimed to have faced personal insolvency while in Germany 6% of those with credit problems had faced personal insolvency and 16% had made a Statutory Declaration to their creditors.

Fig.20 Debtors in the UK are more likely to reach agreement with creditors while their counterparts in France & Germany are more likely to face financial breakdown

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9 This figure is derived from answers to the consumer survey and is unlikely to include Individual Voluntary Arrangements.
10 Eidesstattliche Versicherung., effectively the new fast track insolvency process.
(iii) This relatively harsh application of sanctions is reflected in French and German borrowers experiencing more far reaching problems in the aftermath of default on credit than their UK counterparts. French and German borrowers appeared more likely to have experienced a range of financial and other difficulties including problems with housing and employment and difficulties in managing utilities, rent payments and affording essentials such as adequate food, shoes or clothing.

**Fig. 21** French and German borrowers are more likely to suffer significant damage to wider social and financial well-being in wake of their default

![Bar chart showing the comparison of problems experienced by borrowers from UK, France, and Germany](chart.png)

Base: Those with credit problems
4.3 Illegal lending

An extra dimension is added by the absolute exclusion of the credit impaired in France and Germany which has created the conditions for illegal lending

(i) It would appear that the adverse impact of lenders’ risk aversion on the most vulnerable credit users on low incomes is intensified by the absolute credit exclusion of the credit impaired in both France and Germany. Adverse history impacts a significant sub set of the low-income population in each territory, and is markedly more likely to affect households with children. The comprehensiveness of the German SCHUFA system, which captures a wider set of adverse measures than either the French FICP or the commercial providers in the UK results in a higher proportion of low income German households being registered.

The credit impaired in France and Germany appear more likely to use illegal lenders than in the UK where there are legal credit options for such borrowers

(ii) Those with a need to borrow cash and no legitimate credit options may turn to illegal lenders, with this appearing to be most likely for the credit impaired. Clearly, it is impossible to obtain accurate figures on the extent of illegal lending. However, the consumer surveys indicate there appears to be significantly more illegal lending to such consumers in both France and Germany than in the UK. In the UK 3% of those on low incomes who are credit impaired\textsuperscript{11} are prepared to admit that either they or someone living in their household have used an unlicensed lender. This compares with 7% in France and 8% in Germany. Among those on low incomes who have been refused a loan, this rises to 4% in the UK, 12% in France and 10% in Germany. Perhaps unsurprisingly, more people are prepared to admit that they know of friends and family using unlicensed lenders than admit to using such lenders themselves. This is most marked in Germany, where 14% of all those on low incomes and three in ten of the credit impaired claimed to know of someone among their own social circle of family and friends who had used illegal lenders. This may reflect the activity of some sections of the thriving and colourful broker sector in Germany, which has become effectively the de facto sub prime sector. Credit intermediaries are indeed currently the subject of a forthcoming regulatory clampdown, the long German tradition of self regulation appearing to have broken down in this instance, as has consumer trust in the sector. The sector is highly fragmented, features many very small operators and lacks a trade association strong enough to enforce codes of practice.

\textsuperscript{11} Interdit Bancaire or Interdit Chequier, FICP registered, Banque de France supervised arrangement with creditors, insolvency in France, SCHUFA registered, Statutory Declaration or Insolvency in Germany, County Court Judgement, default registration with credit reference agencies, insolvency in UK
Fig. 22 Credit impaired in France and Germany are much more likely to turn to illegal lending than their counterparts in the UK

% myself or someone in my household have used illegal lender
Glossary

Payday loan

Payday loans are taken out for small sums, typically €200 – 300, over a very short term contract, usually 14 days. Loans are however typically re-financed several times, with an average of 3.5 times across all US states. Security for the loan is a cheque for the amount of the loan or direct access to the borrower’s account to debit payment plus the fee due, dated for the next Payday or electronic access to the borrowers account for direct debit on Payday.

RTO (Rent To Own)

Rental contract in which title to goods (typically of white goods or electronics) remains with store until end of contract, usually 12 – 24 months.

Check cashing

Service to cash cheques (usually Government) in exchange for a small fee (usually a percentage of the face value subject to a minimum charge). The service is provided to un-banked (as an alternative to a bank account, which attract maintenance charges in the US) and banked not wishing to transit cheques through their accounts (for example, if they are already over their overdraft limit).

Revolving credit

Credit where there is no fixed repayment schedule of the principal of the loan. Interest payments are due on schedule, however. Typically describes credit card debt. The revolving credit cards sold in France to low income borrowers in the last few years have not been revolving cards on the VISA model (though VISA cards are now being sold into this market also). The revolving credit cards referred to in the consumer research in France rested on a model in which borrowers elect to make a monthly payment for the duration of the contract, which has an indefinite term. They are then provided with a credit line of a multiple of the monthly payment (typically between 15 and 24 times). The card could be used to buy goods in a limited range of outlets and to withdraw cash at tills and a limited number of designated ATMs.

Auto Title loan

30 day loans, secured on the borrower’s vehicle and usually for 33% of its value. It is usual for the lender to hold the proof of title and a copy of the keys.

Home credit

Small scale cash loans and shopping vouchers, typically in range £50 - £500. Average loan values are slightly less than £300. Loans are short term, typically payable over 23 weeks or 55 weeks. Transactions (both advance of the loans at the outset and collection of repayments) are carried out in the borrower’s home with an agent on a weekly basis.

Bounce protection

Unsecured credit line marketed by mainstream banks as “bounce protection” against NSF (Non Sufficient Funds) fees being levied on bank accounts in event of insufficient funds being available to meet scheduled payments / cheques.
Sub-prime

Borrowers whose credit score is lower than that required for mainstream lending. Factors in the UK which can reduce credit scores can include: failure to appear on the electoral roll, the work or income history of the applicant, missed repayments on a mortgage or another form of credit, debt-related County Court Judgements, bankruptcy, being a director of a business that has gone under, having your home or other possessions repossessed.

Sub-prime portfolios are those made up of loans to borrowers with higher-risk characteristics. There is no commonly accepted universal definition, which varies considerably, with their being more shades of grey in the US than in the UK. At the top end of the sub prime range, a stringent definition of a sub prime portfolio might take in relatively minor delinquency such as two or more 30-day delinquencies in the past year, or one 60-day delinquency in the past two years. A less stringent definition of sub prime would rest on having fallen three months into arrears on a credit contract, default on a credit contract, a county court judgement or bankruptcy in the past 5 years. Alternatively, in some cases, definition may rest on judgements of debt relative to income with a debt service-to-income ratio of 50% or greater widely regarded as sub prime.

Credit impaired

In the context of this study, the credit impaired are taken to be those whose adverse credit history is sufficiently serious to effectively exclude them from access to the credit mainstream. In France this will be registration with the FICP, Interdit Bancaire or Interdit Chequier, in Germany, registration with the SCHUFA and in the UK, default registration with the commercial providers of credit information (Experian, Equifax) or a County Court Judgement. In all three territories, bankruptcy will also have the same effect.

NSF (Not Sufficient Funds)

Fees levied by banks where there are not sufficient funds in the account to cover a demand for payment from a third party (for example, “bounced” cheque or refused electronic payment).

FICP (Fichier des Incidents de Crédit aux Particuliers)

Main negative credit reference database administered by the Banque de France. Payment irregularities which have not been rectified within a given period are maintained on the database for a period of five years. Registration precludes access to any form of commercial credit.

IB (Interdit Bancaire)

Cheques are much more commonly used in France and continue to be central to money transmission. Writing a cheque without sufficient funds or not meeting payment commitments is viewed very seriously (cheque guarantee cards on the UK model are not a feature of the market). If a cheque has bounced or an electronic payment been refused, the bank is legally obliged to inform the Banque de France. The account holder is also informed and unless the position is rectified within a thirty day period he/she becomes Interdit Bancaire or Interdit Chequier. The term has recently been reduced from ten to five years. Cheque books must be returned and banking facilities are limited to cash withdrawal and deposit. Interdit Bancaire status leads automatically to registration with the FICP.
SCHUFA

The national German credit risk bureau, which covers not just credit related information but a range of transactional data from 5,000 contractual partners (not just credit providers but also telcos, mail order, retailers, utilities, insurers and social agencies. Registration precludes access to any form of commercial credit.

APR

Annual Percentage Rate. Statutory formula used throughout the EU based on internal rate of return (IRR).

TAP

Total Amount Payable. Total amount which borrower has to pay out during the course a loan, including principal, interest, fees and other charges.

Chargeable events.

These are incidents of account irregularity which trigger account charges, most usually on credit cards or bank accounts. Typical examples will include:

- Bounced cheque
- Missed or delayed payment on a loan
- Refused direct debit or standing order
- Going over credit limit
- Unauthorised use of overdraft
- Writing cheques not covered by funds or overdraft facility

Informal borrowing

Borrowing from individuals who do not lend in the course of a business (for example, loans from a family member)

Non status

To some extent the term non status borrowers is used as inter-changeable with sub prime but there is a tendency for it to be used to refer to people who cannot provide proof of “status”, typically registration on the electoral roll, proof of secure income or employment, or more simply, of a previous credit history.

Coloured pricing

The credit charge is included in the price of the goods, so that a purchase does not appear as a credit transaction. Typically used for instalment sales in appliance stores serving low income household and for catalogue credit.

Risk pool

The group of borrowers to whom credit is extended